



**PRACTICE OF SELL AND BUY BACK AGREEMENT
IN MALAYSIA: AN ANALYTICAL ASSESSMENT ON
REGULATORY AND SHARIAH REQUIREMENTS**

BY

SITI NURAH BT HARON

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the degree of Master of Science (Islamic Banking and
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**IIUM Institute of Islamic Banking and Finance
International Islamic University Malaysia**

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ABSTRACT

The primary objective of this study is to examine the compliance of the practice of Islamic repurchase agreement (repo) in Malaysia with Shariah principles. In doing so, this study adopts a triangulation approach, consisting of a number of data collection methods namely, library research, document review and semi-structured interviews with experts. While the gap between the Shariah requirements and practicality of Islamic repo remains unresolved in the market, it is found that the opinions among the Islamic jurists on the practice of Islamic repo tend to be mixed. For instance, while it is widely criticized by international scholars, the Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM) has permitted the use of bilateral promise (*muwa'adah*) in Islamic repo using a sell and buy back (SBBA) structure. In addition, this study also identifies and discusses key Shariah issues related to Islamic repo, namely, the existence of *bay' al-'inah* elements in Islamic repo and the use of *wa'ad* in a sale transaction. The novelty of this study lies in the proposed recommendations on alternative structures of Islamic repo which can be potentially adopted in the Malaysian market.

خلاصة البحث

الهدف الرئيسي في هذه الدراسة هو الإختبار على المطاوعة للمبادئ الشرعية في العملية الإلتفافية لإعادة الشراء لدى البنوك الإسلامية في ماليزيا. لذلك، تستخدم هذه الدراسة منهج التثليث ، الذي ينطوي فيه بعض القواعد تتعلقونبجمع البيانات كالمكتبة الأبحاث والمراجعة الوثيقة وال مقابلة مع المتخصصين. على الرغم من الفجوة بين المتطلبات الشرعية و بين التطبيق العملي في عملية إعادة شراء ، قد تتفاوت الآراء بين الفقهاء حول هذه العملية . وبصرف النظر عن ال نقاد على الحد الواسع لدى الفقهاء من أنحاء العالم ، قد أجاز المجلس الاستشاري الشرعي للبنك المركزي الماليزي عملية المواعدة في إعادة الشراء. وبالزيادة على ذلك، تميز و تناقش هذه الدراسة القضايا المهمة التي تتعلقون بالعملية إعادة الشراء. على سبيل المثال، توافر عملية البيع العينة في إعادة الشراء و استعمال الوعد في العقد البيع. المأثرة من هذه الدراسة تتضمن في إقتراحاتها لتحسن العملية إعادة الشراء في ماليزيا. من هذه الإقتراحات هي تجا هز بعض مناسب وملائم العقود والتصرفات التي تتعلقون بالعملية إعادة الشراء مع الصلة إلى المذكورة التوجيهية من البنك المركزي الماليزي على الإلتفافية إعادة الشراء.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

.....
Salina Hj. Kassim
Supervisor

.....
Rusni Hassan
Co-Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

.....
Zariah Abu Samah
Internal Examiner

This dissertation was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance).

.....
Syed Musa Alhabshi
Dean, IIUM Institute of Islamic
Banking and Finance (IIiBF)

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LIST OF ABBREVIATIONS & ACRONYMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADIB	Abu Dhabi Islamic Bank
AIBIM	Association of Islamic Banking Institutions Malaysia
ANM	Akauntan Negara Malaysia
BNM	Bank Negara Malaysia
BNMM- <i>Murabahah</i>	Bank Negara Monetary Notes- <i>Murabahah</i>
BNNN	Bank Negara Negotiable Notes
CEO	Chief Executive Officer
CMMA	Corporate <i>Murabahah</i> Master Agreement
CMO	Commodity <i>Murabahah</i> Programme
CPO	Crude Palm Oil
FAST	Fully Automated System for Issuing /Tendering System
FX	Foreign Exchange
GCC	Gulf Cooperation Council
GII	Government Investment Issue
IAB	Islamic Accepted Bills
ICM	Islamic Capital Market
ICMA	International Capital Market Association
IFA	Islamic <i>Fiqh</i> Academy
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IIMM	Islamic Interbank Money Market

INI	Islamic Negotiable Instruments
INID	Islamic Negotiable Instruments of Deposit
IPDS	Islamic Private Debt Securities
IRS	Islamic Rate Swap
IS	<i>I'aadat al-Shira'a</i>
KLIFF	Kuala Lumpur Islamic Finance Forum
MII	Mudharabah Interbank Investment
MITB	Malaysian Islamic Treasury Bills
MRA	Mini Master Repo Agreement
NBAD	National Bank of Abu Dhabi
NIDC	Negotiable Islamic Debt Certificate
PLS	Profit and Loss Sharing
RA-i	Ar-Rahnu Agreement-i
Repo	Repurchase Agreement
RM	Ringgit Malaysia
SAC	Shariah Advisory Council
SBBA	Sell and Buy Back Agreement
SBNMI	Sukuk BNM Ijarah
SC	Securities Commission
SMC	Cagamas Mudarabah Bonds
SSBs	Standard-Setting-Bodies
TTM	Two-Tier Mudarabah
US	United States of America
USD	US Dollar
WI	When Issue
WPA	<i>Wakalah</i> Placement Agreement

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Having a sound and stable financial system is of utmost importance to the regulators of any banking and financial system. Bank Negara Malaysia (BNM), the Central Bank of Malaysia, has enforced a number of monetary policy tools in ensuring ideal level of money supply in the market. There are numerous monetary policy tools adopted by policy makers and market regulators all around the world such as open market operations, statutory reserve deposit and discount policy. Among these market mechanisms, the open market operations are most favoured by many central banks due to its ease of use and flexibility. In practice, open market operations involve purchases and sales of securities or short-term financial instruments such as repurchase agreement (repo) by the central banks (Ismail, 2010).

In essence, repo is a concurrent sale and repurchase of an asset which typically involves a security. Hegazy and Ismael (2015) defined repo as sales of securities with repurchase commitment at a specific date and a pre-determined price. In practice, the selling party sells a security to the buying party at a pre-determined price and subsequently, on the buy-back date, the original seller buys back the security from the original buyer at the original purchase price plus interest amount charged on the implied loan created in the whole transaction (Al-Shobili, n.d.; Fleming & Garbade, 2003; Norris, 2011; Hegazy & Ismael, 2015). Repo binds both selling and buying parties to carry out their obligations. The seller is obliged to sell and transfer the

underlying securities to the buyer at a specific date and pre-determined price and later to repurchase the securities back from the original buyer. Whilst, the buyer is entitled to purchase the underlying securities from the seller and subsequently sell back the same securities to the original seller at a specific date and pre-determined price.

Ever since it was first promulgated by the US Federal Reserve in 1918, repo has become a major component of the global money markets today. According to Choudhry (2004), it is evident that market players including securities houses, investment banks, fund managers, corporate treasurers and local authorities have shown greater preference over the usage of repo in the recent years due to its effectiveness and flexibility. He further explained that repos are regarded as one of the most effective instruments for open market operations adopted by many major central banks around the globe due to; (i) the increase of non-bank funding together with disintermediation, (ii) rising level of public debts, (iii) greater awareness on counterparty risk, (iv) liquidity need to cover short positions as well as; (v) high rating of collateral, in which mostly comprises of the government debts.

One of the unique features of repo includes the buyer's rights to sell the underlying securities to a third party without referring to the Court or the seller in the case of inability of the original seller to repurchase the securities. This is due to the fact that repo is an outright contract for sale of securities. Apart from that, repo allows the buyer to transfer profits and returns to the seller during the contract period as the seller has undertaken to purchase back the underlying securities at maturity (Shrar, 2012; Al-Fzia; 2015; Hegazy & Ismael, 2015).

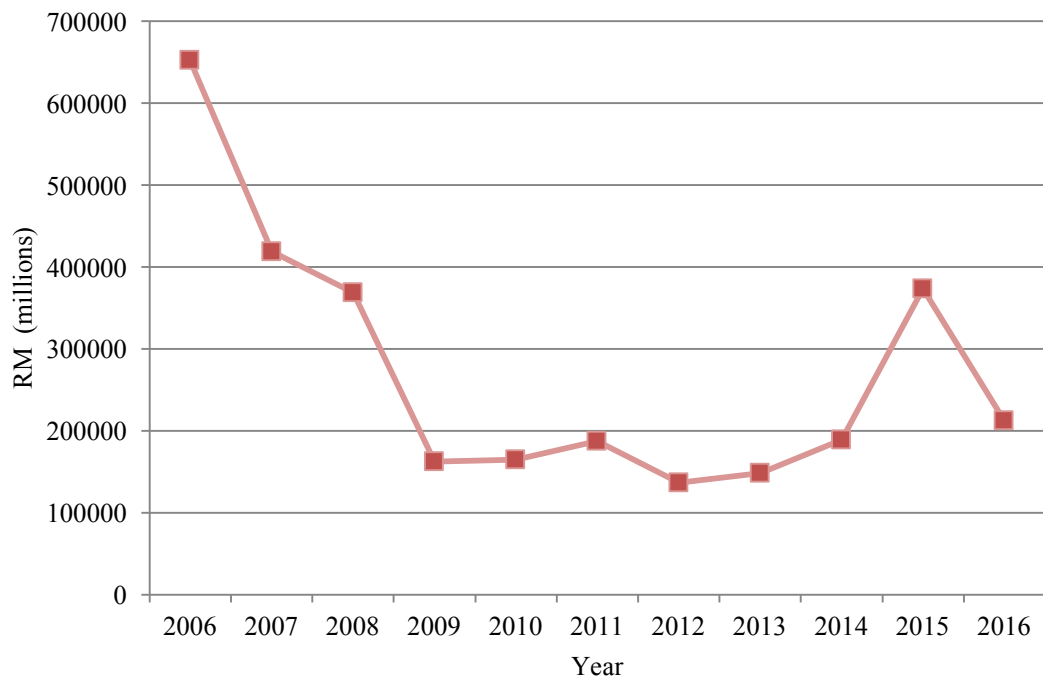
Meanwhile, in the Islamic sphere, an alternative monetary policy tool for conventional repo, so-called as “Islamic repo” has been introduced, serving as a Shariah-compliant financial instrument for the purpose of enhancing liquidity level in the Islamic Interbank Money Market (IIMM). Modified to comply with Shariah principles, Islamic repo performs similar functions as its conventional counterparts including becoming a liquidity management tool, a platform for secondary trading of money market instruments and an avenue for monetary policies to be conducted by the Central Bank (ISRA, 2016). The introduction of Islamic repo is anticipated to provide additional avenue for the participants of the IIMM to source their funding requirements, hence addressing the issue of lack of Shariah-compliant money market instruments available in the market.

In the context of Malaysia, an Islamic repo product called sell and buy back agreement (SBBA) has been designed in accordance to Shariah principles by the virtue of Shariah Resolution in Islamic Finance No. 71 issued by the Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM) in which the application of “sale and buy back” contract has been approved. SBBA refers a combination of contracts of which is a sale contract followed by an undertaking to repurchase the underlying asset (*wa'd*). For instance, two contracting parties enter into a sale contract whereby the original seller subsequently gives a promise to buy back the underlying asset from the original buyer at a stipulated date. This kind of trade arrangement is considered as a valid conditional sale contract as the pre-agreed conditions (e.g. promise to buy back the underlying asset) does not affect the objective and validity of the first contract (e.g. selling the underlying asset) initiated as well as the transfer of ownership of the underlying asset. Apart from that, in order to assist the IIMM participants in the

conduct of SBBA transactions with best practices, the BNM issued the Guidance Notes on Sell and Buy Back Agreement (“Guidance Notes on SBBA”) in August 2002, which was later revised on 28 June 2013.

Figure 1.1 represents the amount of repo and SBBA traded in the Malaysian money market. It is recorded that the volume of repo and SBBA traded continued to fluctuate over the last decade.

Figure 1.1 Yearly Repo/SBBA Volume in Malaysia (in RM millions)



Source: Bond Info Hub (2017)

1.2 PROBLEM STATEMENT

Repo steadily gains traction from the global market especially in Europe and the US, reaching up to EUR 5,378.5 billion in size, according to a survey conducted by the International Capital Market Association (ICMA) on 67 institutions as at 8 June 2016 (ICMA, 2016). This is, however, not the case for the Islamic repo markets. In Malaysia, for instance, the size of repo and SBBA market significantly plunged from 2006 to 2016, despite substantially traded in the market, as shown in *Figure 1.1* as many Islamic banks have been leaning towards other money market products such as innovative sukuk and Shariah-compliant commercial papers for short-term liquidity purposes (Islamic Finance News, 2015). This is despite the SAC of BNM's Shariah resolution permitting the SBBA transactions involving various types of Shariah-compliant underlying assets such as sukuk. Mohamad Safri Abdul Hamid, the previous acting CEO of CIMB Islamic, commented that "repos are not a popular product as Islamic banks still prefer to use other money market instruments".

The main reason behind this sluggish growth of Islamic repo markets is the lack of consensus on its permissibility from a Shariah standpoint among practitioners and scholars. Based on the author's observation throughout her several years of experience handling money market transactions in Malaysia, differing views on the permissibility of SBBA exist not just among Shariah Committee members and Shariah officers of different Islamic banks but also between two different Shariah functions (e.g. Shariah compliance unit and Shariah advisory unit) of an Islamic bank. This observation is supported by the view of Vizcaino and al-Zaquan (2014) who opined that the progress in developing "Islamic repos" has been slow due to a lack of consensus among bankers, regulators and scholars on what structures would be both

religiously permissible and financially effective. As a result, these differing Shariah opinions may be translated into incongruent practices of Islamic repo among market participants. For instance, the Malaysian practice of SBBA has been shunned by many Gulf Cooperation Council (GCC) Islamic banks, which argue transfer of ownership of assets in SBBA is not clearly executed.

It becomes apparent that the very phrase “Islamic repo” is least preferred among some Shariah scholars as it is feared to simply replicate its conventional counterparts without addressing the objectives of Islamic transactions (*muamalat*) and meeting a real economic need. Shariah scholars’ vigilance towards expressing their opinions on the permissibility of Islamic repo could be due to a fear of abuse of the product and ruse to circumvent the prohibitions in Islamic finance, just like in the case of winding-up of Lehman Brothers. Previously, repo was used by Lehman Brothers as a tool to reduce the level of indebtedness in its financial statements in the months leading up to its collapse (Hunter, 2011).

In the spirit of promoting the global acceptance of Islamic repo as a viable liquidity management tool for Islamic banks, a series of ongoing discussions and debates on the permissibility of Islamic repo from Shariah point of view has taken place at both domestic and international level. For example, Shariah interpretations of Islamic repo had been revisited in *Muzakarah Penasihat Syariah Kewangan Islam*, Kuala Lumpur Islamic Finance Forum (KLIFF) in 2010. In the intellectual discourse, Shariah scholars raised their concerns that today’s practice of Islamic repo may trigger several Shariah issues, namely: Is the use of *wa’ad* (undertaking) to purchase back the

underlying assets at pre-agreed price in future permissible? And whether or not the element of *bay' al-'inah* is present in the current practice of Islamic repo?

Despite being a persistent topic of discussion for years, these Shariah concerns related to the permissibility of Islamic repo, unfortunately, have yet to be resolved up to this date and the Islamic finance standard-setting bodies (SSBs) and regulators seems failed to reach a consensus on the legitimacy and practical aspects of Islamic repo. Even worse, some may view that religious principles are likely to constrain the use of Islamic repo (Vizcaino, 2012). For instance, calculating margin calls on repos would be almost impossible since it can be seen as using an implicit interest rate. Shariah restrictions over trading repo underlying assets with a third party (*bay' al-dayn*) and pure monetary speculation - which has been long practiced by investors in money markets - makes Islamic repos even less attractive economically. Apart from that, a Shariah requirement that actual ownership of underlying assets must be transferred to repo buyer is argued to limit Islamic repo's penetration to the international markets. Another limitation is the practice of netting in repo may not be recognized by regulators and Shariah advisory council of many GCC countries where Islamic repos are mostly traded.

With so many unresolved Shariah issues as scholars failing to reach consensus among them given the controversial nature of Islamic repo, perhaps one should ask: Is Shariah-compliant repo even possible in the first place? Admittedly, bridging the gap between Shariah principles and market practice by designing a workable and internationally accepted Islamic repo structure which could be both permissible from Shariah point of view and practical from market perspective is not an easy task to

begin with. Despite of the difficulties to agree on Islamic repo structures, regulators are now facing mounting pressure to ensure that there are adequate liquidity risk management products in the market as the banking environment becomes fiercer with competition. This is due to the requirement for banks to maintain high quality liquid assets under Basel III banking standards.

There have been global initiatives on the use of Islamic repo conducted by SSBs and regulators to promote market liquidity in the view of the lack of adequate Shariah-compliant money market instrument. These include the issuance of Technical Note on *Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets* by the Islamic Financial Services Board (IFSB) on March 2008, outlining recommendations for development of Islamic money markets at the national level. Apart from that, the International Islamic Financial Market (IIFM) released a Reference Paper on *I'aadat al-Shira'a* (Repo Alternative) on 28 July 2010, in Manama, Bahrain. This paper proposes some concepts and possible structures of *I'aadat al-Shira'a* to be adopted as an alternative to the conventional repo. Another milestone which is said to fuel activities in repo markets for coming years is the issue of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah Standard No. 58 on Repurchase. The standard sets out the Shariah rulings on repo and reverse repo, and the main permissible alternatives. At country level, a group of Indonesian Islamic banks agreed on a standard contract template for repo transactions called Mini Master Repo Agreement (MRA) in July 2015, following the launch of Master Collateralized *Murabahah* Agreement by the Bahrain-based IIFM in late 2014. Meanwhile, in the UAE, the Dubai Financial Market and the NASDAQ Dubai are going to encourage

more sukuk rating (since sukuk listed on Dubai's exchanges are well-suited for repo due to its size and ratings) to facilitate cross-border Islamic repo activities.

Notwithstanding the commendable efforts by the SSBs and regulators in enhancing the platform for Islamic repo trading, analysis on Shariah aspects which have repercussions on the structures of Islamic repo has been lacking hence needs for more research to be done. Zarizan Ibrahim, Shariah Research and Secretariat Manager at CIMB revealed that today's discussions on elements and functions of Islamic repo are general with no depth Shariah deliberations. Similarly, Ijlal Alvi, the Chief Executive Officer (CEO) of the IIFM agreed that while efforts have been made to develop Islamic repos as they are used in the conventional market, however, there is still need for further research to see if we can actually achieve that (Vizcaino and Hamzah, 2014).

1.3 PURPOSE OF THE STUDY

This study is motivated by the contentious issue of lack of Shariah consensus on the practice of repo. This study, therefore, aims to provide a thorough review of both classical and contemporary Islamic scholar's views on the permissibility of the practice of Islamic repo with Shariah principles. Apart from that, this study also attempts to identify potential Shariah issues on the practice of Islamic repo such as whether: (i) it is permissible in Shariah to stipulate a condition to purchase back the same asset in a contract of sale; (ii) there is a real transfer of ownership of underlying assets to buyer's account and; (iii) it is permissible for assets to be repurchased at a pre-agreed mark-up price or it has to be marked-to-market. Based on the analysis of Shariah scholars' view and understanding of the Shariah issues related to Islamic repo,

this study then recommends possible alternative structures of Islamic repo which can be practiced in the Malaysian market.

1.4 RESEARCH OBJECTIVES

This study aims to achieve the following objectives;

1. To provide a thorough review of both classical and modern Islamic scholars' opinions and Shariah rulings on the practice of Islamic repo.
2. To identify Shariah issues on the practice of Islamic repo in Malaysia.
3. To recommend possible alternative structures of Islamic repo which can be practiced in the Malaysian market.

1.5 RESEARCH QUESTIONS

The research questions of this study are as follows;

1. What are the views and Shariah rulings made by both classical and modern Islamic scholars on the practice of Islamic repo?
2. What are the Shariah issues related to the practice of Islamic repo in Malaysia?
3. What are the possible alternative structures of Islamic repo that can be practiced in the Malaysian market?

1.6 SCOPE OF THE STUDY

The permissibility of repo from the standpoint of Shariah is a global concern by many institutions offering Islamic financial products and other stakeholders of the Islamic money market. There are different structures of Islamic repo practiced in different jurisprudences using various Shariah contracts including *murabahah*, *tawarruq*,