

## Chapter 3

# Islamic Banking in Malaysia

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### Learning Objectives

After studying this chapter, you will understand:

- ◆ What Islamic banking is;
- ◆ The set up of Islamic banking system in Malaysia;
- ◆ The structures supporting the operations of Islamic banking;
- ◆ The concepts and mechanisms underlying Islamic banking transactions;
- ◆ The various instruments used in Islamic banking;
- ◆ The Islamic money market and its operations;
- ◆ The contributions of Islamic financing in the banking system; and
- ◆ The problems and challenges of Islamic banking.

## 1. INTRODUCTION

According to the Islamic Banking Act 1983, an Islamic bank is described as a bank that carries on Islamic banking business where the aims and objectives do not involve any element that is not approved by the religion of Islam.

Therefore, Islamic banks are commercial banks, which are an alternative to the conventional banking system and guided by mainly some key religious principles. With the development of Islamic banks, there is also the proliferation of other Islamic products and services that not only emanate from banks but also other companies, which we will term as *Islamic Financial Institutions*. Hence, Islamic financial institutions are institutions where their methods and ways of doing business are based on *Shariah* principles; the main ones being the following:

1. The avoidance of *riba* (interest or any form of usury);
2. Prohibition of *gharar* (uncertainty, risk, speculation);
3. Focus on *halal* (religiously permissible) activities; and
4. More generally the quest for justice, and other ethical and religious goals.

In essence, based on the above principles, Islamic banking operations or financial transactions under the *Shariah* conduct, dealt mainly with risk-sharing and prohibition of products and services having *riba* elements. The profit and loss-sharing concepts are major features of the conduct of business and thus, ensuring justice and equity in the economy. Nevertheless, Islamic banking is for all individuals regardless of their religious beliefs.

The idea of Islamic banking was first mooted in the 1950s, which then saw the creation of the first generation of Islamic financial institutions in Malaysia and Egypt in the early 1960s. In 1974, Dubai Islamic Bank was established as the first private interest-free bank. Over the last decade, Islamic banking has emerged as a rapidly growing alternative system of financial management in Muslim countries as well as in the Western world.

## 2. DEVELOPMENT OF ISLAMIC BANKING IN MALAYSIA

In Malaysia, Islamic banking is provided in a dual banking environment. This means that the Islamic banking system operates in parallel with the conventional banking system. Since Islamic banking does not prohibit participation by non-Muslims, its potential for further growth is tremendous. The following events provide an insight into the development of Islamic banking in Malaysia:

<u>Year</u>	<u>Landmark Developments</u>
1969	Establishment of Lembaga Tabung Haji which mobilises and manages the savings of Muslims for their intention to perform the haj
1983	The Islamic Banking Act and the first Islamic bank licensed is Bank Islam Malaysia Berhad established on 1 July 1983
1984	First licensed takaful operator was established
1990	Establishment of the Labuan International Offshore Financial Centre (IOFC) which also provides Islamic financial services

Year	Landmark Developments ( <i>cont'd</i> )
1993	BNM set up the Skim Perbankan Tanpa Faedah which was later known as Islamic Banking Scheme (IBS) that allows conventional banks to offer Islamic windows' banking products
1994	Interbank Islamic Money Market was established. This introduced the Islamic interbank cheque clearing system based on the <i>Mudharabah</i> principle where the deficit of the clearing account of one IBS will be funded by the surplus funds from other IBS banks or by BNM
1997	Formation of the National Shariah Advisory Council in BNM
1998	Establishment of the 2 <sup>nd</sup> Islamic bank – Bank Muamalat – with the merging of the Islamic banking assets of Bank Bumiputra, Bank of Commerce and BBMB Kewangan
2001	Launch of the Financial Sector Masterplan which included a 10-year plan for the development of Islamic banking and takaful
2002	The Malaysian Government issues the Malaysian Government Sukuk – the world's first global sovereign <i>sukuk</i> .  Kumpulan Guthrie Berhad issued the world's first global corporate Islamic bond
2004	Conventional banks allowed to establish Islamic subsidiaries and new banking licences were issued to foreign Islamic institutions such as Kuwait Finance House, Asian Finance Bank and Al Rajhi Bank
2006	<ul style="list-style-type: none"> <li>• Malaysia International Islamic Finance Centre was launched</li> <li>• Khazanah Nasional Berhad issued the world's first exchangeable bond</li> <li>• The International Centre for Education in Islamic Finance (INCEIF) was established</li> <li>• Introduction of BNM Guidelines on International Currency Business Unit where full income tax exemption would be accorded to Islamic financial institutions for 10 years effective from the year of assessment 2007</li> </ul>

### 3. ISLAMIC BANKING INSTITUTIONS

During the first 10 years of its establishment, Bank Islam Malaysia Berhad (BIMB) was the sole bank given an Islamic-banking licence to operate in the country. This was to allow BIMB to operate in a smooth manner without undue competition that might hinder the progress of Islamic banking. BIMB, which started with a branch office in Kuala Lumpur, has spread its operations with a total of 122 branches throughout the country by end-2003. The Bank has offered alternatives to most conventional banking products and services, such as accepting deposits, granting various credit facilities and trade financing, provision of safe keeping facilities and funds transfers based on Islamic principles.

The second Islamic bank, Bank Muamalat Malaysia Berhad (BMMB), commenced operations on 1 October 1999 with a network of 40 branches. Today, besides these two Islamic banks, all the local conventional banks with Islamic banking windows have now migrated their Islamic operations to full licensed Islamic bank status and with the liberalisation of the financial system, three Gulf States' banks, namely Kuwait Finance House, Asian Finance Bank and Al-Rajhi Bank have set up their Islamic banking operations in Malaysia.

The development of Islamic banking is embraced in the Financial Sector Masterplan (FSMP), launched in March 2001, which incorporates a 10-year plan for Islamic banking and *takaful*. The overall objective is to create an efficient, progressive and comprehensive Islamic

financial system and to promote Malaysia as a regional financial centre for Islamic banking and finance.

An important milestone in the global development of Islamic banking and finance was the inauguration of the Islamic Financial Services Board (IFSB) in 2002. The IFSB is established to develop international prudential regulatory standards globally to financial soundness and stability in the Islamic financial system. In December 2005, the IFSB adopted two standards:

- a. Guiding Principles of Risk Management and
- b. Capital Adequacy Standard for Institutions.

The IFSB is also tasked with preparing standards on the supervisory review process, transparency and market discipline and special issues in capital adequacy and governance of investment funds.

### STUDENT PRACTICE 1

1. What are the main elements constituting *Shariah* principles? (para 3.1)
2. When was the Islamic Banking Act established and which was the first bank governed by the Act? (para 3.1 & 3.2)

## 4. THE MALAYSIAN ISLAMIC FINANCIAL SYSTEM

The Islamic financial system encompasses:

- a. Islamic banking system,
- b. Islamic money market,
- c. Islamic capital market, and
- d. Islamic insurance or *takaful* and specialised financial institutions.

### 4.1 Islamic Banking System

#### i) Islamic Banking Objectives

In “Islamic Banking: A Practical Perspective”, Khir, Gupta and Shanmugam (2008) informed that the primary objective of establishing Islamic banks is to spread economic prosperity within the framework of Islam by promoting and fostering Islamic principles in the business sector. The key objectives of Islamic banking then are to:

1. **Offer Financial Services:** Islamic banking statutes and laws strictly in line with *Shariah* principles for financial transactions, where *riba* and *gharar* are identified as not Islamic. The thrust is towards financing on risk-sharing and strict focus on *halal* activities. The focus is on offering banking transactions adhering to *Shariah* principles and avoiding conventional interest-based banking transactions.
2. **Facilitate Stability in Money Value:** Islam recognises money as a means of exchange and not as a commodity, where there should be a price for its use. Hence, the *riba*-free system leads to stability in the value of money to enable the medium of exchange to be a reliable unit of account.

3. **Foster Economic Development:** Islamic banking fosters economic development through utilities like *musharakah*, *mudharabah*, etc., with a unique profit and loss-sharing principle. This establishes a direct and close relationship between the bank’s return on investment and the successful operation of the business by the entrepreneurs, which in turn leads to the economic development of the country.
4. **Optimise Resources Allocation:** Islamic banking optimises allocation of scarce resources through investment of financial resources into projects that are considered to be the most profitable, religiously permissible and beneficial to the economy.
5. **Ensure Equitable Distribution of Resources:** Islamic banking ensures equitable distribution of income and resources among the participating parties – the bank, the depositors and the entrepreneurs – with its profit-sharing approach, which is one of a kind.
6. **Encourage Optimist Approach:** The profit-sharing principle encourages banks to go for projects with long-term instead of short-term gains. This leads the banks to conduct proper studies before getting into projects, which safeguard both the banks and investors interests in total. High returns distributed to shareholders maximise the social benefits and bring prosperity to the economy.

**ii) Differences between Islamic and Conventional Banking**

Khair, Gupta & Shanmugam (2008) also provided the differences between Islamic banking and conventional banking systems as listed in the following table:

Characteristics	Islamic Banking Systems	Conventional Banking System (Interest-Based)
Business Framework	Functions and operating modes are based on <i>Shariah</i> law.  Banks have to ensure that all business activities are in compliance with <i>Shariah</i> requirements.	Functions and operating modes are based on secular principles and not based on any religious laws or guidelines.
Prohibition of <i>Riba</i> in Financing	Financing is not interest-oriented and is based on the principle of buying and selling of assets, whereby the selling price includes a profit margin and is fixed from the beginning.	Financing is interest-oriented and a fixed / floating interest is charged for the use of money.
Prohibition of <i>Riba</i> in Deposits	Deposits are not interest oriented but profit and loss-sharing oriented whereby investors share a fixed percentage of profit when it occurs.  Banks get back only a share of profit from the business to which it is a party and in case of loss, the investor loses none in terms of money but foregoes the reward for its activities during that period.	Deposits are interest oriented and the investor is assured of a predetermined rate of interest with a guarantee of principal repayment.
Equity Financing with Risk-sharing	Bank offers equity financing for a project or venture.  Losses are shared based on the equity participation while profit is shared based on the pre-agreed ratio.	Not generally offered but available through Venture Capital Companies and Investment Banks.  Normally they participate in management as well.

Characteristics	Islamic Banking Systems	Conventional Banking System (Interest-Based)
Restrictions	Islamic banks are restricted to participate in economic activities, which are not <i>Shariah</i> -compliant.  E.g. Banks cannot finance business involving pork, alcohol, gambling. However, Islamic banks can provide financing if these items are a small percentage of the overall business.	There are no such restrictions.
<i>Zakat</i> (Religious Tax)	In the modern Islamic banking system, it has become one of the functions to pay <i>zakat</i> .	Does not deal in <i>zakat</i> .
Penalty on Default	Have no provision to charge defaulters any extra money.  Note: Some Muslim countries allow collection of a penalty; the justification is the cost incurred in collecting the penalty which is normally 1 per cent of the instalment amount due.	Normally charges additional money (compound rate of interest) in case of defaulters.
Prohibition of <i>Gharar</i>	Transactions with elements of gambling and speculation are strictly forbidden.  E.g. Derivative trading is prohibited due to its speculative nature.	Trading and dealing in any kind of derivative / futures involving speculation is allowed.
Customer Relations	The status of the bank in relation to its clients is that of partner / investor and entrepreneur.	The status of the bank, in relation to its clients, is that of creditor and debtors.
Shariah Supervisory Board	Each bank should have a Shariah Supervisory Board to ensure that all business activities are in line with <i>Shariah</i> requirements.	There is no such requirement necessary.
Statutory Requirement	Banks have to be in compliance with the Bank Negara Malaysia statutory requirements and also the <i>Shariah</i> Guidelines.	Has to be in compliance with the Bank Negara Malaysia statutory requirements only.

#### 4.1.1 Legal and Regulatory Framework

The existing laws governing the operation of the Islamic banking system in Malaysia is the Islamic Banking Act 1983 for the full-fledged Islamic banks. Despite the fact that all Islamic banking operations are to strictly comply with the *Shariah* requirements, the Shariah Courts have no jurisdiction over Islamic banking matters. Islamic banking still falls under the jurisdiction of the civil courts and the applicable civil laws.

BNM is empowered to regulate and supervise Islamic banking operations in Malaysia. It constantly monitors the operations of Islamic banks through off-site and on-site supervision. Regulatory tools include the minimum requirement for Islamic Banking Capital Funds, the statutory reserve ratio and other prudential guidelines, such as the Guidelines on Risk Management in Islamic Banking and the Guidelines on Islamic Money Market.

### 4.1.2 Shariah Advisory Council

BNM established the Shariah Advisory Council (SAC) in May 1997 as the authority for the application of Islamic law for the purpose of Islamic banking, takaful business, Islamic development financial business and other Islamic financial services business. The Council also serves as the reference point for *Shariah* rulings in court proceedings on Islamic banking and finance cases. The overall effectiveness of the *Shariah* governance framework was significantly enhanced in 2003 with the amendment of the law, which conferred legal stature to the Council.

All Islamic financial institutions have their own Shariah Advisory Boards / Committees to advise their management on the development and approval of Islamic products and services and other banking operations. These financial institutions are required to implement guidelines set by BNM as well as fatwas issued by the SAC governing Islamic financial transactions. Any dispute within or outside the court system on issues concerning *Shariah* matters in financial transactions can be referred to the SAC for guidance or clarification.

## 4.2 Islamic Interbank Money Market

The Islamic interbank money market (IIMM) was introduced on 3 January 1994 as a short-term intermediary to provide a ready source of short-term investment outlets based on *Shariah* principles. The existence of an active IIMM is another important component of the Islamic financial system. Under the *mudharabah* interbank investment (MII) mechanism, Islamic banking institutions can raise funds to meet their short-term funding requirements based on profit-sharing investments. Since its inception in 1994, the volume of MII increased from RM0.5 billion in 1994 to RM283.8 billion in 2003. A broad spectrum of short- and long-term Islamic financial instruments (e.g. Government Investment Issues (GII), Bank Negara Negotiable Notes (BNNN), Islamic private debt securities and the active trading of Negotiable Islamic Debt Certificates (NIDCs), Green Banker's Acceptances and Islamic Acceptance Bills) is available to meet investment and liquidity needs.

BNM also introduced the Islamic interbank cheque clearing system for Islamic and IBS banks. Effective 3 January 1994, cheques of these institutions are segregated from those of conventional banks for clearing purposes. The Islamic interbank cheque clearing system is also based on the *mudharabah* principle whereby the deficit of the clearing account will be funded by the surplus funds from other IBS banks. If there still is a deficit, then BNM will assist to fund the banks based on the *mudharabah* principle.

## 4.3 Islamic Capital Market

In the Islamic capital market, funds for long-term financing of infrastructure and development projects are raised through the issuance of Islamic private debt securities. This helps reduce over-dependence on the Islamic banking system for long-term financing and allows Islamic banking institutions to diversify part of the risks emanating from assets and liabilities mismatches. The issuance of diverse Islamic financial instruments ranging from short-term commercial papers and medium-term notes (MTN) to long-term Islamic bonds (e.g. Cagamas Mudharabah bonds and Khazanah bonds) facilitates Islamic banking institutions in meeting their investment and liquidity needs.

Apart from that, the establishment of the International Islamic Financial Market (IIFM) in 2002 constitutes part of the overall efforts to strengthen the efficacy of the Islamic financial system as a component of the global financing system in achieving balanced growth and development. The International Islamic Financial Market also provides the infrastructure to

facilitate mobilising foreign capital according to *Shariah* principles and stimulating the creation and trading of Islamic financial instruments. Towards this, Malaysia spearheaded the issuance of the first Islamic-based global sovereign bond or *sukuk* in July 2002 to give impetus to the development of the international Islamic financing market. The US\$600 million *sukuk* was positively received by the international investing community. Similarly, Malaysia's International Offshore Financial Centre in Labuan complements the development of the International Islamic Financial Market in issuing, listing and trading of foreign currency-denominated Islamic financial instruments.

#### 4.4 The Takaful Industry and Others

The *takaful* industry adds another significant synergy to the overall Islamic financial system. *takaful* operators, particularly *takaful* business, in general, contribute to mitigate part of the risks of the banking system emanating from mobilising savings for long-term investments and hence strengthen the resilience of the Islamic financial system.

The establishment of takaful operators as at 31 December 2007 is as follows:

Year	Name	Financial Group / interest
November 1984	Syarikat Takaful Malaysia	Bank Islam Group
September 1993	Takaful Nasional *	Malaysia National Insurance
October 2001	Maybank Takaful *	Maybank Group
April 2003	Takaful Ikhlas	MNRB Berhad
January 2006	Commerce Takaful	CIMB Group
July 2006	HSBC Amanah Takaful	HSBC / Jerneh Asia Berhad
September 2006	Prudential BSN Takaful (PruBSN)	Bank Simpanan Nasional / Prudential Holdings
November 2006	Hong Leong Tokio Marine Takaful	Hong Leong Bank / Tokio Marine Insurance
June 2007	MAA Takaful	MAA Holdings / Solidarity

\**Takaful Nasional and Maybank Takaful were merged to become Etiqa under the Maybank Group.*

Besides the *takaful* industry, specialised non-bank institutions also offer Islamic financial products and services. These, which include the development financial institutions, Pilgrims Fund Board, Cagamas Berhad and stock-broking companies, complement the Islamic banking system in expanding to reach specific strategic economic sectors, thereby enhancing the Islamic financial system's capacity in contributing to the nation's economic growth and development.

**STUDENT PRACTICE 2**

1. What are the components of the Islamic financial system? (para 4)
2. What are the functions of the Shariah Advisory Council? (para 4.1.2)
3. What is the main objective of the Islamic money market? (para 4.2)
4. What is *sukuk* and what role does it play or contribute to the Islamic capital market? (para 4.3)

**5. OPERATION OF ISLAMIC BANKING**

The operation of Islamic banking is different from conventional banking. As shown in Table 3, all deposits mobilised through current, savings, investment and other accounts are pooled into a fund in the Islamic bank. From this pool, a small percentage will usually be placed with BNM as statutory reserves and to meet other requirements, after which the balance of the funds will be invested to finance business activities such as working capital, acquisition of assets, project financing and equity participation. The investment of funds generated from deposits is at the bank's discretion.

These financing and investment activities will generate profit-derived revenues from the employment of customers' deposits. The bank is now in a position to distribute the profit allocated to each category of depositors, i.e., savings, General Investment Account (GIA) and Specific Investment Account (SIA) deposits. This is done by applying a profit-sharing ratio, e.g., 70:30 or 60:40, or any ratio that has been agreed upon by the depositors and the bank.

The profit attributable to the bank (assuming 40% of total profit) will be added to the income derived from the employment of shareholders' funds and income from fee-based activities to form the bank's total gross income. From this, operating expenses are deducted to arrive at net profit before *zakat* and taxation.

**Table 3: Mechanics of Islamic Banking and Finance**

Mobilisation of Deposits	Employment of Depositors' Funds	*Revenue Generated by the Employment of Depositors' Funds						
<table border="1" style="border-collapse: collapse;"> <tr> <td style="padding: 2px;">Current Account Deposits</td> <td style="padding: 2px;">)</td> </tr> <tr> <td style="padding: 2px;">Savings Account Deposits</td> <td style="padding: 2px;">)</td> </tr> <tr> <td style="padding: 2px;">Investment Account Deposits</td> <td style="padding: 2px;">)</td> </tr> </table>	Current Account Deposits	)	Savings Account Deposits	)	Investment Account Deposits	)	<ul style="list-style-type: none"> <li>• Statutory reserve</li> <li>• Other investments</li> <li>• Trade financing</li> <li>• Financing of asset acquisition</li> <li>• Project financing</li> <li>• Equity participation</li> <li>• Others</li> </ul>	<ul style="list-style-type: none"> <li>- Profit attributable to depositors (60%)</li> <li>- Profit attributable to bank (40%)</li> </ul> <p style="margin-left: 20px;">X X</p> <p>Add: Income derived from the employment of shareholders' funds and fee-based activities</p> <p style="text-align: right; margin-right: 20px;">X X</p> <hr style="border: 0.5px dashed black;"/> <p>Gross income</p> <p style="text-align: right; margin-right: 20px;">X X</p> <p>Less: Operating Expenses</p> <p style="text-align: right; margin-right: 20px;">X</p> <hr style="border: 0.5px dashed black;"/> <p>Net profit before <i>zakat</i> and taxation</p> <p style="text-align: right; margin-right: 20px;">X</p> <hr style="border: 0.5px solid black;"/>
Current Account Deposits	)							
Savings Account Deposits	)							
Investment Account Deposits	)							

*\*Note: The calculation of the profit distribution is governed by BNM's framework of rate of return issued on 16 October 2001 under BNM GP2-i. The guideline is to address the unique contractual relationship between Islamic banking and depositors under the mudharabah contract. The calculation of the rate is guided by BNM's guidelines in August 2004.*

**5.1 Framework of Rate of Return**

BNM issued the framework of rate of return in part to standardise the method of calculating rate of return for the Islamic banking industry. The objectives of introducing the framework are to:

- Set the minimum standard in calculating the rate of return.
- Provide a level playing field and terms of reference for Islamic banking players in deriving the rate of return.
- Provide BNM with better means of assessing the efficiency of Islamic banking institutions as well as their profitability, prudent management and fairness

Besides providing the guidelines for calculating and distributing profit to the depositors, it also serves as a tool for Islamic banking institutions (IBIs) to assess and monitor their business strategies and financial performance.

In line with the primary role of an Islamic financial institution of fund mobilisation, the underlying principle of the framework is that all deposits accepted by Islamic banking Institutions shall be utilised for:

- Provision of finance,
- Investment in securities,
- Inter-bank placement, and/or
- Other business as prescribed by BNM.

Essentially, to calculate the rate of return for its depositor, an IBI is required to classify its fund management and income and expenses as follows:

Management of Funds	Income and Expenses
<ul style="list-style-type: none"> <li>• <i>Restricted funds:</i> The funds, either short or long term, are to be managed separately, where the utilisation of the funds is identified and matched with specific funds. The fund is known as Specific Investment Deposits. Therefore for IBIs that offer these funds, they are required to prepare separate financial statements for each type of funds.</li> <li>• <i>Unrestricted funds:</i> These funds are co-mingled and managed on a pool basis. The utilisation of these funds is neither identified nor matched with any specific funds. Current, savings, general investment and special investment deposits fall under this category.</li> </ul>	<ul style="list-style-type: none"> <li>• <i>Restricted funds:</i> All income and expenses reported in each fund's financial statement and calculation table (CT) must be clearly identified and matched with the utilisation of the specific fund.</li> <li>• <i>Unrestricted funds:</i> All income and expenses arising from the utilisation of the depositors' fund other than restricted funds shall be shared between depositors and the bank.</li> </ul> <p>The treatment for trading and fee income are as follows:</p> <ol style="list-style-type: none"> <li>1. All trading income, including income arising from intra-day transactions is deemed to utilise depositors' funds.</li> <li>2. Income generated from primary or originating deals inclusive of sell-down activities belong to the bank.</li> <li>3. If the shareholders' funds are managed separately and clearly identified and matched with trading activities, such income belongs to the bank.</li> <li>4. Fee based income shall belong to the bank.</li> <li>5. Nonetheless, income from fee activities that directly or indirectly arise from the utilisation of depositors' funds, such as guarantees and underwriting, shall be shared between the bank and depositors unless these activities are managed separately.</li> </ol>

## 5.2 Profit Equalisation Reserve (PER)

The PER is a reserve maintained by an Islamic bank for the purpose of mitigating the risk of undesirable fluctuations of dividend rates arising from the flux of income, provisioning and total deposits.

The PER refers to the amount appropriated out of total gross income to maintain an acceptable level of return for depositors. It is a provision shared by both the depositors and the bank, and hence deducted from total gross income.

For the purpose of the PER, IBIs are allowed to build up and maintain a maximum accumulated PER of 30% of its shareholders' funds. In addition IBIs are allowed to make a monthly provision up to 15% of gross income plus net trading income, other income and irregular income such as recovery of non-performing financing (NPF) and write-back of provisions.

In the event that IBIs need to provide a monthly PER that exceeds BNM's ceiling, prior approval from BNM is required. IBIs may write back the amount of the PER into total gross income in the event that the prevailing rates have become less competitive.

### STUDENT PRACTICE 3

1. How is net profit calculated before *zakat* and taxation under Islamic banking? (para 5)

## 6. BASIC PRINCIPLES AND CONTRACTS IN ISLAMIC BANKING

### 6.1 Basic principles of Islamic banking

As mentioned in Section 1. Introduction, Islamic banking is premised on two important *Shariah* principles; avoidance of *riba* and prohibition of *gharar*. Khir, Gupta and Shanmugam (2008) in their book, *Islamic Banking: A Practical Perspective*, provide the following descriptions of *riba* and *gharar*.

*Riba* contains the following three elements:

1. **Excess or surplus over and above the loan capital:** Increase in terms of value, which comprises the quantity and quality, immaterial to minimum or maximum increase, fixed or variable increase.
2. **Determination of this surplus in relation to time:** Increase in terms of value upon extension at maturity.
3. **Stipulation of this surplus in the loan agreement:** The surplus condition over the principal is part of the agreement.

## 6.2 Difference between Riba and Profit

There is a clear distinction between trade and *riba* under the *Shariah* whereby trading is welcomed and *riba* prohibited. Trade leads to profit and is totally different from *riba* as explained in the following table:

Riba	Profit
<i>Riba</i> is the premium paid by the borrower to the lender along with the principal amount as a condition for the loan.	Profit is the difference between the value of production and the cost of production.
<i>Riba</i> is pre-fixed. Hence, there is no uncertainty on the part of either the givers or takers of loans.	Profit is post-determined. Hence, its amount is not known until the activity is done.
<i>Riba</i> cannot be negative. It can at best be very low or zero.	Profit can be positive, zero or even negative.
From the <i>Shariah</i> point of view, it is <i>haram</i> (forbidden).	From the <i>Shariah</i> point of view, it is <i>halal</i> (permissible) if all the <i>Shariah</i> rules are followed for trade.

## 6.3 Other Forms of Riba In Islamic Commercial Transactions

Besides *riba qurud* (interest on loans) which also includes interest on debt, i.e., interest on deferred payment of sale of good e.g. one imposed by courts or other types of credit granted where the deferred payment is not amounting to selling price and interest imposed on late payment of loan / debt, there is also *riba* on trading transactions known as *riba buyu*.

*Riba buyu* comprises:




- *Nasi'ah*: Deferred delivery or payment of ribawi items e.g. forward FX. Ribawi items under *Shariah* comprised Gold, Silver and Currency.
- *Fadhl*: Excess from barter transaction of the same type of staple food, e.g., exchange of 1kg rice with 1.5kg rice. This is normally applicable to barter transactions.

Under the *Shariah*, trading of currency (including gold and silver), which was classified as a ribawi item must be done on spot but not necessarily at par because we are exchanging different types of items under the category of 'currency'. Therefore, banks can exchange e.g., MYR and USD at any rate provided it is done on spot. However, Islamic financial institutions are currently exploring the mechanism of implementing FX trading based on the *wa'd* principle, which does not constitute a contract as it is a non binding promise.

The same principle also applies for staple food, which must be done on spot but not necessarily at par, e.g., trading of wheat and barley. However, if one is trading or exchanging similar types under a similar category one needs to be traded at par and on spot basis (e.g., to exchange 1kg of grade A wheat with grade B wheat, the grade needs to be 1kg as well) or gold with gold (to exchange different karats must be at the same measure). Therefore, it makes no sense from a commercial point of view, which basically requires us to sell the goods first, e.g., selling 1kg of grade A wheat and using the proceeds to buy 1kg of grade B wheat and realising some balance, which is fine under *Shariah*.

To facilitate understanding of *riba buyu* (interest in trading transactions), the following table summarises the prohibition and requirements in undertaking Islamic commercial transactions:

Type		Currency				*Staple Food			
		Gold	Silver	USD	MYR	Wheat	Barley	Dates	Salt
Currency	Gold	On spot and at par	On spot basis	Free from above conditions	Free from above conditions				
	Silver	On spot basis	On spot and at par	Free from above conditions	Free from above conditions				
	USD	Free from above conditions	Free from above conditions	On spot and at par	Free from above conditions				
	MYR	Free from above conditions	Free from above conditions	Free from above conditions	On spot and at par				
Staple Food	Wheat					On spot and at par	On spot basis	On spot basis	On spot basis
	Barley					On spot basis	On spot and at par	On spot basis	On spot basis
	Dates					On spot basis	On spot basis	On spot and at par	On spot basis
	Salt					On spot basis	On spot basis	On spot basis	On spot and at par

 On spot and at par  
 On spot basis  
 Free from above conditions

Note: Staple food not limited to the above-mentioned examples but also cover rice and other staple food.

#### 6.4 Definition of *Gharar*

*Gharar* means ‘uncertainty, hazard, speculation, chance or risk’. Islam prohibits uncontrollable risks or uncontrollable obligations as it leads to speculation. In business terms, *gharar* means to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction. Some good examples of transactions, which include the element of *gharar*, are:

- Selling goods that the seller is unable to deliver;
- Selling known or unknown goods against an unknown price, such as selling the contents of a sealed box;
- Selling goods without proper description, such as shop owner selling clothes with unspecified sizes;
- Selling goods without specifying the price, such as selling at the ‘going price’;
- Making a contract conditional on an unknown event that happens at an unspecified time;
- Selling goods on the basis of a false description; and
- Selling goods without allowing the buyer to properly examine the goods.

*Gharar* also involves an element of uncertainty in a contract where the contracting parties do not understand the attributes or consequences of the contract. Some of the examples applicable in the current banking system are:

- *Sighah* (stipulation) e.g., combining the sale and purchase in one transaction, i.e., having the contract of sale (*bai*) and lease (*ijarah*) in one document and concluding the contracts in one *aqad* and mixed with each other.
- Contracting parties, e.g., having sale and purchase without mentioning the price such as signing a blank sale or *ijarah* agreement.

- Subject matter, e.g., sale and purchase of an asset, which does not exist such as executing a purchase agreement without indicating the asset being transacted or same asset being transacted in multiple sale agreements with multiple parties at the same time.
- Delivery - possession, time, ability, e.g., purchase of an insurance policy without certainty of obtaining the coverage.

## 6.5 Islamic Contracts

As extracted from *Islamic Banking: A Practical Perspective*, the *Shariah* Law of Contract is primarily based on three fundamental principles:

1. **The Principle of Justice:** Ensures that neither party to a contract may exploit the other. Hence the *riba* is strictly prohibited.
2. **The Principle of Transparency:** Those concerned must share all available information. Withholding crucial information, which has bearing on the transaction could render the contract invalid. Furthermore, contracts involving a high degree of *gharar* are strictly prohibited. The objective is to prevent transactions that could lead to dispute and lack of trust.
3. **The Principle of ‘Maslaha’:** Means the common interest supported by the spirit of *Shariah* and not by a specific text. On the basis of *maslaha*, a particular form of transaction may be exempted from the general rule if it has been shown to be a common practice to facilitate business.

Basically, Islamic commercial transactions or *muamalat* contracts can be categorised into five categories of contracts:

1. Sale-based, (trading contract)
2. Partnership,
3. Lease-based,
4. Fee-based, and
5. Others:
  - *kafalah* (guarantee)
  - *wa’d* (promise)
  - *tabarru’* (donation)
  - *hibah* (gift)
  - *qard hasan* (benevolent loan)
  - *waqf* (endowment)
  - *zakat* (sacred alms)
  - *ibra* (rebate), etc.

### 6.5.1 Trading Contracts

These contracts are basically for trading, i.e., buying and selling of assets. Islamic banking follows the trading principle for financing customers' needs. The trading contract can be for goods, cash and debt trading. The most common trading contracts adopted by Islamic banks are as follows:

1. ***Bai Murabahah (Cost Plus)***: A sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and the profit. Islamic banks have adopted this contract as a mode of financing.
2. ***Bai Tawliyah***: A sale at cost without any profit for the seller. This sale is again based on the principle of trust (*amanah*).
3. ***Bai Wadiah***: This sale takes place when the seller agrees to sell a commodity at a lower price than that of the cost price. Since the seller is selling the commodity at a lower price, it is also a trust sale.
4. ***Bai Salam***: *Salam* means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract.
5. ***Bai Istisna (Sale by Order)***: A contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or future payment and future delivery. A manufacturer or builder agrees to produce or build a well-described good or building at a given price on a given date in the future.
6. ***Bai Bithaman Ajil (Deferred Payment Sale)***: Refers to the sale of goods on a deferred payment basis at a price that includes a profit margin agreed upon by both the buyer and the seller.
7. ***Bai Istijrar (Supply or Wholesale Financing)***: Refers to an agreement between the client and the supplier, whereby the supplier agrees to supply a particular product on an on-going basis, for example, monthly at an agreed price and on the basis of an agreed mode of payment.
8. ***Bai Inah***: Refers to the selling of an asset by the bank to the customer through deferred payments. At a later date, the bank will repurchase the asset and pay the customer in cash terms. This is normally used for offering overdraft facilities to customers.

## 6.5.2. Participation / Partnership Contracts

Islam encourages equity-based participation where the focus is on profit and loss sharing. Banks and lenders should invest their money to become partners in business instead of becoming creditors. This encourages entrepreneurship. Translated into banking context, the depositor, bank and entrepreneur should all share the risks and rewards of financing business ventures. The objective is that high-risk investments provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts. The most common participation contracts followed by Islamic banks are listed below:

1. **Musarakah:** Financing through equity participation is called *musarakah*. Two or more partners contribute to the capital and expertise for an investment. Profits and losses are shared according to the amounts of capital invested. This type of transaction has traditionally been used to finance medium and long-term investments. Banks have the legal authority to participate in the management of the project, including sitting on the board of directors.
2. **Mudharabah:** Under a *mudharabah* contract, the bank provides the capital needed for a project while the entrepreneur offers labor and expertise. The profits (or losses) from the project are shared between the bank and the entrepreneur at a fixed ratio. Financial losses are assumed entirely by the bank; the liability of entrepreneurs is limited to their time and effort. In cases of proven negligence or mismanagement by entrepreneurs, however, they may be held responsible for the financial losses.
3. **Musaqat:** It is a specific type of *musarakah* contract for orchards. *Musaqat* is an arrangement between the farmer or garden owner, and the worker who undertakes to water the garden, etc., and do all such work, which would help the harvest or fruition. In this case, the harvest is shared among all the equity partners according to their contributions.
4. **Muzarah:** It is essentially a *mudharabah* contract in farming where the bank can provide land or funds in return for a share of the harvest.

## 6.5.3. Leased Based Contracts

Essentially a lease-based contract is a contract whereby a lessor (owner) transfers the usufruct (benefit of use) of an *ijarah* item to a lessee in return for an agreed *ijarah* payment or series of *ijarah* payments for a pre-determined *ijarah* period based upon the *aqad* (contract). The ownership of the leased equipment remains in the hands of the lessor. The most common lease contracts are:

1. **Ijarah Thumma Al Bai (lease ending with sale):** An *ijarah* contract with a *wa'd* (undertaking) by the lessor to sell the *ijarah* item to the lessee or an undertaking by the lessee to purchase the *ijarah* item from the lessor by, or at, the end of the *ijarah* period. The contract begins with an *ijarah* contract for the purpose of leasing the *ijarah* item by the lessor to the lessee; and by, or at, the end of the *ijarah* period, the lessee will purchase the asset at an agreed price from the lessor by executing a separate contract, i.e., a *bai'* (purchase) contract.

2. ***Ijarah Muntahia Bittamleek (lease ending with ownership)***: This contract is similar to the above except that the contract concludes with the legal title of the lease asset being passed to the lessee at the end of the lease. The legal title can be transferred to the lessee for no consideration by entering into a gift contract or by means of issuing a gift deed made conditional upon settlement of the agreed rental payments.

#### 6.5.4 Fee Based and Other Supporting Contracts

There are other contracts in compliance with *Shariah* principles that support and facilitate trading and mobilisation of capital. The most common fee based and supporting contracts adopted by banks are listed below:

1. ***Rahnu (Mortgages)***: An activity whereby a valuable item is collateralised to a debt. It may be utilised as payment if the debt is not repaid within the agreed period. In the event the debtor is not able to repay the debt, the pawned asset will be sold off to settle the outstanding debt and any surplus will be given back to the owner of the asset.
2. ***Kafalah (Guarantee)***: Under this contract, a third party becomes guarantor for the payment of debt. It is a pledge given to the creditor that the debtor will pay the debt.
3. ***Wakalah (Agency)***: A contract of agency is a contract where one person appoints someone else to perform a certain task on his behalf, usually for a certain fee.
4. ***Qardh Hasan (Benevolent Loan)***: An interest-free loan. The borrower is only required to repay the principal amount borrowed, but he may pay an additional amount at his absolute discretion, as a token of appreciation.
5. ***Hiwalah (Transfer of Debt)***: Legally, it is an agreement by which a debtor is freed from a debt by transferring the debt to another person. The other person becomes responsible for the debt or the claim of a debt. Also refers to the document by which the transfer takes place.
6. ***Tabarruu' (Donation)***: A donation or gift for the purpose of welfare or service in the name of God. It is not for commercial purposes. Any benefit that is given by a person to other without getting anything in exchange is called *tabarruu'*.
7. ***Hibah (Gift)***: Basically a gift. Normally, banks give Islamic savings account holders *hibah* for keeping their money with the bank as a token of appreciation.
8. ***Ibraa (Rebate)***: *Ibraa* is a reduction in the balance outstanding upon early settlement of the financed amount. The computation will be based on the terms and conditions agreed to in the contract.

## 6.6 Some Islamic contracts used in the sources and applications of funds

For an overview of the modes of operation, we examine some of the main contractual relationships with customers in terms of the sources and applications of funds under Islamic banking (see Table 4).

**Table 4: Main Contractual Relationships with Customers under Islamic Banking**

Sources of Funds	Applications of Funds
1. Savings Accounts <ul style="list-style-type: none"> <li>• <i>Wadiah</i> (guaranteed custody)</li> </ul>	1. Term Financing <ul style="list-style-type: none"> <li>• <i>Bai' bithman ajil</i> (deferred instalment sale)</li> <li>• <i>Ijarah</i> (leasing)</li> </ul>
2. General Investment Accounts <ul style="list-style-type: none"> <li>• <i>Mudharabah</i> (trustee profit-sharing)</li> </ul>	2. Trade Financing <ul style="list-style-type: none"> <li>• L/C <i>Wakalah</i> (agency)</li> <li>• L/C <i>Murabahah</i> (deferred lump sum sale)</li> <li>• L/C <i>Musyarakah</i> (joint-venture profit-sharing)</li> <li>• <i>Murabahah</i> working capital financing (deferred lump-sum sale or cost plus)</li> </ul>
3. Special Investment Accounts <ul style="list-style-type: none"> <li>• <i>Mudharabah</i> (trustee profit-sharing)</li> </ul>	3. Other Facilities <ul style="list-style-type: none"> <li>• <i>Qardhul hasan</i> (benevolent loan)</li> <li>• <i>Bai' al-istina</i> (sale on order)</li> </ul>
4. Shareholders' Equity <ul style="list-style-type: none"> <li>• <i>Musyarakah</i> (joint-venture profit-sharing)</li> </ul>	4. Investment <ul style="list-style-type: none"> <li>• <i>Musyarakah</i> (joint-venture profit-sharing)</li> </ul>

Adapted from *Islamic Banking Practice – From the Practitioner's Perspective*, Bank Islam Malaysia Berhad

### 6.6.1 Sources of Funds

#### a. Current Accounts - Wadiah

*Wadiah* means 'deposit of money allowing somebody to claim the funds in the account'. Customers' deposits in the form of current accounts are under the *wadiah yad dhamanah* contract. It is based on the combination of two categories of Islamic commercial contracts, namely *wadiah* (custody) and *dhamanah* (guarantee). The details are as follows:

- i) The bank accepts deposits from its customers looking for safe custody of their funds and absolute convenience in their use in the form of current accounts on the *wadiah yad dhamanah* principle.
- ii) The bank requests permission from its customers to make use of their funds so long as these funds remain with the bank.
- iii) The customers may withdraw a part or the whole of their balances at any time they so desire, and the bank guarantees refund of such balances.

- iv) All profits generated by the bank from the use of such funds belong to the bank. (Customers do not share the profits.)
- v) The bank provides its customers with cheque books and the other usual services connected with current accounts

**b. Savings Accounts – Wadiah**

Customers' deposits in savings accounts are taken by the bank under the *wadiah yad dhamanah* contract (guaranteed custody) with payment of profit at the bank's absolute discretion. All the bank's generated profits from the use of such funds belong to the bank. However, in contrast to current accounts the bank may, at its discretion, reward the customers by returning a portion of the profit generated from the use of their funds.

**c. General Investment Accounts – Mudharabah (Trustee Profit-Sharing)**

Under customers' deposits in General Investment Accounts (*mudharabah* – trustee profit-sharing), the bank accepts deposits from customers looking for investment opportunities for their funds based on the *mudharabah* principle. The bank acts as an "entrepreneur" with the customers as "providers of capital" and both agree on a ratio such as 60 : 40 to distribute any profits between them. However, the bank would not provide guarantee on the profit and capital.

**d. Special Investment Accounts – Mudharabah (Trustee Profit-Sharing)**

Besides accepting deposits from ordinary customers, the bank may also selectively accept deposits from customers in the form of Special Investment Accounts for investment in specific projects. These accounts, similar to General Investment Accounts, are also operated under the *mudharabah* principle. In the event of a loss in the investment, the customers will also share the burden of the loss. The differentiating feature of this account is the requirement that the fund is to be managed separately.

## 6.6.2 Applications of Funds

After meeting the statutory reserve and liquidity requirements, the bank is free to invest its excess funds in the form of financing. Some of the financing facilities are as follows:

**a. Project Financing (Mudharabah – Trustee Profit-Sharing)**

The bank may undertake to finance viable projects under the *mudharabah* principle. As provider of capital, the bank will provide 100% project financing. The initiator of the project (the entrepreneur) will manage the project, and both the bank and entrepreneur agree on a certain profit-sharing arrangement. The bank will bear all losses if incurred from the project.

**b. Project Financing (Musyarakah – Joint-Venture Profit-Sharing)**

Similarly, a project can also be operated under the *musyarakah* principle – joint-venture profit-sharing whereby the bank together with the initiators or entrepreneurs will provide the whole project financing on an agreed profit and loss sharing ratio.

**c. Acquisition of Asset Financing (Bai' Bithaman Ajil – Deferred Instalment Sale)**

The bank may provide financing to a customer to acquire asset but with deferment of repayment for a specific period or by installments under the *bai' bithaman ajil* (BBA) principle. The bank first purchases the asset and then sells it to the customer at the asset's actual cost plus a margin or profit, and allows the customer to settle the payment by instalments over a certain period as agreed. The differences between BBA house financing and conventional housing loan can be best explained by an example.

Under the BBA concept of buying and selling, the total cost of financing will be cost of house plus profit element of the house for the whole duration of financing. Assume the house costs RM100,000 and the profit element for 10 years is RM30,000. The accounting entries under BBA house financing for 10 years will be as follows:

Dr	BBA asset	RM100,000)	Purchase of
Cr	Banker's cheque	RM100,000)	asset by bank
Dr	BBA financing (property cost plus profit element)	RM130,000)	Financing
Cr	Unearned income	RM 30,000)	of asset under
Cr	BBA asset	RM100,000)	BBA concept

There will be a monthly accrual of unearned income as follows:

Dr	Unearned Income	RM250
Cr	Income	RM250

Under conventional housing loan, assume the purchase price of the house is RM100,000. The interest at, say, 6% will be charged every month as shown below:

Dr	Housing loan	RM100,000)	Upon releasing the
Cr	Cash / bank	RM100,000)	purchase price of house

Month-end charging of interest, say, RM500 on monthly rest:

Dr	Housing loan	RM500
Cr	Interest income	RM500

Table 5 summarises the differences between BBA and conventional housing loans.

**Table 5: Differences Between BBA House Financing and Conventional Housing Loans**

BBA House Financing	Conventional Housing Loans
Based on the concept of buying and selling	Lending concept
Profit element is used	Interest is charged
Selling price, i.e., cost of financing plus profit is the contracted price of financing	Principal plus interest is the contractual financing amount
Profit rate / margin is fixed	Interest rate is subject to changes
Legal documentation in accordance with the BBA principle	Conventional legal documentation
Right to any rebate payment over sale price is subject to the bank's sole discretion	Shall be entitled to a rebate upon pre-payment

**d. Financing the Use of Services Derived from Assets (Ijarah – Leasing)**

Banks may finance their customers' acquisition of the right to use services of a given asset under the *ijarah* principle. In this case, the bank first purchases the asset the customer requires, and then leases it to the customer for a fixed period with a monthly lease rental and terms and conditions as agreed to by both parties.

For the financing of cars using *ijarah thumma al-bai*, there are two contracts involved. The first, *ijarah* contract (leasing / renting), and the second, *bai*' contract (purchase), are undertaken one after the other. The customer enters into the first contract and leases the car from the owner (bank) at an agreed rental over a specific period. When the leasing period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price.

**e. Trade Financing**

Islamic banks also provide customers with credit facilities for short-term trade financing and for working capital requirements. These facilities (discussed below) may be granted for purposes of importing or exporting goods and acquiring assets.

**i) Letter of Credit (Wakalah – Agency)**

The customer informs the bank of his requirement for a letter of credit. The bank may require the customer to place a full deposit on the price of the goods to be purchased / imported under the principle of *wadiah yad dhamanah* principle. The bank then establishes the letter of credit, pays the proceeds to the negotiating bank utilising the customer's deposit, and subsequently releases the documents to the customer. In this case, the bank charges the customer fees and a commission for its services under the *al-ujr* (fee) principle.

**ii) Letter of Credit (Musharakah – Joint-Venture Profit-Sharing)**

It should be noted that a letter of credit may be granted under the *musyarakah* principle, i.e., joint-venture profit-sharing. In this case, the customer and bank negotiate the terms of *musyarakah* financing for customer's letter of credit requirement, i.e., the bank and customer share the total finance required as well as the profit from the venture as provided for in the agreement.

**iii) Letter of Credit (Murabahah – Deferred Lump Sum Sale or Cost-Plus)**

A customer informs his bank of his letter of credit requirements and requests the bank to purchase the goods, indicating that he is willing to purchase the goods from the bank upon their arrival under the *murabahah* principle. Upon paying the exporter for the goods, the bank sells the goods to its customer at a sale price comprising the cost plus a profit margin. The customer repays the bank on a deferred term as agreed upon by both parties.

**iv) Financing Working Capital (Murabahah – Deferred Lump Sum Sale or Cost-Plus)**

A customer may approach his bank to provide financing for his working capital requirements to purchase stocks, inventories and other assets. The bank first purchases or appoints the customer as its agent to purchase the required goods and settles the purchase price from his own funds. It subsequently sells the goods to the customer at an agreed price comprising the cost plus a profit margin, and allows the customer to settle the sum on deferred terms of 30 days, 60 days, 90 days, or any other period as the case may be. On the due date, the customer repays the sum owed to the bank.

**f. Other Facilities****i) Benevolent Loan (Qardhul-Hasan)**

This refers to a short-term interest-free loan or benevolent debt-financing contract for which the borrower is not obliged, but has the option, to reward the lender for the benevolent deed. This means the borrower is obliged to repay only the principal sum of the loan (without profit) on maturity. However, it is normal for the borrower to repay more than the principal amount, usually in the form of a gift or bonus. The bank may use the funds at its disposal for what may be considered as the discharge of its social responsibilities through extending loans to deserving customers, e.g., the government and other authorities, for worthy economic projects.

The benevolent nature of this contract also provides a suitable avenue for citizens (both individuals and corporations) to assist the government in financing its socio-economic development projects, e.g., by investing in non-interest bearing Malaysian Government Investment Certificates. Under the *qardhul-hasan* concept, the rate

or the amount of the bonus is not fixed. The gift or bonus is given at the government's discretion.

**ii) Sale on Order (Bai' Al-Istina)**

This contract involves the acquisition of an asset according to specifications given in the sale and purchase agreement. After the parties to the contract have decided on the price, settlement can be delayed or arranged based on the schedule of work completed.

**g. Investment**

Investment is permissible, governed by conditions such as the following:

- i. the money does not generate money in itself but is productive through an activity or work
- ii. it is subject to the rule of profit and loss sharing
- iii. there are no prohibitions on the business activities
- iv. the contract must be free of *gharar* (uncertainty or ambiguity)

Islamic banks may thus, utilise their customers' deposits and shareholders' funds to undertake various types of investments, e.g. wholly-owned subsidiaries, investing in unquoted or quoted companies under the *musyarakah* principle, i.e., joint-venture profit-sharing.

In view of *gharar* (uncertainty), Islamic banks do not undertake any investment or transactions that have elements of speculation such as share margin financing and forward foreign exchange transactions.

To better appreciate the popularity of Islamic financing in Malaysia, see Table 6.

**Table 6: Islamic Financing in Malaysia as at 31 December 2003**

<i>Bai' bithaman ajil</i>	47.7%
<i>Ijarah thumma al-bai'</i>	27.6%
<i>Murabahah</i>	6.2%
<i>Ijarah</i>	1.4%
<i>Musyarakah</i>	0.5%
<i>Istina'</i>	0.6%
Other Islamic concepts	16.0%
<b>Total</b>	<b>100%</b>

Source: Bank Negara Malaysia Report 2003

**STUDENT PRACTICE 4**

1. Differentiate between contracts under *mudharabah* and *musyarakah*? (para 6)
2. What is a benevolent loan under *qardhul-hasan*? (para 6)
3. What is a contract under *bai' al-murabahah*? (para 6)

## 7. SHARIAH COMPLIANCE OVERVIEW

Under the BNM / GPS 1 dated December 2004, it is stated that the Islamic financial institution shall have a Shariah Compliance Manual and that the manual should cover the following aspects:

- a. the manner in which a submission or request for advice is to be made to the Shariah Committee,
- b. the conduct of the Shariah Committee's meeting, and
- c. the manner of compliance with any *Shariah* decision.

Hence, it is not uncommon that in many financial institutions, internal auditors are required to review *Shariah* compliance not just in accordance with BNM / GPS1 but also against the spirit of *Shariah* principles and Islamic law and practices.

The *Shariah* compliance review or audit would make reference to the BNM's National Shariah Advisory Committee's Rulings, Internal Shariah Advisory Committee's decisions, Security Commission Shariah's Rulings and other respected scholarly materials or opinions from AAOIFI and IFSB.

### 7.1 What is Shariah

*Shariah* can be deemed to cover the following areas:

1. Islamic law / jurisprudence, originated from the *Quran* and *Sunnah* (acts or sayings of Prophet Muhammad pbuh);
2. Inclusive of *ijma* (consensus of opinion), *qiyas* (analogical reference), *ijtihad* (personal effort of determination), etc;
3. Objective is one of *maslahah*, (public interest);
4. Covers various aspects of life, e.g., worshipping, personal & family matters, criminal, social, economics, welfare, management, development, science, etc;
5. *Fiqh al-Muamalat* (the science of commercial transactions in Islam) as a branch in the *Shariah* in relation to financial activities; and
6. Principle of permissibility: "All are deemed permissible except when there is contravention to Islamic principles".

### 7.2 What is Shariah compliance in Islamic Banking

As mentioned in chapter 1, the commercial undertakings of Islamic financial institutions and their operations must adhere to the following fundamental *Shariah* requirements:

1. Transaction is free from interest element (*riba*).
2. Transaction is free from any gambling activity.
3. Transaction is free from activities that involve producing and sale of goods and services that are prohibited by the religion of Islam as follows:
  - Alcohol related,
  - Pork related, or
  - Immoral services that promote vice activities.
4. Transaction is free from the '*gharar*' element, i.e., excessive uncertainty, e.g. deceit, fraud, swindle, unlawful gain of property or conditional sale and purchase agreement.
5. Transaction is free from impediments of consent, i.e., fraud, misrepresentation of contracting parties, duress or unfair return of value of the exchange of property.
6. Transaction will not lead to hoarding and manipulation of price including speculation.

In addition, all Islamic banking products are based on *Shariah / Muamalah* principles, for instance,

1. Sale-based: *Murabahah* (cost-plus) / *Bay Bithaman Ajil* (deferred instalments), *inah* (sale with immediate repurchase), *tawarruq* (tri-partite *inah*), *istisna* (construction), *salam* (future-delivery sale), *Bay al-Dayn* (sale of debt).
2. Partnership: *Mudarah* (profit sharing), *musyarakah* (profit-loss sharing).
3. Lease-based: *Ijarah*, *AITAB*.
4. Fee-based: *Wadiah* (safekeeping), *wakalah* (agency), *kafalah* (guarantee), *ujrah* (fee).
5. Others: *Hibah* (gift), *ibra* (rebate).

The Islamic Financial Services Board (IFSB) has, as a guide and to promote uniformity, provided some insight into *Shariah* compliance risk and its framework. IFSB Guiding Principles of Risk Management (Dec 05) indicate:

- *Shariah* compliance is considered as falling within a higher priority category in relation to other identified risks.
- IIFS have in place a comprehensive and sound framework for developing and implementing a prudent control environment for the management of operational risks arising from their activities.
- IIFS have adequate *Shariah* compliance mechanisms in place. These will include well-defined and adequately qualified and staffed organisational structure; clear lines of authority and accountability; policies and procedures pertaining to the approval of products and activities that require adherence to *Shariah* rules and principles.

## 8. APPLICATION OF SHARIAH COMPLIANCE IN ISLAMIC BANKING

As tabulated in section 6, more than 80% of the Islamic Financing portfolio in Malaysia was granted under sale and lease based contracts. The most common products are *bai' bithaman ajil*, *ijarah thumma al' bai* and *murabahah* (cost plus financing). Therefore, the following section will illustrate the application of the *Shariah* compliance review of the two most common contracts.

### 8.1 Sale based Financing

Under sale-based contracts, the **KEY SHARIAH PRINCIPLE** in the operation of the contracts must comply with the five basic tenets as follows:

1. Buyer:
  - i) Must be able to carry out his / her responsibilities (of sound mind, mature and intelligent),
  - ii) Not restricted from dealing in business transaction (not a bankrupt or not an extraordinary extravagant person), and
  - iii) Not being forced into the contract.
2. Seller:
  - i) Must be able to carry out his / her responsibilities (of sound mind, mature and intelligent),
  - ii) Not restricted from dealing in business transaction (not a bankrupt or not an extraordinary extravagant person), and
  - iii) Not being forced into the contract.

3. Goods / Asset / Merchandise must be:
  - i) In existence (except for order sale)
  - ii) Of value which is halal (lawful and permissible by *Shariah*) and valuable.
  - iii) (Seller), must be the owner of the asset / merchandise.
  - iv) (Seller), must be able to deliver the merchandise to the buyer.
  - v) Known to the seller and buyer.
4. Price must be determined in amount and type of currency is specified.
5. Contract, Offer and Acceptance, i.e., in a contract meeting and must be explicit (define and decisive language)

## 8.2 Lease Based Financing

The **KEY SHARIAH PRINCIPLE** for lease-based contracts consists of six basic tenets as follows:

1. Lessor: A party in an *ijarah* contract who owns the *ijarah* item and gives the usage of that item to the lessee. In the context of banking, the bank is the lessor who owns the asset.
2. Lessee: The party in an *ijarah* contract receiving the usage of the *ijarah* item from the lessor and in banking operations also known as the customer.
3. *Ijarah* item: An item whose usage is the subject of *ijarah*. The usage of an item may be the subject of *ijarah* as long as the item is not derived from, does not involve the use of, and is not used to produce elements contrary to the *Shariah*. Examples of items that may be contrary to the *Shariah* are stolen vehicles, vats for producing alcoholic beverages, or slot machines for gambling.
4. *Manfa'ah (usufruct)*: The right to use and enjoy the benefits accruing from an *ijarah* item, so long as that use or enjoyment does not alter or diminish the essence of the item.
5. *Ijarah* payment: For an *ijarah* contract, the monthly payment the bank receives is known as the rental payment or series of rental payments paid throughout the *ijarah* period.
6. Contract: Offer and acceptance of contract as well as the terms and conditions.

## 8.3 Auditing of Sale and Lease-Based Financing Products

To better understand how to audit sale and lease based financing products one must appreciate the mechanics of the products in order to determine the key areas of concern and the controls required to ensure compliance with the basic tenets of sale and lease based financing:

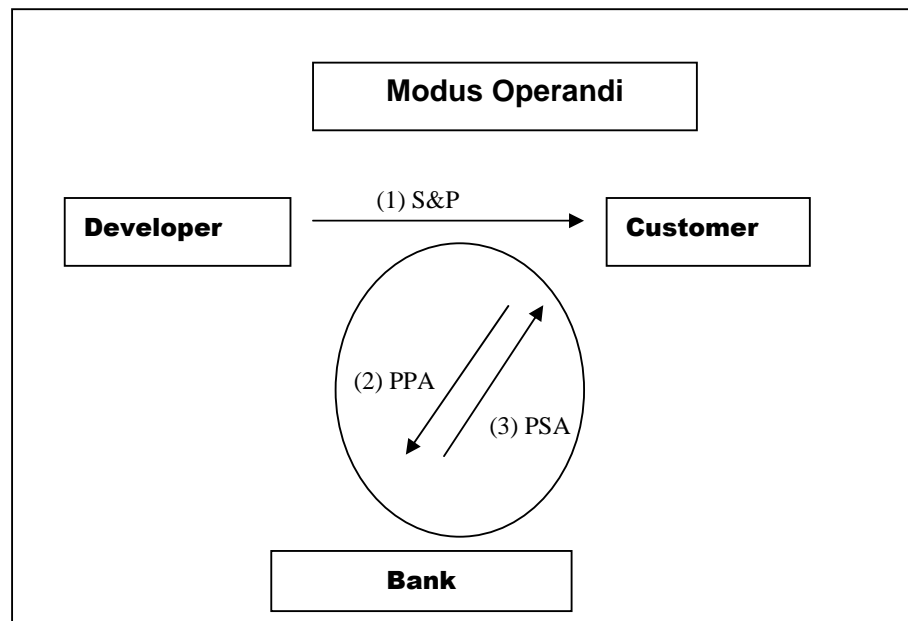
### 8.3.1 **BBA / Bai al-Inah / Murabahah (Sale-Based Financing)**

*Bai' Bithaman Ajil (BBA)* means sale of asset(s) whereby the payment will be on deferred-payment basis within a payment period as per agreement by the contracting parties. The deferred payment could be in the form of a single bullet payment at an agreed date or by instalments, etc.

Basically, *BBA* refers to method of payment of a sale and for banking purposes, the sale price will be at a mark-up price. Under this principle, the seller (Bank) is not obliged to disclose the cost price and mark-up amount. However, under the *murabahah* contract, the seller (Bank) is required to disclose the cost and the mark-up price.

In current practice, the Bank's *BBA* products adopt the *bay al-inah* principle. The following are illustrations of *BBA* products under the *bai al-inah* principle. The illustrations numbered a, b and c, show the differences between the 3 contracts:

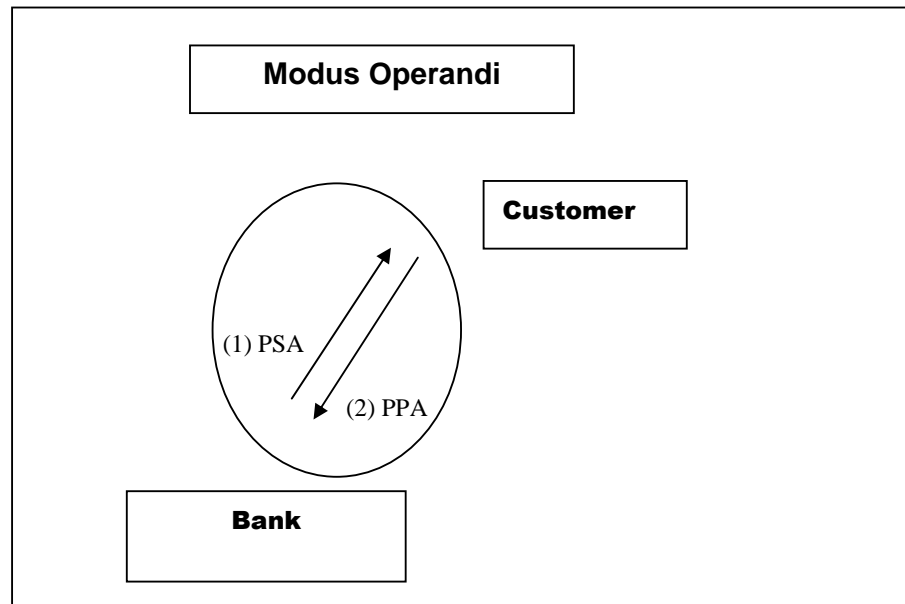
**a. Where the asset transacted belongs to the customer (BBA / Inah Contract).**



1. The customer identifies the asset and signs a Sale and Purchase (S&P) agreement with the developer.
2. The customer sells the asset to bank. The bank executes the Property Purchase Agreement (PPA) with the customer which thus effectively transfers the right of the asset to the bank. The purchase price is effectively the financing amount requested by the customer.
3. The bank then sells the asset back to the customer by executing the Property Sale Agreement (PSA) at a mark-up price, also known as the "Selling Price", which consists of the facility amount and the bank's profit. Both parties shall agree on the price, method of deferred settlement as well as payment period. The customer shall take ownership of the asset and settle payment as per the manner agreed within the specified period.
  - Under this contract, the customer will take ultimate ownership of the asset and settle the purchase price as per the manner agreed within the specified period.

- To conclude the transaction in accordance with the *Shariah* requirement, each leg of the transactions must be concluded separately (i.e., conclusion of offer and acceptance / *aqad*) to evidence the transfer of ownership in compliance with the basic *Shariah* tenets for sale based financing.
- In other words, the operation for the execution of the contracts (*aqad*) must follow the sequence of the *modus operandi* as illustrated above.

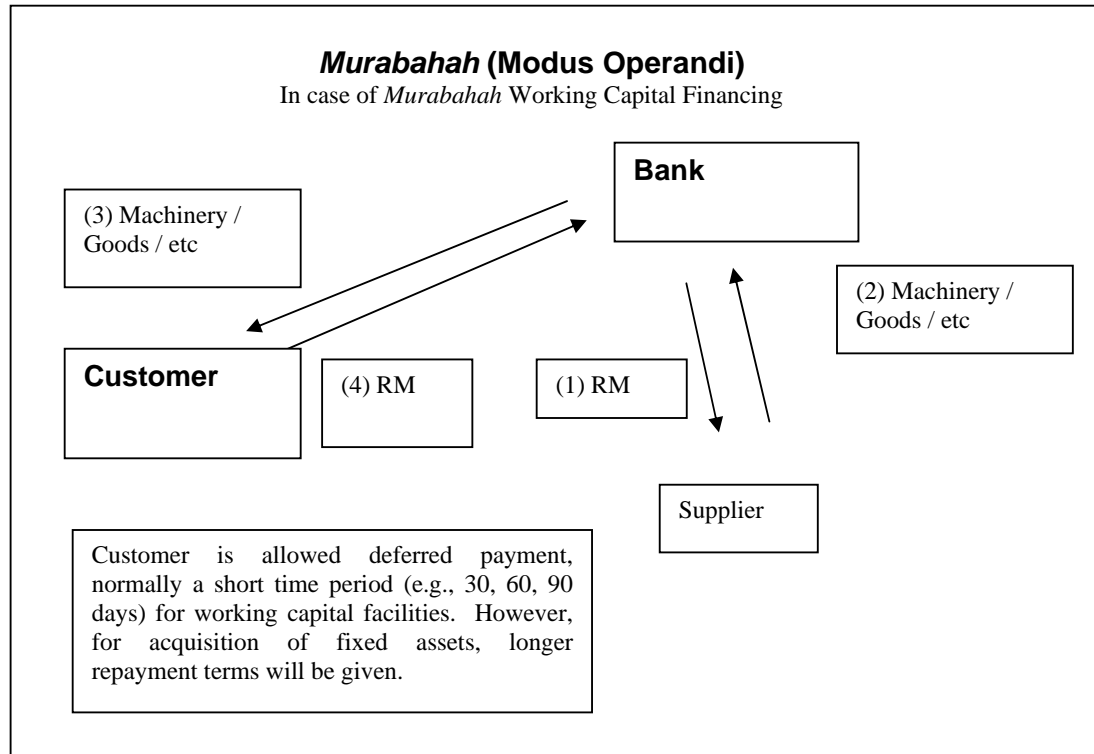
**b. Where the asset transacted belongs to the bank with the end objective of the customer getting cash (Inah)**



1. The bank sells the asset to the customer by executing the Property Sale Agreement (PSA) at a mark-up price also known as the “Selling Price”, which consists of the facility amount and the bank’s profit. Both parties shall agree on the price, method of deferred settlement as well as payment period.
  2. The customer then sells the asset back to the bank in return for cash. The bank will execute the Property Purchase Agreement (PPA) with the customer to buy the asset back from the customer at a lower price. The purchase price is effectively the financing amount requested by the customer.
- Under this contract, the customer will not take ultimate ownership of the asset and settle the purchase price as per manner agreed within the specified period.

- In addition, as this contract is considered a highly controversial contract in the Islamic banking industry, stringent controls must be put in place to comply with the basic tenets pertaining to the asset used for the transaction in order to comply with the following conditions:
  - a. There must be two separate contracts, i.e., a sale contract by the asset owner and a buy back contract for the repurchase of asset.
  - b. Both contracts must involve transfer of ownership of the asset transacted.
  - c. The asset pricing must be reasonable, according to the market price.
  - d. The first contract must be concluded, i.e., meet the *aqad* requirement before entering the second contract.
- The above conditions are to be met in order to comply with the basic tenets for Goods / Assets / Merchandise. The Goods / Assets / Merchandise must be:
  - i. In existence (except for order sale),
  - ii. Of value which is *halal* (lawful and permissible by *Shariah*), and
  - iii. Valuable.For the Goods / Assets / Merchandise:
  - iv. The seller must be the owner of the asset / merchandise,
  - v. The seller must be able to deliver the merchandise to the buyer, and
  - vi. The Asset is known to both seller and buyer.
- Additional controls must be put in place to prevent the particular asset from being transacted with multiple parties at the same time to ensure that the asset meets the *Shariah* tenet pertaining to ownership of the asset.

c. **Murabahah Financing, where the bank purchases the asset and sells it to the customer**



*Murabahah* (cost plus) means sale of asset(s) with disclosure of cost price and profit margin. The cost and profit margin (mark-up) are declared in the transaction and agreed to by the contracting parties. The settlement of sale price can be either via cash basis, deferred lump sum payments (monthly, quarterly or half-yearly) as per the parties' agreement. Among the common banking products that adopt this contract are the Islamic Accepted Bill-I (Purchase Financing) and Trust Receipt – i.

1. The customer will act as the bank's agent to purchase the goods. The bank purchases the identified goods from the supplier and makes payment to the supplier. The bank takes ownership of the goods (in banking terms the title to the goods).
2. The supplier delivers the documents to the bank.
3. The bank then, sells the goods to the customer at a higher price (mark-up price). The bank is required to disclose the cost price and the profit margin.
4. The customer shall make payment as per the manner agreed and take ownership of the goods.

Beside compliance with the basic tenets for Goods / Assets / Merchandise as mentioned under the inah contract, it is a *Shariah* requirement that the bank's profit margin is disclosed in the contract.

### 8.3.2 Ijarah Thumma Al Bai (AITAB / HP - i) – Lease Based

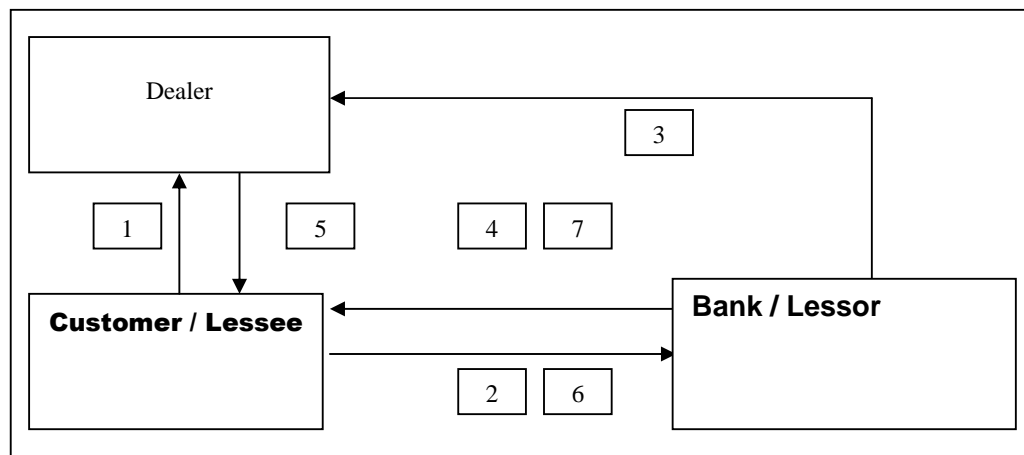
This type of *ijarah* involves a contract whereby a lessor (owner) transfers the usage of an *ijarah* item to a lessee in return for an agreed *ijarah* payment or series of *ijarah* payments for a pre-determined *ijarah* period based upon the *aqad* (contract). The ownership of the leased equipment remains in the hands of the lessor throughout the lease tenor. Currently, the majority of banks adopt the lease contract, which would be followed by a sale known as *ijarah thumma al bai* (lease ending with sale). This refers to two contracts, which are to be concluded separately, i.e.:

- The *al-ijarah* contract for lease or hiring of the asset, and
- The *al-bai* contract for the purchase contract.

Under the first contract, the customer (lessee) leases the goods / asset from the owner (lessor) at an agreed rental over a specific period. During the period of the agreement, the ownership of the asset / vehicle is under the lessor's name (in this case, the bank).

The second contract (purchase contract) will come into effect upon the expiry of the first agreement (upon settlement of the lease rentals) whereby the customer / lessee will enter into a contract to purchase the goods / asset from the owner (lessor / bank) at an agreed price. The second contract will be executed after entering the first contract and under the HP-i product, the contract is also known as "Release Letter".

#### Operation of AITAB, transaction for HP – i / Leasing - i



- 1 The customer approaches the dealer for the preferred vehicle.
- 2 The customer seeks financing from the bank and upon approval, the customer shall execute the *ijarah* agreement (HP – i Agreement)
- 3 The bank disburses the price of the vehicle to the dealer based on the Letter of Undertaking given to the dealer upon facility approval. The bank acquires beneficial ownership of the vehicle (through the ownership claim form) whereby the registered owner is the customer. At the same time the customer would also execute the Release Letter, which constitutes the customer's undertaking to Purchase the vehicle.
- 4 The bank leases the vehicle to the customer.
- 5 The dealer delivers the vehicle to the customer.
- 6 The customer shall pay the *ijarah* payment to the bank and enjoy the usage of the *ijarah* item until the end of *ijarah* period.
- 7 The bank shall transfer the vehicle at the end of the *ijarah* period via a sale (by executing the release letter).

It is essential that the operations of the *AITAB* comply with the basic tenets of leased based financing as stated in the introduction to this section. Often times the stipulation that the assets are identifiable and owned by the bank before executing the rental agreement are not met. To ensure compliance with the process, auditors should observe the contract signing (*aqad*) between the bank and the customer.

## 9. GOING FORWARD

With the mounting interest in Islamic banking especially in non-Muslim countries, it is undeniable that the foundations for sustainable global development of Islamic finance are now in place. The key elements needed to sustain the current momentum are:

- a. Investment in research and development to promote innovation so as to have a broader range of Islamic financial market instruments that include equity ownership features, Islamic asset-backed securities, inclusion of permissible forms of credit enhancement and *Shariah* compliant risk mitigating instruments. Towards this end, Malaysia has established a Shariah Scholar's fund for such research and development efforts as well as to promote greater engagement among international *Shariah* scholars to deliberate the *Shariah* compatibility of newly-developed Islamic financial instruments and markets.
- b. The development of an Islamic finance talent pool. Malaysia has established INCEIF to act as a professional certification body and education institute in Islamic finance. This is reinforced by the International Centre for Leadership in Finance (ICLIF), which provides leadership and management programmes that include Islamic finance for the financial services sector.
- c. The greater use of technology in Islamic finance. In the light of differing Islamic finance concepts and workflows, it is important that *Shariah* compliant systems be assessed and employed. New leading technology can be utilised to provide for operational efficiency, a wider range of delivery channels as well as helping in reducing costs for consumers and businesses.

As for *Shariah* compliance, it is to be noted there are three major Islamic schools of thought (Hambali, Shafie and Hanafi) and each interprets Islamic laws and teachings on commercial transactions with some differences. Therefore, implementation of banking and financial services products and operations would largely rest on the financial institution's Shariah committee as well as on the Shariah Advisory Council of the Muslim country's central bank. It is undeniable that the Gulf countries have a strong influence on the Islamic concepts used for commercial transactions and banking.