

ISLAMIC BANKING

A MATTER OF NO INTEREST

The Islamic banking system renounces the principle of interest charges, an approach which contradicts conventional banking practice. Iran and Pakistan have "Islamised" their entire financial systems, while other Muslim countries practice a dual system in which Islamic banks are excluded from the conventional financial markets. SUDIN HARON explores the general concept of an Islamic financial market, its mechanisms and the alternative instruments permissible in Islamic law.

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An Islamic banking system may be defined as an institutional framework designed to operate within a concept of interest-free banking. The operations of financial institutions in this system are governed by the Islamic laws known as *Shariah*.

The interest-free banking concept was pioneered by Mit Ghamr Local Saving Banks, established in 1963 in a provincial centre in the Nile Delta of Egypt. There are now more than 150 interest-free institutions throughout the world providing services compatible with those services offered by the interest-based institutions or conventional banks.

It was estimated in 1993 that the Islamic banking system had global assets of up to \$US60 billion (De Belder and Khan 1993).

A study of the effects of the adoption of Islamic banking laws in Iran and Pakistan shows that, contrary to fears of the collapse of the financial system, private-sector deposits have grown rapidly in both nations, demonstrating that the system can be effective in mobilising resources (Khan and Mirakhor 1990).

More than a decade after its establishment, the Islamic banking system has become positioned as an alternative to the conventional structure. Islamic banks are playing an important part in the allocation and use of financial resources. They are providing saving facilities to depositors and extending credit facilities to the needy.

Islamic banks also facilitate international trade by providing facilities such as letters of credit, shipping guarantees, bankers' acceptances and collection of foreign trade bills.

Services such as selling and buying foreign currencies, travellers cheques and remittances are also available in

most Islamic banks. Islamic banks are now entering new frontiers of banking. Faysal Islamic Bank of Bahrain (FIBB) has successfully introduced unique Islamic syndicated financing instruments. Since 1987, at least 19 Islamic syndicated transactions worth \$US1.7 billion have been lead-managed by this bank.

TOO MUCH CASH

Overwhelming support from Muslim depositors has resulted in an unusual liquidity problem for Islamic banks. In many cases, the banks' funds remain idle because of limited investment opportunities. Islamic banks are prohibited from channelling these funds to the inter-bank market because the market operates through interest-bearing instruments.

As well as these difficulties in investing excess funds, Islamic banks can also encounter obstacles to expansion. In the event of a need for growth capital, Islamic banks will not be able to borrow from the conventional markets. Acknowledging this problem, some Muslim countries have started to develop a specific Islamic financial market.

The establishment of this market is a key component of an Islamic financial system – although the idea raises many practical questions and highlights many anomalies in areas such as the operational aspects of the markets, the financial instruments, the players and the regulations.

So far, only two countries, Iran and Pakistan, have successfully converted their entire banking systems to Islamic principles. This paper examines the concepts and operating aspects of an Islamic financial market which was recently introduced in Malaysia by the Bank Negara Malaysia (the central bank of Malaysia).

Table 1: Instruments and principles of Shariah for Islamic financial markets

CONVENTIONAL INSTRUMENTS	ISLAMIC INSTRUMENTS	PRINCIPLES OF SHARIAH
Overnight deposits or loans	Overnight deposits or loans	Qard hassan or wadiah
Treasury bills	Treasury investment bills	Qard hassan and wadiah
Negotiable certificate of deposit	Investment deposits certificate	Qard hassan, wadiah or mudarabah
Banker's acceptance	Islamic acceptance bills	Mudarabah or murabaha
Repurchase agreement	Not permissible	-
Government securities	Government investment certificate	Qard hassan or wadiah

BASIC CONCEPTS

The role of a financial market is to transfer funds from savers to borrowers and provide an efficient means for units in the economy to adjust their liquidity. It consists of three specific sectors: cash market, money market and fixed-interest (bond) market. The cash market deals in short-term deposits and advances. The money market deals in short-term discount securities such as treasury notes, banker's acceptances, negotiable certificates of deposit, commercial paper and repurchase agreements. The fixed-interest market trades in coupon securities issued by the government or its agencies.

Similar instruments can be developed for Islamic financial markets. However, they must be without any element of interest, while possessing the other characteristics of conventional instruments.

These characteristics include:

- negotiability, ie, the ability to transfer the instrument easily from one holder to another;
- liquidity, ie, can be easily sold when cash is required;
- they must carry minimum risk; and
- they must be easily priced.

Although many *Shariah* principles are used by Islamic banks, not all of these principles are applicable to the Islamic financial markets. The most likely principles to be used are *wadiah* or "trust", *mudarabah* or "profit-sharing", *murabaha* or "cost-plus financing" and *qard hassan* or "benevolent loans".

WADIAH (TRUST)

The concept of *wadiah* refers to deposits that have been deposited with another person, who is not the owner, for safe-keeping. As *wadiah* is a trust, the depositor becomes the guarantor and, there-

fore, guarantees repayment of the whole amount of deposits, or any part thereof, outstanding in the account of the depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns as a gift (*al-hibah*) to the depositors as a token of appreciation.

MUDARABAH (PROFIT-SHARING)

The concept of *mudarabah* refers to an agreement made between a party who provides the capital and another party (entrepreneur), to enable the entrepreneur to carry out business projects, which will be on a profit-sharing basis, according to pre-determined ratios. In the case of losses, these are borne by the provider of the funds.

QARD HASSAN (BENEVOLENT LOAN)

The concept of *qard hassan* refers to an interest-free loan given mainly for welfare purposes. The borrower is required only to repay the principal amount borrowed, but he may pay an extra amount as a gift at his absolute discretion, as a token of appreciation.

MURABAHA (COST-PLUS FINANCING)

The concept of *murabaha* refers to the sale of goods at a price that includes a profit margin as agreed to by both parties. In a *murabaha* contract, the price, other costs and the profit margin of the seller must be stated at the time of the agreement of sale.

Table 1 shows some potential instruments for Islamic financial markets, based on the above principles.

The principles of *qard hassan* and *wadiah* are the most recommended for overnight deposits or loans. This is because the facility is short-term and in most cases the terms of the loan or deposit are based on a gentleman's agreement. If the principle of *qard hassan* is used, the reward for the providers of funds would be based on the discretion of the borrowers. Similarly, in case of the

deposit made under the principle of *wadiah*, the reward given to the depositor is at the discretion of the users.

The principle of *mudarabah* is inappropriate due to administrative difficulties and time constraints. As for treasury investment bills and government investment certificates, the principles of *qard hassan* or *wadiah* are most likely to be used by the treasury. The rewards for the holders of such certificates are announced at the end of certain holding periods, eg, at the end of the sixth month or after one year, or at the maturity date if the duration less is than one year.

For investment deposit certificates issued by the Islamic banks, the principle of *mudarabah* is most appropriate. The holder of the certificate will receive rewards on maturity, based on the profit generated by funds deposited on those certificates.

The repurchase agreement (repo) is not permitted by *Shariah*. Repo refers to the sale of a short-term security with the condition that, after a period, the original seller will buy it back at a predetermined price. Although the principle of *murabaha* (mark-up or cost-plus financing) may be appropriate for this kind of transaction, it can be held that the transaction is susceptible to *gharar* (speculation) and *gharar* is not permitted by *Shariah*. Furthermore, repos do not originate from a transaction involving goods or merchandise, and this kind of dealing is prohibited by *Shariah*.

THE ISLAMIC FINANCIAL MARKET IN MALAYSIA

Malaysia is committed to developing an Islamic financial system. Unlike Pakistan and Iran, where the financial system is based totally on *Shariah*, the Malaysian government envisages an Islamic system running in parallel with the conventional system (Bank Negara Malaysia 1994).

The establishment of Bank Islam Malaysia Berhad (BIMB) in 1983 marked the beginning of the Islamic banking system in Malaysia. The objective of this

bank is to provide banking facilities and services, in accordance with Islamic principles, rules and practices, to all Muslims as well as the population of Malaysia. By the end of 1993, BIMB had 32 full branches and 10 mini-branches around the country. BIMB is also playing an important role in expanding the Islamic banking system by incorporating three subsidiaries whose operations are governed by *Shariah*: Takaful Malaysia Sdn Bhd, which deals with insurance business, Al-ijarah Sdn Bhd, which is involved in leasing business, and Al-Wakalah Nominees Sdn Bhd, which engages in nominee activities.

The potential opportunities promised by these developments prompted Bank Negara Malaysia to plan a new financial system combining the conventional and Islamic sectors. The first step taken by the Bank Negara Malaysia was the introduction of the "Interest-free Banking Scheme" which enabled existing financial institutions to offer Islamic banking services.

This scheme was launched in pilot form on 4 March 1993 with the three largest domestic commercial banks offering the services. The second phase of the scheme was launched on 21 August 1993 when 10 more financial institutions joined the scheme. By the end of 1993, a total of 21 financial institutions had obtained the approval from Bank Negara Malaysia to offer Islamic banking facilities.

Another breakthrough in the Islamic banking system in Malaysia is the implementation of an Islamic inter-bank money market in January 1994.

THE ISLAMIC INTER-BANK MONEY MARKET

The Malaysian Islamic inter-bank money market covers the following aspects:

- inter-bank trading in Islamic financial instruments;
- Islamic inter-bank investments; and
- Inter-bank cheque clearing system.

ISLAMIC FINANCIAL INSTRUMENTS

BIMB and other financial institutions that participate in the interest-free banking system are allowed to trade among themselves in Islamic financial instruments such as Islamic banker's acceptances. Bank Negara Malaysia has indicated that more Islamic instruments to be traded among these institutions in the future.

ISLAMIC INTER-BANK INVESTMENTS

Islamic inter-bank investment refers to the system whereby a participant with a surplus can make an investment with another participant which is in deficit on the basis of *mudarabah* (profit-sharing). The features of this mechanism are:

- the period of investment is from overnight to 12 months;
- the minimum amount of investment is RM50,000 (RM1.00 = \$US0.50);
- the profit-sharing is based on the period of investment —
 - for periods of one month or less, the profit-sharing ratio is 70:30 (ie, 70 per cent for the provider of funds);
 - for a period exceeding one month and up to three months, the profit-sharing ratio is 80:20; and
 - for periods exceeding three months, the profit-sharing ratio is 90:10.
- the formula for calculating the profit element to be paid to the provider of funds is:

$$X = \frac{P \cdot r \cdot t}{36500} (k)$$

where:

- X = amount of profit (in ringgit) to be paid to the provider of funds
- P = principal investment
- r = rate of gross profit (in % pa) before distribution for investment for one year of the receiving bank
- t = number of days invested
- k = profit-sharing ratio

(At present the profit-sharing ratio is determined by Bank Negara Malaysia. Bank Negara has indicated that in future this ratio will be based on negotiation among the investing and the receiving institutions.)

ISLAMIC INTER-BANK CHEQUE CLEARING SYSTEM

This new clearing system was introduced by Bank Negara Malaysia for BIMB and other financial institutions that participate in the interest-free banking scheme. Cheques relating to Islamic accounts are segregated from conventional cheques for clearing purposes. All participating institutions have to maintain a clearing account with the Bank Negara Malaysia on the principle of *wadiah*. At midnight, during automatic cheque clearing at Bank Negara Malaysia, banks having a deficit are automatically funded from the surpluses of other banks on the basis of *mudharabah*. If the surplus from other banks is insufficient to cover the deficit, additional funds will be provided by Bank Negara on the same principle of *mudharabah*. The profit ratio for this mechanism is 70:30 (ie, 70 per cent for the investor). The repayment will be made the next morning. The formula of calculating the profit is similar to the formula for the Islamic inter-bank investment.

The Malaysian Islamic inter-bank money market was the first Islamic money market in the world (Bank Negara Malaysia 1994, p. 336). One of the key features of the Islamic money market is that both overnight loans (loans extended to the bank having a deficit as a result of clearing settlement) and Islamic inter-bank investment certificates are issued on the basis of *mudharabah*. For banker's acceptances, the basis of operations is the principle of *murabaha*.

The Malaysian Islamic banking system will have a full Islamic financial market on the introduction of interest-free treasury bills and government securities.

Since the government is empowered to issue Islamic securities, there should be no obstacles to the development of a complete Islamic financial market. The principle of *wadiah* should be applied to securities issued by the government. To facilitate trading activities, the govern-

ment should indicate a guaranteed minimum return on the securities. The actual amount of reward will be declared at the maturity period. In cases where the reward given to the holders is more than the minimum return, the recipient of the reward should redistribute part (to be calculated according to the holding period) of the excess amount to the previous holders.

CONCLUSION

This paper highlighted the establishment of an Islamic financial market whose roles and functions are very similar to the conventional financial markets but free from the element of interest. Although this new market is said to be free of interest, it requires some formula to determine the percentage mark-up or mark-down of

certain instruments. For treasury bills and government securities, for example, the minimum guaranteed return would be based on a percentage of the principal sum invested. Similarly, with a banker's acceptance, participants in the market need certain tools in determining the mark-up or mark-down of the face value of the bills.

Habib Bank Limited, Pakistan, in its explanation of the percentage used in calculating the mark-up or mark-down, states that the percentage is just a mathematical device to measure the relationship between two quantitative variables. This figure has nothing to do with *halal* (licit) or *haram* (illicit). A *halal* factor remains *halal* whether it is measured as a percentage or otherwise. Similarly, a *haram* factor remains *haram* whether it is measured as a percentage or not. A "15% profit" is *halal* because profit itself is *halal* and "15% interest" is *haram* because interest is *haram* (Habib Bank Limited 1985).

Government intervention is an important factor in developing this new market. Intervention may be in the form of laws which govern the operations of the entire market. The principle of *wadiah* is appropriate for an overnight loan if the government issues a regulation on the minimum return due on such a loan. The availability of treasury bills and government securities in Islamic financial markets will create more investment opportunities for the Islamic banks and other institutions.

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