Chapter 5
Islamic Banking Products and Tools

5.1 Range of Islamic Banking Products and Services

Islamic financial products and services offered by the Islamic financial institutions in Malaysia can be divided into five categories:

5.1.1 Deposits

The services available under deposit taking are savings account, current account, general investment account, special investment account and Islamic Negotiable Instruments.

5.1.2 Retail and Consumer Banking

Products available for retail customers are house financing, commercial property financing, hire purchase, overdraft facility, share/unit trust financing, factoring, working capital financing, credit card, charge card and umrah and ziarah financing.

5.1.3 Corporate Banking

The products and services under corporate banking include project financing, bridging finance, syndication, revolving finance, bonds, commercial papers, leasing, industrial hire purchase, underwriting, lead arranging and advisory.
5.1.4 Treasury/Money Market Investment Products

Among instruments available are the government investment, Khazanah bonds and Cagamas mudarabah bonds.

5.1.5 Trade Financing

Some of available instruments include letters of credit, Islamic accepted bills, export credit financing, bank guarantee and shipping guarantee.

5.2 Product Principles

Products offered under Islamic banking operate under various Islamic principles. Some of these principles include (BIMB, 1994):

5.2.1 Al-Wadiah Yad Dhamanah Principle

The Al-Wadiah principle is a trust arrangement whereby the bank acts as a “trustee” or “guarantor” and guarantees repayment of the deposits on demand. Wadiah does not provide the depositor with the right to receive the share of profits. The following products use this principle:

(a) Current Account

As in conventional banking, depositors are given a cheque book and are offered services related to current accounts, i.e. salary crediting and standing instructions for bills payment. The balance can be withdrawn at any time using cheques. The bank requests the permission of the customer to make use of the funds, as long as these funds remain within the bank, and profits generated from the use of these funds belong to the bank. Service charges and penalty for returned cheques also apply.
(b) Savings Account

This is a safe custody scheme between depositors and the bank, whereby depositors can withdraw their balances at any time through their savings books or ATM cards. The bank may at its absolute discretion, share part the profits in the form of a gift called "Hibah". The profits to the depositors are determined based on the profits generated from the use of their funds from time to time.

5.2.2 Al-Mudharabah Principle

Basically, this principle promotes the arrangement of profit sharing. The profits (if any), arising from this arrangement may be shared between the two parties in accordance with the pre-determined ratio. Some of products operating under this principle include:

(a) General Investment Accounts

The depositor supplies the capital to the bank who will utilise the capital in business ventures. The bank has the sole responsibility in the management of the business venture and the depositor has no say. Deposits made in this account can be withdrawn at the maturity date agreed upon earlier, and profits made here are shared. For example, the bank will take 30 percent of the profits while 70 percent will be given to the depositor. This ratio can vary from time to time subject to agreement between both parties. If there is a loss as a result of the investment, the depositor will have to bear the loss. This type of investment is popular with individuals and companies.

(b) Project Financing

The bank provides 100 percent of the capital. The loan applicant will manage the project without interference of the bank. The bank however, has the right to
supervise a follow up on the project. Both parties will agree on profit distribution any loss will be borne by the bank.

5.2.3 Al-Musyarakah Principle

This principle is a partnership contract or agreement whereby the partners jointly provide the capital, manage and share in the profit or loss of a business venture. Some of the products following this principle are:

(a) Investment Deposit

Here, the bank shares the cost of the project with the depositor, based on an agreed proportion. Both parties have a right in the management of the investment. Profit sharing will be based on an agreed ratio. In the event of a loss, it will be shared in a ratio agreed upon earlier. This type of investment is popular with government deposits.

(b) Project Financing

The bank and the loan applicant will provide the financing for the project and manage the project jointly. Both parties will agree on profit distribution. Any loss will be borne by both parties in proportion to their share in the financing.

5.2.4 Al-Bai Bithaman Ajil Principle

This principle is basically a trading (buying and selling) transaction.

(a) Asset Acquisition

Upon identification of the asset to be purchase by the customer, the bank purchases the asset and resells it to the customer at an agreed price with a
profit. The profit margin varies according to the value and type of asset. The customer then agrees to pay the resell price through installments.

No penalty is charged for overdue installments, and there are no charges for progressive releases during disbursement.

5.2.5 Al-Kafalah Principle

This principle represents an agreement between a customer and his bank in which the bank guarantees a third party that the customer will fulfill the financial obligation towards the third party.

As the Al-Kafalah takes the form of a bank guarantee, it is best suited for tender guarantee, performance guarantee, customs bond, guarantee for advance payment, guarantee for sub-contract a guarantee for honouring of cheques, among others.

Other products available are stock broking services, TT/fund transfer, travelers cheque, demand draft, cashiers’ orders, standing instruction, ATM services and telebanking. All of them are discharge under the principle of Ujr. The detailed illustration of various Islamic banking products and services together with principle under which they are operated are given in Appendix 5.

5.3 Islamic Money Market

Another major development in Islamic banking was the establishment of the Islamic money market on 3 January 1994 (BNM, 1999). An Islamic money market is integral to the smooth functioning of the Islamic banking system. It plays an important role, firstly, in providing Islamic financial institutions with facilities for adjusting portfolios over the short-term, and secondly, in serving as a channel for the transmission of monetary policy. Hence, as the Islamic banking
sector gains greater significance in mobilizing resources for financing economic activities, the need to develop an Islamic money market would naturally gain importance. BNM did not have the benefit of an existing model Islamic money market in any part of the world to emulate and therefore had to pioneer its own ideas to realize this quest.

After careful consideration, BNM decided to implement the Islamic money market based on the concept of Mudharabah or profit-sharing. Specific guidelines were issued preceding the establishment of the Islamic money market in December 1993 to ensure smooth implementation and running of the market. The Islamic money market comprises three aspects i.e. trading of Islamic financial instruments, Mudharabah inter-bank investments (MII) and the Islamic cheque clearing system (ICCS) (Yakcop, 1996). The Islamic bank and IBS banks are allowed to trade in Islamic financial instruments such as Islamic accepted bills, green bankers acceptances, Islamic bonds and Islamic commercial papers as well as Cagamas Mudharabah bonds among themselves. The MII refers to a mechanism whereby a surplus IBS bank/Islamic bank can invest in a deficit IBS/Islamic bank based on Al-Mudharabah. The tenor of MII is from overnight to 12 months while the minimum amount of investments is RM50,000. The profit-sharing ratio is negotiated among the transacted parties but the rate of return shall be based on the gross profit before distribution for investments of 1 year of the "investee (receiving)" bank.

After monitoring of the Islamic money market during the period 1994-1995, it was realized that adequate incentives have not been put in place to promote efficiency, specifically in terms of rewarding the provider of funds. Although the provider of funds dictated the profit-sharing ratios, the onus was on the investee bank to declare the return on maturity. Such situation had led to exploitation by inefficient banks, thereby hampering the overall integrity of the market. As such, BNM introduced the minimum benchmark for MII in February 1995 using the prevailing rate of the GII plus a spread 0.5 percentage points. Accordingly, the
players were required to observe the minimum benchmark as a reference rate. This has resulted in the banks entering the market when they are really short and in the position to use the funds efficiently.

BNM also recognized the need for a separate cheque clearing system for Islamic banking in order to distinguish it from the conventional cheque clearing system. In January 1994, BNM devised a mechanism to segregate Islamic banking cheques from the conventional banking cheques from the moment the cheques were issued. This was made possible, as the IBS commercial banks and the Islamic bank were required to maintain a Wadiah current account with BNM to facilitate the clearing arrangement, apart from the existing conventional bank’s account. The banks were also required to empower BNM under the concept of Al-Wakalah to square their funding position between the surplus banks and the deficit banks during the automatic cheque clearing system at 12.00 midnights. Should the deficit persist, it would be funded by BNM on the same concept of Mudharabah, subject to maximum of three times in a week, following which a penalty shall be imposed (BNM, 1999).

In managing liquidity in the Islamic Money Market, BNM employs two financial tools, namely the Mudharabah money market tender and the Bai’ Al-Einah Contract. In August 1999, BNM introduced the Mudharabah money market tender (MMT) to further enhance the operations of the MII. The MMT is conducted through the acceptance tender and the investment tender. The former would be used if BNM intends to absorb liquidity from the Islamic money market during times of excess liquidity, and the latter if there is a need to inject liquidity into the Islamic money market when the overall market is in a deficit. The Bai’ Al-Einah Contract (BAEC) refers to issuance of Islamic papers by BNM to inject funds to banking institutions that face difficulties in meeting their daily cash flow requirements, particularly those which could not meet the minimum benchmark rate in the MII. The BAEC paper however, can only be traded between BNM and the participating banking institutions. The availability of these
instruments has assisted BNM in mopping and injecting liquidity in the Islamic money market in an efficient manner as well as enabling BNM to use the appropriate instrument under different circumstances.

All these measures have improved the performance of the MII significantly. From a meagre sum of RM2.1 billion transacted in 1994, the Islamic money market surpassed the RM100 billion mark by recording total transactions of RM138 billion and RM118 billion in 1997 and 1998 respectively. The cumulative volume for the year 2000 amounted to RM283 billion (Bank Negara Malaysia Annual Report, 2000).

5.4 Islamic Capital Market

The Islamic capital market comprises the primary market, in which new issues of Islamic Government securities and the Islamic corporate securities are offered to the public and institutions; and the secondary market, in which existing Islamic Government papers and Islamic corporate securities are traded.

In the Government securities market, the current instruments available in the market are the Government Investment Issues (GIIIs) and the Malaysian Savings Bonds – Islamic Principle. The GIIIs are issued under the Government Investment Act 1983, whereby under the Act, the Government is allowed to issue no-interest bearing government papers to the public based on Islamic principles. The GII is based on the concept of Al-Qardhul Hasan (benevolent loan) whereby the purchase of GII by the public is considered a loan to the Government for its development expenditure. Since the GIIIs are defined as liquid assets, the Islamic bank and IBS banks purchase the GIIIs to meet their liquidity requirements as well as to park their temporary idle funds. As at end-June 1999, the total outstanding issues of GIIIs amounted to RM2 billion. In November 1999, BNM issued the second series of the Malaysian Savings Bonds to retirees totaling RM2 billion, of which RM1 billion was issued based on the concept of Bai’ Al-Einah (buy-back
arrangement). The purpose of the bonds was to provide reasonable returns on investment to retirees during this phase of economic recovery where the return on deposits with the banking system were relatively low. Under the Islamic bonds, BNM sells its identified assets to the public through the designated Malaysian banks and repurchase the assets at a mark-up, which give rise to a debt, evidenced by a registered certificate, which are non-tradable and non-negotiable.

The two major components of the Islamic corporate securities market are the Islamic debt securities market and Islamic equity market. The Islamic debt securities (IDS) made its debut in 1990 when a multinational company issued a RM125 million Bai’ Bithaman Ajil facility for a distillation plant. Since then, IDS has become increasingly popular with various Islamic concepts such as Musyarakah, Ijarah and Qardhul Hasan being applied. Islamic debt securities comprise the medium-term Islamic bonds and the short-term Islamic commercial papers (Islamic CPs). As at end-June 1999, the outstanding IDS amounted to RM17.1 billion, comprising Islamic bonds (RM14.3 billion) and Islamic CPs (RM2.8 billion). Khazanah bonds constituted 40.1% of the total outstanding IDS amounting to RM6.85 billion. The rapid growth of IDS is reflected by its outstanding market share of 20.4% of total PDS outstanding as at end-June 1999 (BNM, 1999).

The first Sanadat (bonds) Mudharabah Cagamas (SMC) was issued in May 1993 totalling RM30 million. The amount represented Islamic house financing purchased from the IBS financial institutions. As at end of 2000, the total outstanding Islamic mortgage financing purchased by Cagamas stood at RM134 million, while SMC issued amounted to RM184 million (Bank Negara Malaysia Annual Report, 2000).

The Islamic equity market is reflected by the presence of Islamic stock-broking operations; Islamic indices; Islamic unit trusts, and a list of permissible counters
in the KLSE issued by the Securities Commission (SC). At present, there is one Islamic stock-broking firm, three conventional stock-broking firms offering Islamic stock-broking services through Islamic windows, and four licensed fund managers. There are currently two Islamic indices: the RHB Islamic Index introduced in 1994 followed by the KLSE Islamic Index in April 1999. The KLSE Islamic Index tracks Shariah-approved counters issued by the SC based on the deliberation of the Shariah Advisory Council of the SC. The SC now issues the list of permissible counters in the KLSE three times a year since June 1997 and as at end-May 1999, 541 or 73% of the total counters in the KLSE have been approved as permissible counters.

The unit trusts are a group of specialized financial intermediaries in the capital market which offer small investors the opportunity to pool their resources in a diversified portfolio of securities which are managed and selected by professional portfolio managers. The inception of Islamic unit trust began in 1993 when Arab-Malaysian Unit Trust introduced Tabung Ittikal. The success of the fund paved the way for the introduction of more Islamic unit trusts and as at end-June 1999, there were 13 Islamic unit trusts in the country with total approved fund size of RM3.55 billion. Notwithstanding that, the net asset value of the Islamic unit trusts is still small, totaling RM1.2 billion as at end-June 1999 (BNM, 1999).

5.5 Product Incentives and Developments

To increase the attractiveness of Islamic banking, in April 1995, BNM allowed IBS commercial banks to offer Ijarah (Islamic leasing) facilities under the IBS subject to a minimum size per transaction of RM200,000. In December 1998, BNM liberalized the acceptance of Islamic repo from non-interbank customers to include all IBS operators, a privilege niche previously accorded only to principal dealers. In April 1999, BNM allowed the Islamic bank and the commercial banks participating in the IBS to offer returns/hibah for all their current account
customers, so long the return does not exceed the return of one-month investment deposits.

In terms of product development, BNM issued two guidelines for two Islamic banking products, namely the Guidelines on Islamic Accepted Bills (March 1993) and Guidelines on Islamic Negotiable Instruments (December 1998). The Islamic Accepted Bills (IAB) is the Islamic version of bankers acceptances and were designed to enhance and deepen further the trading activities in the Islamic money market. The Islamic negotiable instruments comprised two new Islamic deposit-taking products, namely, the Negotiable Islamic Debt Certificate (NIDC) based on the concept of Bai’ Bithaman Ajil and Islamic Negotiable Instrument of Deposits (INID) based on the concept of Al-Mudharabah. The products were created to provide an additional avenue for the Islamic bank and banking institutions participating in IBS to mobilize domestic savings from the public, and at the same time, deepen the Islamic money market with marketable and liquid instruments. BNM also issued three guidelines to facilitate the provision of Islamic financing under the export credit refinancing (ECR), Special Scheme for Low and Medium Cost Houses (SLMMH) and Fund for Small and Medium Industries (SMI).

5.6 Institutional Development

Malaysia has succeeded in implementing a dual banking system, and among countries with a free market economic system, Malaysia has emerged as the first nation to have a full-fledged Islamic banking system operating side-by-side with the conventional banking system. This has helped Malaysia to create a comprehensive Islamic financial landscape, encompassing the Islamic banking system, the non-bank Islamic financial intermediaries and the Islamic financial markets. The Islamic banking system in Malaysia now comprises two Islamic banks regulated and supervised under the Islamic Banking Act 1983 (IBA): and 21 commercial banks, 14 finance companies, 5 merchant banks and 7 discount
houses participating in IBS regulated and supervised under the Banking and Financial Institutions Act 1989 (BAFIA). Islamic banking facilities are now available in 122 branches of the Islamic banks, 2,087 branches of the IBS commercial banks, including seven full-fledged Islamic banking branches, 745 finance companies' branches, including two full-fledged Islamic finance companies branches, and four merchant banks' branches. Total assets of the Islamic banking system as at end of 2000 stood at RM47.1 billion while deposits and financing amounted to RM35.9 billion and RM20.9 billion respectively (Bank Negara Malaysia Annual Report, 2000). The key data of Islamic Banking in Malaysia is given in Appendix 6.

The aspiration of BNM to develop a comprehensive Islamic banking system has encouraged the non-bank Islamic financial intermediaries to improve their participation in the Islamic banking sector. These ancillary institutions have created their own niche market in Islamic banking and may be broadly divided into four groups of institutions, as follows:

(a) the takaful companies;

(b) the savings institutions;

(c) the development financial institutions; and

(d) other financial intermediaries which offer Islamic banking services such as the housing credit institution.

5.7 Summary

Islamic banking is not a negligible or merely temporary phenomenon. An Islamic bank is here to stay and there are signs that they will continue to grow and expand. One of the main selling points of Islamic banking, is that, unlike
conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed Islamic banks on a profit-sharing basis. It is especially in this since that Islamic bank can play a catalytic role in stimulating economic development. In many developing countries development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. In practice, however, Islamic banks have been concentrating on short-term trade finance which is the least risky.

Many Muslims find it more convenient to deal with conventional banks and have no qualms about shifting their deposits between Islamic banks and conventional ones depending on which bank offers a better return. This might suggest a case for more Islamic banks in those countries as would force the banks to be more innovative and competitive. Another solution would be to allow the conventional banks to undertake equity financing and – or to operate Islamic counters or 'windows', subject to strict compliance with the Shariah rules. It is perhaps not wild a proposition to suggest that there is a need for specialized Islamic financial institutions such as mudharabah banks, murabahah banks and musharakah banks which would compete with one another to provide the best possible services.

References:


