Chapter 3

ISLAMIC FINANCIAL INSTRUMENTS

Islamic financial markets offer different instruments to satisfy providers and users of funds in a variety of ways: sales, trade financing, and investment. Basic instruments include cost-plus financing (M*urabahah*), profit-sharing (M*udharabah*), leasing (I*jara*), partnership (*Musharakah*), forward sale (*bay' Salam*) and benevolent loan (*Al-Qarad Al-Hassan*). These instruments serve as the basic building blocks for developing a more complex financial instruments. Suggesting that there is great potential for financial innovation and expansion in Islamic financial markets. Some of the more popular instruments in Islamic financial markets are:

3.1. Equity Based Financial Instruments

Profit-sharing agreement (Al-Mudharabah). This is a joined venture arrangement between the capital owner (Rabb Al-Mal) and the entrepreneur (Al-Mudharib). Under such arrangement, the capital owner will act like the sleeping partner, he provides only financial capital while the entrepreneur will provide human capital. The profit of the business will be shared by the parties involved in a pre-agreed ratio. however, if there is any loss the financier will bear the financial losses up to his investment;(He will bear more than his investment if he has authorized the Mudharib to borrow beyond his investment.) and the labor loss will be born by the entrepreneur. The Islamic law or Shariah also does not allow the capital owner to interfere the running of the business by the Mudharib. The capital is invested in broadly defined activities, and the terms of profit and risk sharing are customized for each investment. This type of financing can be long term or short term depending on the project life on which the capital invested.

Although this type of instrument is considered the core of the Islamic financing, the practical agency problem and excessive risk exposure to the financier made it least popular among the Islamic banks. Fast growing Islamic banks like Bank Islam Malaysia Berhad use only negligible portion of total capital as Mudharabah financing. (0.33% in year 1994)

Strictly speaking Mudharabah financing is a hybrid(Bacha,1997)[11] It is neither equity nor debt it has the features of both equity and debt. It is equity because like the conventional equity there are no fixed annual payments that are due (unlike interest) the profit of the Mudharabah like the dividend in the conventional equity. However, since the Mudharabah financing end when each project has completed, hence it has limited life unlike the conventional equity that has unlimited life. According to some scholars Mudharabah financing has much more high risk than the conventional equity financing. Because first, in a Mudharabah contract the financier can not interfere the day to day operation of the business by the entrepreneur hence the possible moral hazard is unavoidable. There is a lack of legal supervisory mechanism to safeguard the interest of the financier. Second, if a company is financed both by debt and equity then due to the hybrid nature of Mudharabah contract, the Mudharabah financier will only have the residual interest after the debtors while he can not have the prefixed return like the debtor. Third, if the project financed is for a particular unit of a big company, then the success of the project will depend on overall business of the company. While the financier in the Mudharabah contract only can share profit of the particular unit he has to bare the overall business risk of the company. Although there are general consensus that Mudharabah should be the basic financial instrument of Islamic banks, in practice only a minimum portion of the funds is invested by using this instrument.

Equity participation (Al-Musharakah). The word "Musharakah" from the Arabic root word Sharikah which means join or participate or accompany. In the financial term it means an arrangement where few capital owners join hand to venture into business. The profit if any will be shared in a pre-agreed manner, and the losses if any will be shared according to the portion of the capital contributed by each partner. This form of transaction has been used for financing fixed assets and working capital of medium- and long-term duration.

The instrument is similar to the conventional partnership in the sense that the participants have unlimited liability, the Musharakah has limited life (can be dissolved once a project has being completed). The difference between the two lies in the liability sharing ratio in case of partnership dissolvent. For the Musharakah the Islamic law stipulates that the lost must be shared by the partners in the ratio same to their capital contribution; while the conventional partnership shares loss in accordance to their profit sharing ratio. This kind of instrument can be used in any size of the project since unlike Mudharabah the Shariah does not restrict any partners to participate in the business therefore there will be no agency problem and moral crisis.

3.2. Rent Or Leasing Based Financial Instrument

Leasing (Al-Ijarah). Another popular instrument, accounting for about 10 percent of Islamic financial transactions, is leasing. Leasing is designed for financing vehicles, machinery, equipment, house and even aircraft. Different forms of leasing are permissible, including leases where a portion of the installment payment goes toward the final purchase (with the transfer of ownership to the lessee, like conventional hire-purchase). Compare to the Islamic equity financing Ijarah is a relatively low risky instrument most of the Islamic banks now offer such instrument.

3.3. Sales Based Instruments

*Deferred-payment/price sale (*Bay' Mu'ajjal *or* Bay' Bithaman Al-Ajal) and *deferred-delivery sale* (Bay' Salam) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay. A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.

*Trade with markup or cost-plus sale (*Bay' Al-Murabahah*).* One of the most widely used instruments for short-term financing is based on the traditional notion of purchase finance. The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin. In Murabahah contract the profit is determined ex ante, therefore it is similar to the conventional credit contract. Some hard core Islamic scholars are against using such instrument saying that it is "backdoor Riba" however, careful analysis will discover a lot differences between a Murabahah contract and a borrow-lending contract. First Murabahah is a sales contract while the borrowing and lending is a credit contract. Islam prohibit to sell anything which one does not have ownership hence in a Murabahah contract the investor has to secure the ownership of the reselling item first before resell it to the client. Therefore, there are risks involved in the process. Secondly, most of the conventional financing charge interest rate based on BLR plus certain percent, in a Murabahah contract the profit margin once decided is fixed and can not be changed. Thirdly, Islam emphasize the fulfillment of contract hence, refinancing the Murabahah contract is not allowed thus the Murabahah contract is more stable than the loan contract. Due to the above reasons most of current Islamic banks depend on such instrument. Around 75 percent of Islamic financial transactions are cost-plus sales.

3.4. Debt Based Financial Instruments

*Debt Instrument (*Bai Al-Dayn) the sale of debt. Using debt instruments is a very controversial issue. Most Middle East countries reject such instruments saying it involves Riba therefore is prohibited by the Shariah. Some countries, Including Malaysia, have legalized them on the basis of Islamic Jurisdiction of Uruf (tradition). To enable the sale to take places, two principal criteria must be met. First, there must not be any interest rate attached to it, be it fixed interest or floating interest. Secondly, it must arise out of an underlying Islamic transaction. The debt arising out of contract of exchanges or Aqad Al-Muawadhat. Such as trade financing(based on the underlying contract of Bai Muajjal or Bai Bithaman Ajil) are securities, being the certificates of debt or Shahahadah al-dayn. are evidence of the debt and commitment of the debtor under the contract of exchange entered into. These securities are traded in the secondary market under the concept of bai al-dayn . maturities of these securities range from as little as one month to longer terms. Only securities evidencing bona fide commercial transactions can be traded(Sano 2001)[12].

The following Islamic securities instruments are existing in Malaysia:

1. *Al-Bai' Bithaman Ajil, Al-Ijarah, Al-Musharakah, Al-Istisna Islamic Debt Securities.*

Shahadah al-dayn or Islamic debt certificate issues usually take place in the primary market where, in settling its debt, the issuing company will sell debt certificates of bonds to investors. However, debt certificate issues are valid only when they are supported by an asset, i.e., the bonds must be securities.

The underlying security thus may be BBA or al-Murabahah assets. The underlying security may be based on Ijarah, or Musharakah or Istisna'. In these cases, the certificates might be labeled as Sukuk Ijarah or Sukuk Musharakah or Sukuk Istisna'.

It could be briefly stated that Shahadah al-dayn or certificates of debts originate from contracts of exchange such as al-Murabahah, al-Bay Bithaman Al-Ajil, al-Musharakah, Al-Istisna', and al-Ijarah. All these certificates, accepted for Sukuk al-Ijarah, are traded in the secondary market under the concept of bay al-Dayn or debt trading.

The Islamic bonds or securities are usually medium and long term in nature. In Malaysia, Islamic debt securities on the basis of BBA are normally applied for long term financing, i.e. payments which extend beyond one year.

However, the concept of al-bay Bithaman Ajil Islamic debt securities (BaIDS) refers to a bond facility structured under the Shariah concept of deferred installments sale and bay al-dayn or debt trading. This instrument can be used with or without warrants. It has advantages over conventional Bonds in the sense that it had additional investor base compared to conventional bonds. In addition, BaIDS is acknowledged as form of private debt securities, as such, no stamp duty is payable .

One of the advantages of BaIDS is its fixed yield nature as most of the BaIDS were structured on a fixed rate basis and for a long term tenure, it allows issuers the benefit of funds at fixed rates. In volatile interest rate conditions. The disadvantage involves the issuers being unable to benefit from lower interest if it is the case. It can be therefore concluded that the BaIDS is similar to the conventional straight bond facilities except, among others, for the following requirements:

In BaIDS, a proceeding coexisting underlying al-bay Bithaman Ajil contract of buying and selling must be in place whereas this is not the case in the conventional straight bond facilities. The later facilitate can exist without an underlying contract or asset.

The issuer's debt arising out of BBA transaction is to be securitized through the issuance of primary and secondary notes that can be traded in the secondary market under the concept of al-Bai Bithaman al-Ajil and bay al-dayn. The proceeds of BaIDS are to be utilized for lawful purposes.

2. Qard Hassan Islamic Debt Securities With Transferable Subscription Right(TRS)

there are in the market today bonds which were introduced by the Malaysian government through government investment certificate and which are based on the concept of Qaradha al-Hassan. These papers have maturities of up to five years. The Malaysian government has created these loans to enable it to undertake development projects for the benefit of the nation.

The government investment certificates were introduced to facilitate Islamic banks and the Islamic windows of the conventional banks to comply with Bank Negara Malaysia's (the central bank of Malaysia). Liquidity requirement and for them to park their idle funds. These instruments are not available to other investors, institution, or fund managers. With the growing Islamic deposit base and shortage of investment vehicles, these papers are often held until maturity.

Trading is also limited between a particular bank and the central Bank, where bank Negara acts as a ready buyer and seller of these instruments. Inter-bank trading of these papers is not allowed. Thus, a secondary market does not exist for these papers. As it appears, these papers thus are not based on the concept of bay al-dayn. However, if BBA is applied it could be traded in the secondary market amounting to an application of the debt trading.

3. Islamic Accepted Bills (IAB)/Islamic Bankers' Acceptances(IBA)

Islamic Accepted Bills are a Murabahah based instrument, which is created, based on the full acceptance of the customer the full value, the bank's credit raised from a Murabahah transaction.

For example, a customer might need to purchase good where the amount is RM 30, 000. 00 and above, the Islamic bank based on the credibility of the customer will finance such purchase and a scheme whereby such financing can be refinanced through the money market at a much cheap rate.

Then, the customer will become indebted to the bank for the period of financing. Since the amount exceeds RM 30.000.00 the bank will normally draws a special Bills of Exchange, which are evidencing the debt, will be known as the Islamic Accepted Bills. The IAB can be sold in the secondary market to another party at different prices; this is due to the fact that it is a negotiable instrument.

In order to reinforce and expand the concept of the IAB, the Islamic Bankers' Acceptances Facility (IBAF) was created as one of the supportive and important financial instruments for trade financing from Islamic perspectives. This instrument is also a time draft on and accepted by a commercial bank. The Islamic banks and financial institutions use it in order to facilitate the trade

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For example, a customer might need to import goods and thus will approach an Islamic bank to facilitate the transaction. The bank, based on the credibility of the client, will issue a time draft for the company. Upon acceptance, a bank(any commercial bank) will pay to the holder the face value on maturity.

However, in some cases the holder might be in need of cash and will want to sell the bill before the maturity date. in this case, the bank will accept the bill on at discount basis. It is here that the concept on buying al-dayn comes into play because the holder is selling it to a third party at a price not less than cost on the basis of bay'-dayn. Thus, Islamic accepted bills are widely used in Malaysia n financial institutions and are governed by the principle of Murabahah and Bay-dayn.

In other words, the bill created under this instrument will be traded under the concept of bay-al-dayn. An exporter who has been approved an IBAF prepares the export documents as required under the sale contract or letter of

5-Negotiable Islamic Debt certificate.

Negotiable Islamic debts certificate is an instrument introduced by Islamic financial institutions such as Bank Islam Malaysia to attract deposit. This instrument carries a fixed rate of return. It is the Islamic version of the negotiable certificate of deposit (NCD) with some tweaking to qualify for Shariah compliance.

Under the conventional system, the NCD is based on a debt contract and it pays the depositors a specific fixed amount of return(interest) during the term of the certificate.

However, one can say that in Malaysia the concept of Bay-al- dayn or debt trading has made it possible for financial institutions to develop a kind of negotiable Islamic debt certificate to attract deposits with fix rate without contravening Islamic rules of commerce and trading. At the same time, they use the instrument in order to shield themselves from interest risk. Again this instrument is no longer dependent on the debt contract.

In spite of this, it is in essence made up of two separate processes, namely, sale and deferred sell plus debt trading. The following example may shed light on the processes. Assume that company **A** has RM1 million deposit which the Islamic bank is willing to give if the underlying contract is valid.

The process of validity as practiced is that the bank sells an asset (Islamic bank Share certificate) worth 1 million to company A. in doing this, the bank secures a new RM 1 million deposit. Next, the company sells back the asset to the Islamic bank at a deferred price. The bank now will pay company A through the issuance of a debt certificate or Shahadah al-dayn termed the NIDC by virtue of the asset held by the bank.

The issuance of NIDC to company A is undertaken as evidence of the bank's debt to the company , so, at the end of the day, the company can redeem the certificate with the return that it has gained trough the sell-deferred payment. As one can observe, the concept of Bai al-dayn is actively applied in these processes.

*3.5. Loan Based Instrument (*Al-Qardh Al-Hassan)

Islam pays special attention to the poor and the needy of the society. The Quran clearly states that in the wealth of the rich there are due of the poor and needy. Islam provide special assistance to the poor and the needy in the society by giving interest free loan. It is hoped that such provision can reduce the tension between the rich and the poor, it is also hoped that such grant can improve the general welfare of the society thereby provide more conducive investment environment. If we look at violence happened in L.A of US in early 90s due to the jealousy to the rich Asians by the Afro-Americans and the tragedy of the Chinese in Indonesia in later 90s we will not have difficulty to appreciate such instruments. Islamic banks normally give some benevolent loan to the unfortunate group of the society. Such loan provision in Islamic banks in Malaysia is increasing from early 0.1% to about 7% now.

Chapter 4

ISLAMIC FINANCIAL INSTRUMENTS PRACTICE IN DIFFERENT ECONOMIES

Generally, there are two approaches for adapting the Islamic Financial Instruments in a country's economy. One is revolutionary approach, which seeks to replace the conventional financial system with Islamic financial system totally, another is evolutionary dual banking system approach, which Islamize the conventional system and allow the Riba' based system and Non-Riba' based system coexist in the economy. Among the countries that adopt