APPLICATIONS OF SECURITY INSTRUMENTS AND ASSETS IN ISLAMIC PROJECT FINANCING: A *SHARĪʿAH* PERSPECTIVE ANALYSIS

BY

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ABSTRACT

Security or collateral plays a pivotal role in mitigating credit risk in banking, functioning as a safeguard against customer default. While its application is widespread in both conventional and Islamic banking systems, there remain persistent questions concerning the *Sharīʿah* compliance of various security instruments and the underlying assets used. The absence of a standardized framework for Islamic security arrangements has led to inconsistent practices across jurisdictions, resulting in legal uncertainties and a heightened risk of *Sharīʿah* non-compliance, particularly in Islamic project finance. This study aims to fill this critical gap by evaluating the *Sharīʿah* compatibility of security instruments and asset classes commonly employed in project financing. Employing a qualitative comparative methodology, the study undertakes doctrinal legal analysis of statutory provisions, case law, and secondary literature, while complementing it with *Sharīʿah* analysis grounded in classical and contemporary juristic discourse. Particular emphasis is placed on *rahn* and *ʿuqūd al-tawthīqāt* (security contracts). Field interviews with industry practitioners, legal experts, and *Sharīʿah* officers provide practical insights and validation of theoretical interpretations. Findings reveal that the *rahn* shares some resemblance with charge, mortgage, pledge, and lien in terms of providing security to the creditor, but it differs in key characteristics. The *rahn* closely parallels the collateral instrument of a charge, meeting flexible *rahn* requirements of possession and asset diversification. Unlike a mortgage, which transfers ownership of the asset to the creditor, *rahn* does not require such a transfer. Similarly, pledge and lien require delivery and possession of the asset by the creditor, which is not mandatory in *rahn*. Furthermore, common law quasi-security arrangements, such as guarantee contracts, and assignments, have comparable Islamic counterparts in *kafālah*/*ḍamān* and *ḥawālah* contracts, despite some differences. The study also evaluates the *Sharīʿah* permissibility of various asset classes used as collateral in project financing. Real estate, Islamic cash-based assets (e.g., deposits, reserves), and Islamic financial assets (e.g., *sukūk*, Islamic unit trusts) are fully *Sharīʿah*-compliant and acceptable as collateral. Conventional assets like fixed deposits and bonds are only allowed up to the principal, excluding any interest (*ribā*). For conventional insurance, only the premium paid is permissible. Shares of companies engaged in non-compliant core activities are strictly impermissible. However, shares that breach *Sharīʿah* benchmarks due to non-compliant income may be accepted as collateral, limited strictly to the *ḥalāl* portion of their value. Book debts are permitted due to constructive possession. Future assets under floating charges are conditionally accepted based on the *Mālikī* view if safeguards against *gharar* are in place. Intellectual property is also allowed, being recognized as *ḥaqq mālī* with tradeable and lasting value. This research contributes a clearer understanding of *Sharīʿah*-compliant security instruments and assets for Islamic project financing stakeholders and regulators.

ملخص البحث

يلعب الضمان أو الرهن دورًا محوريًا في التخفيف من مخاطر الائتمان في القطاع المصرفي، إذ يُعد وسيلة حماية ضد تعثّر العملاء في السداد. وعلى الرغم من شيوع استخدامه في كل من النظامين المصرفيين التقليدي والإسلامي، لا تزال هناك تساؤلات قائمة بشأن مدى توافق أدوات الضمان المختلفة والأصول المستخدمة معها مع أحكام الشريعة الإسلامية. وقد أدى غياب إطار معياري موحد لترتيبات الضمان الإسلامية إلى ممارسات غير متسقة عبر مختلف الأنظمة القضائية، مما نتج عنه غموض قانوني وزيادة في مخاطر عدم الامتثال الشرعي، لا سيما في مجال تمويل المشاريع الإسلامية. تهدف هذه الدراسة إلى سد هذه الفجوة من خلال تقييم مدى توافق أدوات الضمان وفئات الأصول المستخدمة في تمويل المشاريع مع أحكام الشريعة. وتُعتمد الدراسة على منهج نوعي مقارن، يجمع بين التحليل القانوني الفقهي وللنصوص التشريعية، والسوابق القضائية، والمصادر الثانوية، بالإضافة إلى التحليل الشرعي المستند إلى الآراء الفقهية الكلاسيكية والمعاصرة، مع تركيز خاص على عقد الرهن وعقود التوثيقات .كما تُعزز الدراسة بإجراء مقابلات ميدانية مع ممارسين في القطاع، وخبراء قانونيين، ومسؤولي الهيئات الشرعية، بهدف إضفاء بُعد تطبيقي ودعم النتائج النظرية. تكشف النتائج أن الرهن الإسلامي يشترك في بعض أوجه التشابه مع أدوات تقليدية مثل الرهن القانوني والرهن العقاري والرهن الحيازي والحجز، من حيث توفير الضمان للدائن، إلا أنه يختلف عنها في خصائص جوهرية. ويُعتبر الرهن الأقرب إلى الرهن القانوني، من حيث تلبيته لمتطلبات الشريعة المتعلقة بالحيازة وتنويع الأصول، دون الحاجة إلى نقل الملكية. وعلى خلاف الرهن العقاري الذي يستلزم نقل الملكية إلى الدائن، لا يشترط الرهن ذلك. كما أن الرهن الحيازي والحجز يشترطان التسليم الفعلي وحيازة الأصل من قبل الدائن، وهو ما لا يُعد شرطًا في الرهن الشرعي. علاوة على ذلك، فإن الترتيبات شبه الضمانية في القانون العام، مثل عقود الضمان والتنازلات، لها نظائر شرعية في الكفالة/الضمان والحوالة، رغم وجود بعض الفروقات في البنية التعاقدية. كما تُقيّم الدراسة مدى جواز استخدام فئات مختلفة من الأصول كضمان في تمويل المشاريع. وتشمل الأصول المتوافقة مع الشريعة العقارات، والأصول النقدية الإسلامية (مثل الودائع والاحتياطيات)، والأصول المالية الإسلامية (مثل الصكوك وصناديق الاستثمار الإسلامية). أما الأصول التقليدية مثل الودائع الثابتة والسندات، فهي جائزة فقط في حدود رأس المال دون الأرباح الربوية. وبالنسبة للتأمين التقليدي، يُسمح فقط بمقدار الأقساط المدفوعة. وتُعد أسهم الشركات ذات الأنشطة الأساسية غير المتوافقة شرعًا غير جائزة، بينما يمكن استخدام الأسهم التي تخالف معايير الشريعة بسبب نسبة من الإيرادات

غير المشروعة ضمن حدود الجزء الحلال فقط. كما تُعتبر الديون الدفترية جائزة بسبب تحقق القبض الحكمي، ويجوز قبول الأصول المستقبلية المشمولة برهون عائمة بشروط، وفقًا للرأي المالكي إذا وُجدت ضوابط تمنع الغرر. أما الملكية الفكرية، فهي مقبولة باعتبارها حقًا ماليًا له قيمة قابلة للتداول والبقاء. تُقدّمُ هذه الدراسة إطارًا عمليًا وتنظيميًا يمكن أن تسترشد به الجهات المعنية بتمويل المشاريع في المصارف والمؤسسات الإسلامية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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This work is lovingly and gratefully dedicated to:

My beloved mother, Khadijah Yaakub,

whose unwavering prayers, strength, and endless sacrifices have shaped the person I am today.

And to the cherished memory of my late father, Haron Awang,

whose quiet strength, wisdom, and integrity remain etched in my heart.

To my dearest wife, Amalina Shawaldin,

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your laughter fills my heart with hope,

and your love is the purest source of my inspiration.

You are the legacy I cherish most.

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Infrastructure development poses a global challenge and holds significant importance in public policy worldwide. The provision of high-quality infrastructure is vital for stimulating economic growth, reducing unemployment, and addressing poverty (Challoumis, 2024). It is estimated that approximately $60 trillion will need to be invested globally in infrastructure assets by 2030, highlighting the urgent need for strategic planning and substantial investments to meet the expanding infrastructure demands (PricewaterhouseCoopers, 2020). Prioritizing infrastructure development allows nations to pave the way for long-term growth and enhance the well-being of their citizens.

Amidst this challenge, Islamic finance has emerged as a potential solution for financing infrastructure development, particularly in emerging markets. Although Islamic finance currently represents a small portion of the global financial market, it has experienced substantial growth in the past two decades and is projected to reach approximately $8.2 trillion in assets by 2032 (Islamic Finance Market Size & Insights Report, 2025). This growth has garnered the interest of global financial players, underscoring the need to understand Islamic finance's unique features and mechanisms. Additionally, the increasing demand for project finance, especially in Muslim-majority countries, presents a significant opportunity to leverage Islamic finance as a mainstream mode of financing (Organisation for Economic Co-operation and Development (OECD), 2020).

In project financing, which differs from corporate financing, the focus lies on the future cash flows generated by the projects being financed, rather than the strength and historical performance of debtors with existing balance sheets. Conversely, corporate financing is relatively straightforward as financiers rely on the strength and historical performance of debtors, supported by their existing balance sheets (Grundy & Verwijmeren, 2020). Project financing is commonly utilized in various industrial

sectors, including large-scale infrastructure projects (e.g., toll roads, power plants, airports) and natural resource exploitation projects (e.g., hydroelectric dams, mining projects, oil and gas assets) (Müllner, 2017). In the context of Islamic finance, project financing adheres to *Sharīʿah* principles and encompasses unique financing structures such as *mudārabah* (joint-venture partnership), *wakālah* (agency), *mushārakah* (equity partnership), *murābaḥah* (cost-plus profit), *bay' al-mua'jjal* (deferred payment sale), *istisnā'* (manufacture/construction contract), *salam* (forward sale), and *ijārah* (leasing contract) (Ayub, 2019). These structures provide alternatives to conventional interest-based financing principles and accommodate the requirements of Islamic finance (Hussain, 2019).

Security plays a crucial role in project finance as the debtor/ borrower's special purpose vehicle lacks a credit history and relies on the project assets as collateral. Establishing security over these assets enhances the debtor/borrower's creditworthiness and instils confidence in creditors regarding repayment (Karekar & Sharma, 2024). However, the practices of securing assets in Islamic banks differ from those in conventional banks primarily due to limitations associated with obtaining *Sharīʿah* - compliant collateral and inherent constraints in the *rahn* contract (McMillen, 2000).

In the context of Islamic project finance, the assessment of *Sharīʿah* compliance revolves around two critical components: security instruments and security assets. Evaluating the *Sharīʿah* compatibility of security arrangements requires a thorough examination of both these aspects, which are commonly classified by most legal scholars in the legal literature (Gullifer and Goode, 2017). Security instrument refers to the right of a creditor to have specific items of property sold to satisfy the debt owed to the secured party. It is crucial for a security instrument to be properly created and perfected to enforce it against other creditors and in bankruptcy. On the other hand, security assets are any assets that are the subject of a security instrument created by a security agreement (Weiler, 2006, Davis & Kim, 2015).

In Common law, security instruments are categorized as pledge, lien, mortgage, and charge, each with distinct features related to possession, legal ownership, and the category of assets (Gullifer and Goode, 2017). In the context of Islamic project finance, these security instruments are loosely understood as a form of *rahn*, although

inconsistent applications may be observed (Engku Ali et al., 2018, Mc Millen, 2012). This specific aspect is the focal point of this thesis. *Sharīʿah* only recognizes security instruments that adhere to the requirements of a valid Islamic security based on the *rahn* contract, underscoring the need to examine the current adoption of security instruments and ensure their consistency with *Sharīʿah* principles (Engku Ali et al., 2018). The adoption of security instruments and assets that do not fulfil *Sharīʿah* requirements may undermine the validity and enforceability of *rahn* arrangements, particularly in light of both *Sharīʿah* and legal expectations. This underscores the need for a comprehensive examination of current practices and their alignment with applicable *Sharīʿah* principles.

The discussion surrounding security instruments in Islamic finance cannot be divorced from the underlying assets they are tied to. Even if a security instrument is deemed compliant with *Sharīʿah* principles, its validity may be compromised if the underlying asset itself does not adhere to *Sharīʿah* guidelines. Additionally, another crucial element in Islamic security arrangements is the recognition of assets underlying the security. Unlike conventional security arrangements, *Sharīʿah* requires that these assets be compliant with its principles. Assessing the suitability of assets to *Sharīʿah* requirements is essential before they can be used for Islamic security arrangements. It is worth noting that there is a lack of sufficient *Sharīʿah* clarification on the status of certain categories of assets used as security in Islamic project financing. The novel nature of these security assets may attract different *Sharīʿah* perceptions and implications, posing challenges in terms of their *Sharīʿah* compliance status.

Therefore, the assessment of *Sharīʿah* compliance in Islamic project finance involves a comprehensive evaluation of both security instruments and security assets. This study aims to provide valuable insights by examining the nature, implementation, and consistency of security instruments with the *rahn* contract and evaluating the *Sharīʿah* compliance of the underlying assets used as security, ensuring that security arrangements in Islamic project finance align with *Sharīʿah* principles.

1.2 STATEMENT OF THE PROBLEM

The significance of security or collateral in the banking industry has long been acknowledged as a means to protect banks from credit and default risks when granting loans or financing to customers. However, Islamic banking practices differ from conventional banking in terms of taking security, as Islamic principles require that the security be compliant with *Sharīʿah* (Khan & Nisar, 2004, Omar, 2017).

The concept of security encompasses various legal interpretations and definitions, which necessitates a detailed assessment of their compatibility with the Islamic security contract of *rahn* (Engku Ali et al., 2018). The discussion on security can be divided into two categories: security instruments and the assets underlying those security instruments. In Common law, four types of security instruments exist: charge, pledge, mortgage, and lien. Each type has distinct characteristics. For example, in a mortgage, legal ownership of assets must be transferred to the mortgagee, whereas in a charge, pledge, or lien, the ownership or legal title remains with the security owner and is not transferred to the creditor. Additionally, possession of the security asset is required for a pledge, but not mandatory for a mortgage or charge (Gullifer & Goode, 2017).

Despite the observable distinction of security instruments from a legal perspective, inconsistencies remain in how *rahn* is defined and treated across various *Sharīʿah* standards. For example, the BNM Policy Document on *Rahn* (2018) employs the term 'pledge' interchangeably with *rahn* throughout the document, raising concerns about the proper *Sharīʿah* classification of other legal instruments such as charge, lien, and mortgage. The interchangeable use of terminology, without a clear *Sharīʿah* framework for each distinct legal instrument, creates ambiguity that may affect the validity of commonly adopted security mechanisms in Islamic banking, particularly the charge (Engku Ali et al., 2018). Given these inconsistencies, this study focuses specifically on *rahn* as the core subject of analysis. This is because *rahn* represents the most established and juristically recognised form of asset-based security in Islamic law, with a more developed body of classical and contemporary *Sharīʿah* discourse. By anchoring the analysis on *rahn*, the study provides a structured lens through which the compatibility of modern security practices—such as charge, pledge, lien, and quasi-

securities—can be assessed for their alignment with *Sharīʿah* principles. This focused approach enables a more precise examination of how far contemporary instruments have deviated from, or conform to, the essential features of a valid *Sharīʿah*-compliant security contract.

Similarly, AAOIFI (2017), in its English translation of *Sharīʿah* Standard No. 39 on *al-Rahn wa Taṭbīqātuhu al-Muʿāṣirah*, uses the term 'Mortgage and Its Contemporary Applications' and applies the term 'mortgage' throughout the Standard. While this may facilitate modern security understanding, the substantive features of a mortgage—such as the transfer of beneficial ownership, foreclosure rights, and registration mechanisms—may not necessarily align with the essential *Sharīʿah* requirements of *rahn*, which emphasises possession without transfer of ownership. The core concern is not merely the terminological overlap, but the potential conflation of fundamentally distinct legal constructs. Applying *Sharīʿah* rulings developed for *rahn* to instruments such as charge, pledge, lien, or mortgage without scrutinising their substantive attributes may result in inconsistence with *Sharīʿah* requirements. Therefore, aligning these instruments with *Sharīʿah* must go beyond labels and examine whether their underlying legal effects fulfil the *Maqāṣid* and essential conditions of Islamic security contracts. This reinforces the principle that, in *Sharīʿah*, substance must prevail over form, ensuring that legal enforceability does not compromise *Sharīʿah* principles.

In Islamic project finance, security instruments—such as charges, liens, pledges, and quasi-security arrangements including assignments, debentures, and guarantees—are widely utilised to mitigate credit risk and secure financial obligations (Aziz & Gintzburger, 2009). While these mechanisms serve critical commercial functions, their *Sharīʿah* permissibility remains a subject of ongoing scholarly scrutiny.

The substance of many of these instruments, including those tied to future-acquired assets, rights under assignments, and insurance proceeds, continues to raise unresolved questions within *Sharīʿah* scholarship (DeLorenzo, 2007). Although widely adopted in practice, these arrangements often lack clear and authoritative *Sharīʿah* resolutions to justify their usage. As noted by Ang (2013), the legitimacy of such asset classes and security mechanisms is not always firmly established within *Sharīʿah* legal

theory. This ambiguity not only poses risks to contractual enforceability but also raises concerns over the *Sharīʿah* integrity of entire project financing structures.

In light of these challenges, this study seeks to critically examine the substantive nature of security instruments, their underlying assets, and quasi-securities within the context of Islamic project finance. Adopting a qualitative research methodology—specifically document analysis and semi-structured interviews—the study seeks to assess the extent to which current practices conform to *Sharīʿah* principles. Addressing this gap is essential to promoting regulatory consistency, strengthening industry confidence, and ensuring that Islamic project finance structures remain both legally enforceable and *Sharīʿah*-compliant.

1.3 RESEARCH OBJECTIVES

The objectives of this study are as follows:

1. To examine the concept of security instruments and security assets from the perspective of Islamic law.
2. To investigate the concept of modern security instruments and security assets and assess its compatibility with Islamic law on security contracts.
3. To identify and analyze the application of security instruments and security assets in selected Islamic project financing.
4. To evaluate the compliance status of security instruments and security assets in Islamic project finance with *Sharīʿah* requirements.

1.4 RESEARCH QUESTIONS

The research questions guiding this study are as follows:

1. What is the concept of security instruments and security assets from the perspective of Islamic law?
2. (a) What is the concept of modern security instruments and security assets from a legal perspective?

(b) Are modern security instruments and security assets compatible with the Islamic law on security contracts?

3. How are modern security instruments and security assets applied in Islamic project financing?
4. Are the security instruments and security assets used in Islamic project finance compatible with the *Sharīʿah* requirements?

1.5 SIGNIFICANCE OF THE STUDY

This study is significant in contributing to the understanding and clarification of security arrangements in Islamic project finance, an area that currently lacks detailed discussions and literature. This study is expected to clarify the legal perspective on modern security arrangements, including security instruments, underlying assets, and selected quasi-securities. A comprehensive comparative analysis of security arrangements in both Islamic and Common law will be concluded. The study compares the security instruments found in Common law, such as charge, mortgage, pledge, and lien, with the Islamic security contract of *rahn*. The analysis explores the similarities, differences, and compatibility between these security arrangements, considering the nature, characteristics, legal requirements, and underlying assets associated with each. The findings will be used as a basis for the study to further analyses the practical applications of security arrangement in Islamic project financing and its compatibility with Islamic law.

Furthermore, the study also verifies the *Sharīʿah* status of some of the practical applications in security arrangement applied in Islamic project finance. The research outcomes are expected to address and clarify the uncertainties regarding the status and compliance of security arrangements in Islamic project finance from the *Sharīʿah* perspective. By resolving these uncertainties, the findings have the potential to be a valuable resource for Islamic banks, enabling them to widen the range of security assets that are in accordance with Islamic principles. In turn, this can contribute to more effective risk management and a reduction in non-performing financing.

The study also aims to provide insights to regulators, industry players, *Sharīʿah* advisors, and academicians regarding the compatibility of security instruments and security assets used in Islamic project finance with *Sharīʿah* principles. The findings of this study can inform policymakers and regulators in developing precise guidelines or directives for the use of security arrangements in Islamic financing transactions. Moreover, the study contributes to the academic field by enriching the sources and references in Islamic finance and opening new areas of research.

1.6 LIMITATION OF THE STUDY

This research is subject to certain limitations that should be acknowledged. This section discusses the limitations of the current study, providing insights into the factors that may have influenced the research process and outcomes.

Firstly, this study focuses exclusively on security arrangements in project finance, which can be structured through *sukūk* instruments and financing methods. Consequently, other common types of *sukūk* and financing that do not fall under the category of project financing are beyond the primary scope of this research. This delimitation is critical as it may imply that the findings may not be directly applicable to those excluded areas.

Secondly, in evaluating security arrangements from a *Sharīʿah* perspective, the scope of this study is intentionally limited to the four classical and juristically recognised Islamic security contracts: *rahn*, *kafālah*, *ḍamān*, and *ḥawālah*. These contracts have a strong foundation in classical *fiqh* literature and are supported by well-established *Sharīʿah* principles, making them suitable for systematic analysis and comparison with contemporary practices. The focus on these specific contracts allows the study to assess their adaptability and relevance in modern project finance structures while maintaining fidelity to *Sharīʿah* authenticity.

Thirdly, the analysis of security arrangements from the legal perspective is specifically circumscribed within the Common law framework. This constriction implies that the study does not partake in a comparative analysis of security

arrangements under different legal systems, which might otherwise have offered additional insights and perspectives.

Fourthly, the findings and conclusions are primarily predicated on the literature, research books, articles, and publicly accessible documents available. The quality and availability of these sources are themselves constrained, and this might have repercussions on the robustness of the analysis presented.

The fifth limitation pertains to the content analysis based on a selected sample of publicly available documents related to the application of security arrangements in Islamic project finance. This implies that the findings may not necessarily capture the full spectrum of industry practices, particularly where there is confidential or undisclosed information.

Another significant limitation arises from the reliance on self-reported data, which is inherently subject to response biases and inaccuracies. Participants' responses may be influenced by social desirability bias or their own subjective interpretations of the questions. While measures were taken to ensure confidentiality and anonymity, this remains an inherent limitation.

Additionally, the temporal scope of this study is restrictive. The research was conducted within a specific timeframe, which limits the exploration of long-term trends or changes in security mechanisms in Islamic project financing. External factors and the evolving nature of the field may render the findings less applicable to future contexts.

Furthermore, the availability and accessibility of pertinent data sources could present challenges. Despite concerted efforts to amass comprehensive and current literature, there might have been barriers in accessing certain sources or obtaining complete information. This might have implications on the comprehensiveness of the literature review and the depth of the analysis.

It is also paramount to acknowledge that the researcher’s biases and subjectivity may have influenced the interpretation and analysis of the data. Researchers inherently bring their perspectives, experiences, and preconceptions to the table, and these can

shape the research process and findings. This study aimed to address this through reflexivity and transparency, with a clear documentation of the researcher's positionality and potential biases.

In summary, while these limitations are acknowledged, this study nevertheless provides valuable insights into security mechanisms in Islamic project financing. It is through the recognition and acknowledgment of these limitations that future researchers are equipped to build upon this study and address the gaps to contribute further to the understanding of this topic.

1.7 LITERATURE REVIEW

The literature review will be discussed across three chapters; each aligned with a core aspect of this thesis. First, Chapter 2 explores Islamic law literature on security contracts, focusing on the foundational principles and classical juristic interpretations of *rahn*, *kafālah*, *ḍamān*, and *ḥawālah*. While a considerable body of work exists on these contracts in traditional *fiqh*, there remains a lack of systematic analysis on their application in contemporary financial contexts, particularly in Islamic project finance.

Second, Chapter 3 reviews common law literature, highlighting how legal constructs such as mortgage, charge, lien, pledge, and assignment have evolved to support modern secured transactions. Although these instruments are frequently adopted or adapted within Islamic finance frameworks, there is limited scholarship evaluating their substantive compatibility with *Sharīʿah* principles beyond superficial terminological comparisons. Finally, Chapter 6 examines contemporary applications of security arrangements in Islamic project finance. Despite growing practical adoption, the literature lacks a *Sharīʿah* compatibility cohesive framework that maps the actual industry practices of Islamic project finance against established *Sharīʿah* standards of security instruments and assets.

These three chapters collectively reveal critical gaps in existing scholarship—namely, the insufficient integration of Islamic legal theory with modern security instruments, the lack of *Sharīʿah*-based analysis of quasi-securities, and the absence of

a clear evaluative framework for assessing the legitimacy of security assets in Islamic project finance. This thesis aims to fill these gaps by bridging doctrinal analysis, legal comparison, and industry practice. The detailed juristic discussion and its relevance to modern security arrangements will be elaborated in Chapters 2, 3, and 6.

1.8 STRUCTURE OF THE THESIS

This thesis consists of seven chapters with a brief description presented as follows:

Chapter One: Introduction

Chapter One provides an outline of the background of this study, the statement of problem, the research objectives, and the research questions. The chapter continues with the significance of this study, the limitation, literature review and the structure of this thesis. This chapter sets the foundation for the entire research and shapes its structure.

Chapter Two: A Review of the Concept of Security Instruments and Assets in Islamic Law

Chapter Two provides a comprehensive overview of the concept of security instruments and assets in Islamic law, focusing on their nature, classifications, and requirements from a *Sharīʿah* perspective. It explores the essential elements of Islamic security contracts, including *rahn* (pledge), *kafālah* (guarantee), *ḍamān* (suretyship), and *ḥawālah* (transfer of debt). The discussion examines their characteristics, legal requirements, and the underlying assets involved. The chapter further analyzes these security contracts from the *Sharīʿah* perspective, drawing on evidence from the Qur'an, Sunnah, and juristic opinions. The objective is to provide a thorough understanding of these contracts and their pivotal role in Islamic security arrangements.

Chapter Three: An Overview of Modern Security Instruments and Assets and Their Compatibility with *Sharīʿah*

Chapter Three provides an in-depth exploration of security instruments and assets from a legal perspective, focusing on their application in both Common law and Islamic law frameworks. It examines the nature, purpose, characteristics, forms, and underlying assets of recognized security instruments in Common law, including mortgages,

charges, pledges, and liens. Additionally, it considers equivalent instruments such as assignments, debentures, and guarantees, offering a comprehensive understanding of the legal framework governing security arrangements. The chapter further undertakes a detailed comparative analysis of security arrangements in Islamic and Common law. Specifically, it compares and contrasts Common law instruments such as charges, mortgages, pledges, and liens with the Islamic security contract of *rahn*. The study also comparing the selected quasi securities i.e assignments, debentures, and guarantees with its equivalent instruments in *Sharīʿah* perspective. The analysis highlights their similarities, differences, and compatibility, taking into account their nature, characteristics, legal requirements, and underlying assets. Finally, the chapter establishes key parameters for compatibility of modern security instruments and assets. These parameters, derived from the comparative findings, serve as a framework for exploring the practical application of security arrangements in Islamic project finance, a topic to be examined in detail in the subsequent chapter.

Chapter Four: Research Methodology

Chapter Four elaborates on the research methodology employed in this study by laying down the selected research approach and philosophical assumptions. Data collection and analysis techniques are explained. Lastly, the research framework is presented and followed by the chapter summary.

Chapter Five: Analysis and Discussion of the Interviews' Findings

Chapter 5 outlines the insights and inputs gathered from these interviewees regarding the application of security instruments and assets in Islamic project financing. Their opinions will be analyzed in detail and thoroughly draw meaningful conclusions from the findings. The interview findings will also be supported by the literature review on their applications. These conclusions will serve as benchmarks for subsequent Chapter, specifically focusing on the *Sharīʿah* compatibility of the application of security instruments and assets in Islamic project financing.

Chapter Six: *Sharīʿah* Appraisal of Applications of Security Arrangements in Islamic Project Finance

Chapter 6 examines the contemporary applications of security arrangements in Islamic project finance. It explores how security arrangements are utilized in project financing through *sukūk* instruments and financing structures. This chapter addresses the fourth research objective i.e. to evaluate the compliance status of security instruments and security assets in Islamic project finance with *Sharīʿah* requirements. The chapter is divided mainly into two sections. The first section will elaborate the overview of Islamic project finance and its contemporary structure. While the second section will examine the applications of security instruments and assets in Islamic project finance from a *Sharīʿah* perspective. The conclusion of the chapter will highlight the *Sharīʿah* compatibility status of the security arrangement in Islamic project finance.

Chapter Seven: Conclusion

Chapter 7 concludes the whole study based on the findings, analyses, and discussions presented in the prior chapters. The chapter highlights the contributions and drawbacks of this study, besides providing suggestions for future research work.

1.9 CHAPTER SUMMARY

This chapter has provided an overview and context for the study, detailing the concept security arrangement and its applications in Islamic project financing. It addresses the statement of the problem, emphasizing the study's aim to assess the *Sharīʿah* compatibility of security instruments and assets within Islamic project financing. Furthermore, this chapter outlines the research questions and objectives, highlights the significance of the study, and identifies gaps concerning security instruments and assets in Islamic project financing. These gaps are addressed through the research conducted in this study. Finally, the chapter concludes with an overview of the thesis structure.

CHAPTER TWO

A REVIEW OF THE CONCEPT OF SECURITY INSTRUMENTS AND ASSETS IN ISLAMIC LAW

2.1 INTRODUCTION

This chapter serves as a critical starting point for the thesis, exploring the *Sharīʿah* analysis of security arrangements in the context of Islamic project finance. To address the first research question and establish a strong foundation for the study, it is essential to provide a comprehensive overview of the concept of security arrangements from an Islamic perspective. By examining classical and contemporary literature on Islamic law, this study aims to clarify the authentic Islamic understanding of security arrangements, which will guide our research.

This chapter will primarily focus on exploring the concept, components, and elements of security arrangements in *Sharīʿah*. Through an analysis of existing literature, the objective is to uncover the intrinsic meaning and essence of Islamic security and grasp its framework and fundamental characteristics. Special attention will be given to the *rahn* contract, examining its significance, legality, and key components. A detailed examination will be conducted to explore the main requirements and intricate details of the *rahn* contract.

In addition to the *rahn* contract, other significant security contracts prevalent in Islamic law, such as *kafālah, ḍamān*, and *ḥawālah*, will also be explored. By analyzing their nature, features, and related issues, we will develop a comprehensive understanding of the unique characteristics of each contract and their compatibility with Islamic principles. By the end of this chapter, a thorough comparative analysis will be presented, highlighting the similarities and differences among the Islamic security contracts of *rahn, kafālah, ḍamān*, and *ḥawālah*. This analysis will provide valuable insights into the nature, features, and applications of these contracts within the context of security arrangements in Islamic project finance.

2.2 CONCEPT OF SECURITY ARRANGEMENTS IN ISLAMIC LAW

2.2.1 Classical and Contemporary Jurists

The concept of security arrangements in Islamic law has been extensively discussed in both classical and contemporary Islamic law literature. In the classical perspective, jurists primarily focus on Islamic security contracts (*ʿuqūd al-tawthīqāt*), which aim to secure debt obligations (Abu ʿAqeel, 2008). Classical jurists particularly discuss security contracts within the context of loans (*qard*), emphasizing the importance of documenting a legitimate loan through mechanisms such as *rahn* (pledge), *kafīl* (guarantee), or witness (Al-Ansari, 1997; Qalyūbi, 1995). Discussions also cover security contracts related to trade contracts (*ʿuqūd muʿāwaḍāt*), such as selling and renting, benevolent contracts (*ʿuqūd tabarruʿāt*), including gifts and bequests, and security contracts (*ʿuqūd tawthīqāt*) encompassing *rahn, kafālah, ḍamān*, and *ḥawālah* (Al-*Zuḥaylī*, 2003). Classical jurists provide detailed explanations of the distinct characteristics and conditions of these contracts in their respective literature (Ibn ʿĀbidīn, 2003; Al-Dusūqī, 1815; Al-Shirbīni, 2000; Ibn Qudāmah, 1997).

According to Niz*ā*r (1993), the term "*al-tawthīq*" refers to strengthening and guaranteeing the recovery of rights in the event of default or dispute. Muhammad Al-*Zuḥaylī* (1982) explains that Islamic security contracts play a crucial role in the financial and commercial context by reinforcing rights and protecting both creditors and debtors from disputes or disagreements regarding debt amounts or maturity. These contracts can also serve as evidence in legal disputes.

Islamic security contracts include various forms such as *rahn, kafālah, ḍamān*, and *ḥawālah* contracts, each with its own specific nature and *Sharīʿah* requirements (Abū ʿAqeel, 2008). This study will particularly focus on the *rahn* contract due to its comparability with the four types of security instruments in Common law discussed previously, as both *rahn* and common law security instruments involve the provision of an asset. The contracts of *kafālah, ḍamān*, and *ḥawālah* will be examined subsequently to evaluate their comparability with modern quasi-security arrangements such as assignment, and guarantee.

Contemporary Islamic law literature extensively discusses the concept of security arrangements within the context of Islamic commercial contracts applicable to Islamic banking and finance. While the study primarily focuses on contemporary literature, relevant references to classical Islamic law literature are also made, particularly regarding the detailed rules and requirements of each Islamic security contract.

Al-Halīl (2001) asserts that the concept of security arrangements is consistently discussed within the framework of *ʿuqūd al-tawthīqāt*, as its main objective is to secure debt payments. According to Muslim scholars, Islamic security contracts, including *rahn, kafālah, ḥawālah*, and *ḍamān*, are considered integral to *ʿuqūd al-tawthīqāt*, each with its own distinct nature and adherence to *Sharīʿah* principles (Abu ʿAqeel, 2008; Al-*Zuḥaylī*, 2006).

While the contemporary approach shares similarities with the classical view by examining the notion of security within the context of Islamic security contracts, it takes a broader perspective. The contemporary approach expands on the classical position by providing a more comprehensive analysis of the concept of security arrangements, which was not previously discussed exclusively within the framework of *ʿuqūd tawthīqāt* itself.

2.3 CONCEPT OF *RAHN*

The primary focus of this research is the concept of *rahn*, as it is comparable and directly relevant to modern security instruments recognized under Common law, commonly used in the banking sector. This section provides an overview of the concept of *rahn* in Islamic law, including its definition, legality, types, components, conditions, and other relevant aspects.

2.3.1 Definition of *Rahn*

2.3.1.1 Linguistic Meaning

According to Fayruz Abadi (2005), the Arabic word "*rahana*" has a literal meaning of constancy or holding and bindingness. Based on this understanding, *rahn* refers to the act of holding an asset, indicating the binding nature of a *rahn* contract. Al-*Zuḥaylī* (2002) supports this interpretation, highlighting verse 38 of Al-Muddaththir, which refers to the binding aspect of *rahn*. The verse states:

{كُلُّ نَفْسٍ بِمَا كَسَبَتْ رَهِينَةٌ}

Meaning: "Every soul will be (held) in pledge for its deeds."(Yusuf Ali, 2025)

2.3.1.2 Technical Meaning

To grasp the technical meaning of *rahn*, it is necessary to examine various definitions provided by Muslim jurists. This literature review categorizes the definitions of *rahn* in Islamic law into two groups:

i. Classical definitions of *rahn*: This category includes the definitions of *rahn* provided by scholars from earlier periods, reflecting their understanding and interpretation of *rahn* during classical Islamic legal discourse.
ii. Contemporary definitions of *rahn*: This category encompasses the definitions put forth by modern scholars who have contributed to the field of Islamic law, considering the evolution of legal thought and the application of *rahn* in contemporary contexts.

By exploring both classical and contemporary definitions of *rahn*, this literature review aims to provide a comprehensive understanding of the concept within the framework of Islamic law.

(A) Overview of Classical Definitions

This section presents definitions from four schools of thought (*madhāhib*), followed by a critical review of each definition.

(i) Ḥanafī School:

Ḥanafī scholars define *rahn* as follows:

حبس شيء مالي، بحق يمكن استيفاؤه منه، كلا أو بعضا، كالدين حقيقة أو حكما

Meaning: *Rahn* involves the withholding of a financial asset, based on rights that can be fully or partially recovered from it, such as tangible or intangible debt (Ibn ʿĀbidīn, 2003).

From this explanation, it is evident that *rahn* involves the action of holding an asset as a form of security, enabling the recovery of a legal claim or debt, either partially or in its entirety. Al-Marghīnāni (2000) emphasizes that *Ḥanafī* scholars specifically highlight the element of confining or restraining (حبس) in their definition, indicating the act of taking control or possession of the *rahn* asset. This possession can be achieved through actual delivery of the asset or granting the creditor access to it. According to the *Ḥanafī* school, the possession of *rahn* assets is considered one of the necessary conditions for a valid and enforceable *rahn* contract.

(ii) Mālikī School

Mālikī scholars define *rahn* as follows:

بذل من له البيع ما يباع أو غررا، ولو اشترط في العقد، وثيقة بحق

Meaning: "A person given having a right to sell gives a saleable asset or assets with ambiguity, even if required by the contract, it is a secured right" (Al-Dusūqī, 1815).

According to Al-Ḥaṭṭāb (1997), *Mālikī* scholars have a different perspective and use the term "بذل" (giving) instead of "حبس" (withholding) in their definition of *rahn*. This reflects their majority opinion, which does not consider taking possession of the *rahn* asset as a primary requirement for the conclusion, validity, or enforceability of a *rahn* contract. Consequently, a *rahn* contract can be deemed concluded, valid, and enforceable through the proper expression (*ṣīghah*) of offer and acceptance. In other words, the *murtahīn* (person providing the *rahn*) may request the *rāhin* (person receiving the *rahn*) to deliver the *rahn* asset at a later date after the *rahn* contract is concluded.

Abu ʿAqīl (2008) provides further elaboration on the *Mālikī* scholars' explanation of the criteria for *rahn* assets in their definition. One criterion is that the *rahn* assets must be something saleable (ما يباع). This means that any assets eligible for sale are also eligible for *rahn*. On the contrary, assets that are not eligible for sale, such as swine, liquor, and carcasses, are not eligible for *rahn*. However, the *Mālikī* definition recognizes *gharar* (ambiguity) or an asset with ambiguity as an eligible *marhūn* (pledged asset). Abu ʿAqīl (2008) further explains that, according to the *Mālikī* opinion, an asset with ambiguity is something that can be tolerated in the context of *rahn*, even though it is not permissible in a sale. According to him, some *Mālikī* scholars even permit the *rahn* of highly uncertain assets, such as an escaped camel or a crop that has yet to prove its viability.

(iii) Shāfiʿī School

Shāfiʿī scholars define *rahn* as follows:

جعل عين مال وثيقة بدين يستوفى منها عند تعذر وفائه

Which in translation means, “assignment of a tangible asset as security for a debt, such that the asset is used for payment in case of default” (Al-Shirbīni, 2000).

According to Al-Shirbīni (2000), the definition adopted by *Shāfiʿī* scholars employs the term "عين" (tangible asset), which specifically pertains to tangible assets only. The *Shāfiʿī* scholars maintain the opinion that it is impermissible to utilize usufruct

(*manfaʿah*) or debt (*dayn*) as pledged assets (*marhūn*) because their nature is temporary, and there is a significant likelihood that they may not remain intact over an extended period of time. This would undermine the effectiveness of the security provided.

(iv) Ḥanbalī School

Ḥanbalī scholars define *rahn* as:

المال الذى يجعل وثيقة بالدين ليستوفى من ثمنه إن تعذر استيفاؤه ممن هو عليه

Which in translation means, "The asset used as a security for a debt, such that the proceeds of the (sale of the *rahn*) asset are used for payment of the debt in the event of default of the debtor" (Ibn Qudāmah, 1997).

According to Al-Mardawi (1995), the *Ḥanbalī* scholars share the same viewpoint as the *Shāfiʿī* school regarding the eligibility of usufruct and debt as *rahn* assets. They consider these assets as ineligible for use as *rahn* due to their temporary nature and the inability to deliver them to the creditor.

Summary of Classical Definitions

The classical definitions of *rahn* provided by the four schools of thought reveal variations in their understanding of *rahn*. These differences are reflected in their rulings concerning the requirements for a valid *rahn* contract. The summarized differences are as follows:

i. *Ḥanafī* scholars emphasize the aspect of confining and restraining the assets, requiring the *marhūn* (pledged asset) to remain under the possession of the creditor (*murtahin*) at all times. The *Mālikī* scholars, in contrast, do not consider possession of the *rahn* asset by the creditor as a requirement.
ii. The *Shāfiʿī* school emphasizes the need for tangibility in *rahn* assets. While the *Ḥanafī* and *Ḥanbalī* definitions do not explicitly mention tangibility, it can be inferred that their understanding of *rahn* assets is limited to tangible assets. The *Mālikī* definition, however, does not address tangibility,

allowing for more flexibility in considering usufruct and debt as eligible *marhūn*.

iii. The *Mālikī* school exhibits greater flexibility by accepting all assets capable of sale as qualifying for *marhūn*, even if they involve *gharār*. Other jurists argue that the *marhūn* must be eligible for sale and free from significant *gharār*.

In conclusion, the differences in the classical definitions of *rahn* illustrate the varying perspectives of different schools of thought regarding the requirements and eligibility of *rahn* contracts. The *Ḥanafī* scholars emphasize possession and control, while the *Mālikī* scholars do not consider possession necessary. The *Shāfiʿī* scholars focus on tangibility, with the *Ḥanbalī* scholars sharing this perspective. Additionally, the *Mālikī* school demonstrates flexibility by allowing assets with *gharār*. These differences reflect the diverse interpretations and approaches of the schools of thought to the concept of *rahn*.

(B) Overview of Contemporary Definitions

Moving on to contemporary definitions, several scholars and *Sharīʿah* bodies have provided their interpretations of *rahn*, shedding light on its significance in modern Islamic finance practices. *Al-Zuḥaylī* (2003) describes *rahn* as a contract where a valuable asset is held as security for a debt, allowing for full or partial recovery of the debt using the asset. Alwi (2000) defines a *rahn* contract as the act of charging or lodging a tangible property of material value as security for a debt or obligation. Azmi and Engku Ali (2007) highlight that *rahn*, from an Islamic perspective, provides backing and security for loans or other forms of indebtedness.

Sharīʿah bodies such as AAOIFI (2017) and SAC BNM (2018) also provide definitions for *rahn* contracts in the context of Islamic banking and finance. AAOIFI (2017) in its *Sharīʿah* Standard No. 39 on *rahn* (translated as mortgage in the English version) provides a definition of *rahn* as:

جعل عين مالية أو ما في حكمها وثيقة بدين يستوفى منها أو من ثمنها إذا تعذر الوفاء

"To assign a financial asset or the like as security for a debt such that the asset or its value is used for payment in case of default."

Similarly, the SAC BNM (2018) in its Policy Document on *Rahn* provides the following definition for *rahn*:

> A contract where a party, as the pledgor (*rāhin*), pledges an asset as collateral (*marhūn*) to another party, a pledgee (*murtahin*), to fulfill the obligor's liability or obligation (*marhūn bih*) owed to the pledgee in the event of default by the obligor.

These contemporary definitions emphasize the role of *rahn* in providing security and support for debts, both in traditional Islamic contexts and in modern Islamic financial institutions. By considering these definitions, practitioners and scholars can better understand and apply *rahn* in various financial transactions while adhering to Islamic principles.

Analysis of the Definitions of *Rahn* Contract

Based on the classical and contemporary definitions of *rahn*, the following observations can be made:

i. Despite using different terms and descriptions, all definitions share a common meaning: a *rahn* contract involves using an asset as collateral for a debt, with the asset or its value being utilized for payment in case of default.

ii. The differences in certain aspects of the classical definitions by the four *madhāhib* stem from their divergent views on the requirements of a *rahn* contract. For instance, the majority of jurists (*Ḥanafī*, Shāfi'ī, and *Ḥanbalī*) consider possession as a requirement for a valid and binding *rahn* contract, while *Mālikī* jurists view it as a condition to enforce the *rahn* when needed. Another difference lies in the eligible *rahn* assets, with the majority of jurists restricting them to tangible property (*ʿayn*), whereas *Mālikī* jurists

display more flexibility by including usufruct (*manfaʿah*) and debt (*dayn*) as potential *rahn* assets.

iii. The definitions provided by AAOIFI and SAC BNM offer comprehensive and practical insights into the contemporary understanding of *rahn* within the Islamic banking and finance industry. AAOIFI's definition is precise, focusing on the core of the *rahn* contract, while SAC BNM's definition includes additional elements such as the involved parties and the subject matter.

iv. Considering the context of this study, AAOIFI's definition serves as the most suitable working definition. It strikes a balance between precision and comprehensiveness, accommodating a broader range of assets beyond tangible property (*ʿayn*), including usufruct, debt, rights, and other relevant asset classes recognized by *Sharīʿah*. This definition is well-suited for addressing the complexities of modern Islamic financial products and accommodating emerging asset classes in the current Islamic banking industry.

2.3.2 Legality of *Rahn* Contract

The legality of *rahn* is based is firmly rooted in the Quran, the Hadith and the consensus (*ijmāʿ*) of Muslim jurists.

(i) Quranic verses:

The permissibility of *rahn* contract is primarily derived from the following verse (2: 283):

وَإِن كُنتُمْ عَلَى سَفَرٍ وَلَمْ تَجِدُواْ كَاتِباً فَرِهَانٌ مَّقْبُوضَةٌ

If ye are on a journey and cannot find a scribe a pledge with possession (may serve the purpose) (Yusuf Ali, 2025)

Ibn Kathīr (1999) offers an interpretation of the aforementioned verse, attributing it to Ibn 'Abbas (may Allah be pleased with him). According to Ibn Kathīr, the verse specifically addresses the situation of a traveler who needs to borrow money but lacks the means to document the loan due to the

absence of a scribe or the necessary writing materials. In such cases, Allah instructs the debtor to provide something as collateral to the creditor. The phrase "فَرِهَانٌ مَّقْبُوضَةٌ" (a taken pledge) indicates that the possession of the pledged assets by the creditor is the main requirement of a *rahn* contract, which aligns with the majority opinion of jurists (excluding the *Mālikī* school) (Ibn Kathīr, 1999).

Ibn Kathīr also references narrations by Anas ibn *Māl*ik (may Allah be pleased with him) stating that the Prophet Muhammad (pbuh) passed away while his shield was being held as collateral by a Jew. Another narration by Āishah (may Allah be pleased with her) mentions that the Prophet (pbuh) had pledged his shield in exchange for thirty ṣāʿ (approximately 90 kg) of barley (Ṣaḥīḥ al-Bukhārī, 2002).

Furthermore, Al-Qurtubī (2006) in his book "al-Jāmiʿ li Aḥkām al-Qurʾān" explains that Allah commanded debt transactions to be recorded and witnessed in order to protect people's rights over their property, as stated in *Sūrah Al-Baqarah* verse 282:

يَا أَيُّهَا الَّذِينَ آمَنُواْ إِذَا تَدَايَنتُم بِدَيْنٍ إِلَى أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ

"O ye who believe! when ye deal with each other in transactions involving future obligations in a fixed period of time reduce them to writing (Yusuf Ali, 2025) "

This verse is followed by the verse on *rahn* i.e., *Al-Baqarah*: verse 283.

وَإِن كُنتُمْ عَلَى سَفَرٍ وَلَمْ تَجِدُواْ كَاتِباً فَرِهَانٌ مَّقْبُوضَةٌ

If ye are on a journey and cannot find a scribe a pledge with possession (may serve the purpose) (Yusuf Ali, 2025)

The verse suggests that if it is not feasible to document a debt, the creditor has the option to acquire possession of a *rahn* asset as an alternative means of securing the debt.

(ii) Hadīth (Prophetic Traditions)

There are several ḥadīth that indicate the permissibility of *rahn* as the following:

عَنْ عَائِشَةَ رضى الله عنها : أَنَّ النَّبِيَّ صلى الله عليه وسلم اشْتَرَى مِنْ يَهُودِيٍّ طَعَامًا إِلَى أَجَلٍ وَرَهَنَهُ دِرْعَهُ

'Āishah narrated that the Prophet (pbuh) purchased food from a Jew for deferred payment and pawned his shield to him (Ṣaḥīḥ al- Bukhāri, 2002).

عن أنس بن مالك رضي الله عنه: أنه مشى الى رسول الله بخبز شعير، وإهالة سنخة قال: (ولقد رهن درعا له عند يهودي بالمدينة وأخذ منه شعرا لأهله)

Anas ibn *Māl*ik (may Allah be pleased with him) narrated that: "The Prophet (pbuh) pawned a shield with a Jew in Madīnah and he took from him some barley for his family" (Ṣaḥīḥ Al-Bukhārī, 2002).

عن أبي هريرة رضي الله عنه قال: قال رسول الله صلى الله عليه وسلم : (الرهن يركب بنفقته إذا كان مرهونا، ولبن الدر يشرب بنفقته إذا كان مرهونا، وعلى الذي يركب ويشرب النفقفة)

Abu Hurayrah (may Allah be pleased with him), the Prophet (pbuh) was narrated to have said: "pawned riding animals may be mounted in exchange for their expenses and the milk of pawned dairy animals in exchange from their expenses and the one who rides or drinks is thus responsible for the animal's expenses" (Ṣaḥīḥ Al-Bukhārī, 2002).

The aforementioned hadiths serve as clear examples of Prophet Muhammad (pbuh) engaging in *rahn* transactions, indicating the permissibility of such contracts in Islam. These hadith illustrate the practical application of *rahn* by the Prophet, who pawned assets like shields and animals to meet immediate needs or borrowed items with deferred payment. Thus, these examples provide concrete evidence that using assets as collateral or security through pawning is an acceptable practice in Islam, enabling individuals to fulfill their immediate needs or obtain financing.

(iii) Consensus of Muslim Jurists

Muslim scholars unanimously agree on the permissibility of *rahn* contracts from a *Sharīʿah* perspective (Ibn Qudāmah, 1997; *Al-Sharbīnī*, 2000; Al-Qarāfī, 1994; *Al-Sarakhsī*, 2001).

In summary, *rahn* contracts are generally considered valid in Islam, supported by the Quran, the Sunnah, and the consensus among Muslim jurists. These sources confirm that *rahn* contract can be used to fulfill financial obligations. However, it is important to acknowledge that there may be varying viewpoints among jurists regarding the specific requirements and parameters of *rahn* contracts. Different scholars may hold differing opinions on the elements necessary for a *rahn* contract to be legally binding and enforceable.

2.3.3 General Characteristic of *Rahn* Contracts

According to Al-Shakhānīyyah (2010) and Al-*Zuḥaylī* (2003), *rahn* contracts are considered both security contracts (*ʿuqūd tawthīqāt*) and charitable contracts (*ʿuqūd al-tabarru'āt*) due to their characteristic of not involving any financial consideration. This places them in line with other charitable contracts such as *hibah* (gift), *iʿārah* (borrowing), *al-ida'* (deposit), and *al-qard* (loan) (Abu ʻĀqīl, 2008).

Al-Zarqa (2008) presents the majority view among scholars, where a valid *rahn* contract requires the creditor to physically possess (*qabadh*) the pledged asset. This condition is based on the Islamic legal maxim "التبرع لا يتم إلا بالقبض" (Mejelle Ahkam Adliyyah: item no. 701), which states that charitable contracts are not considered complete and valid until the subject matter is delivered. Therefore, for a *rahn* contract to be binding, the creditor must physically possess the pledged asset. However, the *Mālikī* school of thought holds a different view, considering a *rahn* contract as concluded, valid, and binding through the proper language of offer and acceptance (*ṣīghah*), without requiring the possession of the pledged asset (Al-Ḥaṭṭāb, 1997).

In summary, these different perspectives highlight varying interpretations and approaches among scholars regarding the specific conditions and requirements of *rahn* contracts. While the majority of scholars emphasize the importance of possession, the *Mālikī* school offers an alternative viewpoint based on the validity of contractual language. The following section will further explain the detailed essential elements of a *rahn* contract.

2.3.4 Essential Components of a *Rahn* Contract

There are two lines of opinions among Muslim jurists regarding the components of a valid *rahn* contract:

(i) First view: This is the opinion of the majority of Muslim jurists from *Mālikī*, *Shāfiʿī* and *Ḥanbalī* schools of law (Ibn Rushd 2006; Al-Qarāfī, 1994; Al-Shirbīnī, 2000; Al-Mardawī, 1995; *Al-Buhūtī*, 1997). According to this view, a valid *rahn* contract consists of four elements:

a) The contracting parties, namely the *rāhin* and *murtahin*

b) The *rahn* asset (*marhūn*)

c) The debt obligation (*marhūn bihi*)

d) Offer and acceptance (*ījāb* and *qabūl*)

(ii) (ii) Second view: This is the opinion of the Hanafī school of law (*Al-Kāsānī*, 2003; Al-Marghīnānī, 2000; Ibn al-Humām, 2003; Ibn ʿĀbidīn, 2003). In this case, they consider offer and acceptance (*ījāb* and *qabūl*) as the only element of a *rahn* contract. The subsequent section will delve into the requirements of a *rahn* contract in a more detailed manner.

2.3.5 Requirements of a *Rahn* Contract

The requirements of a *rahn* contract relate to each component of its essential elements, as stipulated below:

2.3.5.1 Requirement of Contracting Parties: Rāhin and Murtahin

The contracting parties in a *rahn* contract consist of (i) *rāhin*, who acts as the debtor providing a *rahn* asset as security at the request of the creditor, and (ii) *murtahin*, who acts as the creditor receiving the *rahn* assets from the debtor (*Al-Kāsānī*, 2003; Ibn Rushd, 2006; Al-Shirbīnī, 2000; Al-Mardāwi, 1995). Generally, the contracting parties in a *rahn* contract, namely the *rāhin* and *murtahin*, must satisfy the following conditions:

i. The contracting parties must be mentally sound ('*āqil*).

Jurists unanimously agree that a *rahn* contract can only be entered into by mentally sound individuals. Contracts entered into by mentally unfit individuals are considered invalid. This requirement upholds the principle of informed consent and fairness, ensuring that all parties fully understand the terms and implications of the contract (*Al-Kāsānī*, 2003; Ibn Rushd, 2006).

ii. The contracting parties must be of legal age (*bāligh*) and competent (*rashīd*).

According to *Shāfiʿī* and Hanbalī scholars, the contracting parties in a *rahn* contract must be of legal age (Al-Mardāwī, 1995). They argue that even if a minor is considered discerning (*mumayyiz*), they are not capable of entering into a valid *rahn* contract due to their lack of capacity to transact (*tasarruf*) independently. Minors are also not regarded as eligible donors (*ahl tabarruʿ*) in the context of viewing *rahn* as one of the *tabarru'* contracts (Al-Mardāwī, 1995).

The Hanafī scholars hold a different view on this issue. They set a lower age limit for contracting parties, recognizing discerning minors as eligible and capable of entering into a *rahn* contract. Their main argument is that since *rahn* is secondary or subsidiary to a sale contract, the permissibility of a discerning minor executing certain types of sales (*tafīh*) also applies to the *rahn* contract.

The *Mālik*ī jurists (Al-Khurāshī, 1994) consider the condition of legal age not essential for a valid *rahn* contract but more related to the bindingness of the contract. According to this view, a discerning minor can enter into a valid *rahn* contract, either as a *rāhīn* or *murtahin*, but the enforceability of the contract is subject to the consent of the legal guardian.

It is observed that the *Mālik*ī's view is the more moderate and practical opinion, allowing a discerning minor to enter a valid *rahn* contract, but its enforceability is subject to the ratification of their legal guardian. In this case, the legal guardian may give consent to proceed with the contract initiated by the minor or revoke the contract if they find it detrimental to the minor. This indirectly educates the minor about commercial transactions and provides them an avenue to understand the requirements of Islamic transactions under the supervision of their legal guardian.

The ruling for discerning minors also applies to contracting parties who lack competency (*rushd*). In such cases, if this type of person enters into a *rahn* contract, the *rahn* contract is valid but suspended, subject to the permission of their legal guardian (Al-Shirbīnī, 2000).

iii. The contracting parties must not be under duress (*ikrah*)

A fundamental requirement for a valid *rahn* contract is that all parties involved must act freely and without coercion. If a contracting party enters into a *rahn* contract due to duress or coercion, the *rahn* contract is deemed invalid. This provision ensures the preservation of individual autonomy and fair dealings in all *rahn* transactions (Al-Mardāwī, 1995).

In conclusion, the validity of a *rahn* contract in Islamic law is contingent upon several fundamental conditions. Firstly, all parties involved must be mentally sound, ensuring comprehensive understanding and informed consent. Secondly, the contracting parties must be of legal age and possess the capacity to make informed decisions, although interpretations differ among Islamic schools of thought. While some allow discerning minors to be involved under the supervision of their legal guardians, others strictly require parties to be of legal age and fully competent. Finally, freedom from duress is crucial, as any form of coercion renders the contract invalid, safeguarding the rights and autonomy of all parties involved.

2.3.5.2 Requirement of Rahn Assets (marhūn)

This section explores the perspectives and arguments of various jurists regarding the necessity of *rahn* assets or *marhūn*. *Marhūn* refers to the asset provided by a debtor to a creditor as security in a *rahn* contract, which is a crucial element in Islamic debt transactions. If the debtor defaults, the creditor can sell the *marhūn* to recover the debt. It is widely agreed among the majority jurists that the *marhūn* must be a saleable asset. This study aims to analyze the criteria and characteristics of *marhūn* as defined by traditional and current Islamic scholars, serving as the basis for discussing the compatibility of modern security arrangements with the existing *marhūn* requirements.

2.3.5.2.1 General Ruling on the Requirement of Rahn Assets

To understand the requirement of *marhūn*, it is important to consider the perspectives of classical jurists. There are two main opinions regarding the eligibility of *rahn* assets:

First opinion: Muslim jurists unanimously agree that whatever is eligible for a sale is also eligible for a *rahn* contract (كل ما جاز بيعه جاز رهنه). Therefore, the requirements for a valid sale, such as the asset's existence, known, value, deliverability, and ownership, also apply to a *rahn* contract (*Al-Kāsānī*, 2003; Ibn Rushd, 2006; Al-Shirbīni, 2000; Al-Mardāwī, 1995).

Second opinion: However, there is a different interpretation by *Mālikī* scholars in another related maxim"whatever is not eligible for a sale is deemed not eligible for a *rahn*" (ما لا يجوز بيعه لا يجوز رهنه) in which employed by the majority jurists on its impermissibility. In contrast, the *Mālikī* scholars have a different perspective on this issue as they provide an exceptional case with regards to element of *gharar* to the said maxim. This is in line with exceptional under *rahn* contract assets which allow the creditor to accept saleable assets and assets with ambiguity (Al-Ḥaṭṭāb, 1997). This difference will lead to different rulings on the permissibility of the *rahn* assets to be used as security assets.

The contrasting views between majority scholars and the *Mālikī* viewpoint result in different rulings on the permissibility of *rahn* assets as security. Thus, a comprehensive examination of the requirement of *rahn* assets will consider insights from both perspectives.

2.3.5.2.2 Criteria of the Rahn Assets

Generally, the classical jurists underline the requirement of *marhūn* as the following:

(i) The *marhūn* shall be a property (*māl*) that is recognised from the *Sharīʿah* perspective

Muslim jurists (*Al-Sarakhsī*, 2001; Ibn Rushd, 2006; Al-Ḥaṭṭāb, 1992; Ibn Qudāmah, 1997) stipulated that the *marhūn* must be a *Sharīʿah* recognised property. The property can be in various forms, either movable (vehicle, inventory, stocks, cash, etc.) or immovable (land, building, trees, etc.). Other types of eligible properties include fungible assets (*mithliyyāt*) such as gold and silver; as well as non-fungible assets (*qīmiyyat*) such as trade goods, animals, etc. On the other hand, *Sharīʿah* does not recognise prohibited items property such as a carcass, blood, etc., as properties, therefore they are not eligible to be used as *marhūn* (*Al-Kāsānī*, 2003; Al-Qarāfī, 1994; Al-Māwardī, 1999; Ibn Qudāmah, 1997).

With regards to the use of usufruct (*manfaʿah*) as *marhūn*, the jurists had different opinions on its permissibility. Majority jurists consisting of *Ḥanafī*, *Shāfiʿī* and *Ḥanbalī*' schools (Ibn Qudāmah, 1997; *Al-Buhūtī*, 1968) stipulate that usufruct is not eligible as *marhūn*. The argument by *Ḥanafī* scholars is that usufruct is not categorised as property, hence, not eligible as *marhūn*.

Whereas the *Shāfiʿī* and *Ḥanbalī* scholars, despite their recognition of usufruct as *māl*, refuse to accept its usage as *marhūn* on the ground that that by nature, usufruct is non-deliverable and cannot be possessed by the creditor. Thus, it is difficult to ensure its continued existence throughout the tenure of the debt and it is hard, if not impossible, for the creditor to recover from the usufruct in the case of default by the debtor (*Al-Buhūtī*, v3, 321, Al-Shirbīni, 2000). However, the *Shāfiʿī* jurists only forbade the use of usufruct as *marhūn* at the inception but allow its use as a collateral without a formal *rahn* contract to recover the debt. For example, if a person who has rights to usufruct of some properties dies while being indebted, the rental value of the usufruct may be used to pay the creditors (Al-*Zuḥaylī*, 2003).

The *Mālikī* jurists (Al-Qarāfī, 1994; Al-Ḥaṭṭāb, 1992); however; permit the use of usufruct (*manfaʿah*) as *marhūn*. They argue that the use of usufruct as *marhūn* can attain a similar effect of security as good as tangible property. In this regard, the *Mālikī* jurists further clarify that even the debtor may not be able to deliver the usufruct to the creditor; it is still eligible as *marhūn* due to the potential benefits to the creditor in the event of the debtor's failure to repay the debt.

The argument by the *Mālikī* scholars seem to be more tenable because the creditor can cause the usufruct to be sold or leased to recover the debt amount. It should be noted that the *Mālikī* school has the most flexible view regarding assets eligible as *marhūn*. For example, they also allow for the use of an asset associated with ambiguity and unknown elements which are not excessive as *marhūn* because according to them, it is better to have a security rather than having nothing.

(ii) The *marhūn* shall be a valuable property

The main purpose of *rahn* is to secure the debt by using the *marhūn* to satisfy the outstanding debt in the case of default therefore, the *marhūn* must be a valuable property from the *Sharīʿah* perspective. Muslim jurists unanimously agree that it is impermissible for a Muslim to offer or accept prohibited items such as liquor or swine as *marhūn* because they are deemed to be of no value. (Al- Sarakhsī, 2001; Al-Qarāfī, 1994; Al-Māwardī, 1999; Ibn Qudāmah, 1997). This rule applies when both parties are Muslims; or only one party is Muslim and the other a non-Muslim, even when the contract stipulates that it will be placed under the possession of the non-Muslim. This ruling follows the fact that a Muslim may neither repay his debts nor collect debt repayments from forbidden items. On the other hand, *Al-Zuḥaylī* (2003) highlights an exception to this rule. This involves a *rahn* contract between a non-Muslim debtor and a non-Muslim creditor. In this situation, Islamic law validates the use of *marhūn* assets that are prohibited by *Sharīʿah* for Muslims but recognised as valuable properties among the non-Muslims such as liquor or swine.

(iii) The *marhūn* shall be under a valid ownership

Muslim jurists unanimously agree that a debtor can use a property owned by him as a *marhūn* to secure his debt obligation. It is also permissible for him to use a property owned by a third party if the owner gives his consent (*Al-Kāsānī*, 2003; Ibn Rushd, 2006; *Al-Sharbīnī*, 2000; Ibn Qudāmah, 1997). They differ over the permissibility of using a property owned by a third party before the owner's consent is obtained. This arrangement is known as *rahn fuḍūlī*. According to the *Ḥanafī*s (*Al-Kāsānī*, 2003; Ibn ʿĀbidīn, 2003) and *Mālikī*s (Ibn Rushd, 2006; Al-Qarāfī, 1994), the status of the *rahn* remains pending until permission is obtained from the asset

owner. On the other hand, the *Shāfiʿī*s (*Al-Sharbīnī*, 2000; Al-Māwardī, 1999) and *Ḥanbalī*s (Ibn Qudāmah, 1997; Ibn Mufliḥ, 1985) hold that it is impermissible to use a third party's asset as *marhūn* without the owner's consent. They argue that since a third party's asset cannot be sold without the owner's permission, the use of the same as *marhūn* must also be prohibited. Muslim jurists unanimously agree to the permissibility of the inverse case: a person can place an asset he owns as a security of another's debt even without the debtor's permission. They base this on the analogy with the permissibility of offering a guarantee in favour of someone even without his consent. (*Al-Kāsānī*, 2003; Al-Qarāfī, 1994; *Al-Sharbīnī*, 2000; *Al-Buhūtī*, 1997). (iv) The *marhūn* shall be in existence at the inception of *rahn* contract

Muslim jurists have discussed the permissibility of *rahn* of assets that are non-existent at the time of the charge. These are assets that are expected to exist or become available, such as *rahn* of crops that have yet to mature, a foetus in the womb, or production of flour for the current season, etc. According to the majority of Muslim jurists (*Ḥanafī*s, *Shāfiʿī*s and *Ḥanbalī*s) (*Al-Kāsānī*, 2003; Al-*Shāfiʿī*, 1393H; Ibn Qudāmah, 1997), the *marhūn* must exist at the inception of the *rahn* contract. They argue that it is not permissible to sell a non-existent asset, and the same rule applies to the *rahn* contract. Based on this view, it is not permissible to use non-existent assets as *marhūn*. However, the *Mālikī* jurists (Al-Qarāfī, 1994; Al-Ḥaṭṭāb, 1992) allow for the *rahn* of non-existent assets whether doing so is stipulated in the contract. They argue that the debt obligation originally exists without any requirement of having *rahn*; thus, it is better to have collateral rather than having nothing. This is the preferred view because *rahn* is just to support the recovery of the debt. That being the case, some collateral is indeed better than none.

(v) The *marhūn* shall be deliverable at the inception of *rahn*

According to the majority of Muslim jurists, the *marhūn* shall be capable of delivery. This is based on their recurring principle that the requirements for the object of a sale contract also apply to the *marhūn*. An asset being sold must be capable of delivery; otherwise, the sale contract will be void. Likewise, it is not permissible for assets that are not capable of delivery at

the time of the contract to be used as *marhūn*; for example, escaped animals or birds in the sky, etc. (*Al-Kāsānī*, 2003; *Al-Sharbīnī*, 2000; Ibn Qudāmah, 1997). On the contrary, the *Mālikī* jurists (Al-Qarāfī, 1994; Al-Ḥaṭṭāb, 1992) rule that *rahn* of non-deliverable assets, whether stipulated or not stipulated in the contract, is permissible. They argue that the requirement of deliverability in a sale does not necessarily apply to a *rahn* contract. The delivery of the *rahn* asset remains the responsibility of the chargor, and if the chargor manages 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. This is again the preferred view for the same reason as in the previous dispute.

(vi) The *marhūn* shall be known and specified at the point of *rahn* contract

Jurists differ on the permissibility of an unknown asset (*majhūl*) serving as *marhūn*. The *Shāfi ʿī* and *Ḥanbalī* jurists (Al-Māwardī, 1999; Ibn Qudāmah, 1997) do not allow the use of any unknown or unspecified asset as *marhūn*, arguing that lack of information (*jahālah*) invalidates both sale and *rahn* contracts. The *Ḥanafī*s (*Al-Kāsānī*, 2003; Affendī, 2003) make a distinction between minor and major levels of *jahālah* in a sale contract. They excuse minor levels because they are unlikely to lead to a dispute between the contracting parties. Based on that, they consider minor *jahālah* to also be acceptable for a *marhūn*. On the other hand, major *jahālah* is likely to lead to a dispute between the contracting parties and is thus unacceptable in either a sale or a *rahn* contract. On the other hand, the *Mālikī* jurists (Al-Qarāfī, 1997) view a *marhūn* with any element of *jahālah* to be permissible as they do not accept the principle that all the requirements of a sale must apply to a *rahn* contract. They also compare the arrangement of *rahn* to the concept of testimony (*shahādah*). Since there is no requirement to specify a particular witness, similarly, there is also no requirement to specify a particular asset for *rahn*. This is relevant because both *rahn* and testimony share a similar purpose, i.e., to provide security (*tawthīq*) for the transaction. This is again the preferred view for the same reason as in the previous dispute.

In summary, classical jurists have discussed the requirements for *rahn* assets in detail. The majority of jurists agree that the *marhūn* must be a recognized property from a *Sharīʿah* perspective and should be valuable and under valid ownership. They also emphasize that the *marhūn* should exist, be deliverable, and be known and specified at the time of the *rahn* contract. However, there are differences of opinion on certain aspects. One obvious difference is regarding the permissibility of using usufruct as *marhūn*. The majority jurists generally prohibit it due to its non-deliverability and difficulty in recovery. On the other hand, the *Mālikī* scholars allow its use, considering the potential benefits it can provide to the creditor. There are also differing views on the use of unknown or unspecified assets as *marhūn*. While some jurists prohibit it due to the requirement of transparency and clear specification, the *Mālikī* scholars permit it, drawing an analogy with the permissibility of offering a guarantee without consent. These divergences in opinion provide different perspectives on the permissibility of certain assets as *rahn* and contribute to the broader understanding of *rahn* contracts in Islamic law.

2.3.5.3 Requirement of Underlying Debt Obligation (marhūn bihi)

Marhūn bihi refers to the underlying legal right against which an object is being pledged as collateral (*rahn*) (*Zuḥaylī*, 2003). Musa (2018) outlines five requirements for *marhūn bihi* as follows:

a) The underlying debt or liabilities must be in the form of a debt.

   According to consensus among jurists, *rahn* cannot be used to secure non-guaranteed assets (*ʿayn ghayr madmūnah*), such as goods deposited under *wadīʿah* or property given as capital in a *muḍārabah*. However, if the custodian (in the case of *wadīʿah*) or *mudārib* (in the case of *mudārabah*) is negligent, *rahn* can be used as security (Al-Jasās, 1995), but only to cover losses resulting from the negligence. On the other hand, there are differing opinions among jurists regarding the permissibility of using *rahn* to secure guaranteed assets (*ʿayn madmūnah*). The majority of jurists (*Al-Kāsānī*, 2003; Ibn Rushd, 2006; *Al-Buhūtī*, 1968), except Shāfi'ī, permit the use of *rahn* to secure guaranteed assets based on their nature or external arrangements. They argue that *rahn* is intended to secure the rights or

interests of another party, which also applies to guaranteed assets. However, Shāfi'ī and a few *Ḥanbalī* jurists prohibit the use of *rahn* to secure physical assets (*ʿayn*), contending that *rahn*'s primary objective is to secure a debt (*dayn*) and not a physical asset (*ʿayn*), as evident from Quranic verses in *Sūrah Al-Baqarah* (verses 282 and 283). Therefore, allowing *rahn* to secure an asset (*ʿayn*) contradicts the original intention of *rahn*, which is to ensure the payment of a debt only (Al-Shirbīni, 2000).

b) The underlying debt and liabilities must be clearly known in terms of amount and characteristics.

If one or more contracting parties are uncertain about which specific debt (in the case of two debt obligations) is intended to be covered by the *rahn* asset, such an arrangement is invalid (*Al-Ramlī*, 1984).

c) The debt must be binding or about to be binding.

Mālikī, *Shāfiʿī*, and *Ḥanbalī* scholars allow the conclusion of *rahn* for the underlying debt or liability under two circumstances: (i) when the debt is binding, such as a *qard* or deferred payment after the price of sale becomes binding, and (ii) when the debt is about to be binding, for example, during the option period (*khiyar*) in a sale contract when it is about to expire (ʿUllaysh, 1984; *Al-Nawawī*, 1991; *Al-Buhūtī*, 1968). *Ḥanafī* scholars (*Al-Kāsānī*, 2003) agree with the majority's opinion on the permissibility of *rahn* only for binding debts, not for debts that are about to be binding. However, *rahn* cannot be created when a liability has not yet become an established debt. For instance, *rahn* cannot be validly created to secure the liability in a *juʿalah* before the completion of the task, as it is not considered an established and binding debt at that point (Al-Shirbīni, 2000).

d) The underlying debt must be an established debt.

Jurists unanimously agree that *rahn* can be concluded after the debt obligation has been established. The creditor can request a *marhūn* as security since the debtor already has an obligation to pay the debt. This is similar to the act of guarantee (*ḍamān*) of debt payment (Ibn Rushd, 2006; Al-Shirbīni, 2000; *Ibn Mufliḥ*, 2003; Al-Tusi, 1998). It is also permissible to conclude the *rahn* contract at the same time as the establishment of the debt obligation. For example, a seller may say to a purchaser, "*I will sell this car to you at an agreed price provided that you provide me with*

collateral security, which will be your land." Jurists have different opinions on the permissibility of *rahn* for future debts. *Ḥanafī* jurists (Ibn ʿĀbidīn, 2003) allow such transactions, as they believe that the right over *rahn* lies with the creditor (*murtahin*), thus allowing them to request it in advance. This is similar to the analogy where a seller holds onto sold assets until full payment is made. However, *Shāfiʿī* (*Al-Ramlī*, 1984) and *Ḥanbalī* (Ibn Qudāmah, 1997) scholars do not permit this practice. They argue that although the right to request *rahn* belongs to the creditor, it is not allowed when the debt is yet to be established. This is akin to the right to call a witness to testify, which is allowed only after the case has been established.

e) The underlying debt or liabilities should be recoverable from the *rahn* asset. *Al-Zuḥaylī* (2003) provides examples of ineligible underlying liabilities, such as the liability in a *kafālah* contract to bring an accused person to court. Such liabilities cannot be fulfilled by any *rahn* asset. The same applies to liabilities not recognized from a *Sharīʿah* perspective, such as wages for persons engaged in prohibited acts (e.g., someone who wails at funerals or a dancer, etc.). Contracts hiring a person to perform forbidden acts are invalid and therefore do not create any recovery from the *rahn* asset. This is the consensus among jurists from all schools of thought (*Al-Sarakhsī*, 2001; Ibn Rushd, 2006; Al-Shirbīni, 2000; Ibn Qudāmah, 1997).

In conclusion, the requirement of the underlying debt obligation in *rahn* contract encompasses several important aspects. The debt must be in the form of a debt, and *rahn* cannot be used to secure non-guaranteed assets. It is crucial to clearly identify and know the debt and liabilities. The debt must be binding or about to be binding, and *rahn* can be employed for established debts. However, there are differing opinions regarding the permissibility of *rahn* for future debts. Lastly, the debt or liabilities should be recoverable from the *rahn* asset. These discussions shed light on the necessary conditions for valid *rahn* contract, ensuring fairness and security for all parties involved.

2.3.5.4 Requirement of Offer and Acceptance (ṣīghah)

According to *Mālikī*, *Shāfiʿī*, *Ḥanbalī*, and *Ḥanafī* views on *rahn*, ṣīghah (offer and acceptance) is considered a component of the contract. These scholars argue that *rahn*, like any other contract, requires mutual consent and can only be executed upon possession (*Al-Zuḥaylī*, 2003). Jurists emphasize that there are no specific requirements regarding the language of the offer and acceptance (*ṣīghah*), as long as it is based on the mutual consent (*tarādhi*) of the parties involved (Ibn Arafah, 2014). This aligns with the guidance from the Quranic verse (4:29):

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِنْكُمْ

"O ye who believe! eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual good-will" (Yusuf Ali, 2025)".

In summary, the requirement of offer and acceptance (*ṣīghah*) is considered essential in *rahn* contracts according to the *Mālikī*, *Shāfiʿī*, *Ḥanbalī*, and *Ḥanafī* scholars. Both the chargor (*rahin*) and chargee (*murtahin*) must agree and consent to the terms of the contract. Jurists emphasize that there are no specific language requirements for the offer and acceptance, as long as mutual consent is established. This perspective aligns with the Quranic verse promoting fair trading through mutual agreement. By emphasizing the importance of offer and acceptance, *rahn* contracts ensure that both parties willingly enter the agreement with a clear understanding of their rights and obligations.

2.3.6 Additional Discussions Related to *Rahn*

2.3.6.1 Requirement of Possession (Qabḍ)

There are differing opinions regarding whether the possession or receipt of the *rahn* asset by the *murtahin* is a condition for a valid *rahn* contract. Muslim scholars hold two main views on this matter:

(a) The majority of scholars, including *Ḥanafī*s (*Al-Sarakhsī*, 2001), *Shāfiʿī*s (*Al-Ramlī*, 1984), and *Ḥanbalī*s (Ibn Qudāmah, 1997), argue that taking possession (*qabḍ*) of the *marhūn* is a prerequisite for a valid *rahn* contract. They support this view with the following evidence:

The Quranic verse states:

"And if you are on a journey and cannot find a scribe, a pledge with possession [may serve the purpose]" (*Al-Baqarah*: 283).

They also cite the ḥadīth:

"The Prophet (pbuh) purchased grain from a Jew for deferred payment and charged his armour to him" (Ṣaḥīḥ Al-Bukhārī, 1422H). It indicates that the armour was delivered to the Jew in the *rahn* contract.

(b) Some Muslim scholars, primarily from the *Mālikī* School (Ibn Rushd, 2006; Al-Qarāfī, 1994), hold the view that taking possession of the *marhūn* (collateral) is not a mandatory requirement for the conclusion, validity, or enforceability of a *rahn* contract. Instead, they consider it as a recommended practice within the contract. According to this perspective, even without the delivery of the *marhūn* from the debtor to the creditor, the *rahn* contract remains valid. The *murtahin* (creditor) can later request the delivery of the *marhūn* (Ibn Juzay, 1979; Ibn Qudāmah, 1997). The *Mālikī* jurists supporting this opinion base their argument on the interpretation of the same verse in Sūrah *Al-Baqarah* (verse 283). They suggest that the verse already recognizes the *marhūn* as valid collateral (referred to as *rihān*) before adding the phrase "that is possessed" as a descriptive statement. In other words, a valid *rahn* contract exists first, and the descriptive statement merely emphasizes the recommended practice of taking possession of the *marhūn* to fulfill the contract's purpose (Abu Aqīl, 2008). This perspective aligns with the preferred opinion of the *Mālikī* scholars.

This opinion has been adopted by the few contemporary bodies such as AAOIFI and SAC of BNM. This is also implied by the AAOIFI (2017) *Sharīʿah* Standard No. 39, item 3/1/1:

The AAOIFI (2017) *Sharīʿah* Standard No. 39, item 3/1/1:

> 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.

Additionally, the SAC of BNM (2018) in its Policy Document on *Rahn* also stated that the following in para 9.2:

> *Rahn* is binding on the pledgor upon entering into the contract. The pledgor does not have the right to revoke the *rahn* contract without the consent of the pledgee.

Based on the above, AAOIFI and SAC of BNM view that the contract of *rahn* is binding once it is concluded and that possession is not one of the primary conditions for a valid *rahn* contract. The AAOIFI (2017) in *Sharīʿah* Standard No. 39 further elaborates that possession may take place in several forms, i.e., actual possession or legal possession, as provided under item 3/1/2:

> Possession of the mortgaged asset takes place based on 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.

This stance is supported by SAC of BNM in its Policy Document on *Rahn* which stated in the following paragraphs of 14.7 and 14.8:

> 14.7 Unless a pledgee approves a delay in possession, the collateral shall be immediately possessed by the pledgee upon entering into *rahn* contract.
>
> 14.8 Possession of collateral by the pledgee shall be in the form of–
> (a) physical possession (*qabḍ* haqiqi); or
> (b) constructive possession (*qabḍ* hukmi).

The inclusion of possession (*qabḍ*) as a requirement in *rahn* contracts is a topic that elicits varying opinions among Muslim scholars. The dominant viewpoint, upheld by *Ḥanafī*s, *Shāfiʿī*s, and *Ḥanbalī*s, asserts that possession is essential for a *rahn* contract to be considered valid. This stance is supported by references from the Quran and ḥadīths. Conversely, *Mālikī* scholars contend that possession is not a prerequisite

for validity but rather a recommended practice that serves the contract's purpose. Their interpretation of the Quranic verse posits that the *marhūn* (collateral) is inherently recognized as valid, irrespective of possession. The AAOIFI *Sharīʿah* Standard and SAC of BNM aligns themselves with the *Mālikī* perspective. Considering prevailing practices in Islamic banking, the viewpoint of *Mālikī* scholars, the AAOIFI and SAC of BNM emerges as a more practical and feasible option. It enables greater flexibility to accommodate the intricate and sophisticated nature of contemporary Islamic financial products while meeting the requirements of individuals and businesses.

Considering this issue, it can be argued that the opinion of the *Mālikī* scholars, regarding possession of the *marhūn* as a best practice rather than a mandatory requirement, is preferable. This viewpoint is also supported by AAOIFI and SAC of BNM, indicating that possession is not a primary condition for a valid *rahn* contract.

2.3.6.2 Requirement of Right of Disposal of the Rahn Asset

In *rahn* contract, the right of disposal of the *rahn* asset is a critical aspect of ensuring fairness and equity between the debtor (rāhin) and creditor (murtahin). According to the majority of classical Muslim scholars, including Al-Marghīnānī (2000), *Al-Buhūtī* (1997), Ibn Qudāmah (1997), *Al-Sharbīnī* (2000), and *Al-Nawawī* (2003), the creditor is obligated to return the *rahn* asset to the debtor upon the fulfillment of debt obligations within the specified timeframe. However, if the debtor fails to settle the debt fully or partially, the creditor retains certain rights over the *rahn* asset, including the right to liquidate it to recover the outstanding liability. In such cases, the debtor or their representative must sell the *rahn* asset with the creditor's permission, as the creditor holds a vested interest in the asset in the event of default.

Contemporary regulatory bodies, such as the AAOIFI (2020) and SAC of BNM (2018) have built upon these classical foundations to develop detailed guidelines for the liquidation of *rahn* assets. The AAOIFI *Sharīʿah* Standard No. 39 provides clear guidance on the rights of disposal of the *rahn* asset. Key provisions include:

> 3/1/3 The mortgagee has the right to appoint an agent to possess the mortgage on his behalf. The agent, thus appointed, should have the same rights of disposition which the principal has. The mortgage can also be put in the hands of the mortgagee or in the hands of a third party known as the notary, to be agreed upon between the two parties. When the mortgage is kept by a notary neither of the two parties has the right to transfer it to any other location.

This provision allows the creditor to delegate the management of the *rahn* asset to an agent or entrust it to a neutral third party, such as a notary, with mutual consent. Such arrangements ensure transparency and prevent disputes over the custody of the pledged asset.

> 3/1/4 The mortgagee has the right to stipulate a condition that the mortgagor should appoint him or his representative as an agent who can sell the mortgaged asset and repay the debt out of its value in case of default, without resorting to judiciary. The mortgagor does not have the right to retreat from such agency once agreed upon.

Additionally, AAOIFI also emphasizes that the mortgagee may stipulate in the contract that the mortgagor (debtor) appoints them or their representative as an agent authorized to sell the *rahn* asset in the event of default. This pre-authorization mechanism streamlines the liquidation process by eliminating the need for judicial intervention, thereby reducing delays and administrative burdens.

Similarly, The BNM Policy Document on *Rahn* (2018) elaborates on the practical aspects of liquidating *rahn* assets, emphasizing transparency, mutual consent, and adherence to contractual terms. Key provisions include:

> 17.1 The liquidation of collateral shall be carried out in accordance with the terms of the agreement entered into by the contracting parties.
> 17.2 The contracting parties may stipulate at the time of entering the *rahn* contract that the owner authorises the pledgee, his agent or other party to perform the liquidation process.
> 17.3 In the absence of any stipulation as per paragraph 17.2, any person who performs the liquidation process must obtain prior approval of the owner.

These provisions highlight the importance of prior authorization or consent for liquidation, ensuring respect for the debtor's property rights. If no prior stipulation exists, the creditor must seek the debtor's approval before initiating the liquidation process.

The liquidation process may involve the sale of the entire *rahn* asset or only a portion thereof, depending on the outstanding liability. The pledgee has the right to claim proceeds from the liquidation to settle the debtor's liabilities, with any surplus returned to the debtor and any shortfall remaining the debtor's obligation. In cases where the liquidation proceeds fall short of the total liability, the pledgee may either demand the outstanding balance from the debtor or waive their right to claim it.

The classical scholarly perspectives, AAOIFI standards, and BNM policy document on *Rahn* collectively underscore the importance of structured and equitable mechanisms for managing the *rahn* asset in the event of liquidation or disposal or *rahn* assets. While classical jurists focus on jurisprudential foundations of the right of disposal, AAOIFI and BNM provide practical and actionable guides to operationalize these principles in contemporary financial systems. Key areas of convergence include the conditional nature of the creditor's right of disposal, which arises only upon default, and the necessity of obtaining prior authorization or consent for liquidation, ensuring respect for the debtor's property rights. Additionally, the allocation of proceeds from the liquidation process prioritizes the settlement of the creditor's claims while safeguarding the debtor's residual entitlements.

2.3.6.3 Arrangement of Rahn with Other Contracts

The integration of the *rahn* contract with other Islamic financial contracts is governed by specific principles and conditions to ensure compliance with *Sharīʿah* requirements.

(i) The Application of *Rahn* with Permissible Sale-Based Contracts

Rahn is effectively utilized alongside permissible sale-based contracts such as *murabahah*, *tawarruq* and other equivalent contracts. These arrangements are designed to secure creditors' rights while adhering to *Sharīʿah* principles, ensuring fairness and transparency in financial transactions. This is supported by SAC of BNM, in its BNM Policy Document on *Rahn* :

> 19.2 The collateral provided under a *rahn* contract may be liquidated to recover any outstanding debt amount arising from sale-based contracts like murabahah, *tawarruq*, or bai' inah. This provision ensures that creditors have recourse to the pledged asset in the event of default, thereby mitigating risks associated with non-repayment.

AAOIFI also highlighting in its AAOIFI *Sharīʿah* Standard No. 39, Para 3/3/1:

> The debt secured by *rahn* must arise from a permissible transaction, such as income from a sale, compensation for damages, or deferred payment obligations in contracts like *salam* or *istisnā"*. It is permissible to execute a *rahn* contract either before, simultaneously with, or after the establishment of the debt. However, the debt must not stem from impermissible sources, such as usurious loans (*ribā*), or non-debt arrangements like spot sales where the commodity remains in the seller's possession.

This underscores the compatibility of *rahn* with sale-based contracts, provided the underlying debt is lawful and the terms of the *rahn* are clearly defined. By securing creditors' rights through collateralization, *rahn* enhances the enforceability of sale-based contracts while maintaining adherence to *Sharīʿah* principles.

(ii) The Application of *Rahn* with Equity-Based Contracts (*Mushārakah*, *Muḍārabah*, Wakalah bi al-Istithmar)

Jurists hold that the application of *rahn* (رَهْن) in equity-based contracts such as *mushārakah* (مُشَارَكَة), *muḍārabah* (مُضَارَبَة), and wakalah bi al-istithmar (وَكَالَة بِالِاسْتِثْمَار) is subject to stricter conditions due to their trust-based nature. These contracts are fundamentally designed to emphasize profit-and-risk sharing, making the introduction of *rahn* a sensitive issue that requires careful consideration. Specifically, elements such as guaranteeing capital or profit are prohibited in equity-based contracts, as they undermine the principles of shared risk and mutual trust. To address these concerns, scholars and regulatory bodies have established clear guidelines to ensure that the use of *rahn* does not conflict with the foundational principles of these contracts.

One key principle is that *rahn* should not be used to guarantee capital or profits in equity-based contracts. For instance, the BNM Policy Document (2018) on *Rahn* explicitly states:

> 23.1: A *rahn* contract shall not be arranged in a *muḍārabah*, musyarakah, or wakalah bi al-istithmar contract to guarantee the capital or profit.

Similarly, the AAOIFI (2020) *Sharīʿah* Standard No. 39 para 3/3/2 reinforces this stance, stating:

> 3/3/2 It is impermissible to stipulate mortgage as a condition in trust-based contracts such as agency, deposit, *Mushārakah*, *Muḍārabah* and leasing contracts…

Despite this general prohibition, both frameworks recognize that *rahn* may be permissible under specific circumstances where it serves as a safeguard against misconduct, negligence, or breach of contract of the contracting parties. For instance, the BNM Policy Document outlines exceptions as follows:

> 23.2 Notwithstanding paragraph 23.1, if–
> (a) the rabbul mal (capital provider) takes collateral from the mudarib (entrepreneur) in *muḍārabah*;
> (b) any partner is required to provide collateral in musyarakah; or
> (c) the muwakkil takes collateral from the wakil (agent),the collateral can only be liquidated in the event of losses due to misconduct, negligence or breach of specified terms of contract by the mudarib, partner(s) or wakil.

The AAOIFI *Sharīʿah* Standard No. 39, Para 3/3/2 further elaborates on this principle, clarifying: AAOIFI *Sharīʿah* Standard No. 39,

> …If mortgage in such contracts is to be confined to indemnity in case of transgression, negligence or breach of the contract, then it is permissible.

These guidelines reflect the delicate balance between securing creditors' rights and preserving the trust-based nature of equity contracts. By restricting the use of *rahn* to cases of misconduct or negligence, the frameworks uphold the foundational principles of *Mushārakah*, *Muḍārabah* and Wakalah which not capital guaranteed while providing limited recourse for accountability.

In conclusion, the arrangement of *rahn* with other contracts underscores its versatility as a security mechanism while highlighting the critical importance of adhering to *Sharīʿah* principles. In sale-based contracts, such as murabahah, *tawarruq*, and their equivalents, *rahn* is widely applicable and serves as a robust tool for securing debts arising from these transactions. Regulatory frameworks like those of the Bank Negara Malaysia (BNM) and the Accounting and Auditing Organization for Islamic

Financial Institutions (AAOIFI) provide clear guidelines to ensure the legitimacy and enforceability of *rahn*, thereby enhancing creditors' rights while maintaining compliance with *Sharīʿah* requirements. In contrast, the application of *rahn* in equity-based contracts, such as *mushārakah* , *muḍārabah*, and wakalah bi al-istithmar is more restricted, being permitted only in exceptional cases involving misconduct, negligence, or breach of terms. This limitation preserves the trust-based nature of these contracts, ensuring that *rahn* does not undermine their foundational principles of risk-sharing. By understanding these distinctions and adhering to the prescribed conditions, Islamic financial institutions can effectively utilize *rahn* to enhance security while upholding the legal standards of *Sharīʿah* compliance.

2.3.6.4 Ranking of Debt Priorities Among Multiple Pledgees

In certain scenarios, the same collateral may be pledged to secure multiple debt obligations. This raises the question of how to prioritize claims among creditors in the event of default or insolvency, particularly when the pledged asset must be liquidated to repay outstanding debts. Such arrangements are structured through agreements that establish a hierarchy of claims, often referred to as the "waterfall principle." Under this principle, secured creditors have priority over unsecured creditors, and within each category, claims are settled in a predetermined order based on the terms of the contracts.

From a *Sharīʿah* perspective, the prioritization of debt claims among creditors is permissible under specific conditions. The general principle in Islamic jurisprudence is that all creditors are treated equally (pari passu). This position is supported by the following evidences:

على اليد ما أخذت حتى تؤديه

The person remains liable for what he took until he returns it back (Ibn Majah, hadith no 2400).

من أخذ أموال الناس يريد أداءها أدى الله عنه ومن أخذ يريد إتلافا أتلفه الله

Whoever takes the money of people with the intention of repaying it, Allah will repay it on his behalf, and whoever takes it in order to spoil it, then Allah will spoil him (Al-Bukhari, hadith no 2387).

Based on the above hadiths, it can be said that all liabilities of creditors are considered equal in terms of their eligibility to being repaid. Nevertheless, Muslim jurists have discussed in the case of liquidation, certain creditors can be given priority over others in certain situations. For example, the seller sells an asset to the buyer who has subsequently been declared as bankrupt after the conclusion of the sale contract. In this case, the seller would be given choice either to reclaim the asset or to leave it. Should the seller choose to reclaim the asset, he will have priority over all creditors with regard to that particular commodity. Otherwise, should he choose not to reclaim it, he will be ranked pari passu with the other creditors of the insolvent party.

Contemporary *Sharīʿah* standards and regulatory frameworks have provided clear guidelines on the ranking of debt priorities among multiple pledgees including AAOIFI and SAC of BNM. AAOIFI (2020) has allowed the practice of ranking of debt priorities among the creditors in its *Sharīʿah* Standard no 39 on Mortgage and its Contemporary Applications, 3/2/3 which provides that:

> The same asset can be mortgaged to more than one mortgagee. If all the mortgagees are of the same rank the consent of all the parties has to be sought, and the mortgage right in the asset is to be shared among them in proportion to their respective debts. If the mortgages are ranked in such a way that a succeeding mortgagee should get his debt repaid only when his precedent mortgagee does, the consent of the succeeding mortgagee alone has to be sought.

Additionally, SAC of BNM also adopting the same approach as stated in its Policy Document of *Rahn* (2018):

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

Thus, in this case of ranking of debt priorities among the multiple creditors where the senior creditors will receive debt amount first in preference is accepted from the Shari'ah perspective so long as the consent from the junior creditors is sought. There is no Shari'ah objection to the above arrangement where all debt obligations are ranked based on priority amongst its creditors. Furthermore, the senior and junior creditors are aware of the disclosure made in the relevant agreements mutually agreed among them on this arrangement in relation to collateral arrangement. This mutual agreement is based on the concept of taradi (mutual consent) as per mentioned in the following verse (Al-Nisa': verse 29):

يا أَيُّهَا الَّذينَ آمَنوا لا تَأكُلوا أَموالَكُم بَينَكُم بِالباطِلِ إِلّا أَن تَكونَ تِجارَةً عَن تَراضٍ مِنكُم وَلا تَقتُلوا أَنفُسَكُم إِنَّ اللَّهَ كانَ بِكُم رَحيمًا

... O ye who believe! eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual good-will: nor kill (or destroy) yourselves: for verily God hath been to you Most Merciful (Yusuf Ali, 2025)

2.4 OTHER TYPES OF UQŪD TAWTHĪQĀT (SECURITY CONTRACTS)

In the preceding sections, we extensively explored the *rahn* contract, delving into its intricacies. Now, our attention turns towards investigating additional types of security contracts, known as *ʿuqūd tawthīqāt*, apart from *rahn*. Specifically, the study will examine the contracts of *kafālah, ḍamān*, and *ḥawālah*, comparing and contrasting their characteristics with one another and with the *rahn* contract. The objective is to gain a comprehensive understanding of these contracts and assess their suitability within the realm of Islamic security arrangements, particularly in the context of Islamic financing. This analysis plays a crucial role in establishing the conceptual framework of Islamic security contracts, laying the groundwork for this study.

2.4.1 Contract of *Kafālah*

This section will explore the contract of *kafālah*, focusing on its definition, legality, components, and key requirements.

2.4.1.1 Definition

Literal Meaning

The root word for *kafālah* is kafala, which means "to guarantee," "to take responsibility," or "to support" (Ibn Manẓūr, 1993).

In the Quran, the term is used in *Sūrah* Al-Imran (3:37):

…وَكَفَّلَهَا زَكَرِيَّا

" to the care of Zakariya was she assigned" (Yusuf Ali, 2025)

The phrase "wa kaffalahā" has been interpreted in two ways: one reading emphasizes divine entrustment, while the other highlights voluntary care. According to Makkiy as cited by Ibn Manẓūr (1993), these two readings are interconnected. The former implies that Allah entrusted Maryam to Zakariya, obligating him to support her, while the latter suggests that Zakariya voluntarily took Maryam under his care with divine will and ability.

Technical Meaning

Islamic jurists provide distinct definitions of *kafālah* based on their schools of thought:

Ḥanafī scholars (*Al-Kāsānī*, 2003; *Al-Sarakhsī*, 2001) define *kafālah* as follows:

ضم ذمة الكفيل إلى ذمة الأصيل في المطالبة بنفس أو عين أو دين

"A contract where the guarantor's liability is conjoined with the guaranteed person's liability in terms of right of demand against a person (*nafs*), or delivery of asset (*ʿayn*) or debt payment (*dayn*)"

Meanwhile, the famous definition of *kafālah* by the *Mālikī*, *Shāfiʿī* and *Ḥanbalī* scholars (*Al-Sharbīnī*, 2000) is:

أن يلتزم الرشيد بإحضار بدن من يلزم حضوره في مجلس الحكم

"The binding undertaking (*iltizām*) of the prudent guarantor to guarantee the physical attendance of a person (guaranteed party) before a court".

The differences in opinion among jurists regarding the terms *kafālah* primarily arise from the varying definitions they provide for these concepts. These differences reflect the schools' distinct approaches to categorizing and applying *kafālah* in financial and legal contexts:

(a) *Ḥanafī* School: The *Ḥanafī* jurists adopt a broader understanding of *kafālah*, considering it applicable to both personal guarantees (wujūh) and financial guarantees (*māl*). For them, *kafālah* encompasses any form of guarantee, whether related to a person or a financial obligation.

(b) *Mālikī* School: In contrast, *Mālikī* jurists prefer using the term *ḍamān* for both personal and financial guarantees. They view *ḍamān* as a more comprehensive term that can cover all forms of liability, including those involving individuals or assets.

(c) *Shāfiʿī* and *Ḥanbalī* Schools: These schools differentiate between *kafālah* and *ḍamān*, applying *kafālah* specifically to personal guarantees (e.g., ensuring the attendance of an individual) and reserving *ḍamān* for financial guarantees (e.g., ensuring the repayment of a debt). This distinction reflects their emphasis on clarity and specificity in contractual terminology.

These differing definitions highlight the schools' unique perspectives on the scope and application of guarantees. While the *Ḥanafī*s emphasize flexibility and inclusiveness, the *Shāfiʿī*s and *Ḥanbalī*s prioritize precision and categorization. Despite

these variations, the underlying principles of shared liability and mutual responsibility remain consistent across all schools.

In conclusion, the terminological differences between *kafālah* and *ḍamān* do not significantly impact the detailed rulings for both categories. For the purpose of this study, the terms *kafālah* and *ḍamān* will be used interchangeably to encompass the guarantee of financial rights, where a guarantor ensures the payment of the debtor's obligation to the creditor. Other types of guarantees, such as personal guarantees, will be excluded from this discussion.

2.4.1.2 Legality

The permissibility of *kafālah* is firmly established in Islamic jurisprudence, drawing its legitimacy from the Quranic verse, Hadīth, and the consensus (ijmāʿ) of Muslim jurists as the following:

1) Quranic verse:

   The permissibility of the *kafālah* may derive from the following Quranic verses:

   i. The verse no 66 of *Sūrah* Yusuf in the Quran reads:

   قَالَ لَنْ أُرْسِلَهُ مَعَكُمْ حَتَّىٰ تُؤْتُونِ مَوْثِقًا مِنَ اللَّهِ لَتَأْتُنَّنِي بِهِ إِلَّا أَنْ يُحَاطَ بِكُمْ ۖ فَلَمَّا آتَوْهُ مَوْثِقَهُمْ قَالَ اللَّهُ عَلَىٰ مَا نَقُولُ وَكِيلٌ

   Meaning: (Jacob) said : " Never will I Send him with you until Ye swear a solemn oath to me, In God's name, that ye Will be sure to bring him back To me unless ye are yourselves Hemmed in (and made powerless)." And when they had sworn Their solemn oath, He said : " Over all That we say, be God The Witness and Guardian!" (Yusuf Ali, 2025)

   ii. Another verse no 72 in *Sūrah* Yusuf reads:

   قَالُوا نَفْقِدُ صُوَاعَ الْمَلِكِ وَلِمَن جَاءَ بِهِ حِمْلُ بَعِيرٍ وَأَنَا بِهِ زَعِيمٌ

Which means, “They said : “ We miss the great beaker of the king ; For him who produces it, Is (the reward of) A camel load ; I Will be bound by it.” (Yusuf Ali , 2025)

This verse demonstrates the concept of assuming responsibility or guaranteeing an obligation, which aligns with the principles of *kafālah*. The phrase "I will be bound by it" reflects the idea of personal accountability and commitment, which are foundational to the concept of guarantees in Islamic law. Ibn Kathir (1999) explains that this declaration reflects a solemn commitment to fulfilling promises and obligations in Islam. This aligns seamlessly with the essence of *kafālah*, where one assumes responsibility for another’s obligation, ensuring the protection of rights and the fulfillment of duties (Vol. 3, p. 345). Similarly, Al-Qurtubi (1967) emphasizes that *kafālah* plays a pivotal role in upholding justice, as it ensures that individuals honor their commitments and protect the interests of others.

2) Hadīth:

Al-Bukhārī also narrated that the Prophet (pbuh) came to the funeral of a man to pray on his soul. He asked those present: “did he leave any wealth?”, they said “No” Then he asked, “did he die with any debts outstanding?”, and they said “yes, he owed two Dinars”. The Prophet (pbuh) was thus about to leave and said “then you pray on your companion”. At that time, Abu Qatadah said: “I guarantee his debt, Oh Messenger of Allah”, and the Prophet (pbuh) prayed on his soul (Ṣaḥīḥ Al-Bukhārī, (2002) Book of Funerals, Hadith No. 1386).

The hadith elucidates the seriousness of debt in Islam. Ibn Hajar al-Asqalani (1989) explained that the Prophet’s (peace be upon him) reluctance to lead the funeral prayer was not punitive but a teaching moment, emphasizing the need to resolve debts before death. This highlights accountability and the ethical duty to fulfill financial obligations. Abu Qatadah’s guarantee of debt reflects the concept of *kafālah* (guarantee), which *Ibn Qudāmah* (1997), stressing its role in protecting creditors’ rights and fostering community

trust. Additionally, Imam Nawawi (1996), in his commentary on Ṣaḥīḥ Muslim, notes the spiritual implications, as unresolved debts can suspend a believer's soul until settled, reinforcing the urgency of resolving debts promptly and justly.

3) Ijmaʿ:

There is also a consensus among Muslim jurists that the *kafālah* is permissible. This is due to dire need for such contracts in financial dealings, and to protect debtors (Al-Shirbīni, 2000; *Al-Sarakhsī*, 2001; Ibn Qudāmah, 1997).

To summarize, the validity of the *kafālah* contract is supported by the Quran, Sunnah (hadith), and the consensus of Muslim jurists. This consensus reinforces the Islamic view that the *kafālah* contract is permissible. However, it is important to note that different jurists may hold diverse opinions and interpretations regarding the specific requirements and elements necessary for a *kafālah* contract to be considered valid and enforceable.

2.4.1.3 Categories of Kafālah

Jurists classify *kafālah* into two categories: *kafālah bil-nafs* and *kafālah bil-māl*.

(a) *Kafālah bil-nafs* (personal guarantee):

Kafālah bil-nafs pertains to guarantees that involve the physical presence or attendance of an individual. In the *Ḥanafī* school, it is defined as the guarantor bringing the guaranteed party before the beneficiary (Al-Marghīnāni, 2000; Ḥammad, 2015). *Mālikī* and *Shāfiʿī* scholars share a similar understanding, with *Mālikī* scholars using the term *ḍamān bil-nafs*. They describe it as a commitment from the guarantor to present the guaranteed party to the beneficiary at a specified time (Al-Dardir, 1999; Al-Shirbīni, 2000). This highlights the guarantor's role in ensuring compliance with personal

responsibilities. For example, if a debtor must appear in court or fulfill an obligation, a guarantor may assume *kafālah bil-nafs* (personal surety) to guarantee adherence.

(b) *Kafālah bil-māl* (financial guarantee):

Kafālah bil-māl relates to guarantees associated with financial obligations, such as ensuring the repayment of debts or compensating for damaged or lost assets (Al-Zuhyali, 2003). This type of guarantee is widely used in Islamic financial transactions to safeguard the rights of creditors and promote trust in economic dealings. *Kafālah bil-māl* also known as guarantees associated with financial obligations. It encompasses assurances related to wealth, including the repayment of loans, settlement of liabilities, or compensation for damages (*Al-Kāsānī*, 2003). For instance, if a debtor defaults on a loan, the guarantor under *Kafālah bil-māl* assumes responsibility for fulfilling the financial obligation on behalf of the debtor. This ensures that the creditor's rights are protected, even in cases of default.

These two types of guarantees, *kafālah bil-nafs* and *kafālah bil-māl*, represent distinct aspects within the concept of guarantees. *Kafālah bil-nafs* focuses on ensuring the physical presence of individuals, while *kafālah bil-māl* is concerned with financial obligations and safeguarding wealth.

2.4.1.4 Essential Components of Kafālah

The components of the *kafālah* contract are categorized differently by jurists, reflecting variations in their interpretations and methodologies. While the majority of jurists (*Mālikī*, *Shāfiʿī*, and *Ḥanbalī* scholars) identify several essential elements, *Ḥanafī* scholars adopt a more streamlined approach.

According to the majority of jurists (*Mālikī*, *Shāfiʿī*, and *Ḥanbalī* scholars), the *kafālah* contract consists of the following essential components (Ibn Juzay (1979), Al-Shirbīnī (2000):

(i) The guarantor (kafīl)

(ii) The underlying liabilities (guaranteed right)

(iii) The guaranteed party (debtor)

(iv) The contract language (offer of guarantee)

In contrast, *Ḥanafī* scholars (Ibn ʿĀbidīn, 2003) maintain that a guaranteed contract consists of two components (i) the offer of the guarantor and (ii) the acceptance by the debtor. The subsequent discussion will examine each of these components in detail.

(i) Requirements of the guarantor (kafīl)

The term "guarantor" (*kafīl*) refers to a party that shares joint liability with the guaranteed party for a debt obligation (Ahmad, 2019). *Al-Zuḥaylī* (2003) outlined two main conditions for a guarantor, as stated by *Al-Kāsānī* (2003), Al-Dardir (1119), Al-Shirbīni (2000), and Ibn Qudāmah (1997).

a) The eligibility of the guarantor party to make voluntary contributions (*ahl al-tabarru'*) is a fundamental requirement agreed upon by Muslim jurists. This consensus stems from the understanding that *kafālah* is an act of benevolence. As a result, it is deemed invalid for an unqualified individual, such as a child or someone with mental incapacity, to provide a guarantee. Additionally, *Shāfiʿī* scholars emphasize that the guarantor should be a person of good religious standing (*Al-Zuḥaylī*, 2003).

b) The guarantor must be an independent individual capable of entering into a *kafālah* contract. Therefore, a slave cannot initiate this contract since they are unable to make voluntary contributions without their master's permission. However, if the guarantee is established before a person becomes a slave, the obligations of the *kafālah* contract may still apply upon their attainment of freedom (*Al-Zuḥaylī*, 2003).

In addition to the mentioned conditions, the guarantor must fulfill the minimum criteria applicable to contracting parties, which include having a sound mind, reaching the legal age, and being a competent party (*Al-Kāsānī*, 2003; Al-Dardir, 1119; Al-Shirbīni, 2000; Ibn Qudāmah, 1997).

(ii)Requirements of the underlying liabilities

The requirement for the underlying debt in a guarantee contract to be established has been a subject of debate among jurists. The majority view held by *Mālikī*, *Shāfiʿī*, and *Ḥanbalī* scholars (Ibn ʿĀbidīn, 2003; Al-Dusūqī, 1815; Al-Qalyubi, 1995; Ibn Qudāmah, 1997) is that a specific debt amount and nature are not necessary for a guaranteed contract, as it falls under the category of charitable contracts. This means that the element of the unknown is considered an exception in charitable contracts, similar to acts of *nazr*. However, *Ḥanbalī* scholars impose a stricter requirement, stating that an unknown debt should have a specified amount (Ibn Qudāmah, 1997). On the other hand, some *Shāfiʿī* scholars argue against guaranteeing an unknown debt, emphasizing that the guarantor should be aware of the debt to fulfill their obligations accurately (Al-Qalyubi, 1995).

The differing opinions among jurists reflect ongoing debates regarding the requirement for a specified debt in a guarantee contract. While the majority view accepts the validity of guaranteeing unspecified debts as an exception in charitable contracts, the opposing view highlights the importance of the guarantor's awareness of the guaranteed amount to fulfill their obligations accurately.

(iii) Requirements of the guaranteed party (debtor)

According to *Ḥanafī* and some *Shāfiʿī* jurists (*Al-Kāsānī*, 2003; *Al-Sarakhsī*, 2001, Qalyubi, 1995), it is a requirement for a valid *kafālah* contract that the guarantor knows the debtor. They argue that it is not permissible for a guarantor to guarantee someone unknown to them since the essence of the *kafālah* contract is to secure debt payment in case of the debtor's failure. They also argue that the *kafālah* contract involves ownership and cannot occur without a proper offer and acceptance.

On the contrary, *Mālikī*, *Shāfiʿī*, and *Ḥanbalī* jurists (Al-Dusūqī, 2000, Qalyūbi, 1995, Ibn Qudāmah, 1997) maintain that knowing the guaranteed party is not necessary for a *kafālah* contract. They argue that the debtor's consent is not required, citing a *hadith* where Prophet Muhammad (pbuh) allowed guaranteeing the debt of a deceased

person without prior knowledge of them. It is important to note the differing opinions among jurists regarding the requirement for the guarantor to know the debtor, stemming from different understandings of principles and textual evidence.

The differing opinions among jurists regarding the requirement for the guarantor to know the debtor stem from their interpretations of the principles underlying *kafālah*, which can be viewed through two primary perspectives. The first emphasizes practical considerations, such as familiarity and accountability, to ensure the enforceability of the contract, as argued by *Ḥanafī* and some *Shāfiʿī* jurists who believe knowledge of the debtor is essential to assess reliability and feasibility. In contrast, the second perspective highlights the charitable and benevolent nature of *kafālah* , prioritizing flexibility and inclusiveness, as *Mālikī*, *Shāfiʿī*, and *Ḥanbalī* jurists argue that knowing the debtor is unnecessary, allowing guarantees even for unknown or deceased individuals to promote social solidarity and support. These contrasting views reflect a balance between practicality and benevolence, showcasing how Islamic jurisprudence adapts to diverse contexts while upholding justice and community welfare.

(iv) Requirements of the contract language (offer of guarantee)

Regarding the requirement for contract language in guarantee contracts, opinions differ among jurists. The *Mālikī*s, *Ḥanbalī*s, the most preferred view among *Shāfiʿī*s, and Abu Yusuf argue that the conclusion of a guarantee contract is fulfilled through the offer alone, without requiring acceptance from the debtor. This is because *kafālah* is seen as a binding commitment on the part of the guarantor to settle the debt on behalf of the guaranteed party, without the need for consideration as an act of benevolence. Some scholars also support this view by citing the analogy of the *hadith* of Abu Qatadah, where the offer of guaranty alone was sufficient to establish it (*Al-Zuḥaylī*, 2003).

On the other hand, the view of Abu *Ḥanafī* and Muhammad holds that a guarantee contract requires both an offer from the guarantor and acceptance from the debtor (Ibn Abidin, 2000). These differing views reflect the different interpretations of jurists on the requirement for contract language in guarantee contracts. It is important to consider these perspectives when examining the formation and validity of such

contracts, and further scholarly discussions may contribute to a deeper understanding of this topic within specific legal contexts and reasoning behind each viewpoint. From this perspective, the absence of acceptance from the debtor could lead to ambiguity or disputes, undermining the enforceability of the contract. By requiring both offer and acceptance, the *Ḥanafī* approach seeks to safeguard the interests of all parties involved.

2.4.1.5 Conclusion

The discussion on *kafālah* highlights its critical role in Islamic jurisprudence as a mechanism for ensuring security and fulfilling obligations. *Kafālah* involves a guarantor assuming responsibility for the debtor's obligations, whether in terms of personal presence (*kafālah bil-nafs)* or financial liabilities (*kafālah bil-māl*). Its permissibility is firmly rooted in the Quran, Sunnah, and the consensus (*ijmāʿ*) of Muslim jurists, reflecting its alignment with principles of justice and fairness. By enabling a third party to guarantee obligations, *kafālah* enhances transactional security, mitigates risks for creditors, and fosters confidence in financial and personal dealings. Essential elements—such as the guarantor, guaranteed party, beneficiary, and clear contractual terms—ensure enforceability and accountability, while requirements for legal capacity and mutual consent reinforce its reliability. Overall, *kafālah* exemplifies the practicality and adaptability of Islamic law, offering a robust framework for securing rights

2.4.2 Concept of *Ḍamān*

2.4.2.1 Definition

(i) Literal Meaning

The term *ḍamān* in Arabic literally means "binding undertaking" (iltizām) (Al-Shirbīnī, 2000). It conveys the idea of assuming responsibility or liability, reflecting the essence of guarantees in Islamic jurisprudence.

(ii) Technical Meaning

According to Al- Shawkānī, *ḍamān* refers to joint responsibilities in a debt. Similar definition is explained by the *Ḥanbalī* scholar (Ibn Qudāmah, 1997) whereby there is an established responsibility in the guaranteed right since the obligation of the guarantor is joined to the obligation of the guaranteed person. In addition, it is defined as an obligation to a fixed right in another's debt or another's right (*Al-Sharbīnī*, 2000; ʿUllaysh, 1984)

Nonetheless, many jurists interpret the term *ḍamān* to mean bearing the burden, liability, or responsibility in the event of the destruction of goods sold, and they consider this a requirement for the validity of a sale after purchase (Abdul Razak, et.al., 2017).

It is important to note that while *ḍamān* has its own distinct technical definitions, it is often used interchangeably with *kafālah* in many contexts, particularly when referring to guarantees of financial rights. Given this overlap, the discussion of *ḍamān* will not be elaborated in detail here, as it has been extensively covered under the concept of *kafālah* in previous sections.

2.4.2.2 Legality

Muslim jurists are unanimously agreed on the general permissibility of *ḍamān*, although they have different views on its types and categories. Muslim scholars unanimously agreed that the *ḍamān* contract is permissible from the *Sharīʿah* perspective (Ibn Qudāmah, 1997; *Al-Sharbīnī*, 2000; Al-Qarāfī, 1994; *Al-Sarakhsī*, 2001). The legitimacy of *ḍamān* contract is based on the Quran, Sunnah, and Muslim jurists' consensus which consequently bring to one standpoint of Islam that the *ḍamān* contract is lawful. However, there are diverse opinions and perspectives on the elements and components that constitute such legal and enforceable *ḍamān* contract.

2.4.2.3 Types of Ḍamān

Ḍamān is categorized into three main types, as outlined by Naim (2016):

1. Damān al-ʿaqd (Contractual Liability): This form of guarantee refers to obligations that emerge directly from a contractual agreement. Such a guarantee is commonly associated with binding financial or commercial transactions.
2. Damān al-itlāf (Liability Due to Damage): This type of guarantee is linked to responsibilities that result from causing harm or damage. It is generally applicable in scenarios where damage to a party's property or interests leads to a financial obligation.
3. Damān al-yadd (Trust-Based Liability): This category of guarantee is connected to the duty arising when one is in a position of trust concerning another's assets. This liability is often relevant in fiduciary relationships or situations involving custody or care of property.

These types of *ḍamān* highlight its versatility in addressing various forms of liability, ensuring fairness and accountability in both personal and financial matters. However, as previously mentioned, the detailed discussion of these aspects will not be detailed here, as they overlap significantly with the earlier analysis of *kafālah*.

2.4.2.4 Component of Ḍamān

Majority jurists of *Mālikī*, *Shāfiʿī* and *Ḥanbalī* (Al-Shirbīni, 2000) hold that components of the *ḥawālah* can be categorised into six parts as follows:

(i) A guarantor (*ḍāmin*);
(ii) Guaranteed party (i.e., debtor);
(iii) Beneficiary;
(iv) A guaranteed right (underlying liabilities); and
(v) Contract language (the offer of guarantee).

These components shall not be elaborated further here. However, given the substantial overlap between *ḍamān* and *kafālah*, a detailed discussion of these

components has already been provided under the section on *kafālah*, ensuring clarity and avoiding redundancy.

2.4.2.5 Conclusion

The discussion on *ḍamān* highlights its integral role as a mechanism closely aligned with *kafālah*, particularly in the context of financial guarantees. *Ḍamān* refers to the assumption of liability for a debt or obligation, often overlapping with *kafālah bil-māl* (financial guarantee). Its permissibility is firmly established in Islamic jurisprudence, supported by the Quran, Sunnah, and the consensus (*ijmāʿ*) of scholars. While *ḍamān* emphasizes direct financial liability, its essential components and requirements—such as the guarantor, guaranteed party, and clear contractual terms—are largely encompassed within the broader framework of *kafālah*. In this study, *ḍamān* and *kafālah* will be used interchangeably in the context of financial guarantees, as both mechanisms aim to ensure the fulfillment of obligations, enhance transactional security, mitigate creditor risk, and reinforce trust in financial dealings.

2.4.3 Concept of *Ḥawālah*

This research will explore the concept of *ḥawālah*, including its definition, legality, components, and requirements.

2.4.3.1 Definition

(i) Literal Meaning

The term *ḥawālah* literally means "transfer" or "change" in Arabic (Ibn Manẓūr, 1993). This reflects the essence of the concept, which involves the shifting of liability or rights from one party to another.

(ii) Technical Meaning

According to *Ḥanafī* scholars (*Al-Kāsānī*, 2003), *ḥawālah* is defined as the transfer of liability for a debt from one person (debtor) to another person who becomes liable as specified in the contract. Scholars from the *Mālikī*, *Shāfiʿī*, and *Ḥanbalī* schools also provide similar definitions of *ḥawālah* as the transfer of debt from one party to another (Al-Ḥaṭṭāb, 1992; *Al-Sharbīnī*, 2000; *Al-Ramlī*, 1984).

While the technical definitions across schools of thought are largely consistent, slight variations exist in their interpretations of the conditions and applications of *ḥawālah*. These differences will be explored further in subsequent sections under discussion of its components.

2.4.3.2 Legality

The permissibility of *ḥawālah* is derived from the *ḥadīth* (sayings and actions of Prophet Muhammad (pbuh) and the consensus of Muslim jurists.

a) Hadith

The permissibility of *ḥawālah* is supported by the following hadith:

مطل الغني ظلم، فإذا أتبع احدكم على ملئ فليتبع

> Procrastination (delay) in repaying a debt by a wealthy person is injustice. If one of you transfers a debt to another who is solvent, let him do so." (Ṣaḥīḥ Al-Bukhārī, Book of Obligations (Kitāb al-Dayn), Chapter on Transferring Debt (Ḥawālat al-Dayn, 2287).

This hadith underscores the importance of facilitating debt repayment through mechanisms like *ḥawālah*, particularly when the original debtor is unable to fulfill their obligation.

b) Consensus of the Muslim jurists (*ijmāʿ*)

Muslim jurists are unanimously agreed on the general permissibility of *ḥawālah*, although they have different views on its types and categories (*Al-Sharbīnī*, 2000; Ibn Qudāmah, 1997; *Al-Buhūtī*, 1997).

The legality of the *ḥawālah* contract is established based on the Sunnah (teachings and practices of Prophet Muhammad), and the consensus of

Muslim jurists, leading to a unified stance in Islam that the *ḥawālah* contract is permissible. However, there exist varying opinions and viewpoints regarding the specific elements and components that make up a valid and enforceable *ḥawālah* contract.

2.4.3.3 Types of Ḥawālah

According to AAOIFI (2017) , the contract of ḥawālat al-dayn involves a clear offer (ijābah) from the transferor (muḥīl)—who seeks to transfer the debt—and an acceptance (qabūl) by the transferee or payer (muḥāl ʿalayhi), signifying mutual consent and intent to transfer the liability for the debt. This process ensures transparency and adherence to the principles of fairness and justice in financial dealings. Furthermore, ḥawālat al-dayn is contingent upon the debtor's consent, as the transfer of liability may affect their obligations or relationship with the original creditor.

Khan (2010) further elaborates on the distinctions between the two types of *ḥawālah*. He explains that *ḥawālat al-dayn* is typically used when the debtor wishes to delegate their payment obligation to a third party, whereas *ḥawālat al-ḥaqq* is employed when the creditor transfers their right to receive payment to another party. Khan emphasizes that *ḥawālat al-dayn* requires explicit consent from all parties involved, including the debtor, to ensure fairness and avoid disputes. In contrast, *ḥawālat al-ḥaqq* does not necessarily require the debtor's consent, as it primarily involves the transfer of the creditor's rights rather than the debtor's obligations.

Contemporary scholars have further explored the distinctions and applications of these two types of *ḥawālah*. For instance, Usmani (2002) explains that *ḥawālat al-dayn* is particularly suited for modern Islamic finance because it allows for the restructuring of debts and enhances liquidity management. He highlights that this type of *ḥawālah* aligns with the broader objectives of Islamic law (*Maqāṣid al-Sharīʿah*), such as promoting economic stability and equitable dealings. Similarly, Abu Ghuddah (2006) underscores that ḥawālat al-dayn facilitates smoother transactions and reduces counterparty risks, making it especially relevant for debt-based contracts.

Overall, *ḥawālat al-dayn* serves as a vital tool for enhancing liquidity management and risk mitigation in Islamic finance. By enabling the transfer of debt obligations, it facilitates smoother transactions, reduces counterparty risks, and aligns with the broader objectives of Islamic law to promote economic stability and equitable dealings. In contrast, *ḥawālat al-ḥaqq*, though less frequently addressed in contemporary Islamic finance, remains integral to specific applications, offering flexibility and adaptability in addressing diverse financial needs, such as trade finance and supply chain management.

2.4.3.4 Components of Ḥawālah

The components of *Ḥawālah* are essential to understanding its structure, permissibility, and application in Islamic jurisprudence. These components ensure the validity and enforceability of the contract.

According to the majority of *Mālikī*, *Shāfiʿī*, and *Ḥanbalī* jurists (Al-Shirbīni, 2000), the components of *ḥawālah* can be classified into six parts: (i) the principal debtor or transferor, (ii) the creditor or transferred party, (iii) the transferee or ultimate debtor, (iv) the subject matter (transferred item), (v) a debt owed to the principal debtor by the transferee or ultimate debtor, and (vi) the offer and acceptance (*ṣīghah*).

However, *Ḥanafī* jurists (*Al-Kāsānī*, 2003) consider the components of *ḥawālah* to be limited to the offer by the debtor, acceptance by the transferee, and the creditor's consent. According to this view, the consent of the transferee is required as the contract transfers the liability for the debt to them. This highlights the importance of mutual agreement in ensuring the enforceability of the contract. The detailed components of *Ḥawālah* are outlined in the following section.

2.4.3.5 Requirements of Ḥawālah

(i) Requirement on principal debtor or transferor

The transferor (principal debtor) must meet specific eligibility criteria to engage in the *ḥawālah* contract. This includes being of legal age (bulūgh) and possessing a sound mind (*rashad*). Financial contracts such as *ḥawālah* require sanity and discernment, as they involve significant legal and financial obligations (*Al-Kāsānī*, 2003; Al-Marghīnānī, 2000). Consequently, transfers of debt initiated by mentally incompetent individuals or underage children are considered invalid. In the case of a discerning child (mumayyiz), the transfer is not enforceable unless approved by their guardian (walī), at which point it becomes valid (Ibn Qudāmah, 1997).

(ii) Requirement on creditor or transferred party

Similar eligibility requirements of transferor apply to the creditor (transferred party). The creditor must also be of legal age and possess a sound mind to enter into the *ḥawālah* contract (*Al-Nawawī*, 2003). If the creditor is underage, the approval of their guardian is necessary for the contract to be valid. Furthermore, the majority of *Ḥanafī*, *Mālikī*, and *Shāfi ʿī* jurists emphasize that the consent of the creditor is a prerequisite for the transfer of debt. Without the creditor's explicit consent, the *ḥawālah* contract is deemed nullified (*Al-Sharbīnī*, 2000).

(iii) Requirement on transferee or ultimate debtor

The transferee (ultimate debtor) must also meet the same eligibility criteria as the transferor and creditor. They must be legally competent, meaning they must have reached the age of majority and possess mental capacity (*Al-Sarakhsī*, 2001). These requirements ensure that all parties involved in the *ḥawālah* contract are capable of fulfilling their respective obligations.

(iv) Requirement on the subject matter (transferred item)

Jurists outline several conditions regarding the subject matter of the *ḥawālah* contract, specifically in the form of debt (*Al-Zuḥaylī*, 2003) where the subject matter must indeed be a debt, meaning the transferor must owe a debt to the transferred party. If no existing debt exists, the contract transforms into an agency contract (*wakālah*) rather than a transfer of debt, the debt must be binding to be eligible for transfer. This is the consensus among most jurists, except for the *Ḥanbalī* school of thought. In cases where one debtor replaces another in their relationship with the creditor, the established debt must represent a fungible liability. Jurists unanimously agree on the validity of such transfers of debt, with the transferor acting as the principal debtor and the transferee as the ultimate debtor (AAOIFI, 2020).

In the case of the transfer of rights, where one debtor replaces another in their relationship with the creditor, if the established debt for which one debtor is replaced is a fungible established liability, then the transfer of debt is considered a valid transfer of rights, with the transferor as the principal debtor and the transferee as the ultimate debtor. Jurists unanimously agree on the validity of such transfers of debt.

(v) Requirement on offer and acceptance (ṣīghah)

The *ḥawālah* contract can be completed through verbal or written offers and acceptance (ṣīghah). The process of offer and acceptance must be clear and unambiguous to ensure mutual understanding and agreement between the parties (*Al-Sharbīnī*, 2000). This aligns with the general principles of Islamic contract law, which emphasize transparency and consent in all contractual arrangements.

2.4.3.6 Conclusion

The discussion on *ḥawālah* highlights its profound significance as a mechanism for transferring debt or rights in Islamic jurisprudence, encompassing its definition, legality, types, components, and requirements. Technically, *ḥawālah* refers to the

transfer of liability from one party to another, with applications ranging from simple personal transactions to sophisticated financial products in modern Islamic finance. Its permissibility is firmly rooted in the Sunnah, and the consensus (ijmāʿ) of Muslim jurists, ensuring alignment with core Islamic principles such as justice, transparency, and mutual consent. The two primary types—ḥawālat al-dayn (transfer of debt) and ḥawālat al-ḥaqq (transfer of rights)—demonstrate its versatility in addressing diverse financial needs, from debt restructuring to trade-based financing. By enabling the transfer of debt obligations to a solvent party, *ḥawālah* simplifies complex financial relationships, enhances transactional security, mitigates risks for creditors, and ensures the timely fulfillment of liabilities. The essential components and requirements—such as legal capacity, clarity of terms, enforceability, and the necessity of consent—further reinforce its role in safeguarding the rights of all parties involved. Overall, *ḥawālah* exemplifies the adaptability and practicality of Islamic law, offering a robust tool that not only acts as a security mechanism but also fosters trust, stability, and equitable dealings in financial transactions.

2.5 COMPARISON BETWEEN THE CONTRACTS OF *RAHN*, *KAFĀLAH*, *ḌAMĀN* AND *ḤAWĀLAH*

Based on the preceding sections discussing *rahn* and other equivalent Islamic security contracts—namely *kafālah, ḍamān* , and *ḥawālah* —this study provides a comparative analysis to distinguish their unique characteristics and overlapping features. The comparison between these contracts reveals both similarities and differences in terms of their nature, contracting parties, subject matter, and eligible assets. Below is the comparison:

Table 2.1 Comparison between the contracts of *rahn, kafālah, ḍamān*, and *ḥawālah*

Item	(i)*Rahn*	(ii) *Kafālah*	(iii) *Ḍamān*	(iv) *Ḥawālah*
Nature	Act of as holding an item in lieu of a legal right that may be satisfied from that item to recover the outstanding debt amount	The guarantor conjoining the liability with the guaranteed party. The debt liability of guaranteed party is not absolved.	Applicable for guarantee related to obligations regarding financial assets only.	Transfer of debt liability from the transferor to the transferee.
Contracting Parties	Debtor (*rāhin*) and creditor (*murtahin*)	Guarantor, guaranteed party and beneficiary	Guarantor, guaranteed party and beneficiary	Transferor, transferee and Creditor
Subject Matter	Debt liability and *rahn* asset	Debt payment, delivery of assets or physical attendance	Property/ assets	The debt liability
Eligible Assets	Both tangible and intangible assets. Limited to *Sharīʿah* compliant assets only	Not applicable	Not applicable	Not applicable

Researcher's own

2.5.1 Analysis of the Comparison of Islamic Security Contracts (*ʿUqūd Tawthīqāt*)

The analysis of the comparison between Islamic security contracts - *rahn, kafālah, ḍamān*, and *ḥawālah* - reveals several key points:

a) Each contract serves the primary purpose of securing the creditor's right to receive debt payment. However, they have unique characteristics and requirements based on their specific nature.

b) *Rahn* involves using an item as collateral to recover outstanding debt, while *kafālah* relies on a guarantor's liability to provide assurance for the debt. *Rahn* utilizes valuable property as collateral, which is not the case in *kafālah*. *Rahn* also differs from *ḥawālah*, as it involves using specific assets as security, whereas *ḥawālah* entails the transfer of debt from one person to another.

c) *Kafālah* and *ḍamān* are often regarded as guarantee contracts, though some jurists, particularly *Ḥanbalī* scholars, draw distinctions between them. However, for the purposes of this study, *kafālah* and *ḍamān* will be used interchangeably when discussing financial guarantees, as jurists do not differentiate between them in this context. Both contracts serve the same function of ensuring the fulfillment of financial obligations.

d) The use of assets as security for debt payment is unique to the *rahn* contract and is not required in *kafālah, ḍamān*, or *ḥawālah*. Therefore, discussions regarding security arrangements involving assets or property as collateral are most relevant in the context of the *rahn* contract.

In summary, while these Islamic security contracts share the objective of securing debt payment, their individual characteristics and requirements distinguish them. *Rahn* involves collateralizing specific assets, *kafālah* focuses on the liability of a guarantor, *ḍamān* covers guarantees related to property, and *ḥawālah* centers around the transfer of debt. Understanding these distinctions is essential for comprehending the unique features and applications of each contract.

2.6 CHAPTER SUMMARY

The chapter provides a comprehensive summary of the discussion on the concept of *rahn* in Islamic law, covering its meaning, legality, components, requirements, and related issues based on the perspectives of jurists. The primary focus is on understanding the role of *rahn* in providing security to creditors in cases of debtor default, a feature that is universally accepted by jurists despite variations in definitions among the four schools of Islamic law.

The chapter establishes the legality of the *rahn* contract by citing evidence from the Quran, hadith, and consensus among Muslim scholars. It identifies the essential elements of the *rahn* contract, with most jurists categorizing them as the contracting parties, the debtor (*marhūn*), the *rahn* asset (*marhūn bihi*), and the offer and acceptance (*ṣīghah*). However, *Ḥanafī* scholars consider the offer and acceptance as the sole essential element.

The definition of *rahn* varies among the four schools of thought and scholars, as well as the interpretations provided by *Sharīʿah* organizations. Both classical and modern understandings of *rahn* involve using an asset as collateral for a debt, enabling its use or value to be utilized for debt settlement in case of default. The definition proposed by AAOIFI is more comprehensive, encompassing a broader range of assets and aligning with the complexity of financial instruments and new asset classes in the Islamic banking market.

The requirements of the *rahn* contract differ among jurists, particularly regarding the contracting parties, offer and acceptance, possession and eligibility of *rahn* assets, and the eligibility of underlying liabilities or debt. The chapter also explores the broader concept of Islamic security contracts, which include *rahn, kafālah, ḍamān*, and *ḥawālah* contracts. However, the study prioritizes *rahn* due to its resemblance to modern asset-based security instruments widely used in contemporary finance.

In conclusion, this chapter establishes a foundational understanding of *rahn* within Islamic jurisprudence while touching on complementary security contracts i.e.

kafālah, ḍamān, and *ḥawālah* contracts. It serves as a foundation for further exploration and analysis of security arrangements within the Islamic framework.

CHAPTER THREE

AN OVERVIEW OF MODERN SECURITY INSTRUMENTS AND ASSETS AND THEIR COMPATIBILITY WITH *SHARĪʿAH*

3.1 INTRODUCTION

This chapter addresses the second research question (a) and (b) of this study, focusing on the concept of modern security arrangements under Common law and their compatibility with *Sharīʿah* requirements. The discussion is divided into two parts: the first explores the notions of security instruments and security assets within the Common law framework, while the second examines the compatibility of these arrangements with Islamic finance principles, particularly the *Rahn* contract.

This chapter focuses on exploring the notions of security instruments and security assets within this legal framework. The topic of security or collateral can be divided into two main categories: the security instrument or instrument, and the security asset. The security instrument refers to the contract itself, granting the creditor the right to recover from a specific property pledged as security for a debt. Examples include charges on personal assets or mortgages on real estate. On the other hand, the security asset represents the underlying assets used as collateral in these security instruments. This chapter provides a detailed examination and analysis of these security instruments and assets. It is worth noting that the study specifically concentrates on security instruments and assets in the context of businesses, rather than individuals, due to their wide acceptance in banking practices.

The first part of this Chapter shall delve into the definition of security arrangements, followed by an exploration of the rationale behind their creation. Subsequently, the chapter examines four distinct forms of security instruments recognized in Common law: pledge, lien, mortgage, and charge. These types are examined in terms of their differences, similarities, features, scope, and classification. The study then moves on to discuss permissible security assets, including commonly used security assets in banking practice. Furthermore, the chapter explores concepts related to quasi-security, assignment, and guarantee, along with associated issues.

The second part of the chapter compares modern security instruments like mortgages, charges, pledges, and liens with Islamic security contract, particularly *Rahn*. This comparative analysis evaluates the similarities, differences, and compatibility of these perspectives, offering insights into their potential integration within Islamic banking frameworks. Additionally, the study explores quasi-security instruments that do not involve tangible assets, assessing their alignment with applicable *Sharīʿah* principles. The research findings presented in this chapter serve as a basis for the subsequent sections of the study, shaping the overall direction and focus of the research project.

3.2 HISTORICAL PERSPECTIVE OF SECURITY ARRANGEMENTS

Before delving into the legal and intrinsic nature of security arrangements, it is imperative to understand their historical evolution, as this provides a foundation for appreciating their contemporary applications. According to Smith (1947), the concept of security arrangements in money lending is not a modern phenomenon but rather a deeply entrenched practice that has historically underpinned lending activities across civilizations. Levy (2016) traces the origins of this practice to ancient Sumer in the 30th Century BC during the early to middle Bronze Age, a period marked by the absence of standardized currencies such as coins or banknotes. Instead, societies relied on traditional mediums of exchange, including grains, copper ingots, and silver, to facilitate trade and financial transactions. Loans were formalized through contracts inscribed on clay tablets in the presence of witnesses, with creditors safeguarding their interests through pledges and collateral. Virtually any item of value could serve as collateral, ranging from land and utensils to spouses, children, slaves, and livestock (Levy, 2016; Polanyi, 1957).

The use of collateral in ancient societies was not merely a practical measure but also a reflection of the socio-economic structures of the time. For instance, Hudson (2000) highlights that in Mesopotamian economies, the pledging of assets was often intertwined with social hierarchies and power dynamics, where wealthier individuals or institutions held significant leverage over borrowers. Similarly, in ancient Greece and Rome, the concept of pignus (pledge) emerged as a formalized mechanism to secure

debts, laying the groundwork for later developments in Roman law and common law systems (Watson, 1969). These early practices underscore the universality of security arrangements as a means of mitigating risk and ensuring trust in financial transactions.

Smith (1947) further emphasizes that the necessity of security arrangements in lending arises from the inherent risks associated with borrower default. In modern financial systems, particularly within banking institutions, security arrangements—commonly referred to as collateral—are indispensable for mitigating these risks. As defined in Re Wiggins Ltd [1931] OR 337, collateral constitutes any property assigned or pledged to secure the fulfillment of an obligation, with the understanding that the property will be released upon repayment. This legal framework underscores the enduring role of security arrangements in protecting creditors' interests while facilitating economic activity.

Over time, the importance of security arrangements has grown alongside the complexity of financial systems. However, many individuals fail to fully grasp the legal intricacies involved, often perceiving security arrangements as monolithic solutions. In reality, security instruments vary significantly in form and function, encompassing charges, pledges, mortgages, and liens, each tailored to address specific risks and transactional needs (Engku Ali et al., 2018; Goode, 2011). For instance, mortgages are typically used to secure real estate transactions, while charges are employed in corporate financing to provide creditors with recourse against a company’s assets. Similarly, liens grant creditors legal claims over specific assets, such as vehicles or equipment, until the debt is repaid.

The concept of security arrangements has been deeply rooted in the money-lending business since ancient times, evolving from rudimentary pledges in agrarian societies to sophisticated mechanisms in modern financial systems. Evidence from ancient Sumer demonstrates the use of collateral, such as grains and metals, to protect creditors during transactions, while later developments in Roman and medieval European law formalized these practices into structured legal frameworks (Hudson, 2000; Watson, 1969). Over the centuries, security arrangements have become indispensable components of financial systems, particularly for banks and lending institutions. It is crucial to recognize that security arrangements take different legal

forms and serve distinct roles in mitigating risks for creditors. Understanding the complexity of these mechanisms is essential for navigating the intricacies of contemporary financial landscapes.

In conclusion, the concept of security arrangements has been rooted in the money-lending business since ancient times. Evidence from ancient Sumer demonstrates the use of collateral, such as grains and metals, to protect creditors during transactions. Over the centuries, security arrangements have become indispensable in modern financial systems, particularly for banks and lending companies. It is crucial to comprehend that security arrangements take different legal forms and serve specific roles in mitigating risks for creditors. Understanding the complexity of these security arrangements is essential for navigating the intricacies of contemporary financial landscapes.

3.3 DEFINITION AND NATURE OF SECURITY

3.3.1 Definition of Security

The concept of security is foundational to both legal and financial systems, serving as a mechanism to mitigate risks associated with lending and borrowing. According to the Dictionary of Law (2007), security refers to assets pledged or deposited to ensure the fulfillment of an obligation. It can also encompass property used as financial backing for a loan or other contractual commitments. Similarly, Oran (2000) defines security as a right in property held to guarantee payment or the performance of a specific action. In cases where the debtor defaults, the creditor is entitled to sell the secured property to recover the outstanding debt.

Wu Min Aun (1996) elaborates on this definition by describing security as an interest in property—whether owned by another party or subject to incomplete rights—that grants certain rights to the creditor to enforce payment or performance of an obligation, whether agreed upon by contract, implied by law, or directed by a third party. Cranston (1997) further refines this understanding, explaining that security represents an interest in property that serves as collateral to secure the performance of an

obligation, typically the repayment of a loan. This arrangement provides creditors with rights against the property, offering protection in cases of borrower insolvency.

Gullifer and Goode (2017) emphasize the practical application of security, defining it as a situation where a creditor takes collateral for a loan. If the debtor's total assets are insufficient to satisfy all creditors, the secured creditor has the right to use the collateral to obtain full or partial payment. Balkenhol and Schütte (2000) view security as a relationship between collateral and monetary obligations, wherein the collateral can be liquidated if the obligations remain unpaid, and the proceeds are used to settle the debt. This conceptualization underscores the role of security instruments such as mortgages, pledges, charges, and liens in safeguarding creditors' interests (LoPucki, 2013).

In summary, security refers to an interest in another person's property created to secure a debt or loan owed by that person. The creditor retains the right to utilize the security to settle debts in the event of default. Various forms of security instruments—such as mortgages, pledges, charges, and liens—are employed to ensure the performance of obligations and facilitate debt repayment.

3.3.2 Nature of Security

The nature of security is intrinsically linked to interests in property, which serve as the foundation for its legal and functional characteristics. According to Hugh Beale et al. (2016), Common law recognizes two primary types of property interests: (i) absolute interests related to ownership or possession of assets, and (ii) security interests created to secure obligations, which are extinguished upon fulfillment of the underlying obligation. The primary purpose of security instruments is to enhance creditors' likelihood of recovering their claims, particularly in financing contexts where default poses significant risks.

Hugh Beale et al. (2016) further explain that if a debtor defaults, the secured creditor can enforce the security instrument and obtain payment from the specific property allocated for that purpose. Key characteristics of security instruments include

being a right granted by a debtor to a creditor in an asset for securing an obligation, which restricts the debtor's ability to dispose of the asset without the creditor's consent.

Holden et al. (2003) provide further explanations of common concepts related to security instruments:

i. A security instrument is a conditional property right that secures an obligation, typically seen in transactions involving pledges, mortgages, and other personal property arrangements. It becomes enforceable if the borrower defaults.
ii. A security instrument attaches to collateral when it becomes enforceable against the debtor who granted the security instrument.
iii. A security instrument is perfected when the secured creditor/lender (the party holding the security instrument) enforces it against third parties, including other creditors with security instruments in the same property, individuals with liens on the property, or individuals who purchase the collateral from the debtor.

These characteristics highlight the dual function of security instruments: they protect creditors by providing recourse to specific assets while imposing restrictions on debtors to preserve the integrity of the collateral.

In conclusion, security is a crucial concept in legal and financial contexts, providing protection against loan default. Its definition, nature, and characteristics encompass a wide range of assets and forms. Understanding these elements is vital for navigating the context of law and finance effectively.

3.4 CREATION OF THE SECURITY

The primary objective of a security instrument is to ensure the fulfillment of an obligation, typically the repayment of a debt (Black's Law Dictionary, 8th Ed). Everett and McCracken (2009) outline four principal approaches to the creation of security instruments, each with distinct characteristics and legal implications as follows:

(i) Security Instrument Created by Transfer of Legal Title

This approach involves the transfer of legal title to the creditor as a means of securing an obligation. A classic example is a legal mortgage, where the mortgagor transfers the legal title of their property to the mortgagee as assurance for fulfilling their obligations. In this arrangement, the debtor retains equitable ownership of the property, while the creditor holds legal title until the debt is repaid.

The transfer of legal title provides the creditor with strong legal rights, including the ability to enforce the security interest through foreclosure if the debtor defaults. This method is particularly relevant in real estate transactions, where legal mortgages are commonly used to secure large loans. However, it also imposes strict requirements, such as registration in public registries, to ensure transparency and protect third parties.

(ii) Security Instrument Created by Agreement

Security instruments created by agreement are based on contractual arrangements and confer an interest in the property that is enforceable according to the terms of the contract. Examples include equitable mortgages and charges, which arise through mutual consent without the need to transfer legal title.

Equitable mortgages and charges are flexible and widely used in commercial transactions, particularly in cases where transferring legal title is impractical or unnecessary. However, they require careful drafting to ensure enforceability and may involve additional steps, such as registration, to perfect the security interest. This approach highlights the importance of mutual consent and contractual clarity in creating security arrangements.

(iii) Security Instrument Created by Possession

This approach applies to pledges, where a security instrument arises consensually through the transfer of possession. A pledge occurs when the pledgor delivers tangible property to the pledgee as security for a debt. The pledgee gains the right to retain possession of the pledged asset until the debt is repaid. If the debtor defaults, the pledgee may sell the asset to recover the outstanding amount.

Pledges are commonly used for securing loans involving movable property, such as inventory, equipment, or financial instruments. The transfer of

possession ensures that the creditor has control over the collateral, reducing the risk of unauthorized disposal by the debtor. However, this method is limited to tangible assets and may not be suitable for intangible property or situations where the debtor needs to retain possession of the asset for operational purposes.

(iv) Security Instrument Created by Operation of Law

Security instruments created by operation of law arise automatically under specific legal principles, without the need for explicit agreement between the parties. A common example is a lien , which grants the creditor the right to retain personal chattels until a debt is paid. Liens are often associated with professions or trades, such as solicitors, stockbrokers, bankers, factors, artisans, common carriers, and innkeepers, who are entitled to retain possession of goods or documents until their fees are settled.

Liens can be classified into two types: general liens , which apply to all property of the debtor in the creditor's possession, and particular liens , which are limited to specific goods or services provided. While liens provide creditors with a powerful tool for securing payment, they are subject to statutory limitations and may not offer the same level of protection as consensual security instruments.

To summarize, security instruments are primarily created through agreements, operation of law, possession, or transfer of legal title. This study focuses on examining the main type of consensual security instrument recognized in Common law, as it is widely acknowledged and applicable within this legal framework.

3.5 PURPOSE OF TAKING SECURITY

Taking security in credit transactions serves several critical purposes, each contributing to the stability and reliability of financial arrangements. These purposes are particularly relevant in mitigating risks associated with lending and ensuring equitable treatment of creditors in the event of debtor insolvency. Below, we explore the key objectives of taking security, supported by scholarly insights and practical examples.

(i) Reduction of Credit Risk and Priority Over Other Creditors

One of the primary purposes of taking security is to reduce credit risk and establish priority over other creditors in the event of the debtor's bankruptcy or liquidation. As noted by Gullifer & Goode (2017) and Cranston (1997), a secured creditor has a legal claim over specific assets pledged as collateral, which enhances their chances of recovering the funds owed to them. This priority ensures that secured creditors are paid before unsecured creditors, thereby safeguarding against potential losses.

In cases of insolvency, unsecured creditors often face significant challenges in recovering their claims, as they must compete for a share of the debtor's remaining assets after secured creditors have been satisfied. By contrast, secured creditors benefit from proprietary rights over the collateral, enabling them to liquidate the asset to recover their dues. This distinction underscores the importance of security in protecting creditors' interests and maintaining confidence in credit markets.

(ii) Protection Against Debtor Insolvency

The primary purpose of taking security is to protect the creditor from the risk of the debtor becoming insolvent, as emphasized by Joana (2000). When a debtor defaults, the creditor faces the possibility of non-repayment, which can result in substantial financial losses. A security instrument provides a form of protection by granting the creditor enforceable rights over specific assets.

This mechanism is particularly crucial in situations where the debtor's financial position is precarious or uncertain. By securing the loan with collateral, the creditor ensures a higher probability of receiving payment, even if the debtor is unable to fulfill their obligations through personal liability alone. This dual layer of protection—personal liability and proprietary rights—enhances the creditor's ability to mitigate risks effectively.

(iii) Proprietary and Possessory Rights Beyond Personal Liability

Security arrangements offer more than just a reliance on the debtor's personal liability. They provide an additional layer of assurance by granting the creditor proprietary or possessory rights that can be exercised to obtain payment. As highlighted by E.P. Ellinger et al. (2011), these rights

strengthen the creditor's ability to recover their funds beyond solely relying on the debtor's promise to repay.

For example, in a pledge arrangement, the creditor gains possession of the pledged asset, ensuring control over its use and disposition until the debt is repaid. Similarly, in a mortgage, the creditor retains legal title to the property, allowing them to enforce their rights through foreclosure if necessary. These mechanisms provide tangible safeguards that enhance the creditor's confidence in the transaction.

(iv) Reduction of Borrowing Costs for the Debtor

Offering security can result in reduced borrowing costs for the debtor, as highlighted by Hugh Beale et al. (2000). By mitigating the risk of default, the presence of security enables creditors to provide more favorable credit terms and conditions. For instance, secured loans typically carry lower interest rate compared to unsecured loans, as the collateral reduces the creditor's exposure to risk.

This reduction in credit costs can be beneficial to the debtor, making borrowing more accessible and affordable. It also encourages creditors to extend credit to debtors who may otherwise struggle to secure financing due to perceived risks. In this way, security arrangements promote financial inclusion while ensuring sustainable lending practices.

(v) Control and Monitoring of the Debtor's Affairs

Taking security grants the creditor the opportunity to exert control over the debtor's affairs during crucial moments and to a certain extent monitor the debtor's company, as explained by Hugh Beale et al. (2000). By possessing a security instrument coupled with enforcement rights, the creditor gains a level of influence and the means to ensure that the debtor fulfills their obligations.

For example, covenants in security agreements may require the debtor to maintain specific financial ratios or seek the creditor's approval before undertaking significant business decisions. This ability to control and monitor helps maintain the stability and dependability of the credit relationship, reducing the likelihood of default and fostering trust between the parties.

In summary, establishing security instruments in credit transactions serves several purposes. It diminishes credit risk, ensures priority over other creditors in the event of insolvency, enhances payment assurance beyond personal liability, reduces borrowing costs, and enables control and monitoring. These objectives collectively contribute to the overall stability and reliability of credit transactions.

3.6 FORMS OF SECURITY INSTRUMENTS

Common law recognizes four main types of security instruments: mortgage, charge, pledge, and lien, as stated by Gullifer and Goode (2017) and Hugh Beale et al. (2007). Each type serves a distinct purpose and is tailored to specific transactional needs, offering varying degrees of protection and enforceability for creditors.

3.6.1 Mortgage

A mortgage is a widely recognized form of security that involves the transfer of ownership of an asset as collateral, with the condition that ownership will be returned to the debtor upon fulfilling their obligation (Gullifer & Goode, 2018). In this arrangement, the mortgagor transfers the legal title of the mortgaged asset to the mortgagee while retaining the equity of redemption, which ensures the mortgagor's right to reclaim the property once the debt is repaid. According to Beale (2007), a mortgage is classified as a non-possessory security instrument, meaning the mortgagor typically retains possession of the property during the term of the mortgage. Meanwhile, the mortgagee holds legal title and has the right to foreclose and take possession of the property in the event of default. Once the debtor fulfills their obligation, the mortgage is discharged, and the mortgagee must re-transfer ownership to the mortgagor.

Holden et al. (2014) further elaborate on this concept, stating that a mortgage involves the transfer of property rights to the creditor, granting them the authority to foreclose and take possession of the property, including the ability to convey title. This mechanism is underpinned by the principle of the equity of redemption, which ensures that despite the transfer of legal title, the mortgagor retains a significant interest in the

property. Benjamin (2000) explains that a mortgage essentially involves the delivery of title as security, where the mortgagor transfers the title of the mortgaged asset to the mortgagee while preserving the equity of redemption.

One distinguishing feature of a mortgage is that it entails the acquisition of an existing interest rather than the creation of a new one, setting it apart from an equitable charge (Gullifer & Goode, 2018). This characteristic highlights the flexibility of mortgages, as they can be applied to various types of assets—both tangible and intangible—without being contingent upon physical possession.

Everett and McCracken (2009) offer an alternative perspective on mortgages, emphasizing that the creation of a mortgage involves transferring the legal title of the property from the mortgagor to the mortgagee. However, this transfer is not intended to serve as an absolute disposal of the property but rather as a mechanism to ensure the debtor's performance of their obligation. Their analysis identifies two fundamental consequences of this transfer:

i. The transfer is made with the understanding that upon payment of the debt or fulfillment of the obligation by a specified date, the title will be retransferred to the mortgagor.
ii. The mortgagor retains a significant interest known as the equity of redemption, which prevents the mortgagee from exploiting their temporary legal ownership of the property. Equity recognizes the mortgagor as the rightful owner, even though the legal title is held by the mortgagee.

Mortgages are often regarded as the strongest form of security by financial institutions because they confer legal title to the property upon the mortgagee. This provides creditors with robust enforcement rights, including the ability to foreclose and sell the property to recover outstanding debts. Despite its advantages, however, demanding a mortgage as security may not always be commercially viable or practical (Gullifer & Goode, 2018). For instance, requiring a mortgage for smaller loans or personal financing may impose unnecessary burdens on borrowers, particularly when alternative forms of security, such as charges or guarantees, would suffice. Additionally, the formalities associated with creating and registering a mortgage, especially in real

estate transactions, can be time-consuming and costly, potentially limiting its use in certain contexts.

In summary, a mortgage involves the transfer of ownership of an asset as security, with the expectation that ownership will be returned to the debtor upon fulfilling their obligation. It is a non-possessory security instrument that grants the mortgagee the right to foreclose and take possession of the property in the event of default. The equity of redemption safeguards the interests of the mortgagor, ensuring fairness and preventing the mortgagee from taking undue advantage. While a legal mortgage provides strong security by conferring legal title, its practicality depends on factors such as the nature of the asset, the size of the loan, and the associated costs and formalities.

3.6.2 Charge

The second type of security instrument recognized in Common law is the charge. A charge is an agreement between the creditor and debtor where a specific asset or group of assets is designated to satisfy the debt. Unlike other security instruments, such as mortgages or pledges, a charge does not involve the transfer of ownership or possession of the asset. Instead, it creates an encumbrance or restriction on the asset, granting the creditor the right to seize it if a specified condition occurs—typically when the debtor fails to fulfill their obligations (Goode, 2000). This mechanism ensures that the creditor can rely on the asset and its proceeds to repay the debt, taking priority over unsecured creditors and junior encumbrances.

As Gullifer (2018) explains, charges do not require the transfer of possession or ownership. Instead, they represent the creditor's right, established through trust or contract, to appropriate a designated asset for debt repayment. The debt is satisfied through the proceeds from the voluntary or enforced sale of the asset, which may occur through court orders or the appointment of a receiver. Importantly, a charge exists only in equity or by statute, as it is considered a mere encumbrance rather than a legal conveyance or assignment. Everett and McCracken (2009) emphasize that the charge agreement itself constitutes the charge. It does not transfer title or an existing interest in

the property to the chargee but instead creates rights for the chargee in the event of default, such as the right to realize the property. Once the debt secured by the charge is satisfied, the rights of the chargee are automatically extinguished.

Benjamin (2000) describes a charge as less substantial compared to other security instruments. While a pledge involves the delivery of possession and a mortgage involves the delivery of title, a charge represents the right of the charge to appropriate the asset to satisfy the debt. Unlike a pledge, which can only be legal, and a mortgage, which can be either legal or equitable, a charge can only exist in equity. It arises in relation to assets whenever there is an effective agreement to create a charge. Holder et al. (2014) further elaborate that a charge grants the creditor the property right to seize an asset upon the occurrence of a specified condition, such as the debtor's failure to fulfill their obligation.

An important characteristic of a charge is that, in the event of default, the creditor is entitled to sell the secured assets without obtaining the debtor’s consent. When a charge is created, it establishes the right to access judicial processes, allowing the chargee to seize the charged property and sell it to satisfy the debt (Holder et al., 2014).

3.6.2.1 Types of Charges

In Common law, charges are categorized into two types: fixed charges and floating charges.

(i) Fixed Charge

A fixed charge is created over a specific asset of a company, giving the creditor the right to receive repayment from the sale of that asset in the event of borrower default. This type of charge grants the creditor significant control and priority over the collateral, making it particularly suitable for permanent assets such as land and fixtures (Gullifer & Goode, 2018). Fixed charges provide the highest level of security for creditors, as they ensure immediate attachment to specific assets and prevent the debtor from disposing of them without the creditor’s consent.

(ii) Floating Charge

In contrast, a floating charge is not tied to a specific asset but covers a class of assets held by the company (Everett & McCracken, 2009). It allows the debtor to conduct regular business operations without restrictions on the covered assets, providing flexibility. The floating charge becomes fixed and attaches to specific assets under certain conditions, typically when default occurs (Gullifer & Goode, 2018). The characteristics of a floating charge were described in United Overseas Bank Ltd v The Asiatic Enterprise (PTE) LTD [1999] 4 SLR 226 as follows:

- It is a charge on a class of assets of a company, both present and future.
- The class of assets is one that, in the ordinary course of business, would change from time to time.
- It is contemplated by the charge that, until some future step is taken by or on behalf of those interested in the charge, the company may carry out its business in the ordinary way as far as concerns the particular class of assets.

Floating charges provide flexibility for businesses to operate freely while still offering creditors a degree of security. However, they become fixed upon default, restricting the debtor's ability to transact with the charged assets.

Advantages of Fixed and Floating Charges

Understanding the distinctions between fixed and floating charges is crucial for establishing secure and flexible security arrangements. Fixed charges grant the creditor the highest priority over other claimants, offering greater control and immediate attachment to specific assets (Everett & McCracken, 2009). On the other hand, floating charges provide flexibility for regular business operations, allowing the debtor to freely utilize the covered assets. However, floating charges rank lower in priority compared to fixed charges and other secured creditors in the event of insolvency.

These distinctions play a significant role in shaping the rights and obligations of both creditors and debtors when establishing security arrangements. For example, creditors seeking maximum control and priority may prefer fixed charges, while debtors

requiring operational flexibility may opt for floating charges (Gullifer & Goode, 2018 and Everett & McCracken, 2009).

In conclusion, charge is a security instrument in Common law that allows a creditor to seize an asset if the debtor fails to fulfill their obligations. It is an agreement where a specific asset or group of assets is designated to satisfy the debt, granting the creditor priority over unsecured creditors. Unlike transferring ownership, a charge creates an encumbrance on the asset. Charges can be equitable or statutory and exist in equity or under specific statutes. They do not involve a transfer of ownership and are considered encumbrances. There are two primary types of charges: fixed and floating. A fixed charge provides control and priority over a specific asset in case of default, while a floating charge covers a class of assets, allowing flexibility until default triggers attachment. The rights of the chargee are extinguished upon debt satisfaction. Understanding these distinctions is crucial for creditors and debtors when establishing secure and flexible security arrangements.

3.6.3 Pledge

A pledge is a type of possessory security in which the pledgor delivers possession of goods to the pledgee as collateral for a debt or obligation (Wu Min Aun, 1996). This form of security is distinct from others, such as mortgages, because it involves the transfer of possession rather than ownership. According to Benjamin (2000), this characteristic ensures that the pledgor retains ownership of the pledged goods while granting the pledgee a specific interest in them. The pledgee, in turn, holds legal title to the pledged assets and has the authority to sell them if the pledgor defaults, making it one of the most powerful forms of security instruments in Common law (Goode, 2004).

In practice, the pledgee's rights are robust. For instance, they have the right to retain the goods until the pledge is fulfilled, and they can take legal action against the pledgor in the event of default (Gullifer and Goode, 2017). Wu Min Aun (1996) notes that the pledgee is also empowered to sell the goods and recover the debt from the proceeds without requiring a court order, unless otherwise stipulated by statute. This

streamlined enforcement process enhances the appeal of pledges, particularly in situations where swift recovery of debts is essential.

The creation of a pledge requires the delivery of possession of tangible goods, either through actual or constructive means, to establish its validity. Gullifer and Goode (2017) emphasize that intangible property cannot be pledged, as a pledge inherently necessitates a tangible asset. Beale et al. (2007) further explain that once the debt is fully repaid, the pledge is terminated, and the goods are returned to the pledgor, restoring full control over the asset.

A key distinction between a pledge and other security instruments, such as a mortgage, lies in the retention of ownership by the pledgor. While a mortgage involves the transfer of ownership to the mortgagee, a pledge allows the pledgor to retain ownership. Instead, the pledgee acquires a special interest in the item, enabling them to retain the goods until the pledge is honored. If the pledgor fails to fulfill their obligations, the pledgee has the right to bring legal action against the pledgor. As highlighted by Gullifer and Goode (2017), the pledgee may also sell the goods to recover the debt, ensuring that the creditor's interests are protected.

Despite its potency as a security instrument, a pledge is less commonly used compared to other forms of security, such as mortgages, charges, or liens. Holden et al. (2014) argue that this is largely due to its impracticality for assets that need to generate income to service the debt. For example, businesses often require continuous access to pledged assets, such as inventory or equipment, to maintain operations. In such cases, alternative security instruments like floating charges or mortgages are preferred because they allow the debtor to utilize the assets while still providing security to the creditor. Beale et al. (2007) further elaborate that these alternatives strike a balance between securing the creditor's interests and enabling the debtor to operate efficiently.

In conclusion, a pledge is a possessory form of security where the pledgor transfers possession of goods to the pledgee as collateral for a debt or obligation. It grants the pledgee a specific interest in the goods while the pledgor retains ownership. A pledge bestows significant rights upon the pledgee, including the power to sell the goods in the event of default without requiring a court order. However, due to

limitations related to income-generating assets, pledges are less commonly used compared to other forms of security instruments. Understanding the nature and characteristics of a pledge is crucial for creditors and debtors when determining the most suitable form of security in financial transactions. Each type of security instrument possesses unique features and implications, and the appropriate choice depends on the specific circumstances and needs of the parties involved.

3.6.4 Lien

A lien is widely recognized as a possessory security instrument that grants the holder the right to retain possession of another person's property until specific obligations are fulfilled. As noted by Benjamin (2010), a lien is fundamentally rooted in common law and is based on possession rather than ownership. This characteristic distinguishes it from other security instruments such as mortgages, charges, and pledges, which may involve the transfer of ownership, legal title, or specific interests in the property. According to Holdsworth (1925), liens have historically served as an essential mechanism for securing payment in professions and trades where possession of goods or documents is incidental to the service provided.

Unlike mortgages, charges, or pledges, a lien does not transfer ownership or confer control over the property. Instead, it allows the lien holder to retain possession of the property until their claims are satisfied. The lien holder's rights are limited to retaining possession and do not generally include the authority to sell the property unless specific exceptions apply, such as in the case of equitable liens or banker's liens (Joanna Benjamin, 2000; Hugh Beale et al., 2007). For instance, a banker's lien permits the creditor to sell securities held in custody if the debtor defaults, but this is an exception rather than the norm (Gullifer & Goode, 2017).

Although a lien provides security through possession, it generally does not offer the same level of control or enforcement rights as other security instruments. For example, a lien usually does not permit the sale of the property without a court order, unless it is a banker's lien or an equitable lien (Halsbury's Laws of England, 2021).

Additionally, the rights of the lien holder are typically limited to the property in their possession, whereas mortgages or charges may cover a broader range of assets.

A lien can be classified into two main types: particular liens and general lien. A particular lien arises in relation to specific goods or services provided by the lien holder, such as repairs performed by an artisan. In contrast, a general lien extends to all property of the debtor in the possession of the lien holder, such as the rights of solicitors or bankers over funds or documents entrusted to them (Halsbury's Laws of England, 2021). As explained by Pollock and Maitland (1988), the distinction between particular and general liens reflects the historical evolution of possessory rights in English law, where certain professions were granted broader retention rights due to their fiduciary roles.

Comparison with Other Security Instruments

While a lien provides security through possession, it generally offers more limited enforcement rights and scope compared to other security instruments like pledges, mortgages, and charges. Below is a detailed comparison to highlight these distinctions:

(i) Possession vs. Ownership:

A lien focuses solely on possession, whereas a mortgage involves the transfer of legal title, and a charge creates an encumbrance over specific assets. In contrast, a pledge requires the transfer of possession but does not involve ownership transfer (Wu Min Aun, 1996). For example, in a mortgage, the mortgagor retains equitable ownership while transferring legal title to the mortgagee. Similarly, a charge does not require possession or ownership transfer but grants the creditor enforceable rights over designated assets.

(ii) Enforcement Rights:

A lien holder typically lacks the authority to sell the property without a court order, except in specific cases like equitable or banker's liens. In contrast, a pledgee has the

right to sell pledged goods upon default, and a mortgagee can foreclose on the property to recover the debt (Goode, 2004). Charges, particularly fixed charges, provide creditors with significant control over specific assets, enabling them to take possession and sell the asset in the event of default. Floating charges, while less restrictive, still grant creditors priority over unsecured creditors during insolvency (Gullifer & Goode, 2017).

(iii) Scope of Coverage:

The rights of a lien holder are typically limited to the property in their possession. For instance, an artisan's lien applies only to the specific item repaired, and a solicitor's lien extends only to documents or funds in their custody (Benjamin, 2010). Mortgages and charges, on the other hand, can cover a broader range of assets, including both tangible and intangible property. A floating charge, for example, encompasses a class of assets that may change over time, providing greater flexibility for businesses (Holden et al., 2014).

(iv) Practical Implications:

Liens are often used in professions or trades where possession of the debtor's property is incidental to the service provided. For example, mechanics, artisans, and solicitors commonly rely on liens to secure payment for their services (Pollock & Maitland, 1988).

To summarize, a lien is a possessory security instrument that allows the holder to retain possession of someone else's property until specific obligations are fulfilled. Its focus on possession sets it apart from other security instruments. While providing security, lien generally offer more limited enforcement rights and scope compared to pledges, mortgages, and charges. However, the limited scope and enforcement rights of liens make them less suitable for large-scale financing arrangements, where mortgages, charges, or pledges are preferred due to their stronger legal protections and broader coverage.

Advantages and Limitations of Lien

Lien offer several advantages, particularly in contexts where possession of the debtor's property is integral to the transaction. For instance, they provide a simple and cost-effective mechanism for securing payment without the need for formal agreements or registration. Additionally, liens are enforceable under common law, making them accessible even in the absence of statutory frameworks (Holdsworth, 1925).

However, liens also have significant limitations. Their reliance on possession restricts their applicability to tangible property, excluding intangible assets like shares or intellectual property. Furthermore, the inability to sell the property without a court order limits the lien holder's ability to recover debts swiftly, especially in cases of insolvency (Goode, 2004). These limitations make liens less versatile compared to mortgages, charges, or pledges, which offer greater flexibility and enforceability (Benjamin, 2010).

Conclusion

To summarize, a lien is a possessory security instrument that allows the holder to retain possession of someone else's property until specific obligations are fulfilled. Its focus on possession sets it apart from other security instruments such as pledges, mortgages, and charges, which involve varying degrees of ownership transfer, encumbrances, or enforceable rights. While lien provide security through possession, they generally offer more limited enforcement rights and scope compared to other security instruments. Understanding the nature and characteristics of liens is crucial for creditors and debtors when determining the most suitable form of security in financial transactions. Each type of security instrument possesses unique features and implications, and the appropriate choice depends on the specific circumstances and needs of the parties involved.

3.7 COMPARISON OF THE FOUR SECURITY INSTRUMENTS: MORTGAGE, CHARGE, PLEDGE, AND LIEN

The four primary security instruments—mortgage, charge , pledge , and lien —serve the common purpose of securing loans and ensuring the fulfillment of obligations. However, they differ significantly in terms of ownership rights, power of sale , nature of interest, and other key characteristics. Below is a comprehensive analysis of their similarities and differences for each comparison point.

3.7.1 Ownership Rights

(i) Mortgage

A mortgage involves the transfer of legal ownership of the asset to the creditor (mortgagee), while the debtor (mortgagor) retains equitable ownership. This dual-layered structure ensures that the mortgagee holds legal title and has significant control over the property until the debt is repaid. Once the obligation is fulfilled, the legal title is re-transferred to the mortgagor.

(ii) Charge

A charge does not involve the transfer of ownership. Instead, it creates an encumbrance or restriction on the asset without transferring legal or equitable ownership. The debtor retains full ownership of the asset, but the creditor gains enforceable rights over it.

(iii) Pledge

In a pledge, the pledgor retains ownership of the goods, but the pledgee gains possession of the pledged goods as security. The pledgee does not acquire ownership but has control over the goods until the debt is repaid.

(iv) Lien

A lien does not involve the transfer of ownership or possession unless specifically required. Instead, it grants the lien holder the right to retain possession of the asset until the debtor fulfills their obligation. The debtor retains ownership, but the lien holder has limited rights over the property.

Conclusion

Mortgages are unique in transferring legal ownership, making them the most robust form of security. Charges, pledges, and liens do not involve ownership transfer, with charges creating encumbrances, pledges focusing on possession, and liens retaining possession without ownership. This distinction highlights the varying levels of control creditors have over secured assets.

3.7.2 Nature of Interest

(i) Mortgage

The nature of interest in a mortgage is ownership-based. The mortgagee holds legal title to the property, giving them strong security and control over the asset. This makes mortgages one of the most robust forms of security instruments.

(ii) Charge

The nature of interest in a charge is encumbrance-based. It creates a right for the creditor to appropriate the charged asset for debt satisfaction without transferring ownership or possession. Charges can be either fixed (specific assets) or floating (classes of assets), providing flexibility for creditors.

(iii) Pledge

The nature of interest in a pledge is possession-based. The pledgee gains physical control over the pledged goods, ensuring that they can enforce their rights by selling the

goods if the debtor defaults. However, the pledgee does not acquire ownership, limiting their rights to the pledged goods.

(iv) Lien

The nature of interest in a lien is also possession-based, but it is more restrictive than a pledge. A lien holder retains possession of the asset until the obligation is fulfilled, but they do not have ownership or the authority to sell the asset without a court order. This makes liens less versatile compared to other security instruments.

Conclusion

The nature of interest varies significantly across these instruments. Mortgages are ownership-based, charges are encumbrance-based, and pledges and liens are possession-based. This distinction underscores the different levels of security and control afforded to creditors, with mortgages offering the strongest protection and liens being the most limited.

3.7.3 Power of Sale

(i) Mortgage

Mortgages grant the mortgagee significant power of sale . If the debtor defaults, the mortgagee can foreclose on the property and sell it to recover the outstanding debt. This power is typically outlined in the mortgage agreement and may not always require court intervention, depending on the jurisdiction.

(ii) Charge

A charge generally does not confer the power of sale directly. Fixed charges provide the creditor with immediate control over specific assets, but enforcement often requires judicial processes, such as the appointment of a receiver or obtaining a court order to

sell the charged assets. Floating charges only become enforceable upon crystallization, at which point the creditor may exercise rights over the assets.

(iii) Pledge

A pledgee has the power of sale over the pledged goods if the debtor defaults. The pledgee can sell the goods to recover the debt without requiring court intervention, provided the pledge agreement permits it. However, this power is limited to the pledged goods and does not extend to other assets.

(iv) Lien

Lien generally do not confer the power of sale. The lien holder's rights are limited to retaining possession of the asset until the obligation is fulfilled. In most cases, the lien holder cannot sell the property without a court order, except in specific cases like equitable liens or banker's liens.

Conclusion

Mortgages and pledges provide creditors with strong enforcement rights, including the power of sale, making them highly effective for recovering debts. Charges and liens, however, are more restrictive, with charges requiring judicial intervention and liens rarely allowing the sale of the property. This highlights the importance of selecting the appropriate instrument based on the desired level of enforcement.

3.7.4 Creation of Security

(i) Mortgage and Charge

Both mortgages and charges are established through formal agreements that outline the terms and conditions of the security instrument. These agreements often require registration to ensure enforceability against third parties. For example, real estate mortgages must be registered with the relevant land registry, while charges over company assets may need to be filed with corporate registries.

(ii) Pledge

A pledge is created by physically delivering possession of the goods to the creditor as collateral. The act of delivery serves as evidence of the security arrangement, and no formal documentation is typically required.

(iii) Lien

Lien can arise automatically under common law, statute, or contract, depending on the circumstances. For instance, artisans' liens arise when repair work is performed, while solicitors' liens apply to client funds held in trust. Unlike mortgages or charges, liens do not require formal agreements or registration.

Conclusion

Mortgages and charges require formal agreements and registration, making them more structured and legally robust. Pledges rely on physical delivery, while liens arise automatically, making them simpler but less formalized. The choice of instrument depends on the need for formality and enforceability.

3.7.5 Right of Redemption

(i) Mortgage

Mortgages typically provide the right of redemption, allowing the mortgagor to reclaim the property upon full repayment of the debt. This ensures that the debtor has the opportunity to regain ownership once their obligations are fulfilled.

(ii) Charge, Pledge, and Lien

In contrast, charges, pledges, and liens generally do not offer a formal right of redemption. Once the obligation is satisfied, the debtor does not have an automatic right to reclaim the property. For example, in a pledge, the creditor may sell the pledged

goods if the debtor defaults, leaving no residual claim for the debtor. Similarly, a lien holder may retain possession of the property until the debt is repaid, after which the property is returned.

Conclusion

Mortgages provide debtors with the right of redemption, offering a clear path to reclaim ownership. In contrast, charges, pledges, and liens lack this feature, making them less debtor-friendly. This distinction is critical for debtors seeking flexibility and control over their assets.

3.7.6 Possession

(i) Mortgage and Charge

In both mortgages and charges, immediate possession of the property by the creditor is not required. The debtor retains possession and use of the property while the security instrument remains in place. This makes mortgages and charges particularly suitable for long-term financing arrangements where the debtor needs ongoing access to the asset.

(ii) Pledge

A pledge requires the creditor to hold physical possession of the pledged goods as security. This ensures that the creditor has control over the goods until the debt is repaid. However, this requirement limits the practicality of pledges for income-generating assets that the debtor needs to utilize during the loan term.

(iii) Lien

The possession requirements for a lien vary depending on the type of lien. For example, an artisan's lien requires the creditor to retain possession of the repaired goods, while a solicitor's lien applies to documents or funds already in the creditor's custody. Some

liens, such as equitable liens, may not require physical possession but instead rely on legal principles.

Conclusion

Mortgages and charges allow debtors to retain possession and use of the asset, making them ideal for long-term financing. Pledges and liens, however, require possession, limiting their applicability to situations where the debtor does not need ongoing access to the asset. This distinction is crucial for determining the practicality of each instrument.

3.7.7 Eligible Assets

(i) Mortgage and Charge

Mortgages and charges more versatile, covering both tangible and intangible assets. For example, mortgages are commonly limited to existing assets only i.e real estate, while charges can be created over financial assets, intellectual property, or even future receivables.

(ii) Charge

Charges offer greater flexibility than mortgages because they can include existing and future assets. Floating charges, in particular, are designed to cover a class of assets that may change over time, making them ideal for businesses with dynamic asset portfolios.

(iii) Pledge

Pledges are limited to tangible movable property, such as inventory, jewelry, or equipment. Intangible assets like shares or intellectual property cannot be pledged because the security mechanism relies on physical possession.

(iv) Lien

Lien is typically limited to the property in the creditor's possession, making them less versatile than mortgages or charges. They are most commonly used in professions or trades where possession of the debtor's property is incidental to the service provided, such as mechanics, artisans, or solicitors.

Conclusion

Mortgages and charges are the most versatile, covering a wide range of assets, including intangible ones. Pledges and liens are limited to tangible property, with pledges requiring possession and liens being restricted to specific contexts. This highlights the importance of aligning the security instrument with the type of asset involved.

3.7.8 Flexibility

(i) Mortgage

Mortgages are best suited for long-term financing of high-value assets, particularly real estate. They are less flexible for businesses that require ongoing access to their assets.

(ii) Charge

Charges are highly flexible, especially floating charges, which allow businesses to operate freely while still providing security to creditors. Floating charges cover a class of assets that may change over time, making them suitable for dynamic business environments.

(iii) Pledge

Pledges are ideal for short-term financing of tangible goods but are impractical for income-generating assets that the debtor needs to use during the term of the loan.

(iv) Lien

Liens are limited to professions or trades where possession of the debtor's property is incidental to the service provided. They are less flexible and are typically used for small-scale transactions.

Conclusion

Charges are the most flexible, particularly floating charges, which adapt to changing asset portfolios. Mortgages are rigid but secure, while pledges and liens are limited in scope and application. The choice of instrument should align with the debtor's operational needs and the creditor's risk tolerance.

3.7.9 Conclusion of the Comparison

(i) In terms of overall assessment, charges stand out as the most versatile and widely applicable security instrument. Their ability to cover both tangible and intangible assets—including existing and future assets—makes them indispensable in modern financial and business transactions. Floating charges, in particular, adapt seamlessly to changing asset portfolios, while fixed charges provide immediate control over specific assets. By offering enforceable rights without transferring ownership, charges strike a balance between creditor protection and debtor flexibility, making them ideal for dynamic business environments.

(ii) Mortgages remain the gold standard for securing large-scale, long-term obligations involving immovable property. Their robust enforcement mechanisms, including foreclosure and sale, provide unparalleled security for creditors in real estate financing. Additionally, mortgages are unique in that they involve the transfer of legal title to the creditor, typically a bank or financial institution, which ensures strong creditor protection. This transfer of legal title, however, can create operational hurdles for debtors, as it imposes significant restrictions on their use and control of the

mortgaged property during the loan term. For businesses or individuals requiring ongoing operational flexibility, this can be a notable limitation.

(iii) For smaller, short-term transactions, pledges and liens serve their respective niches effectively. Pledges are practical for securing tangible, movable goods, relying on possession for enforceability but limiting their use to scenarios where the debtor can relinquish control of the asset. Liens, being the simplest and least formalized, are well-suited for small-scale transactions or professions like artisans and solicitors, where possession-based security suffices. However, both pledges and liens are less versatile and flexible compared to charges, particularly due to their focus on existing assets and limited scope.

(iv) Ultimately, the choice of security instrument should align with the specific needs of the transaction, the type of asset involved, and the level of risk mitigation required. Mortgages, while highly secure, may pose operational challenges for debtors due to the transfer of legal title, making them less suitable for transactions requiring flexibility. Charges, on the other hand, offer greater adaptability for businesses, while pledges and liens cater to niche scenarios with simpler requirements.

(v) It is also important to note that the application of these four security instruments is subject to the governing laws or jurisdiction of respective states, which may impose specific requirements, limitations, or formalities. By understanding the nuances of each instrument, whether it be their ownership structure, enforcement mechanisms, or flexibility—creditors and debtors can make informed decisions that balance security, operational needs, and practicality.

Table 3.1 Key similarities and differences of security instruments

Item	Mortgage	Charge	Pledge	Lien
Ownership	Transferred to the mortgagee.	Ownership is not transferred	Retaining the property however	A lien is a claim on asset, and

		however title can be in custody.	ownership is not transferred.	they may retain the goods. Title would be deposited with the creditor. Ownership however still remains.
Power of Sale	The power is conferred upon and is allowed.	Conferred by statutes i.e (land & property) except in matters that are not covered by statutes.	Sale is allowed however no court order may be required unless statute requires otherwise	No power of sale in a typical lien however a banker's lien and a statutory of sale, sale of the property is allowed.
Usual Assets involved (in non-exhaustive manner)	Land, property such as apartments, vessels, aircraft	Land, property however when it comes to debentures, all assets of the company which may include shares or stocks.	Usually Gold, shares, securities	Usually property
Type of Assets	Both tangible and intangible assets.	Both tangible and intangible assets.	Tangible assets only	Tangible assets only

	Limited to existing assets.	Can be both existing and new creation of assets.		
Contracts	Yes	Depends. If it is a charge in land, instrument under the National Land Code would be suffice. However, when it comes to charge over company assets, debenture will be used. The same principle of a contract will be applicable to debenture.	Yes	Depends. However, when it comes to statutory lien, it is not required.
Right of redemption	Yes	No	No	No
Actual Possession	No unless there is a default. Physical and constructive possession of mortgaged assets are not required as the titled already transfer to the mortgagee.	No unless there is a default. Physical or constructive possession are not required. A charge is an agreement itself.	Yes Physical or constructive delivery is required as the pledged asset must be under the possession by the pledgee.	Depends. For possessory lien, possession of the lien asset is required and for non-possessory lien, the actual

				possession is not required.
Right to use the assets	Mortgagor can still utilise the assets during the mortgage period since possession by mortgagee is not required.	Chargor can still utilise the assets during the charge period since possession by chargee is not required.	Pledge asset cannot be used by the pledgor since possession by pledgee is required.	Depends. The asset cannot be utilized for possessory lien; however, can be utilise in non-possessory lien.

Researcher's own

3.8 SECURITY INSTRUMENTS UNDER THE MALAYSIAN LEGAL SYSTEM

3.8.1 Introduction

This section explores the application of security instruments—such as mortgages, charges, pledges, and liens —under common law within the Malaysian legal system. The study is crucial for understanding the applicability of these security instruments in Malaysia, as their interpretation and enforcement may vary across jurisdictions. These variations significantly impact how such instruments are applied in specific legal contexts.

3.8.2 Mortgage

The discussion begins with an analysis of mortgages, focusing on their traditional common law principles and their evolution under Malaysian legislation.

3.8.2.1 Mortgage Under Traditional Common Law

The concept of a mortgage, as established under traditional English common law, represents a fundamental mechanism for creating a security interest in land or property. In *Santley v Wilde* [1899] 2 CH 474, a mortgage is defined as "a conveyance of land or an assignment of chattels as security for the payment of a debt or the discharge of some other obligation for which it is given" (p. 476). In simpler terms, a mortgage arises when a borrower (mortgagor) pledges land or property as collateral to secure a loan from a lender (mortgagee). Once the debt is fully repaid, the mortgagor regains possession of the property.

A defining feature of the traditional common law mortgage is the transfer of ownership to the mortgagee as security for the loan. This principle is illustrated in *Keith and Another v Burrows and Another* [1876] 1 C.P.D 722, where the court held that the mortgagee acquires ownership of the asset as security for the loan. Specifically, the mortgagee retains legal ownership of the property until the mortgagor redeems it by repaying the debt in full. For example, in the context of a ship mortgage, the court emphasized that the mortgagee acquires ownership as security for the loan, akin to any other type of mortgage. This arrangement was designed to protect the mortgagee's interests by granting them control over the asset until the debt was discharged.

3.8.2.2 Legislative Influence on Mortgages

While the traditional common law mortgage emphasizes the transfer of ownership to the mortgagee, modern legislation has curtailed this feature to enhance commercial efficiency and flexibility. For instance:

1. United Kingdom:
    - In the United Kingdom, the Law of Property Act 1925 redefined mortgages over land. Instead of transferring ownership, a mortgage is now created through a "charge by deed expressed to be by way of legal mortgage." This mechanism allows the mortgagee to retain rights to sell the property in case of default but without acquiring ownership (Thomson Reuters, 2022).

- This legislative shift reflects the practical need for greater flexibility in commercial transactions while ensuring legal certainty.

2. Malaysia:
    - Similarly, in Malaysia, the National Land Code (NLC) governs land transactions, replacing the traditional mortgage with the concept of a charge. A charge is a security interest created over land without transferring ownership to the lender.
    - Section 206 of the NLC defines a charge as "a security for the payment of money or the performance of an obligation." Unlike a mortgage, a charge does not involve the transfer of ownership; instead, it creates an encumbrance on the title of the property. This statutory framework ensures that the mortgagor retains ownership and can continue to use the land while the charge remains in place.

This demonstrates that the common law mortgage can be shaped by legislation, as seen in both the UK and Malaysia.

3.8.2.3 Mortgage Under the Malaysian Legal System

The discussion of mortgages under the Malaysian legal system revolves around limited assets, namely land, vessels, and aircraft, each governed by specific laws and ordinances. Below is an analysis of the applicability of mortgages to these assets within the Malaysian legal context.

(a) Land

Mortgages on land in Malaysia do not follow the traditional common law mortgage model. Instead, they are governed by the National Land Code (NLC), which classifies land transactions as statutory charges rather than mortgages. The NLC prohibits the transfer of ownership to the mortgagee. Instead, a charge is created over the land, allowing the mortgagor to retain ownership. This arrangement enhances commercial efficiency by enabling the mortgagor to use the land for other purposes while the charge remains in place. The mortgagee retains the right to enforce the charge and sell the land

in the event of default, ensuring their interests are protected. In short, the traditional common law mortgage is not applicable to land in Malaysia. Instead, the statutory charge under the NLC governs secured lending over land.

(b) Vessels

Mortgages over vessels in Malaysia are regulated by the Merchant Shipping Ordinance 1952 (MSO). Section 41(1) of the MSO allows a registered ship to serve as collateral for a loan, provided the mortgage instrument adheres to the prescribed form issued by the Minister.

However, the Merchant Shipping Ordinance prevent the ownership of the vessel to be transferred to the mortgaged. This is reflected in Section 44 of the Merchant Shipping Ordinance where the mortgagee is not allowed to be the owner of the vessel. Therefore, in contrast to the traditional mortgage common law, the ownership still lies with the owner. This shows that the existence of statutes again that determine the characteristics of a mortgage. Further, this is also a reflection of the powerful nature of legislation where it can remove the feature of transfer of ownership which is a prevalent feature of common law mortgage.

While such prevalent feature of ownership can be removed or restricted by legislation, what remains is the right of the mortgagee to sell the assets in the event of default. The mortgagee has a power of sale as stated in Section 45 of the Merchant Shipping Ordinance. Therefore, a mortgagee is allowed to sell the vessel if there is a default by the mortgagor. This feature remains so because a power of sale is a remedy granted to the mortgagee so that the mortgagee will not be prejudiced and is able to recoup the losses in the event of default by the mortgagor.

As for the order of priority, Section 43 of MSO specifically states that if there is more than one mortgagee, then the mortgages shall have priority in the order of the date on which the mortgage is recorded in the register book. Section 45 of MSO also stated clearly that the subsequent has no right to sell the vessel without the concurrence of every prior mortgagee unless there is a court order to reflect so. In short, the prior mortgagee would have an advantage over the subsequent mortgagee.

(c) Aircraft

Mortgages over aircraft are governed by the Civil Aviation Regulations 2016 (CAR). Section 17 of the CAR outlines the process for registering aircraft mortgages with the Civil Aviation Authority of Malaysia (CAAM). Unlike the Merchant Shipping Ordinance, the Civil Aviation Regulations did not mention if the ownership of the aircraft remains with the owner. In the absence of such clause, it can always be a subject of litigation. However, this is also a prime example where legislation does not describe the characteristic of a mortgage. In such cases, it shall be up to the contracts between the parties. However, it must be taken at this point that the traditional common law mortgage is not as popular as it should be. The transfer of ownership to the mortgagee restricts the creation of a subsequent mortgage and is not that great for commercial and business efficiency. Therefore, the parties may contract that title of the aircraft may not be transferred to the mortgagee but rather stays with the mortgagor. However, in a basic commercial finance for secured loans in regard to aircraft, the remedy of the mortgagee remains whereby upon an event of default, the lender shall be allowed to recoup its losses by selling the aircraft.

Based on interviews with legal experts in Malaysia, they confirmed that the application of mortgage, as understood under common law, does not fully apply within the Malaysian legal system. Instead, the term "mortgage" is often colloquially used to refer to property or land transactions, which are governed by statutory charges rather than the traditional mortgage instrument.

The application of mortgages in Malaysia reflects a blend of common law principles and statutory modifications, with modern legislation significantly departing from traditional common law mortgages by emphasizing commercial efficiency and asset-specific needs. While traditional mortgages involved the transfer of ownership to the mortgagee, Malaysian laws like the National Land Code (NLC), Merchant Shipping Ordinance (MSO), and Civil Aviation Regulations (CAR) have redefined this concept, replacing it with mechanisms akin to statutory charges.

For land, mortgages are replaced by charges under the NLC, ensuring ownership remains with the mortgagor. Similarly, vessel mortgages under the MSO prohibit

ownership transfer while granting the mortgagee rights to sell in case of default, mirroring charge-like features. Aircraft mortgages under the CAR, though less clear, also prioritize remedies for mortgagees without transferring ownership. Overall, the evolution of mortgage law in Malaysia demonstrates a shift away from traditional common law principles toward a more flexible, charge-based system that enhances legal certainty and operational efficiency, though ambiguities remain in certain areas like aircraft. Thus, modern Malaysian mortgage practices no longer fully align with the original common law concept but instead reflect a pragmatic adaptation to contemporary commercial demands.

3.8.3 Charge

The concept of a charge has been elaborated in detail earlier, particularly in the context of common law. Under the Malaysian Companies Act 2016, Division 7 (Sections 352-364) governs charges over a company's assets. While the Act does not explicitly enumerate security instruments such as pledges, mortgages, or liens, it primarily emphasizes charges as the predominant form of security instrument. The following discussion outlines the key requirements and procedures for creating and registering charges in Malaysia, focusing on two primary frameworks: (i) registration under the Companies Act 2016, and (ii) charges over land governed by the National Land Code (NLC).

(a) Registration of Charge under the Companies Act 2016 (Act 777)

Under the Companies Act 2016, a charge is broadly defined to include a mortgage and any agreement to create or execute a charge or mortgage, whether upon demand or otherwise. However, it is important to note that the Act does not create charges but rather mandates their registration with the Companies Commission of Malaysia (CCM). This requirement applies only to companies, meaning individuals are not obligated to register charges under this Act. Failure to register a charge renders it void against the company and its liquidator, and the secured debt becomes immediately payable.

The types of charges that require registration under the Companies Act 2016 include:

- *A charge to secure the issuance of debentures.*
- *A charge on uncalled share capital;*
- *A charge on shares of a subsidiary owned by the company;*
- *A charge on assignments created by the company;*
- *A charge on land;*
- *A charge on book debts;*
- *A floating charge on the company's undertaking or property;*
- *A charge on unpaid calls made on shares;*
- *A charge on ships, aircraft, or shares in ships or aircraft;*
- *A charge on intangible assets such as goodwill, patents, trademarks, copyrights, or licenses; and*
- *A charge on the credit balance in a company's deposit account*.

Notably, the definition of a charge under the Companies Act 2016 encompasses mortgages. Therefore, when other legislation—such as the Merchant Shipping Ordinance or Civil Aviation Regulations —refers to mortgages over vessels or aircraft, these are treated and registered as charges under the Companies Act. The fact that the Companies Act 2016 have different types of charge shows that charge can be created over other assets. Usually, fixed charge is able to cover different assets including shares especially when it comes to corporate assets. And they will be reflected by their own relevant contracts. Only charge under the National Land Code which shall be explained further have its own instruments.

In essence, the Companies Act 2016 establishes the formalities for registering charges but does not create them. Whether a charge or mortgage is involved, registration with the Companies Commission Malaysia is mandatory for companies to ensure enforceability.

i. Charge on Land under the National Land Code (NLC)

   A charge under Malaysian law is a statutory creation, distinct from the common law concept of a mortgage. In Malaysia, the power of banking

institutions to create legal charges arises from statutes such as the National Land Code (NLC). Unlike a mortgage, which transfers ownership to the creditor under common law, a charge under the NLC creates an encumbrance on the land without transferring ownership.

The main concept of charge under a statute is that it requires registration with its relevant authority. The Malaysian law position requires charge to be registered under the National Land Code. The effect of registering a charge is: (a) the land becomes security; (b) the charge will get indefeasibility of title; (c) an interest is created in the land; (d) becomes an encumbrance on the land and the owner is not able to deal with the land without permission of the chargee. The purpose of the charge is to secure repayment of money. In *Yee sin Cheong v UMBC* (1992), the court held that charge is to secure repayment of any debt.

A Malaysian charge is different than the traditional common law mortgage that confers ownership. In charge, the ownership still lies with the owner, and it does not transfer to the creditor. What is transferred in a charge is the interest in the land. English common law of mortgage in land does not exist in Malaysia.

In *Gan Khor v Soan bin Pelita* [1935] MLJ 158, Chief Justice Sir Samuel Thomas C.J held that "*It must be remembered that a charge is a very different transaction to a mortgage. There is no such thing as a mortgage of land known to the law of the Federated Malay States. Charges alone are recognised. The rights arising from a charge are contained in the Land Code. It is not possible to seek to introduce the elements of an English mortgage into a charge as provided by the law of the Federated Malay States, and therefore apart from any express powers it is not correct to say that a chargee has the right to enter into occupation. Were it otherwise, there would undoubtedly be such an interest in land that it would be unquestionable that the charge itself was invalid under section 8 of the Malay Reservations Enactment, 1913*".

Therefore, it is very clear that the English common law of mortgage is not available for land matters in Malaysia and that it is very different from the charge that is recognized under National Land Code. Regardless, they do

share similarities in the sense that they are both served to secure the creditor interest and revolve around the use of a property as security.

In short, a charge is a creation of National Land Code and actually, National Land Code is a complete and comprehensive law when it comes to land. Therefore, mortgage in land would have no room of application in Malaysia. The greatest evidence of that is the fact the National Land Code only allows creation of charge over land, and in no way, there is a single characteristic of mortgage. It cannot be further emphasized at this point that English Law and equitable principles in regards to land have no room for application in regards to land in Malaysia. This is affirmed by the Privy Council decision in *United Malayan Banking Corporation Bhd v Pemungut Hasil Tanah, Kota Tinggi* [1984] 2 MLJ 47. The Privy Council in *United Malayan Banking Corporation Bhd* had ruled that the National Land Code is a complete and comprehensive code of law governing the tenure of land in Malaysia and there is no room for importation of England Law in the field except in so far as the National Land Code may expressly provide so.

In summary, the concept of a charge under Malaysian law is governed by statutory frameworks, with distinct regulations for different types of assets. The Companies Act 2016 mandates the registration of charges over corporate assets with the Companies Commission of Malaysia (CCM) to ensure their enforceability. Similarly, the National Land Code (NLC) provides a comprehensive framework for charges over land, detailing their creation, registration, and enforcement processes. These statutory mechanisms reflect the modernization and standardization of secured lending practices in Malaysia, ensuring clarity and legal certainty. By focusing on the charge as a statutory instrument, Malaysian law prioritizes an efficient and asset-specific approach to securing creditors' interests, making it a central feature of the country's legal and financial systems.

3.8.4 Pledge

In Malaysia, the legal framework governing pledges is primarily derived from the Contracts Act 1950 (Revised 1974) and, to a limited extent, English common law where

applicable. A pledge, as defined in Section 125 of the Contracts Act, refers to "the bailment of goods as security for the payment of a debt or the performance of a promise." The party delivering the goods as security is referred to as the pawnor (or pledgor), while the party receiving the goods is known as the pawnee (or pledgee). According to Wu Min Aun (1996), a pledgor is someone who deposits an item as security, whereas a pledgee is the recipient of the pledged item and holds it as collateral.

A fundamental characteristic of a pledge is that the pledgee must have possession of the pledged goods, either through actual delivery or constructive delivery (Gullifer and Goode, 2017). Constructive delivery occurs when the pledgor provides the pledgee with control over the goods indirectly, such as handing over the key to a warehouse where the goods are stored. Importantly, the delivery of goods does not need to coincide with the loan agreement. A pledge can be perfected even if delivery occurs after advance payments have been made. However, if no payment has been made, the intended pledgee only has a contractual right and no enforceable interest in the pledged item (Wu Min Aun, 1996).

Under Section 126 of the Contracts Act, the pledgee has the right to retain the pledged goods not only for the repayment of the debt but also to cover any accrued interest and necessary expenses incurred in storing and preserving the goods. If the pledgor defaults, the pledgee has the right to sell the pledged goods under Section 129 of the Contracts Act. This right of sale does not require a court order unless otherwise stipulated by statute. After the sale, if the proceeds exceed the amount owed, the surplus must be returned to the pledgor. A pledge terminates when the pledgee returns the pledged goods to the pledgor upon full repayment of the debt (Wu Min Aun, 1996). This marks the conclusion of the pledgee's special interest in the goods.

Under Section 131 of the Contracts Act, only a person in possession of the goods or a document of title can create a valid pledge. This provision broadens the scope of documents that can be used to establish a pledge compared to English common law. While English common law limits the recognition of documents of title to specific cases such as bills of lading, Malaysian law explicitly recognizes a wider range of documents of title as valid instruments for creating a pledge (Wu Min Aun, 1996). For instance,

the delivery of a duly indorsed bill of lading constitutes a valid pledge under both systems, but Malaysian law extends this principle to other types of documents of title.

In summary, a pledge under Malaysian law is a statutory creation governed by the Contracts Act 1950, with provisions that align closely with English common law principles but incorporate broader recognition of documents of title. While pledges provide a straightforward mechanism for securing debts through the possession of goods, their practical utility is limited in modern commercial settings. Pledges are particularly unsuitable for revenue-generating assets, as they require the debtor to surrender possession of the pledged item. Nevertheless, they remain relevant in specialized contexts, such as international trade financing, where bills of lading serve as critical tools for securing transactions.

3.8.5 Lien

The concept of a lien in Malaysia is governed by both statutory provisions and common law principles, with specific applications depending on the context. In the banking sector, liens are primarily addressed under Section 124 of the Contracts Act 1950 (Act 136), which recognizes the banker's lien as a possessory right over goods or documents deposited with the bank. Beyond this, a unique form of lien exists under the National Land Code (NLC) —a statutory lien that serves as a non-registrable security interest over land. This section explores the legal framework and practical implications of liens in Malaysia, focusing on their creation, enforcement, and relevance in modern transactions.

3.8.5.1 Statutory Lien Under the National Land Code

A statutory lien is created under Section 281(1) of the National Land Code, which provides a mechanism for securing debts through the deposit of a document of title and the lodging of a lienholder caveat at the relevant land office. The process involves two essential steps:

1. Deposit of Document of Title: The debtor must deposit the original document of title (e.g., the land title) with the creditor as security for the debt.
2. Lodging a Lienholder Caveat: The creditor must apply for the entry of a lienholder caveat to formalize the lien.

In *Mercantile Bank Ltd v The Official Assignee of the Property of How Han Teh* [1967] 2 MLJ 104, Justice Raja Azlan Shah (as he then was) emphasized that the registration of the lienholder caveat is an essential requirement for a valid statutory lien. However, he also noted that courts may recognize equitable rights even if the caveat is not lodged, provided there is sufficient evidence of intention to create the lien.

3.8.5.2 Intention to Create a Lien

The creation of a lien under Section 281(1) requires clear intention from the parties involved. Courts have consistently held that such intention can be inferred from the circumstances of the case. For instance:

- In *Zeno v Prefabricated Construction Co Malaya Ltd* [1967] 2 MLJ 104, Justice Raja Azlan Shah ruled that intention could be deduced from the conduct and actions of the parties.
- Similarly, in *Palaniappa Chetty v Dupire Brothers* [1922] 1 FMSLR 370, the court held that the existence of a loan agreement or other contractual arrangements could serve as evidence of intent to create a lien.

In typical banking transactions, the loan documentation itself is often sufficient to demonstrate the intention to create a lien, particularly when accompanied by the deposit of the land title.

If the debtor defaults, the lienholder has the right to enforce the lien by seeking a court order for the sale of the secured property. The process generally involves the following steps:

1. Obtaining a Judgment : The creditor must first obtain a judgment against the debtor for the outstanding debt.

2. Application for Sale : Once the judgment remains unsatisfied, the creditor can apply to the court for an order to sell the property under Section 281(2) of the National Land Code .

This process was illustrated in *Perwira Habib Bank (M) Sdn Bhd v Tin Siang Sdn Bhd & Ors* [1922] 3 CLJ Rep 265. In this case, the plaintiff bank sought a public auction of the second defendant's land to recover a judgment sum of RM3,980,311.49, along with accrued interest and costs. The second defendant, acting as a guarantor, had deposited the land title with the bank as security. After the debtor defaulted, the court recognized the bank's status as a lienholder under Section 281 of the NLC and granted the application for sale.

Statutory liens under Section 281(1) of the NLC are relatively straightforward to establish, making them a convenient option for securing smaller loans or short-term financing. Unlike mortgages or charges, statutory liens do not require formal registration or complex documentation, reducing administrative burdens for both creditors and debtors. However, their simplicity also limits their scope, as they are typically used for less significant financial obligations where formal security instruments like mortgages or charges may be unnecessary.

In summary, liens in Malaysia are governed by both statutory provisions, such as those under the Contracts Act and the National Land Code, and common law principles. A statutory lien under Section 281(1) of the NLC provides a practical and efficient mechanism for securing debts through the deposit of a document of title and the lodging of a lienholder caveat. While the creation of a lien requires clear intention, courts are willing to infer such intent from the circumstances of the case or supporting documentation, such as loan agreements. The remedy for lienholders includes obtaining a court order for the sale of the secured property, as demonstrated in cases like *Perwira Habib Bank.* Although statutory liens are less formal than other security instruments, their ease of use makes them particularly suitable for smaller loans or short-term financing needs. However, their limited scope means they are less commonly employed in large-scale or long-term transactions.

3.8.6 Conclusion

The application of security instruments in Malaysia reflects a shift from traditional common law principles to statutory frameworks tailored for modern commercial needs. Mortgages, once involving ownership transfer, have been replaced by charge-based systems under laws like the National Land Code (NLC), Merchant Shipping Ordinance (MSO), and Civil Aviation Regulations (CAR), ensuring ownership remains with the debtors/borrower while granting creditors enforceable rights. Charges, governed by the Companies Act 2016 and NLC, provide a comprehensive and efficient mechanism for securing assets, particularly land and corporate property. Pledges, governed by the Contracts Act 1950, allow creditors to take possession of pledged goods as security, with broader recognition of documents of title compared to English common law, making them suitable for specialized contexts like international trade financing through bills of lading. Lien, on the other hand, are facilitated under Section 281(1) of the NLC, enabling creditors to secure debts by depositing the document of title and lodging a lienholder caveat, with courts recognizing equitable rights even without formal registration.

3.9 QUASI SECURITY: DEBENTURE, ASSIGNMENT AND GUARANTEE

According to Kate (2013), quasi-security structures encompass transactions that may not have legal standing as security instruments but nonetheless have the practical effect of providing security. Various types of quasi-security instruments, such as debenture, guarantee, indemnity, assignment, and retention of title, are utilized in financing. For the purpose of this study, the focus will be limited to debenture, assignments and contracts of guarantee, as they are more practical and widely practiced in financing, particularly within the banking industry. The primary distinction between quasi-security transactions and security lies in the fact that security can only be granted in the assets of the debtor. Quasi-security arrangements, on the other hand, do not necessarily involve assets as collateral. For instance, debentures are often included as part of a security package in financing transactions, even though they may not inherently constitute security instruments. Assignments, meanwhile, involve the transfer of rights

or liabilities under a contract, while guarantees entail a person assuming responsibility for another's debt, thereby becoming liable as the principal debtor.

3.9.1 Debenture

The traditional legal definition of debenture is that it is an instrument creating a debt or acknowledging it (*Levy v Abercorris Slate and Slab Co* (1887) 37 Ch D 260). Thus, any obligation, covenant, undertaking, guarantee to pay or acknowledgement of a debt is a debenture.[1] In the context of financial institutions, a financial institution may issue a debenture to the borrower and the borrower acknowledges the debt owed by executing the debenture (Re City Securities Pte; Ho Mun-Tuke Don & Anor v. Dresdner Bank &Ors [1990] 2 MLJ 257).

The term debenture is also used to refer to a series of bonds which evidence the fact that a company is liable to pay the amount specified, with a charge over the company's assets (Birds et al., Boyle, 2014). In this sense, a debenture is a debt paper, i.e., a form of security which may be traded and is issued by a company to raise funds by borrowing from lenders.[2] It can be concluded that a debenture is not in itself a security instrument. However, a debenture often contains a term that the borrower charges or agrees to charge his assets to ensure the repayment of the debt, or in the case of debenture stock, that the company charges or agrees to charge its assets for that purpose. Due to this term, there is some confusion whether a debenture is a security instrument[3].

Nonetheless, although a debenture may contain terms referring to a charge over a borrower's assets, the presence of this clause does not mean that the debenture on its own is a security instrument or that it creates a valid legal charge. This is because the

[1] For example, a promissory note which is a signed document containing a written promise to pay a stated sum to a specified person or the bearer at a specified date or on demand is a form of a debenture.
[2] See Section 2 of the Companies Act 2016: "Debenture" includes debenture stock, bonds, notes and any other evidence of indebtedness of a corporation for borrowed monies, whether or not constituting a charge on the assets of the corporation. This definition excludes, among others, bank deposit slips, bills of exchange and promissory notes. Section 2, CMSA 2007 has similar definition of debenture as the one under Section 2, Companies Act 2016 but provides an excluded list of categories of instruments which are not classified as debenture.
[3] Based on interview with senior legal practitioners dated 21 October 2024.

law in Malaysia requires compliance with certain formalities such as the registration requirement under Section 353(a), Companies Act 2016, for it to be valid as against the liquidator and to have priority in the payment of the company's debt upon the winding up of a company[4]. In this form, the debenture could either be a fixed or a floating charge.

Nevertheless, as noted earlier, a debenture in the form of bonds can be issued by a company to generally raise funds by borrowing from lenders. In this form, the debenture is a type of security (an asset class, not a collateral instrument)[5] and can be utilized as an underlying asset to secure the debenture holder's indebtedness.

3.9.2 Assignment

Assignment refers to the transfer of rights or liabilities to a third party. There are three ways in which assignments can be created: through contract, equitable assignment, or statutory assignment. The term "chose in action" is commonly associated with assignments and refers to the right to sue, which will be further explained.

In a contractual assignment, the parties agree to transfer their benefits and obligations under the contract to a third party. In the case of debt, the parties may arrange for any amount payable by the debtor to the assignor to be payable to the assignee instead. In other words, the debtor is obligated to treat the assignee as the creditor, as confirmed in Robinson v Podosky [1905] St R Qd and Olsson v Dyson (1969) 120 CLR 365.

Equitable assignment, as explained in Comptroller of Stamps (VIC) v Howard Smith (1936) 54 CLR 614, occurs when a creditor assigns the benefit of a contractual right owed by the debtor to an assignee by demonstrating an intention to assign.

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[4] However, even if the charge is not registered, it does not mean that the creditor does not have any recourse for the debt. The Companies Act 2016 provides that if the charge securing the debenture is not registered, the debt will become payable immediately: Section 352(2).

5 Refer to the definition of 'securities' under Section 2 of CMSA, i.e. "securities" means: -
(a) debentures, stocks or bonds issued or proposed to be issued by any government.
(b) shares in or debentures of, a body corporate or an unincorporated body; or (c) units in a unit trust scheme or prescribed investments, and includes any right, option or interest in respect thereof". These securities behave as asset classes regulated under CMSA 2007.

Statutory assignment, on the other hand, typically involves complying with statutory requirements. In Malaysia, the relevant statute governing assignments is section 4(3) of the Civil Law Act. In Chartered Bank v Rashid bin Mohamed [1986] 2 MLJ 219, the court established three conditions that must be met under section 4(3) of the Civil Law Act. Firstly, the assignment must be absolute. Secondly, it must be in writing. Thirdly, an express notice must be given to the debtor informing them that the assignee is entitled to claim the debt or thing in action. However, there are certain assignments that are excluded from section 4(3), such as conditional assignments and assignments by way of charge, as noted by Dr. Clarence (2003). An assignment by way of a charge grants the right to receive payment from the chose in action without transferring the chose in action itself (Dr. Clarence, 2003).

An example of an assignment is the absolute assignment of a life policy, as stated by Ng Kim Kang (2007). Section 4(3) of the Civil Law Act can be applied to assign life policy proceeds as security. In practice, a deed of assignment is commonly used, containing language such as "I assign to the assignee the full benefits of all money assured or become payable." Furthermore, a bank holding an absolute assignment can dispose of the property without requiring an order for sale, as supported by the Federal Court decision in Phileoallied Bank (Malaysia) Bhd v Bupinder Singh Avatar Singh & Anor [2002] 2 MLJ 513.

In an absolute assignment, only the assignee has the right to sue the debtor, while the assignor, who has already assigned their rights or chose in action to the assignee, does not retain that right. Assignments are a commonly used instrument in the finance world and have gained popularity over time.

3.9.3 Guarantee

A guarantee is a straightforward type of quasi-security. In the cases of Bank of New South Wales v Permanent Trustee Co of New South Wales Ltd (1943) 68 CLR 1 and Sunbird Plaza Pty Ltd v Maloney (1988) 166 CLR 245/ 77 ALR 2015, it was established that a guarantee is a promise made by one person to be responsible for the debt of another person. In essence, if the principal debtor defaults, the bank may choose to

enforce its rights against the guarantor when necessary. It is common for banks to pursue guarantors even if other remedies have not been exhausted, although this can lead to unfairness, particularly in more serious situations such as bankruptcy.

According to the Malaysian Contracts Act 1950 (Revised 1974), a contract of guarantee is defined as a contract to perform the promise or discharge the liability of a third person in case of their default. The person providing the guarantee is referred to as the "surety," the person in respect of whose default the guarantee is given is called the "principal debtor," and the person to whom the guarantee is given is referred to as the "creditor." A guarantee can be either oral or written.

Although financial institutions may use a contract of guarantee to secure financing transactions, this type of contractual arrangement is typically provided without any assets being used as security. A financial institution may require a guarantee from the directors or major shareholders of a corporate client for the financing facility provided to the company. If the agreed-upon guarantee is for the payment of a debt or a sum of money that has become due, the creditor may sue the guarantor when the principal debtor fails to make the payment. The contract of guarantee is a secondary contract, and its validity is closely tied to the debt obligation. The responsibility of the guarantor is equivalent to that of the principal debtor, meaning that the liability of the guarantor matches that of the principal debtor (McCracken et al., 2013). Therefore, if the primary debt contract is void or unenforceable, the contract of guarantee is also void or unenforceable (Swan v Bank of Scotland (1836) 10 Bligh (Ns) 627).

It is known that one of the bank's remedies is to have the debtor declared bankrupt, which would also involve the guarantor. The Insolvency Act 1967, which came into force in November 2017, provides protection for guarantors. The act protects two types of guarantors: social guarantors and guarantors other than social guarantors. A social guarantor is defined as a person who provides a guarantee without profit motive, and the purpose of the guarantee is either to support a loan, scholarship, or grant for educational purposes, or to guarantee a hire purchase transaction for personal use of a vehicle, or to guarantee a housing loan for personal dwelling. Section 5(3) of the Insolvency Act prohibits creditors from initiating bankruptcy proceedings against social guarantors. For guarantors other than social guarantors, the bank must obtain leave from

the court, and the court must be satisfied that the creditor has exhausted all methods of execution and enforcement to recover debts owed by the debtor. In other words, the bank, as a creditor, must first initiate seizure and sale, judgment debtor summons, garnishee, or bankruptcy or winding-up proceedings against the principal debtor before pursuing the guarantor. Social guarantors, however, are completely protected under the Insolvency Act, and bankruptcy proceedings cannot be taken against them. Nevertheless, other methods such as a writ of seizure and sale, judgment debtor summons, and garnishee are still permissible against guarantors.

3.9.4 Conclusion

Quasi-security instruments, such as debentures, assignments, and guarantees, provide practical mechanisms to secure debt obligations without vesting proprietary rights in the creditor over the debtor's assets. While debentures may include clauses creating charges over assets, they are not inherently security instruments unless specific legal formalities, such as registration under Section 353(a) of the Companies Act 2016, are met. Assignments transfer rights or liabilities, often serving as security when structured to ensure debt satisfaction, with assignees gaining direct claims over receivables unlike chargees. Guarantees, on the other hand, involve a secondary obligation where guarantors assume co-extensive liability with the principal debtor. Together, these instruments play a vital role in modern financing by balancing risk management with equitable treatment of all parties.

3.10 COMPATIBILITY ANALYSIS OF SECURITY INSTRUMENTS WITH *RAHN* CONTRACT

This section addresses Research Question No. 2 (b) by conducting an elaborate comparison of modern security instruments—mortgage, charge, pledge, and lien —with the *Rahn* contract. The analysis will delve deeply into key comparison points, including ownership, possession, power of sale, nature of interest, and eligible assets, to provide a comprehensive understanding of their compatibility.

3.10.1 Compatibility Analysis Between Mortgage and *Rahn* Contract

(i) Ownership

Mortgage: In a mortgage, the transfer of legal ownership to the creditor is a defining feature. The debtor retains equitable ownership, but the creditor holds legal title to the property until the debt is repaid. This mechanism ensures strong creditor protection, as the creditor has significant control over the mortgaged asset, including the ability to foreclose and sell it in case of default. The transfer of legal ownership serves as a form of security, enabling the creditors to enforce their rights without requiring debtor consent in many jurisdictions.

***Rahn*:** In *rahn*, the collateral assets can be the debtor's own- or third-party assets subject to its consent to be placed as collateral for other's debt. Among the key requirements of the *rahn* asset is that the ownership of the collateral (*marhūn*) must remain entirely with the debtor or a consenting third party (in the case of third-party assets used as collateral). During the period of *rahn* contract, possession may be transferred to the creditor be it physically or constructively, ensuring that the debtor retains full ownership rights.

Compatibility Analysis

The transfer of legal ownership in a mortgage creates a fundamental incompatibility with the principles of the *rahn* contract. From a *Sharīʿah* perspective, transferring ownership to the creditor could imply a form of sale rather than collateralization, which contradicts the essence of *rahn*. Jurists have extensively discussed the prerequisites for *rahn*, emphasizing that the collateral (*marhūn*) must remain under valid ownership by the debtor or a consenting third party (in the case of collateral of the third party).

The ownership structure of a mortgage is fundamentally at odds with the *rahn* contract's requirement that ownership remains with the debtor or a consenting third party. In *rahn*, the debtor retains full ownership, and only possession may be transferred to the creditor. Thus, this divergence renders mortgages largely incompatible with the principles of *rahn*.

Compatibility: Incompatible.

The transfer of legal ownership in a mortgage directly contradicts the *rahn* principle of retaining ownership with the debtor or a consenting third party, making mortgages largely incompatible with *rahn*.

(ii) Possession

Mortgage: In a mortgage, the debtor typically retains possession and use of the mortgaged property during the loan term. This arrangement allows the debtor to continue utilizing the asset for income generation or personal use, which is particularly advantageous for long-term arrangements such as real estate loans. While the debtor physically retains the asset, legal ownership of the property is effectively transferred to the mortgagee (creditor). This transfer of legal ownership grants the mortgagee significant rights over the asset, including the ability to foreclose and seize the property in the event of default by the mortgagor (debtor). Additionally, by relying on legal mechanisms such as registration and documentation, the creditor secures their interest without requiring physical control of the asset.

***Rahn*:** In a *rahn* contract, jurists hold differing views regarding whether possession of the *marhūn* (collateral) is a prerequisite for a valid contract. The majority view, held by the *Ḥanafī*, *Shāfiʿī*, and *Ḥanbalī* schools, asserts that possession (*qabḍ*) of the *marhūn* is mandatory. They argue that possession serves as an additional layer of security, ensuring that the debtor cannot misuse or dispose of the asset during the loan period. In contrast, the *Mālikī* school adopts a more flexible stance, contending that possession is not a mandatory condition for the validity of a *rahn* contract but rather a recommended practice. According to this view, the *rahn* contract remains valid even without immediate possession, provided the creditor can later request delivery of the *marhūn*.

This view aligns with contemporary practices in Islamic finance, as reflected in the standards issued by AAOIFI (2017) and the SAC of BNM (2018). These institutions recognize that a *rahn* contract is binding once concluded, and possession is not one of the primary conditions for its validity. Additionally, possession of collateral can be

either physical (*qabḍ* haqiqi) or constructive (*qabḍ* hukmi). While immediate possession is preferred, it is not a strict requirement for the validity of the *rahn* contract. Given the intricate nature of modern Islamic financial products, adopting the *Mālikī* perspective provides greater flexibility, enabling the accommodation of diverse needs of individuals and businesses while maintaining *Sharīʿah* compliance.

Compatibility Analysis

Although there are two differing views regarding the requirement of possession in *rahn*, the majority view holds that possession is a prerequisite, while the *Mālikī* view considers possession a recommended practice rather than a mandatory condition. By adopting the *Mālikī* perspective, it becomes evident that both mortgages and *rahn* contracts can operate without the necessity of transferring possession of the asset to the creditor. However, it is worth mentioning that the structural differences between the two instruments remain significant as the following:

(a) Ownership vs. Security Interest:

In a mortgage, the transfer of legal ownership to the creditor fundamentally alters the nature of the transaction, making it more akin to a sale-based arrangement rather than a pure security mechanism. In contrast, *Rahn* strictly prohibits the transfer of ownership, ensuring that the collateral remains the debtor's property. This distinction highlights a structural incompatibility between the two instruments.

(b) Possession as a Symbolic vs. Practical Concept:

While the debtor in a mortgage retains physical possession of the property, the transfer of legal ownership to the mortgagee significantly diminishes the practical significance of this possession. In *Rahn*, possession whether physical (*qabḍ haqiqi*) or constructive (*qabḍ hukmi*) is a meaningful safeguard that protects the interests of both parties. It ensures that the creditor's rights are secured while maintaining fairness and transparency for the debtor.

In contrast, the symbolic nature of possession in mortgages becomes evident when examining the broader implications of the transaction. Although the debtor retains the right to utilize the mortgaged property during the loan tenure, the legal title is effectively transferred to the mortgagee from the outset. This legal transfer creates a dual claim over the asset: the debtor holds physical possession, but the mortgagee holds legal ownership. The legal title only reverts to the debtor upon full repayment of the debt. In the event of default, the mortgagee has the authority to foreclose on the property, further undermining the debtor's autonomy and security. This arrangement raises critical concerns from a *Sharīʿah* perspective:

- Diminished Practical Control: Despite retaining physical possession, the debtor's control over the property is limited by the mortgagee's legal ownership. This undermines the practical significance of possession, as the debtor cannot exercise full ownership rights during the loan period.
- Conflict with *rahn* Principles: In *rahn*, possession serves as a protective mechanism to ensure that the collateral remains intact and available to secure the creditor's interest. However, in mortgages, the transfer of legal ownership strips the debtor of their ownership rights, creating a structural divergence from the *Sharīʿah* -compliant concept of *rahn*.
- Symbolic Retention of Possession: The debtor's retention of physical possession in a mortgage is largely symbolic, as the legal framework prioritizes the mortgagee's rights over the debtor's. This contrasts sharply with *rahn*, where possession—whether physical or constructive—is a substantive and enforceable condition that safeguards both parties' interests.

Compatibility: Incompatible

While the *Mālikī* perspective allows for some alignment between mortgages and *rahn*, the transfer of legal ownership in mortgages create substantial and structural divergences which lead to significant challenges in fully aligning mortgages with *rahn*.

(iii) Nature of Interest

Mortgage: A mortgage is fundamentally an ownership-based security instrument. In this arrangement, the creditor gains legal ownership of the property, which provides them with strong control and enforcement rights. This transfer of ownership ensures that the creditor can take decisive actions, such as foreclosing and selling the property, in the event of default. The legal ownership structure is a defining feature of mortgages, designed to offer robust protection to the creditor while securing the debt obligation

***Rahn*:** The *rahn* contract is a possession-based security instrument. Even when possession is involved (as required by the majority view), the focus remains on securing the asset as collateral while the debtor retains full ownership of the pledged asset (*marhūn*). This ensures that the debtor's rights over the property are preserved, aligning with the *Sharīʿah* principle that collateralization should not result in the loss of ownership. The emphasis in *rahn* is on using possession as a means of securing the debt, rather than altering ownership. Furthermore, the *Mālikī* perspective, which allows for flexibility regarding possession, reinforces the adaptability of *rahn* without compromising its core principles.

Compatibility Analysis

The fundamental difference between mortgages and *rahn* lies in their underlying nature, which directly impacts their compatibility:

(a) *Mortgage:* The creditor's security is rooted in ownership, with legal title to the property serving as the primary mechanism for enforcing the debt. This ownership-based structure grants the creditor extensive control over the asset, including the ability to foreclose and sell the property in the event of default. The transfer of legal ownership to the creditor fundamentally alters the debtor's rights, creating a dual claim over the asset—one for the creditor (legal ownership) and one for the debtor (physical possession during the loan period).

(b) *Rahn*: In contrast, the creditor's security in *rahn* is rooted in possession, with the debtor retaining full ownership of the rahn asset (*marhūn*). Possession serves as a secondary layer of security, ensuring that the debtor

cannot misuse or dispose of the asset during the debt period. The emphasis in *rahn* is on preserving the debtor's ownership while using possession as a means of securing the debt.

Compatibility: Incompatible.

The ownership-based nature of mortgages makes them fundamentally incompatible with the possession-based structure of *rahn*.

(iv) Power of Sale

Mortgage: In a mortgage, the transfer of legal ownership to the creditor (mortgagee) is a defining feature. The mortgagee's enforcement rights are rooted in their ownership of the asset, enabling them to act unilaterally in many cases. In the event of default, the mortgagee can exercise their ownership rights to foreclose on the property and sell it to recover the outstanding debt. This process is typically outlined in the mortgage agreement and may not always require court intervention, depending on the jurisdiction. The transfer of legal ownership provides the mortgagee with significant control over the asset, allowing them to enforce their rights without requiring debtor consent.

***Rahn*:** Under a *rahn* contract, the debtor retains full ownership of the pledged asset (*marhūn*), and only possession may be transferred to the creditor. The creditor does not acquire ownership but instead gains a conditional right of disposal over the *rahn* asset in the event of default. Classical jurists such as Al-Marghīnānī (2000) , *Al-Buhūtī* (1997) , Ibn Qudāmah (1997) , *Al-Sharbīnī* (2000) , and *Al-Nawawī* (2003) have established robust principles governing this right:

- If the debtor fulfills their obligations within the agreed timeframe, the creditor is obligated to return the *rahn* asset without delay.
- In the event of default, the creditor acquires a conditional right to sell the asset, but only with the debtor's explicit permission or mutual consent. This ensures fairness and prevents unilateral actions by either party.

- Proceeds from the sale must first settle the outstanding debt. Any surplus is returned to the debtor, while any shortfall remains the debtor's liability.

Contemporary regulatory bodies like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2017) and SAC of BNM (2018) have further refined these principles:

- AAOIFI emphasizes that the creditor may only sell the asset with prior authorization or mutual consent, ensuring transparency and fairness.
- SAC of BNM mandates strict adherence to the terms of the *rahn* agreement during liquidation, protecting both parties' rights.

Compatibility Analysis

The fundamental difference between mortgages and *rahn* lies in the nature of ownership and its implications for the power of sale:

- *Mortgage:* Since the mortgagee already owns the mortgaged asset, the concept of "power of sale" does not arise in the same way it does in *rahn*. The mortgagee's enforcement rights are rooted in their ownership of the asset, enabling them to act unilaterally. This approach prioritizes creditor protection but contradicts the *Sharīʿah* principle that the debtor must retain ownership of the pledged asset.
- *Rahn:* The power of sale is more regulated and aligned with *Sharīʿah* principles, as the asset belongs to the debtor. The creditor's right of disposal is conditional and requires prior authorization or consent, ensuring fairness, transparency, and the protection of both parties' rights.

From a *Sharīʿah* perspective, the transfer of ownership in mortgages renders the concept of power of sale incompatible with *rahn*. The legal transfer of ownership in mortgages implies a form of sale rather than collateralization, which is antithetical to the essence of *rahn*.

Compatibility: Incompatible.

The transfer of ownership in mortgages renders the concept of power of sale incompatible with *rahn*, as the legal transfer of ownership contradicts the *Sharīʿah*

principle of collateralization under *rahn*. Therefore, the comparison of the power of sale between the mortgage and *rahn* is inapplicable in nature.

(v) Eligible Assets

Mortgage: Mortgages typically cover a wide range of assets, including both tangible and intangible assets, though they are most commonly applied to immovable property such as real estate. However, mortgage is limited to the existing assets only and cannot be applied for future assets. The eligibility of assets for mortgages is generally determined by their market value, legal ownership, and ability to serve as collateral. A key feature of mortgages is that they are generally limited to existing assets only. Future assets or contingent claims (e.g., future receivables) are typically not eligible for mortgage-based financing. This limitation ensures that the creditor has a concrete and identifiable asset to secure the debt obligation.

***Rahn*:** In a *rahn* contract, the eligibility of assets is a critical factor that ensures the validity and enforceability of the agreement. Classical Muslim jurists have outlined robust principles governing the eligibility of assets under *rahn*, emphasizing that only specific types of assets can serve as collateral. These principles ensure compliance with *Sharīʿah* requirements and safeguard the interests of both parties involved. The key criteria for eligible assets are as follows:

(i) *Sharīʿah* Compliant Assets

The asset pledged as collateral must be permissible (*halal*) under Islamic law. Any asset derived from or associated with prohibited activities (e.g., alcohol, gambling, or interest-based transactions) is ineligible for use in a *rahn* contract.

(ii) *Sharīʿah* Valuable Assets

The asset must possess intrinsic value and utility, meaning it should be capable of being exchanged or utilized in a manner consistent with Islamic principles. Jurists emphasize that intangible or non-valuable items cannot serve as valid collateral, as they fail to provide the necessary security for the creditor. Tangible assets such as real estate, gold, or vehicles are

typically preferred due to their inherent value and ability to secure the debt effectively. However, some jurists of *Mālikī* allow for the use of intangible assets for the collateral as is better loan secured with something rather than nothing.

(iii) Valid Ownership

The debtor must have clear and undisputed ownership of the asset at the time of pledging. This principle ensures that the collateral asset is free from disputes, liens, or encumbrances, thereby protecting the creditor's rights and ensuring the enforceability of the *rahn* contract. Without valid ownership, the collateral loses its legal and practical significance, undermining the purpose of the *rahn* mechanism.

(iv) Existing and Deliverable Assets

The asset must exist and be deliverable at the time of the contract. Jurists unanimously agree that future or hypothetical assets cannot be used as collateral, as their existence and value cannot be guaranteed. Additionally, the asset must be physically or constructively deliverable to the creditor, depending on the type of possession required under the specific interpretation of *rahn*.

The Adoption of the Flexible Opinion of Mālikī Perspective

The *Mālikī* school's pragmatic approach addresses many of the limitations of the majority view, making *rahn* more adaptable to contemporary financial practices. By allowing intangible assets, non-existent assets, and minor ambiguities, the *Mālikī* perspective enhances the accessibility and versatility of *rahn* contracts. For instance:

- Intangible Assets: In modern finance, assets such as intellectual property, digital currencies, or receivables play a significant role. The *Mālikī* view accommodates these assets, aligning *rahn* with the evolving nature of wealth and commerce.
- Non-Existent Assets: The inclusion of future assets (e.g., crops or expected revenues) broadens the scope of *rahn*, enabling its application in forward-looking financial products.
- Flexibility in Possession: By not mandating physical possession, the *Mālikī* perspective allows for constructive possession through legal mechanisms, making *rahn* more compatible with modern financial systems.

Compatibility Analysis

The eligibility criteria for assets in *rahn* and mortgages reveal both convergence and divergence:

- Convergence: When mortgages involve existing and tangible assets, they align well with *rahn*, subject to the fulfilment of certain conditions including *Sharīʿah*- compliant asset, under valid ownership and deliverability.
- Divergence: The use of *Sharīʿah* non-compliance assets is not part of requirement in mortgage; therefore, it might be incompatible to *rahn*. Additionally, the use of intangible assets for mortgage, which are generally excluded under the majority view of *rahn*. However, the *Mālikī* perspective bridges this gap by allowing such assets, enhancing potential compatibility between the two instruments.

Compatibility: Moderate

When mortgages involve existing and tangible assets, they align well with *rahn* subject to fulfilling *rahn* assets requirement. Furthermore, the compatibility of mortgages with *rahn* can be further enhanced by adopting flexible opinion of *Mālikī* perspective, particularly in cases involving existing intangible assets.

3.10.2 Compatibility Analysis Between the Charge and *Rahn* Contract

(i) Ownership

Charge: In a charge, ownership of the asset remains entirely with the debtor, and the creditor is granted a legal interest or lien over the asset as security for the debt. The creditor does not acquire legal ownership but holds enforceable rights over the asset in the event of default. This mechanism ensures that the debtor retains full ownership and use of the asset during the loan term, while the creditor relies on legal mechanisms—such as registration or documentation—to secure their interest. By maintaining the

debtor's ownership, charges align with principles of fairness and transparency, ensuring that the debtor can continue utilizing the asset for personal or commercial purposes.

***Rahn*:** The *rahn* contract explicitly mandates that ownership of the collateral asset (*marhūn*) must remain entirely with the debtor or, in some cases, a consenting third party (in the case of third-party assets). Only possession may be transferred to the creditor, while that the debtor retains full ownership rights. This principle is rooted in *Sharīʿah* law, which prohibits the transfer of ownership to creditor which defeat the purpose of collateral arrangements. Instead, *rahn* emphasizes the use of possession as a means of securing the debt, safeguarding both the debtor's rights and the creditor's interests.

Compatibility Analysis

The retention of ownership by the debtor is a defining feature for both charges and *rahn* that creates significant alignment between the two instruments. In both cases:

- The debtor retains legal ownership of the asset.
- The creditor gains enforceable rights over the asset as security for the debt.
- Collateralization occurs without transferring ownership, ensuring compliance with *Sharīʿah* principles in the case of *rahn*.

From a *Sharīʿah* perspective, the retention of ownership in *rahn* aligns closely with the security instrument of charges, ensuring compatibility in this aspect. Both instruments emphasize the importance of the concept of collateral arrangement without undermining the debtor's ownership rights, which is a key requirement under the *rahn* contract.

Compatibility: High.

The retention of ownership by the debtor in both charges and *rahn* ensures strong compatibility, making them well-suited for alignment in financial transactions. This compatibility is further reinforced by their shared emphasis on the nature of collateral arrangement which aligns with the *Sharīʿah* principles.

(ii) Possession

Charge: In a charge, possession of the asset remains entirely with the debtor. The creditor does not take physical or constructive possession of the asset but instead secures their interest through legal mechanisms such as registration or documentation. This non-possession-based structure allows the debtor to retain full use and control of the asset during the loan term, ensuring operational continuity and flexibility in financial transactions.

***Rahn*:** In a *rahn* contract, jurists hold differing views regarding whether possession of the *marhūn* (collateral) is a prerequisite for a valid contract. The majority view, held by the *Ḥanafī*, *Shāfiʿī*, and *Ḥanbalī* schools, asserts that possession (*qabḍ*) of the *marhūn* is mandatory. They argue that possession serves as an additional layer of security, ensuring that the debtor cannot misuse or dispose of the asset during the loan period. In contrast, the *Mālikī* school adopts a more flexible stance, contending that possession is not a mandatory condition for the validity of a *rahn* contract but rather a recommended practice. According to this view, the *rahn* contract remains valid even without immediate possession, provided the creditor can later request delivery of the *marhūn*.

This view aligns with contemporary practices in Islamic finance, as reflected in the standards issued by AAOIFI and the SAC of BNM. These institutions recognize that a *rahn* contract is binding once concluded, and possession is not one of the primary conditions for its validity. Additionally, possession of collateral can be either physical (*qabḍ haqiqi*) or constructive (*qabḍ hukmi*). While immediate possession is preferred, it is not a strict requirement for the validity of the *rahn* contract. Given the intricate nature of modern Islamic financial products, adopting the *Mālikī* perspective provides greater flexibility, enabling the accommodation of diverse needs of individuals and businesses while maintaining *Sharīʿah* compliance.

Compatibility Analysis

The compatibility between charge and *rahn* is significantly enhanced when adopting the *Mālikī* perspective, which regards possession as a recommended practice rather than a mandatory requirement in *rahn*. This approach aligns closely with the non-possession-based nature of charges, where the creditor secures their interest through legal

mechanisms such as registration or documentation rather than physical control of the asset. The *Mālikī* stance accommodates the realities of modern financial transactions, ensuring that *rahn* can coexist seamlessly with charges without imposing undue restrictions. From a *Sharīʿah* perspective, the *Mālikī* view bridges the gap between traditional principles and contemporary practices. It enables *rahn* to function effectively in modern financial systems by recognizing alternative forms of security, such as legally enforceable covenants, while preserving the debtor's ownership rights. This flexibility ensures that both charges and *rahn* can operate harmoniously, particularly in contexts where physical possession is impractical or unnecessary. For instance, in the case of intangible assets or large-scale commercial transactions, the legal registration of charges serves as a sufficient mechanism to secure the creditor's interest.

Compatibility: High.

The non-possession-based nature of charges aligns seamlessly with the *Mālikī* perspective on *rahn*. This compatibility ensures that both instruments can coexist effectively in modern financial systems, governed and enforced through legal covenants such as the registration of charges.

(iii) Nature of Interest

Charges: Charges are encumbrance-based security instruments. They create a legal right for the creditor to appropriate the charged asset for debt satisfaction without transferring ownership or possession. The debtor retains full control and use of the asset during the loan term, while the creditor relies on legal mechanisms (e.g., registration or contractual agreements) to enforce their interest in case of default. This encumbrance-based structure ensures that the creditor's rights are protected without requiring physical control or ownership of the asset.

***Rahn*:** The *rahn* contract is fundamentally a possession-based security instrument, as emphasized by the majority of jurists (*Ḥanafī*s, *Shāfiʿī*s, and *Ḥanbalī*s), who consider physical possession (*qabḍ*) of the collateral (*marhūn*) a mandatory requirement. This

requirement ensures that the debtor cannot misuse or dispose of the pledged asset during the loan period, thereby safeguarding the creditor's interests.

However, the *Mālikī* perspective offers a more flexible interpretation, holding that possession is not a mandatory condition for a valid *rahn* contract but rather a recommended practice. For the *Mālikī* jurists, the *rahn* contract becomes binding upon its creation, irrespective of whether possession is transferred. According to this view, the primary objective of *Rahn* is to secure the debt, and it is preferable to accept some form of collateral—even without physical possession—rather than having no security at all. As long as the purpose of *rahn* is achieved—namely, the ability to liquidate the collateral in the event of default—the absence of possession does not invalidate the contract. In practice, the creditor may still opt to gain either physical possession or constructive possession to ensure the asset is safeguarded during the loan period. This approach aligns more closely with modern financial practices, where enforceable legal frameworks and mechanisms (e.g., through registration, documentation, or legal mechanisms) govern the security of transactions. The *Mālikī* view thus provides greater adaptability, allowing *rahn* to accommodate contemporary financial systems while remains *Sharīʿah*-compliant.

Compatibility Analysis

The nature of interest in *rahn* reflects a balance between safeguarding creditors' rights and accommodating the realities of modern transactions. While the majority view emphasizes possession to ensure security, the *Mālikī* perspective provides greater flexibility by recognizing the bindingness of the *rahn* contract upon its creation, independent of possession. This flexibility ensures that *rahn* remains relevant and adaptable in contemporary financial systems, governed by enforceable legal frameworks. This flexibility allows *rahn* to seamlessly integrate with instruments like charges, which rely on legal mechanisms rather than possession to secure creditors' interests.

Compatibility: High

The *rahn* is significantly compatible with charges, as both instruments emphasize enforceable or bindingness of instruments via legal mechanisms over possession. This

alignment enables *rahn* to function effectively within contemporary financial systems while adhering to *Sharīʿah* principles.

(iv) Power of Sale

Charge: In a charge, creditors are granted immediate control over specific assets as security for the debt. Enforcement of charges typically involves judicial processes, such as appointing a receiver or obtaining a court order to sell the charged assets. These mechanisms ensure that enforcement is conducted fairly and in accordance with legal frameworks, protecting both the creditor's and debtor's rights. The structured and regulated nature of these processes ensures transparency and minimizes the risk of unilateral actions by either party.

***Rahn*:** Under a *rahn* contract, the debtor retains full ownership of the pledged asset (*marhūn*), and only possession may be transferred to the creditor. The creditor does not acquire ownership but instead gains a conditional right of disposal over the *rahn* asset in the event of default. Classical jurists such as Al-Marghīnānī (2000), *Al-Buhūtī* (1997), Ibn Qudāmah (1997), *Al-Sharbīnī* (2000), and *Al-Nawawī* (2003) have established robust principles governing this right:

- If the debtor fulfills their obligations within the agreed timeframe, the creditor is obligated to return the *rahn* asset without delay.
- In the event of default, the creditor acquires a conditional right to sell the asset, but only with the debtor's explicit permission or mutual consent. This ensures fairness and prevents unilateral actions by either party.
- Proceeds from the sale must first settle the outstanding debt. Any surplus is returned to the debtor, while any shortfall remains the debtor's liability.

Contemporary regulatory bodies like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2017) and Bank Negara Malaysia (SAC of BNM, 2025) have further refined these principles:

- AAOIFI emphasizes that the creditor may only sell the asset with prior authorization or mutual consent, ensuring transparency and fairness.

- BNM mandates strict adherence to the terms of the *rahn* agreement during liquidation, protecting both parties' rights.

Compatibility Analysis

Both charges and *rahn* impose similar constraints on enforcement rights, reflecting a shared emphasis on controlled and regulated mechanisms. While charges are generally more flexible in their enforcement processes—allowing for judicial oversight and the appointment of receivers, their structured approach aligns well with the framework of *Rahn*, which prioritizes fairness and transparency in the event of liquidation.

The requirement in *rahn* that the sale of the pledged assets must be conducted fairly and transparently resonates with the judicial processes often involved in enforcing charges. Both instruments emphasize the protection of the rights of both the debtor and creditor, ensuring that enforcement is carried out in a manner consistent with legal and *Sharīʿah* principles. This alignment underscores the compatibility of the two instruments, particularly in contexts where adherence to *Sharīʿah* principles is paramount.

Compatibility: High

Both instruments allow for controlled enforcement mechanisms, aligning well with *Sharīʿah* principles and ensuring strong compatibility. The emphasis on fairness, transparency, and judicial oversight in charges mirrors the regulated and consensual liquidation process in *Rahn*, making them highly compatible in practice.

(v) Eligible Assets

Charge: Charges are highly versatile, covering a broad spectrum of assets, including both tangible and intangible assets. Examples include real estate, machinery, financial instruments, intellectual property, and even future receivables. Floating charges, in particular, offer unparalleled flexibility by adapting to changes in a company's asset

base, allowing creditors to secure interests over fluctuating or evolving asset portfolios. This adaptability makes charges particularly suitable for modern financial transactions involving complex and diverse asset types.

***Rahn*:** In a *rahn* contract, the eligibility of assets is a critical factor that ensures the validity and enforceability of the agreement. Classical Muslim jurists have outlined robust principles governing the eligibility of assets under *rahn*, emphasizing that only specific types of assets can serve as collateral. These principles ensure compliance with *Sharīʿah* requirements and safeguard the interests of both parties involved. The key criteria for eligible assets are as follows:

(i) *Sharīʿah* -Compliant Assets

The asset pledged as collateral must be permissible (*halal*) under Islamic law. Any asset derived from or associated with prohibited activities (e.g., alcohol, gambling, or interest-based transactions) is ineligible for use in a *rahn* contract.

(ii) *Sharīʿah* -Valuable Assets

The asset must possess intrinsic value and utility, meaning it should be capable of being exchanged or utilized in a manner consistent with Islamic principles. Jurists emphasize that intangible or non-valuable items cannot serve as valid collateral, as they fail to provide the necessary security for the creditor. Tangible assets such as real estate, gold, or vehicles are typically preferred due to their inherent value and ability to secure the debt effectively. However, some jurists of *Mālikī* allow for the use of intangible assets for the collateral as is better loan secured with something rather than nothing.

(iii) Valid Ownership

The debtor must have clear and undisputed ownership of the asset at the time of pledging. This principle ensures that the collateral asset is free from disputes, liens, or encumbrances, thereby protecting the creditor's rights and ensuring the enforceability of the *rahn* contract. Without valid ownership, the collateral loses its legal and practical significance, undermining the purpose of the *rahn* mechanism.

(iv) Existing and Deliverable Assets

The asset must exist and be deliverable at the time of the contract. Jurists unanimously agree that future or hypothetical assets cannot be used as collateral, as their existence and value cannot be guaranteed. Additionally, the asset must be physically or constructively deliverable to the creditor, depending on the type of possession required under the specific interpretation of *rahn*.

The adoption of the Flexible opinion of Mālikī Perspective

The *Mālikī* school's pragmatic approach addresses many of the limitations of the majority view, making *rahn* more adaptable to contemporary financial practices. By allowing intangible assets, non-existent assets, and minor ambiguities, the *Mālikī* perspective enhances the accessibility and versatility of *rahn* contracts. For instance:

- Intangible Assets: In modern finance, assets such as intellectual property, digital currencies, or receivables play a significant role. The *Mālikī* view accommodates these assets, aligning *rahn* with the evolving nature of wealth and commerce.
- Non-Existent Assets: The inclusion of future assets (e.g., crops or expected revenues) broadens the scope of *rahn*, enabling its application in forward-looking financial products.
- Flexibility in Possession: By not mandating physical possession, the *Mālikī* perspective allows for constructive possession through legal mechanisms, making *rahn* more compatible with modern financial systems.

Compatibility Analysis

The eligibility criteria for assets in *rahn* and charges reveal both convergence and divergence:

Convergence:

When charges involve existing assets, including tangible and intangible ones, they align well with *rahn*, subject to fulfilling certain conditions such as *Sharīʿah* compliance

assets, valid ownership, and deliverability for tangible assets. Additionally, the *Mālikī* perspective may be adopted to justify the use of intangible assets, even though they are generally prohibited by the majority view, due to current needs and sophistication in modern finance.

Divergence:

(i) *Sharīʿah* Non-Compliant Assets: Charges do not impose restrictions on the *Sharīʿah* -compliance of assets, which may render them incompatible with *rahn*. However, this issue can be managed by ensuring that only *Sharīʿah* -compliant assets are used in Islamic financial contexts.

(ii) Future Acquired Assets: Floating charges often involve future-acquired assets, which are generally excluded from the majority view of *rahn*. However, the *Mālikī* perspective bridges this gap by allowing such assets, enhancing potential compatibility between the two instruments.

Compatibility: Moderate

When charges involve existing assets, including tangible and intangible ones, they align well with *rahn*, provided the assets meet *Rahn* requirements such as *Sharīʿah* compliance, valid ownership, and deliverability. Furthermore, the compatibility of charges with *Rahn* can be further enhanced by adopting the flexible opinion of the *Mālikī* perspective, particularly in cases involving future-acquired assets. The eligibility of assets highlights a strong alignment between charges and *rahn*. While charges are inherently versatile, the flexibility offered by the *Mālikī* perspective in *Rahn* ensures that both instruments can secure diverse asset portfolios effectively. This adaptability makes them well-suited for alignment in modern financial systems. However, the application of floating charges—particularly regarding the involvement of *gharar* (uncertainty) for future and possibly *Sharīʿah* non-compliant assets—requires further research to assess its compatibility from a *Sharīʿah* perspective.

3.10.3 Compatibility Analysis Between the Pledge and *Rahn* Contract

(i) Ownership

Pledge: In a pledge, the pledgor retains ownership of the pledged goods, while the pledgee gains possession of the goods as security. The pledgee does not acquire ownership but holds control over the goods until the debt is repaid. This arrangement ensures that the pledgor remains the rightful owner of the asset, even as it serves as collateral for the debt. By maintaining ownership with the debtor, pledges align with principles of fairness and transparency, ensuring that the debtor's rights are preserved while providing adequate security to the creditor.

Ownership in *Rahn*:

Under a *rahn* contract, ownership of the pledged asset (*marhūn*) must remain with the debtor (rāhin). The creditor (murtahin) may gain possession of the asset, but they do not acquire ownership rights. This principle aligns seamlessly with the concept of pledges, as both instruments emphasize the retention of ownership by the debtor. The *rahn* framework ensures that the debtor's ownership rights are safeguarded, while the creditor's interests are protected through possession or constructive control of the asset.

Compatibility Analysis

Both pledges and *rahn* share a fundamental principle: ownership of the pledged asset must remain with the debtor. This alignment underscores their compatibility, as both instruments prioritize the debtor's rights while using possession as a means of securing the debt. In both cases:

- The debtor retains legal ownership of the asset.
- The creditor gains enforceable rights over the asset as security for the debt.
- Collateralization occurs without transferring ownership, ensuring compliance with *Sharīʿah* principles in the case of *rahn*.

This shared emphasis on retaining ownership creates a strong foundation for compatibility between pledges and *rahn*, making them well-suited for alignment in

financial transactions. Both instruments ensure that the debtor's rights are protected while providing creditors with adequate security, reinforcing their practicality and fairness.

Compatibility: High

Both instruments retain ownership with the debtor, ensuring strong compatibility. This alignment makes pledges and *rahn* highly compatible in practice, particularly in contexts where adherence to *Sharīʿah* principles is essential.

(ii) Possession

Pledge: Pledges require the creditor to hold physical possession of the pledged goods as security. This reliance on possession ensures that the creditor has control over the goods until the debt is repaid. Physical possession serves as a safeguard, preventing the debtor from misusing or disposing of the asset during the loan period. This strict requirement for physical possession underscores the creditor's need for direct control over the collateral, ensuring robust security.

Possession in *Rahn*: Under a *rahn* contract, possession of the pledged asset (*marhūn*) may or may not be transferred to the creditor (murtahin), depending on the terms agreed upon by the contracting parties and the scholarly perspective adopted:

- Majority View (*Ḥanafī*s, *Shāfiʿī*s, *Ḥanbalī*s): Physical possession (qabḍ) is considered a prerequisite for a valid *Rahn* contract. This ensures that the debtor cannot misuse or dispose of the asset during the loan period, thereby safeguarding the creditor's interests.
- *Mālikī* View: Possession is not mandatory but rather recommended. The methods such as through registration, documentation, or legal mechanisms—is deemed sufficient. This flexibility allows *rahn* to accommodate modern financial practices where possession may be impractical or unnecessary.

For a detailed discussion on possession in *rahn* assets, including juristic perspectives and contemporary practices, refer to the earlier section on 2.3.6.1 Possession of the *Rahn* Asset.

Compatibility Analysis

Both pledges and *rahn* emphasize the importance of possession as a means of securing the debt. However, their approaches differ significantly:

Pledges: Mandate physical possession by the creditor, making it a strict requirement for the validity of the security arrangement. This reliance on physical possession ensures direct control over the collateral but limits flexibility.

***Rahn*:** Offers greater flexibility, as possession is not always a mandatory condition. While physical possession provides an additional layer of security, the absence of possession does not invalidate the *rahn* contract, particularly under the *Mālikī* perspective. This adaptability makes *rahn* more suitable for modern financial systems, where various methods through legal mechanisms are often sufficient. The reliance on physical possession in pledges creates a potential divergence with *rahn*, particularly when adhering to the majority view requiring possession. However, adopting the *Mālikī* perspective significantly enhances compatibility, as it aligns with the non-possession-based nature of pledges in certain contexts. The *Mālikī* stance accommodates the realities of modern financial transactions, ensuring that *rahn* can coexist with pledges without imposing undue restrictions.

Compatibility: Moderate

The reliance on physical possession in pledges contrasts with the flexibility offered by *rahn*, particularly under the *Mālikī* perspective. While there is moderate compatibility between the two instruments, *rahn* demonstrates greater adaptability, making it more suitable for application remains relevant and practical in contemporary financial systems.

(vi) Power of Sale

A pledgee has the authority to sell the pledged goods if the debtor defaults, providing strong enforcement rights. This power is typically limited to the pledged goods and does not extend to other assets. In many jurisdictions, enforcement of pledges may occur without judicial oversight, allowing the pledgee to sell the goods unilaterally. This flexibility enhances efficiency and ensures swift recovery for the creditor.

Power of Sale in *Rahn*: Under a *Rahn* contract, the creditor (murtahin) may sell the pledged asset (*marhūn*) upon default, but this process is subject to agreed terms to ensure fairness and compliance with *Sharīʿah* principles. In most Islamic jurisdictions, the sale of the pledged asset requires court approval or mutual consent to prevent unilateral actions by the creditor and safeguard the debtor's interests. This structured approach ensures that the sale is conducted transparently and equitably, aligning with the broader objectives of justice and fairness in Islamic finance.

For a detailed discussion on the power of sale in *rahn*, including juristic perspectives and contemporary practices, refer to the earlier section on 2.3.6.2 Requirement of Right of Disposal of the *Rahn* Asset.

Compatibility Analysis

Both pledges and *rahn* allow for the sale of the secured asset upon default, reflecting a shared emphasis on controlled enforcement mechanisms. The requirement for pledge and *rahn* ensures that the sale of the pledged asset is conducted fairly and transparently, which resonates with the judicial processes often involved in enforcing pledges in regulated environments. This alignment underscores the compatibility of the two instruments, particularly in contexts where adherence to *Sharīʿah* principles is paramount.

Compatibility: High.

Both instruments allow for the sale of the secured asset upon default, subject to mutually agreed terms and respective regulatory requirements where applicable. The emphasis on fairness and transparency in *rahn* aligns well with judicial oversight mechanisms in pledges, making them highly compatible in practice.

(v) Eligible Assets

Pledge: Pledges are limited to existing, tangible, movable goods such as inventory, jewelry, or equipment. The security mechanism of a pledge relies heavily on physical possession which inherently excludes intangible assets like shares, intellectual property, or receivables. This limitation restricts the scope of assets that can be used as collateral under a pledge, making it less versatile compared to other security instruments. As a result, pledges are primarily suited for traditional, possession-based transactions and may not adequately address the needs of modern financial systems involving diverse asset types.

Eligible Assets in *Rahn:* The *rahn* contract demonstrates greater flexibility and adaptability to various types of assets, including both tangible and intangible assets, provided they meet *Sharīʿah* -compliant criteria. Classical jurists have outlined robust principles governing eligible assets, ensuring compliance with Islamic law:

- Tangible Assets: Such as real estate, gold, vehicles, and other valuable goods are widely accepted as collateral.
- Intangible Assets: Some jurists, particularly from the *Mālikī* school, allow for the inclusion of intangible assets like intellectual property, digital currencies, or receivables, arguing that it is better to secure a loan with something rather than nothing.
- Future-Acquired Assets: Under the flexible opinion of the *Mālikī* perspective, future-acquired assets (e.g., crops, expected revenues) may also be considered, broadening the scope of eligible assets.

This flexibility ensures broader applicability in Islamic finance, allowing *rahn* to be used in diverse financial arrangements while adhering to *Sharīʿah* principles.

For a detailed discussion on eligible assets in *rahn*, including juristic perspectives and contemporary practices, refer to the earlier section on 2.3.6.3 Eligible Assets for *Rahn*.

Compatibility Analysis

The eligibility criteria for assets in pledges and *rahn* reveal both convergence and divergence:

- Pledges: Are strictly limited to existing, tangible, movable goods due to their reliance on physical possession. This narrow scope makes pledges less adaptable to modern financial systems, where intangible and future-acquired assets play a significant role.
- *Rahn*: Offers greater flexibility by accommodating a wider range of assets, including tangible, intangible, and potentially future-acquired assets (under the *Mālikī* view). This adaptability aligns *rahn* with the evolving nature of wealth and commerce, ensuring its relevance in contemporary financial contexts.

While pledges are restricted to physical possession-based security, *rahn* provides a broader framework that can include intangible and future-acquired assets within *Sharīʿah* -compliant boundaries. This flexibility ensures strong alignment in terms of eligible assets, particularly when adopting the *Mālikī* perspective, which bridges the gap between traditional principles and modern financial practices.

Compatibility: Moderate

Pledges are limited to tangible, movable goods, whereas *rahn* may include tangible and intangible assets, as well as future-acquired assets under the *Mālikī* view. While there

is some overlap in eligible assets, the broader scope of *rahn* enhances its compatibility with modern financial practices.

3.10.4 Compatibility Analysis Between the Lien and *Rahn* Contract

(i) Ownership

Ownership in Lien: A lien does not involve the transfer of ownership or possession unless specifically required by the terms of the agreement. Instead, it grants the lien holder the right to retain possession of the asset until the debtor fulfils their obligation. Ownership remains with the debtor, and the lien holder's rights are limited to securing the debt through possession or legal claims. This arrangement ensures that the debtor retains full ownership rights while providing the creditor with a mechanism to safeguard their interest.

Ownership in *Rahn*: Similarly, under a *rahn* contract, ownership of the pledged asset (*marhūn*) remains with the debtor (rāhin). Possession may or may not be transferred to the creditor (murtahin), depending on the terms agreed upon by the contracting parties. However, even when possession is transferred, ownership is preserved with the debtor, ensuring compliance with *Sharīʿah* principles. The retention of ownership by the debtor is a fundamental requirement in *rahn*.

Compatibility Analysis

Both liens and *rahn* emphasize the importance of retaining ownership with the debtor. This shared principle ensures strong compatibility between the two instruments, as both prioritize the debtor's rights while using possession or legal claims as a means of securing the debt. In both cases:

- The debtor retains legal ownership of the asset.
- The creditor gains enforceable rights over the asset as security for the debt.

This shared emphasis on retaining ownership creates a strong foundation for compatibility between liens and *rahn*, making them well-suited for alignment in

financial transactions. Both instruments ensure that the debtor's rights are protected while providing creditors with sufficient security, reinforcing their practicality and fairness.

Compatibility: High

Both instruments preserve the debtor's ownership, ensuring strong compatibility. This alignment makes liens and *rahn* highly compatible in practice.

(ii) Possession

Possession in Lien

Lien can arise automatically under common law, statute, or contract, depending on the circumstances. For instance, artisans' lien arises when repair work is performed, while solicitors' liens apply to client funds held in trust. In some cases, possession of the debtor's property is incidental to the service provided, while in others, possession may not be involved at all.

Possession in *Rahn*: Under a *rahn* contract, possession of the pledged asset (*marhūn*) may or may not be transferred to the creditor (murtahin), depending on the terms agreed upon by the contracting parties and the scholarly perspective adopted:

- Majority View (*Ḥanafī*s, *Shāfiʿī*s, *Ḥanbalī*s): Physical possession (qabḍ) is considered a prerequisite for a valid *Rahn* contract. This ensures that the debtor cannot misuse or dispose of the asset during the loan period, thereby safeguarding the creditor's interests.
- *Mālikī* View: Possession is not mandatory but rather recommended. The methods such as through registration, documentation, or legal mechanisms—is deemed sufficient. This flexibility allows *rahn* to accommodate modern financial practices where possession may be impractical or unnecessary.

For a detailed discussion on possession in *rahn* assets, including juristic perspectives and contemporary practices, refer to the earlier section on 2.3.6.1 Possession of the *Rahn* Asset.

Compatibility Analysis

The reliance on possession in lien varies significantly, creating partial alignment with *Rahn*:

- Liens: Some types of liens, such as artisans' liens, involve possession of the debtor's property, aligning closely with the *rahn* principle of using possession as a security mechanism. However, other types of liens, such as equitable or statutory liens, do not involve possession at all. This inconsistency reduces overall compatibility, as *rahn* consistently emphasizes possession (physical or constructive) as a key security mechanism.
- *Rahn*: Offers greater flexibility, as possession is not always a mandatory condition. While physical possession provides an additional layer of security, the absence of possession does not invalidate the *rahn* contract, particularly under the *Mālikī* perspective. This adaptability makes *rahn* more suitable for modern financial systems, where various methods through legal mechanisms are often sufficient.

The reliance on physical possession in certain liens creates a potential divergence with *rahn*, particularly when adhering to the majority view requiring possession. However, adopting the *Mālikī* perspective significantly enhances compatibility, as it aligns with the non-possession-based nature of certain liens (e.g., equitable or statutory liens). The *Mālikī* stance accommodates the realities of modern financial transactions, ensuring that *rahn* can coexist with liens without imposing undue restrictions.

Compatibility: Moderate

The reliance on possession in lien varies significantly, creating partial alignment with *rahn*. While possessory lien aligns well with *rahn*, non-possessory lien reduce compatibility due to the absence of possession as a security mechanism. The flexibility

offered by the *Mālikī* perspective enhances compatibility but does not fully address the inconsistency.

(iii) Nature of Interest

Nature of Interest in Liens:

Liens are possession-based security instruments when possession is involved. For example, artisans' liens rely on possession of the debtor's property as security for unpaid services, ensuring that the creditor has control over the asset until the debt is settled. However, other types of liens, such as equitable lien, do not require possession. Instead, they rely on legal claims or equitable rights to secure the debt. This variability in interest creates a flexible but inconsistent framework for liens, depending on the type of lien and its legal context.

Nature of Interest in *Rahn*: Similarly, the *rahn* contract is a possession-based security instrument if possession is transferred. The creditor's interest in the *rahn* asset arises only upon default, and the asset serves solely as a means of securing the debt.

For a detailed discussion on the nature of interest in *rahn*, including juristic perspectives and contemporary practices, refer to the earlier section on 2.3.6.2 Requirement of Right of Disposal of the *Rahn* Asset.

Compatibility Analysis

Both liens and *Rahn* emphasize the importance of possession as a means of securing the debt, ensuring strong compatibility in cases where possession is involved. However, the inconsistent nature of liens—where some rely on possession and others do not—creates partial alignment with *rahn*.

Compatibility: Moderate

The reliance on possession in liens varies, creating partial alignment with *rahn*. While possessory liens align well with *rahn*, non-possessory liens reduce compatibility due to the absence of possession as a security mechanism.

(iv) Power of Sale

Power of Sale in Lien: Lien generally do not confer the power of sale to the lien holder. The lien holder's rights are typically limited to retaining possession of the asset until the debtor fulfills their obligation. In most cases:

- The lien holder cannot sell the property without a court order, except in specific cases like equitable liens or banker's liens, where limited enforcement rights may exist.
- Judicial intervention is often required to enforce the lien, which can delay the recovery process and reduce the efficiency of the security mechanism.

This limitation on the power of sale reflects the cautious approach of legal systems in protecting debtors' rights while ensuring creditors have adequate recourse.

Power of Sale in *Rahn*: Under a *rahn* contract, the creditor (murtahin) may sell the pledged asset (*marhūn*) upon default, but this process is subject to regulatory frameworks designed to ensure fairness and compliance with *Sharīʿah* principles.

For a detailed discussion on the power of sale in *rahn*, including juristic perspectives and contemporary practices, refer to the earlier section on 2.3.6.2 Requirement of Right of Disposal of the *Rahn* Asset.

Compatibility Analysis

The power of sale represents a significant divergence between liens and *rahn*:

- *Rahn*: Allows for the sale of collateral in the event of default, subject to necessary regulatory requirements and mutual agreement terms. This provides creditors with a clear and structured mechanism for enforcing their rights.

- Liens: Are generally weaker in this regard, as they rarely confer the power of sale. Most liens require judicial intervention to enforce, limiting their effectiveness as a security instrument. The absence of a direct power of sale reduces their compatibility with *Rahn*, which emphasizes regulated but enforceable mechanisms for liquidating collateral.

While both instruments prioritize fairness and debtor protection, the limited enforcement rights of liens create a gap in functionality compared to *rahn*, particularly in contexts where timely recovery is essential.

Compatibility: Low

The power of sale highlights a critical difference between liens and *rahn*. While *rahn* provides creditors with a regulated mechanism to sell collateral upon default, liens lack this feature, relying instead on judicial processes that can delay enforcement. This limitation reduces the overall compatibility between the two instruments.

(v) Eligible Assets

Eligible Assets in Lien: Liens are limited to professions or trades where possession of the debtor's property is incidental to the service provided. They are most commonly used in professions or trades such as mechanics, artisans, or solicitors. This limited scope restricts the applicability of liens to specific contexts, making them less versatile compared to other security instruments. For example:

- Artisans' Liens: Apply to goods repaired or improved by the creditor.
- Solicitors' Liens: Apply to client funds held in trust for unpaid legal fees.
- Banker's Liens: Apply to funds or assets held by the bank on behalf of the debtor.

The narrow focus of liens limits their use to specific industries or scenarios, reducing their overall flexibility and applicability in broader financial contexts.

Eligible Assets in *Rahn*: The *rahn* contract demonstrates greater flexibility and adaptability to various types of assets, including both tangible and intangible assets, provided they meet *Sharīʿah* -compliant criteria. Classical jurists have outlined robust principles governing eligible assets, ensuring compliance with Islamic law:

- Tangible Assets: Such as real estate, gold, vehicles, and other valuable goods are widely accepted as collateral.
- Intangible Assets: Some jurists, particularly from the *Mālikī* school , allow for the inclusion of intangible assets like intellectual property, digital currencies, or receivables, arguing that it is better to secure a loan with something rather than nothing.
- Future-Acquired Assets: Under the flexible opinion of the *Mālikī* perspective, future-acquired assets (e.g., crops, expected revenues) may also be considered, broadening the scope of eligible assets.

This flexibility ensures broader applicability in Islamic finance, allowing *rahn* to be used in diverse financial arrangements while adhering to *Sharīʿah* principles.

For a detailed discussion on eligible assets in *rahn*, including juristic perspectives and contemporary practices, refer to the earlier section on 2.3.6.3 Eligible Assets for *Rahn*.

Compatibility Analysis

The limited scope of liens reduces their alignment with the broader applicability of *rahn* contracts:

- Liens: Are restricted to specific professions or trades, limiting their use to contexts where possession of the debtor's property is incidental to the service provided. This narrow focus makes liens less versatile and adaptable to modern financial systems involving diverse asset types.
- *Rahn*: Offers significantly greater flexibility, accommodating a wide range of assets, including tangible, intangible, and potentially future-acquired assets under the *Mālikī* view. This adaptability ensures that *rahn* can be applied to a broader array of financial transactions, aligning with the evolving nature of wealth and commerce.

The restricted scope of liens creates a significant divergence with *rahn*, which is designed to be more versatile and adaptable to various asset types within *Sharīʿah* compliant frameworks.

Compatibility: Low.

The limited scope of liens reduces their alignment with the broader applicability of *rahn* contracts. While *rahn* accommodates diverse asset types, liens are restricted to specific contexts, creating a significant gap in compatibility.

3.10.5 Conclusion

Based on the above analysis, the compatibility of modern security instruments with *rahn* is as follows:

1) **Most Compatible: Charge**

   Charge is the most compatible modern collateral instrument with *rahn.* This compatibility arises from several key alignments. First, charges allow the debtor to retain ownership of the asset, which aligns with *rahn's* requirement that ownership must remain with the debtor. Second, charges are flexible, as they do not require the creditor to take possession of the asset. This flexibility aligns with *rahn's* principle that the debtor can continue to use the asset (with the creditor's consent) unless there is a default. Third, charges can cover both existing and future assets, enhance their versatility and making them adaptable to various financial arrangements. Finally, both charge and *rahn* require formal documentation for enforceability, ensuring legal clarity and compliance with regulatory frameworks. This alignment in ownership retention, flexibility, and comprehensive coverage makes charge highly compatible with *rahn*.

2) **Moderately Compatible: Pledge**

   Pledge demonstrates moderate compatibility with *rahn*. While there are significant similarities, notable differences reduce its overall alignment. Both pledge and *rahn* emphasize the importance of securing debt through tangible assets, ensuring strong alignment in this aspect. However, a key

difference lies in possession. In a pledge, the creditor typically takes possession of the asset, limiting the debtor's ability to use it. This contrasts with *rahn's* flexibility, which allows the debtor to retain and use the asset (with the creditor's consent). Additionally, pledges are generally limited to tangible, movable assets and do not cover future assets, restricting their applicability compared to *rahn*, which is more versatile in accommodating various types of assets within *Sharīʿah*-compliant frameworks. While pledge aligns well in terms of nature and enforceability, its stricter approach to possession and limited scope make it only moderately compatible with *rahn*.

3) **Least Compatible: Lien**

Lien is the least compatible with *rahn*, primarily due to its limitations in enforcement rights and flexibility. Unlike *rahn*, liens generally do not confer the power of sale. Instead, the lien holder retains possession of the asset until the debt is repaid, relying heavily on judicial intervention for enforcement. Additionally, liens often involve possession by the creditor, restricting the debtor's ability to use the asset. This strict approach contrasts with *rahn's* flexibility, which allows the debtor to retain possession and use the asset (with the creditor's consent). Furthermore, liens are typically limited to specific professions or trades, such as mechanics or artisans, and do not cover future assets. This narrow scope further reduces their alignment with *rahn*, which is broader in its applicability. These limitations make lien less compatible with *rahn*, particularly in terms of enforcement rights and flexibility.

4) **Not Compatible: Mortgage**

Mortgage is fundamentally not compatible with *rahn*, as its core principles directly contradict the foundational requirements of *rahn*. Mortgages inherently involve the transfer of ownership or legal title to the creditor, either outright or as security for the debt. This directly contradicts *rahn's* principle that the asset must remain under the debtor's possession and ownership. In *rahn*, ownership is strictly retained by the debtor, and only possession (if agreed upon) may be transferred to the creditor. Additionally, since *rahn* prohibits any form of ownership transfer, it cannot be applied in the context of a mortgage. Given these fundamental contradictions,

mortgage is not compatible with *Rahn* and cannot be adapted to align with its principles without significant restructuring.

3.11 COMPATIBILITY TABLE

The compatibility table below provides a compatibility status for the alignment between *rahn* and security instruments on various criteria:

Table 3.2 Compatibility Table of Security Instruments with *Rahn* Contract

Security Instrument	Transfer of ownership	Possession of Assets by Creditor	Nature of Interest	Power of Sale	Eligible Assets	Compatibility with *Rahn* Contract
Mortgage	In a mortgage, legal title to the asset is typically transferred to the creditor's ownership. In contrast, under *rahn*, legal ownership of the asset remains with the debtor	In a mortgage arrangement, possession of the asset by the creditor is not a prerequisite, as legal title is already transferred to the creditor (mortgagee). In contrast, under *rahn*, legal ownership remains with the debtor, and possession may or may not be transferred to the creditor subject to the creditor's consent.	A mortgage creates a legal interest in the property in favor of the creditor, granting enforceable rights over the mortgaged asset. In contrast, under *rahn*, the creditor does not acquire a legal interest or ownership in the asset, but rather holds a security right over the collateral—while ownership remains with the debtor—	In a mortgage, the mortgagee has the legal right to sell the mortgaged property directly upon the mortgagor's default. This is not the case under *rahn*, where the creditor does not have the authority to dispose of the collateral unless consented by the mortgagee or otherwise the mortgage will dispose it to settle the debt.	In a mortgage, the applicable assets are generally limited to existing tangible or intangible properties. A mortgage cannot be created over future assets. In contrast, *rahn* offers greater flexibility, as it may be applied to a broader range of assets—including both tangible and intangible, as well	**[Incompatible]** A mortgage is largely not compatible with *rahn*, as many of its key features—such as the transfer of legal title, nature of interest, unilateral enforcement rights, and limitation to existing assets—are not fully aligned with the principles of *rahn* under *Sharīʿah*.

Security Instrument	Transfer of ownership	Possession of Assets by Creditor	Nature of Interest	Power of Sale	Eligible Assets	Compatibility with *Rahn* Contract
					as existing and, in some views, future assets—provided that certain *Sharīʿah* conditions are fulfilled.	
Charge	Under a charge, the asset remains under the ownership of the debtor—similar to the structure of *rahn*, where legal ownership is retained by the debtor while the asset is charged as security.	In a charge, possession of the asset is not required, as the charge agreement itself establishes the creditor's right to claim the asset in the event of default. Similarly, under *rahn*, possession may or may not be transferred to the creditor. The debtor may retain possession and continue to utilize the charged asset, subject to the creditor's consent,	A charge creates a right or claim over an asset without transferring its possession or ownership—an arrangement that is also accepted under a *rahn* contract, where the creditor holds a security right while legal ownership remains with the debtor.	Under a charge, the chargee may sell the charged asset upon the chargor's default, often without the need for court intervention. Similarly to *rahn*, where the creditor does have power of sale over the *rahn* assets either by himself which consented by the debtor or the debtor is responsible disposing of the asset to settling his debt.	A charge is similar to *rahn* in that it may be applied to a broader range of assets—including both tangible and intangible, as well as existing and, to a certain extent, future assets—provided that specific *Sharīʿah* conditions are fulfilled.	**[High]** A charge is generally compatible with *rahn*, as many of its key features—such as the retention of ownership by the debtor, non-requirement of possession, nature of security interest and flexibility in asset types including tangible, intangible, existing, and to some extent future assets—are broadly aligned with the principles of *rahn* under *Sharīʿah*, subject to fulfillment of specific conditions.
Pledge	Under a pledge, the asset remains under the ownership of the debtor—	In a pledge, possession of the asset by the creditor is mandatory for the security to	A pledge involves the transfer of possession, but not ownership—similar to *rahn*, where	The pledgee may sell the pledged asset upon the debtor's default, typically following	A pledge is generally limited to existing tangible or intangible	**[Moderate]** Pledge is generally moderately compatible with *rahn*, as some of its key

Security Instrument	Transfer of ownership	Possession of Assets by Creditor	Nature of Interest	Power of Sale	Eligible Assets	Compatibility with *Rahn* Contract
	similar to the structure of *rahn*, where legal ownership is retained by the debtor while the asset is pledged as security for a debt obligation.	be effective. This contrasts with *rahn*, where possession is not a strict requirement, and the debtor may retain possession and continue using the asset with the creditor's consent	the creditor may take possession of the asset as security while legal ownership remains with the debtor.	applicable legal procedures. This is contrast under *rahn*, where the creditor does have power of sale over the *rahn* assets either by himself which consented by the debtor or the debtor is responsible disposing of the asset to settling his debt.	assets, and it cannot be created over future assets. In contrast, *rahn* offers greater flexibility, as it may be applied to both tangible and intangible assets, and—according to certain juristic views—even to future assets, provided that specific *Sharīʿah* conditions are satisfied.	features—such as the retention of ownership by the debtor, the nature of the security interest, and the transfer of possession without ownership—are aligned with the principles of *rahn* under *Sharīʿah*,
Lien	Under a lien, the asset remains under the ownership of the debtor, as the lienholder merely holds a right to retain possession until the debt is satisfied. Similarly, in *rahn*, legal ownership of the	In a lien, possession of the asset by the creditor is mandatory for the security interest to be effective. This contrasts with *rahn*, where possession is not a strict requirement; the debtor may retain possession and continue to use the asset,	A lien is a right to retain possession of an asset until the associated debt is discharged. Similarly, *rahn* allows the creditor to hold the pledged asset as security until the debt is fully settled; however, unlike a lien, possession	Typically, liens do not confer the power of sale; the creditor may only retain possession of the asset until the debt is discharged. This is contrast under *rahn*, where the creditor does have power of sale over the *rahn* assets either by	A lien is generally limited to tangible assets only, as it relies on the creditor's possession to secure the debt. In contrast, *rahn* offers greater flexibility, as it may be applied to both tangible and	**[Low]** A lien is generally of low compatibility with *rahn*, as only a few of its key features—such as the retention of ownership by the debtor, the nature of the security interest, and the transfer of possession without ownership—are aligned with the principles of

Security Instrument	Transfer of ownership	Possession of Assets by Creditor	Nature of Interest	Power of Sale	Eligible Assets	Compatibility with *Rahn* Contract
	asset remains with the debtor, while the creditor holds a security right	subject to the creditor's consent	under *rahn* is not mandatory and may remain with the debtor, subject to the creditor's consent	himself which consented by the debtor or the debtor is responsible disposing of the asset to settling his debt.	intangible assets—and, according to certain *Sharīʿah* views, even to future assets—provided specific conditions are fulfilled.	*rahn* under *Sharīʿah*.

Rahn Compatibility Index (RCI)

Instrument	**Ownership Retained by Debtor**	**Possession Requirement**	**Security Interest Nature**	**Enforcement Rights**	**Asset Flexibility (Tangible, Intangible, Future)**	**Compatibility Level**	**RCI Score (/10)**
Mortgage	✕ (Transferred to creditor)	✕ Not mandatory (Not applicable since legally assets owned by creditor)	✕ (right over legal title)	✕ (creditor may enforce legally the disposal of his assets)	(Existing tangible and intangible only)	Incompatible	**1 / 10**
Charge	✓ (Retained by debtor)	✓ Not Mandatory	✓ (right claim over the assets)	✓ (Legal claim)	✓ (All range of assets)	High	**10 / 10**
Pledge	✓ (Retained by debtor)	Mandatory	✓ (right claim over the assets)	✓ (Legal claim)	(Existing tangible and intangible only)	Moderate	**5 / 10**
Lien	✓ (Retained by debtor)	Mandatory	✕ (no right claim over the assets)	✕ (Holding only, no sale rights)	(Existing tangible existing only)	Low	**4 / 10**

Explanation of Compatibility Levels

(a) Scoring Methodology
Each of the five features is given up to 2 points, depending on alignment with *rahn*:

- 2 = Fully aligned = represented by ✓
- 1 = Partially aligned = represented by
- 0 = Not aligned =represented by ×

Maximum score = 10

(b) Interpretation of RCI Score

- **8–10**: High Compatibility
- **5–7**: Moderate Compatibility
- **3–4**: Low Compatibility
- **0–2**: Incompatible

3.12 QUASI SECURITY INSTRUMENTS FROM *SHARĪʿAH* PERSPECTIVE

3.12.1 Debenture from *Sharīʿah* h Perspective

Debentures are unsecured debt instruments that rely on the creditworthiness and reputation of the issuer, such as corporations or governments. Investors are assured of periodic interest payments and the return of principal based on the issuer's overall financial health (Wilson, 2008). From a *Sharīʿah* perspective, debentures can be understood as debt certificates that represent existing debts owed by the debtor to the creditor. By issuing debentures, creditors are entitled to claim repayment from the debtor, making them akin to *rahn al-duyun*, or collateralization of debts. However, for a debenture to be *Sharīʿah* -compliant, the underlying debt must adhere to Islamic principles. If the debt involves non-compliant elements, such as interest (*ribā*), the recoupment is restricted to the principal amount only, as per the SAC of SC, (2023) and Bank Negara Malaysia's Policy Document on *Rahn* (SAC of BNM, 2018).

Debentures are highly versatile and widely used in various financial contexts, such as raising capital for infrastructure projects, corporate expansions, or government funding initiatives. A key characteristic of debentures is that they do not involve specific

physical assets but instead represent claims to receivables as collateral. Similarly, in the context of *rahn* al-duyun the collateralized debt does not involve tangible assets but represents an intangible financial obligation. This reliance on intangible assurances—creditworthiness in conventional debentures and debt obligations in *rahn* al-duyun — demonstrates compatibility in terms of asset requirements (*Al-Sarakhsī*, 1993). However, *Sharīʿah* compliance necessitates that the underlying debt be free from prohibited elements such as *ribā*, *gharar* (uncertainty), or *maysir* (gambling). If the debt involves non-compliant elements, the recovery is limited to the principal amount, excluding any interest or prohibited components (*Ibn Qudāmah*, 1997).

Conclusion

From a *Sharīʿah* perspective, debentures can be viewed as a form of *rahn* al-duyun, where debts serve as collateral. However, their acceptance in Islamic finance hinges on the *Sharīʿah* compliance of the underlying debt. If the debt involves non-compliant elements, the recovery is restricted to the principal amount, as outlined by SAC of BNM (2018) and SAC of SC (2023). This restriction ensures that Islamic financial practices remain aligned with *Sharīʿah* principles while addressing modern financial needs. By leveraging the concept of *rahn* al-duyun, Islamic finance can offer innovative, *Sharīʿah* -compliant alternatives to conventional debentures and fostering inclusivity in financial systems.

3.12.2 Assignment from *Sharīʿah* Perspective

Ḥawālah involve the transfer of rights or obligations, making them functionally similar. In an assignment, the assignor transfers rights, such as receivables or contractual rights, to the assignee (Wilson, 2008). Similarly, *Ḥawālah* involves the transfer of debt obligations from the original debtor to another party, ensuring the continuity of obligations (AAOIFI, 2017). Their shared purpose of reallocating financial responsibilities and facilitating seamless transactions results in a high degree of functional compatibility (Kahf, 1998).

Assignments are widely used to enhance liquidity and financial flexibility, such as transferring receivables to third parties in trade finance or corporate settings. Similarly, *Ḥawālah* is applied in trade financing and personal debt arrangements to transfer debt obligations, enabling efficient risk management (Usmani, 2002). Both instruments play a critical role in facilitating the efficient management and transfer of financial responsibilities, demonstrating their broad applicability and high compatibility across diverse scenarios (Ali & Hussain, 2017).

Assignments typically involve the transfer of intangible rights or obligations, such as receivables, intellectual property rights, or contractual claims, rather than physical assets (Companies Act 2016). Similarly, *Ḥawālah* focuses on transferring debt obligations without requiring physical collateral (*Al-Sarakhsī*, 1993). This similarity in not relying on physical assets but instead focusing on the transfer of rights or obligations highlights their alignment and high compatibility (*Ibn Qudāmah*, 1997).

Both instruments require formal agreements to clearly outline the transfer of rights or obligations. Assignment agreements must comply with contract law requirements, ensuring enforceability under applicable legal frameworks (Wilson, 2008). In contrast, *Ḥawālah* contracts must adhere to both legal standards and *Sharīʿah* principles, ensuring ethical compliance and fairness (AAOIFI, 2017). While the additional requirement for *Sharīʿah* compliance in *Ḥawālah* introduces an extra layer of scrutiny, the fundamental need for clear and formal documentation ensures a high level of compatibility between the two instruments.

Conclusion

The comparative analysis reveals that Assignment and *Ḥawālah* exhibit significant compatibility in terms of nature, applicability, asset requirements, and instrument formalities. Both instruments share the common goal of reallocating financial responsibilities and ensuring the continuity of obligations, making them indispensable tools in their respective systems. However, the distinguishing feature of *Ḥawālah* lies in its adherence to *Sharīʿah* principles, which ensures ethical integrity and aligns with the broader objectives of Islamic finance. By leveraging the strengths of *Ḥawālah*,

Islamic finance can offer robust, *Sharīʿah* compliant alternatives to conventional assignments, addressing modern financial needs.

3.12.3 Modern Guarantee from *Sharīʿah* Perspective

Both modern guarantees and *Kafālah* serve as essential security instruments designed to ensure the fulfillment of obligations in financial and commercial transactions. In conventional finance, a guarantee represents a commitment by one party (the guarantor) to fulfill the debtor's obligations if the debtor defaults, thereby providing assurance to creditors (Wilson, 2008). Similarly, *Kafālah*, as a *Sharīʿah*-compliant mechanism, ensures performance or fulfillment of obligations by acting as a guarantor for the debtor. The shared function of both instruments—providing security and assurance in transactions—results in a high degree of functional compatibility (AAOIFI, 2017). This alignment highlights their ability to mitigate risks and enhance trust between parties in diverse financial contexts.

Modern guarantees are widely utilized across various financial and commercial transactions, including loan agreements, lease agreements, and performance contracts. Similarly, *Kafālah* is applied in scenarios requiring performance guarantees, such as construction projects, service agreements, and trade finance arrangements (Usmani, 2002). Both instruments play a critical role in enhancing the security of transactions and mitigating risks, demonstrating their broad applicability and high compatibility in addressing modern financial needs (Ali & Hussain, 2017).

A key similarity between conventional guarantees and *Kafālah* lies in their non-reliance on specific physical assets as collateral. Instead, both instruments depend on the guarantor's commitment to fulfill obligations in the event of default by the primary party (*Al-Sarakhsī*, 1993). This reliance on the guarantor's promise, rather than tangible assets, underscores their alignment in terms of asset requirements and further highlights their compatibility (*Ibn Qudāmah*, 1997). By focusing on intangible commitments, both mechanisms offer flexibility and adaptability to various financial structures.

Both modern guarantees and *Kafālah* necessitate formal, detailed documentation to clearly outline the guarantor's obligations and specify the conditions under which the guarantee is enforceable. In conventional finance, guarantee agreements are legally binding documents governed by applicable laws. In contrast, *Kafālah* agreements must not only meet legal standards but also adhere to *Sharīʿah* principles, ensuring ethical compliance and fairness (AAOIFI, 2017). While the additional requirement for *Sharīʿah* compliance in *Kafālah* introduces an extra layer of scrutiny, the fundamental need for comprehensive and formal documentation ensures a high level of compatibility between the two instruments.

Conclusion

The comparative analysis reveals that modern guarantees and *Kafālah* exhibit significant compatibility in terms of nature, applicability, asset requirements, and instrument formalities. Both instruments share the common goal of securing obligations and mitigating risks, making them indispensable tools in their respective financial systems. However, the distinguishing feature of *Kafālah* lies in its adherence to *Sharīʿah* principles, which ensures ethical integrity and aligns with the broader objectives of Islamic finance. By leveraging the strengths of *Kafālah*, Islamic finance can offer robust, *Sharīʿah* -compliant alternatives to guarantees, addressing modern financial needs.

Table 3.3 Compatibility table for the alignment between conventional quasi-securities and their Islamic counterparts

Feature /Characteristic	Debenture	Assignment	Guarantee	Hawālah (Islamic)	Damān (Islamic)	*Kafālah* (Islamic)	Compatibility Level
Nature	Unsecured debt backed by issuer's creditworthiness	Transfer of rights	Promise to fulfill obligations	Transfer of debt	Guarantee of performance	Contract of guarantee	Moderate
Applicability	Wide range of financial contexts	Wide range of rights and	Various financial transactions	Debt transfer scenarios	Performance guarantees	Financial transactions	High

		properties					
Assets	Not secured by specific assets	Typically involves rights, not assets	No specific assets	Involves transfer of debt, not specific assets	Guarantee of obligations, not assets	Guarantor's promise, not specific assets	High
Instrument Requirements	Formal documentation, regulated	Formal agreement	Formal contract	*Sharīʿah*-compliant documentation	*Sharīʿah*-compliant documentation	*Sharīʿah*-compliant documentation	High
Ethical Considerations	Governed by secular principles	Governed by secular principles	Governed by secular principles	Rooted in *Sharīʿah* principles	Rooted in *Sharīʿah* principles	Rooted in *Sharīʿah* principles	Moderate

The detailed compatibility analysis reveals that debentures and *Kafālah*, assignments and Hawālah, and guarantees and Damān exhibit varying degrees of compatibility. High compatibility is observed in their nature, applicability, asset requirements, and documentation needs, while moderate compatibility is noted in ethical considerations. Understanding these nuances can help financial practitioners and regulators develop frameworks that integrate both conventional and Islamic principles, enhancing financial inclusivity and robustness in global markets.

3.13 CHAPTER SUMMARY

Chapter three provides a comprehensive examination of modern security instruments and assets in Common law. It explores the concept of security arrangements, distinguishing between security instruments and assets. The chapter discusses the historical perspective of security arrangements and their importance in financial systems.

The chapter focuses on the four main types of security instruments recognized in Common law: mortgage, charge, pledge, and lien. It explains their definitions, features, and implications. The nature and role of quasi-security instruments such as assignments and guarantees are also examined, emphasizing their practical importance despite lacking the same legal status as formal security instruments.

The study also compares the compatibility of modern security instruments with *rahn*. Charge is the most compatible as it allows ownership retention, ensures flexibility by permitting debtor use of the asset, and applies to both present and future assets. Pledge is moderately compatible as it secures debt through tangible assets but differs in possession requirements, where the creditor typically takes possession, limiting the debtor's use. Lien is less compatible due to its limited enforcement rights, reliance on judicial intervention, and strict possession requirements, which contrast with *rahn*'s flexibility. Mortgage is fundamentally incompatible, as it involves ownership transfer, violating *rahn*'s principle that the asset must remain under the debtor's ownership

Additionally, the study compares modern quasi-security instruments, such as debenture, assignment, and guarantee, with their Islamic counterparts—*kafālah* (guarantee), *ḥawālah* (debt transfer), and *ḍamān* (suretyship). A high level of compatibility is observed in terms of nature, applicability, asset requirements, and documentation needs.

In summary, this chapter provides a comprehensive examination of security instruments and assets in Common law. It also offers valuable insights for understanding and navigating the complexities of security arrangements in credit transactions.

CHAPTER FOUR

RESEARCH METHODOLOGY

4.1 INTRODUCTION

This chapter provides a detailed explanation of the research methodology used to address the research questions and objectives highlighted in Chapter one. The methodological structure encompasses the research approach, design, data collection methods, and the research framework. The section begins by outlining the research method employed in this study. Subsequently, it discusses the research design, which is critical for achieving the research objectives, taking into account the availability of relevant data and the practicality of the study. Then, the section covers the data collection methods, using both primary and secondary sources, to shed light on security arrangement practices in Islamic project finance. Finally, this section wraps up with an overview of the research framework guiding this study.

4.2 RESEARCH APPROACH

This research is qualitative in nature and adopts a mixed-method approach, integrating doctrinal and interview-based methods to address the research objectives and questions. The methodology is designed to explore the two legal systems governing security contracts—Islamic law and Common law—and to examine contemporary security arrangements in Islamic project finance. Through this approach, the study seeks to provide a comprehensive understanding of security mechanisms in Islamic project financing, analyzing both frameworks and industry practices.

4.2.1 Choice of Research Approach

The choice to employ a doctrinal and interview-based approach is informed by the research objectives and the complexity of the subject matter. The research aims to offer a comprehensive analysis of security arrangement in Islamic project financing by

examining both Islamic and legal frameworks as well as the practical implementation aspects. By incorporating the doctrinal research method, the study ensures a robust understanding of the legal principles governing security arrangements in Islamic law (Abdul-Rahman, 2018). At the same time, qualitative research methods via interview allow for a deeper exploration of industry practices, challenges, and perspectives, which are crucial for a holistic assessment of security mechanisms (Creswell & Poth, 2018).

The adoption of a doctrinal research method is driven by the need to explore and analyze legal principles, doctrines, and precedents that govern security arrangements in Islamic project financing. By delving into Islamic and legal texts, court judgments, legislative provisions, and scholarly works, the doctrinal research method enables a systematic examination of the legal landscape surrounding security mechanisms in Islamic project financing. This approach allows for a rigorous analysis of the underlying legal principles and helps establish a solid foundation for understanding the doctrinal aspects of security in Islamic law (Sekaran & Bougie, 2019).

In addition to the doctrinal research method, the incorporation of qualitative research methods via interview is essential to capture the perspectives, experiences, and insights of key stakeholders involved in Islamic project financing. This research approach acknowledges the complex and dynamic nature of security arrangements, which goes beyond legal principles and encompasses practical implementation and industry practices (Braun & Clarke, 2019). By conducting interviews with Islamic scholars, legal practitioners, and industry experts, valuable firsthand knowledge can be obtained regarding the actual application of security mechanisms in Islamic project financing. This qualitative approach allows for an in-depth exploration of the subjective and context-specific aspects of security, shedding light on the challenges, perspectives, and emerging trends in this field (Creswell, 2007).

In conclusion, the combination of doctrinal and qualitative interviews methods provides a comprehensive and well-rounded approach to examining security mechanisms in Islamic project financing. This research approach enables the study to delve into both theoretical and practical dimensions of security, addressing the research objectives and the complex nature of the topic.

4.3 RESEARCH DESIGN

The research design outlines the systematic approach adopted to achieve the study's objectives. This study employs a mixed-method qualitative design, incorporating doctrinal research and interviews to ensure both theoretical depth and empirical validation.

4.3.1 Doctrinal Research

This method involves an extensive examination of literature, including Islamic legal sources, legal texts, court judgments, legislative provisions, and scholarly works. This method focuses on the analysis and interpretation of legal principles, doctrines, and precedents that govern security arrangements in Islamic project financing. It enables systematic exploration of the legal framework, principles, and concepts underlying security mechanisms. By critically reviewing the existing legal literature, this method helps to establish a foundation for understanding the doctrinal aspects of security in Islamic law (Abdul-Rahman, 2018). This approach ensures a comprehensive analysis of security mechanisms within the Islamic finance industry.

4.3.2 Interview Based-Research

Complementing the doctrinal research, interview-based methods will be employed to delve into the perspectives and experiences of key stakeholders involved in Islamic project financing. This approach allows for an in-depth exploration of the subjective and context-specific aspects of security mechanisms. Semi-structured interviews will be conducted with Islamic scholars, legal practitioners, and industry experts to capture their insights, perceptions, and experiences related to security arrangements (Creswell & Poth, 2018). The interviews will provide valuable data on the practical implementation, challenges, and perspectives regarding security mechanisms in Islamic project financing. Additionally, document analysis will be employed to gather further insights into industry practices, legal documents, and contextual dynamics (Sekaran & Bougie, 2019).

The data collected through interviews and document analysis will be analyzed using thematic analysis, which involves identifying patterns, themes, and categories within the data. This analytical approach will allow for a systematic exploration of the qualitative data, enabling the identification of key themes and insights related to security mechanisms in Islamic project financing (Braun & Clarke, 2019).

By integrating the doctrinal research method and qualitative research methods, this study aims to provide a comprehensive analysis of security mechanisms in Islamic project financing. The combination of these approaches allows for a thorough examination of the legal principles and perspectives, as well as the practical implementation and challenges associated with security arrangements in this context.

4.4 DATA COLLECTION METHODS

The process of data collection plays a crucial role in ensuring the reliability and validity of research findings. In this study on security mechanisms in Islamic project financing, a combination of data collection methods, including document analysis and interviews, has been employed. These methods have been carefully selected to align with the research approach and objectives, facilitating a comprehensive exploration of the topic.

4.4.1 Document Analysis

Document analysis serves as a primary data collection method in this study. Various legal documents, including court judgments, legislative provisions, contracts, and industry guidelines, are meticulously examined to gather relevant information regarding the legal framework and historical development of security mechanisms in Islamic project financing. Document analysis enables the researchers to extract valuable insights, identify patterns, and establish a foundation for doctrinal analysis. By critically reviewing and interpreting these documents, the study gains a comprehensive understanding of the legal principles governing security arrangements (Sekaran & Bougie, 2019).

4.4.2 Semi- Structured Interviews

For the purpose of this study, data collection was conducted in the form of an interview which suited the research questions and sufficed the data required for this study. The interviews were designed to acquire first-hand information valuable insights and perspectives regarding the practical implementation, challenges, and trends related to security mechanisms in Islamic project financing. In relation to this, several key informants were interviewed to capture the present practice of security mechanisms in Islamic project financing. The use of interview as a form of data collection is justified because the data were obtained from those Islamic scholars, legal practitioners, and industry experts, with experience and knowledge in the security arrangement in Islamic project finance area.

The three different types of interviews frequently used in qualitative research are semi-structured interview, unstructured interview and biographical interview (Harding, 2013, p. 30). This study adopted semi-structured interviews for data collection because it provided some structure and guidance for the interviewer, besides being appropriate in many research situations (Harding, 2013, p. 31). The semi-structured interviews allow for in-depth conversations, enabling participants to elaborate on their experiences, provide nuanced interpretations, and share industry-specific knowledge. The interview data, captured through audio recordings and transcriptions, provide rich qualitative information that complements the doctrinal analysis and offers a deeper understanding of the real-world application of security arrangements (Ali et al., 2020).

4.4.2.1 Selection of Informants

For data sampling purposes, this study adopted the purposive sampling technique as it is frequently used in qualitative research to gather data from specific and targeted informants or respondents (Ahmad, 2017). Purposive sampling refers to a sampling approach that decides on the unit of analysis (targeted informants) according to a set of criteria, in order to ensure that the targeted informants will have the ability to answer the research questions. (Bryman, 2012, p. 418). The scope of this study is security arrangement in Islamic project financing; thus, the targeted informants were scoped

down to the relevant departments in a Bank. Due to the fact that there is involvement of few key parties for security arrangement in Islamic project financing, relevant Bank's experts such as corporate bankers, legal, and *Sharīʿah* were determined based on discussions with academicians with working experience in the financial industry. For each expert selected for the interview process, the person was chosen to be the informant for two reasons, (i) having a comprehensive overview of the arrangement of security in Islamic project financing, and (ii) usually having extensive experience in the industry which at least 15 years in the corporate banking industry.

The determination of sample size in qualitative research is contextual and largely dependent on the nature of the adopted research paradigm (Boddy, 2016). A key guiding principle in qualitative research is the concept of data saturation, which is reached when no new information or themes emerge from the data (Guest et al., 2006). This suggests that when respondents are carefully selected based on their expertise, even a relatively small sample size can yield comprehensive and reliable data. Furthermore, Hagaman and Wutich (2017) found that most metathemes in qualitative research could be identified within 20 interviews, reinforcing the argument that expertise and relevance of respondents play a more critical role than sheer sample size. Similarly, the concept of "information power," as discussed by Malterud, Siersma, and Guassora (2016), supports the notion that fewer participants are needed when they possess high levels of experience, the study focus is narrow, and the data obtained is rich. For this study, an initial sample of ten informants was selected, consisting of five respondents from a *Sharīʿah* background, three Islamic project finance practitioners and three legal experts. All informants have extensive experience working in banks that are heavily involved in Islamic project finance, which is the focus of this study. However, most informants chose not to disclose their institutions due to confidentiality concerns related to internal policies and industry practices. The greater representation of *Sharīʿah* experts is justified by the study's focus on the compatibility of the security arrangements in Islamic project finance, which involves various *Sharīʿah* considerations. Additionally, the study seeks to determine whether new *Sharīʿah* resolutions are necessary or whether Islamic banks can rely on existing collateral mechanisms. Meanwhile, the number of legal experts and practitioners from Islamic project finance is comparatively smaller because the study incorporates various secondary sources and aims to validate the practical application of these security arrangements. Notably, the informants from the Islamic

project finance and legal domains each possess a minimum of 25 years of experience, further justifying the smaller sample size by ensuring that the data collected is derived from highly knowledgeable and seasoned professionals. Even the sampling number is small, in this case, all participants involved in the interviews hold about at least 15 years relevant experience in their area in relation to application of Islamic project finance which justify the moderate sampling numbers of informants. The aim was to seek understanding and experience on the practice of security arrangements in Islamic project finance, so as to explore the similarities and the differences in the practices that offer richer data and deeper insight to the study. Data were collected from 11th June 2024 through 31st August 2024 from 11 informants comprising of *Sharīʿah*, Islamic project finance and legal practitioners. The detailed list of informants is presented as follows:

Table 4.1 Detailed list of informants

Participant Code	Designation	Company	Years of Experience	Background
P1	Head of *Sharīʿah*	NA	15	*Sharīʿah*
P2	Head of *Sharīʿah* Advisory	NA	16	*Sharīʿah*
P3	Chief *Sharīʿah* Officer	N/A	15	*Sharīʿah*
P4	Head of *Sharīʿah* Advisory	NA	16	*Sharīʿah*
P5	Head of *Sharīʿah*	N/A	16	*Sharīʿah*
P6	Vice President	NA	15	Islamic Project Finance Expert

P7	Head of Corporate Banking	NA	20	Islamic Project Finance Expert
P8	Islamic banking professional	NA	25	Islamic Project Finance Expert
P9	Senior Associate	NA	25	Legal Expert
P10	Partner	NA	30	Legal Expert
P11	Legal Counsel	NA	25	Legal Expert

Preparation for the interview is discussed in the following section.

4.4.2.2 Interview Process

The process of interview preparation began with structuring the interview questions since semi-structured interview was adopted for data collection. Interview questions were prepared in three sets. The first set was for the informants from the *Sharīʿah* background, as the questions were structured related to the *Sharīʿah* issues related to application of security arrangement in Islamic project financing. The second set was specifically for the Islamic project finance practitioners on the real application of security arrangement in Islamic project financing. Lastly, the third set was developed to get legal understanding and practicality of security arrangement from legal standpoint of view in the context of Malaysia law.

The interview questions were developed based on the purpose of the study and research questions guiding the study. As the qualitative interview is described as "attempts to understand the world from the subjects' point of view, to unfold the meaning of their experience and to uncover their lived world" (Creswell & Poth, 2018), the interview followed a conversational mode (Yin, 2016, p. 142). Therefore, naturally the interview questions were open-ended in nature. After developing the interview questions, the researcher then approached experts to review the initial questions relating

to the language, wording and relevance. An expert with extensive experience in the Islamic banking industry were approached to get insights on the initially developed interview questions. The expert was an experienced Islamic corporate banker with more than twenty (20) years of service in the banking industry in Malaysia.[1]

Additionally, the interview questions were also reviewed by the researcher's supervisors as they are considered academic experts. The main supervisor has ample involvement in Islamic project finance research meanwhile the co-supervisor is highly experienced in conducting interviews as data collection method. Technically, the interview questions for this study have been reviewed by two experts and the questions were refined and revised after each expert review session to improvise the interview questions. A sample of the list of interview questions is provided in Appendix 1.

Proper planning for interview was arranged with the respective informants mostly through email and over the phone. Interview settings were mostly conducted at the informants' offices as per their choice, which enabled the informants to be comfortable in their own setting to capture more viable information. An interview protocol or interview guide was designed and utilized during the interview session. Using an interview guide helps researcher to navigate the interview into a "guided conversation". Interview guide may represent a set of reminders to the researcher, not the actual list of questions, therefore it is not considered as a questionnaire (Yin, 2016).

The interviews were audio-recorded with the consent of the informants, ensuring that both individual and company anonymity were maintained throughout the study. While all informants opted for anonymity, some had no objections to disclosing their company names, whereas others requested confidentiality due to sensitive corporate policies. Audio recordings were transcribed by the researcher into interview transcripts. Performing the interview transcription task by the researcher himself took more time than outsourcing the task to others who offer transcription service. However, this allowed the researcher to be close to the data, which will aid the data analysis process (Castleberry & Nolen, 2018).

[1] The researcher would like to humbly thank to Dr Nazri Muhammad for his expert review of the initially formulated interview questions.

4.5 DATA ANALYSIS

The five steps in conducting qualitative data analysis are: compiling, disassembling, reassembling, interpreting, and concluding (Castleberry & Nolen, 2018; Yin, 2016, p. 185). Compiling is the first step in qualitative data analysis, and it involves transcribing audio recording of the interview for the researcher to easily see and work with the data. At this stage, the researcher familiarised himself with the data and looked at the data as a whole set. As the researcher is still novice, the transcribing process took tremendous amount of time to accomplish. For every one hour of audio recording, the researcher needed about eight hours of transcribing, and the pace picked up towards the end of the transcribing process as the researcher got used to it. This process took almost two months to complete transcribing 10 interview transcripts with an average of 40 minutes of interview time.

After all the audio recordings had been transcribed and organised from audio format to word format, the second step is to disassemble the data. Contrary to the first step where data were seen as a whole set; data in this second stage were separated into codes and code groups. Interview transcripts were read through and coded in the process of data analysis. Coding is the process of gradually converting raw data into usable data by identifying ideas, concepts, or themes that are connected with one another (Castleberry & Nolen, 2018). Data coding process was carried out using the Atlas.ti computer software to assist in data organisation as it involved a considerable amount of data. The third step is reassembling the data by mapping the codes or code groups to create meaningful connections and to produce themes. According to Braun and Clarke (2006), a theme can be understood as follows:

> a theme captures something important about the data in relation to the research question, and represents some level of patterned response or meaning within the data set

To give a clearer picture of the relationship between codes and themes, as an analogy of a house, individual codes act as the individual bricks of a wall, and the wall itself is the theme (Braun & Clarke, 2012). Among the tools used to help visualise the data within the reassembling step include hierarchies, matrices, flowcharts, diagrams and concept maps (Castleberry & Nolen, 2018). Codes with the most frequency

(repetition) were selected and the ones with minimal frequency were omitted. After reducing the number of codes, they were organised and grouped together in a hierarchical order, so as to give a clearer picture in conveying the study findings. This step took about two months for the researcher to sort out.

The data analysis was continued with the fourth step which is interpreting the data. This is a critical step as the researcher is required to make analytical conclusions based on the data reassembled in the form of codes and themes. Albeit the steps of data analysis listed above are presented in a linear arrangement, the interpretation process does not necessarily have to wait until the end of the data analysis. Yin (2016) emphasised that the relationship between the steps in conducting qualitative data analysis is a recursive one. At any step of data analysis, the researcher may have to revisit the previous step to revise the data as the need arises. Yin (2016) suggested five attributes that constitute a good interpretation: completeness, fairness, empirical accuracy, value added and credibility.

After completing all four steps, the final step is to conclude the findings. The conclusion should provide a captivating story about data based on the researcher's analysis (Braun & Clarke, 2012). Having said that, a conclusion should encapsulate a broader significance of the study (Yin, 2016).

4.6 RESEARCH FRAMEWORK

The research framework for this study combines all elements into a guiding structure that helps the researcher conduct the study in a structured manner. The research framework integrates both doctrinal and qualitative approaches to achieve the research objectives and answer the research questions.

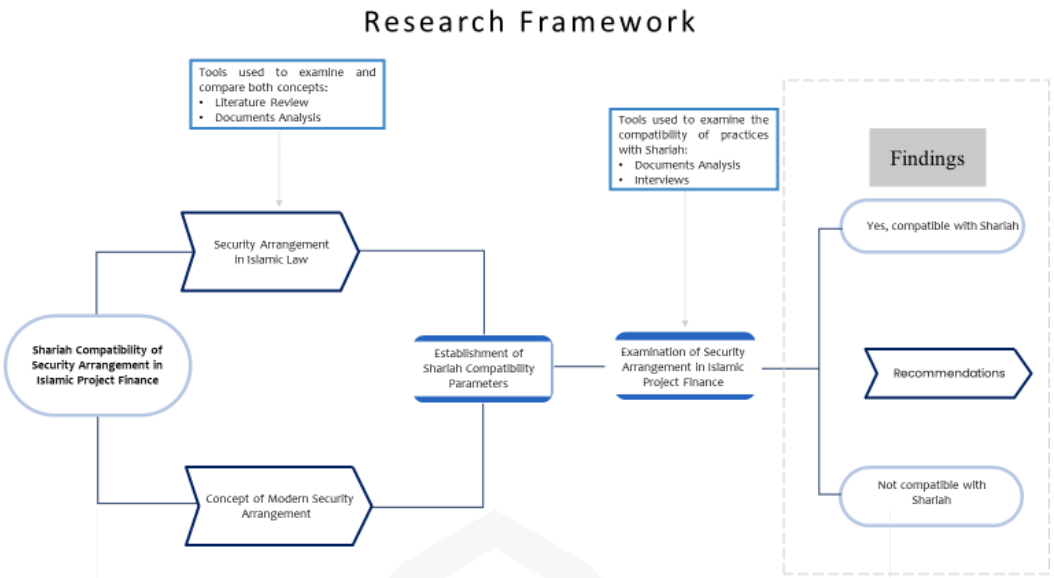


Figure 4.1 Research framework

4.6.1 Deductive and Inductive Approaches

The research will apply a deductive approach to evaluate the security arrangements from Common Law and Islamic Law perspectives. This approach involves deriving specific conclusions based on general principles and concepts. For the assessment of the application of security arrangements in Islamic project finance, an inductive approach will be adopted. This approach involves drawing general conclusions based on specific observations and data collected from the analysis of contemporary applications (Creswell & Poth, 2018).

4.6.2 Research Objectives and Methods

The diagram below illustrates the research objectives, and the methodologies employed to accomplish them:

No	Research Objective	Research Method Applied
RO 1	To examine the concept of security interests and security assets from the perspective of Islamic law	• Literature Review • Document Analysis
RO 2	To study the concept of modern security interests and security assets, as defined by the law, and assess its compatibility with Islamic law on security contracts.	• Literature Review • Document Analysis
RO 3	To analyze the application of security interests and security assets in selected Islamic project financing.	• Document Analysis • Interviews • Gaps Analysis
RO 4	To evaluate the compliance status of security interests and security assets in Islamic project finance with Shariah requirements.	• Findings • Views of Experts • Researcher's own

Figure 4.2 Research objectives and methods

The diagram above illustrates all four objectives and the methodologies employed to accomplish them. The study aims to achieve four research objectives, each requiring different methods for their attainment:

1. Research Objective 1 (RO1): To explore the concept of security instruments and security assets from the perspective of Islamic law. Given that the concept of Islamic security arrangements is extensively discussed in classical and contemporary Islamic juristic books, the methodology utilized to address RO1 primarily involves document analysis and literature observation. Data on the concept of security under Islamic law will be collected from various *Sharīʿah*-based research materials, including relevant research books, academic journals, conference presentations, brochures, newspaper articles, magazines, official websites, and other pertinent sources (Abdul-Rahman, 2018).
2. Research Objective 2 (RO2): To examine the concept of modern security instruments and security assets from a legal perspective, assessing its compatibility with Islamic law. RO2 focuses on understanding the legal framework and instruments associated with security arrangements by employing document analysis and literature observation methods. Various legal documents, such as court judgments, legislative provisions, contracts, and industry guidelines, will be meticulously examined to gather relevant information regarding the legal framework of security mechanisms. This study will conduct a comprehensive comparative analysis of security

arrangements to establish parameters for analyzing security arrangement practices in project finance, exploring similarities, differences, and compatibility between modern security arrangements defined by law and security arrangements in Islamic law (Ali et al., 2020).

3. Research Objective 3 (RO3): To examine contemporary applications of security arrangements in Islamic project finance. This objective focuses on understanding how security arrangements are utilized in project financing through *sukūk* instruments and financing structures. To identify existing practices, document analysis and the interview method will be employed. Relevant documents, such as literature works, will be analyzed to identify common security instruments and underlying assets used in Islamic project finance. Additionally, semi-structured interviews will be conducted with Islamic scholars, legal practitioners, and industry experts to gain valuable insights and perspectives on the practical implementation, challenges, and trends related to security arrangements in Islamic project financing. Through this examination, the study aims to determine whether security arrangements have been practiced in Islamic project financing and to identify any gaps in the current practice of security arrangements in the area of Islamic project financing (Braun & Clarke, 2019).
4. Research Objective 4 (RO4): To assess whether the security instruments and security assets used in Islamic project finance are compatible with *Sharīʿah* requirements. This objective relies on the established parameters from RO2, which define recognized security arrangements in Islamic law. The assessment will be based on these parameters and will include the researcher's own observations and opinions, drawing on the outcomes of RO2 and RO3. The findings will determine the compatibility of the current security arrangements with *Sharīʿah* requirements in Islamic project finance. Recommendations and suggestions will be proposed based on the evaluation of security arrangement practices, providing input and information that can be implemented in Islamic project financing security arrangements (Creswell, 2007).

In conclusion, the methodology employed in this study combines doctrinal and qualitative interviews approaches, utilizing document analysis and semi-structured

interviews to achieve a comprehensive understanding of security mechanisms in Islamic project financing. This mixed-method approach ensures that both theoretical and practical dimensions are explored, providing a holistic assessment of the topic.

4.7 CHAPTER SUMMARY

Chapter 4 outlines the research methodology that underpins the study and explains how the research objectives were achieved. The study adopted a dual approach, combining both doctrinal and qualitative methods, each contributing uniquely to the research process. The doctrinal approach, which is reflected in Chapters 2 and 3, involved an extensive review of existing legal principles, frameworks, and scholarly literature. This method was critical in addressing the first two research objectives, as it provided a solid theoretical foundation through a detailed literature and document review. On the other hand, the qualitative approach involved document analysis and semi-structured interviews with key stakeholders such as Islamic project finance practitioners, Senior *Sharīʿah* officers, and legal experts. These interviews were essential for achieving the third research objective, as they offered valuable insights and practical perspectives on the subject matter. Finally, the fourth research objective was addressed by synthesizing expert opinions with the researcher's own analysis, enabling a deeper exploration of the topic. Overall, this chapter highlights the methodological rigor of the study and sets the stage for the presentation of findings in the subsequent chapter.

CHAPTER FIVE

ANALYSIS AND DISCUSSIONS ON INTERVIEWS' FINDINGS

5.1 INTRODUCTION

This chapter addresses third objective of the research, i.e. the application of security instruments and assets in Islamic project financing in this study through a qualitative method. As highlighted in Chapter 4, the data collection method employed a qualitative approach, involving document analysis and semi-structured interviews with key stakeholders, including Islamic project finance practitioners, Senior *Sharīʿah* officers, and legal experts. These interviews were crucial for achieving the third research objective, namely the application of security instruments and assets in Islamic project finance. Chapter 5 outlines the insights and inputs gathered from these interviewees regarding the application of security instruments and assets in Islamic project financing. Their opinions will be analyzed in detail and thoroughly to draw meaningful conclusions from the findings. The interview findings will also be supported by the literature review on their applications. These conclusions will serve as benchmarks for subsequent Chapter, specifically focusing on the *Sharīʿah* compatibility of the application of security instruments and assets in Islamic project financing.

5.2 PROFILE OF THE EXPERTS INTERVIEWED

This section highlights the profiles of the participants who significantly contributed to the research. It details their varied backgrounds, roles, and experiences, offering insights into their respective companies, including their sizes, years of operation, and the products or services they provide. Table 6.1 divided informants into three classifications: 1) Senior *Sharīʿah* Officer, 2) Islamic project Finance experts, and 3) Legal Experts. Each category is coded as P1 to P11 respectively to preserve confidentiality of the interviewees. Understanding these profiles is essential for contextualizing their perspectives and insights, thereby strengthening the credibility and relevance of the study's findings.

The interview invitations were sent to 13 experts, and 11 responded. These respondents include highly experienced Senior *Sharīʿah* Officers, Islamic project finance specialists, and legal experts in Islamic project finance, each with 15 to 30 years of experience. Collectively, they demonstrated a deep understanding of both Islamic and conventional project finance, providing valuable insights and thoroughly addressing the questions related to the application of security instruments and assets in Islamic project finance.

Table 5.1 Profile of the Interviewees

Participant Code	Designation	Company	Years of Experiences	Background
P1	Head of *Sharīʿah*	NA	15	*Sharīʿah*
P2	Head of *Sharīʿah* Advisory	NA	16	*Sharīʿah*
P3	Chief *Sharīʿah* Officer	N/A	15	*Sharīʿah*
P4	Head of *Sharīʿah* Advisory	NA	16	*Sharīʿah*
P5	Head of *Sharīʿah*	N/A	16	*Sharīʿah*
P6	Vice President	NA	15	Islamic Project Finance Expert
P7	Head of Corporate Banking	NA	20	Islamic Project Finance Expert
P8	Islamic banking professional	NA	25	Islamic Project Finance Expert
P9	Senior Associate	NA	25	Legal Expert
P10	Partner	NA	30	Legal Expert
P11	Legal Counsel	NA	25	Legal Expert

5.3 FINDINGS AND ANALYSIS

The interviews were conducted between mid-July 2024 and August 2024, with each session lasting around 30 to 40 minutes. At the outset, participants were briefed on the study's purpose and the main topics discussed in the interview questions. Responses were recorded, with consent, using an audio device, while some chose to submit written answers. The data was analyzed thematically to identify common patterns that reflected the interviewees' views on the application of security instruments and assets in Islamic project financing. This process was supported by ATLAS.ti, a renowned software for qualitative data analysis (Friese, 2019). The researcher followed the six-step thematic analysis process outlined by Braun and Clarke (2006). First, the interview data was transcribed verbatim to ensure the accuracy of coding. Initial codes were then identified in the second phase, and these codes were subsequently organized into themes during the third phase. In the fourth step, the identified themes were compared with the original coded data to ensure coherence, before naming the themes in the fifth stage. Finally, the researcher described each theme in detail during the sixth stage. To ensure the analysis remained objective, a peer review process was implemented, as recommended by Creswell (2009), which helped minimize potential bias. It is important to note that not all participants responded to every section of the questionnaire. Different groups tended to focus on the area's most relevant to their expertise. For instance, *Sharīʿah* officers were more interested in the *Sharīʿah* aspects of security instruments and assets in Islamic project financing, a trend similarly noted by Hassan and Lewis (2007) in their study of Islamic banking. In contrast, Islamic project finance practitioners and legal experts, while less inclined to address *Sharīʿah*-related issues, provided detailed commentary on the operational and legal aspects of Islamic project finance, corroborating the interdisciplinary nature of Islamic finance as highlighted by El-Gamal (2006).

5.3.1 Themes Identification and Assembling

In the analyzed transcripts, a total of six unique themes were identified, which were classified under four main categories. The first category addresses issues related to understanding on collateral instruments and assets from a *Sharīʿah* perspective. The

second category focuses on the legal perspective. The third section investigates the application of security instruments and assets in Islamic project finance. Lastly, the fourth category explores the potential challenges associated with the application of security instruments and assets in Islamic project finance. Table 6.5 below illustrates all identified themes under their respective categories, along with the related interview questions.

Table 5.2 Identified themes and related questions

Concept of Security Instruments and Its Assets from the *Sharīʿah* Perspective		
No	Categorical Theme	Interview Question
1	Understanding the concept of security instruments and assets from *Sharīʿah* perspective	What is your understanding of the term and concept of collateral instruments and collateral assets within the context of Islamic law?
2	Understanding the common *Sharīʿah* contracts used for security instruments	What types of *Sharīʿah* contracts are commonly used as collateral instruments?
Concept of Security Instruments and Its Assets from the Legal Perspective		
3	Understanding the concept of security instruments and assets from legal perspective	What is your understanding of the legal term and concept of collateral instruments and collateral assets in the context of Islamic banking practice?
4	Understanding the legal framework of security instruments used in banking practice Malaysia	What are the primary types of collateral instruments recognized under legal frameworks in Malaysia? What of these frameworks is most applicable in banking practice?
3. Applications of Security Instruments and Assets in Islamic Project Finance and its *Sharīʿah* compatibility		
5	Common assets applied in Islamic project finance and its compatibility	What are the most commonly accepted collateral assets/ asset classes for

	with *Sharīʿah*	collateral purposes in Islamic project finance?
4. Potential Challenges of the Application of Security Instruments and Assets in Islamic Project Finance		
6	Potential *Sharīʿah*, legal and commercial Challenges	Can you explain the application of the collateral instruments and collateral assets in Islamic project finance and are the any potential challenges arising from its?

Researcher's own

5.3.1.1 Concept of Collateral Instruments and Its Assets from the Sharīʿah Perspective

Understanding the concept of security instruments and assets from the *Sharīʿah* perspective, as well as the common *Sharīʿah* contracts used, is essential for analyzing their role in Islamic project finance. The informants in this study consist of senior *Sharīʿah* officers.

As discussed in Chapter Two, the literature emphasizes the use of security instruments within an Islamic framework. The informants were asked two questions:

(i) their understanding of these concepts in Islamic law and

(ii) the types of *Sharīʿah* contracts commonly used as Islamic security instruments.

(i) Understanding Collateral Instruments and Assets in Islamic Law

The informants unanimously agreed that collateral instruments and assets are permissible in Islamic law. They also emphasized their critical role in Islamic banking, particularly in securing financing. However, they noted that the specific requirements and applications of these instruments may vary depending on the nature of the security assets used. This flexibility, rooted in Islamic jurisprudence, allows for the adaptation

of *Sharīʿah* principles across diverse financial contexts. There was no disagreement among the informants regarding this fundamental objective.

This consensus aligns with Al-Suwailem (2006), who highlights that collateral mechanisms like *rahn* are consistent with the ethical foundations of *Sharīʿah*, as they provide financial protection in the event of debt default. He emphasizes that collateral should not only secure the creditor's interests but also preserve fairness and balance risks between the debtor and the creditor. Similarly, Usmani (1998) underscores the importance of collateral as a mechanism to ensure equitable outcomes in financial transactions. Usmani asserts that collateral arrangements in Islamic finance play a pivotal role in maintaining fairness by protecting both the debtor and the creditor/financier. Legally binding collateral instruments ensure transparency and accountability, particularly in cases where the debtor defaults. This reinforces the principles of preventing exploitation and ensuring fair dealing.

(ii) Common *Sharīʿah* Contracts Used for Collateral Instruments

Regarding the second question, which pertains to the most commonly used *Sharīʿah* contracts for collateral instruments in Islamic law, the interviewees categorized Islamic security instruments into two main groups: asset-based and non-asset-based.

1. Asset-Based Security

   All informants agreed that the most common *Sharīʿah* contract used for asset-based security is the *rahn* contract. In this arrangement, tangible assets—referred to as *rahn* assets—are pledged to secure financing. These assets often include real estate, vehicles, or gold, and their value must be sufficient to cover the financing. Ownership of the collateral remains with the debtor unless a default occurs, ensuring compliance with *Sharīʿah* principles of equity and fairness.

2. Non-Asset-Based Security

   The informants expressed varying opinions on non-asset-based security. While some viewed *kafālah* (third-party guarantees) and *wa'd* (promises or commitments, including negative pledges) as viable mechanisms, others recognized only *kafālah* as a legitimate non-asset-based security

instrument. Below are excerpts from the interviews: Below are excerpts from the interviews:

P1, a *Sharīʿah* specialist in Islamic banking, recognized both *kafālah* and *wa'd* as mechanisms for non-asset-based security:

> Collateral instruments encompass various types of security arrangements, such as pledges, charges, mortgages, liens, security deeds, and negative pledges. In Islamic finance, these are categorized into asset-based and non-asset-based security. Asset-based security involves the use of tangible assets, commonly through *rahn* contracts, where the pledged assets—known as *rahn* assets—secure financing. Non-asset-based security relies on personal guarantees or commitments, such as *kafālah* (third-party guarantees) and *wa'd* (promises or commitments), especially in cases involving negative pledges.

P2, a senior *Sharīʿah* officer, however, considered only *kafālah* as a valid form of non-asset-based security in collateral arrangements under Islamic law:

> In Islamic law, collateral arrangements are supplementary agreements designed to reinforce an existing obligation. Although distinct from the underlying financial contract, these arrangements are binding on both parties. Common forms of collateral in Islamic transactions include *rahn* and *kafālah* (guarantee), or other agreements mutually decided upon by the parties. Despite being supplementary, these agreements carry significant legal weight and ensure compliance with the underlying obligations.

P3 further supported the use of *kafālah* as a non-asset-based security mechanism:

> Collateral instruments in Islamic finance are essential tools for securing financial obligations. They ensure that, in the event of default, the financier can take possession of specific assets. Common collateral arrangements include pledges (*rahn*) and guarantees (*kafālah*). Collateral assets often include tangible items like real estate, vehicles, or gold, and their value must be sufficient to cover the financing. In accordance with *Sharīʿah*, ownership of the collateral remains with the debtor unless default occurs. The asset's value must be fair to prevent exploitation and ensure compliance with Islamic principles of equity.

The findings indicate that the informants held differing views on non-asset-based security, particularly concerning *kafālah* and wa'd. While *kafālah* is widely accepted and practiced as a mechanism for securing financing alongside *rahn*, the use of wa'd remains a subject of debate. The key distinction is that wa'd is merely a unilateral

promise, lacking the binding implications and enforceability of *kafālah* or *rahn*. Therefore, its role as a security instrument is questionable. In contrast, *kafālah* is recognized as a legally enforceable arrangement that provides an additional layer of security in Islamic financial transactions. This suggests that, in practice, *kafālah* remains the preferred non-asset-based security mechanism, whereas the application of wa'd as a security tool appears to be inaccurate and inconsistent with its legal nature.

Conclusion

The expert insights, supported by scholarly references, confirm that collateral instruments and assets are permissible in *Sharīʿah* and play a vital role in Islamic finance by securing financing arrangements. The informants unanimously agreed on the importance of these instruments in ensuring financial protection while adhering to the principle of fairness among contracting parties.

Regarding the most commonly used contracts for security instruments in Islamic law, the informants categorized them into two main types:

(i) Asset-Based Security:

All informants agreed that the *rahn* contract is the primary mechanism for asset-based security. Under this arrangement, tangible assets such as real estate, vehicles, or gold are pledged to secure financing, with ownership remaining with the debtor unless a default occurs.

(ii) Non-Asset-Based Security:

The informants expressed differing views on non-asset-based security. While some emphasized *kafālah* (third-party guarantees) as the sole recognized mechanism, others included *wa'd* (promises or commitments, including negative pledges) alongside *kafālah*. However, the study indicates that *kafālah* is legally recognized as a valid non-asset-based security mechanism, whereas the use of *wa'd* as a security tool appears inaccurate and inconsistent with its legal nature. This is because *wa'd* is merely a unilateral promise, lacking the binding implications and enforceability associated with *kafālah* or *rahn*.

The combination of asset-based (*rahn*) and non-asset-based (*kafālah*) security instruments provides a comprehensive framework for managing risk in Islamic finance.

5.3.1.2 Concept of Collateral Instruments and Its Assets from the Legal Perspective

Collateral instruments and assets are foundational to the security of financial transactions, providing legal assurances to creditors and financiers. The legal framework governing these instruments is crucial for protecting the interests of creditors and ensuring that obligations are secured through enforceable agreements. In this section, the study explores the understanding of collateral instruments and assets from a legal standpoint, drawing insights from legal experts with extensive experience in the field, each possessing 25 to 30 years of expertise. These experts were posed two critical questions:

(i) Their understanding of the legal term and concept of collateral instruments and collateral assets.

(ii) The primary types of collateral instruments recognized under legal frameworks in Malaysia, and which of these frameworks are most applicable in banking practice.

(i) Collateral Instruments and Assets from the Legal Standpoint

P9, a legal expert with 25 years of experience in security arrangements in Malaysian banking, emphasized that collateral or securities are taken by banks to ensure that the customer can repay the financing provided by the bank. In this context, collateral serves as a critical risk mitigation tool, enabling creditors to secure tangible or financial assets to reduce the risk of financial loss in the event of debtor default. This is particularly crucial in large-scale corporate or project financing, where significant amounts are at stake, and the potential for non-performing financings (NPFs) is heightened. The use of security arrangements must be legally supported to base on respective security instruments or arrangements used such as charge, pledge, lien, assignment and others.

P10, another legal expert with 30 years of experience, corroborated this view, stating that banks generally accept any collateral assets deemed adequate to secure

debts. However, he stressed that the primary concern is not merely the availability of collateral but its applicability and legal enforceability. Any asset that lacks clarity in terms of ownership, value, or enforceability—or is open to dispute—poses significant risks to the creditor. Any ambiguity in these elements may lead to disputes, thereby weakening the creditor's security position and potentially affecting debt recovery efforts.

P11 explains that the concept of security instruments is a very broad term where it consists various types of security instruments i.e. charge, pledge, debenture or other types of support that provide security effect such as guarantee or assignment. He concurs with P9 and P10, the legal enforceability is the main factor for the bank in adopting the relevant security arrangements.

The importance of enforceability aligns with the observations of Rosly (2010), who highlights that proper documentation and transparency in ownership and asset valuation are crucial for the effectiveness of collateral agreements. In jurisdictions with less developed or inconsistently applied legal frameworks, these challenges become more pronounced, affecting the ability of financial institutions to recover debts efficiently.

(ii) Understanding the Legal Framework of Security Instruments and Assets Used in Banking Practice in Malaysia

The legal framework governing collateral instruments and assets in Malaysia is an integral component of financial transactions, particularly in the context of Islamic project financing. Based on inputs from legal experts P9, P10 and P11, this section analyzes the understanding of collateral instruments, their legal foundations, and the challenges associated with their application in both conventional and Islamic finance.

From a legal perspective, collateral instruments in Malaysia are governed by various legal frameworks. For instance, land charges fall under the National Land Code (NLC), which outlines the procedures for registering charges and disposing of land in case of default. Corporate assets are registered with the Companies Commission of Malaysia (SSM) under the Companies Act 2016. These frameworks ensure that

collateral instruments are enforceable and legally binding, reducing the risk of financial loss for creditors.

While mortgages are commonly recognized under common law jurisdictions, P9 notes that they are not applicable in Malaysia due to the absence of specific legislation governing such arrangements. This observation aligns with Kader & Mohamad (2019), who argue that Malaysia has shifted from traditional common law principles to statutory frameworks tailored for modern commercial needs. Mortgages, which traditionally involved the transfer of ownership, have been replaced by charge-based systems under mortgages assets laws such as the National Land Code (NLC), Merchant Shipping Ordinance (MSO), and Civil Aviation Regulations (CAR). These statutory frameworks ensure that ownership remains with the debtor while granting creditors enforceable rights (Dahlan, 2014).

P10 further reinforced this perspective, emphasizing that the term "mortgage" in Malaysia refers specifically to land or real estate assets governed by the National Land Code. This reflects the dominance of charge mechanisms over traditional mortgage concepts in Malaysian banking and finance. The shift toward charge-based systems highlights the adaptability of security instruments to contemporary commercial needs, prioritizing enforceability and legal certainty.

While charges dominate the landscape, other mechanisms such as pledges and liens play supplementary roles, particularly in small-scale financing. According to P11, pledges, governed by the Contracts Act 1950, provide a legal framework for creating and enforcing security interests over movable assets such as gold, jewelry, or shares. Similarly, liens are recognized under specific statutes like the National Land Code, where they serve as a form of security interest in certain contexts. However, these instruments are less prevalent compared to charge-based systems due to their limited scope and applicability.

(iii) Types of Collateral Instruments and Their Legal Differences

P9, P10 and P11 provided key distinctions between various collateral instruments used in Malaysia:

Charges: Charges allow the debtor to retain possession of the asset while it is used as security for financing. For example, a land charge enables the debtor to continue using the property while securing the financing. This is a common form of security in real estate transactions, governed by the NLC. In the case of corporate assets, the charge is registered with SSM as required by the Companies Act 2016.

Pledges: Pledges involve the transfer of possession of an asset to the creditor as security for the financing. For instance, when shares are pledged, the creditor holds the share certificates, giving them control over the asset in case of default. Pledges are commonly used in financing arrangements involving movable assets like shares or financial instruments.

Liens: Liens are lighter forms of security, often used in cases involving financial instruments such as fixed deposits (FDs). A lien is placed on the FD, and the creditor has a security interest in the deposit. According to P9, liens are temporary measures used until a formal charge can be created. For instance, the Bank often uses lien holder caveats for temporary security until more formal legal measures are in place. However, P9 cautioned that while lien holder caveats offer flexibility, they can carry risks, particularly if not handled properly at the land office.

(iv) Legal Registration and Documentation

P10 and P11 emphasizes the importance of registering collateral instruments to ensure their enforceability. P10 notes that "registration requirements vary based on the subject matter of the security and the party giving the security." For example, charges on land must be registered with the relevant land office, while charges on company assets must be registered with SSM. This process ensures that third parties are aware of the creditor's security interest in the asset, providing public notice and protecting the creditor's rights in the event of default.

P10 also explains the process of registering debentures and assignments, which involves filing documents such as the deed of assignment, charges of project accounts, and Memorandum of Deposit (MOD). These documents must be stamped and filed for accord, often involving specific forms (e.g., Form 34 at SSM) and fees to ensure legal

compliance. This process ensures that the creditor's security interest is enforceable and protected from legal challenges.

P10 underscores the importance of registering collateral instruments to establish legal enforceability. Registration processes vary based on the asset class and security type:

(i) Land Charges: Must be registered with the relevant land office under the NLC.
(ii) Corporate Assets: Charges on corporate assets require registration with SSM under the Companies Act 2016.
(iii) Debentures and Assignments: Charges over present and future assets (e.g., debentures) and assignments also necessitate registration with SSM under the Companies Act 2016

P10 and P11 elaborated that registration serves multiple purposes. Firstly, it provides creditors with a legally recognized claim over the asset, ensuring their interests are protected in the event of debtor default. Secondly, it informs third parties of existing security interests, thereby preventing conflicting claims. This dual function of registration is vital for maintaining transparency and legal certainty in financial transactions.

This perspective aligns with the insights provided by P9 and P11, who emphasized that registration effectively "announces to the world" the existence of a registered security interest. Such public notice plays a crucial role in determining the priority of claims in cases of insolvency or competing creditors, as highlighted by Gullifer (2017). According to Gullifer, the ranking of debt claims is significantly influenced by the registration process, which establishes a clear hierarchy of creditor rights.

Analysis

Based on the inputs provided by P9, P10 and P11, several key themes emerge regarding the legal framework and application of collateral instruments in Malaysian banking practice:

(i) Legal Enforceability and Registration:

The legal enforceability of collateral instruments is critical for protecting the interests of creditors. Proper registration with the land office, SSM, or other relevant authorities is essential to ensure that the creditor's security interest is recognized and protected. This process is particularly important in both conventional and Islamic finance, where legal compliance must be coupled with *Sharīʿah* adherence.

(ii) Flexibility in Collateral Instruments:

The use of different collateral instruments—charges, pledges, and liens—provides flexibility for banks to tailor their security arrangements based on the type of asset involved and the nature of the financing. For instance, land charges are commonly used for real estate, while pledges are applied to moveable assets like shares. Liens offer temporary security and are often used in cases involving fixed deposits or interim security measures. Notably, common law mortgages are not applicable in Malaysia, as they lack specific legislative support. Instead, charge-based systems have replaced traditional mortgage concepts, particularly for land and corporate assets.

Conclusion

The findings from this study provide a comprehensive understanding of collateral instruments and collateral assets from a legal perspective, as well as their practical application within the Malaysian banking framework. Based on insights from legal experts with decades of experience, the study highlights collateral instruments are fundamental to financial security, ensuring that obligations are secured through legally enforceable agreements.

In Malaysia, collateral arrangements are governed by multiple legal frameworks, including the National Land Code (NLC) for land charges, the Companies Act 2016 for corporate assets, and the Contracts Act 1950 for pledges and liens. Unlike common law jurisdictions where mortgages involve the transfer of ownership, Malaysia has adopted charge-based security systems, which allow debtors to retain ownership while granting

creditors enforceable security interests. This shift enhances legal clarity and aligns security instruments with modern commercial needs.

Among the various collateral instruments, charges are the most widely governed and applied security mechanism in Malaysian banking, particularly in real estate and corporate financing. Charges provide a structured, legally recognized, and enforceable security interest without requiring the transfer of ownership, making them more practical and widely accepted compared to other forms of security such as pledges and liens. While pledges are used primarily for movable assets, and liens serve as temporary security measures, charges offer a more comprehensive and regulated approach to securing financing. The preference for charge-based securities aligns with Malaysia's statutory frameworks, which prioritize legal certainty and creditor protection.

The study also finds that legal enforceability and registration are crucial for protecting creditors' rights. Proper registration with the land office, SSM, or other relevant authorities ensures transparency, priority of claims, and enforceability in case of default. The registration process plays a dual role: it protects the creditor's security interest and informs third parties to prevent conflicting claims.

5.3.1.3 Applications of Security Instruments and Assets in Islamic Project Finance and Its Sharīʿah Compatibility

(i) Common Assets Applied in Islamic Project Finance

The insights provided by the informants reveal a comprehensive understanding of the collateral assets utilized in Islamic project finance. These assets can be viewed from two perspectives: (i) as underlying project finance assets that directly support the project's operations, or (ii) as mitigation tools designed to enhance the cash flow of the project itself.

The assets encompass tangible, intangible, and financial instruments, each carefully selected based on their ability to secure financing while adhering to *Sharīʿah* principles. This section explores the most commonly used types of collateral, as

identified by the informants, and evaluates their implications from both a *Sharīʿah* compliance perspective and in terms of their practical applications. The analysis is further supported by relevant literature to validate and assess the insights shared by the interviewees, ensuring a robust foundation for drawing conclusions. The informants contributing to this section include legal experts, senior *Sharīʿah* officers, and Islamic project finance practitioners, all of whom possess extensive exposure to Islamic project finance and direct involvement in drafting and formulating security arrangements. Their diverse expertise provides a holistic view of the application of security instruments and assets in this domain.

P1 provides a broad list of commonly accepted collateral assets, stating: "*The most common collateral assets include fixed deposits, deposit accounts, debentures, real estate, fixed assets, account receivable, shares, marketable securities, inventory, goods in transit, and rights to issue and deliver capital call notices*." This comprehensive list highlights the flexibility and reliability required in large-scale Islamic project finance. Notably, P1 mentions the inclusion of capital call notices, which allow financiers to enforce collateralization over future commitments—a sophisticated mechanism essential for managing the long-term risks involved in such projects. The wide range of assets aligns with the flexibility inherent in Islamic finance, as it seeks to balance risk management with *Sharīʿah* compliance (Ahmed, 2011).

P2 emphasizes specific financial instruments, including both Islamic and conventional fixed deposits, *sukūk*, bonds, and debentures. His statement: "*The most commonly accepted collateral assets include fixed deposits (whether Islamic or conventional), assignment of proceeds, shares, bonds, sukūk, and debentures,*" reflects the dual use of Islamic and conventional products to secure financing. While the flexibility to use conventional fixed deposits and bonds may benefit financiers by providing more options, it introduces *Sharīʿah* concerns. For instance, the SAC BNM (2015) resolution permits the use of conventional fixed deposits, but only to the extent of the principal amount to avoid *ribā*. However, further *Sharīʿah* clarification is needed for other instrumentals such as conventional insurance proceeds and debentures as there is no clear resolutions so far.

P3 explains some of the common security assets utilised in Islamic project finance i.e cash in Special Reserve Accounts, fixed deposit, and floating charge or commonly known as debenture. P3 also highlights the importance of cash as a form of collateral, particularly through reserve accounts like Special Reserve Accounts and Project Special Reserve Accounts. He notes that proceeds from the financing are often held as collateral in reserve accounts, allowing financiers to secure repayment by ring-fencing the project's cash flow. The use of reserve accounts provides a secure and accessible form of collateral that financiers can draw upon in case of default (Karekar & Sharma, 2024). The direct correlation between the project's performance and the availability of funds for repayment aligns well with Islamic principles in ensuring transparency in the financing arrangement. In addition, fixed deposits are often used to create a stable and secure form of collateral that is easily accessible to the financier in case of a default. He also highlighted that debentures are commonly used as collateral instruments in Islamic project finance. However, there remains a lack of *Sharīʿah* clarification regarding their use, particularly because they involve collateralization of future assets, which raises concerns related to uncertainty (*gharar*) and the permissibility of securing assets that may not yet exist (Ali, et al. 2018). Further *Sharīʿah* guidance is needed to determine the compliance of such practices.

P4, P5, and P8 emphasize tangible collateral such as real estate, equipment, and machinery which are key in securing debt for construction and manufacturing projects, as these assets are often easily liquidated in case of default. Such tangible assets are highly valued due to their liquidity and legal security, especially in sectors like construction, manufacturing, and logistics. Additionally, P4 discusses the use of financial instruments like *sukūk* and Islamic shares, which offer more flexibility in securing debt. However, different treatment will be applied for conventional bond and shares which only the principal amount is allowed to be recognised as collateral assets (Ali & Hussain, 2015). He also highlights the potential to use accounts receivable as collateral but advises caution where receivables are mixed between *Sharīʿah* -compliant and non-compliant debts. This aligns with Islamic finance principles that prohibit the collateralization of *ribā*-based assets (Ayub, 2007).

P6 provides further insights into the use of both movable and immovable assets, such as shares, cash, and assignment of proceeds. He explains: "Long-term offtake

agreements, like electricity purchase agreements, are commonly assigned to the financing bank, ensuring the bank is the first recipient of payments." This approach secures cash flow for the financier based on the project's success, offering a performance-based security structure. P6 also discusses third-party guarantees, backed by fixed deposits or cash deposits, to further ensure the project's viability. This dynamic use of collateral illustrates the flexibility required in Islamic finance, while still adhering to *Sharīʿah* principles (Rosly, 2010).

P7 elaborates on the use of more complex security mechanisms, noting: "All types of assets are acceptable, including assignments of revenue accounts, insurance or takaful proceeds, contracts, and any income the project is set to receive. Debentures, both floating and fixed, are used." However, P7 acknowledges some unresolved *Sharīʿah* issues, particularly with floating debentures and conventional insurance proceeds. He adds that the status of debentures involving future assets and insurance proceeds remains unclear under *Sharīʿah* law. This points to the challenge of incorporating future assets as collateral without violating *Sharīʿah* principles, as future assets may introduce elements of *gharar* (uncertainty). Furthermore, the use of insurance proceeds, particularly from conventional insurance, may raise *Sharīʿah* compliance issues due to the involvement of *ribā* and *gharar* (Khan, 2008).

P9, P10 and P11 provide a legal perspective on using real estate as collateral, especially in the context of Malaysia's legal framework. P9 explains: "Land and real estate are commonly used as collateral, governed by the National Land Code (NLC), providing legal protection through registered charges." P10 adds: "Deeds of assignment for properties under construction can also be used, ensuring the financier's rights in case of default." These legal instruments provide a secure foundation for using real estate in Islamic project finance, ensuring compliance with both legal and *Sharīʿah* requirements.

Analysis

The analysis of common collateral assets in Islamic project finance highlighted by various informants' testimony supported by relevant literatures as follows:

1. Real Estate and Land

   Real estate and land are consistently favored as collateral assets due to their stability and liquidity. Informants such as P1, P4, P5, P7, P8, P9, P10 and P11 emphasize their importance, particularly given the clear legal framework provided by the National Land Code. These assets offer financiers reliable security while adhering to *Sharīʿah* principles.

2. Cash-based asset/ reserve account and Fixed Deposits

   Cash-based assets/ reserve account and fixed deposits, highlighted by P1, P2, P3, P4, P6 and P7, are commonly used due to their liquidity and security. The use of reserve accounts further enhances project finance structures by providing financiers with direct access to project cash flow, ensuring secure repayment. Whereby, the use of fixed deposits as collateral in Islamic project finance reflects a flexible approach, allowing both Islamic and conventional fixed deposits to be utilized. However, a critical distinction is that for conventional fixed deposits, only the principal amount can be used as collateral to ensure *Sharīʿah* compliance as resolved by SAC of Bank Negara Malaysia, which prohibits the use of any interest generated by conventional fixed deposits as collateral.

3. Account Receivables

   Receivables serve as an important collateral asset in projects with consistent cash flows. As mentioned by P1, P4, P5 and P7, the assignment of receivables ensures financiers can claim project revenues directly in the event of a default. However, care must be taken to ensure these receivables are entirely *Sharīʿah* compliant.

4. Financial Instruments i.e Shares, *Sukūk*/ Bonds

   These assets, recognized by P1, P2, P5, and P7 are particularly useful in projects that involve more complex financing structures. *Sharīʿah* compliant Shares and *Sukūk* are accepted collateral in Islamic finance, as noted by P1 and P2. However, the use of conventional bonds introduces potential *Sharīʿah* issues, particularly concerning *ribā* as Islamic finance must ensure that only compliant financial instruments are used in such cases.

5. Debentures (Floating Charges)

Discussed by P1, P2, P3, and P7, debentures or floating charges, provide flexibility for financiers by securing both current and future assets. However, as P3 points out, as debenture involves the use of future assets, this introduces a critical issue in Islamic banking, as future assets can involve uncertainty (*gharar*), which is prohibited under *Sharīʿah*. The concept of using future assets as collateral must be carefully examined to avoid violating the principle of certainty in transactions.

6. Assignment of Project or Insurance Proceeds

   As mentioned by P1, P2, P3, P6 and P7 assignment of proceeds. While assignment of project proceeds or insurance proceed are commonly accepted, the use of insurance proceeds (particularly from conventional insurance) raises *Sharīʿah* concerns due to the potential involvement of non-compliant elements like *ribā* and *gharar*. As noted by P7, further *Sharīʿah* clarification is needed to determine the permissibility of these instruments.

Conclusion

The analysis of collateral assets in Islamic project finance demonstrates a diverse set of tools that range from tangible assets like real estate and machinery to financial instruments like *Sukūk* and reserve accounts. Real estate, favored for its stability and legal clarity, remains a cornerstone of collateral assets, while fixed deposits and cash provide liquidity. The use of reserve accounts and floating charges adds depth to Islamic project finance by ensuring that both current and future assets are fully secured. These assets and instruments reflect the dynamic nature of Islamic finance, balancing security with the need to adhere to *Sharīʿah* principles in large-scale financing projects.

Table 5.3 Summary of interview outcomes for commonly accepted collateral assets in Islamic Project Finance

Respondent	Real Estate and Land	Fixed Deposits and Cash	Accounts Receivables	Shares and Financial Instruments	Debentures/Floating Charges	Assignment of Proceeds/ Insurance Proceeds
P1	Yes	Yes	Yes	Yes	Yes	Yes
P2		Yes		Yes	Yes	Yes
P3		Yes			Yes	Yes
P4	Yes	Yes	Yes			
P5	Yes		Yes	Yes		
P6		Yes				Yes
P7	Yes	Yes	Yes	Yes	Yes	Yes
P8	Yes					
P9	Yes					
P10	Yes					
P11	Yes					Yes

'Yes' indicates the interviewee's confirmation that the corresponding asset is commonly used as a security or collateral in Islamic project finance based on their institutional experience or practice.

Collateral Asset Adoption Rates

Collateral Asset	**Indicated By (Participants)**	**Adoption Rate (%)**
Real Estate and Land	P1, P4, P5, P7, P8, P9, P10, P11	72.73%
Fixed Deposits and Cash	P1, P2, P3, P4, P6, P7	54.55%
Assignment of Proceeds / Insurance	P1, P2, P3, P6, P7, P11	54.55%
Accounts Receivables	P1, P4, P5, P7	36.36%

Shares and Financial Instruments	P1, P2, P5, P7	36.36%
Debentures / Floating Charges	P1, P2, P3, P7	36.36%

5.3.1.4 Key Observations and Insights Based on Interviewee Responses

- **Most Widely Adopted – Real Estate and Land (72.73%)**
  Real estate and land emerged as the most commonly accepted form of collateral, endorsed by **72.73%** of participants. This finding is consistent with traditional preferences in Islamic finance, where tangible, immovable, and high-value assets are considered ideal. These assets offer clear legal ownership and stability, aligning well with the principles of *rahn*, which emphasize asset specificity, permanence, and enforceability.
- **Broad Institutional Acceptance – Fixed Deposits and Cash (54.55%)**
  Fixed deposits and cash followed closely, with **54.55**% of respondents recognising them as acceptable collateral. These assets are valued for their liquidity and ease of realisation. In Islamic finance, *Sharīʿah*-compliant fixed deposits are typically used. However, in some cases, conventional deposit accounts may be accepted, provided that specific *Sharīʿah* conditions are met (e.g., only the principal amount is recognised and any interest element is excluded).
- **Moderate Utilisation – Accounts Receivables, Shares, and Debentures/Floating Charges (36.36%)**
  These instruments each recorded 36.36% usage. Their flexibility in structuring makes them attractive, especially in project finance. However, from a *Sharīʿah* perspective, their acceptability varies:
  - **Receivables** must satisfy the criteria of *rahn al-dayn*, including constructive possession (*qabḍ ḥukmī*) and certainty of claim.
  - **Shares and financial instruments** are accepted when they relate to *Sharīʿah*-compliant entities. Instruments such as *sukūk*, Islamic unit trusts, or equity in halal businesses are generally permissible, although their fluctuating value makes them less popular than fixed assets.
  - **Conventional financial instruments**, such as bonds or interest-bearing shares, may be accepted only under strict conditions—primarily limited to the recognition of their principal amount, excluding any interest or non-halal components.

- **Debentures and floating charges** present *Sharīʿah* concern due to their enforcement mechanisms and the lack of clarity around the future assets as collateral which affect the ownership and possession. Their compatibility with *rahn* principles remains contested and context dependent.

- **Conditionally Accepted – Assignment of Proceeds / Insurance Proceeds (54.55%)**

  Accepted by half of the participants, these instruments reflect practical preferences for risk mitigation rather than direct asset-based collateralisation. In Islamic project finance, *takaful* proceeds may be assigned to cover potential losses, offering a *Sharīʿah*-compliant risk-transfer mechanism. However, the treatment of conventional insurance proceeds remains unclear, as questions persist regarding the permissibility of using proceeds derived from interest-based or *gharar*-prone (excessively uncertain) contracts as collateral.

5.3.1.5 Potential Challenges of the Application of Security Instruments and Assets in Islamic Project Finance

The application of security instruments and assets in Islamic project finance is not without its challenges, primarily revolving around *Sharīʿah* compliance, legal frameworks, and commercial issues. These complexities arise due to the need to reconcile Islamic principles with the requirements of modern financial structures.

(i) Sharīʿah Compliance Issues

P1 and P2 raise significant concerns about maintaining the *Sharīʿah* compliant nature of collateral throughout the financing period. According to P1, "The collateral assets must remain *Sharīʿah* compliant at all times," pointing out that shares or other financial instruments may become non-compliant due to changes in the issuing company's operations or business practices. This issue has been echoed by Usmani (1998), who emphasizes that Islamic finance must continually monitor the compliance status of its

instruments, as *Sharīʿah* violations could invalidate the entire contract. The problem is further compounded by the dynamic nature of certain assets, where compliance may shift due to external factors like changes in regulations or business activities. Islamic collateral is also described as less flexible compared to conventional collateral since it must strictly adhere to the principles of *rahn*, which places constraints on the types of assets that can be used as security.

P2 delves further into the challenges of maintaining *Sharīʿah* compliance. "Ensuring compliance with *Sharīʿah* requirements is crucial. One issue is determining the *Sharīʿah* compliance status of assets during the charge period, such as shares becoming non-compliant." This is particularly problematic when dealing with long-term financing, as assets can change in compliance status over time. P2 also raises concerns about whether banks can utilize cash deposits as collateral without violating *Sharīʿah* principles by inadvertently turning them into loans (*qard*), which could result in interest-based transactions. The discussion on usufruct as collateral also indicates differing opinions among scholars, adding another layer of complexity.

Another concern raised by P3 is the uncertainty (*gharar*) associated with floating charges. P3 explains, "The first concern with floating charges is that they involve assets that will be available in the future, which do not exist today. There is a question of whether *Sharīʿah* accepts the level of uncertainty (*gharar*) associated with floating charges." *Sharīʿah* prohibits *gharar*, or excessive uncertainty, making it difficult to use floating charges, which depend on future assets whose value and compliance may fluctuate. This creates a significant hurdle for Islamic financial institutions, particularly when structuring long-term projects where assets may not be available immediately but are critical for securing financing. This principle is further supported by El-Gamal (2006), who notes that the inherent uncertainty in floating charges often clashes with Islamic principles.

P4 also discusses potential *Sharīʿah* issues with the use of *rahn* and *kafālah* (guarantee). The pledge or guarantee must remain *Sharīʿah* compliant and free of *ribā* (interest). Additionally, the fees for maintaining these instruments must not disguise interest charges, as this would be considered non-compliant under Islamic law. Wilson (2007) supports this view, stating that Islamic financial contracts, especially those

involving collateral, must be strictly monitored to avoid indirect violations of Islamic law.

Another critical issue mentioned by P3 is the back-to-back guarantee. In such cases, an Islamic bank may issue a *Sharīʿah* compliant guarantee, but this is backed by a conventional bank guarantee. This creates a compliance issue because the underlying guarantee could be interest-bearing, which violates Islamic principles. This back-to-back arrangement, while seemingly compliant on the surface, presents a hidden *Sharīʿah* risk, as described by Rosly and Bakar (2003), who argue that financial structures must be transparent at all levels to maintain their *Sharīʿah* integrity.

(ii) Legal and Commercial Challenges

In addition to the *Sharīʿah* -related challenges, there are significant legal and commercial hurdles. P5 points out, "Islamic project financing in Malaysia is straightforward, often involving halal projects like solar energy or hydroelectric plants." However, P5 highlights the lack of clear *Sharīʿah* rulings on specific contracts and assets, which forces Islamic banks to rely on conventional methods for valuation and credit assessments. This duality between conventional and Islamic practices leads to inconsistencies, as conventional assessments may not fully align with Islamic values. Haniffa and Hudaib (2011) have similarly noted that the reliance on conventional financial tools within Islamic banks sometimes undermines the ethical principles upon which Islamic finance is built.

P6 elaborates on the difficulty of realizing security in compliance with *Sharīʿah* law. "Banks will accept any collateral that can be charged," but the process becomes difficult when dealing with conventional instruments like insurance or non-compliant shares. P6 underscores the importance of ensuring that these assets are liquidated in a way that adheres to Islamic guidelines, a challenge also highlighted by Visser (2009). He notes that Islamic banks face additional regulatory hurdles when liquidating assets that are not fully *Sharīʿah* -compliant, requiring specialized procedures and legal oversight.

The legal complexity of enforcing collateral in Islamic finance is further underscored by P8, P9 and P11. P8 explains, “In cases of default, the liquidation process involves getting a court judgment and petitioning for the asset to be disposed of.” This legal process must comply not only with the local legal framework but also with *Sharīʿah* principles. For example, if conventional fixed deposits or shares are used as collateral, the Islamic bank may only recognize the principal amount, as interest-based earnings must be excluded from the liquidation process. P9 and P11 add that the order in which creditors are paid, based on the registration of charges, must also comply with *Sharīʿah* guidelines, which may differ from conventional practices. This can create friction between Islamic and secular legal systems, especially when assets are subject to multiple claims from different financial institutions.

El-Gamal (2006) highlights that Islamic banks often struggle to develop fully compliant security instruments due to the complex interplay between *Sharīʿah* law and the commercial requirements of large-scale project finance. This is particularly true for unconventional assets, such as those used in sectors like oil and gas exploration, where specific *Sharīʿah* rulings are often absent, as P5 mentions. The lack of clear guidelines creates uncertainty, forcing Islamic banks to adopt hybrid models that might not fully align with Islamic principles.

(iii) Risk Management and Operational Issues

P7 emphasizes the need for ongoing due diligence and compliance checks to ensure that collateral remains compliant throughout the financing term. "By closely monitoring the collateral's compliance throughout the financing term, we can address and resolve any issues that arise, maintaining the integrity of the Islamic financial system." This continuous monitoring is essential but operationally challenging, as it requires both financial expertise and a deep understanding of *Sharīʿah* principles. El-Hawary, Grais, and Iqbal (2004) also stress that Islamic financial institutions must enhance their risk management capabilities to handle the complexities of collateral management within *Sharīʿah*-compliant frameworks.

The operational risk of managing assets that might lose their *Sharīʿah* compliance over time is significant. For example, P3 points out the potential for future assets to become non-compliant under floating charges. This presents a fundamental conflict with Islamic law, which demands that all assets used in financial transactions remain compliant throughout the contract's duration. The challenge is further compounded when dealing with long-term project financing, where future revenues or assets are uncertain.

Analysis

1. *Sharīʿah* Compliance Concerns: A key issue is the challenge of ensuring that collateral assets remain *Sharīʿah* compliant throughout the financing term. Assets such as shares, which can change compliance status, introduce risks that could jeopardize the entire transaction. This challenge requires continuous monitoring and due diligence, as noted by both P1 and P2, and supported by Usmani (1998).
2. Legal and Commercial Complexities: The reliance on conventional valuation and credit assessment methods poses risks to the ethical foundation of Islamic finance. Without clear *Sharīʿah* rulings, Islamic financial institutions are forced to adopt conventional practices, which may lead to inconsistencies, as pointed out by Haniffa and Hudaib (2011). This creates an environment where commercial necessities conflict with Islamic principles.
3. Operational Risks: The use of complex financial structures such as floating charges or back-to-back guarantees presents significant operational risks. These instruments, while useful in conventional finance, are fraught with *Sharīʿah* compliance issues, particularly around uncertainty (*gharar*) and interest (*ribā*), as outlined by El-Gamal (2006). Islamic banks must develop more robust mechanisms to manage these risks without violating Islamic law.

Conclusion

The challenges of applying security instruments and assets in Islamic project finance stem from the need to balance *Sharīʿah* compliance with commercial and legal realities. *Sharīʿah* compliance must be continuously monitored, and banks must find ways to ensure that collateral remains valid under Islamic law. Legal frameworks must also be adapted to accommodate Islamic principles, and more precise *Sharīʿah* rulings are needed, particularly for unconventional assets and complex financial structures. As Islamic project finance continues to grow, addressing these challenges will be critical to maintaining its relevancy.

5.4 CHAPTER SUMMARY

As highlighted in Chapter 4, the data collection method employed a qualitative approach, combining literature analysis with semi-structured interviews involving key stakeholders such as Islamic project finance practitioners, Senior *Sharīʿah* officers, and legal experts, to explore the application of security instruments and assets in Islamic project finance. This chapter synthesizes insights from these interviews, supported by relevant literature, across four interrelated themes: (i) the *Sharīʿah* perspective on security instruments and their permissibility under Islamic principles, (ii) the legal perspective on collateral arrangements within the Malaysian regulatory framework, (iii) the practical applications of security instruments and assets in Islamic project finance, and (iv) the challenges associated with their implementation. The findings reveal that security instruments and assets are widely accepted under *Sharīʿah* principles, with *rahn* being the preferred contract for asset-based security and *kafālah* (guarantee) for non-asset-based security. From a legal standpoint, charge-based systems dominate in Malaysia due to their robust statutory backing under laws such as the Companies Act 2016 and the National Land Code (NLC), effectively replacing common law mortgages, which lack specific legislative support in the Malaysian context. Pledges and lien, while less prevalent, offer flexibility for small-scale financing, particularly for movable assets like shares or temporary security measures such as fixed deposits. The study also identifies a clear hierarchy of commonly used collateral assets in Islamic project finance, including real estate and land, cash-based assets (e.g., deposit accounts and reserve accounts), receivables, financial instruments (e.g., *Sukūk*, bonds, and shares), debentures or floating charges, and the assignment of project or insurance proceeds,

reflecting their practicality and alignment with *Sharīʿah* principles. Despite these advancements, challenges remain in reconciling *Sharīʿah* compliance, legal enforceability, and commercial needs, particularly in ensuring ethical alignment, addressing administrative complexities, and balancing formal requirements with flexibility for diverse financing scenarios. Themes ii and iii, which focus on the legal frameworks and practical applications of security instruments, form the foundation for Chapter 6, where the compatibility status of these instruments in Islamic project finance will be critically evaluated.

CHAPTER SIX

SHARĪʿAH APPRAISAL OF APPLICATIONS OF SECURITY INSTRUMENTS AND ASSETS IN ISLAMIC PROJECT FINANCING

6.1 INTRODUCTION

This chapter addresses the fourth research objective i.e. to evaluate the compliance status of security instruments and security assets in Islamic project finance with *Sharīʿah* requirements. The chapter is divided mainly into two sections. The first section will elaborate the overview of Islamic project finance and its contemporary structure. While the second section will examine the applications of security instruments and assets in Islamic project finance from a *Sharīʿah* perspective.

6.2 OVERVIEW OF PROJECT FINANCE

This section begins with a comprehensive overview of general project finance, discussing its fundamental principles, advantages, and disadvantages, as well as how it contrasts with conventional financing methods. The role of security in project finance will also be examined, emphasizing its importance in securing financial arrangements. Following this, the focus will shift to Islamic project finance, exploring its unique characteristics and the key differences between Islamic and conventional project finance.

6.2.1 Definition of Project Finance

According to Esty (2004), project finance is defined as a specialized financing method where loan repayment depends primarily on the cash flows generated by a specific project, rather than the general assets or creditworthiness of the project's sponsors. This approach is particularly well-suited for large-scale infrastructure and industrial projects, including power plants, transportation systems, and natural resource developments,

where the project itself can generate predictable and stable revenue streams over time, as noted by Yescombe (2013).

One of the defining features of project finance, as highlighted by Gatti (2012), is the creation of a Special Purpose Vehicle (SPV). This SPV is a legally independent entity established solely for the execution of the project. It effectively insulates the project's financial risks from the sponsors, ensuring that only the assets and cash flows of the project are exposed, thereby safeguarding the sponsors' broader financial resources.

Hoffman (2007) explains that project finance is typically structured as non-recourse or limited recourse financing. In this structure, lenders or creditors have limited claims against the sponsors if the project fails to generate the expected cash flows. Instead, they rely on the revenues generated by the project itself, which underscores the importance of a thorough evaluation of the project's feasibility and risk factors. Furthermore, Finnerty (2013) points out that this method of financing is characterized by rigorous due diligence, complex contractual arrangements, and a long-term horizon, often extending over decades. This makes project finance particularly suitable for sectors such as energy, infrastructure, telecommunications, and natural resources—industries where the scale and complexity of projects demand innovative and flexible financing solutions, as observed by Nevitt and Fabozzi (2000).

In summary, project finance is a robust tool for funding large, capital-intensive projects. By aligning financial structures with the specific risks and opportunities inherent in each project, and through careful planning and strategic risk allocation, project finance offers a sustainable pathway for sponsors and lenders to successfully execute large-scale ventures.

6.2.2 Project Finance vis a vis Corporate Finance

Project finance and common finance differ fundamentally in their approach to repayment, risk allocation, and structure. As Esty (2004) explains, repayment in project finance is primarily based on the cash flows generated by the specific project being

financed. This approach often involves the creation of a Special Purpose Vehicle (SPV), which, according to Gatti (2012), serves to isolate the project's financial risk from the sponsors' broader financial interests. Risk in project finance is carefully allocated among all parties involved, including sponsors, lenders, contractors, and operators, through detailed contractual agreements, as noted by Hoffman (2007). Typically, as Finnerty (2013) describes, lenders in project finance have limited or no recourse beyond the project's assets and revenues, meaning they cannot pursue the sponsors' other assets in case of failure. Extensive due diligence is conducted to assess the project's feasibility and to ensure that it can generate sufficient cash flow to cover operating costs and debt service, a point emphasized by Yescombe (2013). This method is particularly suited for large-scale, long-term projects such as infrastructure, energy, and industrial developments, as Nevitt and Fabozzi (2000) discuss.

In contrast, common finance, also known as corporate finance, relies on the overall financial health of the borrower, including their total assets and income, as Hoffman (2007) points out. Financing in this context is backed by the borrower's entire asset base, without the need for a separate entity like an SPV, a distinction highlighted by Esty (2004). The financial strength of the company as a whole is the primary focus, with less emphasis on detailed risk allocation among different parties, as Gatti (2012) explains. In common finance, lenders have full recourse to the borrower's assets, meaning they can pursue all of the borrower's assets in case of default, as described by Nevitt and Fabozzi (2000). Due diligence in common finance typically focuses on the borrower's creditworthiness and financial stability, as noted by Yescombe (2013). This type of financing is commonly used for general business purposes, including working capital and smaller-scale projects, with terms that can vary from short to long-term, as discussed by Finnerty (2013).

In conclusion, while both project finance and common finance serve essential roles in the financial world, they are suited to different purposes and risk environments. Project finance is particularly effective for large-scale, capital-intensive projects where isolating financial risk is crucial, and where the project's success is directly tied to its ability to generate revenue. On the other hand, common finance is more appropriate for ongoing business operations and smaller-scale projects where the overall financial strength of the borrower is a key factor. Understanding these differences is vital for

selecting the appropriate financing structure based on the specific needs and risks of the project or business.

Table 6.1 Differences between project finance and common/corporate finance

	Project Finance	Common/Corporate Finance
Repayment	Primarily based on the cash flows generated by the specific project being financed	Based on the overall financial health, including the total assets and income of the borrower
Structure	Involves the creation of a Special Purpose Vehicle (SPV) to isolate the project's financial risk from the sponsors' broader financial interests	Financing is backed by the borrower's entire asset base without the need for an SPV
Risk Allocation	Risks are carefully allocated among sponsors, lenders, contractors, and operators through detailed contractual agreements	The financial strength of the company as a whole is the primary focus, with less emphasis on detailed risk allocation
Recourse	Lenders have limited or no recourse beyond the project's assets and revenues; they cannot pursue the sponsors' other assets in case of failure	Lenders have full recourse to the borrower's assets, meaning they can pursue all of the borrower's assets in case of default
Due Diligence	Extensive due diligence is conducted to assess the project's feasibility and to ensure sufficient cash flow to cover operating costs and debt service	Standard due diligence focuses on the borrower's creditworthiness and financial stability
Applications	Particularly suited for large-scale, long-term projects such	Commonly used for general business purposes, including

	as infrastructure, energy, and industrial developments	working capital and smaller-scale projects
Financing Tenure	Typically involves long-term financing, often extending over decades	Financing terms can vary widely, from short-term to long-term, depending on the loan's purpose
Financial Flexibility	Off-balance-sheet treatment helps improve financial ratios and preserves borrowing capacity	Lenders face heightened risks due to reliance on project-specific cash flows and non-recourse financing, restricting claims to project assets
Equity Preservation	Leverages debt without diluting equity, preserving ownership structure	Higher risk profile leads to elevated interest rates and fees, impacting financial viability
Covenant Avoidance	Circumvents restrictive covenants in existing financial arrangements, offering greater flexibility	Lender oversight and control mechanisms can limit sponsor flexibility and slow decision-making
Favorable Financing Terms	Access to attractive debt financing, including lower interest rates and credit enhancements	Extensive reporting requirements can be burdensome and divert resources from core activities
Capital Allocation	Aligns with internal capital commitment policies, allowing strategic resource management	Comprehensive insurance coverage is required, adding complexity and cost
Investment Diversification	Facilitates diversification across regions and sectors, reducing political and geographical risks	Encourages potentially unacceptable risk-taking due to limited sponsor liability, leading to moral hazard

Researcher's own

6.2.3 Advantages of Project Finance

Project finance offers a range of strategic advantages that make it an attractive option for companies, particularly those seeking to undertake large-scale projects with minimized risk. Yescombe (2014) and Gatti (2018) emphasize that one of the key benefits is the limitation of recourse financing, where the sponsor's liability is confined to the project's assets and cash flows, thereby protecting the sponsor's broader financial portfolio. Additionally, Gatti (2018) notes that project finance can provide off-balance-sheet treatment in certain scenarios, allowing debt to be kept off the sponsor's balance sheet. This improves financial ratios and preserves borrowing capacity, which is advantageous for sponsors managing multiple projects or seeking financial flexibility. Another significant advantage, highlighted by Finnerty (2013), is the ability to leverage debt without diluting equity, enabling sponsors to finance large projects while maintaining their ownership structure and avoiding the dilution of existing shareholders' stakes.

Yescombe and Farquharson (2018) further point out that project finance offers the benefit of circumventing restrictive covenants in existing debt or equity arrangements, providing greater flexibility in structuring project financing without interference from other financial obligations. Gatti (2018) also explains that project finance allows access to attractive debt financing and credit enhancements, such as lower interest rates and extended tenors, which might not be available through direct loans. This form of financing aligns well with internal capital commitment policies, enabling companies to strategically allocate resources while adhering to their capital investment guidelines, as noted by Yescombe (2014).

Moreover, Sawant (2010) discusses how project finance facilitates the diversification of investments across different geographic regions and sectors, thereby mitigating political and geographical risks associated with individual projects. Esty (2004) highlights risk sharing as another critical advantage, as project finance involves multiple stakeholders—such as lenders, contractors, and equity investors—who share the financial and operational risks, thus reducing the burden on any single party. According to Finnerty (2013), collateral requirements in project finance are typically limited to the project's assets, safeguarding the sponsor's broader asset base. Yescombe

and Farquharson (2018) also note that lenders in project finance have a vested interest in collaborating during financial distress to restructure troubled loans, ensuring the project's continuity.

Gatti (2018) further explains that project finance enables the matching of specific assets with specific liabilities, which enhances financial stability by ensuring that the cash flows generated by the project are used to service its debt. Finally, Sawant (2010) highlights that project finance broadens the sponsor's access to credit opportunities, facilitating the pursuit of additional projects and diversification of financing sources, especially in times of constrained credit markets. These advantages demonstrate that project financing is a versatile and strategic tool, tailored to meet the varying needs and risk profiles of different projects, while supporting companies in achieving their long-term objectives.

In conclusion, project finance offers significant advantages for companies undertaking large-scale projects. By limiting recourse to project-specific assets and cash flows, it protects sponsors' broader financial interests while providing financial flexibility through off-balance-sheet treatment and leverage of debt. The ability to circumvent restrictive covenants and access favorable financing terms further enhances its appeal. Additionally, project finance supports risk-sharing and diversification, making it an effective tool for managing complex projects. Overall, these benefits make project finance a powerful strategy for achieving long-term corporate goals.

6.2.4 Disadvantages of Project Finance

While project finance offers significant strategic advantages, it also comes with several notable disadvantages that require careful consideration. Yescombe (2014) and Gatti (2018) underscore that the complexity of risk allocation among various stakeholders—such as sponsors, lenders, contractors, and operators—can lead to prolonged negotiations and increased transaction costs. This complexity may sometimes result in misaligned risk allocation, which can cause disputes and potential delays that undermine the success of the project. Esty (2004),Kleimeier and Megginson (2000) further emphasize that lenders face heightened risks in project finance due to the heavy

reliance on project-specific cash flows and the non-recourse nature of the financing, which restricts their claims to the project's assets. This increased risk exposure is particularly concerning during the early stages of a project, where issues like construction delays, cost overruns, and operational failures are most likely to occur.

Additionally, Finnerty (2013) highlights that the higher risk profile associated with project finance often leads to elevated interest rates and fees, which can significantly impact the financial viability of the project. The complexity of these transactions frequently necessitates the involvement of multiple advisors, further escalating costs. Yescombe and Farquharson (2018) add that lenders typically impose stringent oversight and control mechanisms to mitigate their risks, including regular monitoring of the project's progress, adherence to loan covenants, and approval of significant project decisions. This level of supervision can restrict the flexibility of project sponsors and slow down critical decision-making processes. Gatti (2018) also points to the extensive and continuous reporting requirements inherent in project finance, which can be burdensome for sponsors, diverting resources and attention from core project activities.

Moreover, Finnerty (2013) notes that project finance arrangements often require comprehensive insurance coverage, including construction, operational, and performance insurance, to mitigate various risks. Securing such coverage can be both costly and complex, adding to the overall expense of the project and placing additional strain on its financial resources. Esty and Megginson (2003) further caution that the structure of project finance may incentivize sponsors to undertake projects with higher risk profiles, given that their liability is limited to the invested capital. This moral hazard can lead to overly ambitious or speculative projects that may not align with sound financial management principles, potentially resulting in project failures and financial losses.

Furthermore, while risk sharing is intended to distribute risks among multiple parties, it can also dilute responsibility, making it harder to identify and address issues promptly (Esty, 2004). The limitation of collateral to project assets, although protecting sponsors' broader asset base, can restrict the resources available for securing the project, potentially leading to higher borrowing costs (Finnerty, 2013). Lender cooperation,

while beneficial during restructurings, can sometimes be challenging to achieve due to conflicting interests among lenders, which can complicate efforts to maintain project continuity (Yescombe & Farquharson, 2018). Additionally, the necessity to match specific assets with liabilities, although it improves financial stability, can complicate the financial structure, making it less flexible and harder to manage (Gatti, 2018). Finally, while project finance can expand credit opportunities by tapping into various pools of capital, it can also expose sponsors to varied and sometimes conflicting lender demands, which may complicate the financing process (Sawant, 2010).

Despite these challenges, the strategic benefits of project finance often outweigh the disadvantages, provided that risks are effectively managed through careful planning, robust contractual frameworks, and diligent oversight.

Table 6.2 Advantages and disadvantages of project finance

	Advantages	Disadvantages
Risk Allocation	Limits sponsor's liability to the project's assets and cash flows, protecting broader financial interests	Complexity in risk allocation can lead to prolonged negotiations, higher transaction costs, and potential disputes
Financial Flexibility	Off-balance-sheet treatment helps improve financial ratios and preserves borrowing capacity	Lenders face heightened risks due to reliance on project-specific cash flows and non-recourse financing, restricting claims to project assets
Equity Preservation	Leverages debt without diluting equity, preserving ownership structure	Higher risk profile leads to elevated interest rates and fees, impacting financial viability
Covenant Avoidance	Circumvents restrictive covenants in existing financial arrangements, offering greater flexibility	Lender oversight and control mechanisms can limit sponsor flexibility and slow decision-making

Favorable Financing Terms	Access to attractive debt financing, including lower interest rates and credit enhancements	Extensive reporting requirements can be burdensome and divert resources from core activities
Capital Allocation	Aligns with internal capital commitment policies, allowing strategic resource management	Comprehensive insurance coverage is required, adding complexity and cost
Investment Diversification	Facilitates diversification across regions and sectors, reducing political and geographical risks	Encourages potentially unacceptable risk-taking due to limited sponsor liability, leading to moral hazard
Risk Sharing	Distributes financial and operational risks among multiple stakeholders, reducing burden on any single party	Risk sharing can dilute responsibility, complicating issue resolution
Collateral Limitation	Limits collateral to project assets, safeguarding the sponsor's broader asset base	Limitation of collateral to project assets can restrict available resources for securing the project, leading to higher borrowing costs
Lender Cooperation	Lenders are more inclined to cooperate in restructuring troubled loans, ensuring project continuity	Lender cooperation can be difficult to achieve due to conflicting interests among lenders, complicating restructuring efforts
Lender Cooperation	Matches specific assets with specific liabilities, improving financial stability	Matching assets with liabilities can complicate financial structure, reducing flexibility
Credit Opportunities	Expands access to credit, enabling the pursuit of additional projects	Expanded credit opportunities can expose sponsors to varied and conflicting lender demands, complicating the financing process

6.3 ROLE OF SECURITY IN PROJECT FINANCE

In the realm of project finance, security mechanisms are crucial in mitigating risks and ensuring that lenders and other stakeholders are adequately protected against potential failures of the project to generate anticipated revenues. Gatti (2012) emphasizes that, unlike traditional financing where the borrower's overall creditworthiness and asset base primarily determine the security structure, project finance focuses on the project's assets and cash flows as the primary sources of repayment. This fundamental difference underscores the importance of security arrangements in project finance, as they provide a safety net for lenders in non-recourse or limited recourse financing structures, where the sponsors' other assets are not at risk.

One of the primary roles of security in project finance is to provide lenders with assurance that, in the event of project failure, they have recourse to specific assets or cash flows to recover their investments. As Nevitt and Fabozzi (2000) discuss, the security package typically includes collateral such as the project's physical assets (e.g., real estate, machinery, and equipment), assignments of contracts, and rights to project cash flows. Finnerty (2013) notes that these security interests are often formalized through legal instruments like mortgages, pledges, and assignments of rights, which give lenders a priority claim over these assets. Such arrangements are critical in non-recourse financing, where lenders' claims are limited to the project's assets.

In addition to providing collateral, security in project finance plays a vital role in the allocation and management of risks among different parties involved in the project. Yescombe (2014) discusses how security arrangements are structured to distribute risks associated with construction, operation, and market fluctuations between the project sponsors, lenders, and other stakeholders. For example, performance bonds and guarantees may be required from contractors to mitigate construction risks, ensuring that the project is completed on time and within budget. Similarly, Sawant (2010) highlights that revenue streams from off-take agreements or contracts for the supply of inputs may be assigned as security, thereby protecting lenders from market risks.

Moreover, security mechanisms in project finance often involve intricate legal and financial arrangements that provide lenders with rights to step into the project in case of default or underperformance. According to Hoffman (2007), these rights might include replacing the project operator, enforcing collateral, or taking over the project's operations to maximize recovery. Such provisions are essential in maintaining the project's continuity and ensuring that any disruptions are managed effectively without compromising the lenders' ability to recover their investments. Esty (2004) adds that these arrangements often require detailed negotiation and documentation to ensure that all parties' rights and obligations are clearly defined.

The importance of security in project finance is also reflected in the rigorous due diligence processes undertaken by lenders. Yescombe (2014) highlights that before committing to financing, lenders conduct exhaustive assessments of the project's feasibility, legal structure, and potential risks. This thorough due diligence ensures that the security arrangements are robust and sufficient to cover the project's debt obligations under various adverse scenarios. This contrasts sharply with traditional financing, where the focus might be more on the borrower's overall financial health and credit history than on specific project assets.

In conclusion, as Finnerty (2013) asserts, security mechanisms in project finance are indispensable in safeguarding the interests of creditors and other stakeholders. They provide a structured approach to risk management, ensuring that even in the face of uncertainties and potential failures, the project's assets and cash flows offer sufficient protection to recover the invested capital. As such, security plays a pivotal role in the successful execution of high-stakes infrastructure and industrial projects, distinguishing project finance from more conventional forms of financing.

6.4 COMMON UNDERLYING ASSETS USED IN PROJECT FINANCE

In project finance, the underlying assets play a crucial role in securing funding, mitigating risks, and generating cash flow for debt repayment. Unlike corporate finance, where financing decisions are based on the overall creditworthiness of a company, project finance is structured around the cash flow potential and asset value of a specific

project (Gatti, 2012). This structure relies heavily on the underlying assets of the project, which serve as collateral for lenders and mitigate risks associated with large-scale investments. For the purposes of this study, underlying assets in project finance may include the project assets themselves or other assets that serve as credit mitigation tools, providing liquidity in the event of unforeseen project risks or financial distress.

This section provides a detailed analysis of the four main categories of underlying assets in project finance—tangible assets, intangible assets, financial assets, and commodity-based assets (Raikar & Adamson, 2020):

1. Tangible Assets (Physical Assets)

Tangible assets form the backbone of project finance transactions due to their physical nature, measurability, and income-generating potential. These assets provide direct security interest to lenders and investors, making them ideal for use as collateral under both conventional and Islamic financing models (Scannella, 2012). Their intrinsic value and ability to generate consistent revenue streams make them indispensable in securing funding for large-scale projects.

(a) Real Estate & Land

Land plays a pivotal role in many infrastructure projects, providing the physical space required for development (Goetzmann et al., 2021). Industrial land is often utilized for manufacturing plants, refineries, and large-scale industrial complexes, which are essential for economic growth. Energy and utility land supports power plants, oil and gas refineries, and renewable energy sites such as solar farms and wind farms, contributing significantly to sustainable development. Transportation and infrastructure land, including spaces for roads, highways, airports, seaports, and metro stations, facilitates connectivity and enhances trade. In Public-Private Partnerships (PPPs), governments frequently lease land to private developers for a specified period, creating opportunities for innovative financing arrangements (Nikityuk, 2020). Additionally, in jurisdictions where companies receive licenses rather than full ownership of land, alternative financing structures are required to address the lack of traditional collateral (Zyla, 2019).

(b) Buildings & Facilities

Buildings and facilities are another critical subset of tangible assets, serving as essential components in project finance by providing physical spaces that generate cash flow. Power plants, industrial facilities such as oil refineries, LNG terminals, and hydroelectric plants are prime examples of income-generating buildings (Raikar & Adamson, 2020). Similarly, commercial buildings like hotels, shopping malls, and office towers are often financed under project-specific structures to ensure stable revenue streams. Transport hubs, including airports, ports, and railway stations, are typically financed through concession agreements, where private entities operate these facilities for a fixed period in exchange for revenue-sharing arrangements (Notteboom et al., 2021). These structures not only enhance operational efficiency but also align with long-term financial goals.

(c) Machinery & Equipment

High-value machinery and equipment are indispensable in capital-intensive industries such as energy, transportation, and construction. Heavy industrial machinery, specialized equipment like energy transmission infrastructure and water desalination plants, and transport vehicles such as aircraft, ships, and trucks are commonly used as collateral in project finance (Raikar & Adamson, 2020). These assets not only contribute to the operational efficiency of projects but also provide lenders with a sense of security due to their measurable value and income-generating potential (Hassan & Mollah, 2018). For example, drilling rigs in oil exploration projects or desalination plants in water-scarce regions exemplify how machinery and equipment can directly impact a project's success.

(d) Vehicles & Transport Assets

Vehicles and transport assets play a key role in logistics, transport, and infrastructure projects, offering long-term revenue generation. Commercial fleet vehicles, including trucks, oil tankers, and logistics fleets, are critical for supply chain operations, while maritime and shipping assets such as LNG tankers, container ships, and offshore support vessels facilitate global trade (Noble, 2019). These assets not only generate revenue but also serve as collateral for lenders, enhancing the financial viability of projects.

2. Intangible Assets

Intangible assets, though non-physical, are crucial for securing financing as they contribute to a project's revenue and legal rights (Zyla, 2019). There are few types of intangible assets as follows:

(a) Contracts & Concessions

Long-term contracts and concessions provide security for lenders by guaranteeing future cash flows. For instance, PPP contracts between governments and private entities enable the development of infrastructure projects, while power purchase agreements (PPAs) ensure a steady stream of revenue by allowing electricity producers to sell their output to government or corporate buyers (Nikityuk, 2020). Toll road concessions, which grant private operators the right to collect tolls for a fixed period, and mining and extraction licenses, which authorize companies to extract minerals, oil, or gas, are other examples of intangible assets that secure financing. A hydroelectric power plant with a specific period of PPA exemplifies how long-term agreements can ensure stable cash flow and secure Islamic project financing (Raikar & Adamson, 2020).

(b) Receivables and revenue streams

Receivables and revenue streams are another category of intangible assets that serve as future collateral for financing. Expected cash flows from infrastructure projects, such as electricity tariffs, toll road collections, and rental income, are often securitized to raise funds (Nakamura et al., 2019). Asset securitization via *Sukūk* converts these revenue streams into tradable securities, enabling projects to access additional capital while adhering to *Sharīʿah* principles (Bacha & Mirakhor, 2017). For example, a toll road project may issue *Sukūk* using future toll revenue to finance expansion, demonstrating how intangible assets can be leveraged to support sustainable growth.

(c) Intellectual property (IP)

In the context of Islamic Project Finance (IPF), intellectual property (IP) rights, including patents, trademarks, and software, are becoming increasingly valuable in technology-driven projects (Loumioti, 2012). As economies shift towards

digitalization and innovation, IP assets are now being recognized as collateral in project financing, particularly in sectors such as fintech, biotechnology, and renewable energy. Furthermore, IP rights can be monetized through licensing agreements, royalties, and commercialization strategies, providing alternative revenue streams to secure project financing. However, the valuation, enforceability, and risk assessment of IP assets remain key challenges, necessitating robust legal frameworks to ensure that IP-based securities align with the commercial outfit.

3. Financial Assets

Financial instruments and reserve accounts are among credit mitigations tools to provide liquidity and risk management in project finance. Debt service reserve accounts (DSRA) ensure stability in debt repayment by setting aside funds specifically for this purpose. Maintenance reserve funds, on the other hand, cover long-term maintenance costs, reducing the risk of operational disruptions. Escrow accounts secure project earnings before distributing them to lenders, ensuring transparency and accountability throughout the financing process (Karekar & Sharma, 2024)

Additionally, equity contributions in Special Purpose Vehicles (SPVs) represent another form of financial asset, as project-specific companies are formed to isolate risks and facilitate financing (Havemann et al., 2020). SPVs play a critical role in project finance structures, ensuring that financial commitments are contained within a separate legal entity, thereby limiting sponsor liabilities and enhancing the bankability of the project. Furthermore, fixed deposits, bonds, and *sukūk* can also serve as financial assets that strengthen the reliability of project finance payments, offering stability and predictability in cash flows (Nakamura et al., 2019).

4. Commodity-Based Assets

Commodity-backed financing is common in energy and natural resource projects, where oil, gas, and mineral reserves serve as critical collateral. Oil and gas fields are often financed, where financiers fund exploration activities in exchange for future refined oil or gas production. Mining rights for gold, copper, and lithium also play a significant

role in large-scale extraction projects, providing a stable source of revenue for lenders (Clews, 2016).

Renewable energy assets, including solar, wind, and hydroelectric projects are increasingly used to secure funding (Kołakowski & Rutkowski, 2022). Carbon credits and environmental assets are also gaining traction as part of green *Sukūk* issuance, enabling projects to raise capital while adhering to environmental, social, and governance (ESG) standards (Ramadhan & Wirdyanigsih, 2020). For example, a solar farm project issuing green *Sukūk* demonstrates how commodity-based assets can support sustainable growth while complying with *Sharīʿah* principles.

Conclusion

The diverse range of underlying assets in project finance plays a crucial role in securing financing, mitigating risks, and ensuring the long-term viability of infrastructure, industrial, and energy projects. From tangible assets such as land, buildings, and equipment to intangible assets like contracts, revenue streams, and intellectual property, each asset type contributes uniquely to project sustainability and financial structuring. The inclusion of financial assets like debt service reserves and commodity-based assets such as oil reserves and renewable energy sources further strengthens the risk management framework of project finance.

6.5 ISLAMIC PROJECT FINANCING: SALIENT FEATURES

Islamic project financing is a sophisticated form of project finance that aligns with the ethical and legal principles of Islamic law. As articulated by Usmani (2002), it involves funding large-scale infrastructure and industrial projects through mechanisms that adhere to *Sharīʿah* principles, which emphasize justice, risk-sharing, and the prohibition of unethical practices such as *ribā* (interest), *gharar* (excessive uncertainty), and *maysir* (speculation). Unlike conventional project finance, which often prioritizes profit maximization, Islamic project finance is grounded in the broader objectives of social welfare, equitable wealth distribution, and the promotion of economic activities that benefit society as a whole.

6.5.1 Salient Features of Islamic Project Financing

Islamic project financing is characterized by several salient features that distinguish it from conventional project financing. These features align with the principles and guidelines of Islamic finance, promoting ethical and socially responsible investment practices. The following salient features are commonly associated with Islamic project financing:

i. Prohibition of *Ribā*

One of the most fundamental principles of Islamic project finance is the prohibition of *ribā*, or interest. This prohibition is deeply rooted in Islamic economic thought, which views interest as an unjust transfer of risk and wealth from one party to another without corresponding value creation. As Usmani (2002) emphasizes, *ribā* is considered exploitative because it allows the lender to earn a guaranteed return without bearing any of the risks associated with the underlying economic activity. In Islamic project financing, instead of relying on interest-based loans, financiers use various *Sharīʿah*-compliant structures that can be categorized into equity-based, debt-based, or lease-based contracts. Debt-based contracts, such as *murābahah* and *istisnā"*, involve the sale of goods or services at a profit margin agreed upon in advance, while *ijārah*, a lease-based contract, allows for the use of an asset in exchange for rental payments. Equity-based contracts like *muḍārabah* and *mushārakah* involve profit-and-loss sharing, where the financier and the entrepreneur share the risks and rewards of the project. These structures not only comply with the prohibition of *ribā* but also encourage a more equitable distribution of risk and reward, fostering a partnership-like relationship between financiers and project sponsors (Iqbal & Mirakhor, 2011; Ayub, 2007).

ii. Prohibition of *Gharar*

Another critical feature of Islamic project finance is its prohibition of *gharar*, which refers to excessive uncertainty or ambiguity in contractual terms. *Gharar* is prohibited in Islamic finance to prevent unjust enrichment and to ensure that all financial transactions are conducted fairly. El-Gamal (2006) explains that Islamic finance mandates that contracts be clear, precise, and fully understood by all parties involved. This requirement is

particularly important in project financing, where long-term contracts and large investments are common. For instance, in *istisnā'*, a contract widely used in manufacturing and construction projects, the specifications of the project—such as cost, delivery timelines, and the quality of materials—must be clearly defined and agreed upon at the outset to avoid *gharar*. This level of contractual clarity contrasts with some conventional financial practices, where flexible terms and vague agreements can lead to disputes, financial misalignment, and project failures during the project's lifecycle. By eliminating *gharar*, Islamic project finance promotes transparency, fairness, and trust among all parties involved, reducing the likelihood of conflicts and ensuring a smoother project execution (Archer & Karim, 2013).

iii. Prohibition of *Maysir*

The prohibition of *maysir*, or speculative transactions, is another cornerstone of Islamic finance. Siddiqi (2006) notes that Islamic finance explicitly prohibits *maysir* because it involves gambling-like behavior, where parties engage in highly speculative transactions with uncertain outcomes. Such activities are seen as harmful because they create economic instability and can lead to significant financial losses without contributing to real economic value. In contrast, Islamic project finance emphasizes investments in real economic activities that involve tangible assets. Contracts like *ijārah* (leasing) and *istisnā'* are examples of asset-backed financing methods commonly used in Islamic project finance, where the financial transaction is directly tied to physical assets or productive activities. Iqbal and Mirakhor (2007) argue that by tying financial transactions to real assets, Islamic finance reduces the risk of financial bubbles—situations where asset prices are artificially inflated due to speculative trading without corresponding increases in real economic value. This focus on asset-backed financing promotes economic stability and sustainability, as it ensures that financial activities are grounded in the real economy, contributing to long-term development and reducing the likelihood of market distortions (Visser, 2019; Obaidullah, 2005).

Conclusion

Islamic project financing is characterized by its adherence to *Sharīʿah* principles, which emphasize the prohibition of *ribā, gharar*, and *maysir*. These prohibitions are not merely legal constraints but are central to ensuring that financial activities are conducted ethically, transparently, and with a focus on social responsibility. By promoting risk-sharing, transparency, and investments in real economic activities, Islamic project finance offers a sustainable and equitable alternative to conventional project financing.

6.5.2 Differences Between Islamic and Conventional Project Financing

Islamic and conventional project financing differ fundamentally in several key aspects, reflecting the distinct principles and practices that underpin each approach. Islamic project financing avoids interest-based lending, known as *ribā,* and instead relies on *Sharīʿah* compliant contracts such as equity-based structures like *muḍārabah* and *mushārakah*, or asset-backed contracts like *ijārah*, *murābahah*, and *istisnā'* (Usmani, 2002; Iqbal & Mirakhor, 2011). In contrast, conventional project financing primarily utilizes debt instruments that involve fixed interest payments, providing predictable returns to lenders.

A significant distinction between the two systems lies in the approach to risk-sharing. Islamic project financing emphasizes a collaborative approach, where profits and losses are distributed among partners based on pre-agreed ratios, ensuring that all parties have a vested interest in the project's success (Khan, 2010; Iqbal & Mirakhor, 2011). Conventional project financing, on the other hand, typically places the financial risk squarely on the borrower, with lenders expecting fixed returns regardless of the project's outcome.

Another critical difference is the prohibition of *gharar* (excessive uncertainty) in Islamic project financing. Islamic contracts must be free from ambiguity, with all terms and risks clearly defined and agreed upon by all parties to ensure fairness and transparency (El-Gamal, 2006; Archer & Karim, 2013). This contrasts with

conventional financing, where flexible terms may sometimes lead to disputes and financial misalignment during the project lifecycle.

Moreover, Islamic project financing prohibits speculative transactions (*maysir*), instead focusing on real economic activities involving tangible assets, which helps reduce the risk of financial bubbles and promotes economic stability (Siddiqi, 2006; Iqbal & Mirakhor, 2007). Conventional project financing, however, allows for speculative transactions, which can lead to financial instability.

The role of collateral also differs significantly between the two systems. In conventional project financing, collateral is often a central element, with lenders heavily relying on it to secure loans and mitigate risks. Borrowers typically pledge assets to guarantee loan repayment, and if they default, lenders can seize these assets (Minsky, 1999). Islamic project financing, however, approaches collateral with stringent *Sharīʿah* requirements. Not all assets can qualify as collateral; the collateral must be recognized and permissible under *Sharīʿah* law. This means that the asset used as collateral must be *halāl* (permissible) and free from elements that are prohibited in Islam, such as alcohol or gambling-related assets (Usmani, 2003). Moreover, Islamic finance emphasizes that the collateral should be tied to productive, tangible assets, ensuring that the financing supports real economic activities and aligns with the principles of fairness and justice in *Sharīʿah*. This approach not only reduces excessive reliance on collateral but also promotes investments that contribute to long-term economic and social development.

These differences underscore the unique ethical and structural foundations of Islamic project financing, which not only seeks to align financial practices with *Sharīʿah* principles but also aims to promote transparency, fairness, and social responsibility in economic activities.

Conclusion

Islamic project financing, rooted in *Sharīʿah* principles, prohibits *ribā* (interest), *gharar* (uncertainty), and *maysir* (speculation) while emphasizing equity-based risk-sharing and asset-backed transactions. In contrast, conventional project financing relies heavily

on debt instruments with fixed interest payments, placing financial risk primarily on the borrower and ensuring predictable returns for lenders. The collateralization approach also differs significantly; while conventional financing relies on collateral as a primary risk mitigation tool, Islamic finance ensures that collateral assets comply with *Sharīʿah* principles and contribute to real economic activities.

Table 6.3 Key differences between Islamic and conventional project financing

	Islamic Project Financing	Conventional Project Financing
Prohibition of *ribā*	Avoids interest-based lending (*ribā*); uses *Sharīʿah* compliant contracts such as *muḍārabah*, m*ushārakah*, *ijārah*, *murābahah,* and i*stisnā'*	Primarily relies on interest-based debt instruments, where lenders receive fixed interest payments.
Risk Sharing	Emphasizes shared risk and reward; profits and losses are distributed among partners according to pre-agreed ratios, fostering collaboration	Most financial risk is borne by the borrower; lenders expect fixed returns regardless of the project's outcome.
Prohibition of *gharar*	Contracts must be free of excessive uncertainty (*gharar*); all terms and risks must be clear and agreed upon to ensure fairness and transparency	Contracts may include flexible terms, leading to potential disputes and financial misalignment during the project lifecycle.
Prohibition of *maysir*	Prohibits speculative transactions (*maysir*), focusing on real economic	Allows speculative transactions, which can lead to

	activities involving tangible assets, reducing financial bubbles and promoting stability	financial bubbles and economic instability.
Collateral Role	Collateral must be recognized and permissible under *Sharīʿah*; assets used must be *halāl* and tied to productive, tangible assets, promoting ethical and socially responsible investment	No specific limitation on the requirement of collateral, with a focus on securing loans and mitigating lender risk through asset seizure in case of default.
Ethical Consideration	Guided by Islamic ethical principles, including social justice, equitable wealth distribution, and avoidance of investments in *harām* (forbidden) industries	Primarily focused on profit maximization, often without specific ethical constraints or considerations.

Researcher's own

6.6 TYPES OF *SHARĪʿAH* CONTRACTS USED IN ISLAMIC PROJECT FINANCING

Islamic project financing utilizes various *Sharīʿah* compliant contracts specifically designed to align with the principles of Islamic finance. These contracts are tailored to meet the unique needs and characteristics of different projects while ensuring full compliance with *Sharīʿah* principles. The following are some of the commonly used types of *Sharīʿah* contracts in Islamic project financing (Usmani, 2003):

a) *Murābahah*

Murābahah is a cost-plus contract commonly used in Islamic project financing. It involves the sale of a specific asset by the project sponsor to the investor at an agreed-upon cost plus a predetermined profit margin. The investor pays this total amount in instalments, providing the project sponsor

with immediate financing while allowing the investor to earn a return on their investment. *Murābahah* is particularly suitable for projects requiring the purchase of goods or equipment, as it facilitates asset acquisition in a *Sharīʿah* compliant manner (Visser, 2019; Iqbal & Mirakhor, 2011).

b) *Ijārah*

Ijārah refers to a leasing contract frequently employed in Islamic project financing. Under *ijārah*, the project sponsor leases an asset to the investor for a specified period and rental amount. The rental payments provide the project sponsor with a steady income stream, while the investor benefits from the use of the asset. At the end of the lease term, the asset may either be transferred to the investor or the lease may be renewed, depending on the terms of the agreement (Archer & Karim, 2013; Thomas et al., 2005). This arrangement is particularly effective for projects involving long-term infrastructure or equipment usage.

c) *Mushārakah*

Mushārakah is a partnership-based contract where two or more parties contribute capital to a project. In the context of Islamic project financing, *mushārakah* enables project sponsors and investors to pool their resources and share both the profits and risks of the project according to pre-agreed ratios. This collaborative approach fosters a sense of shared responsibility and ensures that the interests of all parties are aligned (Archer & Karim, 2013; Ayub, 2007).

d) *Muḍārabah*

Muḍārabah is a profit-sharing partnership in which one party, the investor or *rabbul māl*, provides the capital, while the other party, the entrepreneur or *mudārib*, contributes expertise and manages the project. In Islamic project financing, *muḍārabah* allows investors to finance projects by providing the necessary capital, with project sponsors utilizing their expertise to manage and execute the project. Profits generated from the project are shared between the parties based on a pre-agreed ratio, while losses, if any, are borne solely by the investor unless caused by negligence or misconduct by the *mudārib* (Iqbal & Mirakhor, 2011; Obaidullah, 2005).

e) *Istisnā'*

Istisnā' is a contract specifically used for construction and manufacturing projects. In Islamic project financing, *istisnā'* involves a contract where the project sponsor agrees to construct or manufacture a specific asset according to pre-defined specifications and milestones. The investor provides the necessary financing, and the project sponsor delivers the completed asset within the agreed-upon timeframe. *Istisnā'* is highly versatile and is especially useful for projects that require customized construction or manufacturing solutions (Ayub, 2007; Obaidullah, 2005).

f) *Wakālah*

Wakālah is an agency agreement where the investors appoint an agent (*Wakeel*) to invest funds on their behalf. The *wakeel* is responsible for managing the project and generating returns, which are then distributed to the investors. This structure is particularly useful for projects requiring professional management and oversight (Ayub, 2007).

These types of *Sharīʿah* contracts offer flexibility and adaptability, allowing them to meet the diverse requirements of different projects across various sectors and industries. By employing these contracts, Islamic project financing ensures adherence to *Sharīʿah* principles while facilitating the successful funding and execution of projects in a manner that is both ethical and economically viable.

6.7 METHODS OF RAISING FUNDS IN ISLAMIC PROJECT FINANCE

In Islamic project finance, funds are typically raised through several *Sharīʿah* compliant methods, primarily via Ṣukūk and Islamic financing, which can be structured either bilaterally or through syndication (Ayub, 2019).

6.7.1 Ṣukūk

Definition and Structure: Ṣukūk represents a *Sharīʿah* compliant financial certificate that serves as an alternative to conventional bonds. Unlike conventional bonds, which

involve interest, Ṣukūk are structured to ensure that investors earn returns through profit-sharing, lease payments, or asset appreciation, rather than interest (Hassan, 2018). The issuance of Ṣukūk is typically linked to specific assets or projects, meaning that Ṣukūk holders have a direct ownership interest in the underlying assets, or the revenues generated by the project (Wilson, 2008; Iqbal & Mirakhor, 2011).

Operation in Project Finance: In Islamic project financing, Ṣukūk can be issued by the project company or a Special Purpose Vehicle (SPV) specifically created for this purpose. The proceeds from the Ṣukūk issuance are used to finance the project, such as building infrastructure, energy plants, or industrial facilities. Ṣukūk holders receive periodic payments derived from the profits generated by the project or from the lease payments if the Ṣukūk is structured as an *ijārah* Ṣukūk (Ayub, 2012). At maturity, the principal is either paid through the sale of the asset, the project's revenues, or by refinancing. Ṣukūk structures can vary, including *Ijārah* Ṣukūk (lease-based), *Murābahah* Ṣukūk (cost-plus sale), or *Mushārakah* Ṣukūk (partnership), depending on the specific needs of the project and the preferences of the investors (Archer & Karim, 2013). This structure allows for pooling of capital from a broad base of investors while maintaining compliance with Islamic principles.

6.7.1.1 How Ṣukūk Structure Operates

When a project requires funding, the project company or an SPV issues Ṣukūk to investors. These Ṣukūk are backed by the project's assets or the revenues they generate. For example, in an *Ijārah Sukūk*, the project company might lease an asset, such as a building or equipment, to the Ṣukūk holders in exchange for lease payments. These payments represent the returns on the Ṣukūk (Lahsasna et al. 2018). Over time, the revenue generated by the project is used to pay the *Sukūk* holders, and at the end of the Ṣukūk term, the principal amount is returned. This structure ensures that the investors' returns are tied directly to the project's success, aligning their interests with those of the project sponsor (Bacha, & Mirakhor, 2017).

6.7.2 Islamic Financing (Bilateral or Syndication)

Bilateral Financing:

In a bilateral financing arrangement, a single Islamic financial institution provides the necessary funds for a project. This arrangement is straightforward, with the financier and the project sponsor agreeing on a specific *Sharīʿah* compliant contract, such as *murābahah* (cost-plus sale), *istisnā'* (construction or manufacturing), or *ijārah* (leasing) (Su'un, et al (2018). The financing agreement specifies how the funds will be used, the terms of repayment, and the profit margins or rental payments involved. For example, in a *murābahah* contract, the financial institution purchases the necessary equipment or materials for the project and sells them to the project sponsor at a pre-agreed profit margin, which is paid overtime (Ayub, 2007). This method is typically used for smaller projects or when a specific institution has a strong relationship with the project sponsor.

Syndicated Financing:

For larger projects requiring substantial capital, Islamic financing is often arranged through syndication. In a syndicated financing arrangement, multiple Islamic financial institutions pool their resources to fund a single project (Ayub, 2012). This structure allows for the sharing of risk among several financiers, reducing the exposure of any one institution. The syndicated loan is usually arranged by a lead bank or financial institution, which coordinates the financing and ensures that all terms comply with *Sharīʿah* principles. The terms of the financing, including profit-sharing ratios, repayment schedules, and the specific *Sharīʿah* contracts used (e.g., *mushārakah*, *ijārah*), are agreed upon by all participating financiers (Visser, 2019). In practice, the project sponsor receives the total funding required for the project, and each financier receives a proportionate share of the profits generated by the project. This method is particularly useful for large-scale infrastructure projects, such as transportation networks, energy facilities, or industrial complexes, where the capital requirements are too large for a single institution to handle alone.

6.7.2.1 How Islamic Bilateral and Syndicated Financing Structures Operate

In bilateral financing, the project sponsor approaches a single Islamic financial institution to provide the necessary funds. The two parties agree on the specific *Sharīʿah*-compliant contract that best suits the project's needs (Jobst, 2007). For instance, in a *murābahah* arrangement, the financier purchases the materials or equipment needed for the project and sells them to the project sponsor at a marked-up price. The project sponsor then repays this amount over time, typically in instalments (Finnerty, 2012). In a syndicated financing arrangement, multiple Islamic financial institutions collaborate to provide the necessary funds for a larger project. The lead bank organizes the syndication, ensuring that the terms of the financing comply with *Sharīʿah* principles. Each participating institution contributes a portion of the total financing, and profits are distributed according to the proportion of the financing each institution has provided (Ayub, 2012). This structure spreads the risk among multiple financiers and ensures that large-scale projects can be financed in a *Sharīʿah* compliant manner.

In summary, Islamic project finance employs Ṣukūk and Islamic financing (bilateral or syndicated) as primary methods to raise funds for large-scale projects. These structures operate within the framework of *Sharīʿah* law, ensuring that all financial transactions are ethically grounded and contribute to real economic activities. The flexibility of these structures allows Islamic project finance to adapt to various project needs while maintaining compliance with Islamic principles, making it a viable alternative to conventional project financing.

6.8 APPLICATION OF SECURITY INSTRUMENTS IN ISLAMIC PROJECT FINANCING (IPF) IN MALAYSIA

The findings from Chapter 5, based on insights from industry legal experts and existing literature, highlight the most commonly applied security instruments in Islamic project finance in Malaysia. The study demonstrates the following:

i. Charge

   The charge is the most frequently utilized security instrument in Islamic project financing. This arrangement involves the creation of a security

interest over an asset owned by the debtor without transferring its ownership to the financier (Gullifer, 2017). Charges, governed by the Companies Act 2016 and NLC, provide a comprehensive and efficient mechanism for securing assets, particularly land and corporate property (Dass (1985). This also supported by legal experts on the use of charge assets compared to other instruments due to it widely practice in the market.

ii. Mortgage

The application of security instruments in Malaysia reflects a shift from traditional common law principles to statutory frameworks tailored for modern commercial needs (Kader & Mohamad, 2019). Mortgages, once involving ownership transfer, have been replaced by charge-based systems under laws like the National Land Code (NLC), Merchant Shipping Ordinance (MSO), and Civil Aviation Regulations (CAR), ensuring ownership remains with the debtor while granting creditors enforceable rights (Dahlan, 2014). This is also supported by the interview with legal experts which confirmed that the application of mortgage in Malaysia in this context typically refers to real property and estate rather than a legal security instrument.

iii. Pledge and Lien

Pledges and liens complement charges in certain scenarios. Both mechanisms involve retaining possession of the asset by the financier or creditor until the debt is settled (Sheehan, 2018). These instruments adhere to *Sharīʿah* principles by safeguarding the ownership rights of the debtor. In Malaysia, the pledges, governed by the Contracts Act 1950, allow creditors to take possession of pledged goods as security, with broader recognition of documents of title compared to English common law, making them suitable for specialized contexts like international trade financing through bills of lading (Manap, et al, 2013). Liens, on the other hand, are facilitated under Section 281(1) of the NLC, enabling creditors to secure debts by depositing the document of title and lodging a lienholder caveat, with courts recognizing equitable rights even without formal registration (Oseni, et.al, 2019).

In summary, charge-based security instruments dominate the Malaysian Islamic project finance landscape, offering clarity, flexibility, and enforceability under the current legal framework. Mortgages are no applicable in Malaysia, given legal constraints on ownership transfer, while pledges and liens remain niche instruments with limited practicality in large-scale financing. Moving forward, the preference for charges is expected to continue, reinforcing their role as the primary security mechanism in Islamic project finance in Malaysia.

6.8.1 Compatibility of Charge, Pledge and Lien Instruments with *Rahn*

The compatibility of modern security instruments with the *rahn* concept in Islamic project financing varies significantly based on their alignment with *Sharīʿah* principles. Among these instruments, charges are the most compatible and widely practiced in Malaysia due to their flexibility and adherence to *rahn*'s core requirement that ownership of the collateral remains with the debtor. Charges allow debtors to retain ownership and use of assets while providing security to creditors, and they cover both existing and future assets, making them highly versatile. This is further supported by clear legal frameworks such as the Companies Act 2016 and the National Land Code (NLC), which facilitate their application in Islamic finance. In contrast, pledges demonstrate only moderate compatibility because they require creditor possession of the asset, limiting the debtor's ability to use it, and are restricted to tangible, movable assets, excluding future ones. Similarly, liens are the least compatible due to their reliance on judicial enforcement, creditor possession, and narrow applicability to specific professions.

6.8.2 Compatibility of Mortgage Instruments with *Rahn*

In contrast, security instruments that involve the transfer of ownership, such as modern security instrument of mortgage is inherently incompatible with the *Sharīʿah* requirements of *rahn*, which mandates that ownership of the asset must remain with the debtor. Ownership transfer contradicts the fundamental principles of Islamic finance, which prioritize fairness, transparency, and the protection of the debtor's rights. This is

supported by the interviews with industry expert[1] which revealed that the concept of a modern instrument of mortgage is not applied in the Malaysian context of Islamic project financing. The absence of clear governing laws for such instruments further reinforces this incompatibility. In practice, the term "mortgage" in Malaysia is used to describe security arrangements involving real property or land, which are structured through various security instruments such as charges, pledges, and liens. These arrangements ensure that ownership remains with the debtor, aligning with Islamic legal principles, unlike the ownership-transfer nature of common law mortgages.

6.8.3 Conclusion

In summary, the application of security instruments in Islamic project finance in Malaysia is heavily focused on charges, which are widely practiced due to their clear legal provisions and alignment with *Sharīʿah* principles. Instruments like pledges and liens are less frequently adopted due to their requirement for physical possession, which may not align with modern transactional needs. Notably, the modern concept of mortgage is not applicable in Malaysia's Islamic finance framework, as it involves the transfer of ownership, which contradicts the principles of *rahn*.

Thus, the following discussion on the application of security assets in Islamic project finance, along with their *Sharīʿah* compatibility, will primarily focus on assets secured under charges, while also considering applicable assets under pledges or liens where relevant. Additionally, insights from the interview sessions on commonly used assets in Islamic project finance will be incorporated to provide a comprehensive analysis.

[1] Interview with P10 (a legal expert with more than 25 years of experience in handling banking security arrangements), conducted on 10 October 2024, revealed that the application of a common law mortgage in Malaysia is not feasible. He explained that the current acts governing mortgaged assets do not permit the transfer of legal ownership as required under a traditional common law mortgage. Therefore, in the Malaysian context, mortgages are primarily associated with real estate assets, such as land, rather than other types of instruments.

6.9 THE APPLICATION OF SECURITY ASSETS IN ISLAMIC PROJECT FINANCING IN MALAYSIA

6.9.1 Introduction

As previously discussed, the most prevalent form of security arrangement in Malaysia is the "charge," primarily due to its comprehensive legal framework under the Companies Act 2016. While the concept of a mortgage exists for specific assets such as land, vessels, and aircraft, it does not align with the traditional common law definition of a mortgage due to the respective governing acts restrict the transfer of ownership—a fundamental characteristic of a mortgage. In the Malaysian context, mortgages are more akin to charges, as they are categorized under the registration requirements for charges outlined in the Companies Act (2016). Pledges and liens, on the other hand, are less commonly utilized in Islamic project finance. The focus remains predominantly on assets governed by charges, a fact corroborated by interviews conducted with banking industry professionals.

6.9.2 Security Assets Practiced in Islamic Project Finance

The Companies Act 2016 serves as the primary regulatory framework governing charges over corporate assets, applying exclusively to corporate entities rather than individuals. This study adopts the Act as a foundational framework for analyzing the application of security assets in Islamic project finance, a perspective supported by industry experts who confirm that charges are the predominant security instrument in Islamic project financing.

Additionally, the study examines collateral assets based on findings from industry experts and literature, which reveal a hierarchical preference for commonly accepted security assets in Islamic project finance. These include:

1. Real estate and land
2. Cash-based assets (deposit and reserve accounts)
3. Receivables
4. Financial instruments (fixed deposits, shares, *Sukūk*, bonds)

5. Debentures and floating charges
6. Insurance proceeds

Furthermore, this study analyzes chargeable asset classes under Section 353 of the Companies Act 2016, assessing their compatibility with *Sharīʿah* principles to ensure alignment with Islamic jurisprudence in Islamic project finance.

6.9.3 Types of Security Assets and Its Compatibility with *Sharīʿah* Requirements

This section examines the types of collateral assets and their applications in Islamic project finance, with a focus on their compatibility with *Sharīʿah* principles.

6.9.3.1 Real Estate and Land as Collateral

As highlighted earlier, the tangible assets such as real estate and land among the backbone of project finance transactions due to their physical nature, measurability, and income-generating potential. These assets provide direct security interest to creditors and investors, making them ideal for use as collateral under both conventional and Islamic financing models (Scannella, 2012). Their intrinsic value and ability to generate consistent revenue streams make them indispensable in securing funding for large-scale projects. These assets are the most consistently favored collateral assets in Islamic project finance, as highlighted by the majority of interviewees, due to their stability, liquidity, and alignment with *Sharīʿah* principles, further supported by a robust legal framework which is National Land Code. A charge under Malaysian law for both land and real estate is a statutory creation, distinct from the common law concept of a mortgage. In Malaysia, the power of banking institutions to create legal charges arises from statutes such as the NLC. Unlike a mortgage, which transfers ownership to the creditor under common law, a charge under the NLC creates an encumbrance on the land without transferring ownership. The main concept of charge under a statute is that it requires registration with its relevant authority. The Malaysian law position requires charge to be registered under the National Land Code. The effect of registering a charge is: (a) the land becomes security; (b) the charge will get indefeasibility of title; (c) an

interest is created in the land; (d) becomes an encumbrance on the land and the owner is not able to deal with the land without permission of the chargee. The purpose of the charge is to secure repayment of money. In *Yee sin Cheong v UMBC* (1992), the court held that charge is to secure repayment of any debt.

***Sharīʿah* Ruling:**

Under Islamic law, the concept of a charge over land and property, as practiced under Malaysian statutory law, can be reconciled with the principles of *Sharīʿah* through the contract of the *rahn*. *Rahn* refers to the charging of an asset as security for a debt, where the creditor is granted rights over the charged asset in the event of default. While traditional interpretations of *rahn* often emphasize physical possession of the pledged asset, the *Mālikī* school of thought provides a flexible perspective, recognizing that the *rahn* contract can be valid and binding without physical possession, relying instead on the legal encumbrance created by the agreement. This aligns with the charge instrument, where the registration of the charge under the National Land Code (NLC) creates an enforceable encumbrance on the land without transferring ownership to the creditor.

The charge serves the legitimate purpose of securing repayment of a debt, as affirmed in cases such as *Yee Sin Cheong v UMBC (1992)* , and ensures fairness to both parties. From a *Sharīʿah* perspective, the registration of the charge under the NLC fulfills the requirement of transparency and legal recognition, which is essential for the enforceability of the *rahn* contract. Additionally, the creation of an indefeasible title and the restriction on the owner's ability to deal with the charged land without the chargee's permission further reinforce the creditor's rights, ensuring that the arrangement complies with the principles of justice and equity in Islamic law.

Thus, there is no inherent *Sharīʿah* issue with the use of a statutory charge over land in Malaysia, provided that the underlying transaction adheres to Islamic principles. The charge functions similarly to the *Mālikī* interpretation of *rahn*, where the contract itself is sufficient to bind the parties, and physical possession of the asset is not a prerequisite. This makes the statutory charge a viable and *Sharīʿah* compliant mechanism for securing debts in Islamic finance, particularly in jurisdictions like Malaysia where the legal framework supports such arrangements.

6.9.3.2 Cash Based Assets as Collateral

Cash-based assets play a critical role in enhancing Islamic project finance structures by providing financiers with direct access to cash flows. Typically, cash-based assets serve as supporting tools in project finance, ensuring liquidity and effective risk management. They contribute to stability in debt repayment by setting aside funds specifically for this purpose (Karekar & Sharma, 2024). Cash-based assets can be categorized into several types, including deposit accounts and reserve accounts.

(a) Deposit Accounts

Deposit amount can be utilized as collateral is the debtor's cash, specifically the credit balance in a deposit account. This can include savings accounts, current accounts, or fixed deposit accounts held by the debtor. Charging the credit balance in a deposit account is considered one of the safest forms of security against financing provided by banks (Engku Ali et al., 2018). Under the Companies Act 2016, Section 353(k) explicitly recognizes that the credit balance of a company in a deposit account constitutes a registrable charge. For this charge to be valid as security, it must be registered in accordance with the requirements stipulated by the Act. By registering this charge, the creditor establishes a legal claim over the credit balance in the debtor's deposit account, providing additional security for the project financing arrangement. This ensures that the creditor has a recognized right to the funds held in the deposit account in the event of default by the debtor (Mohd Ghazali & Abdul Rahman, 2019).

In project financing, deposit accounts are particularly valuable as they provide a reliable and liquid source of collateral. Project financiers often require borrowers to maintain a minimum balance in a designated deposit account to mitigate risks associated with project delays, cost overruns, or revenue shortfalls. These accounts act as a financial buffer, ensuring that sufficient funds are available to meet repayment obligations. For example, in large-scale infrastructure projects, lenders may require borrowers to pledge the credit balance in a deposit account as part of the overall security package. This not only enhances the lender’s confidence but also aligns with the principle of risk-sharing in Islamic finance, where tangible and identifiable assets are preferred (Wilson, 2017).

Using a deposit account as collateral offers a high level of security for the creditor, as the funds are readily available and can be easily accessed and controlled. It provides a tangible and easily identifiable asset that can be used to satisfy the debt in case of default. Furthermore, deposit accounts are less susceptible to valuation fluctuations compared to other forms of collateral, such as real estate or receivables, making them an attractive option for both conventional and Islamic financiers (Abdul Rahman et al., 2021). In summary, a debtor's credit balance in a deposit account can serve as collateral for financing.

(b) Reserve Accounts

A reserve account is a critical form of cash-based collateral commonly utilized in Islamic project finance. It involves setting aside a portion of the project's cash flows into a dedicated account, which serves as security for the financier. This account acts as a vital cash buffer to address potential shortfalls in funding for debt service obligations or major maintenance expenses, which may arise due to temporary operating cash flow deficiencies. Typically, within a term sheet, the reserve account is required to be funded up to a specified percentage—often 100%—of the aggregate scheduled principal and financing costs due and payable over the next 12 months. This ensures that sufficient liquidity is available to meet debt obligations even during periods of financial stress. Additionally, the reserve account can also be structured to cover anticipated maintenance costs, ensuring that the project's operational integrity is maintained without compromising its ability to generate revenue (Abdul Rahman et al., 2021).

Reserve accounts are particularly valued for their liquidity and ability to provide financiers with direct access to project cash flows, thereby reducing the risk of default (Hassan & Ali, 2020). By segregating these funds, the financier gains greater control and assurance that the borrower has the necessary resources to fulfil their financial commitments. This mechanism aligns with the principles of transparency and risk mitigation in Islamic finance, where tangible and identifiable assets are preferred to ensure fairness and stability in financial transactions (Wilson, 2017). Furthermore, the use of reserve accounts provides a clear and structured approach to managing financial uncertainties in project finance.

***Sharīʿah* Ruling:**

The *Sharīʿah* justification for both deposit accounts and reserve accounts revolves around the same concern: the permissibility of using cash itself as collateral (*rahn*) to secure financing. The central question is whether it is allowable to use cash as a form of collateral in *Sharīʿah* law, given that *rahn* traditionally involves tangible assets that can be possessed and secured.

Several prominent *Sharīʿah* authorities have addressed this issue in detail and issued specific resolutions regarding the use of cash as collateral. These include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic *Fiqh* Academy of the Organization of Islamic Cooperation (IIFA-OIC), and the *Sharīʿah* Advisory Council of Bank Negara Malaysia (SAC-BNM).

According to AAOIFI (2017) in its *Sharīʿah* Standard No. 39, it is permissible to use cash as collateral to secure debt obligations, provided specific conditions are met. The Standard outlines as follows:

> 6/5/1 In order to secure the future payment of debts on a single payment or an instalment basis, it is permissible for the Institution to stipulate that it is entitled to freeze the customer's investment account, or to revoke his right to withdraw money from such an account entirely or to block an amount in the account equivalent to the debt, which is the preferred option. Nevertheless, the customer remains entitled to share profits on the whole balance of the investment account after deducting the Institution's share for acting as a *Muḍārib*.
> 6/5/2 In a credit transaction, it is not permitted for the Institution to stipulate a right to freeze the customer's current account. However, a stipulation of this kind is allowed where the customer has freely, willingly and absolutely agreed to his current account to be frozen.

This opinion is also supported by Resolution No. 86/3/95 of the Islamic *Fiqh* Academy (1995), which confirms the permissibility of using bank accounts as collateral in its resolution as follows:

> Fourth: Charging deposits, call (current accounts) and investment ones alike is permissible, and charges against their amounts can only take place through an arrangement precluding the account holder having access to it for the whole charge period. In case the bank operating the current account is itself the chargee, the amount must be transferred to an

> investment account, in such a way that the guarantee is no longer applicable in view of the conversion of the loan into a *muḍārabah* (sleeping partnership) and the profits arising from the account shall be credited to the account holder so as to preclude the chargee (creditor) from deriving benefits from any appreciation in the mortgage value.

The SAC of BNM (2017) also ruled that the practice of collaterising deposits and investment accounts to secure a financing obligation is permissible. The account can be utilised by Islamic financial institutions (IFIs) (as pledgee) with the consent of customers (as pledgor), subject to the following conditions:

> (i) Customers are allowed to choose any type of account, including deposit or investment account as collateral against the payment of financing obligation; and
> (ii) The financial obligation or liability owed by the customer to the IFI does not arise from a loan(qard) contract

Both AAOIFI and the Islamic *Fiqh* Academy permit a creditor to require the placement of a deposit as collateral by a debtor and to freeze the debtor's cash account, provided there is explicit agreement from the debtor. In cases where such deposits are placed in a *muḍārabah* account (where the bank acts as the *muḍārib)*, the debtor, as the *rabb al-māl* (capital provider), is entitled to a share of the profits generated from the account, while the bank retains its portion as the *muḍārib* (entrepreneur-manager). The *Sharīʿah* Advisory Council (SAC) of Bank Negara Malaysia similarly permits the practice of collateralising deposit and investment accounts for the purpose of securing financing obligations. However, this is subject to the condition that the underlying contract must not be a *qard* (loan) contract, in order to avoid the prohibition of profiting from a loan (*ribā*).

However, all these resolutions are specifically applicable to *Sharīʿah* compliant bank accounts where cash is used as collateral. The treatment may differ when dealing with conventional deposit accounts that generate income, as this could raise *Sharīʿah* concerns due to the involvement of prohibited elements such as *ribā* (interest) or unjust enrichment.

Treatment of Conventional Deposit/Reserve Accounts as Collateral

The use of conventional deposit/ Reserve accounts as collateral raises specific *Sharīʿah* concerns due to their inherent involvement in prohibited elements such as *ribā* (interest) and unjust enrichment. The SAC of BNM has addressed this issue thoroughly, providing detailed resolutions to ensure compliance with *Sharīʿah* principles while allowing flexibility in the use of such financial instruments.

According to the SAC of BNM (2018), mixed financial assets—those comprising both *Sharīʿah*-compliant and *Sharīʿah* non-compliant components—can be used as collateral, provided that the *Sharīʿah*-compliant and non-compliant portions are clearly segregated. Furthermore, the value of the collateral must be limited solely to the portion of the asset that is *Sharīʿah*-compliant. This principle was discussed during the SAC-BNM's 160th meeting on 30th June 2015, where the council ruled on the permissibility of using shares of companies representing mixed financial assets as collateral. The ruling stipulated the following conditions:

1. The core business of the company must be recognized as *Sharīʿah* compliant; and
2. For mixed assets, only the *Sharīʿah*-compliant portion may be used as collateral, with the value of the collateral limited to that portion.

In the same meeting, the SAC of BNM extended this ruling to *Sharīʿah* non-compliant financial assets, such as conventional fixed deposits, bonds, and unit trusts. In these cases:

- The collateral value of conventional fixed deposits and bonds is limited to the principal amount, excluding any interest or returns generated.
- For unit trusts, the collateral value is restricted to the investor's initial and subsequent investments, excluding any gains derived from impermissible activities.

These resolutions were further formalized in the Policy Document on *Rahn* issued in July 2018. The document affirms the permissibility of using financial assets as collateral under the following conditions:

1. For mixed financial assets, the core business of the entity issuing the asset must be *Sharīʿah* -compliant; and
2. For *Sharīʿah* non-compliant financial assets, the recognized collateral value must be limited to the principal amount of the asset.

Based on these rulings, it is evident that the SAC of BNM permits the use of *Sharīʿah* non-compliant deposit and reserve accounts as collateral, provided that only the principal amount is considered for collateral purposes. This ensures that the arrangement avoids any direct or indirect benefit from prohibited earnings, thereby maintaining compliance with *Sharīʿah* principles.

In summary, while both AAOIFI and the Islamic *Fiqh* Academy provide clear guidelines for using *Sharīʿah*-compliant deposit accounts as collateral, the SAC of BNM offers specific resolutions for addressing the challenges posed by conventional deposit accounts. By restricting the use of collateral to the principal amount and excluding interest or returns, the SAC of BNM ensures that the arrangement adheres to the requirements of *Sharīʿah*, safeguarding against potential *Sharīʿah* non-compliance.

6.9.3.3 Book Debts and Accounts Receivables as Collateral

The charge on book debts, also known as a charge on receivables, is a widely accepted form of collateral in Islamic project finance, as highlighted by insights from interviewees. This type of security represents future cash inflows and is used as collateral due to its potential to convert into liquid assets. It is particularly significant in contracts where future revenue streams are critical for the success of the project.

A book debt refers to a debt arising in the ordinary course of a trader's business, typically recorded in the trader's books, and includes any debts owed to the owner of a business (Thai, 2007). While book debts are often considered synonymous with accounts receivables or trade receivables, they are generally narrower in scope. Accounts receivables have been defined as "the right to repayment of a sum of money, whether presently or in the future, for goods supplied, services rendered, or facilities made available" (Gullifer, 2008), essentially representing an entitlement to payment

(Gallop, 1994). Legally, case law such as *Burns v Commissioner of Inland Revenue* (2011) confines book debts to ordinary trading debts, while accounts receivables are broader in scope. Despite these distinctions, both asset classes share a common characteristic: they represent choses in action, meaning the holder has the right to claim payment of the debt owed.

Book debts and accounts receivables are also categorized as circulating assets, as their outstanding balances can fluctuate significantly depending on the time taken to settle debts and the level of trading activity conducted by a company (Kane, 2014). These debts cease to exist as book debts or accounts receivables once the amount owed is paid or discharged.

A charge over book debts and accounts receivables typically relates to debts that are not yet collected. However, it is not uncommon for creditors and debtors to agree that the proceeds from these debts be deposited into a designated account. In such cases, the company may or may not be allowed to use these funds in the ordinary course of its business without the creditor's consent. This arrangement treats uncollected debts as a separate asset class from their associated proceeds, effectively creating two distinct charges over them (Narev & Rubenstein, 1994; Kane, 2013).

Another notable feature of book debts is that the debtor uses debts owed to it—often payable in the future—to secure its own indebtedness. In this context, book debts can include debts that are not yet payable, such as future book debts. This could involve situations where the principal amount is not yet due but interest on the principal is payable (Hudson, 2013).

In some cases, creditors may require that the proceeds of book debts or accounts receivables be paid into a deposit account. However, it is important to note that money deposited by a trader into a bank account is generally not considered a book debt, as this is a normal consequence of trading activity. Section 353(k) of the Companies Act 2016 specifically addresses charges on the credit balance of a company in any deposit account, distinguishing it from charges on book debts. This provision clarifies that a charge over book debts excludes the company's credit balance in a deposit account.

Case law, such as *In Re BCCC (No 8)* [1998] AC 214 and *In Re Spectrum Plus* [2005] 2 AC 680, further supports this distinction by implying that deposits with banks are unlikely to fall under the definition of "all book debts and other debts." Thus, Section 353(k) of the Companies Act 2016 resolves any ambiguity by explicitly excluding cash deposits in a customer's bank account from the scope of book debts. Instead, such deposits are governed separately under the same section.

***Sharīʿah* Ruling:**

From the *Sharīʿah* perspective, the charge over book debts or account receivables is equivalent to *rahn al-duyūn* (pledging of debts). Muslim scholars have extensively debated the permissibility of *rahn al-duyūn,* with differing opinions among the schools of thought. Hammad (2015) classified *rahn al-duyūn* into two categories: the use of third-party debt and a creditor's debt to the creditor himself as collateral.

1) The Use of Third-Party Debt as Collateral

A charge of third-party debt closely resembles a charge over book debts. In this arrangement, a debtor who has rights to debt receivables from a third party uses these receivables as collateral to secure their debt to a creditor.

The permissibility of such an arrangement has been a subject of disagreement among Muslim jurists. The *Ḥanafī*, *Shāfiʿī*, and *Ḥanbalī* schools generally prohibit the charge of third-party debt. Scholars such as *Al-Jaṣṣāṣ* (1992), *Al-Sharbīnī* (2000), and *Al-Buhūtī* (1997) argue that such a charge is invalid because the debtor cannot guarantee the delivery of the subject matter (the third-party debt) to the creditor. *Al-Shirāzī* (1995) further asserts that this prohibition stems from the element of uncertainty (*gharar*) regarding the delivery of the debt, which renders the contract void. This view is also supported by *Al-Qalyūbī* (2003) and *Al-Ṭaḥāwī* (2001).

In contrast, the *Mālikī* school (*Al-Dardīr*, 1989) and a minority opinion within the *Shāfiʿī* school (*Al-Sharbīnī*, 2000; *Al-Ramlī*, 1984) permit the charge of third-party

debt. Their reasoning is based on the permissibility of selling a debt to a third party and the legal maxim:

(كُلُّ ما يُمْكِنْ أَنْ يُسْتَوْفَى مِنْهُ – أَوْ مِنْ ثَمَنِهِ أَوْ مَنافِعِهِ – الدَّيْنُ أَوْ بَعْضُهُ، جازَ رَهْنُهُ بِهِ، وَإِلَّا فَلا)

Whatever can be used to recover the debt (fully or partially)—whether directly or from its price or its usufruct—is permissible to be used as *rahn* (collateral); otherwise, it cannot. (*Al-Muqarri*, 2005).

Hammād (2015) supports the second view, arguing that a confirmed debt of a third party can be used as collateral because it is deliverable, like other *rahn* assets in the event of default. This position aligns with the AAOIFI (2017) in its *Sharīʿah* Standard No. 39 on Mortgage and Its Contemporary Applications which resolved that it is allowable to charge both the debt of a creditor and the debt of a third party:

> 3/2/2 In principle, the mortgaged object should be a tangible asset, yet it can be a debt, a cash amount, a fungible asset or a consumable commodity….
> 3/2/11 With due consideration to item (5), it is permissible to mortgage debt, whether such debt is owed by the mortgagee or anyone else.

Justifications for the Preferred Opinion

Based on the above discussion, *rahn al-duyūn* is highly relevant to the contemporary practice of charging book debts or account receivables, where a debtor pledges their book debts (third-party debts) to a creditor (e.g., a bank) as collateral. Some opponents argue that this form of charge does not fulfil the requirement of possession (*hiyāzah*) of the *rahn* asset by the creditor. However, this argument can be refuted by the practice of properly documenting and registering the charge with the relevant authority once the book debt is charged to a specific creditor.

In such cases, the creditor gains the right to claim any receivable or payable amount under the book debt if the debtor defaults or fails to meet their obligations. This may be regarded as the creditor taking constructive possession (*qabḍ taʿwīlī*) of the charged asset, rather than actual physical possession (*qabḍ ḥaqīqī*). This concept is further supported by AAOIFI (2017) in *Sharīʿah* Standard No. 39 :

> 3/1/2 Possession of 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.
> 3/2/12 Possession of mortgaged debt takes place by possession of the debt's document or by attestation of the debt at the time of its mortgaging. When a debt is mortgaged, the mortgagee becomes more entitled to it than anyone else.

In conclusion, the permissibility of use of book debts or account receivable as collateral depends on the interpretation of *rahn al-duyūn* and the concept of possession. While some schools of thought prohibit the charge of third-party debts due to uncertainty (*gharar)*, others, including the *Mālikī* school and AAOIFI, permit it under specific conditions. Contemporary practices, supported by proper documentation and registration, align with the permissive view, allowing creditors to take constructive possession of the charged asset. This ensures compliance with *Sharīʿah* principles while addressing the practical needs of modern financial transactions.

(2) The Use of Creditor's Debt to Himself as Collateral

The use of a creditor's debt to himself as collateral may arise in situations where two parties have reciprocal debt obligations. This arrangement has been the subject of extensive debate among Muslim jurists, resulting in differing opinions across the schools of thought.

According to the majority of Muslim jurists, including the *Ḥanafī*s (*Al-Kāsānī*, 2003), *Shāfiʿī*s (*Al-Nawawī*, 1996), and *Ḥanbalī*s (*Al-Buhūtī*, 1997), it is not permissible to use a creditor's debt to himself as collateral. *Al-Damīrī* (2004) and *Al-Ramlī* (1984) explain that this impermissibility stems from the absence of possession (*hiyāzah)* of the charged asset (debt). If the debt is settled by its debtor (who is also the creditor and chargee in this case), the debt obligation ceases to exist, rendering the charge ineffective. *Al-Juwaynī* (2002) further asserts that the requirement of *marhūn* (charged asset) is that it must be a tangible or identifiable asset, as the purpose of *rahn* is to secure

the debt obligation. Therefore, it is not permissible to secure a debt by netting it with another debt owed by the creditor.

In contrast, *Mālikī* jurists (*Al-Gharnāṭī*, 1998), some *Shāfiʿī* jurists, and some *Ḥanbalī* jurists adopt a more permissive stance, allowing the use of the creditor's debt as collateral for the same creditor. They argue that the requirement of possession (*qabḍ)* of the *marhūn* (charged asset) is satisfied through constructive possession (*qabḍ ḥukmī*), which does not necessitate physical or direct control over the asset. In this context, constructive possession refers to the legal recognition and enforceability of the right to receive payment, which suffices as a form of possession under Islamic law.

This view is grounded in the understanding that a debt obligation represents a valid and enforceable claim, akin to a tangible asset in its ability to secure the creditor's interest. *Al-Qurṭubī* (2001) and *Ibn Shās* (2005) support this perspective, emphasizing that the *marhūn* need not always be a corporeal or physical asset. Instead, it can include intangible rights, such as receivables, provided they meet the essential conditions of being identifiable, quantifiable, and legally enforceable. This broader interpretation aligns with the principle that the purpose of *rahn* is to secure the creditor's claim, and this objective can be achieved even through non-physical assets that hold intrinsic value.

Furthermore, proponents of this view highlight that the prohibition of using a creditor's debt as collateral, as argued by the majority, may stem from concerns about the potential for ambiguity (*gharar)* or the absence of tangible possession. However, these concerns are mitigated in cases where the debt is well-defined, documented, and legally enforceable. By recognizing constructive possession, this approach provides greater flexibility in modern financial transactions, where intangible assets such as debts, receivables, and other contractual rights often play a critical role in securing obligations.

Justifications for the Preferred Opinion

The researcher's tends to the second group's opinion which also the view of Hammad (2015), which permits the charge of a creditor's debt to himself, based on the following justifications:

a) Scholars who allow *rahn al-dayn* (charge of debt) argue that it fulfils the essential requirement of *rahn*, specifically the possession of the *marhūn* (*farihān maqbūḍah)*, in the form of constructive possession (*qabḍ ḥukmī*). According to *Al-Qurṭubī* (2001), since the debt receivable represents a valid and enforceable right to receive payment, it is permissible to use it as a charged asset by analogy with tangible assets. This reasoning is supported by Ibn *Mufliḥ* (1995), who emphasizes that the essence of *rahn* lies in securing the creditor's claim, which can be achieved through intangible rights such as debts. The concept of constructive possession ensures that the legal recognition of the debt suffices as possession, thereby addressing concerns about the absence of physical control over the asset.

b) The main legal maxim in *rahn* contract stipulates the following:

كل ما جاز بيعه جاز رهنه

"Any item which is permissible as the subject matter of sale is also permissible as collateral" (*Ibn ʿAbd al-Barr*, 1988).

This maxim provides a strong basis for permitting the charge of a creditor's debt to the creditor himself. If the sale of a debt to the debtor (e.g., through redemption or repayment) is permissible, then the same ruling should apply to its use as collateral in a *rahn* contract. This analogy underscores the consistency between the principles of sale and *rahn*, ensuring that debts, which are legally recognized as valuable rights, can serve as valid security instruments.

The contemporary examples of *rahn al-dayn* under this category will be as follows:

(i) Islamic Fixed Deposit

A contemporary example of pledging a creditor's debt to the creditor himself can be observed in Islamic financial institutions (IFIs) through structured products such as Islamic fixed deposits (FD) under commodity *murābaḥah* or *tawarruq* arrangements. In this scenario, a customer opens an Islamic FD account with an IFI, where the IFI sells a commodity to the customer at a deferred price (*murābaḥah* price). The customer subsequently sells the commodity in the open market for cash, leaving the IFI as the

debtor owing the *murābaḥah* price to the customer upon maturity. Later, when the same customer seeks a financing facility from the IFI, they are required to provide collateral. To meet this requirement, the customer pledges their right to receive the *murābaḥah* price (debt receivables) from the IFI under the Islamic FD as security for the financing facility. In this unique arrangement, the IFI acts as both the creditor (for the financing facility) and the debtor (for the fixed deposit), effectively receiving its own debt as collateral.

(ii) *Sukūk* or other Islamic instruments

Other financial products that fall under this category include Islamic debt certificates, *sukūk,* or any other instruments based on sale contracts that represent indebtedness by the Islamic Financial Institutions (IFIs) to the customers. For instance, *sukūk* holders may charge their ownership rights in the underlying assets or their entitlement to periodic distributions as collateral for financing facilities extended by the Bank itself. Similarly, Islamic savings or current accounts, which are often structured on sale-based contracts such as *murābaḥah* or *wakālah*, can also serve as collateral assets. These accounts represent a debt owed by the IFI to the customer, akin to the fixed deposit arrangement, and can be utilized as security while adhering to *Sharīʿah* principles.

Conclusion

The permissibility of using a creditor's debt to the creditor himself as collateral remains a contested issue among Muslim jurists. While the majority view prohibits it due to the absence of tangible possession and the nature of the *marhūn,* the minority view—supported by *Mālikī*, some *Shāfiʿī* , and some *Ḥanbalī* scholars—allows it based on the concept of constructive possession (*qabḍ ḥukmī)* and the broader application of legal maxims. *Hammād* (2015) favors the minority view, emphasizing its alignment with contemporary financial practices and the principles of fairness and flexibility in Islamic jurisprudence. This perspective acknowledges the evolving nature of financial transactions, where intangible assets such as debts and receivables play a critical role in securing obligations. By recognizing constructive possession and the legal

enforceability of debts, the minority view offers a pragmatic solution that addresses the complexities of modern finance while remaining rooted in *Sharīʿah* principles.

The researcher aligns with *Hammād*'s perspective, as the minority view is more practical and better suited to address the intricacies of modern financial systems. It strikes a balance between maintaining the integrity of Islamic law and accommodating the needs of contemporary economic practices. For instance, in contemporary Islamic finance, instruments based on sale contracts that represent indebtedness by Islamic Financial Institutions to customers—such as Islamic fixed deposits or *sukūk* —are increasingly used as collateral for financing facilities extended by the same institution. These examples demonstrate how the minority view can be applied effectively in practice, ensuring compliance with *Sharīʿah* while addressing the demands of modern financial systems. By adopting this perspective, Islamic finance can continue to innovate and respond to the challenges of a dynamic global economy without compromising its *Sharīʿah* requirements.

It worth mentioning that the above discussion applicable for Islamic receivables and book debts. The treatment of conventional receivables and book debts shall be guided by the SAC of BNM (2018) which allow only up to principal amount and to exclude *ribā* element which is similar to the practice of the conventional fixed deposit and bond as collateral assets.

6.9.3.4 Financial Instruments/ Assets

In project finance, the use of financial assets as collateral plays a critical role in enhancing creditworthiness and securing financing arrangements. These assets provide creditors with an additional layer of protection, mitigating risks associated with large-scale, long-term projects that often involve significant uncertainties. Financial assets commonly utilized as collateral include fixed deposits, bonds (including *sukūk*), unit trusts, shares, deposit/current accounts, and other asset classes, as highlighted by insights from industry experts. Each of these assets contributes to strengthening the credit profile of the debtor/borrower and ensuring the security of the creditor/lender's indebtedness in different ways.

The discussion on the permissibility of the use of financial assets as collateral will be divided into two parts:

i. The permissibility of using *Sharīʿah*-compliant financial instruments as collateral and their *fiqh* characterization.
ii. The permissibility of using *Sharīʿah* non-compliant financial instruments as collateral.

(i) The permissibility of using *Sharīʿah*-compliant financial instruments as collateral and their *fiqh* characterization.

Sharīʿah-compliant financial instruments are generally permissible for use as collateral in Islamic finance, provided they meet specific conditions under Islamic jurisprudence. These instruments include fixed deposits, *sukūk*, shares, investment accounts, and others that align with *Sharīʿah* principles. Below is an analysis of their permissibility and *fiqh* characterization:

a) Islamic Fixed Deposits

Islamic fixed deposits (FDs) are commonly structured under commodity *murābaḥah* or *tawarruq* arrangements. In this arrangement, a customer opens an Islamic FD account with an Islamic Financial Institution (IFI), and the IFI sells a commodity to the customer at a deferred price (the *murābaḥah* price). The customer then sells the commodity in the open market for cash, leaving the IFI as the debtor owing the *murābaḥah* price to the customer upon maturity.

Later, when the same customer seeks a financing facility from the IFI, they are required to provide collateral to secure the facility. To meet this requirement, the customer pledges their right to receive the *murābaḥah* price (debt receivables) from the IFI under the Islamic FD as security for the financing facility. This creates a unique scenario where the IFI acts as both the creditor (for the financing facility) and the debtor (for the fixed deposit). Effectively, the IFI receives its own debt as collateral. This arrangement is referred to as *rahn* al-duyūn, or the use of the creditor's (IFI) debt to himself as collateral.

b) Sukūk

The use of *sukūk* as collateral is permissible under *Sharīʿah* principles due to its inherent compliance with Islamic finance principles. However, the *fiqh* characterization of *sukūk* as collateral depends on the structure of the *sukūk* and the nature of the financing arrangement. Below, the study analyzes two distinct scenarios that affect the *fiqh* characterization of *sukūk* when used as collateral:

1. Sukūk Used as Collateral for the Creditor (IFI) in which the Indebtedness by IFIs to Sukūk holders.

In this scenario, *sukūk* are structured under sale-based contracts such as *murābaḥah*, *ijārah*, or *salam*, where the *sukūk* represent indebtedness by the Islamic Financial Institution (IFI) to the *sukūk* holders. Specifically, *sukūk* holders have ownership rights in the underlying assets or entitlements to periodic distributions (e.g., rental income or sale payments). The IFI issues *sukūk* to *sukūk* holders, creating a contractual obligation to pay periodic returns based on the selling price of the *sukūk*. Later, the *sukūk* holders seek financing facilities from the same IFI and charge/pledge their *sukūk* holdings (entitlements to periodic distributions) as collateral. This arrangement falls under the concept of *rahn* al-duyūn, or the use of the creditor's debt to himself as collateral. This is because:

- The IFI acts as both the creditor (for the financing facility) and the debtor (owing periodic distributions or repayment to the *sukūk* holders).
- The *sukūk* holders are effectively charging/pledging the IFI's own debt obligations as security for the financing facility.

This scenario is akin to the use of Islamic FDs as collateral, where the customer charges/pledges their right to receive *murābaḥah* price (debt receivables) from the IFI. Both arrangements involve the concept of *rahn* al-duyūn.

2. Sukūk Used as Collateral for Third-Party Financing

In this scenario, *sukūk*. are issued by a *sukūk* issuer to *sukūk* holders, who later pledge their *sukūk*. certificates as collateral to secure financing from a third-party financier (not the original *sukūk* issuer). The *sukūk* issuer creates *sukūk* certificates that represent either entitlements to periodic distributions

or ownership rights in underlying assets, depending on the structure of the *sukūk*. For instance:

- In debt-based *sukūk* (e.g., *murābaḥah*, *ijārah*, *salam*), the *sukūk* certificates represent contractual entitlements to fixed periodic payments. This arrangement falls under the concept of charging/pledging a third-party debt (*rahn al-dayn al-ghayrī*), where the collateral involves a debt owed by a party other than the creditor (i.e., the *sukūk* issuer owes periodic distributions to the *sukūk* holders).
- In equity-based *sukūk* (e.g., *mushārakah*, *muḍārabah*), the *sukūk* certificates represent ownership stakes in the underlying assets or business ventures. The collateral is not deemed as receivables per se but rather as ownership rights in the underlying *sukūk* assets or business. This shifts the focus from charging/pledging a debt to pledging ownership rights.

  The *sukūk* holders then charge/pledge these certificates to a third-party financier as security for a financing facility. The third-party financier relies on the enforceability of the *sukūk* holder's rights against the *sukūk* issuer to recover the pledged value in case of default. This arrangement allows *sukūk* holders to monetize their *sukūk* holdings without liquidating them, while providing the financier with a secure form of collateral.

c) Islamic Unit Trusts

In Islamic unit trusts which are structured on equity-based models, such as *mushārakah*, *wakālah* or *muḍārabah*, the unit trust holders represent ownership stakes in the underlying assets or business ventures. These assets typically include a diversified portfolio of *Sharīʿah*-compliant investments, such as equities, real estate, commodities, or other permissible asset classes. Unlike debt-based instruments, which involve entitlements to periodic distributions (receivables), Islamic unit trusts focus on ownership rights. Consequently, when these unit trusts are used as collateral, the charge/pledge is not deemed as receivables per se but rather as ownership rights in the underlying assets or business ventures. This shifts the focus from charging/pledging a debt to pledging tangible ownership rights, ensuring compliance with *Sharīʿah* principles. The use of Islamic unit trusts as collateral aligns with the concept of charging/pledging ownership rights

(*rahn al-milk)*, where the charge is placed on the right over the assets rather than the right to receive debt. This principle ensures that the collateral is tied to identifiable and enforceable ownership stakes, avoiding the ambiguities associated with intangible receivables. The same principle applies to other Islamic financial instruments structured on similar ownership models, such as equity-based *sukūk*, where the focus is on tangible ownership rather than debt obligations.

ii) The Permissibility of Using *Sharīʿah* Non-Compliant Financial Instruments as Collateral and Its *Fiqh* Characterization

The permissibility of using *Sharīʿah* non-compliant financial instruments as collateral has been a subject of significant discussion among contemporary jurists. While classical jurists unanimously agree that the asset of *rahn* must be *Sharīʿah*-compliant, modern scholars have introduced nuanced distinctions to address the complexities of contemporary financial systems. These distinctions are particularly relevant to financial instruments that become non-compliant due to external factors, such as the inclusion of prohibited elements like *ribā* (interest) or capital guarantees, rather than being inherently non-compliant.

Classical jurists (*Al-Sarakhsī*, 2001, *Ibn Rushd*, 2006, *Al-Ḥaṭṭāb*, 1992, *Ibn Qudāmah,* 1997) unanimously agree that assets inherently non-compliant with *Sharīʿah* principles—such as swine, liquor, or carcasses—cannot be recognized as collateral. These assets do not qualify for sale under Islamic law because they lack intrinsic value and are not recognized as legitimate property in *Sharīʿah*. Consequently, they are also ineligible for use as collateral in a *rahn* contract. A more detailed discussion of the juristic views and supporting evidence is provided in Chapter 2, Section 2.3.5.22, under the criteria for eligible *rahn* assets.

Contemporary Jurists' Differentiation of *Sharīʿah* Non-Compliant Assets

Contemporary jurists (Ali. M, 2018) have expanded the discussion by differentiating between two categories of *Sharīʿah* non-compliant assets:

a) Assets Inherently *Sharīʿah* Non-Compliant

This category includes items that are inherently prohibited by *Sharīʿah*, such as swine, liquor, or other unlawful goods. Classical and contemporary jurists unanimously agree that these assets cannot be used as collateral because:

- They do not qualify for sale under *Sharīʿah*.
- They lack recognized value in Islamic jurisprudence.

There is no difference of opinion regarding this category, and such assets remain impermissible for use as collateral.

b) Assets that Become *Sharīʿah* Non-Compliant Due to External Factors

This category refers to assets that are naturally permissible but become non-compliant due to external factors, such as the inclusion of prohibited elements like *ribā*, *gharar* (uncertainty), or *maysir* (gambling). Examples include conventional fixed deposits, interest-bearing bonds, and non-compliant unit trust funds. Contemporary jurists have extensively discussed this category, particularly in the context of modern financial instruments used in Islamic banking.

For the purpose of this study, it is important to note that contemporary scholars focus exclusively on this second category. They do not dispute the impermissibility of inherently non-compliant assets as collateral but instead explore whether certain financial instruments can be adapted for use in a *Sharīʿah*-compliant manner.

Fiqh Characterization of *Sharīʿah* Non-Compliant Financial Instruments

(1) Conventional Fixed Deposits

Conventional fixed deposits are structured on interest-based contracts, making them non-compliant with *Sharīʿah* principles. However, contemporary jurists, including the *Sharīʿah* Advisory Council of the Securities Commission (SAC of SC), have ruled that the principal amount of such instruments may be used as collateral, provided the following conditions are met:

- The collateral value is limited to the principal amount of the fixed deposit.

- Any interest or returns generated by the fixed deposit are excluded from the collateral value, as they are considered impermissible under *Sharīʿah*.

This approach ensures that the financing arrangement avoids direct involvement in prohibited elements while still utilizing the underlying asset's intrinsic value.

(2) Conventional Bonds

Bonds are debt instruments that typically involve the payment of interest, making them non-compliant with *Sharīʿah* principles. In the context of collateral, contemporary jurists i.e SAC of BNM (2018) have adopted a similar approach to fixed deposits:

- The collateral value is limited to the principal amount of the bond.
- Any interest or coupon payments associated with the bond are excluded from the collateral value.

This ruling reflects the principle that while the bond itself is *Sharīʿah* non-compliant due to its interest-bearing nature, the principal amount represents a legitimate claim that can be recognized under *Sharīʿah*.

(3) Conventional Unit Trusts

Unit trusts are investment vehicles that pool funds from investors to invest in a diversified portfolio of assets. If the unit trust fund is *Sharīʿah* non-compliant due to investments in prohibited activities (e.g., interest-bearing securities, unethical industries), contemporary jurists (SAC of BNM (2018) and SAC of SC (2015) have ruled as follows:

- The collateral value is limited to the initial investment and any additional investments made by the investor.
- Any returns or interests generated by the non-compliant unit trust fund are excluded from the collateral value, as they are derived from impermissible sources.

This ruling ensures that the *rahn* is based solely on the investor's legitimate contributions, avoiding any indirect benefit from prohibited activities.

In summary, the contemporary jurists have addressed the permissibility of using modern financial assets as collateral in two categories:

1. *Sharīʿah* -Compliant financial assets: Islamic fixed deposits, *sukūk*, and Islamic unit trusts are unanimously permissible as collateral. Differences among jurists focus on their *fiqh* characterization, depending on the nature of the underlying contracts.
2. *Sharīʿah* Non-Compliant Assets: Jurists agree that inherently non-compliant assets (e.g., swine, carcasses) cannot be used as collateral. However, for financial assets that become non-compliant due to external factors (e.g., conventional fixed deposits, bonds, *Sharīʿah* non-compliant unit trusts), contemporary jurists, such as the SAC of BNM, permit their use provided that the non-compliant elements are excluded. For example:
   - Collateral value is limited to the principal amount for fixed deposits and bonds.
   - For unit trusts, it is restricted to the initial and additional investments, excluding impermissible interests.

This approach ensures *Sharīʿah* compliance while addressing modern financial needs, reflecting the adaptability of Islamic finance to contemporary practices.

6.9.3.5 Company Shares/Stock

Shares is also one of the key asset classes frequently used in Islamic project finance. According to insights from interviewees, *Sharīʿah*-compliant shares are commonly accepted as collateral by financial institutions due to their liquidity and inherent value. Ahmad and Rahman (2018) further elaborate that Islamic financial institutions often recognize company shares as viable security assets because they can be liquidated easily while adhering to *Sharīʿah* principles. A share generally represents a shareholder's interest in a corporation, as established in the landmark case of *Borland's Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279. Additionally, under Section 2 of the Malaysian Sale of Goods Act 1957, shares are legally classified as "goods," thereby constituting movable property belonging to the shareholder (Malaysian Government, 1957). This

classification enables shareholders to use their shares as collateral when securing financing facilities from financial institutions.

Shares are intangible property, and ownership is typically evidenced by registration in the shareholder's name. For unlisted companies, ownership is recorded in the register of members, as noted by Chin and Lee (2020). Conversely, for listed companies, ownership is maintained in the register of depositors held by the stock exchange. Omar (2019) highlights that shares used as collateral may include those owned by the borrowing company itself or shares of related entities, such as subsidiaries or other affiliated companies.

In some jurisdictions, particularly for private companies, share certificates still serve as evidence of ownership. Customers may pledge their shares by placing the share certificates with the financial institution, which creates a practical restriction on any dealings involving the shares since the financier holds the certificate. However, Hassan (2021) points out that this method of pledging shares is not feasible for companies listed on a stock exchange or for private companies that do not issue physical share certificates.

Alternatively, customers may create a charge over their shares. The formalities for creating a charge depend on whether the customer is an individual or a corporate entity. Under Malaysia's Companies Act (2016), corporate clients are legally required to register the charge with the Registrar of Companies to ensure its validity. Ali and Wong (2022) emphasize that failure to register the charge may render it ineffective against third parties, particularly in cases of insolvency.

Shares are rarely used as collateral through mortgages because mortgages involve transferring ownership to the financier, with an obligation to re-transfer the asset once the secured obligations are fulfilled. If a legal mortgage is created over shares, the shares must be registered in the financier's name. As Smith (2017) explains, this process can have significant accounting, regulatory, tax, and legal implications for the financier. Despite these challenges, common law generally accepts the use of shares as collateral assets, provided the necessary formalities are observed.

Sharīʿah Ruling

The permissibility of using shares as collateral in Islamic finance is contingent upon their classification and treatment under *Sharīʿah* principles. Since a share represents a proportional stake in a company's capital and assets, its use as a *rahn* asset depends on differing scholarly opinions regarding the use of shared or undivided property (*al-mushā'*) as collateral. This section explores the concept of *al-mushā'* and presents the views of jurists on the permissibility of use such property as collateral.

Jurists' Opinions on the Permissibility of Rahn Mushā'

Scholars have differed on the permissibility of *rahn* of undivided shares (*rahn mushā')*. Their opinions can be categorized into two main schools of thought:

(1) The First Opinion:

This group prohibits the *rahn* of undivided shares (*mushā'*). This view is held by the *Ḥanafī* school, as explained by *Al-Sarakhsī* (1993) and *Al-Kasāni* (2001), and is also the preferred opinion among the *Ḥanbalī* school, as noted by *Ibn Qudāmah* (1997) and *Ibn Mufliḥ* (2004). According to this perspective, it is not permissible to use shares as collateral if they represent undivided portions in a company's capital or assets. The rationale behind this prohibition lies in the ambiguity and potential disputes that may arise from pledging an asset that lacks clear boundaries or separable ownership (*Al-Sarakhsī*, 1993).

Reasoning of the Prohibition

Possession (*hiyāzah*) is a necessary condition for a valid *rahn* contract. Since *mushā'* is jointly owned and not clearly divided, it is challenging to establish exclusive possession over the *rahn* asset. The nature of *mushā'* makes it difficult to determine the exact portion being *rahn*. This ambiguity can lead to disputes and conflicts, which are contrary to the principles of clarity and certainty emphasized in Islamic contracts (*Al-Sarakhsī*, 1993; *Al-Kāsānī*, 2001).

Islamic law requires contracts to be free from ambiguity (*gharar)*. Pledging something that is not clearly defined or divided violates this principle,

rendering the transaction impermissible. Without clear possession, the purpose of the *rahn*—securing the creditor's rights—cannot be effectively fulfilled (*Al-Kāsānī*, 2001). For instance, if a shareholder *rahn* their undivided share in a company, it may be unclear which specific assets or liabilities correspond to that share. This lack of clarity undermines the integrity of the *rahn* and increases the risk of disputes between parties.

(2) The Second Opinion

This group permits the *rahn* of undivided shares (*mushā'*). This is the view of the majority (*jumhūr)* of scholars, including the *Mālikī*, *Shāfiʿī*i, *Ḥanbalī*, and *Ẓāhirī* schools (*Mālik*, 1998; Al-Sharbini, 2003; *Ibn Qudāmah*, 1997; Ibn Hazm, 2005).

According to the *Mālikī* school, Imam *Mālik* (1998) permits the pledging of shared property (*musha')* even if it is not physically divided. It is permissible provided the owner maintains possession and manages the property jointly with other co-owners. The owner may lease or manage the property collectively with partners, even while it remains undivided. Al-Sharbini (2003) stated that it is valid to pledge shared property (*musha')* by a partner or anyone else. Possession of the shared property is established through the collective possession of all parties, similar to the manner of taking possession of a sold item. Permission from the other partners is not required except in the case of movable property.

Ibn Qudāmah (1997) explained that if someone pledges their share of a portion of shared property, and it is something that cannot be divided, then it is permissible if division is possible. There are two possibilities:

- It is valid to pledge it because selling it is permissible.
- It may also be argued that it is not valid because the pledged item might end up in the share of one of the partners after division.

Al-Mardawi (2001) further clarified that it is permissible to pledge shared property (*musha'*). This is the established position of the *Ḥanbalī* school, explicitly stated, and supported by the majority of the companions of the school. Ibn Hazm (2005) stated it is permissible for a person to pledge their share of shared property (*musha')*, whether it is divisible or indivisible, whether the pledge is made with a partner or a third party. Allah did not differentiate between shared (*musha')* and divided property in the verse

(*Sūrah Al-Baqarah*: 283). The verse applies generally to all forms of *rahn* assets.

Contemporary *Sharīʿah* authorities like AAOIFI (2017) and SAC of BNM (2018) also support *rahn* for undivided or shared property. AAOIFI states in their *Sharīʿah* Standard as follows:

> 4/2 It is permissible to mortgage usufruct-based *Sukūk* which represent 4/2 It is permissible to mortgage usufruct-based *Sukūk* which represent common shares in the usufructs of specific assets, or assets in the common shares in the usufructs of specific assets, or assets in the form of a specific indebtedness.

SAC of BNM also states in their Policy Document on *Rahn* (2018) as follows:

> 14.6 An undivided asset that is jointly owned by the pledgor with another third party may be pledged– (a) in proportion to the value of the pledgor's ownership; or (b) as a whole in the event the undivided asset cannot be pledged in proportion to the value of the pledgor's ownership, provided that the consent of the third party is obtained.

Reasoning of the Permissibility

The permissibility of *rahn* shared property (*musha'*) is supported by several key principles derived from Islamic jurisprudence, Quranic texts, and practical considerations. These principles provide a strong foundation for the majority view that permits such pledges.

1. *Collective Possession (Qabḍ al-Jami')*

   Possession of shared property (*musha*ʿ) can be established collectively, even if the property is not physically divided. This satisfies the condition of possession (*ḥiyāzah*), which is a fundamental requirement for a valid pledge (*rahn*). In cases of shared ownership, collective possession ensures that the pledgor retains control over their proportional stake, thereby fulfilling both the legal and practical requirements of a pledge (*Al-Sharbīnī*, 2003; *Ibn Qudāmah*, 1997). The concept of collective possession aligns with the realities of shared ownership, where individual shares are often intertwined but remain identifiable and manageable. As *al-Mardāwī* (2001) explains, collective possession is sufficient to establish the necessary control over the pledged asset.

2. *Generality of Quranic Verses*

The Quranic verse in *Sūrah Al-Baqarah* (2:283), which supports *rahn,* does not impose restrictions on the type of property that can be pledged. This verse applies generally to all forms of pledges, including shared property (*musha')*. The absence of specific exclusions in the text indicates that the principle of *rahn* encompasses both divided and undivided property (Ibn Hazm, 2005). According to Ibn Hazm, the generality of the Quranic text implies that no distinction is made between shared and divided property, reinforcing the permissibility of pledging *musha'.*

3. *Practical Realities of Shared Ownership*

Shared property (*musha'*) is a tangible asset that can be sold, leased, or managed jointly, either through percentage-based ownership or unitized shares. Given its economic value and utility, it can also be pledged without violating Islamic principles (AAOIFI, 2017). Allowing pledges of shared property aligns with the practical realities of modern financial transactions, where undivided shares often represent significant assets. Contemporary *Sharīʿah* authorities, such as AAOIFI (2017) and SAC of BNM (2018), recognize the economic importance of shared property and permit its use as collateral under specific conditions.

4. Consistency with Islamic Legal Principles

Since shared property (*musha'*) represents a proportional stake in an asset, it is considered a tangible and identifiable portion of the whole. Even if the exact boundaries of the share are not physically demarcated, the pledgor's proportional interest is sufficient to validate the pledge. This approach is consistent with broader Islamic legal principles, which emphasize fairness, clarity, and the facilitation of beneficial transactions (*Al-Kāsānī*, 2001). *Al-Kāsānī* highlights that Islamic law prioritizes the facilitation of lawful and equitable transactions, provided they do not lead to harm or ambiguity.

Discussion and Analysis of the Scholars' Opinions

The crux of the disagreement among jurists regarding the permissibility of pledging shared property (*musha'*) revolves around whether shared property can be possessed. The majority of scholars (*jumhūr*), including the *Mālikī*, *Shāfiʿī*'i, *Ḥanbalī*, and *Ẓāhirī* schools, supported by contemporary *Sharīʿah* authorities such as AAOIFI (2017) and SAC of BNM (2018), permit pledging shared property (*musha'*). Their reasoning is based on the generality of Quranic verses such as *Sūrah Al-Baqarah* (2:283) and *Sūrah Al-Mā'idah* (5:1), which support the permissibility of pledging shared property without restriction. They also rely on the principle that shared property (*musha'*) is a tangible asset that can be sold and, therefore, can also be pledged (Ibn Hazm, 2005; Al-Sharbini, 2003). On the other hand, some *Ḥanafī* and *Ḥanbalī* scholars prohibit pledging shared property due to concerns about the inability to establish clear possession (*hiyazah)* and potential complications arising from division after the *rahn* (*Al-Sarakhsī*, 1993; *Ibn Qudāmah*, 1997). In light of the evidence, the view permitting *rahn* of shared property (*musha')* appears stronger (*rajih)*, as it aligns with the generality of the Quranic texts and the practical realities of shared ownership.

The Researcher's Opinion

The researcher finds the second opinion—the one that permits pledging shared property (*musha'*) absolutely—more compelling (*rajih*). The reasons for preferring this opinion are as follows:

1. The generality ('*umum* ') of Quranic verses such as *Sūrah Al-Baqarah* (2:283) and *Sūrah Al-Mā'idah* (5:1) supports the permissibility of pledging shared property without restriction.
2. The principle that shared property (*musha')* is a tangible asset that can be sold also supports its permissibility for pledging.
3. The *Ḥanafī* argument against pledging shared property is based on the difficulty of establishing exclusive possession (*hiyazah)*, but this concern is mitigated by the concept of collective possession (*Qabḍ al-jami'*) in shared property. Additionally, the *Ḥanafī* position does not align with the practical realities of shared ownership or the broader interpretation of Islamic legal principles.

Permissibility of the Use of Share as Collateral

Generally, the study concludes that shares can be used as collateral even if they fall under the category of *mal musha'* (shared property). However, the permissibility of charging such shares as collateral depends on the *Sharīʿah* compliance of the underlying assets represented by the shares. This section explores the permissibility of using both *Sharīʿah*-compliant and *Sharīʿah* non-compliant shares as collateral.

1. Sharīʿah-Compliant Shares

Shares that are *Sharīʿah*-compliant can be further categorized into two distinct types based on the nature of the underlying business activities:

(i) Shares of Companies with Entirely *Sharīʿah*-Compliant Business Activities
These shares represent ownership in companies whose underlying assets and business activities are fully *Sharīʿah*-compliant and do not involve any non-compliant activities, such as *Sharīʿah* compliant businesses engaged in real estate, construction, or manufacturing of halal goods. The use of such shares as collateral is permissible because the underlying assets align with the requirement that *rahn* (pledged assets) must be *Sharīʿah*-compliant (SAC of BNM, 2018). Since the company's operations are entirely halal, there is no risk of violating *Sharīʿah* principles when these shares are pledged as collateral.

(ii) Shares of Companies with Mixed Business Activities
These shares represent ownership in companies engaged in a mix of *Sharīʿah*-compliant and *Sharīʿah* non-compliant activities. The permissibility of using such shares as collateral depends on the proportion of *Sharīʿah*-compliant versus non-compliant activities, as well as adherence to financial benchmarks established by *Sharīʿah* authorities. Various methodologies have been developed by *Sharīʿah* authority bodies to assess the compliance level of shares, among which is the approach developed by the SAC of SC (2015).

The SAC of SC (2015) adopts a two-tier quantitative approach, which applies business activity benchmarks and financial ratio benchmarks to determine the *Sharīʿah* status of listed securities. Hence, the securities will

be classified as *Sharīʿah*-compliant if their business activities and financial ratios meet the prescribed thresholds. In addition to the above two-tier quantitative criteria, the SAC also takes into account the qualitative aspect which involves public perception or image of the company's activities from the perspective of Islamic teaching.

In conclusion, the SAC of SC (2015) has developed a comprehensive *Sharīʿah* screening methodology to assess shares for investment purposes. This assessment is based on the nature of the business, followed by an evaluation of the financial ratios related to *Sharīʿah* non-compliant business activities, conventional cash, and debt. A company must meet all stipulated requirements for its shares to be eligible for *Sharīʿah*-compliant status. Failure to comply with any of these requirements may render the company's shares *Sharīʿah* non-compliant.

If the collateral involves listed shares that have been evaluated by the SAC of SC, Islamic Financial Institutions (IFIs) can refer to the list issued by the SC to determine their *Sharīʿah*-compliant status (SAC of SC, 2015). It is worth noting that this assessment is applicable only to listed companies, as the index provides access to their data and information. However, it may not apply to non-listed companies due to limited transparency regarding their financials and business activities.

If the collateral involves non-listed shares, prior to accepting as collateral the IFIs must conduct their own evaluation of the *Sharīʿah*-compliant status of such shares. It is important to note that the purpose of evaluating shares for collateral differs from that of investment. The nature of investment is to participate in the company's business to generate profit, requiring the shares to be *Sharīʿah*-compliant. In contrast, in the case of collateral, the shares remain the property of the owner, and the chargee's right is limited to recovering the outstanding debt from the sale proceeds of the shares when necessary.

2. Sharīʿah Non-Compliant Shares

The treatment of *Sharīʿah* non-compliant shares as collateral is a nuanced issue, with scholars offering distinct rulings based on the nature of the non-compliance. Hussain and Ali (2017) classify *Sharīʿah* non-compliant shares into two categories:

(i) Shares with Non-Compliant Core Business Activities

These shares represent ownership in companies whose core business activities are inherently non-*Sharīʿah* compliant, such as casinos, alcohol production, or *ribā*-based banking. Scholars argue that when the core business of a company is *Sharīʿah* non-compliant, the contract of purchasing such shares is void (*bāṭil*) (*Ibn Qudāmah*, 1997; *Al-Kāsānī*, 2001). Since the shares represent the company, they are considered impermissible to own from a *Sharīʿah* perspective. As a result, Muslim shareholders do not truly "own" these shares, and therefore, they cannot be used as collateral. This ruling aligns with the fundamental requirement of *rahn* (pledge): the pledged asset (*marhūn)* must be permissible in *Sharīʿah* (*Al-Sarakhsī*, 1993).

Several *Sharīʿah* resolutions have been issued by contemporary *Sharīʿah* entities on the use of *Sharīʿah* non-compliant financial assets as collateral. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) explicitly prohibits the use of *Sharīʿah* non-compliant shares as collateral in its *Sharīʿah* Standard No. 39 (2017) :

> It is impermissible to mortgage the financial papers and *Sukūk* that should not be issued or transacted according to *Sharīʿah*… Such financial papers include also traditional investment certificates, certificates of traditional investment deposits, and shares of companies that pursue impermissible activities like manufacturing of alcohols, swine trade, and dealing in *Ribā*."

The above ruling which, among others, prohibits *Sharīʿah* non-compliant shares is in line with the main requirement of the *rahn* contract, i.e., that the *marhūn* must be an asset permissible in *Sharīʿah*. Supporters of this ruling argue that the main purpose of a *rahn* contract is to settle the debtor's outstanding debt in the event of default by selling the charged assets. They

further argue that if the status of the charged asset is *Sharīʿah* non-compliant then it cannot be sold. They rely here on the main maxim governing *rahn*:

> Anything that is permissible to sell is also permissible to use as collateral (*Al-Jazīrī* 2003).

However, the researcher argues that this principle should not be interpreted to imply the reverse position—that an item impermissible as the subject of sale must also be impermissible as collateral. Sale, as a primary exchange contract, is subject to more stringent requirements for its subject matter due to its direct impact on ownership and wealth distribution. In contrast, *rahn* is a secondary and supporting contract, designed to secure debts rather than facilitate wealth transfer. As such, it should enjoy greater flexibility in its subject matter.

Additionally, the researcher is of the view that the distinctions should be made between Muslim and non-Muslim debtors and creditors, as the requirements for each may differ based on their respective legal and religious obligations (*Ibn Qudāmah*, 1997). The property (*marhūn*) must be valued to ensure it can be used to repay the pawning party's debt. This valuation is a critical aspect of the *rahn* contract, as it ensures that the pledged asset serves its intended purpose of securing the debtor's obligation. However, not all assets are permissible as *rahn* . For instance, a Muslim is not allowed to pawn forbidden items such as wine or pork, nor is it permissible for a Muslim to accept such items as pawned objects from either a Muslim or a non-Muslim. This ruling is based on the principle that a Muslim may neither repay debts nor collect debt repayments using forbidden products, as these items hold no legitimate value in Islamic law (*Al-Kāsānī*, 2001; *Ibn Qudāmah*, 1997).

If a Muslim debtor were to pawn forbidden items with a non-Muslim creditor, the latter would not be obligated to guarantee the pawned objects. This is analogous to the ruling that a usurper does not guarantee value-less forbidden objects for their owner, as such items are deemed devoid of legitimate worth in Islamic jurisprudence (*Al-Sarakhsī*, 1993). On the other hand, if a non-Muslim debtor were to pawn wine with a Muslim creditor, the Muslim creditor would be obligated to guarantee the wine for the debtor.

This is because, while the wine is considered non-property (*mā lā yaqūmu bihi al-milkiyyah*) for the Muslim, it retains value as a legitimate property for the non-Muslim. Consequently, the two resulting debts may be offset against one another, provided the transaction adheres to the principles of fairness and mutual consent (Wahbah, 2003).

In cases involving non-Muslim debtors and non-Muslim creditors, Islamic law recognizes the pawning of forbidden items such as pork or wine as valid, as both parties recognize these objects as valuable properties. This recognition aligns with the broader principle of respecting the legal frameworks and customs of non-Muslims in matters that do not conflict with Islamic teachings (Wahbah, 2003). Thus, the permissibility of *rahn* is contingent upon the nature of the asset, the identities of the parties involved, and the alignment of the transaction with *Sharīʿah* principles.

(ii) Shares with Peripheral Non-Compliance Exceeding Benchmarks

These represent ownership in companies engaged in both permissible and impermissible activities, where the contribution of non-compliant activities exceeds specified thresholds. Contemporary scholars have addressed this issue in detail, particularly regarding scenarios where initially *Sharīʿah*-compliant shares become non-compliant during the financing tenure due to changes in financial ratios or business activities.

SAC of SC issued a resolution on the acceptance of *Sharīʿah* non-compliant assets as collateral in its 188th meeting, held on 25 August 2016. This resolution was made regarding the holding of shares that are later reclassified as *Sharīʿah* non-compliant during the financing tenure. The SAC of SC resolved that it is permissible to maintain the initially *Sharīʿah*-compliant securities, which are later reclassified as *Sharīʿah* non-compliant, as collateral until the end of the financing tenure. However, at the point of enforcement (crystallization), the impermissible (*ḥarām)* element must be excluded from the collateral value.

According to Hussain and Ali (2017), if the shares are recognised as *Sharīʿah* non-compliant due to the existence of external elements that are prohibited, they can be used as collateral, provided that the prohibited (*ḥarām*) element is excluded. They view that the contract is not void as a whole. It is valid for the *ḥalāl* portion and invalid for the *ḥarām* portion.

Thus, if the underlying transaction involves a mixture of *Sharīʿah* compliant and non-compliant assets, the contract is valid for the *Sharīʿah* compliant assets and invalid for the *Sharīʿah* non-compliant assets.

This is also supported by the SAC of BNM where they accepted the collateral of the mixed asset can be used as collateral provided that the *Sharīʿah* compliant assets and *Sharīʿah* non-compliant can be segregated, and the value of the collateral shall be limited only to the portion of the assets that is *Sharīʿah* compliant. SAC of BNM in its 160th meeting (on 30th June 2015), discussed the issue of *rahn* comprised of both *Sharīʿah* compliant and *Sharīʿah* non-compliant assets. The SAC ruled that shares of companies representing mixed assets (both permissible and impermissible) may be accepted as collateral provided that the following conditions are fulfilled:

(1) the core business of the company is recognized as *Sharīʿah* compliant; and
(2) the mixed asset can be used as collateral provided that the *Sharīʿah* compliant assets and *Sharīʿah* non-compliant can be segregated, and the value of the collateral shall be limited only to the portion of the assets that is *Sharīʿah* compliant.

The SAC of BNM (2015) resolved in the same meeting that a similar ruling also applies to *Sharīʿah* non-compliant financial assets such as conventional fixed deposits, bonds and *Sharīʿah* non-compliant unit trusts. The collateral value shall be limited to the principal amount of the fixed deposits and bonds. As for unit trusts, the collateral value is limited to the value of the investor's initial and subsequent investments.

The above resolutions are reflected in the issuance of BNM Policy Document on *Rahn* (2018). It affirms the permissibility of using a financial asset that is *Sharīʿah* compliant, partially *Sharīʿah* compliant (referred to as a mixed financial asset) or *Sharīʿah* non-compliant, subject to fulfilment of the following conditions:

(1) Where a mixed financial asset is used as collateral, the core business of the entity issuing such asset must be *Sharīʿah* compliant; and
(2) Where a *Sharīʿah* non-compliant financial asset is used as collateral, the recognised collateral value must be limited to the principal amount of the financial asset.

Based on this ruling by the SAC of BNM, there are two conditions for accepting mixed financial assets, as follows:

(1) The *Sharīʿah* compliant asset and *Sharīʿah* non-compliant asset within that instrument can be segregated; and
(2) The collateral is accepted only up to the value of the portion of the assets that is *Sharīʿah* compliant.

In conclusion, the *Sharīʿah* Advisory Council (SAC) of Bank Negara Malaysia (BNM) has adopted a more flexible approach compared to the position of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which generally prohibits the use of non-compliant shares as collateral regardless of the nature of non-compliance. The SAC of BNM distinguishes between non-compliance inherent in the asset itself and that arising from financial assets like shares, which differ in their nature of non-compliance. The SAC has clarified the permissibility of using mixed financial assets as collateral, provided specific conditions are met. Mixed assets may be accepted as collateral if the *Sharīʿah*-compliant and non-compliant portions can be segregated, and the collateral value is limited to the *Sharīʿah*-compliant portion. Additionally, for companies with mixed business activities, the core business must be *Sharīʿah*-compliant for their shares to qualify. Similarly, *Sharīʿah* non-compliant financial assets, such as conventional fixed deposits, bonds, and unit trusts, may be used as collateral, but their recognized value is restricted to the principal amount or the investor's initial and subsequent investments. These rulings demonstrate flexibility in contemporary financial transactions while ensuring the practical utilization of financial assets without compromising *Sharīʿah* compliance.

Based on the above rulings of *Sharīʿah* authorities and scholarly perspectives, the study recommends the following guidelines for the use of *Sharīʿah* non-compliant shares as collateral:

1. Prohibition of Shares with Non-Compliant Core Businesses

It is categorically prohibited to use shares as collateral if the core business of the company is entirely *Sharīʿah* non-compliant. In such cases, the *rahn* contract is void (*bāṭil*), as the shares themselves are impermissible (*Ibn Qudāmah*, 1997; AAOIFI,

2017). This prohibition ensures that IFIs do not inadvertently support businesses engaged in activities that violate *Sharīʿah* principles, such as alcohol production, gambling, or *ribā* -based banking.

However, this position may differ for non-Muslim shareholders, as the prohibition primarily applies to Muslim ownership, given the religious obligation to avoid impermissible assets. For IFIs, distinguishing between Muslim and non-Muslim shareholders poses a practical challenge, highlighting the need for clear policies and documentation to address such distinctions.

2. Treatment of Shares with Changes in Sharīʿah Compliance Status During Financing Tenure

If initially *Sharīʿah*-compliant shares become non-compliant during the financing tenure due to benchmark issues, they may remain as collateral until the end of the tenure. However, upon enforcement of the pledge, the impermissible (*ḥarām*) element must be excluded from the collateral value. This is as per SAC of SC Malaysia (2015) resolution. This approach acknowledges the practical challenges of monitoring changes in *Sharīʿah* compliance status while ensuring that the collateral remains aligned with *Sharīʿah* principles at the time of enforcement. By excluding the impermissible portion, IFIs can uphold the integrity of the *rahn* contract and maintain compliance with *Sharīʿah* requirements.

3. Permissibility of Using Mixed-Compliance Financial Assets as Collateral

Mixed financial assets may be accepted as collateral under the following conditions:

1. The *Sharīʿah*-compliant portion must be identifiable and segregable.
2. The collateral value must be limited to the *Sharīʿah*-compliant portion.

These conditions ensure that only permissible elements are considered in the valuation of the collateral, thereby maintaining compliance with *Sharīʿah* principles (AAOIFI, 2017). For example, this approach can be applied to conventional financial instruments such as bonds, fixed deposits, or unit trusts, where the principal amount

(which is *Sharīʿah*-compliant) can be separated from the *ribā* -based interest component.

These guidelines provide a practical framework for IFIs to evaluate and accept mixed-compliance shares as collateral while ensuring adherence to *Sharīʿah* principles. By adopting these measures, IFIs can mitigate risks associated with *Sharīʿah* non-compliance while facilitating the use of diverse financial assets as security.

6.9.3.6 Floating Charge

The floating charge is among the most popular tools used in Islamic project finance due to its flexibility in securing both current and future assets. Industry experts often use the terms "debenture" and "floating charge" interchangeably, which raises questions about whether a debenture should be considered an instrument or an asset. A debenture is typically understood as evidence of debt or a certificate representing a financial obligation. However, in this context, a debenture refers specifically to an instrument rather than an asset, serving as a mechanism to create a floating charge. This distinction is critical because a floating charge provides financiers with significant flexibility by securing not only existing assets but also those acquired in the future.

The use of future assets in a floating charge introduces a critical issue in Islamic banking. Future assets inherently involve uncertainty (*gharar*), which is prohibited under *Sharīʿah* principles. The concept of a floating charge must therefore be carefully examined to ensure compliance with the principle of certainty in transactions, a fundamental requirement in *rahn* contracts (*Ibn Qudāmah*, 1997; *Al-Sarakhsī*, 1993). For the purposes of this study, the discussion will focus on the concept of floating charges, particularly their application to assets acquired in the future. The topic of debentures as evidence of debt or security instruments will be addressed separately in this thesis.

To better understand the implications of floating charges, it is necessary to first examine the classification of charges, namely fixed charges and floating charges, and their respective characteristics.

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 includes the requirement that the creditor's consent 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 (Goode, 2018). Additionally, the creditor must receive and maintain control of the proceeds. Under a fixed charge, the subject matter of the charge is 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, meaning the chargor cannot dispose of or engage in any dealings involving the asset(s) without the consent of the chargee (Clarke, 2017).

Floating Charge

A floating charge is a security interest applied to constantly changing assets of the debtor. A floating charge attaches to the assets that the chargor currently owns or acquires afterward, provided that the newly acquired assets fall within the same asset class (Hanif & Mahmud, 2015). 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 a similar nature. Floating charges remain over the property they are intended to affect, leaving the debtor free to sell, buy, and vary the assets subject to the charge until the debtor defaults. At that point, the floating charge "fixes" on the existing specific asset or assets, a process known as the "crystallization" of the charge. When a floating charge crystallizes, it attaches to all the assets that the debtor/chargor currently owns within the charged class. After crystallization, the creditor can deal with any of the assets then existing under the charge, but the debtor company is no longer able to deal with the assets in the ordinary course of its business (Graham & Smith, 2020).

In *Re Cosslett (Contractors) Ltd* [1998] Ch 495, 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 most important characteristics to determine whether a charge is fixed or floating are whether the asset subject to the charge is under the control of the chargee/creditor and 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 (Clarke, 2017). These criteria help distinguish the level of control exercised by the creditor and the nature of the assets involved, which are critical in classifying the charge as either fixed or floating. The key differences between fixed and floating charges are summarised in below table.

Table 6.4 Summary of key differences between fixed and floating charges

Key Differences	Floating Charge	Fixed Charge
Definition	Refers to 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.	Refers to a charge on a specific fixed asset (such as a parcel of land) to secure the payment of a financing.
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	In this arrangement, no charge is registered against the asset and the debtor (chargor) of the asset can deal or dispose of the asset in the normal course of business without requiring consent from the creditor (chargee). In the event of default, OR if 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.	In this arrangement, the asset is signed over to the creditor, and the debtor (chargor) would need the creditor's permission to deal in or dispose of it. The financier also registers a charge against the asset which remains in force until the financing is paid.

Sharīʿah Ruling

As discussed earlier, a floating charge is a charge on a class of assets—both 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 remains in effect until it is crystallized into a fixed charge when any of the crystallization events or conditions outlined in the debenture occur. Until then, the assets remain under the full control of their owner, i.e., the debtor, who retains the ability to sell them, further charge them, or acquire new assets of the same class, which are automatically included under the floating charge. These features of a floating charge contain elements that may render it incompatible with the general requirements of a *rahn* contract, particularly regarding possession, certainty, and the nature of the collateral.

In order to address these concerns, a more detailed scrutiny must be conducted on specific issues to conclusively determine the *Sharīʿah* status of a floating charge. For this purpose, the *rahn* contract is used as a benchmark framework to assess the *Sharīʿah*

compatibility of a floating charge. Since floating charges involve future assets, this section begins by examining the requirements related to the taking of possession (*Qabḍ*) of the *marhūn* (collateral). Additionally, the discussion will address issues of uncertainty (*gharar*), ignorance (*jahālah*), and the non-existence (*ma'dūm*) of the *marhūn,* as these are critical factors in determining whether a floating charge aligns with *Sharīʿah* principles (*Al-Kāsānī*, 2001; *Ibn Qudāmah*, 1997).

Sharīʿah 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) The majority of Muslim scholars, including the *Ḥanafī*, *Shāfiʿī*, and *Ḥanbalī* schools, maintain that taking possession of the *marhūn* (collateral) is a condition for a valid *rahn* contract (*Al-Sarakhsī*, 1993; *Al-Ramlī*, 1995; *Ibn Qudāmah*, 1997). This opinion is supported by evidence from the Qurʾān and Sunnah.

   Allah says in the Qurʾān:

   > And if you are on a journey and cannot find a scribe, then a pledge with possession [may serve the purpose]" (Qurʾān, 2:283).

   This verse underscores the importance of possession in the context of *rahn* contract. Additionally, the following hadith supports this view:

   > The Prophet charged his armor to a Jew in Madinah and bought barley bread from the Jew for his family (Al-Bukhari, Hadith No. 1963).

   This tradition indicates that the armor had been delivered to the Jew in the *rahn* contract, reinforcing the requirement of possession.

b) On the other hand, some Muslim scholars, primarily from the *Mālikī* school of thought, argue that taking possession of the *marhūn* is not a condition for the conclusion, validity, or enforceability of a *rahn* contract but rather a best practice (*Al-Qarāfī*, 1998; Ibn Rushd, 1996). According to this view, a *rahn* contract remains valid even without the delivery of the *marhūn* by the

> debtor to the creditor. The contract is binding, and the chargee may later demand delivery of the collateral (*Ibn Juzay*, 1979).

In arriving at this opinion, this group of *Mālikī* jurists also relies on the same verse from *Sūrah Al-Baqarah* (2:283) but interprets it differently. They argue that the verse already recognizes the *marhūn* as a valid collateral (referring to it as *riḥān)* before adding the phrase "that is possessed" as a description. In their interpretation, the description serves to explain the best practice for fulfilling the purpose of the *rahn* contract, i.e., by taking possession of the *marhūn* rather than being a condition for validity (Tawfeeq, 2008).

Preferred Opinion

On this issue, it is submitted that the preferred opinion is the view of the *Mālikī* scholars, which holds that taking possession of the *marhūn* is merely a best practice rather than a condition for validity. This perspective is implied in the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Sharīʿah* Standard No. 39 (AAOIFI, 2017). Item 3/1/1 of the Standard states:

> 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.

Based on this, AAOIFI views the *rahn* contract as binding once it is concluded, without explicitly requiring possession as a primary condition for validity. Furthermore, the Standard elaborates that possession may take several forms, including actual possession or legal possession. Item 3/1/2 of the Standard provides:

> Possession of 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.

Sharīʿah Status of Taking Possession (Qabḍ) of Marhūn in A Floating Charge

The discussion on the status of taking possession of the *marhūn* 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 *Mālikī*s, were of the view that taking possession of the *marhūn* is a requirement for a valid *rahn* contract. On the other hand, the *Mālikī* jurists view it as merely fulfilling 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.

The Issue of Uncertainty (Gharar) In Floating Charge

The issue of *gharar* is very much relevant in determining the *Sharīʿah* 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 *Sharīʿah* 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 the 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 *jahālah* 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 *Sharīʿah* issues arising from these three factors are interrelated and therefore will be dealt with together in the following.

Sharīʿah 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 Chapter two 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 *Mālikī* school that allows for some tolerance towards *gharar* element in *rahn* contract be adopted. By adopting the *Mālikī*'s position, the existence of *gharar* in the *marhūn* 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,[2] 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 crystallization.

Despite some elements of uncertainty (*gharar)* in the asset specification under the current arrangement of a floating charge, this can still be tolerated by adopting the opinion of the *Mālikī* scholars, who allow the charge of assets that contain elements of *gharar*. This flexibility is based on the understanding that the *rahn* contract is supplemental in nature and does not require the same stringent conditions as a primary sale contract. Consequently, the requirements of *rahn* can be less restrictive compared to those of a sale contract (*Al-Qarāfī*, 1998).

The main objective of the *rahn* contract is to secure or provide comfort to the creditor regarding the debtor's obligation in the event of non-performance of debt repayment. This aligns with the opinion of some *Mālikī* jurists, who permit the *rahn* of non-existent assets, whether stipulated or not stipulated in the contract (*Al-Qarāfī*, 1998). They argue that since the debt obligation exists independently of the *rahn* , it is preferable to have a *rahn* arrangement—even if imperfect—than to have no security at all. This pragmatic approach ensures that the creditor's interests are protected while accommodating the practical realities of modern financial transactions.

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

(a) Regarding the absence of asset specification under a floating charge, the majority of Muslim jurists—namely, the *Ḥanafī*, *Shāfiʿī*, and *Ḥanbalī* schools—hold that the detailed specification of *rahn* assets must be made clear and known in a *rahn* contract. This requirement is rooted in the principle that uncertainty (*gharar)*[3] in the subject matter of a contract renders it invalid.

Al-Kāsānī (1995) of the *Ḥanafī* School, in his work *Badāʾiʿ al-Ṣanāʾiʿ* , stated::

(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 an 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.

Similarly, *Al-Shirāzī* (1997) of the *Shāfiʿī* School, in his book *Al-Muhadhdhab* , explained:

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 an unknown item, shall not be used as an object of *rahn* contract; 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 an unknown item indicates the same prohibition to use a *marhūn* which is unknown in nature.

Ibn Qudāmah (1997) of the *Ḥanbalī* School, in *Al-Mughnī,* further elaborated:

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[3] Scholars disputed on the conceptual distinction between *gharar* and *jahālah* in Islamic jurisprudence. While both terms relate to uncertainty, many jurists maintain that they serve distinct legal functions. Specifically, *gharar* refers to excessive uncertainty or ambiguity in a contract that casts doubt on the existence, delivery, or fundamental terms of the transaction, potentially rendering the contract null and void (*bāṭil*). In contrast, *jahālah* denotes ignorance or lack of specific information (such as price, quality, or timing), but where delivery or execution is still possible, the contract may remain valid (*ṣaḥīḥ*)—albeit with certain conditions or clarifications required. In the context of floating charges in Islamic project finance, however, the practical discourse does not always differentiate clearly between these two forms of uncertainty. Instead, the *Sharīʿah* analysis tends to evaluate the degree of uncertainty present—i.e., whether it is tolerable, resembling jahālah, or intolerable, akin to *gharar*.

"(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) an 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.

Based on the above, the majority of Muslim jurists, including the *Ḥanafī*, *Shāfiʿī*, and *Ḥanbalī* schools, unanimously agree that the detailed specification of *rahn* assets is a fundamental requirement for the validity of a *rahn* contract. They argue that just as the sale of an unknown item is impermissible, so too is the use of unspecified or uncertain assets as collateral, since the primary objective of a *rahn* contract—to secure the creditor's claim and ensure the fulfilment of the debtor's obligation—parallels the purpose of a sale contract. These scholars emphasize that the characteristics and specifications of the *marhūn* must be explicitly determined at the time of contracting to eliminate any element of uncertainty, ensuring transparency and protecting the rights of both parties.

(b) In contrast, the *Mālikī* School, some *Shāfiʿī* jurists, and a dominant opinion among *Ḥanbalī* scholars adopt a more flexible approach. *Al-Dusūqī* (2003) of the *Mālikī* School argues that the sale of an asset does not present during the contract session is valid, provided that its characteristics and specifications are determined upon execution of the contract. Similarly, *Al-Nawawī* (2003) of the *Shāfiʿī* School and *Al-Buhūtī* (1997) of the *Ḥanbalī* School support this view, emphasizing that the absence of the asset at the time of contracting does not invalidate the transaction if its description is sufficiently detailed.

This minority view aligns with the practical realities of modern financial instruments, such as floating charges, where the assets may fluctuate or remain unspecified until crystallization. By allowing flexibility in asset specification, this perspective accommodates the dynamic nature of contemporary transactions while ensuring that the fundamental objectives of the *rahn* contract are preserved.

The Preferred View

Although the majority of Muslim scholars are of the view that a *marhūn* must not be an unknown asset, the context of unknown element (*jahālah*) refers to that type of *jahālah* which leads to dispute and injustice among contracting parties. Thus, it is submitted that, should the reasons for *jahālah* being prohibited, i.e., strong probability of dispute and injustice among contracting parties are eliminated, the *jahālah* alone shall not invalidate the contract.

In the context of *rahn*, following the views of the *Mālikī*'s jurists, some *Shāfiʿī*'ie jurists, and a dominant opinion of the *Ḥanbalī* 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 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 *jahālah* element in a floating charge, it is believed that the registration of the charge with the respective authorities 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 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*.

Underlying Assets in a Floating Charge and Possibility of Sharīʿah Non-Compliance

There might be a possibility that the assets used in a floating charge consist of *Sharīʿah* non-compliant elements.[4] This could arise in the following instances:

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

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

The Use of Sharīʿah Non-Compliant Assets as Collateral

Muslim scholars have extensively deliberated on the issue of using *Sharīʿah* non-compliant assets as collateral. Generally, the majority of Muslim jurists ruled that *rahn* involving *Sharīʿah* non-compliant assets, such as alcohol or swine, is impermissible (*Al-Kāsānī*, 1995; *Al-Ḥaṭṭāb*, 2001; *Al-Ramlī*, 1984; *Ibn Qudāmah*, 1997). This ruling stems from the fact that such items are not recognized as valid property (*māl*) for Muslims and, therefore, cannot be lawfully sold or pledged. However, in cases involving non-Muslim creditors and debtors, the jurists adopt a different perspective. According to *Ḥanafī* jurists like *Al-Sarakhsī* (1993), it is permissible for both non-Muslim contracting parties to pledge *Sharīʿah* non-compliant assets, such as swine or liquor, as these items are considered valuable properties within their belief system.

The classical discussions by early Muslim jurists primarily focus on specific assets that are explicitly prohibited by the Qurʾān and Sunnah, such as swine, wine,

[4] Insights from the interviews session with industry players.

carcasses, and blood, which are inherently unlawful (*ḥarām li-dhātihi)*. These rulings are based on clear textual evidence from Islamic sources. However, for financial assets, they are quite different in term of their definition of *Sharīʿah* non-compliant statust. This is due toa the application of these principles to modern financial assets requires a more nuanced analysis. Financial assets, such as fixed deposits, shares, bonds, and other instruments, differ significantly in nature and characteristics from traditional tangible assets. Given the absence of explicit rulings by early jurists on modern financial assets, contemporary scholars have relied on independent reasoning (*ijtihād*) to address this gap. Their classification as *Sharīʿah*-compliant or non-compliant is determined by external factors and parameters established by contemporary *Sharīʿah* scholars, such as the nature of the business activities, financial ratios, and compliance benchmarks (AAOIFI, 2017). 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 *Sharīʿah* authority. While classical rulings provide a foundational framework, the unique nature of modern financial assets necessitates a contextual and adaptive approach to ensure alignment with *Sharīʿah* principles.

Sharīʿah Discussion on the Use of Sharīʿah Non-Compliant Financial Assets as Collateral in a Floating Charge

There are several *Sharīʿah* resolutions issued by contemporary *Sharīʿah* scholars related to using *Sharīʿah* non-compliant financial assets as collateral. Among others are AAOIFI (2017) which prohibits IFIs from accepting any *Sharīʿah* non-compliant shares as collateral for Islamic financing in its *Sharīʿah* Standard No 39 (Mortgage and Its Contemporary Application):

> (4/3) It is impermissible to mortgage the financial papers and *Sukūk* 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 *Ribā*…

The above ruling which among others prohibits *Sharīʿah* non-compliant shares is in line with the main requirement of *rahn* contract, i.e., that the *marhūn* 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 *Sharīʿah* 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 (Ibn Juzay, 1979)

In addition, there are also resolutions issued by the *Sharīʿah* Advisory Council (SAC) of BNM in its 160th meeting on 30th June 2015 that discussed the issue of *rahn* which comprised of both *Sharīʿah* compliant and *Sharīʿah* 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:

1) the core business of the company is recognized as *Sharīʿah* compliant; and
2) the mixed asset can be used as collateral provided that the *Sharīʿah* compliant assets and *Sharīʿah* non-compliant can be segregated and the value of the collateral is limited only to the portion of the assets that are *Sharīʿah* 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 *Sharīʿah* 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 *Sharīʿah* compliant asset and *Sharīʿah* 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 *Sharīʿah*-compliant

There is also another resolution in relation to acceptance of *Sharīʿah* non-compliant assets as collateral issued by the *Sharīʿah* 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 *Sharīʿah* non-compliant status during the tenure of financing. In this case, the SAC resolved that it is permissible to maintain the initially *Sharīʿah*-compliant securities, which have later been reclassified into *Sharīʿah* 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 *Sharīʿah* 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 *Sharīʿah* non-compliant assets into two types:[5]

a) The asset which form and substance is *Sharīʿah* non-compliant in itself such as pork, wine and the like. This type of asset is not permissible for *rahn* purposes from the *Sharīʿah* perspective.
b) The asset that becomes *Sharīʿah* non-compliant due to other elements or external factors. This is illustrated in the case where the *rahn* asset is *Sharīʿah* compliant but changes its status to non-compliant due to external elements such as *ribā* (interest) in conventional fixed deposits and bonds. This type of asset is permissible for *rahn* purposes provided that the element of *ḥarām* 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 *Sharīʿah* non-compliant by themselves, then they cannot be used as collateral. However, if the current assets are recognised as *Sharīʿah* non-compliant due to the existence of other external

[5] Abdul Mukarrami and Afiqah (2017), *Research On Acceptability Of Shariah Non-Compliant Asset As Collateral,* paper presented in Kuala Lumpur Islamic Finance Forum (KLIFF).

elements that are prohibited, they can be used as collateral, provided that the prohibited (*ḥarām*) element is eliminated/excluded.

b) As for assets that are initially *Sharīʿah* compliant but may become *Sharīʿah* non-compliant either due to future acquisition, or changes in the status of the asset to *Sharīʿah* 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 *Sharīʿah* non-compliant assets. The status of *Sharīʿah* 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 *ḥarām* element in the *Sharīʿah* non-compliant assets shall be excluded from the collateral.

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 (*Ḥanafī*s, *Shāfiʿī*'ies and *Ḥanbalī*s). Nonetheless, the flexibility of the *Mālikī* 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, *Mālikī* 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 *Mālikī* school that tolerates elements of uncertainty and *jahālah* of the *marhūn* in a floating charge.

There are, however, further issues in a floating charge, particularly with regard to the possibility of the charged assets becoming *Sharīʿah* non-compliant or mixed with *Sharīʿah* non-compliant assets in the future.[6] 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 *Sharīʿah* non-compliant. The *Mālikī*s along with the majority of Muslim jurists do not allow *rahn* on 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 *marhūn*, 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 *Sharīʿah* perspective.

6.9.3.7 The Use of Takaful and Insurance Proceeds as Collateral

[6] As identified in interview with banking expert which was conducted on 19 September 2024.

In project finance, the assignment of takaful or insurance proceeds represents a unique category of financial assets that can be used as collateral. This arrangement is designed to secure the project against potential risks, such as damage, loss, or other misfortunes that may impact the project's assets or operations. By assigning these proceeds as security, financiers aim to mitigate risks and ensure recovery in the event of unforeseen circumstances.

While the use of takaful proceeds as collateral is generally accepted from a *Sharīʿah* perspective due to its compliance with Islamic principles, it still requires justification. Specifically, since takaful proceeds is not available during inception of *rahn* and are contingent upon the occurrence of a future event, their compliance with the requirements of *rahn* (pledge) assets—such as being identifiable, tangible, or enforceable—must be carefully examined. On the other hand, the status of conventional insurance proceeds remains ambiguous and has been a subject of debate among scholars and practitioners. This discussion will explore the *fiqh* characterization of both takaful and conventional insurance proceeds as collateral, addressing their permissibility and treatment under Islamic jurisprudence.

The Use of Takaful Proceeds (Future Asset) as Collateral

The assignment of takaful proceeds as collateral in Islamic finance is generally acceptable due to its compliance with *Sharīʿah* principles. However, a critical question arises regarding whether such an arrangement meets the classical requirements of *rahn* (pledge) from a *Sharīʿah* perspective. Specifically, the issue revolves around whether it is permissible to pledge something that does not exist at the time of the pledge's inception, as takaful proceeds are contingent upon the occurrence of a future event and thus represent future rights rather than existing assets. Classical jurists have extensively debated the permissibility of pledging future assets, resulting in differing opinions among the schools of thought.

The majority view, held by the *Ḥanafī* , *Shāfiʿī*, and *Ḥanbalī* schools, strictly prohibits the pledging of future assets. This prohibition is rooted in the fundamental requirements of *rahn* (pledge) , which mandate that the pledged asset (*marhūn*) must

be identifiable, tangible, and in existence at the time of the pledge (*Al-Sarakhsī*, 1993; *Al-Nawawī*, 2000; *Ibn Qudāmah*, 1997). According to this view, the absence of tangibility and physical possession renders future assets ineligible for use as collateral. The rationale behind this stance is that a pledge serves as a guarantee for the repayment of debt, and only assets that are present and possess intrinsic value can fulfill this purpose effectively. Additionally, the uncertainty (*gharar*) associated with future assets—since their realization depends on contingent events—further undermines their suitability as collateral under classical interpretations of *Sharīʿah* (*Al-Zuḥaylī*, 2003).

In contrast, some contemporary scholars, along with the *Mālikī* school, adopt a more flexible approach by permitting the pledge of future assets under specific conditions. This view is based on the principle of constructive possession (*Qabḍ ḥukmī)* , which allows for the recognition of intangible or future rights as valid collateral if they meet certain criteria (Ibn Rushd, 1995; Hammad, 2015). According to this perspective, the key determinant is whether the future asset is legally enforceable, and its value can be reasonably estimated at the time of the *rahn*. For instance, receivables or claims tied to valid contracts, such as takaful proceeds, may qualify as collateral because they represent legitimate and enforceable rights, even though they are contingent upon the occurrence of a future event.

This flexible approach is further supported by modern regulatory frameworks and standards, such as the BNM Policy Document (2018), which explicitly permits the pledging of future assets under a *rahn* contract. Specifically, para 14.4 states:

> In relation to paragraph 14.3, the pledgor may pledge an asset that will exist and will be owned in the future as collateral under a *rahn* contract (BNM, 2018).

Similarly, AAOIFI (2017) *Sharīʿah* Standard no. 39 provides additional clarity on this issue. Para 7 of the Standard states:

> It is permissible to mortgage an income which is still to be owned if the principal (income-earning asset) is specified. The contract in this case is valid whether such income is to be mortgaged along with the principal or independently

These provisions highlight the adaptability of Islamic finance principles to accommodate contemporary financial practices while ensuring compliance with *Sharīʿah*.

The enforceability of takaful proceeds as collateral is a critical factor in addressing concerns about uncertainty (*gharar)* and ensuring compliance with the requirements of *rahn*. One way to mitigate these concerns is through the legal mechanism of assignment, which provides a clear and enforceable framework for *rahn* takaful proceeds as security. Under this arrangement, the rights to future takaful proceeds are assigned to the financier, and this assignment is typically registered under relevant regulatory frameworks, as required by the Companies Act 2016. This registration process ensures that the assignment is legally recognized and enforceable, thereby reducing ambiguity and enhancing the certainty of the financier's claim.

From a regulatory perspective, the requirement to register the assignment of takaful proceeds serves as a safeguard against disputes and ensures transparency. By formalizing the charge through registration, the financier gains priority over the proceeds in the event of default, aligning with the principles of *rahn* . This regulatory framework not only mitigates the element of uncertainty but also reinforces the legitimacy of takaful proceeds as a valid asset for collateral purposes.

Furthermore, the contingent nature of takaful proceeds—where payouts are triggered only upon the occurrence of a specified event (e.g., loss or damage)—does not invalidate their status as a *rahn* asset. This is because the concept of *rahn* itself is contingent upon the occurrence of default by the borrower. In other words, both takaful proceeds and the enforcement of *rahn* share a similar nature: they become applicable only upon the occurrence of a specific event. For instance, just as takaful proceeds are payable only when a covered event occurs, the *rahn* is enforceable only when the borrower defaults on their obligation. This shared contingency underscores the compatibility of takaful proceeds with the requirements of *rahn*, as both mechanisms are designed to address risks and provide security in uncertain circumstances.

The divergence between these two perspectives reflects broader debates within Islamic jurisprudence regarding the adaptability of classical principles to contemporary

contexts. While the majority view prioritizes the avoidance of uncertainty and the need for tangible assets, the minority view of *Mālikī*s highlights the importance of flexibility and practicality in addressing the complexities of modern finance. This nuanced discussion underscores the need for careful consideration of both traditional principles and evolving financial realities when determining the permissibility of future assets as collateral.

The Use of Conventional Insurance as Collateral

Based on the above discussion, the use of takaful proceeds as collateral is permissible, even though the proceeds are contingent upon future events. In contrast, conventional insurance is generally non-compliant with *Sharīʿah* principles due to its reliance on prohibited elements such as *ribā* (interest), *gharar* (excessive uncertainty), and *maysir* (gambling) (AAOIFI, 2017). Conventional insurance operates on a risk-transfer model, where premiums are paid in exchange for guaranteed payouts, raising questions about its status as collateral.

Contemporary jurists have debated the permissibility of using conventional insurance proceeds as collateral. The SAC of SC (2023) provides detailed guidance on this issue. It emphasizes that assets should ideally be covered through a takaful scheme. However, if an asset is already covered under an existing conventional insurance policy, the entire value of the conventional insurance policy coverage may be accepted as collateral until the policy expires. Once the policy expires, the asset must transition to a takaful scheme. If takaful is unavailable or not commercially viable—as determined by the *Sharīʿah* adviser—the asset may remain covered under a conventional insurance policy, and the entire value of the policy coverage may still be accepted as collateral. However, if the policyholder renews the conventional insurance policy without considering takaful coverage, the value of the policy acceptable as collateral is limited to the *Sharīʿah*-compliant portion, which constitutes the total amount of premiums paid by the policyholder.

However, the SAC of BNM (2018) remains silent on the explicit use of insurance as collateral in its Policy Document on *Rahn*. However, it provides general guidelines

for *Sharīʿah* non-compliant financial assets, stating that such assets may be accepted as collateral, provided their value is limited to the principal amount only.

Ali and Hussain (2017) further clarify that an insurance policy can be accepted as a pledge, but only up to the total amount of premiums paid by the policyholder. This is because the insurance company does not retain ownership rights over the premiums paid, while the policyholder has no ownership rights over the coverage itself. As a result, the policyholder cannot pledge the insurance policy directly due to the absence of ownership rights. However, the benefit of the insurance policy can be pledged up to the amount of premiums paid, as this represents the policyholder's financial contribution.

In conclusion, based on above opinions, it is noted that the conventional insurance contracts are inherently non-compliant with *Sharīʿah* principles, some scholars permit the use of their proceeds as collateral under specific conditions:

- The collateral value is limited to the expected payout or compensation amount under the insurance policy.
- Any interest or returns generated by the insurance company are excluded from the collateral value, as they are considered impermissible under *Sharīʿah*.

Conventional insurance proceeds are treated similarly to other *Sharīʿah* non-compliant financial instruments as per SAC of BNM (2018) guideline in Policy Document on *Rahn*. The collateral value is restricted to the principal amount or expected payout, excluding any prohibited elements. This approach aligns with the principle of limiting the use of non-compliant assets to their intrinsic value while avoiding direct involvement in prohibited activities. By adhering to these guidelines, Islamic finance can effectively utilize conventional insurance proceeds as collateral while maintaining the *Sharīʿah* requirements.

6.9.3.8 Intellectual rights (goodwill, on a patent or licence under a patent, on a trademark, or on a copyright or a licence under a copyright)

Intellectual property rights encompass a collection of exclusive rights that possess inherent value (OECD, 2015). These rights grant holders a period of monopoly. Developers of innovative intellectual property are rewarded under the law with an exclusive timeframe during which they have sole rights to the economic benefits derived from their intellectual property (Kerrigan, 2018). As a result, intellectual property is recognized as a valuable asset and is accepted by banks as collateral for loan purposes. Each of these rights serves as an asset or income source for its owner. Consequently, intellectual property rights have gained recognition as viable collateral for borrowing funds from financial institutions, including banks (OECD, 2015).

The recognition of intellectual property as collateral is also evident in Malaysia. Sinaga (2016) notes that Malaysia allocated an RM200 million budget to Malaysian Debt Ventures (MDV) in 2013 for the establishment of an intellectual property fund scheme, highlighting the importance of intellectual property rights (Sinaga, 2016). This initiative enables Malaysian small and medium-sized enterprises (SMEs) in sectors such as biotechnology, green technology, advanced technology, and information and communication technology to utilize their intellectual property rights as a means of securing funding (Sinaga, 2016). Startups, in particular, can greatly benefit from leveraging their intellectual property rights as they seek financial support for their businesses (Sinaga, 2016).

In Malaysia, there are five recognized categories of intellectual property rights, namely trademarks, industrial designs, patents, copyrights, and geographical indications (Aziz & Mohd Yusof, 2022). However, only trademarks and registered industrial designs have specific statutes allowing them to be registered as security instruments (Aziz & Mohd Yusof, 2022). The Trademark Act 2019 permits trademarks to be used as collateral for loans, while the Industrial Design Act 1996 allows registered industrial designs to serve as security instruments.

On the other hand, there are no explicit provisions in the law regarding the use of patents, copyrights, and geographical indications as collateral. It remains uncertain whether they can be utilized as security instruments, although there is a possibility that they can be. Currently, the securitization of intellectual property assets is not extensively developed.

IP-backed loans enable companies to leverage the economic value of their intellectual property to secure loans from banks (OECD, 2015). In this arrangement, a company can use its intellectual property assets as collateral, and the value of these assets is assessed for loan purposes. The bank determines the loan amount based on the valuation of the intellectual property. In the event of insolvency or loan default, the creditor has the right to seize the intellectual property, and any proceeds or receivables from the intellectual property assets go to the creditor.

According to Asia IP (2019), the concept of IP collateralization has been present in Malaysia for some time. However, the acceptance of intellectual property as a form of collateral has not gained significant traction due to limited understanding and awareness of this innovative financing approach through IP assets. Although banks are gradually becoming more receptive to the concept, progress in this area may still be slow.

In Malaysia, intellectual property assets are recognized as an acceptable asset class for the purpose of collateral under company law (Asia IP, 2019). The Companies Act 2016 specifically addresses charges on intellectual property rights, such as trademarks, patents, and copyrights, requiring their registration to establish priority of payment (Companies Act 2016).

In conclusion, intellectual property rights are considered valuable assets and can be used as collateral for financing. Malaysia has implemented initiatives to support the use of intellectual property as collateral, particularly for SMEs in specific sectors. Trademarks and registered industrial designs have clear provisions allowing their use as collateral, while the use of patents, copyrights, and geographical indications remains uncertain. IP-backed loans enable companies to leverage their intellectual property assets to secure loans, but further awareness and understanding are needed to promote wider acceptance in Malaysia's banking industry. The Companies Act 2016 recognizes charges on intellectual property and requires their registration for priority of payment.

Sharīʿah Ruling

In relation to the use of IP as collateral from the *Sharīʿah* perspective, it is pertinent to examine whether intellectual property is a suitable subject matter for the purpose of Islamic collateral.

(1) The permissibility of the Intellectual property as property (māl).

In Islamic jurisprudence, the element of *māl* is an important yardstick to the legitimacy of any commercial transaction (Schact 1964). Hence, the first determination that needs to be made is whether IP is recognized as property (*māl*) and could therefore be a suitable subject matter of *rahn*.

The majority of classical scholars define *māl* in a broad sense, encompassing both corporeal/tangible assets as well as non-corporeal/intangible assets. *Shāfiʿī*i scholars (*Al-Zarkashī*, n.d.), define *māl* as anything which is permissible under the *Shariʾah* to benefit from, either corporeally or by usufruct. *Al-Shāṭibī* (n.d.), of the *Mālikī* School, views *māl* to be anything which can be owned and in which all the incidental rights of ownership can be exercised. *Ibn Qudāmah* (1997) of the *Ḥanbalī* School defines *māl* as something which is permissible to enjoy (*manfaʿah mubāḥah*) in normal circumstances; i.e., not in situations of necessity or exigency (*ḍarūrah* or *ḥājah*). Based on the above definitions, it can be concluded that the majority of scholars agree that *māl* is not limited to something that has physical features but can also include something that is intangible (*maʿnawī*) as long as it fulfils the criteria of *māl* such as having value and being capable of being owned and benefited from according to the *Sharīʿah*.

On the contrary, the majority of *Ḥanafī* scholars limit their definition of *māl* to corporeal or physical assets only. Thus, they do not recognize intangible assets such as usufruct (*manfaʿah*) and rights (*ḥuqūq*) as *māl* due to their lack of physicality, and physical possession is essential in the *Ḥanafī* School (Badran n.d.). Hence, *ʿAlī Al-Khafīf* (1996), following the prevailing *Ḥanafī* view, defines *māl* as something which is capable of being possessed, physically acquired, where normal enjoyment is possible in ordinary times (*ʿādah*) as opposed to times of emergency (*iḍṭirār*). It should, however be noted that some *Ḥanafī* jurists are of the view that *māl* may also include intangible

things like usufruct in addition to tangibles. For example, *Al-Kāsānī* (2003) states that *māl* includes the corporeal (*ʿayn*) as well as the usufruct (*manfaʿah*).

A number of contemporary scholars such as al-Nashmī (1998), *al-ʿUthmānī* (1998), *al-Zuḥaylī* (1998), *al-Būṭī* (1998), Engku Ali (2003) and *Bouheraoua et al.* (2015) are in favour of the majority view. The Islamic *Fiqh* Academy of the OIC (Resolution No. 43 (5/5)) and AAOIFI *Sharīʿah* Standard No. 42 have also adopted the majority view of the classical Muslim jurists. Anderson (1976) asserts that the modern concept of *māl* is "all that has commercial value", or "those corporeal, usufructuary and other rights of any kind, the exchange of which is customary". It includes both movables and immovables and specific objects and their use (or income which they produce). These also include what a man owns and has in his possession and what is owed to him; i.e. a chose in action.

In the context of IP, some contemporary scholars have classified it as *māl* in the form of *manfaʿah*. Prominent proponents of this view include *al-Duraynī* (1984), *ʿAbd al-Samīʿ* (1988), *Al-Sāddah* (1964), *Al-Najjār* (1995), and *Al-Shawribī* (1993).

However, it should be emphasised that there are some differences between IP and traditional *manfaʿah* as understood in the *fiqh* literature. Firstly, the usufructuary rights of IP differ from traditional *manfaʿah* in terms of source and origin. Whilst the source and origin of usufructuary rights of tangible property are the physical property itself, the origin and source of IP is human intellect or effort, which can only be understood notionally. Secondly, in the case of traditional *manfaʿah*, the continued possession of the tangible property is essential to the exercise of the rights to use it. As for IP, it is acknowledged that the physical embodiments of the intellectual ideas are crucial to the recognition of the IP rights residing therein in all cases, especially in common law jurisdictions. Nonetheless, the ownership rights over intellectual ideas, though represented in physical embodiments and mandated to be so under Malaysian law, exist independently and are not dependent on the physical elements. The physical embodiments are mere vehicles and do not determine the proprietary nature of intangible property. Hence, IP is capable of providing utility (*manfaʿah*) by itself, independent of its physical embodiments.

As such, it can be argued that IP is *māl* not only because it is a form of *manfaʿah* but because it independently fulfils the criteria of *māl* as discussed by the jurists. In fact, a number of contemporary scholars prefer to classify IP as a financial right (*ḥaqq mālī*). For instance, AAOIFI includes intangible assets as a type of financial right under Standard No. 42. More specifically, clause 3/3/2 of Standard 42 provides that financial rights to intangible assets are of many kinds including: "rights to trade name, trading addresses, trademarks, commercial licenses, intellectual property, technical and industry know-how, patents and copyrights". A similar view was also expressed by the Islamic *Fiqh* Academy of the Organisation of the Islamic Conference in Resolution No. 43 (5/5) of 1998:

Business name, corporate name, trademark, literary production, invention or discovery, are rights belonging to their holders and have in contemporary times, financial value which can be traded. These rights are recognized by *Sharīʿah* and should not be infringed.

In addition, *Bouheraoua et al.* (2015) pointed out that numerous studies concluded that IP is a right that is legally protected, and this position is supported by reference to the Qurʾān, the Sunnah, *ijmaʿ* (consensus) and *qiyās* (analogy).

From the above, it would appear that contemporary scholars have no difficulty in accepting IP as a financial right (*ḥaqq mālī*); thus, by extension, it constitutes *māl* as it possesses value, can be traded and inherited, and possesses a certain degree of permanence.

(2) The Use of IP as collateral

Can IP be made the security for a financing? Considering the view among some scholars that IP represents a form of *manfaʿah*, it is perhaps relevant to examine the permissibility of *manfaʿah* as *marhūn* in the *fiqh* literature. There are some disagreements among Muslim jurists on this. With the exception of the *Mālikī*s, most jurists are of the view that usufruct may not be charged, for example; they disallow the charging of the right to use a house for a stipulated period. The *Shāfiʿī*s, for example, define *rahn* as "taking a non-fungible property as security against a fungible debt,

whereby the debt may be extracted from the held property if it is not repaid" (in *Al-Zuḥaylī* (2003). *Al-Zuḥaylī* (2003) observes that the usage of the term "*ʿayn*" (non-fungible property) is an indication that usufruct may not be used as the object of a *rahn* contract as it is transient and thus does not provide the required security.

It is clear from the preceding discussion that the reservation Muslim jurists have with respect to usufruct is with regard to whether it can provide the required security. It is submitted that this view is not valid for IP as it differs from the traditional conception of *manfaʿah* in that the value of IP is derived from intangible ideas and is not dependent on the physical medium. This is unlike the typical conception of *manfaʿah*, which involves usage rights of physical property such as rent, lease and the like.

Moreover, intangibles and financial assets are now being accepted as charged items; for example, income receivables, book debts, shares and stocks of corporations, etc. In relation to IP, there are various possibilities by which it could be used as collateral. First, it is possible that the copyright, trademark or a patent itself could be collateralized. Second, it is also possible that income stream from the copyright license, trademark or patent could be collateralized. In all instances, the IP is realised while leaving the physical medium intact. This is not possible with other usufructuary rights, in which realization would entail the disposal of the physical property.

AAOIFI *Sharīʿah* Standard No. 42 clarifies the rules governing intangible assets, including IP as follows:

> 3/3/3/1 Rights to trade names, trading addresses, trademarks, copyrights, inventions and patents are the rights of their respective owners. These possess recognised monetary value in contemporary business and commercial custom. Since these rights are recognized and protected by the *Sharīʿah*, it is not permissible to violate them.
> 3/3/3/2 Since rights to intangible assets are recognised as financial rights, it is permissible to dispose of or transfer them for consideration provided that such transactions are free of *gharar* (ambiguity), deception and fraud.
> 3/3/3/3 Commercial license: A commercial license is a right given by the relevant authority to certain businesses to engage in specified activities. It is permissible for the license holder to dispose of it for or without consideration unless specifically prohibited by law.
> 3/4 Financial rights can be acquired by contracts, stipulated conditions, inheritance or court order. Financial rights may be established by long-standing continuous use without objection or first use subject to

fulfilment of all *Shari'ah* conditions required for the acquisition of such rights.

In summation, it is submitted that the collateralisation of IP assets should not be any different from a typical collateralisation involving financial rights or income receivables that are *Shariʾah* compliant.

The main concern should be whether these assets can provide security upon default on payment and can be used to recover back the loan/debt. What is more important is the realisability, saleability and tradability of security. This, it is submitted, is possible with IP as it has been practiced in other countries. However, care must be taken that the IP used as collateral is valid and remains valid for at least the period during which the debt is payable and that it is marketable in the event of foreclosure or bankruptcy. The following discussion will discuss on the existence of IP as *Marhūn*.

(3) Existence of IP as Marhūn

Most Muslim jurists stress that the charged item must exist at the time of the security agreement. Thus, *al-Zuḥaylī* (2003) is of the view that it is not permissible to charge items that do not exist, or whose existence is uncertain, at the inception of the contract.

However, as pointed out earlier, the *Mālikī* jurists (*Al-Qarāfī* 1994, vol. 8, p. 92; *Al-Ḥaṭṭāb* 1992, vol. 6, pp. 538-539) were of the view that such a transaction is valid because even if the charged object is defective or lost, the right of the creditor remains intact as a liability on the debtor. These arguments are important as far as IP is concerned. It may be possible that a company would want to create a charge over all of its incoming royalty or licensing fees. This revenue stream could be fixed at a percentage of total income rather than a fixed amount. The only element of uncertainty is the exact amount of revenue derived from the transactions. Even in such instance, if there is a steady income stream, the level of uncertainty would arguably be minimal and the *Shariʾah* concern that the security (*marhūn*) should not be uncertain at the time of the inception of the contract could be avoided.

This can be supported by AAOIFI *Sharīʿah* Standard No. 39 (2017), in relation to the conditions for the assets under security, which provides:

> 3/2/1 The mortgaged asset should be a *Shari'ah*-permissible property. It should also be well specified (through pointing, naming).
> 3/2/2 In principle, the mortgaged object should be a tangible asset, yet it can be a debt, a cash amount, a fungible asset or a consumable commodity. Perishable objects can also be mortgaged as they can be sold and replaced by their value. Moreover, a mortgaged object can be a share of common property which can be identified and sold separately.

The IP, together with its proceeds—for example, the income stream derived from licensing, franchising, and royalty from copyright licensing—has been considered as *ḥaqq mālī* (financial rights) by many contemporary scholars as mentioned earlier. Dr. *Abdul al-Samīʿ* (1988) views the pecuniary right of the author to be *ḥaqq ʿaynī mālī* that is derived from intangible assets. In our opinion, the proceeds of IP can be considered as *dayn* or *ḥaqq fī dhimmah* before their accrual, and *māl ʿaynī* once they are accrued. The income stream may be limited in duration or jurisdiction depending on the type of licensing agreement. Nevertheless, this does not negate the "proprietary nature" of these rights and the ability to transact with these rights.

In summary, looking at the above arguments, it is submitted that IP can be a suitable item for a charge or *rahn*. In an information-based society, IP may fetch greater value than physical assets. The saleability and commercial value of IP is unquestionable in this new economy. These IP assets are quantifiable, and several valuation methods exist and are currently being developed to ensure a reliable form of assessing the value of IP. Royalty fees and licensing fees, franchise, distribution agreement, publishing rights, technology license agreement, copyright license agreement, joint ventures—all these can be valued separately from the business. These new assets are liquid, predictable and bring in predictable cash flows.

The rest of the requirements—deliverability, known and identified property, not being attached and being separate—hardly pose any hurdles to the creation of a security interest over IP. All that needs to be done is to ensure the security agreement is clear enough to contain all the information needed to ensure that the security transaction is

valid. The type of IP involved must be clearly identified, for example, a patent on software or copyright fees on the licensing of the software.

Summary of the Analysis of Security Assets Applied in IPF

This section has provided a comprehensive exploration of the *Sharīʿah* compatibility status of diverse security assets in Islamic project finance, as highlighted through interviews and the governance framework under the Companies Act 2016. The analysis covered a wide range of asset classes, including fixed assets, cash-based assets, book debts, financial assets, company shares/stock, floating charges (future assets), takaful and insurance proceeds, and intellectual property rights. Each asset class possesses distinct characteristics and entails specific legal and *Sharīʿah* considerations that must be carefully addressed to ensure compliance with both regulatory and ethical standards. The Companies Act 2016 serves as the governing framework for creating and registering charges on these assets, providing clarity on procedures and establishing a clear hierarchy for debt repayment. This legal foundation is essential for ensuring transparency, enforceability, and alignment with broader financial regulations, thereby upholding the objective of *ḥifẓ al-māl* (preservation of wealth) within the *Maqāṣid al-Sharīʿah* framework. Ensuring enforceable rights also protects the interests of both creditors and debtors, aligning with *ḥifẓ al-ʿahd* (protection of contractual obligations).

From a *Sharīʿah* perspective, the permissibility of these assets as collateral hinges on their compliance with the principles of *rahn*. It is important to note that while the majority of jurists (jumhūr al-fuqahāʾ)—including the *Ḥanafī*s, *Shāfiʿī*s, and *Ḥanbalī*s—impose relatively strict requirements on *rahn*, aligning closely with the conditions applicable to assets used in sale contracts, the *Mālikī* school adopts a more flexible view. According to *Mālikī* jurists, since *rahn* is a subsidiary contract (ʿaqd tābiʿ) that merely supports the principal contract, not all conditions required for sale (ʿaqd al-bayʿ) must apply to *rahn*. This contextual leniency permits the acceptance of certain assets that may not be tangible or fully owned at the time of contract, provided the underlying debt is valid and enforceable. This view is supported by the established legal maxim:

"التابع لا يستقل بنفسه في الحكم"

"What is subsidiary does not stand independently in ruling."

(Ibn Nujaym, n.d)

This reflects the understanding that the *rahn* contract derives its legitimacy and scope from the primary contract it supports and may therefore accommodate contemporary needs and practices, particularly in project finance structures where future or intangible assets (e.g., receivables, intellectual property rights) may be pledged to secure obligations. The *Mālikī* flexibility thus aligns with the *Sharīʿah* principle of ease and public interest (*taysīr* and *istiṣlāḥ*) and the higher objective of *ḥifẓ al-māl* (preservation of wealth) under the *Maqāṣid al-Sharīʿah*. This pragmatic approach ensures that Islamic finance remains adaptive, commercially viable, and ethically sound, without compromising its foundational legal and moral framework.

Table 6.5 Security Assets Compatibility Table

No	Categories	Types of Assets	Facility Status	Compatibility with *Sharīʿah*	Amount Allowed
1	Fixed Assets	Real Estate	-	Yes	Full
		Land	-	Yes	Full
2	Cash Based Assets	Deposit Account	Islamic	Yes	Full (principal + profit)
			Conventional	Yes, with condition	Up to principal amount only. To exclude interest portions
		Reserve Account	Islamic	Yes	Full (principal + profit)
			Conventional	Yes, with condition	Up to principal amount only. To exclude interest portions

3	Book Debt and Accounts Receivables	Debt	Islamic	Yes	Full (principal + profit)
			Conventional Debt	Yes, with condition	Up to principal amount only. To exclude interest portions
4	Financial Assets	Fixed Deposit	Islamic	Yes	Full (principal + profit)
			Conventional	Yes, with condition	Up to principal amount only. To exclude interest portions
		Bond/ *Sukūk*	*Sukūk*	Yes	Full (principal + profit)
			Bond	Yes, with condition	Up to principal amount only. To exclude interest portions
		Unit Trust	Islamic	Yes	Full (principal + profit)
			Conventional	Yes, with condition	Up to initial and additional investment amount
5	Company shares	Shares	Islamic	Yes	Full (principal + returns)
			Conventional	Yes, with condition	Up to principal amount only
6	Floating Charge	Present and Future assets	-	Yes, with condition	Up to *Sharīʿah* compliance asset only and to exclude any *Sharīʿah* non-compliance

					elements during liquidation.
7	Takaful/Insurance	Takaful Proceeds	Islamic	Yes	Full (premium paid + takaful coverage)
		Insurance Proceeds	Conventional	Yes, with condition	Up to the premium paid only. To exclude non-compliant element i.e insurance coverage
8	Intellectual Property (IP)	IP assets	-	Yes	Full

Researcher's own (2025)

6.10 CHAPTER SUMMARY

This chapter addresses the fourth research objective: to evaluate the compliance status of security instruments and assets in Islamic project finance with *Sharīʿah* requirements. The chapter is divided into two main sections. The first provides an overview of Islamic project finance and its salient features to establish a foundational understanding. The second section examines the applications of security instruments and assets in Islamic project finance from a *Sharīʿah* perspective, supported by insights from interviews with industry stakeholders and relevant literature.

The research reveals that charges are the preferred mechanism for securing financing in Islamic project finance due to their flexibility, wide range of acceptable assets, absence of possession requirements, and clear governance under Malaysia's Companies Act 2016. In contrast, mortgages in Malaysia align more closely with charge-based systems than traditional common law mortgages, as legislative restrictions prevent the transfer of legal ownership to the mortgagor. From a *Sharīʿah* compatibility perspective, charges, pledges, and liens are generally compatible with the concept of *rahn* (pledge), albeit with differences in key features that do not necessarily invalidate their status. However, mortgages are fundamentally incompatible with *rahn* due to the

transfer of ownership. Since mortgages are not applicable in Malaysia, this incompatibility does not pose a practical issue in the context of Islamic project finance.

An in-depth analysis of the common assets used in Islamic project finance highlights varying levels of *Sharīʿah* compliance across asset classes. Fixed assets, such as land and buildings, are highly favored due to their stability, liquidity, and alignment with *Sharīʿah* principles, supported by robust legal frameworks. Cash-based assets, including deposit and reserve accounts, are fully accepted, though conventional accounts may be limited to the principal amount to exclude interest. Book debts, equivalent to *rahn al-duyūn* (pledge of debts), are permissible as collateral due to constructive possession by the creditor.

For financial assets, such as conventional fixed deposits, bonds, and unit trusts, only the principal amount is accepted to avoid interest. Shares of companies engaged in *Sharīʿah* non-compliant activities cannot be used as collateral, though shares exceeding certain benchmarks may be partially accepted up to the permissible *ḥalāl* portion. Future assets under floating charges may be acceptable based on the view of *Mālikī* jurists, who tolerate elements of uncertainty in supplemental contracts like security agreements, provided regulatory safeguards mitigate such risks. Conventional insurance proceeds are conditionally accepted, limited to premiums paid, due to concerns over *ribā* (interest) and *gharar* (excessive uncertainty). Finally, intellectual property represents an emerging asset class that may be utilized as it fulfils the requirement of physical assets such as being valuable, tradeable, possessed, and having some degree of permanence and recognized by *Sharīʿah*.

CHAPTER SEVEN

CONCLUSION

7.1 INTRODUCTION

This final chapter presents the overall outcome of the study. It begins with a recapitulation of the research framework, followed by a summary of findings aligned with the study's objectives. The chapter continues with the contributions of the study and suggestions for future research are put forward followed. This chapter ends with the chapter summary.

7.2 THE RESEARCH FRAMEWORK RECAPITULATED

In Chapter Four, a research framework was developed to examine the nature and application of security instruments in Islamic project finance. This framework aimed to evaluate their compatibility with *Sharīʿah* principles and their practical adaptation within the modern financial system.

The study began by exploring Islamic security arrangements, focusing on traditional security contracts such as *rahn*, *kafālah*, *ḍamān*, and *ḥawālah*. The study clarifies how these traditional Islamic instruments can be adapted to modern financial practices. This foundational understanding provides insights into the principles governing security arrangements in Islamic finance, ensuring alignment with *Sharīʿah* requirements.

The study explores the concept of modern collateral under Common law, focusing on instruments such as mortgages, charges, pledges, liens. The characteristics, legal frameworks, and practical applications of these instruments are examined to identify their compatibility with Islamic principles. A comparative analysis is conducted to bridge the gap between Islamic legal frameworks and Common law, highlighting the similarities, differences, and potential for alignment between the two systems. This analysis establishes parameters to evaluate the *Sharīʿah* compliance of modern security

instruments and assets, serving as a guide for determining their permissibility and practicality in Islamic project finance.

To address the practical application of these concepts, the study employs a qualitative research methodology, utilizing semi-structured interviews with experts in Islamic finance which further supported by literature analysis. Their insights shed light on how security instruments and assets are utilized in contemporary Islamic project finance, particularly through mechanisms like *sukūk* and other financing structures. This empirical data is complemented by an evaluation of the compliance status of these instruments with *Sharīʿah* requirements, focusing on their alignment with the principles of *rahn* and other relevant contracts.

The findings reveal the contemporary applications of security arrangements in Islamic project finance, emphasizing their compatibility with *Sharīʿah* principles and their role as mitigating security tools. The study concludes by summarizing its contributions, acknowledging limitations, and offering recommendations for future research. By integrating theoretical insights with practical applications, this research provides a holistic understanding of security arrangements in Islamic finance, ensuring both academic rigor and relevance to industry practices.

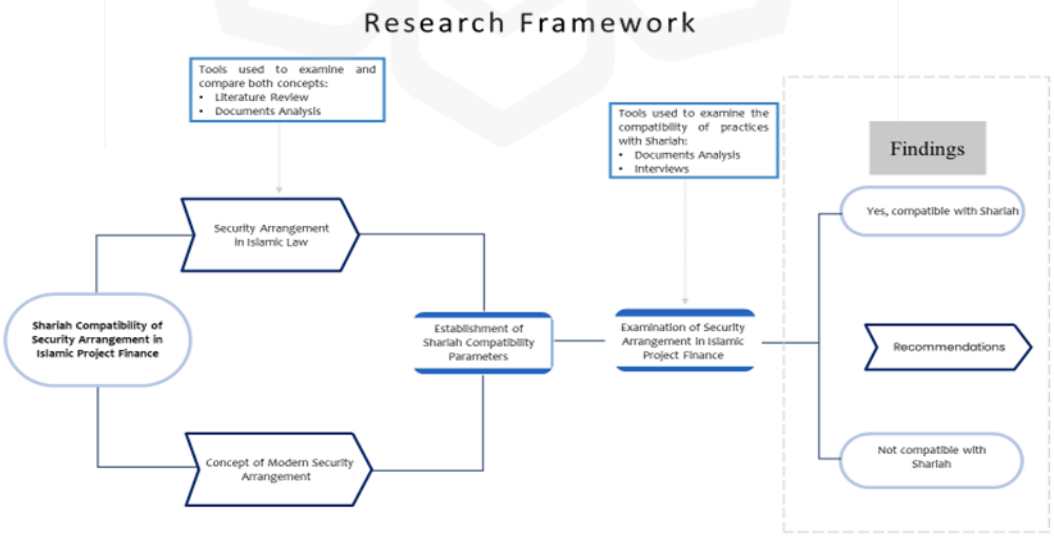


Figure 7.1 Research framework of the study

Source: Author (2025)

7.3 SUMMARY OF THE FINDINGS

In the beginning of this study, the research objectives were outlined to act as a guide in conducting the research. These objectives are (1) to examine the concept of security instruments and security assets from the perspective of Islamic law, (2) to investigate the concept of modern security instruments and security assets and assess its compatibility with Islamic law on security contracts, (3) to identify the application of security instruments and security assets in selected Islamic project financing, and (4) to evaluate the compliance status of security instruments and security assets in Islamic project finance with *Sharīʿah* requirements. In order to accomplish these research objectives, this study attempted to answer four research questions as elaborated in the subsequent paragraphs.

7.3.1 First Research Question

The first research question delves into the concept of security instruments and assets within Islamic law, uncovering a rich and multifaceted framework for securing financial obligations. Islamic jurisprudence provides a robust system through four primary *Sharīʿah*-compliant security contracts: *rahn, kafālah* , *ḍamān* , and *ḥawālah.* While these contracts share the overarching objective of ensuring debt repayment, they each possess distinct characteristics and operational mechanisms tailored to address specific financial needs and contexts.

(a) *Rahn*: Asset-Based Security

The *rahn* contract stands out as a uniquely asset-based mechanism, relying on the collateralization of tangible and identifiable property to secure creditors' claims. In Islamic law, the requirements for *rahn* assets are rigorous, emphasizing clarity, tangibility, and intrinsic value. Assets used as collateral under *rahn* must meet several key criteria:

- They must be identifiable and clearly defined.
- Ownership must be unambiguous, with no disputes or encumbrances.

- The assets must be free from prohibitions such as *gharar* (excessive uncertainty) or *ribā* (usury).

Notably, while most jurists emphasize the necessity of tangible and existing assets for *rahn,* the *Mālikī* school adopts a more flexible approach by permitting future assets or intangible rights to serve as collateral, provided they meet specific conditions. This adaptability highlights the dynamic nature of *rahn* within Islamic jurisprudence and underscores its potential for modern applications, particularly in project finance where diverse asset classes may be involved.

(b) *Kafālah* and Damān

In contrast to *rahn*, *kafālah* (guarantee) and *ḍamān* (suretyship) operate as non-asset-based instruments, focusing instead on personal guarantees to secure debts. These contracts are particularly effective in scenarios where tangible collateral is unavailable or impractical. Although these contracts do not involve tangible assets, their enforceability hinges on the credibility, commitment, and financial capacity of the guarantor, ensuring that the creditor's rights remain protected.

(c) Hawālah

Ḥawālah introduces a dynamic mechanism for restructuring or transferring debt obligations, offering a practical solution for managing liquidity and mitigating risks in commercial settings. Unlike *rahn* , *kafālah* , or *ḍamān* , which focus on securing existing obligations, *ḥawālah* facilitates the transfer of debt from one party to another, often improving cash flow and reducing financial burdens. This instrument is particularly valuable in modern financial systems, where debt restructuring and risk mitigation are critical for maintaining economic stability.

In summary, while all four contracts—*rahn, kafālah*, *ḍamān*, and *ḥawālah* — share the common goal of securing debt repayment, their unique features and applications highlight the depth and flexibility of Islamic law. Each contract addresses specific financial needs and contexts, offering ethical, enforceable, and practical solutions for creditors and debtors alike.

7.3.2 Second Research Question

The second research question explores the concept of modern security instruments and their compatibility with Islamic law, particularly in relation to *Sharīʿah*-compliant security contracts. The findings divided into two:

(a) Under common law, modern security instruments encompass four primary mechanisms: mortgage, charge, pledge, and lien serve the common purpose of securing loans and ensuring the fulfilment of financial obligations, yet they differ significantly in terms of nature and legal characteristics.

- A mortgage involves the transfer of legal ownership of an immovable asset to the creditor while allowing the debtor to retain possession and use of the property.
- In contrast, a charge does not involve ownership transfer but creates a security interest over an asset, ensuring the creditor's legal claim in case of default.
- A pledge requires the transfer of possession of a movable asset to the creditor while ownership remains with the debtor, ensuring enforceability through physical control.
- A lien, the least formal security instrument, grants the creditor a passive right to retain possession of an asset until the debt is settled, typically arising by operation of law in certain professional or commercial relationships (e.g., solicitors, artisans, or warehouse operators).

Apart from the above security instruments, the study also reveals that the quasi-security instruments, such as debentures, assignments, and guarantees, also provide practical mechanisms to secure debt obligations without vesting proprietary rights in the creditor over the debtor's assets.

(b) A comparative analysis reveals varying degrees of compatibility between these instruments and *Sharīʿah* principles, particularly with the *rahn* contract as the following:

(i) Mortgage: Incompatible with Rahn

A mortgage involves the transfer of legal ownership of immovable property to the creditor as security for a loan or financing. It is widely regarded as the "gold standard" for securing large-scale, long-term

obligations, particularly in real estate financing. However, this mechanism is fundamentally incompatible with *Sharīʿah* principles, especially the *rahn* contract. The key issue lies in the transfer of ownership, which contradicts the requirement in *rahn* that the debtor retain ownership of the collateralized asset.

(ii) Charge: High Compatibility with Rahn

A charge creates a security interest over assets without transferring ownership, offering significant versatility by covering both tangible and intangible assets, including future assets. This mechanism exhibits the highest degree of compatibility with the *rahn* contract. Both charge and *rahn* allow the debtor to retain ownership while granting the creditor an enforceable security interest. Additionally, charges are flexible, do not require possession, and can cover a wide range of asset classes, aligning closely with the requirements of *rahn*. This adaptability makes charges particularly relevant for modern financial practices, such as project finance, where diverse and evolving asset classes are involved.

(iii) Pledge: Moderate Compatibility with Rahn

A pledge requires the transfer of possession of movable assets to the creditor as security, making it practical for short-term transactions. However, this mechanism demonstrates only moderate compatibility with *rahn*. While both pledge and *rahn* create enforceable security interests, they differ significantly in their requirement of possession. In a pledge, the creditor must take physical possession of the asset, which limits the debtor's ability to utilize it. Furthermore, pledges typically apply only to tangible assets, excluding intangible and future assets covered by *rahn*. These limitations reduce the applicability of pledges in contexts requiring flexibility and broader asset coverage.

(iv) Lien: Low Compatibility with Rahn

A lien grants the creditor the right to retain possession of an asset until the debt is repaid. While liens allow the debtor to retain ownership, they exhibit low compatibility with *rahn* due to their lack of power of sale and stricter approach to possession. Liens are typically informal and limited to small-scale transactions involving tangible assets.

Unlike *rahn*, which can cover future and intangible assets, liens are restricted to existing, tangible property. This narrow scope further limits their alignment with *Sharīʿah*-compliant security arrangements.

The above comparative analysis highlights significant variations in the compatibility of modern security instruments with *Sharīʿah* principles, particularly the *rahn* contract. Additionally, common law quasi-security arrangements, such as guarantee contracts, and assignments, have comparable Islamic counterparts in *kafālah*/*ḍamān* (guarantee) and *ḥawālah* (transfer of debt) contracts. despite some differences. Meanwhile, another quasi-security instrument, debenture, aligns with the concept of *rahn al-duyūn* based on its debt certificate structure.

7.3.3 Third Research Question

The third research question examines the application of security instruments and assets in selected Islamic project financing, drawing insights from semi-structured interviews with industry experts and supported by literature analysis. These interviews, supplemented by secondary sources, serve as the primary data for this study. The findings divided into two:

(a) The common security arrangements adopted in Islamic project finance project

The findings reveal that the "charge" is the most commonly used security instrument in Islamic project finance in Malaysia, primarily due to its robust legal framework under the Companies Act 2016. While the concept of a mortgage exists for specific assets such as land, vessels, and aircraft, it does not align with the traditional common law definition of a mortgage. This divergence arises because the governing acts in Malaysia restrict the transfer of ownership—a fundamental characteristic of a mortgage—rendering mortgages more akin to charges in practice. In contrast, pledges and liens are less frequently utilized in Islamic project finance due to their limited applicability and operational constraints.

(b) The security assets applied in Islamic project finance

The assets utilized in Islamic project finance vary depending on the nature and requirements of each project. However, this study identifies certain collateral assets commonly applied in Islamic project finance, based on insights gathered from interviews with industry experts and a review of relevant literature. It is important to note that the list of assets provided is not exhaustive but rather illustrative of the types of collateral used in practice. The identified assets include:

1. Land and Real Estate
2. Cash-Based Assets (Deposit and Reserve Accounts)
3. Financial assets including *Sukūk*, bonds, fixed deposits, and receivables
4. Future assets in Floating Charges
5. Shares and Insurance Proceeds
6. Intellectual Property (IP)

The study analyzes the *Sharīʿah* compatibility of each asset class in the fourth research question, providing a detailed examination of how these assets align with Islamic legal principles.

7.3.4 Fourth Research Question

The final research question assesses the *Sharīʿah* compliance status of security instruments and security assets in Islamic project finance. The findings are divided into two key areas:

(a) *Sharīʿah* Compatibility Status of Security Instruments Applied in Islamic Project Finance

As highlighted in Research Question Three, the study reveals that "**charge**" is the most widely used security instrument in Islamic project finance. The application of a charge demonstrates significant compatibility with the *rahn* contract, as it aligns closely with the fundamental principles of *rahn* due to the following reasons:

1. Ownership Retention: Both charge and *rahn* allow the debtor to retain ownership of the asset.
2. Enforceable Security Interest: A charge establishes a clear and enforceable security interest for the creditor, akin to the protection offered under *rahn*, thereby safeguarding the creditor's rights.
3. Flexibility and Versatility: Charges are highly adaptable, covering various asset classes such as real estate, financial instruments, intellectual property, and future receivables, without requiring physical possession, making them closely aligned with *rahn* requirements.
4. Coverage of Future Assets: Unlike pledges or liens, charges can secure future assets, making them ideal for dynamic financial structures like Islamic project finance, where asset portfolios evolve. *Rahn* also supports future assets, in line with the *Mālikī* school's flexible approach, subject to specific conditions.

Based on the above, it is evidence that the compatibility of charges with *rahn* underscores their suitability as a *Sharīʿah*-compliant security instrument in Islamic project finance.

While pledges and liens are used in Islamic project finance, their application is limited. Pledges, though partially compatible with *rahn*, require strict possession, reducing their practicality in modern financing. Liens, with a narrower scope, remain relevant for securing debts through documents of title under statutory frameworks. Conversely, mortgages under Common law are incompatible with Islamic project finance in Malaysia, as local laws prohibit the transfer of legal title to the creditor (mortgagee), preventing their application in *Sharīʿah*-compliant financing structures.

(b) *Sharīʿah* Compatibility Status of Selected Security Assets Applied in Islamic Project Finance

As highlighted in Research Question Three, the study reveals that there is some security assets commonly applied in Islamic project finance in Malaysia. The findings of the compatibility status of the assets will be as follows:

(i) *Real Estate and Land* – Real estate and land are fully *Sharīʿah*-compliant and widely accepted as collateral in Islamic finance due to their tangibility nature as common *rahn* assets. These assets are highly

favored for their ease of valuation, permanence, and ability to mitigate risks effectively.

(ii) *Cash-Based Assets (Deposit and Reserve Account)*– Cash-based assets such as Islamic deposits and reserve accounts are fully *Sharīʿah*-compliant. However, conventional cash-based assets are conditionally permissible, but only to the extent of the principal amount. Any interest (*ribā*) associated with these accounts must be excluded.

(iii) *Receivables/Book Debts* – These assets are allowable as collateral under the concept of *rahn al-duyūn* (pledge of debts), as they confer constructive possession to the creditor. If the receivables include non-compliant elements (e.g., interest-bearing components), the impermissible portions must be excluded.

(iv) *Financial Instruments* – Islamic financial instruments, including Islamic fixed deposits, *Sukūk*, and Islamic unit trusts, are fully *Sharīʿah*-compliant and widely accepted as collateral. Conventional financial instruments, such as bonds or conventional fixed deposits, are conditionally permissible but restricted to the principal amount only. The interest (*ribā*) component is prohibited.

(v) *Shares* – The treatment vary as follows:

- ✓ Non-*Sharīʿah*-compliant shares: Shares of companies engaged in prohibited activities (e.g., liquor, gambling, or other *ḥarām* industries) are not permissible as collateral.
- ✓ Non-Compliance Share due to External Factors: For companies share where non-compliance arises due to external factors (e.g., exceeding financial ratios or thresholds), the shares are conditionally permissible accepted as collateral. The collateral value is limited to the halal portion, and any earnings derived from prohibited activities must be excluded.
- ✓ Mixed-activity shares: Shares of companies operating in both *Sharīʿah*-compliant and non-compliant sectors are conditionally permissible. In such cases, the portion of earnings derived from non-compliant activities (e.g., interest income) must be excluded.

(vi) *Floating Charges (Future assets)– Floating* charges (associated with future assets) are conditionally permissible under the *Mālikī* view,

which allows some degree of uncertainty (*gharar)* in *Rahn* contracts, provided regulatory safeguards are in place to minimize risks.

(vii) *Conventional Insurance Proceeds* – The use of conventional insurance proceeds are conditionally permissible as collateral but only to the extent of the premiums paid by the policyholder. Any returns or benefits derived from interest (*ribā)* or excessive uncertainty (*gharar*) are prohibited.

(viii) *Intellectual Property (IP)* – Intellectual property (IP) is increasingly recognized as a potential collateral asset in Islamic banking. It fulfills the *Sharīʿah* requirements of physical assets, such as being valuable, tradeable, capable of possession, and having some degree of permanence, making it eligible for recognition under *Sharīʿah*.

Conclusion

Most security assets in Islamic project finance comply with *Sharīʿah* principles, except for certain non-compliant assets. Shares in non-*Sharīʿah*-compliant businesses are impermissible due to prohibited activities, while floating charges on future assets may involve *gharar* unless mitigated. Conventional insurance, fixed deposits, and unit trusts are conditionally accepted but limited to the principal amount, excluding *ribā* or non-compliant earnings. Intellectual property (IP), recognized as *haq mālī*, has the potential to be an Islamic collateral asset despite limited market adoption. These findings support expanding the list of *Sharīʿah*-compliant collateral in Islamic banking.

7.4 CONTRIBUTIONS OF THE STUDY

This study was carried out with the motivation to contribute to the understanding and clarification of security arrangements in Islamic project finance for the banking industry in Malaysia. Contributions of this study are divided into several categories as follows: contribution to the body of knowledge and contribution to the banking industry.

7.4.1 Contribution to the Body of Knowledge

This study enhances the academic literature in Islamic finance and project financing by addressing critical gaps in the understanding of security arrangements and their compatibility with *Sharīʿah* principles. The contributions to the academic field include:

(a) *Comprehensive Comparative Analysis:*

This study systematically examines the security instruments used in both Islamic and Common law frameworks, offering a detailed comparative analysis. By evaluating charges, pledges, mortgages, and liens, the study clarifies their similarities, differences, and potential adaptability to Islamic finance. This comparative approach contributes a new dimension to existing literature, providing an empirical foundation for future scholarly inquiry into Islamic legal perspectives on security instruments.

(b) *Clarification of Legal and Sharīʿah Perspectives on Security Arrangements:*

The study delves into the legal intricacies of modern security arrangements, assessing their compliance with *Sharīʿah* principles. It bridges Islamic jurisprudence and financial law, offering clarity on how Islamic security mechanisms can function effectively within modern financial systems.

(c) *Expansion of Islamic Project Finance Literature:*

The study addresses a major research gap by exploring security mechanisms in Islamic project finance, a subject previously underexplored in Islamic finance literature. It extends theoretical discussions on *Sharīʿah*-compliant risk mitigation tools, particularly by examining how Islamic security instruments can serve as viable alternatives to conventional collateral mechanisms. This contribution paves the way for further academic inquiry into the evolution of *Sharīʿah*-compliant security arrangements in financing structures such as *sukūk*, structured Islamic financing, and project-based Islamic funding models.

(d) *Integration of Practical Applications with Theoretical Foundations:*

By linking *Sharīʿah* principles with real-world applications of security arrangements, the study enhances the academic understanding of how security instruments function in Islamic project finance practice. The findings provide valuable empirical insights into how Islamic financial institutions structure security arrangements, making this study a useful

reference for academics, researchers, and students of Islamic finance and law.

7.4.2 Contribution to the Banking Industry

The study offers practical contributions to the banking and financial industry, particularly in Islamic project financing and risk management. It provides financial institutions, policymakers, and regulators with critical insights into the use of security arrangements in *Sharīʿah*-compliant financing.

(a) Improved Risk Management Strategies

By clarifying the *Sharīʿah*-compliance of security instruments, the study provides Islamic financial institutions with a clearer framework for structuring security arrangements in a way that mitigates credit and default risks. The findings enhance the ability of banks to secure Islamic financing transactions, reducing exposure to non-performing assets while adhering to *Sharīʿah* principles.

(b) Guidance for Regulators and Industry Practitioners

The study serves as a key reference for regulators, policymakers, and industry practitioners in developing standardized *Sharīʿah*-compliant security policies. It supports the formulation of comprehensive legal and regulatory frameworks, ensuring greater legal certainty in the use of security instruments in Islamic project finance.

(c) Expansion of Acceptable Security Assets in Islamic Banking

The study expands the scope of *Sharīʿah*-compliant security assets, enabling financial institutions to diversify collateral arrangements. By validating the *Sharīʿah* compliance of alternative assets such as intellectual property (IP), receivables, and floating charges, it encourages Islamic banks to broaden their collateral base, enhancing financial inclusion and asset securitization within Islamic finance.

7.5 RECOMMENDATIONS

This study identifies several critical gaps in the existing framework for security arrangements in Islamic project finance, particularly in relation to *Sharīʿah* compliance, legal enforceability, and industry standardization. To address these challenges and bridge the gaps highlighted in the research, the following key recommendations are proposed for regulators and financial institutions:

(a) *Standardizing the Application of Rahn and Its Compatibility with Modern Security Instruments*

The study identifies inconsistencies in the interpretation and application of *rahn* across various *Sharīʿah* standards and regulatory bodies, particularly concerning its legal classification and enforceability alongside Common law security instruments. Regulators and Islamic financial institutions should work towards harmonizing the definition and application of *rahn*, ensuring that security instruments such as charges, pledges, and others are clearly recognized and enforceable under both Islamic and conventional legal frameworks.

(b) *Establishing Clear Sharīʿah Guidelines for Floating Charges and Other Modern Security Arrangements*

The study highlights a lack of *Sharīʿah* clarity on floating charges, particularly in relation to future assets and their alignment with the *rahn* contract. Regulatory bodies, in collaboration with *Sharīʿah* scholars, should define acceptable conditions for floating charges, ensuring they comply with Islamic jurisprudence while remaining legally and financially viable. A *Sharīʿah*-compliant framework should establish clear parameters for floating charges, ensuring their practical application without excessive *gharar* (uncertainty).

(c) *Expanding the Range of Acceptable Sharīʿah-Compliant Collateral Assets*

The study identifies a narrow scope of acceptable security assets in Islamic finance, particularly in relation to intellectual property (IP), receivables, and future assets. Regulators should establish clear criteria for the inclusion of intangible assets as *Sharīʿah*-compliant collateral, ensuring they meet ownership, valuation, and transferability requirements under Islamic law. Financial institutions should also develop comprehensive risk management

frameworks to assess the *Sharīʿah* compliance and financial viability of alternative collateral assets.

(d) *Establishing Clear Guidelines on the Use of Sharīʿah Non-Compliant Financial Assets*

The study highlights that existing *Sharīʿah* resolutions only cover a limited range of conventional financial assets, such as bonds, conventional fixed deposits, and unit trusts, while the use of other conventional products, such as insurance proceeds, debentures, and other conventional financial instruments, remains inadequately addressed. Regulators and financial institutions should develop clear and comprehensive guidelines on the use of *Sharīʿah* non-compliant financial assets, particularly in structuring mechanisms that exclude *ribā*, *gharar*, and prohibited elements.

These recommendations aim to enhance regulatory clarity, legal enforceability, and the scope of security arrangements in Islamic project finance. By adopting the above suggestions, the regulators and financial institutions can strengthen Islamic secured financing while ensuring *Sharīʿah* and legal compliance.

7.6 SUGGESTIONS FOR FUTURE RESEARCH

While this study has significantly contributed to the understanding of security arrangements in Islamic project finance, further research is needed to address emerging challenges and enhance the applicability of *Sharīʿah*-compliant security instruments. The following three key areas are recommended for future studies:

(a) *The Effectiveness of Security Arrangements in Reducing Default Risks in Islamic Project Finance:*

Future research should conduct empirical studies to analyze the effectiveness of Islamic security mechanisms in mitigating credit risk and reducing default rates. A comparative study between Islamic and conventional project finance could assess whether *Sharīʿah*-compliant security instruments, such as *rahn*, *kafālah*, and other types of Islamic collateral, provide superior financial protection.

(b) *The Role of Regulatory Frameworks in Shaping Security Instruments within Islamic Banking:*

A cross-jurisdictional analysis could examine how different regulatory environments influence the enforceability and recognition of Islamic security arrangements. Given the variations in legal systems across Malaysia, the GCC, and other Islamic finance jurisdictions, future research could evaluate whether standardized legal frameworks or policy reforms are needed to enhance legal certainty, risk mitigation, and cross-border enforceability of *Sharīʿah*-compliant security instruments.

(c) *Integration of Financial Technology (FinTech) in Islamic Security Arrangements*

With the rise of blockchain, smart contracts, and tokenized assets, future research could explore their *Sharīʿah* permissibility and potential to enhance transparency, enforceability, and efficiency in security mechanisms. Studies could examine the feasibility of blockchain-based smart contracts for *rahn* transactions, ensuring automated compliance and reducing legal ambiguity in Islamic project finance security arrangements.

7.7 CHAPTER SUMMARY

This study has provided a comprehensive analysis of security instruments in Islamic project finance, clarifying their legal, practice and *Sharīʿah* implications. The findings contribute significantly to academic literature, offering practical recommendations for industry practitioners, regulators, and policymakers. By addressing key gaps in security arrangements, this study lays the foundation for enhancing risk management frameworks in Islamic project finance, ensuring greater *Sharīʿah*-compliance, financial stability, and legal clarity.

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APPENDIX I

INTERVIEW ON THE APPLICATIONS OF COLLATERAL INSTRUMENTS AND ASSETS IN ISLAMIC PROJECT FINANCING: A *SHARĪʿAH* PERSPECTIVE ANALYSIS

This interview questions are designed to understand the practices among Islamic banks in Malaysia regarding the application of security or collateral arrangements in current Islamic project financing. The results of this research are expected to provide a clear overview regarding the application of collateral instruments or also known as security interests and its collateral assets which provide avenue to the researchers to identify the various types of collateral arrangement as practiced by Islamic banks in Islamic project financing in Malaysia. Analyses of the salient features of different security/collateral instruments and assets will then be made with a view of ascertaining their compatibility or otherwise with the *Sharīʿah* principles. The finding of the research will be used to develop a *Sharīʿah* compatibility table or parameters for securities/ collaterals. This parameter is expected to enable an evaluation to be done on collaterals to ensure the *Sharīʿah* compatibility or otherwise of the various collateral arrangements used in Islamic project financing transactions.

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APPENDIX II

INTERVIEW QUESTIONS (*SHARĪʿAH*)

Concept of Collateral Instruments and Its Assets from the *Sharīʿah* Perspective

1. What is your understanding of the term and concept of collateral instruments and collateral assets within the context of Islamic law?

2. What types of *Sharīʿah* contracts are commonly used as collateral instruments?

3. What are the most commonly accepted collateral assets/ asset classes for collateral purposes in Islamic project finance?

4. How does your bank ensure that the collateral instruments and collateral assets used in Islamic project financing comply with *Sharīʿah* requirements? Are there any specific *Sharīʿah* guidelines or frameworks that your bank follows to ensure compliance in this area?

5. Can you explain the application of the collateral instruments and collateral assets in Islamic project finance and are the any potential *Sharīʿah* issues arising from its?

APPENDIX III

INTERVIEW QUESTIONS (ISLAMIC BANKING PRACTITIONERS)

Applications of Security Interests and Security Assets in Islamic Project Financing

1. What is your understanding of the term and concept of collateral instruments and collateral assets in in the context of Islamic project financing?

2. What types of collateral assets are commonly accepted by the bank for collateral purposes in Islamic project finance?

3. How are collateral instruments and collateral assets applied in Islamic project financing?

4. How important are the roles of collateral instruments and collateral assets in Islamic project finance?

5. What are the challenges in applying collateral assets in Islamic project financing compared to conventional project financing?