

SBBA Transaction: Shariah Issues and Implications

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Abstract

SBBA is an Islamic instrument used by Islamic banks to enhance liquidity and hence enables Islamic banks to remain competitive in the market. However, some Shariah issues related to the underlying principle of SBBA have been raised such as the issue of *wa'ad mulzim*. Since there is no unanimous view on the legality of *wa'ad mulzim*, the Shariah status of SBBA becomes controversial and debatable among the scholars. Therefore, this paper aims to discuss the Shariah issues surrounding the SBBA such as *wa'ad mulzim* and *bay' al-'inah* to see whether or not the controversial Shariah concepts embedded in SBBA plays a vital role to serve the *maqasid al-Shari'ah* or otherwise. For that purpose, the implications of SBBA are also analysed to comprehend the role of SBBA in facilitating liquidity management for Islamic banks. It is found that the *wa'ad mulzim* is instrumental in SBBA as it serves as an alternative mechanism to overcome sale with condition which is considered illegal. *Wa'ad mulzim* is also a form of *makharij* which is thereafter subject to Shariah parameters for the application of *makharij* in Islamic finance. In this regard, SBBA is found to have been in compliance with the parameters especially in the actualization *maqasid al-Shariah*. Library method as well as analytical method is employed in this study to understand the nature of SBBA and the juristic views on *wa'ad mulzim*.

Keywords: Sale and Buy Back Agreement (SBBA), *wa'ad mulzim*, *maqasid al-Shariah*, bilateral promise

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Introduction

The central bank (or simply written as the Bank) has several options to choose on the monetary policy tools.⁴ One of these tools is known as SBBA or repurchase agreement. SBBA can be defined as a sell and buy back agreement which is an Islamic money market transaction entered into by two parties in which a seller sells Islamic financial instruments to a buyer at an agreed price, and subsequently both parties enter into a separate agreement in which the buyer promises to sell back the said financial instrument to the seller at an agreed price⁵.

The Bank may use SBBA to withdraw or neutralize cash in the banking system. For example, a recent report produced by Bloomberg, the Bank may conduct a tri-party reverse repurchase agreement with agency mortgage securities to test one of the tools for an eventual withdrawal of the Bank's unprecedented monetary stimulus.⁶ The eligible collateral for this SBBA, which includes for the first time agency mortgage backed securities.⁷ The aggressiveness of using this tool was due to the failure of the Bank to withdraw the more than USD1 trillion they have pumped into the financial system to combat the deepest recession since the 1930s through the Bank cut its benchmark interest rate to as low as zero in December 2009.

The introduction of Islamic banking system in Malaysia raises the question on the lack of instruments to be utilized for the purpose of enhancing liquidity in the Islamic interbank money market and providing additional avenue for the later participants to source their funding requirements. Hence, sale and buy back agreement (SBBA) was introduced as an Islamic financial instrument. The Bank also issued the Guidance Notes on SBBA on August 2002. It seems that the Bank also has the choice to use this instrument as monetary policy tools. Islamic banks use this instrument in managing their liquidity.

In recently concluded Muzakarah Penasihat Syariah Kewangan Islam, KLIFF 2010, the shari'ah issues of SBBA or Islamic Repo had been scrutinised again.⁸ Shari'ah scholars such as Dr. Aznan Hasan, Dr. Shamsiah Mohamad and Ahmad Suhaimi Yahya argued that the use of SBBA may raise several shari'ah issues such as i) muwa'adah: promise to buy and re-sell at a pre-agreed price in the future and ii) the presence of *bay' al-inah* element in the structure of SBBA. Although the Shariah Advisory Council of Central Bank of Malaysia has already determined that the transactions of *bay' al-Inah* in the money market between Islamic banks are permissible⁹, there is still room for revisiting other shariah issues that surrounding the SBBA.

The name of this instrument shows that both contracting parties promise to buy or re-sell the collateral in future. The shariah scholars agree that the purpose of this instrument is essential for cash line financing in the interbank money market.¹⁰ It raises two *Shari'ah* issues: what is the status and legal effect of a promise in a contract? And whether it is permissible in the *Shari'ah* to stipulate a condition to buy or re-sell the same asset in a contract of sale? However, from a prudential point of view and risk management perspective, it is important to understand the value of *Wa'ad* in *Shari'a*. This issue has given rise to interesting legal and *Shari'a* discussions which have repercussions on structures that use the *Wa'ad* concept.

4 Refer to Ismail (2010) Tools for Controlling Monetary Variables in the Islamic Banking System. ISRA Research Paper No 13.

⁵ http://www.klse.com.my/website/bm/regulation/rules/bursa_rules/downloads/bm_bonds_ch-1.pdf

⁶ As announced on 3rd August 2010. Refer to <http://www.businessweek.com/news/2010-08-03/fed-to-conduct-reverse-repo-tests-as-part-of-readiness-program.html>

⁷ Before this, the collateral was limited to Treasuries and direct agency securities.

⁸ This muzakarah was held on 2nd August 2010 at Nikko Hotel Kuala Lumpur.

⁹ Shariah Resolutions in Islamic Finance, 1st edition, Bank Negara Malaysia, 2007, page 26.

¹⁰ Refer to the National Shariah Council decision at 13th meeting, held on 10th April 2000 / 5th Muharram 1421. The council resolved that *wa'd* in the sale and buy-back agreement is permissible, provided that *wa'd* is not stipulated as a condition for the sale and purchase of the asset. Refer to <http://www.isra.my/fatwas/treasury/interbank/murabaha/152-sale-and-buy-back-agreement-repo.html>

This paper is aimed to revisit those issues in the light of *wa'ad mulzim* that embedded in the SBBA transaction. The remaining discussion of this paper will be divided into three main sections; the features of SBBA, the Shariah issues surrounding the development of sound and the efficient SBBA markets and the implications on risk and accounting treatment. The final section contains concluding thoughts and summary of this paper.

2. Features of SBBA (Sale and Buy Back Agreement)

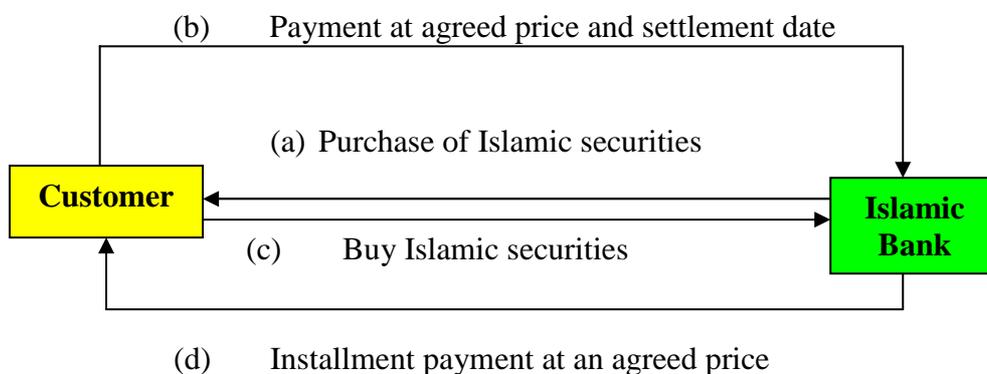
The introduction of sale and buy back agreement (SBBA) as an Islamic financial instrument is aimed to enhance the liquidity in the Islamic Inter-bank Money Market (IIMM) and provide additional avenues for the IIMM participants to source their funding requirements. The rapid development of the Islamic banking system has necessitated the need to create additional instruments for IIMM to address the expanded requirements of Islamic banking participants.

SBBA transactions involve the following steps: (i) Commitment by a party to sell Islamic securities and the other to purchase the Islamic securities, and both parties subsequently promise to perform the reversal at a future date; and (ii) Results in transfer of ownership of the transacted Islamic securities under SBBA. The SBBA is similar to the repurchase (repo) agreement and has been modified to comply with shariah principles.

Securities that are sold by a seller to a buyer at an agreed price, and subsequently, both parties enter into a separate agreement in which the buyer promises to sell back the said asset to the seller at an agreed price. Conditions to buy back will make sales and repurchases null and void but promises will not invalidate them.

The basic elements of SBBA transactions are summarized as follows:

- i) **Basis of Trading**
SBBA transaction shall be traded based on price.
- ii) **Transfer of Ownership**
Ownership of the Islamic securities sold under SBBA shall be transferred from the seller to the buyer.
- iii) **Dealing in SBBA Transaction**
Transacting parties may conduct SBBA transactions via the money brokers or through direct dealing. Both parties shall negotiate the terms of SBBA and agree among others on the type of Islamic securities, SBBA price, tenure and settlement date. The various aspects of risk assessment shall be given due consideration prior to concluding the SBBA transaction.
- iv) **SBBA Agreements, as shown in Diagram 1:**
The parties shall enter into two separate agreements as follows:
 - a) First agreement – the SBBA seller sells outright Islamic securities to the SBBA buyer at an agreed price and settlement date.
 - b) Second agreement – the SBBA buyer promises to sell back the Islamic securities to the SBBA seller, who shall also promise to buy back the instrument at an agreed price and at a future settlement date.
The undertaking made by both the SBBA buyer and SBBA seller to sell and buy back the instrument respectively at the maturity date of the SBBA shall be based on promise. To maintain market, integrity and ensure the smooth operation of the IIMM, the parties should be mindful to perform their obligations as promised.

Diagram 1: SBBA Transaction

- v) **Initiation of SBBA Transaction**
 On value date, the SBBA seller may initiate the SBBA transaction where specified securities are sold and transferred to the SBBA buyer for an agreed cash consideration. Ownership of the securities shall be transferred to the SBBA buyer upon conclusion of the first agreement on the SBBA.
- vi) **Matured SBBA Transaction**
 On maturity date, the SBBA buyer shall perform the reversal of the initial SBBA transaction by selling back specified Islamic securities to the SBBA seller for an agreed cash consideration as promised.

The proceeds shall be calculated based on specific Islamic securities. The rules on Bond Information and Dissemination System (BIDS) provide references for the formula applied on certain scripless Islamic securities and calculation of proceeds for SBBA transactions respectively. BIDS provide the information on BNM's indicative price and last traded price. While the money broker's quote will take the following form: bid and offer price; last traded price; mid price of bid and offer price; and indicative price.

However, in SBBA transactions where the market price cannot be obtained or the available market prices are not sufficiently reliable, then benchmarking will be used. Benchmarking could be done against: private debt securities indicative Yield-to-Maturity (YTM) in BIDS; government securities YTM in BIDS; BNM's indicative prices in BIDS; market value of other comparable instruments; and cost of funds plus margin.

With the above features, SBBA (which is similar to repurchase agreement or repo in conventional transactions) can act as instrument for monetary policy operations. The Bank can specify monetary policy operations either as the SBBA or as collateralised financing (pledge) or both of them.¹¹ Therefore, the SBBA can be an important source of collateral for monetary policy operations and facilitates the circulation of collateral between market participants. As a result, the quoted rates of the SBBA market are a key source of information on the short-term benchmark rate and allow monitoring the financing conditions in the inter-bank market (spreads repo rate-klibor). Hence, it contributes to the circulation of the Bank liquidity and to the transmission of monetary policy. In addition, the question arises on the Bank commitment towards fostering the integration of the financial system among the Islamic financial centres has a particular relevance in the case of the SBBA market (link between various market). The initiatives of the Bank towards the integration of the SBBA market need: (i) the support of the harmonization of shariah rulings of the SBBA

¹¹ The financing operations have to be based on adequate collateral, in order to protect the financial system from financial losses.

transaction; (ii) the broad range of securities accepted as collateral which might facilitate the expansion of SBBA market; and (iii) the definition of standards by the AAOIFI in the fields of clearing and settlement.

3. Shariah Issues Surrounding the Development of Sound and Efficient SBBA Markets

Based on the features of SBBA, several key issues in shariah will be discussed here. The aim is to rectify the legal aspects in Islamic finance which represent an important connection between the governing shariah principles and the practice of Islamic finance. The application of shariah principles in the light of the governing laws and regulations in each Islamic financial transaction are interpreted through legal advice, in legal documentation of the financial transactions, and dealing with disputes. In documenting financial transactions based on specific shariah principles that underlie a financial product, the legal documentation reflects the tenets of shariah and that it is in full compliance with the laws and regulations governing the financial transactions. Varying interpretations of shariah in particular between countries adds to the complexity when cross-border transactions are involved.

Therefore, the shariah issues surrounding the SBBA markets will be linked to the underlying contracts, namely *wa'ad*. In the following discussion, we will highlight the shariah issues related to *wa'ad* as promise.

The *Wa'ad* is an Arabic word which literally means “a promise”. For example, in *Murabahah* transaction, where the purchaser promises the seller to buy a certain asset from the seller in the event the seller buys this asset from a third party.¹² As a promise, shariah scholars have different views on the legality of this concept. Scholars such as Syeikh Mustafa al-Zarqa, Dr. Yusuf al-Qaradawi and Dr. Hasan al-Shadhli¹³ agree that a *Wa'ad* related to a commercial transaction is binding under Sharia'h. However, this was not the case for the traditional Islamic jurists, such as Abu Hanifah¹⁴ and al-Shafi'i¹⁵

The Islamic Fiqh Academy (in short “the IFA”) has decided that the *Wa'ad* is “obligatory not only in the eyes of God but also in a court of law” when:

- it is made in commercial transactions;
- it is a unilateral promise; and
- it has caused the promisee to incur liabilities;

It is also a requirement that the actual sale - if the promise was in respect of selling a certain asset - to be concluded at the time of exchange of the offer and the acceptance (during *Majlis Al Aqd*) and not at the time of the *Wa'ad*. The IFA also agrees that the promisee also has the possibility to claim actual damages from the promisor, if the promisor backs out on a *Wa'ad*. Therefore, some versions of *Wa'ad* remain voluntary while others are obligatory.

The AAOIFI have not issued a standard governing the *Wa'ad*, nevertheless, it is referred to in many of the Standards (see for example paragraph 8 of standard No 9 of the AAOIFI *Shari'a* standards - *Ijarah and Ijarah Muntahia Bittamleek*). Also, some forms of *Wa'ad* are prohibited.¹⁶ The AAOIFI provides some guidelines, below are a few example:

- “...a bilateral promise to purchase and sell currencies is forbidden if the promise is binding ...” (paragraph 2/9 of Standard No. 1 of the AAOIFI *Shari'a* Standards - Bilateral promise to purchase and sell currencies).

¹² For more details about the *Murabaha* to the purchase orderer, please refer to Standard No 8 of the AAOIFI *Shari'a* Standards (2008), paragraph no. 2/3.

¹³ Rafiq Yunus al-Masri (2001), *al-Iqtisad al-Islami, Majallah Jami'ah al-Malik 'Abd al-'Aziz*, 28th October 2001

¹⁴ Kamal Ibn al-Humam (t.t), *Fath al-Qadir*, v.3. Beirut: Dar al-Fikr, pg: 173

¹⁵ Al-Nawawi (1997), *al-Adhkar min Kalam Sayyid al-Abrar*, v. 2. Riyad; Maktabah Mustafa al-Baz, pg: 376

¹⁶ For example, the separate document proofing a promise of sale contingent on a particular event should be independent of the contract of *Ijarah Muntahia Bittamleek* and cannot be taken as in integral part of the contract of *ijarah*.

- "...a binding promise is binding on one party only, while the other party must have the option not to proceed..." (paragraph 8/2 of standard no 9 of the AAOIFI *Shari'a* Standards – Transfer of the ownership in the leased property in *Ijarah Muntahia Bittamleek*).

The reason behind the prohibition is that the bilateral promises between the same parties in respect of the same asset are equivalent to a contract, where both countervalues are deferred. Such contract is prohibited under *Shari'a*.

Other views on how a *Wa'ad* can operate can be seen in the following example:

- "...the document of promise to buy should include a bilateral promise which is binding on both parties..." (Paragraph 2/3 of standard no 8 of the AAOIFI *Shari'a* Standards – The promise from the customer)

The main points from the above examples are as follows:

- i. the bilateral promise is permissible whenever it includes an option to cancel the promise. This option may be given to both parties or to one of them (Paragraph 2/3/3 of Standard No 8 of the AAOIFI *Shari'a* Standards);
- ii. it is possible to change the terms of the promise if both parties agree to such change. No party can solely change the terms of the promise. However, such a change cannot be effected if the parties have executed their obligations under the *Murabaha* (or the relevant agreement) (Paragraph 2/3/4 of Standard No 8 of the AAOIFI *Shari'a* Standards).

The conclusion is that changes to the *Wa'ad* are only valid as long as the parties did not enter into the agreement referred to in the *Wa'ad*. However, if one of the parties insists on changing the terms of the promise, then the changes will constitute a new promise granted by this party to the other - the *Wa'ad* is a standalone agreement. It is not supposed to be embedded in any underlying agreement. For example paragraph 8 of standard No 9 of the AAOIFI *Shari'a* Standards (*Ijarah and Ijarah Muntahia Bittamleek*) states that "...the method transferring the asset to the lessee must be evidenced in a document separate from the *Ijarah* contract documents..." and that "... the separate document evidencing a promise.. should be independent of the contract of *Ijarah Muntahia Bittamleek* and cannot be taken as an integral part of the contract of *Ijarah*"¹⁷.

It should be noted that a *Wa'ad* cannot be used as a mechanism to circumvent *Shari'a* prohibitions. Scholars do not lack the means of prohibiting such structures where each agreement taken separately is *Shari'a*-compliant but when read jointly the structure seems to be less *Shari'a*-compliant. Clause 3 of *Majallah Al Ahkam Al Adliyah* (the *Shari'a* Codification by the Ottomans) provides that "*the real reason of contracts is for the objectives and not for the literal wordings*".

The above discussion also signifies that *wa'ad* has been used as a Syariah tool to legalize the so called '*inah* contract embedded in SBBA. The '*inah* contract is rendered null and void if it is contracted on the condition that the securities will be repurchased by the seller. In this regard, *wa'ad* is used as a measure to free the '*inah* contract from stipulation of condition. Since '*inah* contract itself is a form of legal trick to circumvent *riba* as argued by some jurists such as Ibn Qayyim¹⁸, the application of *wa'ad* in SBBA must be looked into from the Shariah perspective of the application of *hilah* and *makharij* in Islamic finance. A majority of scholars divided *hilah* into two classifications namely permissible *hilah* and impermissible *hilah*. However, scholars who legalize *hilah* under certain circumstances such as al-Shatibi¹⁹ and Ibn Qayyim al-Jawziyyah²⁰ prescribed some conditions to be fulfilled in the usage of *hilah*. The conditions include consideration of *ma'lat al-af'al* which takes the form of *qasd al-Syari'*²¹ and the motive of *mutahayyil* which is termed as *qasd al-mukallaf*.

¹⁷ See also paragraph 2/3/2 of Standard No 8 of the AAOIFI *Shari'a* Standards.

¹⁸ Ibn Qayyim al-Jawziyyah (1973), '*Ilam al-muwaqqi' in 'an Rabb al-'Alamin*, Beirut, Dar al-Jayl, V. 1, pg 288.

¹⁹ Al-Shatibi (2003), '*al-Muwafaqat fi Usul al-Syari'ah*, v. 2. Beirut: Dar al-Kutub al-'Ilmiyyah, pg: 93

²⁰ Ibn Qayyim al-Jawziyyah (1973), '*Ilam al-muwaqqi' in 'an Rabb al-'Alamin*, v. 3. Beirut: Dar al-Jayl, pg: 335

²¹ '*Qasd al-Syari'* is defined by al-Amidi as securing benefit or avoiding harm or both of them. See al-Amidi (2003), '*Al-Ihkam fî Usul al-Ahkam*, v. 3. Beirut: Dar al-Fikr, pg: 183, al-Ghazali defines it as preservation the five essential aspects of human life namely religion, life, intellect, lineage and property. See AbË ×amËd al-

Therefore, *wa'ad* as a form of *hilah* and *makharij* must be examined based on the guidelines of permissible *hilah*. According to the guidelines, the application of *wa'ad* in SBBA should be able to meet the *qasd al-Syari* or *maqasid al-Shariah* in the sense that it does not violate any of the *maqasid* which is of important priority such as *maqasid kulliyah*²², *maqasid 'ammah*²³, *maqasid asliyyah*²⁴ and *maqasid daruriyyah*²⁵.

It is worthy to specify in the first place the status of *wa'ad* from the perspective of *maqasid al-Shariah* as to which level of *maqasid al-Syari'ah* it belongs. It is believed that *wa'ad* in this regard assumes the highest level of the above-mentioned *maqasid al-Shariah*. This is because the previous discussion sheds light on the fact that SBBA is instrumental to facilitate liquidity management for Islamic banks. It is also commonly known that liquidity is very significant for the survival of Islamic banks without which the Islamic banks will be in trouble. Therefore, a special Syariah treatment is necessary to overcome the problem of liquidity or to facilitate it to the extent that Islamic banks can be competitive in the market. *Wa'ad* can play a vital role in SBBA to ensure that *'inah* which serves as the underlying contract for SBBA is practiced accordingly.

However, if it is proven that *wa'ad* in SBBA does not actualize the *maqasid al-Shariah* as it serves as a mechanism to satisfy the interest of certain group (*maqasid juzi'yyah*)²⁶ at the expense of the highest level of *maqasid al-Syari'ah*, then *wa'ad mulzim* in this case is considered impermissible despite that some jurists especially contemporary jurists argue that *wa'ad mulzim* is permissible. In other word, the juristic view on the prohibition of *wa'ad mulzim* in financial transactions is applicable. This is in line with the principle of *maqasid al-Shariah* laid down by al-Shatibi as follows:

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“If a general principle is established on the basis of *istiqra'* then comes a Syariah text on a specific ruling which contradicts the general principle in any form of contradiction that it may take, both must be reconciled because *Syari'* does not prescribe a specific ruling except with preservation of the general principle.”

GhazzÉlÉ (t.t), *al-MustaîfÉ fÉ 'Ilm al-UÎÉl*, v. 1. Beirut: DÉR IÍyÉ' al-TurÉth al-'ArabÉ, pg: 216, al-Shatibi defines it the preservation of necessities, needs and refinements. See al-Shatibi (1421H), *al-Muwafaqat fi usul al-Syari'ah*, v. 3. Jumhuriyyah Misr al-'Arabiyyah: Dar Ib 'Affan, pg: 24

²² *Maqasid Kulliyah* refers to the objective of Shariah intended for the whole of ummah () or for a large group of the ummah. See Ibn 'Ashur (1998), *Maqasid al-Syariah al-Islamiyyah*, T.T.P: al-Basai'r li al-Intaj al-'Ilmi, pg: .220

²³ *Maqasid 'Ammah* refers to the general objective of Shariah which includes the wisdom of Shariah and the secrets intended by Shariah in all Shariah rulings or most of them. This comprises the nature of man (), tolerance (), simplicity (), avoiding difficulty () and harm (). See Ibn 'Ashur, *op.cit.*, pg: 171

²⁴ *MaqÉlÉid AÎliyyah* refers to the objective of Shariah intended from the very beginning () of the imposition of Shariah ruling. Allah prescribes this objective for the *mukallaf* without considering their situations as priority. The priority is given to the preservation the necessities (*daruriyyat*) for the sake of their survival. See al-Shatibi (t.t), *al-Muwafaqat fi usul al-Syari'ah*, v. 2. pg: 176-177

²⁵ It is defined as the objective of Shariah that must be protected to secure masalahah in worldly life and hereafter. It assumes the highest level of *maqasid al-Syari'ah* because its absence will ruin the human system of life. See Al-Shatibi (1991), *al-Muwafaqat*, j. 2. Beirut: Dar al-Kutub al-'Ilmiyyah, h. 7

²⁶ *Maqasid Juzi'yyah* refers to any interest, benefit or good secured for certain individuals or small group of the ummah. See Ibn 'Ashur (1998), *op.cit.*, pg: 220

²⁷ Al-Shatibi (t.t), *al-Muwafaqat*, j. 3, Beirut: Dar al-M'arifah, h. 9

He further said:

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“The second (*dalil*) which is the probable (*dalil*) supported by definitive evidence, using it is prevalent”

Al-Shatibi’s argument indicates that a disagreeable Syariah ruling which is based on probable evidence and against another Shariah ruling can be applied if it serves the *maqasid al-Shariah* or the general principle of Shariah.

4. Implications on Risk and Accounting Treatment

The following describes the common underlying risks in SBBA and some commonly adopted risk management techniques.

(a) Risk

(i) Legal Risk

Legal certainty of transactions: SBBA are undertaken on the basis of a title transfer. Under this approach, funds and securities are transferred against an obligation of the transferee to return the funds and equivalent securities on the maturity of the contract. Like any contract, SBBA may be unenforceable because the counterpart lacks the capacity or authority to enter into repo agreements, or the counterparty may be subjected to certain restrictions imposed on their capacity or authority to engage in SBBA. The use of SBBA may run the risk that a court will re-characterise the transaction as a collateralised loan if documents supporting the transactions were not carefully crafted. Standard legal agreements or master agreements have been developed to address the various legal aspects of SBBA, and clarify the roles and responsibilities of the participants and the legal framework in a particular jurisdiction.

Master agreements: A master agreement is a legal document that specifies the terms that apply to all transactions between parties, or a defined subset of transactions, including remedies in the event of counterparty default. Subsequent transactions between the same parties are consequently subjected to the master agreement through the use of confirmations that supplement the master agreement.²⁹ The master agreement also reduces the burdens associated with negotiating legal and credit terms on a transaction-by-transaction basis. The PSA/ISMA Global Master Repurchase Agreement (GMRA) is commonly used for SBBA.

The following are normally included in master agreements:

- Capacity of the parties, either as agents or principals
- Authority of the parties to purchase or sell securities
- Absolute transfer of legal title
- Market risk management such as mark to market, margin percentages, substitution or re-pricing
- Arrangements for delivery/receipt of securities
- Treatment of dividends payments and timing of payments
- Default procedures and the consequential rights and obligations of the counterparties, including rights of set-off
- Governing law of the agreement

²⁸ Al-Shatibi (t.t), *al-Muwafaqat*, j. 3, Beirut: Dar al-M’arifah, h. 15

²⁹ An example of master agreement can be seen in <http://www.sifma.org/services/stdforms/pdf/95globalrepo.pdf>

Set-off of mutual debts: (Muqassah) The legal enforceability of the right of set-off in the event of an insolvency, is essential in a contract under title transfer due to the obligation of the transferee to return the fund or equivalent securities at maturity. The mutual set-off in the case of a counterparty default is generally recognised. SBBA participants with multiple transactions with each other may seek to enter into a single master agreement that provides for the close-out netting of obligations under all contracts made under the agreement in the event of a default of either counterparty.

Custody: In the custody and management of securities assets, custody risk may arise when the practices and management of securities under custody and the roles and responsibilities of the agent and the principal are unclear. It is beneficial, both for the principals and agents to avoid ambiguities by specifying the rights and obligations of the agent and the principal in the legal agreements. Some custodian agents grant indemnity to compensate for damages or loss. A fairly standard practice is for agent banks to offer the principal indemnification against losses arising from counterparty default.

(ii) Market Risk

Credit evaluation: Participants of SBBA may be exposed to counterparty risk in the event of a counterparty default. Prior to conducting any repo transactions, participants would conduct formal credit evaluations and impose a credit limit on their counterparties. A formal credit evaluation involves participants acquiring comprehensive financial information about the counterparty in order to understand the financial capacity, risk profile and risk management strategy of the counterparty. Formal credit ratings from rating agencies may be used by participants to ensure their counterparties' creditworthiness. Generally, participants set differing limits based on the credit evaluation of their counterparties.

Marking-to-market (re-pricing): A decline in the market value of the securities sold in SBBA creates a credit exposure for the repo buyer, as the value of the securities asset is now lower than the cash value. To mitigate this exposure, marking-to-market is practiced to revalue SBBA using current market prices. The value of all SBBA are usually marked-to-market (or re-priced) on a daily basis to reflect changes in market prices and to re-calculate exposures. Without proper re-pricing, exposure arising from price movements may not be immediately recognised. Mark-to-market margining allows repo buyers to call for additional cash or securities assets from the seller. Notification and settlement of margin calls should be timely and damages for nonperformances of margin calls should be established in legal agreements.

Liquidity: Liquidity risk is the risk that the counterparty cannot settle an obligation for the full value when it is due, but would be able to settle on some unspecified date thereafter. The reason for the counterparty's inability to settle is usually temporary, for example, from a demand for large quantities of securities or funds that renders the counterparty unable to meet its obligations when due. Another reason could be the counterparty's inability to unwind its short outright position. One way to manage the overall liquidity is through the use of buffer securities or reserve cash. The size of buffer may be determined partly by the seller's willingness to sell, and partly by the participant's own risk management policy, for example, a higher buffer for less liquid issues. Some sellers manage their overall liquidity by selling not more than three days' worth of the underlying security's turnover.

(iii) Operational Risk

Trading and settlement procedures in the SBBA market may give rise to operational risk and lead to the occurrences of settlement fails. The following are some common measures used to mitigate operational risk:

- Maintaining a high degree of separation of duties for trading, operations, accounting, client services, marketing, asset/liability and risk management, legal services and compliance.
- Ensuring trades fall within credit limits for counterparties and overall trading limits.

- Ensuring that details of trade confirmation are complete and properly issued and that transactions are accurately recorded in internal systems
- Applying appropriate haircuts and margin call practices
- Emphasising management's role in measuring, monitoring and controlling credit and market risks
- Setting appropriate fail clauses in legal agreements to ensure that the technical (temporary) inability to deliver securities does not give rise to a formal default.

(b) Accounting, Tax and Zakat Treatment of Securities in SBBA

(i) Accounting

According to the accounting standards prescribed by the Council on Corporate Disclosure and Governance,³⁰ parties to a SBBA transaction should recognise the economic benefits rather than the legal nature of the transaction. However, under the Shariah principles, securities that are sold outright under the SBBA shall cease to form part of the seller's investment portfolio. While, the obligation of the SBBA seller to perform its promise to buy back the securities at maturity of the transaction should be treated as contingent liability.³¹ Therefore, the SBBA seller is not entitled to receive all return and other income payment made by the issuer, it has lost the economic benefits of the securities.

(ii) Taxation

The income tax treatment of qualifying SBBA transactions is detailed in the Inland Revenue Board Malaysia (IRBM) on Tax Guidelines on Securities Borrowing and Lending (SBL) published by the Inland Revenue Board Malaysia³²

In essence, the tax treatment outlined in the guide is based primarily on the principle that, and hence will apply only if, the economic ownership of the transferred securities remains with the SBBA seller, even though the SBBA seller does not retain legal title to the transferred securities.

On this basis, the transfer of securities under a qualifying SBBA transaction will not be regarded as a disposal by the SBBA seller. Likewise, the transfer back of equivalent securities will also not be regarded as a re-acquisition of the securities. Accordingly, for income tax purposes, no gain or loss will be recognised by the SBBA seller as a result of the transfer of securities. Conversely, the recognition of gains/losses for income tax purposes in the case of the SBBA buyer is also spelt out in the IRBM Guide.

In addition, specified payments under any qualifying SBBA transactions are exempt from tax.³³ In other cases, specified payments may be subject to tax in Malaysia unless specific tax exemption is granted.

(iii) Zakat

The calculation of zakat-able assets may be subtracted from the various debts as of that date. Because, zakat is not obligatory on wealth that one owes to others. The debt will be deducted from the total wealth of the one who is responsible of paying it off. Thus, on the day of calculation, if seller decides to sell the securities (regardless of whose securities is used), then each one of seller/buyer may deduct the relevant amount from their total wealth. If one of seller/buyer takes full responsibility of paying

³⁰ In particular, Financial Reporting Standard (FRS) 39 Financial Instruments: Recognition and Measurement, which states that "an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it becomes a party to the contractual provisions of the instrument" and "derecognise a financial asset or a portion of a financial asset when, and only when, the enterprise loses control of the contractual rights that comprise the financial asset (or a portion of the financial asset)".

³¹ Refer to Guidance Notes on Sell and Buy Back Agreement - BNM/RH/GL/007-7

³² See, Income Tax (Exemption) (No. 30) Order 1995 - Revised 2008

(http://www.hasil.gov.my/lhdnv3e/index.jsp?process=17000&menu=0&sp=4&pg_title=Tax%20Publications)

³³ Specified payments" means any of the following: (a) lending fees; and (b) the residence status of the seller.

the debt off, then the debt will only be deducted from the total wealth of the seller/buyer taking this responsibility.

In a nutshell, it is not necessary that the debt be deducted from the wealth of the seller/buyer whose securities are used, rather, one of seller/buyer can pass on this responsibility to the other and the other can accept it. If this is the case, each one of seller/buyer will be deducting the percentage of debt that that they taken the responsibility of repaying.

5. Conclusions

In conclusion, SBBA is found to be instrumental in liquidity management for Islamic banks to be competitive in the market. However, this Islamic instrument gives rise to some Syariah issues related to its legality one of which is the issue of *wa'ad mulzim* embedded in the contract. It aims to avoid stipulation of condition that may render the contract null and void. In this regard, *wa'ad* serves as a form of *makharij* whose validity is subject to total adherence to the specific guidelines for the application of *makharij* in Islamic finance. This study found that if the application of *wa'ad* can serve the highest level of *maqasid al-Shariah* which lies in the banks' ability to manage liquidity through SBBA, then the *wa'ad* can be considered in conformation with Syari'ah and vice versa. Instead, it is suggested that the SBBA should be used temporarily for the purpose of achieving the *maqasid al-Shariah* and at the same time, effort must be multiplied to find another Islamic instrument for liquidity management which is free from controversial element. Further study need to be conducted to identify whether or not the SBBA actualized the *maqasid al-Shariah* in Islamic finance as the result of the study will have a great impact on the status of its legality.

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