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# **The Application of Al-Rahn Contract Using Future Asset under Debenture Structure: Analysis on the Aspect of Prohibition of Gharar\***

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## **Abstract**

*One of the essential conditions to conclude al-Rahn (pledge) contract is to ensure that the pledged asset (Mal al-Marhun) is available during contract execution. The absence of this aspect may trigger the issue of Gharar (uncertainty) which would affect the validity of al-Rahn contract. This paper will look into the application of al-Rahn contract under debenture structure where the asset used as security for the debenture may include future asset which shall only be determined during crystallisation stage. The analysis will focus on the concept of Gharar and whether the issue of non existence of pledged asset may tantamount to element of excessive Gharar which is prohibited under Islamic commercial law (Fiqh al-Muamalah).*

## **Introduction**

Debenture is one of the common financial instruments used by conventional banks to secure the payment of loan including interest portion from the customer. Debenture is issued by way of an official document that is given by customer, representing the loan amount from the bank and stating the interest payments that need to be paid. The payment of loan amounts and interest are secured by charging assets which includes present and future assets.

Generally, the assets both present and future, that to be pledged as security under debenture may include the following:

- a. all movable and immovable property, all other assets and rights including raw materials, stock in trade comprising semi-finished products and finished products, patents and trade marks, service marks, trade names, copyrights, design rights whether registered or otherwise;
- b. all stocks, shares, bonds, securities and all other interests in any company, firm or consortium;
- c. all book and other debts, revenues and claims (including takaful/insurance claims) including bank deposits and credit balances.

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In the event of default in payment which would render the facility to be recalled by the bank, the bank may exercise its right under debenture where all the assets that be charged as security will be crystallised and liquidated to recoup the outstanding debt. This paper will discuss on the application of al-Rahn contract for debenture structure and Shariah issue arising from its application in Islamic finance practice. Analysis will focus on the aspect of the non existence of the pledged asset which may trigger the issue of prohibition of Gharar.

### **Pledge Contract (Al-Rahn)**

Under Islamic finance practice, despite the fact that there is no specific resolution made by Shariah Advisory Council of BNM or Securities Commission regarding the permissibility of debenture, its application has been accepted by Islamic bank as one of instrument in securing the payment of financing amount from customer. Further, majority of Sukuk issuance in the market has extensively used debenture as part of the collateral to secure the Sukuk payment.

From Shariah perspective, the structure of debenture can be classified under the concept of al-Rahn (pledge). Under this contract, it is permissible for an institution to stipulate that at or before the conclusion of the contract of a credit transaction, the customer will provide a pledge of security to secure payment, and that possession of the asset so pledged will not prevent it from demanding payment when the payment of the debt falls due.

The Shafiites defined al-Rahn as taking a non fungible asset as insurance against a fungible debt, whereby the debt may be extracted from the held property if it is not repaid.<sup>1</sup> On the other hand, the Hanbalites defined al-Rahn as asset to ensure the payment of a debt in case of default.<sup>2</sup> The Malikites defined al-Rahn as an act of taking valuable asset from its owner as a means of ensuring payment of loan that has matured or is about to mature.<sup>3</sup> The definition given by Majallah al-Ahkam al-Adliyyah refers al-Rahn as the security that can be lawfully employed for satisfaction of a claim in respect of a debt.<sup>4</sup>

In short, the contract of al-Rahn refers to a contract meant for pledging the security of a debt.<sup>5</sup> This contract is different from the contract of guarantee (Kafalah) in a sense that a guaranty contract insures a debt through the liability of a creditworthy individual (the guarantor), while the pledge contract ensures debt payment through the holding of valuable asset for the purpose of foreclosure to make good the outstanding debt payment.<sup>6</sup>

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<sup>1</sup> Al-Khatib al-Sharbini, Mughni al-Muhtaj, v. 2, p. 121

<sup>2</sup> Ibn Qudamah, al-Mughni, v. 4, p. 326

<sup>3</sup> Al-Dardir, al-Sharh al-Saghir, v. 3, p. 303-305

<sup>4</sup> Majelle, Article 701

<sup>5</sup> Abdullah Alwi Haji Hassan (2007), Sales and Contracts in Early Islamic Commercial Law, Kuala Lumpur: The Other Press, p. 215

<sup>6</sup> Wahbah al-Zuhayli, al-Fiqh al-Islami wa Adillatuhu, v. 5, p. 181

The legitimacy of al-Rahn derives from the Quranic verse: “*If ye are on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose)*”.<sup>7</sup> This verse is significant proof for the legality of al-Rahn. The legality of al-Rahn is also established based on the practice of the Prophet (peace be upon him). It was reported by Aishah r.a that the Prophet (peace be upon him) himself practised al-Rahn when he pledged his iron shield with a Jew in Madinah and he took from him some barley for his family.<sup>8</sup> Moreover, a pledge encourages performance and thus prevents the contract from being breached, and this security also justifies its legitimacy.<sup>9</sup>

Basically, the contract of al-Rahn has four essential tenets i.e the contracting parties including the debtor who pledges his asset and the creditor who receives the pledged property, the subject matter of al-Rahn, the underlying debt for which the pledge is given and the offer and acceptance (Sighah). Nonetheless, this paper will not elaborate in details each of the tenets since it is not part of the objective of this paper. The important point here is that all the above conditions need to be achieved in order to perfect the al-Rahn contract. Further, it is also observed that most of the conditions stipulated under al-Rahn are almost akin to the general conditions of terms of contract as required in other contracts.

For instance, the parties involve in al-Rahn contract must fulfil the condition of eligibility (al-Ahliyyah) in which the standard requirement in Shariah is that the parties must be sane, prudent and have the capability and competent to enter into contract. As for the underlying debt, it must be an established debt. Majallah al-Ahkam al-Adliyyah specifies that the liability, of which the pledge is given must be something which give right to claim.<sup>10</sup> Further, the debt must be existent, fixed and binding on the debtor, immediately or in near future.

One of the important conditions in relation to the contract of al-Rahn is that the pledged asset must be possessed by the pledgor (al-Rahin) or debtor. The asset of anyone else, not possessed by the pledgor, may not be secured by him.<sup>11</sup> In this matter, it has been stated in the Quran: “*A pledge with possession may serve the purpose (Farihan Maqbudah)*”<sup>12</sup> In addition, AAIOFI has stated that a pledge asset must be valuable asset that can be lawfully owned and sold. It should be subject to identification by sign, name or description, and capable of being delivered to the creditor. Hence, asset held in common may be produced as a pledge provided the pledge percentage of it is specified, such as pledge of shares.<sup>13</sup> The requirements that a pledge should be a tradable asset that can be owned, saleable, specifiable, deliverable and free from encumbrance by any interest of a third party, are based on the fact that the objective of the pledge is to facilitate recovery of the debt, and if these requirements are not fulfilled, this objective may also not be fulfilled.<sup>14</sup>

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<sup>7</sup> Surah Al-Baqarah: 283.

<sup>8</sup> Narrated by Ahmad, Bukhari, al-Nasai and Ibn Majah

<sup>9</sup> Accounting and Auditing Organization for Islamic Financial Institutions (2008), Shari’a Standards For Islamic Financial Institutions, State of Bahrain, p. 74.

<sup>10</sup> Majelle, Article 710

<sup>11</sup> Abdullah Alwi Haji Hassan, op.cit., p. 215

<sup>12</sup> Ibid.

<sup>13</sup> Accounting and Auditing Organization for Islamic Financial Institutions. op.cit., p. 62-63.

<sup>14</sup> Ibid. Pg:74.

Another condition of al-Rahn contract is that if the pledged asset is not clearly known by the parties and not in existence at the point of contract execution, this may invalidate the contract hence considered it as null and void. According to the conditions of the pledged asset (Mal al-Marhun) in al-Rahn, it must be in existence and clearly described.<sup>15</sup> For instance, Majallah al-Ahkam al-Adliyyah mentions that “*The subject matter of the pledge must be something which may be validly sold. Consequently, it must be in existence at the time of the contract, must have some specific value, and also be capable of delivery*”.<sup>16</sup> As such, it is not permissible to pledge something which is not in existence as it will defeat the purpose of the contract i.e as assurance for debt repayment. Thus, to pledge fruits on trees prior to ripening are invalid according to some jurists, since the object of the pledge in this case is non-existent.<sup>17</sup> However, there are different views on this issue which will be explained in the next part of this paper.

### **Gharar in Debenture?**

From the foregoing discussion, it is clear that as a general rule, the subject matter of any contracts must ideally exist at the moment when the contract is concluded. As in the case of debenture structure which applies future assets as security, it means that the assets are still not in existence at the time of the contract being signed by the bank and customer. Additionally, the assets are not clearly and specifically known by the parties during the contract execution which as the result, would contravene the Shariah requirement. This is due to the fact that non existence of pledged asset would make the contract void for the reason of Gharar.

Literally Gharar means uncertainty, risk or hazard. Gharar is defined as the risk or jeopardy which is the state of being near to destruction or wreckage. For instance, in a contract of sale, Gharar often refers to uncertainty and ignorance of one or both of the parties over the substance or attributes of the subject of contract or of doubt over its existence at the time of contract.

Though there is no verse in the Quran to proscribe Gharar explicitly, but the Quran states an essential general rule that applies to all contracts regarding the prohibition of consuming people’s property unlawfully (al-Batil). Allah says “*And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people’s property*”<sup>18</sup> There is consensus among interpreters that substantial Gharar which makes transactions invalid falls within the category of al-Batil that is prohibited here.

Further to the above discussion, the effect of Gharar on contracts may render a contract totally null and void or it may constitute the basis of indemnity and compensation.<sup>19</sup> The Jurists’ aim is to show that Gharar is one of the major Islamic constraints on

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<sup>15</sup> Abdul Halim El-Muhammady (2001) Undang-undang Muamalat & Aplikasinya Kepada Produk-produk Perbankan Islam, Selangor: Universiti Kebangsaan Malaysia, p. 161.

<sup>16</sup> Majelle, Article 709

<sup>17</sup> Wahbah al-Zuhayli, al-Fiqh al-Islami wa Adillatuhu, v. 5, p. 202

<sup>18</sup> Al-Baqarah: 188

<sup>19</sup> Siti Salwani Razali (2010), Islamic Law of Contract, Singapore: Cengage Learning Asia Pte Ltd, p. 76-88.

transaction which renders some transactions as invalid. However, the question that arises here is whether the non existence of asset (future asset) under debenture structure may involve element of Gharar or not. This is the important aspect that will be focus for analysis in this paper.

In real life, Gharar or uncertainty cannot be totally avoided. With the absence of concept to measure Gharar, there are wide differences among jurists in classifying Gharar and its applications.<sup>20</sup> Some jurists try to categorise Gharar into several types such as permissible Gharar, prohibited Gharar due to its excessiveness and also unavoidable Gharar. Al-Shatibi says *“to remove all Gharar from contracts is difficult to achieve; besides, it narrows the scope of transactions”*. Jurists agree that the Gharar which affects the contract is the excessive Gharar, as it impairs the validity of the contract while a slight Gharar has no impact at all. Some jurists also do permit transactions which involve Gharar if the Gharar is light or in the face of necessity for that transaction, given that this need is general, specific and there is benefit (Maslahah) from the given transaction.<sup>21</sup>

As for the issue of existence of subject matter in any particular contract including al-Rahn, the majority of Islamic jurists suggest that want of knowledge of al-Ma’qud ‘Alayh (the subject matter) is the most illuminating element of Gharar. The basis of this condition is deduced from the Hadith of Habl al-Habla (the sale of a future pregnant animal of the offspring of a pregnant animal) where the underlying reason for its prohibition is want of knowledge of the future subject matter.<sup>22</sup> However, the above requirement was refined by some Islamic jurists by arguing that want of knowledge by itself does not amount to Gharar, especially when it is not a disputable element in the contract. Al-Nawawi mentions that although he maintained that it is necessary to specify the particulars of the subject matter, conceded that the requirement of full knowledge does not mean that everything including trivial or small matters which are routine and self-evident must also be made known.<sup>23</sup>

With this regard, Abdul Rahim al-Saati<sup>24</sup> opines that based on his research, according to Shatibi, the Hadith (which prohibits Gharar) does not intend to prohibit all Gharar because jurists permit some transactions which have Gharar such as selling a house though its foundation has not been seen. The Hadith intends to prohibit Gharar which can cause dispute and cannot be tolerated. According to him, this is the essence of the rule (Manat al-Hukm) of Istihsan, which is, according to Ibn-al Arabi *“to abandon exceptionally what is required by the law, because applying the existing law would lead to departure from some of its own objectives”*.<sup>25</sup>

Istihsan is used by jurists to permit some Gharar transactions, and they stipulate conditions to reduce the cause of dispute to acceptable level. For instance under Bai’ al-Istisna’ (construction contract), Siddiq al-Darir opines that Istisna’ is an obvious

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<sup>20</sup> Abdul-Rahim Al-Saati (2003), *The Permissible Gharar (Risk) in Classical Islamic Jurisprudence*, J.KAU: Islamic Econ., Vol. 16, No. 2, p. 9

<sup>21</sup> *Ibid*, p. 6

<sup>22</sup> Ahmad Hidayat Buang (2000), *Studies in the Islamic Law of Contracts: The Prohibition of Gharar*, ILBS: Kuala Lumpur, p. 113; refer also to Karlani, *al-Kifaya*, vol. iv, pg. 50

<sup>23</sup> Refer to Nawawi, *al-Majmu’*, vol. ix. p. 288

<sup>24</sup> Department of Economics, Faculty of Economics and Administration, King Abdul Aziz University, Jeddah, Saudi Arabia

<sup>25</sup> Mohd Hashim Kamali (1977), *Istihsan and its Application*, IRTI, IDB: Jeddah, p. 25

contract where the subject matter does not exist and it is allowed under the basis of Istihsan by the Hanafites due to the need of the people for such contract. However he believes that eventhough the subject matter in this contract does not exist, its availability is certain, and there is no Gharar.<sup>26</sup>

On the other perspective, Malikites permits the sale of something of unknown types, identity of the subject matter on condition that the buyer has the right to “option of inspection” or in transaction term is known as Khiyar, where the buyer has the option to reject the subject matter after the sight and rescinds the sale. The Hanafites gives this right (option of inspection) to the buyer without it even being stipulated in the contract. Such ruling is allowed since in their view, this option renders Gharar ineffective.<sup>27</sup> As such, a contract cannot be said to be void merely for “want of knowledge” since both Gharar and want of knowledge is different. It is the element of Gharar in want of knowledge that makes the contract void.<sup>28</sup>

In this respect, it may be tentatively submitted that non existence does not invalidate a particular contract unless if it is associated with element of Gharar.<sup>29</sup> The Hanafites is the only school that clearly requires the existence of the subject matter in a contract. For other Madhhab, the condition is mentioned mainly under the condition of ability to deliver.<sup>30</sup> Syaibani, a Hanbalites, maintained that anything that cannot be delivered is similar to non existence.<sup>31</sup> This seems to suggest that most of the jurists consider non existence of an object in a contract falls under the subject of inability to deliver. Ibn Qayyim elaborated the above proposition by suggesting that non existence is not a justification for prohibiting a contract. The real cause for such prohibition is Gharar. Further, there is no nas from Quran or Hadith that clearly mention that non existence of subject matter in a particular contract is prohibited.<sup>32</sup>

In the case of al-Rahn contract, as explained in the first part of this paper, most of the views have accepted that all rules and conditions of a sale contract are also applicable to the pledged asset. However, some exemptions have been made by the jurists to the above requirements. For example, a pledge of fruits which are not yet ready for consumption is valid even without a condition of immediate collection. The reason for this exemption is that the element of Gharar which exists in the above object (being uncertain whether the fruits shall exist or not until they are ripe) does not in any way negate the right of the creditor to collect his debt from the debtor, which is the primary objective of the contract.<sup>33</sup>

The element of uncertainty on the existence of the fruits is not permitted in sale contract as it will affect the interest of the purchaser in the sense that he will loose his money should the fruits have been destroyed. This is not applicable in al-Rahn since the primary aim of the contract is to secure the credit facility rather than selling the object

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<sup>26</sup> Siddiq al-Darir (1991), *al-Gharar wa Atharuhu fi al- 'Uqud*, Jeddah, p. 457; refer also Joni Tamkin Borhan (2002), *Istisna' in Islamic Banking: Concept and Application*, Jurnal Syariah, 10:2, p. 99-108

<sup>27</sup> Abdul-Rahim Al-Saati, *op.cit*, p. 12

<sup>28</sup> Ahmad Hidayat Buang, *op.cit*, p. 131

<sup>29</sup> *Ibid*.

<sup>30</sup> Kasani, *al-Bada'I*, vol. v. pp. 138-139, Ibn Abidin, *Hashiya*, vol. iv. P. 505

<sup>31</sup> Shaybani (1906), *Kitab Nayl al-Ma'arib bi Sharh al-Dalil*, vol. i. Egypt, pg. 73

<sup>32</sup> Ibn Qayyim, *I'lam*, vol. ii, p. 28

<sup>33</sup> Ibn Rushd, *Bidayat*, vol 2, p. 269

(the fruits).<sup>34</sup> The Malikites even of the view that an unknown and non existence asset can be a valid object under al-Rahn contract.<sup>35</sup> In short, the condition such as full knowledge and non existence of the pledged asset under al-Rahn are not important as these requirements according to the jurists do not imperil the aim of the contract and eliminate the right of the creditor to the debt.

Therefore, the element of Gharar which exists in al-Rahn due to non availability of pledged asset could be regarded as trivial or slight Gharar. In this respect, the trivial Gharar should not be assessed only by looking at its mere existence in the contract but rather to measure the probability that Gharar would affect the final objective of a particular contract. Hence, although the existence of Gharar in al-Rahn contract is obvious such as non availability of pledged asset, it can still be considered minimal if the aim of the contract is not disturbed and the interests of the parties involved is not prejudiced.

From the foregoing explanation, it can be concluded that under the debenture structure, the uncertainty of the future assets can be regarded as slight Gharar. It is not an excessive Gharar which may affect the validity of the contract or cause dispute among the contracting parties so long as the process of exercising the debenture is strictly observed. The element of Gharar can be removed if the description and types of assets are mentioned clearly during the crystallisation stage. During this stage, all the present assets as at that point of time, will be determined and be used to recover any outstanding debt demanded by the creditor. As such, this shows that the pledged assets are deliverable thus the element of Gharar can be eliminated.

### **Contracts affected by Gharar**

It is worth noting that the Islamic jurists realised that the prohibition of Gharar could not be applied generally to all types of contract on the same basis or standard as their nature, context, form and characteristics are different. Thus, some jurists are of the view that Gharar only affects contracts which are binding to both parties (*lazim min tarafyn*), such as a sale contract, Salam, Ijarah and etc. In other words, the main characteristic of these contracts is that they are financial commutative contracts.<sup>36</sup> Moreover, the hadiths that mention Gharar only discuss the prohibition of Gharar in sale contracts for example in a pebble sale (*Bai al-Hasah*), a touch sale (*al-Mulamasah*), a toss sale (*al-Munabadhah*), sale of stud sperm, sale of a fetus in the womb, sale of the offspring of an unborn animal and sale of fish in the water.<sup>37</sup> Therefore, this may give the impression that Gharar has no effect on anything but sale contracts.

On the other hand, the Malikites only affects Gharar for *Mu'awada Maliyyah* (financial exchange) contracts. It means that contracts which are complimentary in nature i.e no financial obligation such as voluntarily contract (*aqd al-tabaru'at*) is not subject to the

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<sup>34</sup> Ahmad Hidayat Buang, *op.cit*, p. 179

<sup>35</sup> *Ibid.*; refer also to Ibn Rushd, *Bidayat*, vol. ii, p. 324, Farj Tawfiq al-Walid (1973), *al-Rahn fi al-Shari'a al-Islamiyya*, Najf, pp. 201-209

<sup>36</sup> *Ibid.*

<sup>37</sup> Siddiq al-Darir, *op. cit.*, p. 3



requirement of prohibition of Gharar.<sup>38</sup> The basis of this view is that Gharar is only prohibited in sale contract because of the likelihood that it will cause dispute and unfair treatment on people's right, as explained by the Prophet (peace be upon him) in the Hadith prohibiting the sale of unripe fruits.<sup>39</sup> Conversely, Gharar in voluntarily contract such as Hibah and Kafalah for example, does not result in dispute or unjust since the parties involved would not claim their right between each other since the act is done on voluntarily basis. However, they also opine that non binding contract (al-'Aqd Ghayr al-Lazim) could also be affected by Gharar if it involves exchange of object and price.

As far as al-Rahn contract is concerned, Al-Rahn is not considered as Mu'awada Maliyyah contract. It falls under voluntary charitable contract since the pledged object is given without financial obligation or exchange of item involved, thus it is considered as non binding contract which does not apply the rules of prohibition of Gharar. Nonetheless, there is also view which says that al-Rahn is not totally a non binding contract. In fact, it is a combination of al-Aqd lazim (binding) and ghair lazim (non binding). This is because, al-Rahn is not regarded as totally binding until the pledged object is delivered. Meaning to say that, once the pledged object is delivered to the receiving party, which in this case is the pledgee, the contract is enforceable and binding upon the contracting parties. As such, the rule of prohibition of Gharar shall apply where at that point of time, the pledgor is obliged to ensure that the pledged object is determine and available to cover the debtor's outstanding debt failing which, the debtor is required to make good the shortfall.

### **Concluding Remarks**

The usage of future asset to be pledged as security under debenture structure is to protect the party involved to cover the debt incurred on the occurrence of event of default. This justification is based on the fact that, at the point of enforcing the security under debenture, all present assets shall be crystallised to recover the remaining debt. This shows that the assets are deliverable thus the element of Gharar can be eliminated. Therefore, the structure of debenture is merely as a security mechanism to recover any outstanding debt upon its enforcement. As discussed earlier, as long as the process is strictly observed and there is no disputable element in the transaction, it is acceptable to be applied.

For that reason also, the uncertainty of the future asset can be regarded as slight Gharar and not an excessive Gharar which may affect the validity of the contract or cause dispute among the contracting parties. Hence, this aspect renders the element of prohibited Gharar as ineffective. In addition, the issue of Gharar can be avoided if the description and types of assets are mentioned clearly during the crystallisation stage. In fact, Shariah allows sale with no underlying asset during contract execution like Bai' Salam and Bai Istisna' provided that it must be provided with detail specification of the asset to be delivered which eliminate the Gharar elements. Likewise, debenture may be acceptable because the Gharar aspect has been eliminated by specifying the future pledged asset and furthermore it is valid and enforceable by court of law.

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<sup>38</sup> Ibid.; refer also to Qarafi, al-Furuq, vol. I, p. 150

<sup>39</sup> Siddiq al-Darir, op. cit., p. 375-376. Jabir has narrated that the Prophet (peace be upon him) has forbidden the sale of unripe fruits. (Shahih Bukhari, Hadith no. 1416)

Since not all transactions which involve Gharar are prohibited and the essence of the prohibition (Manat al-Hukm) is to prevent Gharar which can cause dispute and cannot be tolerated i.e excessive Gharar, jurists do permit some Gharar transactions based on Maslahah and with the stipulation of certain conditions such as give both or one party an option, so as to reduce the causes of dispute to an acceptable level. Based on Maslahah and to strictly observe the Maqasid Shariah that need to be achieved as a measure, it is allowed to stipulate conditions in contemporary financial transactions and to achieve the Muqtada' al-'Aqd (objective of contract) of the transaction and in particular, under the debenture structure.

Debenture which falls under Shariah contract of al-Rahn is not considered as Mu'awada Maliyyah contract. Al-Rahn is considered as one of the supporting contracts hence there is no financial obligation or exchange of item involved. For that reason, certain rules and conditions could not be applied totally under al-Rahn unlike the sale contract since its nature and context are different.