CHAPTER TWO
LITERATURE REVIEW

2.0 The Principles of Syariah in Islamic Banking

Muslim jurists and scholars have suggested a number of Syariah principles to be adopted by Islamic banks in delivering their products and services. Among the most widely used syariah principles recommended by these scholars can be broadly classified into four categories as follow:

(i) Profit and loss sharing principles
(ii) Fees or charges based principles
(iii) Free service principle
(iv) Ancillary principles


The Islamic banking’s alternative to riba or interest based financing is ideally based on profit and loss sharing. Islamic banks’ philosophy is to share the entrepreneurial risks with the entrepreneur. By disallowing interest and permitting profits, the shariah has developed two (2) specific forms of business arrangement under the profit and loss sharing system, al-mudharabah (trustee profit sharing) and al- musyarakah (joint-venture profit and loss sharing) as means of sharing profits and losses without charging interest (alternative to interest based financing).
The nature of mudharabah and musyarakah form of financing requires a link between banking and commerce. This gives the Islamic banks the privilege to hold equity claims on firms which the banks have invested and therefore, the banks have control over the operation and involves in the decision-making process of the firms.

Equity-financing takes place when a bank or a group of banks invest in a company by holding shares. It can be in the form of holding ordinary or preference shares and are entitled to receive dividends. Each party has its share in the entity or company proportionate to his capital contribution and similarly has the voting rights (control) in the entity in the same proportion. Therefore, equity-financing in Islam was effected through the contracts of “Uqud al- Ishtirak” (Profit-Sharing Contracts) by using the Al-mudharabah and Al-musyarakah products.

2.1.1 Al-Mudharabah Financing

Mudharabah means “profit-sharing” or “trust finance” or “investment through self-employed entrepreneur”. The Bank may undertake to finance acceptable projects under the principle of al-mudharabah. In this case, the bank is the provider of the capital and may provide the entire financing of a project. The initiator of the project is the entrepreneur who will manage the project entirely. The bank does not take part in the management of the project but monitors the progress of the project by follow-up and
supervision tasks to ensure that the funds are being used in accordance with the mudharabah agreement.

Both parties agree through negotiations on the ratio of the distribution of profits generated from the project, if any. In the event of loss in the project, the financial loss is borne solely by the bank and not the entrepreneur, unless the bank has documentary evidence that the loss is caused by the negligence of the entrepreneur. Since human capital (as representative of present work and effort) in this arrangement shares equal with financial capital, the entrepreneur loses his time, effort and labour and future rewards.

Al - mudharabah is a profit-sharing contract whereby one party, the rabb-al-mal or owner of the capital (the bank) entrusts funds to another party, the mudharib (the entrepreneur) who provides human capital in the form of entrepreneurial skills and management expertise. Under this concept, it is solely the rabb-al-mal who provides funds for the project. The mudharib’s contribution is only in the labour and skill in managing the project.

The mudharib is to utilise the funds in an agreed manner and then refund the capital investment and a share of the profits generated from the project in an amount that has been pre-agreed. The pre-agreement must be in terms of proportion or ratio of the profits achieved from the operations, for example, 70:30 to be distributed to the rabb-al-mal Bank and mudharib (entrepreneur) respectively. All profits are therefore to be
distributed between the partners, whereas losses are only to be absorbed by the bank to the extent of the capital that he has contributed. The mudharib does not share in the losses except for loss of time, efforts and his future return from the project.

The mudharabah contract can either be for a general purpose or a specific purpose. The duration of a specific purpose mudharabah will be limited to the duration of the specific project or business identified. A general purpose mudharabah can have a specific or indefinite duration. An example of a specific mudharabah could be for an investment in a real estate development project. The duration of the contract will be until the completion of the project.

In relation to the above, Islamic banks are expected to be more receptive and pro-active in the process of creating and developing entrepreneurs. The principle of Mudharabah serves as an impetus for creating new entrepreneurs.

2.1.2 Al-Musyarakah Financing

Musyarakah means “partnership” in English. In the context of Islamic banking, musyarakah means ‘participating financing’ or ‘co-financing’. A bank is made a partner of a project. The bank may undertake to finance acceptable projects under the principle of al-musharakah. In this case the bank together with the initiator or initiators of the relevant project will provide the financing for the project in agreed proportions. All parties including the bank have the right to participate in the management of the project but any of the parties have the option to waive such right.
Under this system, the amount of return on the funds invested is neither fixed nor pre-determined. All parties agree through negotiations on the ratio of distribution of the profits generated from the project, if any. Such ratio need not correspond with the ratio of equity-participation in the financing of the project. However, the sharing of any losses is based on the equity-participation ratio.

A **musharakah** can be in the form of mufawada or unlimited, unrestricted and equal partnership in which the partners enjoy complete equality in the areas of capital, management and the right of disposition. In this structure, each partner is the agent and guarantor of the other. A more limited partnership is known as inan. The borrower’s company is known as inan company. This type of musharakah occurs when two or more parties contribute to the capital fund, either with money, contributions in kind or labour. The partners share profits in an agreed manner and bear losses in proportion to their capital contributions. Each partner in this case is the agent but not the guarantor of the other.

The concept of **musharakah** can be used to structure facilities for financing working capital requirements for an identified project or for project financing. As a reward to the financier, the borrower may allocate to the financier a pre-arranged proportion of the profit derived from the project. The projects can either be paid in a periodical basis or on a provisional basis but subject to adjustments on a regular basis for example, annually or
semi-annually. Upon the termination of the musharakah financing contract, a final profit and loss account is prepared and a final adjustment made.

Although a **musharakah** contract is a profit and loss sharing (PLS) contract, the investor is protected on his investments if the losses incurred are due to those arising from mismanagement or negligence or the customers' breach of agreed covenants. The entire loss will then have to be sustained by the customer and the investor may proceed to recover not only his investment but also the profits that it would otherwise have obtained.

### 2.2 Fees or Charge-Based Principles

If Mudharabah and Musyarakah scheme of financing are not applicable, then the Syariah Law does allow the fees or charges based principle to be applied for financing.

Commercial banks today offer various services which are fee-based. As long as the services do not involve fixed rate of interest payments, it is not against the teaching of the religion for an Islamic bank to offer the service. Such services are usually highly profitable to the bank since the costs for providing such services are generally not high and less risky as compared to profit and loss sharing scheme. The above principle can be used to two (2) types of debt financing. By recognising that profit and loss sharing (PLS) principle may not be applicable in all circumstances, the Syariah has specified permissible transactions under debt-financing. Debt-financing can be categorised into:
a) Term financing

b) Trade financing

Term financing is similar to long-term loan financing under the conventional banking. During the tenure of the loan, a fixed amount of repayment or referred as instalments are payable to the banks on a monthly or quarterly basis. The following are the types of term financing used under the Islamic Banking:

(a) Al-Bai Bithaman Ajil

(b) Al-Istisnaa

(c) Al-Ijarah

(d) Al- Ijarah wa-iqtina

2.2.1 Al-Bai Bithaman Ajil (BBA) (Deferred Instalment or Payment Sale)

This principle refers to the sale of goods on a deferred payment basis. Equipment or goods (the assets) requested by the client are bought by the bank, which subsequently sells the goods to the client at an agreed price (the sale price), which included the bank’s mark-up(profit). The client may be allowed to settle payment by instalments within a pre-agreed period or in a lump sum (Bullet payment). Al-Bai Bithaman Ajil is a long term financing facility. As most projects requiring a large sum of financing are normally long term in nature, it is not surprising that the most popular facility for BBA is end-financing for residential and non-residential properties. The types of projects that BBA can finance includes:
(1) Bridging finance and end-finance for large housing projects
(2) Construction of factory, complexes, office buildings and refineries
(3) Development of agriculture projects such as oil palm estates.

BBA by definition requires a buy and sell transaction to be executed between the Financier (Financiers) and the Customer. The property Purchase Agreement represents the purchase of the property or asset by the Financiers and the property Sale Agreement represents the resale of the same property or asset to the customer. It is assumed that the property or asset is already owned by the customer. In such a case the buy and sell transaction is done on the existing asset of the customer and the proceeds of the facility is applied by the customer to the project.

2.2.2 Al-Istisnaa (Order Sale)

Al- istisnaa is basically sale by order. This concept of istinnaa is perfect for Islamic financing of start-up projects, small or mega-sized where the assets do not exist at the beginning of the project. In structuring the Istisnaa facility; reliance is placed on the Construction Contract signed between the customer and the contractor for the project. This Construction Contract is in fact an Istisnaa order by the customer to the contractor to construct the project assets for a certain price. Syariah recognises that although the asset is not yet completed, it's ownership already lies with the customer. Thus, the customer can sell this uncompleted asset to the Islamic Bank to obtain the financing they require for the project. When the bank buys this project at Iistisnaa purchase price, the ownership will be pass to the bank. Now the bank can now sell back the to the customer.
at cost plus a profit margin, called the I'tisnaa selling price which is payable by the customer over a deferred term. From there on, the I'tisnaa facility is very similar to the BBA facility.

An alternative solution to BBA is an Al-I'tisnaa facility. However this facility is confined to financing of new projects only and it has been available in the market for less than 3 years. This facility is not appropriate when the customer needs to raise working capital through refinancing existing assets for which the BBA is more appropriate.

Therefore, Al-I'tisnaa facility is used for project financing whereby the project is yet to be built and there is no assets exist at the beginning of the project. This is in contrast with the BBA financing, which requires availability or existence of an asset for a buy and sell transaction to take place.

2.2.3 Al- Ijarah (Leasing)

Al-ijarah is a Syariah concept of leasing finance. This is a contract under which a bank buys and leases out for a rental fee equipment required by its client. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains in the hands of the bank. The contract is a classical Islamic financial and its use is increasing worldwide now (New Horizon Sept, 1994)
2.2.4 Al-Ijarah wa –iqtina (Lease-purchase)

It is very similar to ijarah, except that there is a commitment from the client to buy the equipment at the end of the rental period. It is also known as al-takjiri. It is pre-agreed that at the end of the lease period the client will buy the equipment at an agreed price from the bank with rental fees previously paid constituting part of the price.

2.3 Trade Financing

Fees or charges based principle is also applied to trade financing.

Trade financing facilities such as issuance of letter of credit (al-murabahah) are not interest-based but involves commission or fees and yields a considerable income to a bank. A bank could make or collect payments on behalf of its customers and charges a service fee on the transaction. Facilities such as the issuance of import or export documents are also sources of income in the form of service charges for the banks.

There are six(6) products under trade financing. The following are listed below:

1) Al-wakalah (Agency)
2) Al-murabahah (Deferred Lump Sum Sale)
3) Al-musyarakah (Joint-venture Profit Sharing)
4) Al-murabahah (Working Capital Financing)
5) Islamic Accepted Bill
6) Islamic Export Credit Refinancing
2.3.1 Al-wakalah is an agreement between a customer and his bank in which the customer appoints the latter as his agent to undertake certain financial transactions on the latter’s behalf. Letter of credit is an example of al-wakalah.

2.3.2 Al-Kafalah represents an agreement between a customer and his bank in which the latter guarantees a third party that the customer will fulfill the financial obligation towards the third party. Bank Guarantee is an example of Al-Kafalah.

2.3.3 Al-murabahah, refers to the sale of goods at a price which covers the purchase price plus the profit margin agreed upon by the two parties. In other words, the lender buys a good (needed by the borrower) at market price and sells it to him at a profit. This arrangement transforms a traditional lending activity into a sales and purchase agreement, under which the lender purchases a good to be sold to another at a higher price. Repayments are usually in instalments and is specified in the contract. However in Malaysia, a shorter tenor of not exceeding 6 months is given and the customer can make a lump sum payment at the end of the tenor. As a financing technique, it is usually used to purchase raw material supplies.

2.4 Free Services

The bank can grant loans to its customers for which it expects the return of the principle sum only. In other words, the loan is given on interest free and there is no profit sharing or service charge requirement imposed. It is known as Qard Hassan (Benevolent or welfare loan).
The loan is given on a short-term basis. For example, an entrepreneur may need a certain sum of money for a few days only, such as to pay a creditor in a day or two before funds are expected to be received from other sources. According to Sobri Salamon, an Islamic economics scholar, the Islamic bank is not only an economic institution but also a religious one. It is an institution that functions for the economic welfare of mankind based on moral values, justice and brotherhood. Within this context, the provision of free loans can be regarded as a social service.

Besides, through this free service, a bank can maintain good rapport with its customers. They will appreciate such free services and be grateful and loyal towards the bank. In this highly competitive world, banks which offer such free services will surely attract many customers.

2.5 Ancillary Principles

In addition to providing financing activities, the banks also assist the customers by giving services such as depositing and safekeeping of cash and other assets (excluding fixed assets). There are two types of products as categorised below:
2.5.1 Wadiah

Wadiah or ‘trusteeship’ refers to an agreement between the owner of assets and another party (the bank), whereby the owner will deposit and give consent to the custodian (the bank) to make use of their assets (funds) as long as these assets remain in the custodian’s hands. Al-wadiah savings and current accounts are examples of the application of the wadiah or ‘trusteeship’ concept.

2.5.2 Rahn

Rahn means pledge or pawn. It is a contract of pledging a security and becomes binding when possession of the pledge has taken place. In this principle, the ownership of the ownership of the security is not transferred to the pledgee (the bank). The bank merely acts as a custodian of the security or assets pledged by the customers. This is similar to the safe deposit box service offered by the conventional banks.

2.6 Islamic Objectives

It is the consensus among Muslim scholars that the various principles adopted by Islamic banks belong to two categories:

(i) strongly Islamic

(ii) weakly Islamic

The principles can be considered ‘strongly Islamic’ if they conform to Islamic objectives both in form and in substance. Islamic banks’ philosophy is to share the entrepreneurial risks with the entrepreneur. Therefore, by sharing the profit or loss of the business
entrepreneur, it is complying with the ‘substance’ in the principle. ‘Weakly Islamic’
principles refer to practices which conform to Islamic norms in form but not in substance.
For example, BBA financing is a fixed fee-based financing which conform to Islamic Norm in ‘form’ and charging fixed fee-rate is permitted under the Syariah Law.
However, the bank did not conform to the ‘substance’ when the bank does not share the business risk with the borrower.
The basis for judgement as to the strength or weakness of a given principle is the extent to which that mode contributes towards achievement of the objectives of Islamic economics (Islamic economics is a social science which studies the economic problems of people inspired with the values of Islam) (Mirakhor, 1987).
Thus, only those principles which permit risk-return sharing between providers and users of funds can be considered strongly Islamic. Muslim scholars consider only two principles, mudharabah and musyarakah as strongly Islamic and the remaining principles are recommended only in cases where risk-return sharing cannot be implemented (Mirakhor, 1987).

2.7 The Concept of Profit Sharing Ratio Under Mudharabah
With reference to Diagram 1 below, Ok and Oe are origins for capital and entrepreneurship respectively. Prices (profit shares) of capital and entrepreneurship in the percentage terms are measured along the left and right vertical axes respectively and the amount of capital along the horizontal axes. The upward sloping supply curve of capital, Sk, implied that the quantity of capital supplied increases as the capital’s share of profit in percentage increases and the downward sloping demand curve for capital, Dk,
implies that the quantity demanded for capital increases as capital's share of profit falls. It should be noted here that the prices of capital and entrepreneurship are indeed the profit shares and not any fixed amount of money.

The Dk and Sk intersect at T which simultaneously determines profit shares of capital and entrepreneurship. It determines 40% profit shares of capital so that the rest 60% of the profit shares goes to entrepreneurship. This analysis will be applicable when any profit is made. When the demand for capital and supply of capital intersects, the profit shares will be determined. Here, the profit is determined on the outcome of the productivity of the investment. If profit is made, it is shared between the financier (bank) and the entrepreneur (client) according to a pre-determined ratio without knowing exactly how much is the profit amount to be derived.
Ex-ante Determination of Profit Shares in Mudharabah Business

Source: Sadeq, Factor Pricing, Journal Of Islamic Economics

Diagram 1

However, if no profit is earned or if losses are incurred, the loss will be borne solely by the bank subject to the amount of capital contributed. The ruling behind this is that the entrepreneur has put his effort, labour and expertise and when the project fails, he is unrewarded and has no more future returns. The entrepreneur loses his present and future returns. On the other hand, the bank has limited liability and therefore it will lose only its total capital contributed. Therefore, both the bank and the entrepreneur are losing but in a different forms.
2.8 The Concept of Profit and Loss Sharing Ratio Under Musyarakah

(Joint-Venture)

![Diagram 2: Ex-ante Determination of Profit Shares in Musyarakah Business](image)

Source: Sadeq, Factor Pricing, Journal of Islamic Economics

In the case of Musyarakah, more than one person can contribute capital. The capital and entrepreneurship factor pricing are again based on profit sharing. Opinions, however, differ as to the basis of profit sharing. In one opinion, it is more justified to share profits on the quantifiable basis of their contribution which is capital. That is, each partner will share in profits on the basis of his percentage contribution in capital (Shafii and Maliki Schools of Islamic jurisprudence). With reference to Diagram 2 below, if partner A contributes 25% of the capital, he gets 25% share of the profit and the other partner gets 75% profit for 75% capital contribution. Therefore, the distribution line is given by OA R OB which represents equality in the percentages of profits and capital.
In other opinion, it is more justified to share profits among the partners on the basis of their organisational and entrepreneurial services (Hanafi and Hanbali Schools of Islamic jurisprudence). According to them, the partners may negotiate and decide about profit sharing in percentage terms irrespective of their shares in capital. The distribution line may vary from a straight line like OA R OB to any curvature above or below the straight line. If the distribution curve is OA N OB, then partner A who contributes 25% capital, might get 50% or 10% if the distribution curve is OA M OB.

On a loss situation, the sharing of losses will be based on the share of capital contributed because the share of entrepreneurial services will go unrewarded. Therefore, the straight line OA R OB will be applicable for the distribution of losses. This is considered as a fair ruling on loss sharing which is limited to the capital contributed.

2.9 Source of Funds

Like conventional banks, beside their own capital, Islamic banks are dependant on the depositors’ money as a major source of funds to invest. The deposit facilities available at Islamic banks can be divided into three (3) types. They are as follows:

1) Current or demand account
2) Savings account
3) Fixed or investment account which can further be divided into general investment specific investment account

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2.9.1 Current or Demand Deposit

Current or demand deposits is accepted under the Al-Wadiah principle. Depositors are given cheque books and offered other services related to current accounts. The balance in the account can be withdrawn at any time through the use of cheques. The bank can obtain depositors’ permission to use their funds in the current accounts but the profits subsequently obtained belong to the bank.

2.9.2 Savings Deposit

The savings deposits are accepted under the Al-Wadiah principle. Depositors can withdraw their balances at any time through the use of savings books. The credit balances in the savings accounts can be used by the banks after it has obtained the permission of the depositors. As in the case of current accounts, all profits generated from the use of the funds belong to the banks. However, in the case of the savings account, the banks can use its own discretion to share part of its profits with its depositors from time to time.

2.9.3 Investment Deposit

The investment deposit account operates under the Mudharabah principle whereby the banks acts as the “entrepreneur” whereas the depositors is the “financier”. The management of investments is run by the bank and the depositors do not participate in it.
The two parties agree beforehand, among others, on the sharing of profits. As an example, the distribution of profits can be 70 percent to the depositors and 30 percent to the bank. The ratio, however, can vary from time to time, subject to agreement of both parties. On the contrary, if there is any loss resulting from the investment, the depositors alone will have to bear it. Therefore, here the bank exercises a prudent and conservative manner in selecting viable and profitable projects to finance in order to reduce the loss suffered by the depositors.

2.10 Funding Options or Structures

The bank obtains its funds primarily from two sources which are as follows:

1) Deposits from customers

   If deposits are sufficient, the bank can commit to provide financing on its own capacity.

2) Islamic Inter-bank surplus funds

   Surplus funds from fellow Islamic banks can be sourced using the Islamic Inter-bank Investment whereby the bank with the surplus funds invests in the bank with deficit funds on the basis Al-Mudharabah (profit sharing).
2.11 Islamic Syndication

Most banking facilities given to a customer are provided wholly by one bank. However there are cases where more than one bank or financial institutions are required to provide financing to a customer. This is usually because the financing required is too large to be provided by one bank.

Examples include:

i. Financing of an infrastructure project;

ii. Financing for the setting up of a large factory / industrial complex;

iii. Bridging finance and/or end financing for a large property project.

Banks normally exercise a prudent maximum for the limit of their financing to any one customer. In Malaysia, this traditional prudence is institutionalised in the form of a directive from Bank Negara Malaysia – called the single customer limit. Banks may not provide financing to any one customer in excess of the single customer limit which is defined as 30% of the Bank’s capital funds. In cases where the financing required is in excess of the single customer limit, the bank shall arrange for the balance of the financing to be provided by other banks. This process is referred to in the banking world as syndication. However one specific bank (in the case of Malaysia) the merchant bank will assume the responsibility of supervision and control of the project.
2.12 Islamic Securitisation

Securitisation refers to the creation of tradeable certificates evidencing a debt arising out of financing facilities.

If customer A owes RM 10.0 million to Bank A, apart from the legal documents, an IOU may be created to evidence this debt, which Bank A may sell to Bank B, Bank C or other interested institutions. The creation of this IOU is referred to as Securitisation.

Under the conventional system these tradeable certificates or securities are issued out of interest-based loans in which case they are called promissory notes or they are issued for the raising of funds without any underlying facility or transaction in which case they are called bonds.

Herein lies the principal difference between Islamic securitisation and non-Islamic securitisation. Islamic securitisation leading to the creation of Islamic Promissory Notes or Islamic Bonds requires the existence of an underlying transaction. Certainly Islamic securitisation cannot arise from non-Islamic facilities such as interest-based lending nor can Islamic securitisation be used as a means to raise funds simply with the issue of paper without any underlying transaction, as in conventional bond issues.

The usual conventional bonds which are issued with its annual coupon rate is not Islamic because of the coupon rate element. Thus it is generally concluded that zero coupon
bonds must by definition be Islamic and acceptable under Syariah as they do not possess a specified coupon rate. A zero coupon bond may appear Islamic because it does not have a coupon rate but if it is not backed or it did not arise out of an underlying Islamic transaction, then the said zero-coupon bond is not an Islamic instrument.

Therefore, there are 2 principal criteria in the creation of an Islamic bonds or security.

i. There must not be any interest to it, be it fixed interest or floating interest.

ii. It must arise out of an underlying Islamic transaction.