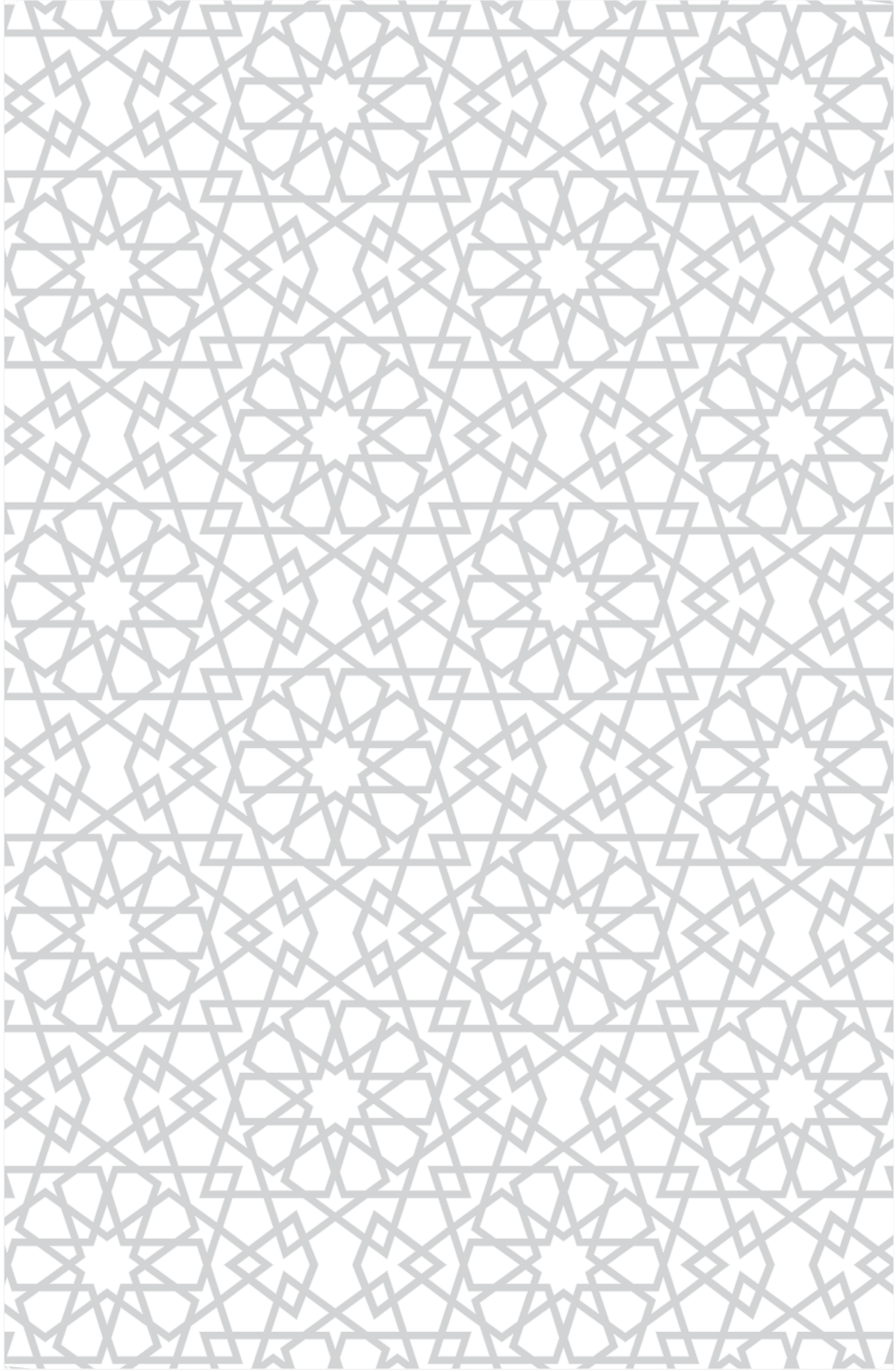


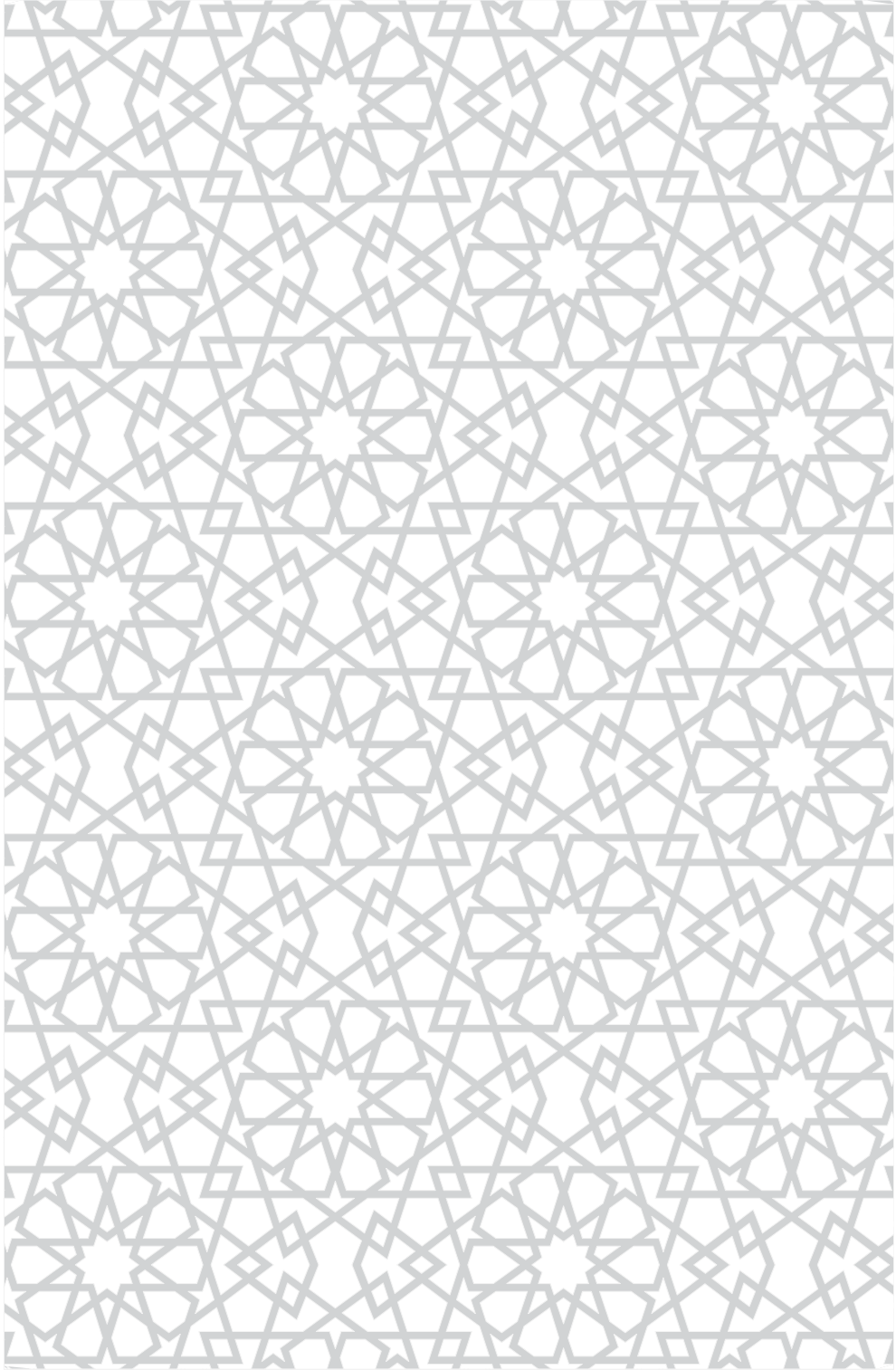
Shari'ah Standard No. (4)

Settlement of Debts by Set-Off
(Revised Standard)



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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The aim of this standard is to outline the rules governing the use of set-off in settling debts, the Shari'ah requirements and conditions applicable to set-off, what is permissible or not permissible in this procedure and the most significant practices of Islamic financial Institutions (Institution/Institutions)⁽¹⁾ in this regard.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers the settlement of debt by way of set-off. The standard shall not apply to discharge of liability by way of transfer, waiving of obligation, composition, acquisition of a right payable or bilateral cancellation of a contract, as they are covered by their respective Standards.

2. Definition of Set-Off and Its Various Forms

A set-off is to extinguish a debt receivable by a debt payable. It is divided into two main forms: mandatory set-off and contractual set-off.

2/1 Mandatory set-off

A mandatory set-off is a set-off that occurs without the need for bilateral agreement or consent of both indebted parties and, in some cases of mandatory set-off, it is one party that is forced to comply with the request of the other party for set-off. It is divided into compulsory set-off (on both parties)⁽²⁾ and set-off on demand (of the person with the superior debt whereby the other party is obliged to comply with the demand).

2/1/1 A compulsory set-off is the spontaneous discharge of two debts that is not contingent on the request or consent of both or either party.

2/1/2 The conditions of the permissibility of compulsory set-off are the following:

- a) Each party should be a creditor and debtor simultaneously.
- b) Both debts should be equal in kind, type, description and maturity. However, if the two debts are not equal in amount, a set-off will take place of an equivalent amount on both

(2) Compulsorily set-off is a set-off that occurs without a need to bilateral agreements or consents of the parties.

sides, and the party that is owed the larger debt will remain a creditor for the remaining balance.

- c) Neither of the two debts should be encumbered by an obligation to a third party, such as the right of a mortgagee to one of the debts. The intention of this is to protect rights associated with the amount of the debt and belonging to third parties.
- d) The set-off should not be arranged in a manner that results in violation of a rule of Shari'ah, such as Riba (usury) or *Shubhat al-Riba* (a transaction potentially involving Riba).

2/1/3 A set-off on demand is the discharge of two debts at the request of the creditor for the superior debt and his consent to forgo the excess of the amount or privilege he is owed over what he owes. This set-off will take place whether or not the creditor for the smaller debt consents.

2/1/4 The conditions of permissibility of a set-off on demand are the following:

- a) Each party should be a creditor and debtor simultaneously.
- b) The creditor for the superior debt, in terms of quality and duration, should consent to relinquish his additional right or privilege. An example of superiority in terms of quality is when the debt is secured by a mortgage, or when a third party has given a guarantee to pay the debt, and the owner of the secured debt consents to relinquish this guarantee. Superiority in terms of duration exists if the duration of one of the debts is shorter, or one debt is now due and the other is not yet due. In these cases, the debt which has the shorter duration or which is now due is superior.
- c) Both debts should be similar in kind and type, but not necessarily in quality and date of maturity. However, if the two debts are not equal in amount, a set-off will take place of an equivalent amount on both sides, and the party that is owed the larger debt will remain a creditor for the remaining balance.

- d) The set-off should not be arranged in a manner that results in violation of a rule of Shari'ah, such as Riba (usury) or a transaction potentially involving Riba.

2/2 Contractual set-off

2/2/1 A contractual set-off is the discharge of two debts by the consent of the two parties to extinguish their obligations towards each other.

2/2/2 The conditions of the permissibility of a contractual set-off are the following:

- a) Each party should be a creditor and debtor simultaneously.
- b) The two parties should mutually consent to the set-off.
- c) The set-off should not be arranged in a manner that results in violation of a rule of Shari'ah, such as Riba or a transaction potentially involving Riba.

2/2/3 A contractual set-off is permissible even without the need for two debts to be similar in kind, type, description or maturity. This is because the agreement on contractual set-off means that each party has agreed to relinquish any extra privilege associated with his debt. A contractual set-off is also permissible if the two debts are not equal in terms of amount, in which case a set-off will take place of an equivalent amount on both sides, and the party that is owed the larger debt is entitled to request payment of the remaining balance. [see item 2/10 (a) of the Shari'ah Standards on Trading in Currencies]

3. Bilateral Exchange of Promises to Conclude a Set-Off in the Future

It is permissible for the Institution and its customers or other Institutions to exchange bilateral promises that debts that may be created between them in the future will be settled by way of set-off, in which case all the conditions mentioned in the items 2/1 and 2/2 will be applicable at the time of actual set-off. However, if the currencies of the two debts differ, a bilateral exchange of promise of set-off should be concluded on the basis

that a set-off will take place based on the current currency exchange rate at the time of actual set-off; this ruling is to prevent the practices of Riba by roundabout methods or by implied agreement for practicing Riba.

4. Application of the Rules of Set-Off to Some Modern Transactions

The followings are some rules of set-off to modern transactions:

- 4/1 Stipulating set-off between the customer and the Institution in respect of debts to the Institution arising out of sales on deferred payment. The agreement on contractual set-off of future debts, commonly known as set-off and consolidation, is a practice employed by a large number of financial Institutions. This form of set-off may take place either compulsorily or contractually depending on whether the situation that gives rise to this set-off meets the conditions of compulsory set-off or the conditions of contractual set-off. Moreover, by pre-stipulating this type of set-off in the agreement, a fresh agreement may be avoided at the time of set-off when the two currencies are different or when one of the debts is superior to the other.
- 4/2 A set-off may take place between a financial Institution accepting a cheque and the drawer of the cheque, through the clearing-house. This form of set-off may also take place either compulsorily or contractually depending on whether the state that gives rise to this set-off meets the conditions of compulsory set-off or the conditions of contractual set-off.
- 4/3 Set-off that is concluded among financial Institutions through international or national networking systems, such as credit card or debit card organisations. This form of set-off may be either compulsory or contractual depending on whether the state that gives rise to this set-off meets the conditions of compulsory set-off or the conditions of contractual set-off.

5. Currency Swaps

The currency swaps that are concluded on the basis of Riba are not permissible. This is because in this process it is the interest-based securities that are set-off against interest-based securities.

6. Date of Issuance of the Standard

This Standard was issued on 29 Safar 1422 A.H., corresponding to 23 May 2001 A.D.

Adoption of the Standard

The Shari'ah Standard on Settlement of Debts by Set-off was adopted by the Shari'ah Board in its meeting No. (6) held on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

In its meeting No. (2) held in Makkah Al-Mukarramah on 10-14 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on settlements of debt by way of set-off.

On Tuesday 27 Ramadan 1420 A.H., corresponding to 4 January 2000 A.D., one Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 18-19 Rabi' I, 1421 A.H., corresponding to 20-21 June 2000 A.D., the Shari'ah Studies Committee discussed the juristic study and made certain amendments to it. The committee also discussed the exposure draft of the Standard in its meeting No. (6) held in Bahrain on 20-21 Jumada II, 1421 A.H., corresponding to 18-19 September 2000 A.D., and asked the consultant to make some amendments in light of the comments made by the members.

In its meeting No. (7) held in Bahrain on 5-6 Sha'ban 1421 A.H., corresponding to 1-2 November 2000 A.D., the Shari'ah Studies Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (5) held in Mecca on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 4-5 Dhul-Hajjah 1421 A.H., corresponding to 27-28 February 2001 A.D. The public hearing was attended by

more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Members of the Shari'ah Studies Committee responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Studies Committee held its meeting No. (8) on 16-17 Dhul-Hajjah 1421 A.H., corresponding to 11-12 March 2001 A.D., to discuss the comments made about the exposure draft. The Committee made the necessary amendments in light of both the written comments that were received and oral comments that took place in the public hearing.

The Shari'ah Board in its meeting No. (6) held in Al-Madinah Al-Munawwarah on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D., discussed the amendments made by the Shari'ah studies committee, and made necessary amendments. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Muharram 1433 A.H., corresponding to November 2011 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (38) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia on 28 Sha'ban to 1 Ramadan 1435 A.H., corresponding to 26-28 June 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved the necessary amendments, and the standard was adopted in its current amended version.

Appendix (B)

The Shari'ah Basis for the Standard

The basis for debt settlements by way of set-off is that it has been practised from time immemorial without any report of disapproval. Moreover, set-off is in line with the objectives of the Shari'ah as it encourages discharging individuals from liability of debt and set-off is one way of discharging debt liabilities without involving futile processes of debt recovery.

In addition, there is no Shari'ah objection to a set-off taking place on demand. The authority for this permissibility is that the person entitled to the superior debt has agreed to forgo the advantage attached to his debt and the Shari'ah will not object to such a gesture.

If set-off is executed contractually, it is then based on the prophetic Hadith stating; *"Muslims are bound by the conditions and agreements they have made, except a condition that has rendered the unlawful lawful or rendered the lawful unlawful."*⁽³⁾

(3) The Hadith has been related by Al-Tirmidhi in his *"Sunan Al-Tirmidhi"* [3: 634] edited by Ahmad Muhammad Shakir and others, Beirut: Dar Ihya' Al-Turath Al-'Arabi. Also, it has been related by Al-Bayhaqi in his *"Sunan Al-Bayhaqi"* [7: 248]; and Al-Manawi, *"Fayd Al-Qadir"* [6: 272], Egypt: Al-Maktabah Al-Kubra, 1356 A.H..

Appendix (C)

Definitions

Debt and Loan

A debt is any liability that is not in terms of a specified or defined item, whatever the cause of its establishment, i.e. whether its origin is in cash or in a commodity, or in a particular described benefit such as the benefit of using particular things or services of persons. For instance, the consideration in deferred sales and loans is described as a debt.

The relationship between a loan and a debt is that the latter is more general than the former, since every loan is described as a debt but the converse is not true. Not all debts originate from a loan. In this sense, a loan is but one cause of the creation of debt.

Due Debt

A due debt is a debt that is immediately payable or that is payable on the creditor's demand, whether on its original due date or, if it has been rescheduled and deferred, on its rescheduled due date.

Deferred Debt

A deferred debt is a debt the payment thereof is due at a certain time in the future, and it may also be due in periodic instalments over time.

Description

A description is a condition that distinguishes particular specimens of the same species from one other. For examples, conditions such as good quality and poor quality, or mortgage of security or personal guarantees, letters of guarantee and the freezing of the amount of cheques for payment which are attached to the debt are considered descriptions.

Ibra' (discharge)

An act by a person to discharge another person from a liability (owed by the latter to the former)

Reconciliation (Sulh)

An agreement to solve dispute between parties.

Iqalah (Mutual Rescission of Contract)

Revocation of a contract and cancellation of its effects with mutual consent of both parties.

