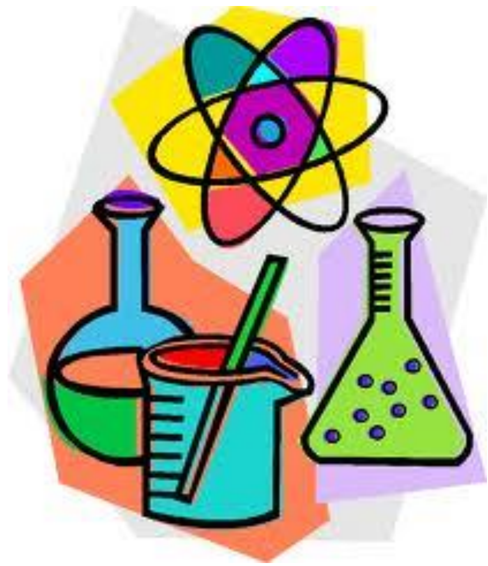
Chapter 4: Islamic Banking Operations and Instruments



Chapter 8 in Textbook

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Historical Development of Islamic Banking and Finance

Since 2000	• Integration of Islamic financial services in the mainstream financial markets • International Islamic Liquidity Management Corporation (Malaysia) 2010 • International Islamic Centre of Reconciliation and Arbitration 2005 • International Islamic Rating Agency (Bahrain) 2005 • International Islamic Financial Market (Bahrain) 2002 • Islamic Financial Services Board (Malaysia) 2002 • Liquidity Management Centre (Bahrain) 2002	• Advances treasury services • Balance sheet management • Innovation & asset management
1990s	• A global phenomenon • Islamic banking and finance in Europe • Emergence of centres of excellence like Bahrain and Malaysia • Bank Muamalat Malaysia Berhad 1999 • The Accounting & Auditing Organization for Islamic Financial Institutions (Bahrain) AAOIFI 1994 • Islamic Interbank Money Market 1994 • Islamic Bank or Brunei 1993	• Equity funds • Leasing • Islamic securitization
1980s	• AHZ Global Islamic Finance (UK) 1989 • Turkey Islamic Bank 1986 • Al Rajhi Bank (Saudi Arabia) 1985 and Mauritania Islamic Bank 1985 • Iraq Islamic Bank 1985 • Dar al Mal Islamic Trust (Switzerland) 1984 • Bank Islam (Malaysia) 1983 • Islamic Bank Bangladesh (1983) • Al-Baraka Group (various countries) 1982 onwards • Qatar Islamic Bank 1982 • International Islamic Bank of Investment and Development (Luxembourg) 1980 • Abu Dhabi Islamic Bank 1980	• Property finance and syndication • Islamic Insurance (Takaful)
1970s	• Jordan Islamic Bank (Jordan) 1978 and Jordan Financial and Investment Bank 1978 • Islamic Investment Company (UAE) 1978 • Kuwait Finance House 1977 • Faisal Islamic Bank (Sudan) 1977 and Faisal Islamic Bank (Egypt) 1976 • Dubai Islamic Bank (UAE) 1975 • Islamic Development Bank (Saudi Arabia) 1975 • Philippine Amanah Bank (Philippine) 1973 • Nasser Social Bank (Egypt) 1971	• Commercial banking
1960s	• Lembaga Tabung Haji Malaysia 1963 • Mit Ghamr (Egypt) 1963	• Primarily retail banking

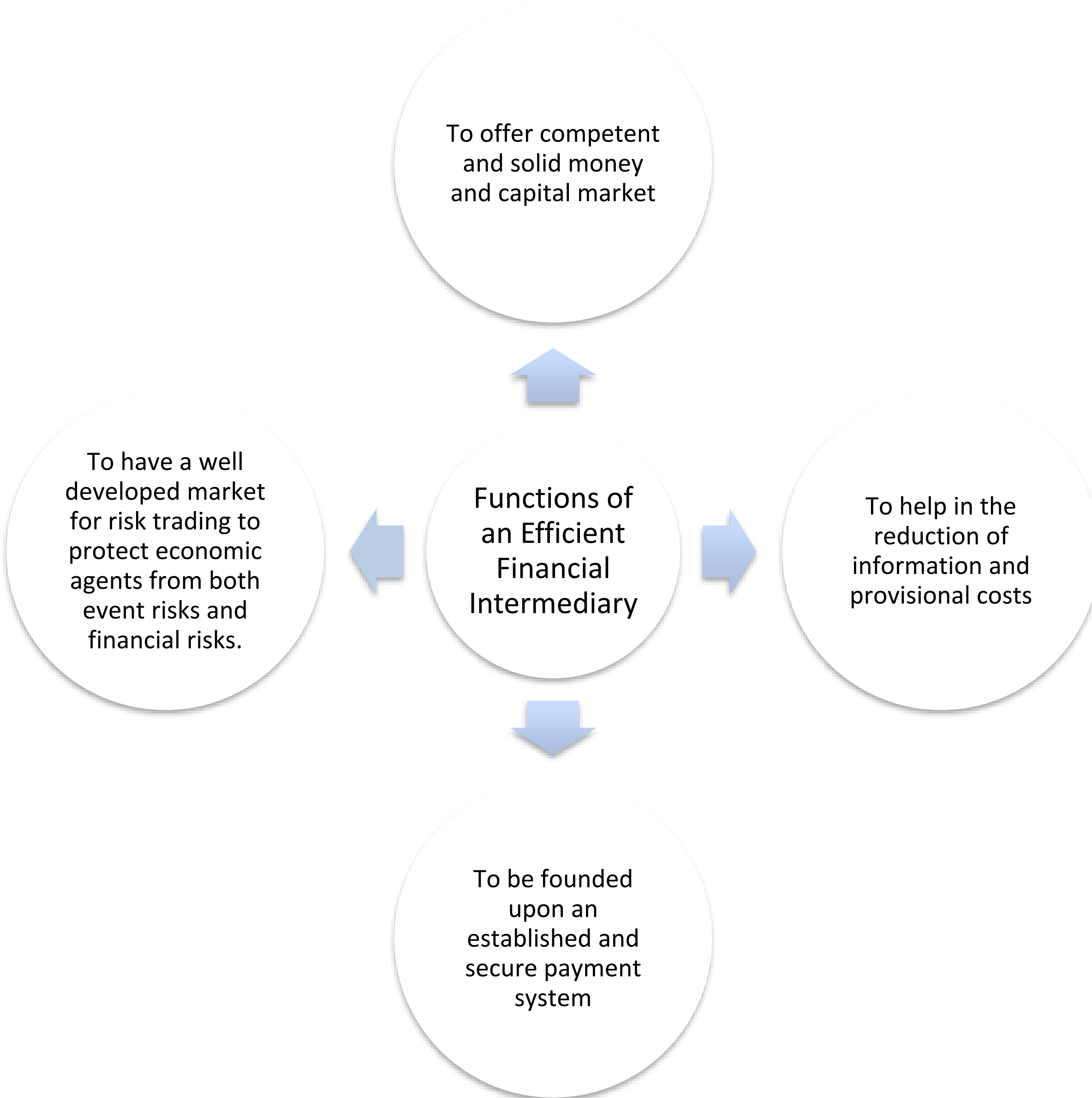
Conceptual Balance Sheet of an Islamic finance institution

Assets	Liabilities
Trade Financing	Demand Deposits
Salam, Murabahah	
Ijarah/ Istisna	Investment Accounts
Mudharabah (Profit / Loss Sharing Investments)	
Musharakah (Equity Partnership)	Special Investment Accounts
Services (Ju'alah, Wakalah, Kafalah)	Capital Equity Reserves

This illustration may not represent a balance sheet of each and every Islamic bank as the Islamic bank may not provide all of these services.

Islamic financial instruments may look like a mirror image of conventional ones, however, their underlying features, contractual relationships, mechanisms and implications are not identical.

Role of Islamic bank



Savings deposit
Current deposit
Term deposit
Investment deposit
Underlying contracts for savings and current deposit

SOURCES OF FUNDS

Sources of Funds: Terms to Know

<table>
<tr><td>Savings Deposit</td><td>A savings deposit permits customers to deposit and withdraw their money at any time and does not require a minimum balance in the deposit account.
It does not have a maturity date, therefore the cash can be withdrawn at any time based on the customer’s demand.</td><td rowspan="2">Qard
Wadi’ah Yad Dhamanah
Mudharabah</td></tr>
<tr><td>Current Deposit</td><td>A form of demand deposit that offers users safe-keeping for their cash deposits, and the choice to be paid in full upon demand.</td></tr>
<tr><td>Term/ Fixed Deposit</td><td>A type of arrangement where the customer’s deposits are held at a bank for a fixed term. These deposits will then be deposited to a number of investment pools where it will be invested in business activities which are in accordance to the Shari’ah.</td><td>Murabahah
Wakalah</td></tr>
<tr><td>Investment Deposit</td><td>Usually known as a profit-and-loss sharing account.</td><td>Mudharabah
Wakalah Bi Istithmar</td></tr>
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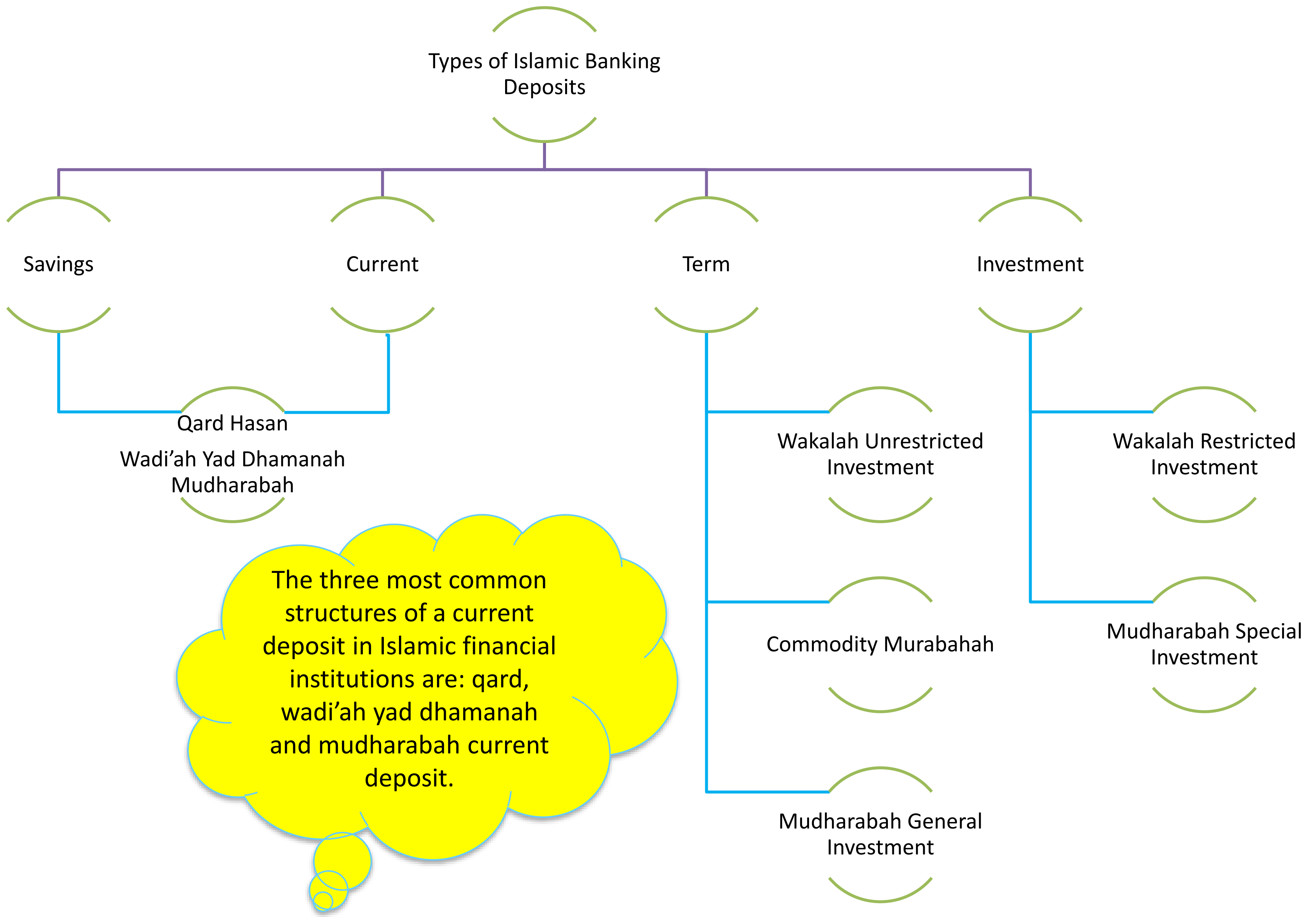


Types of Islamic Banking Deposits
Savings
Current
Term
Investment
Qard Hasan
Wadi'ah Yad Dhamanah
Mudharabah
Wakalah Unrestricted Investment
Commodity Murabahah
Mudharabah General Investment
Wakalah Restricted Investment
Mudharabah Special Investment
The three most common structures of a current deposit in Islamic financial institutions are: qard, wadi'ah yad dhamanah and mudharabah current deposit.

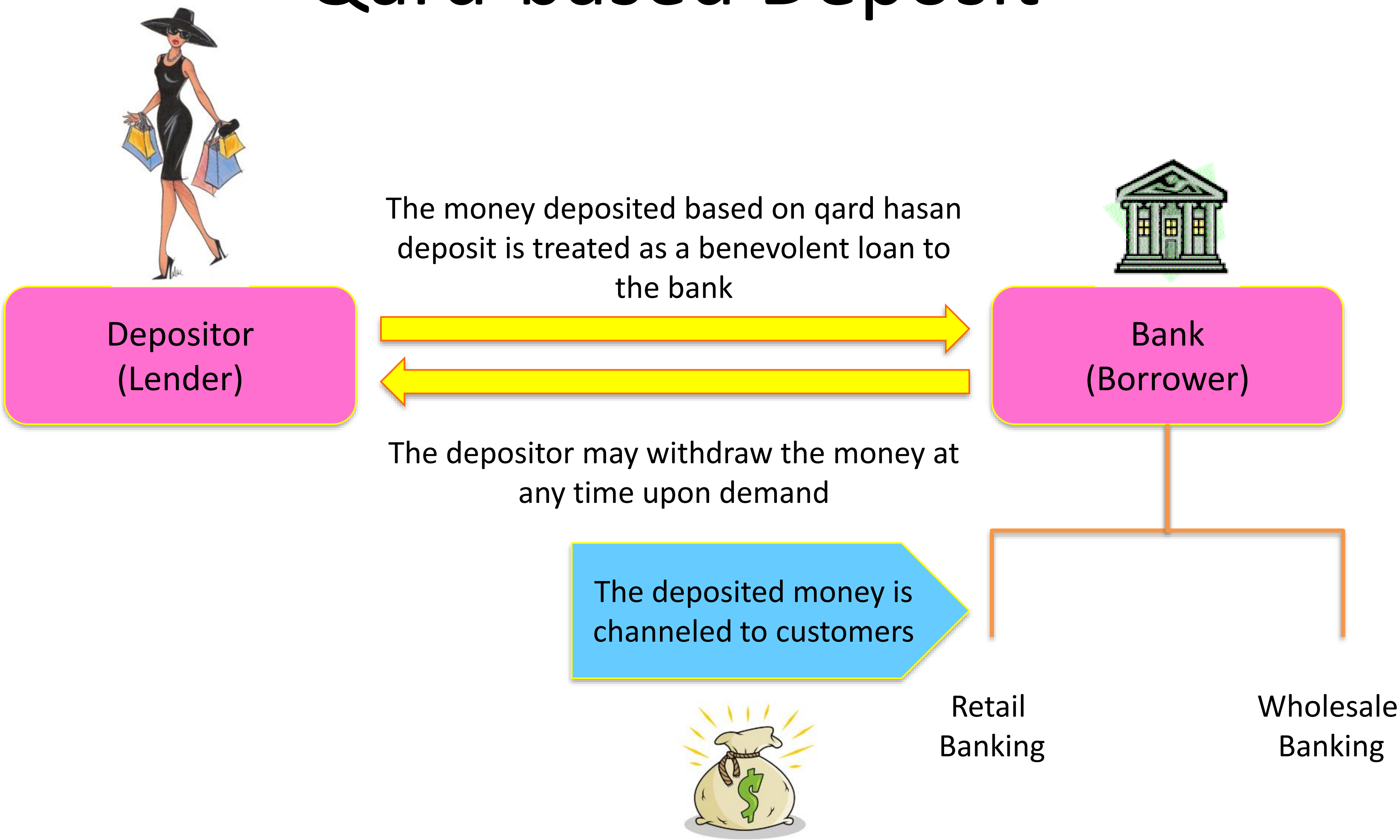
Qard-based Deposit

- The term *al-qard ul-hassan* means beneficial loan or benevolent loan or gratuitious loan.
- It is a loan which is returned by the borrower (in this case, the Islamic bank) to the lender (the account holder) at the end of the agreed period at a full amount, without incurring any extra amount.
- Under this contract, the account holders are entitled to receive his/ her funds on demand for the purpose of making payment to others as mentioned above.
- The account holder, provided by the Islamic bank with a cheque book (for current account), can execute payment to others by issuing a cheque.
- When demanded by the holder/ customer, the bank will pay the whole sum or partial, subject to the balance of the respective current account.

Salient Features of a Qard-based Deposit

- The money deposited in the bank account by the depositor is treated as a form of benevolent loan to the bank.
- The bank is entitled to use these deposited funds at its own risk without any authorization from the depositor.
- The bank only owes the principal amount borrowed from the depositor.
- The principal amount is guaranteed by the bank to the depositor even if there is negligence or loss of wealth from the side of the bank.
- No dividends are due in these deposits.

Qard-based Deposit



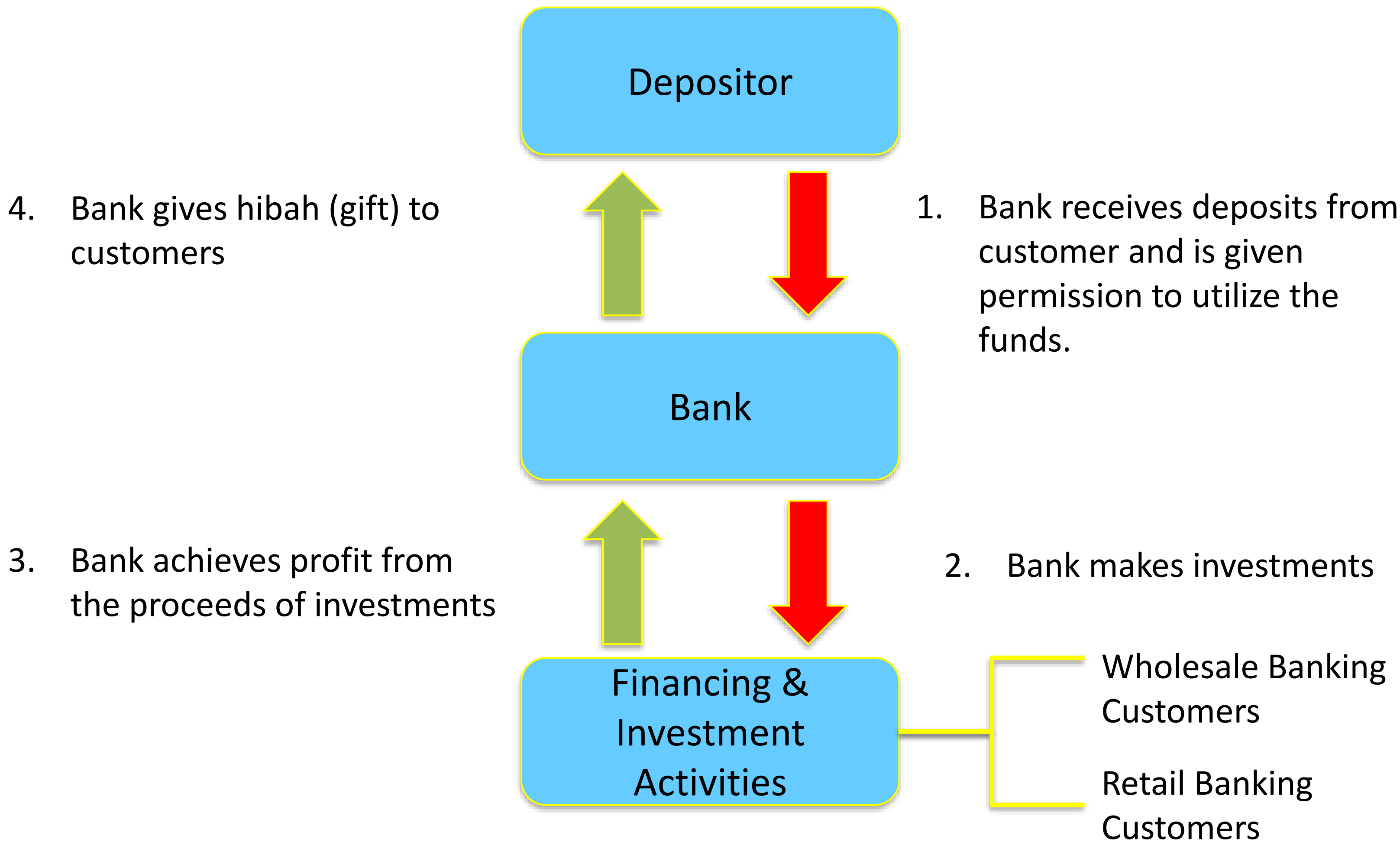
Wadiah Based Deposit

- Under this facility, Islamic bank (as a custodian of funds) accepts deposit from its customer for the purpose of safe custody/ safekeeping.
- As a custodian, the Islamic bank also guarantees repayment of the deposits on demand as requested by the customer.
- However, the account under this contract does not provide the customer/ depositor with the right to receive a share of the profits, unless with the discretion of the Islamic bank.

Features/ conditions of the Wadiah Account

- Islamic bank must get prior permission from customers to make use of their funds.
- Customers may withdraw partly or whole amount of their balances at any time and the Islamic bank guarantees the refund of such withdrawal.
- Any profit earned by the Islamic bank from the utilization of deposit funds belongs to the Islamic bank, not the customers/ depositors.
- Islamic bank may at its absolute discretion rewards the customers by disbursing a portion of the profits generated from the utilization of the funds.

Wadi’ah Yad Dhamanah Deposit



Mudharabah Deposit

- Under this contract, the owner of the capital is the current account holders and the entrepreneur is the Islamic bank.
- Both parties agree to venture into a proposed project (either general or specific projects) and agree to share the profits based on the agreed pre-determined profit sharing ratio (PSR), while the losses, if it occurs, will be borne solely by the owner of the capital.

Mudharabah Muqayyadah
(*Restricted Mudharabah*)
The actions of the mudharib are restricted but should not contrain his actions in his operations.

Mudharabah Mutlaqa
(*Unrestricted Mudharabah*)
The Mudharib can employ his own good judgment and has complete authority on the management of the capital entrusted to him for any type of investment activity.

Mudharabah Deposit

Depositor
(Rabbul Mal)

1. The money deposited based mudharabah deposit.

2. If there is profit, both parties will share based on the pre determined profit-sharing ratio.
If there is a loss, only the depositor will bear the financial loss. The bank will only be liable if the loss is due to negligence.

Bank
(Mudharib)

Mudharabah Mutlaqa
(Unrestricted Mudharabah)

Mudharabah Muqayyadah
(Restricted Mudharabah)

Islamic Deposit vs Conventional Deposit

Islamic Savings Deposit	Conventional Savings Deposit
The principal amount is fully guaranteed (except for Mudharabah).	Both the principal and interest are predetermined and guaranteed.
There is no presence of interest. However, upon the discretion of the bank, the depositors may be offered hibah (gift) which is neither conditional nor promised upfront.	Interest is fixed at a pre determined rate but is subject to revision.
The banks cannot offer any incentives in the form of gifts/ promotional items/ attractive benefits etc. to attract new depositors particularly when it is structured based on qard or wadi'ah.	The banks can offer incentives to attract new depositors.
The deposit is accepted on the condition that the money will be put to work together with the management expertise and skills of the bank.	The deposit is a form of debt given to the bank by the customer.

Term Deposit

- Commodity Murabahah
- Wakalah Unrestricted Investment
- Mudarabah General Investment

Murabahah Fixed Deposit

- Under the contract Murabahah, Islamic banks offer an Islamic fixed deposit returns to depositors.
- The customers may place certain amount of cash to Islamic Banks i.e. RM10,000 for a certain period of time i.e. 3 months.
- Once deposited, the customers' deposit returns can be determined based on their respective deposit amount.
- Example of this product is offered by CIMB Islamic called "Advance Profit Fixed Return Investment Account-i (Tawarruq vis-à-vis Commodity Murabahah)

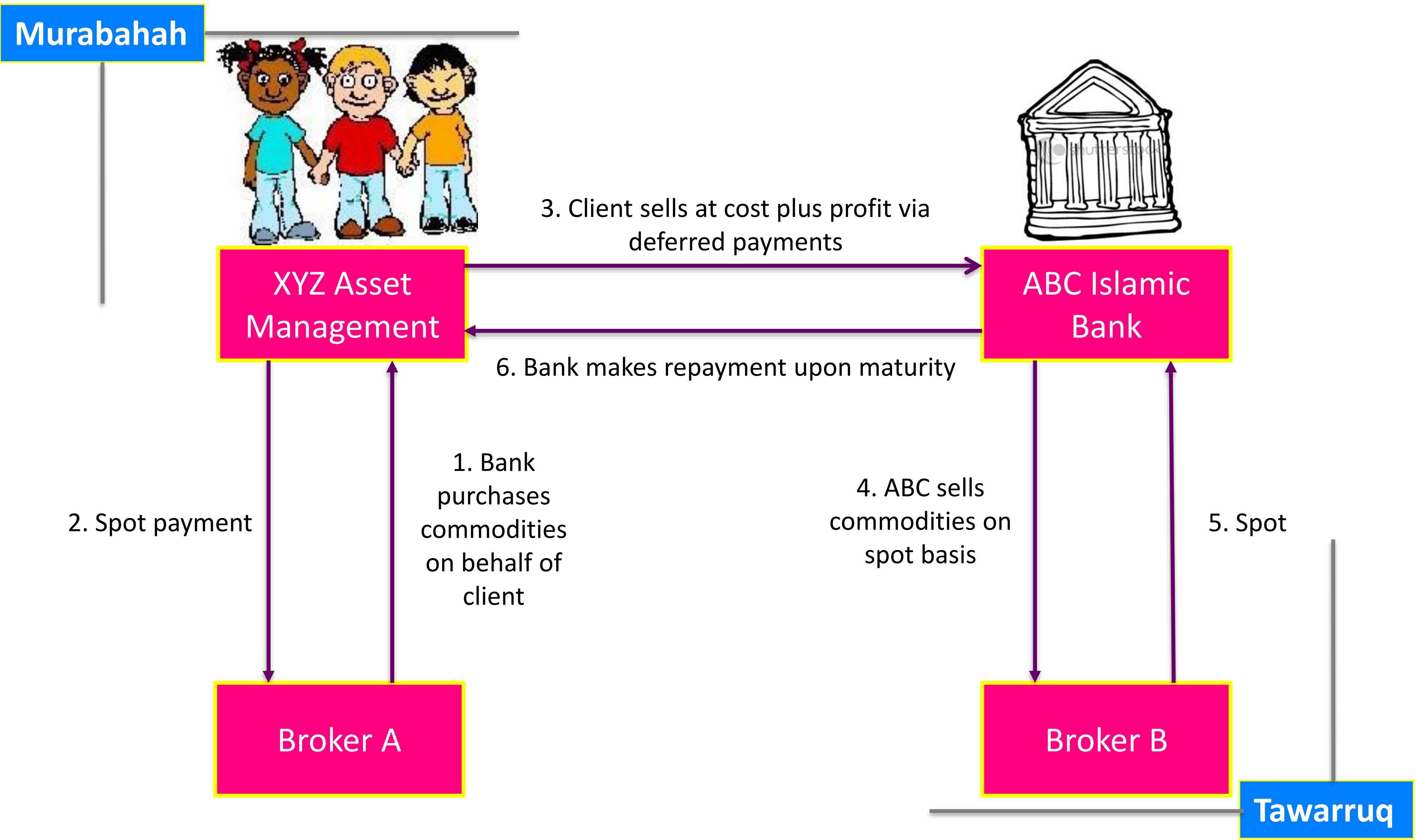
Murabahah Fixed Deposit

- Features of the product:
  - It is based on the concept of Tawarruq (in relation to Commodity Murabahah) which requires the customer to appoint the Islamic bank (under the contract of Wakalah) as an authorized agent to purchase a commodity from a commodity trader on a cash basis.
  - Subsequently the Islamic bank will buy back the commodities from the depositor on a deferred sale at a cost plus profit margin (under the contract of murabahah) and
  - Upon maturity, Islamic bank will sell the commodities back into the commodity market and the sale proceeds will be used to reimburse the amount of principal deposited by the customer during the aqad.
  - The underlying assets used under this facility include crude palm oil, metal-based contracts etc.

Murabahah Fixed Deposit

- Unlike conventional fixed deposit products where returns are paid only upon maturity, this product could make payment of profit to the depositors when the account is opened.
- Customers can indicate to collect either in the form of cash, Banker’s Cheque, Demand Draft or transfer it to other Islamic savings or current accounts.
- Depositors can withdraw their principal when the maturity period expires i.e. three months.

Murabahah Fixed Deposit



Wakalah Unrestricted Investment Deposit

- This contract facilitates the Islamic bank (acting as a wakil/ authorized agent) to define benefits that the depositors (muwakkil/ authorizer) would obtain in the form of certain minimum returns (i.e. monetary returns, takaful coverage).
- As an authorized agent, the Islamic bank will act on behalf of depositors to manage and invest the deposits in various Shariah-compliant instruments/ transactions.
- Expected minimum returns earned from the investment will be agreed between both Islamic bank and deposit customers.

Mudharabah General Investment Account

- Islamic banks accept deposits for the purpose of investment from customer as offered under the deposit facility.
- Mudharabah is a contract between two parties i.e. the owner of the capital (i.e. investment deposit customer) and the entrepreneur (i.e. Islamic bank) of the proposed project (either general or specific projects) where both agree to share the profits based on the agreed pre-determined profit sharing ratio (PSR), while the losses, if occurs, is to be borne by the owner of the capital.

Features of the Mudharabah General Investment Account

- It is an agreement between an investor (capital provider) and an entrepreneur/ Islamic bank, whereby the latter will utilize the capital for a business venture.
- The investment pool takes the form of a general investment account in which investment deposits of different maturities are pooled together.
- If the deposits are not tied to any specific investment project but are utilized in different financing operations of the bank then the contract is called a 'General Investment Account (GIA)'. If it is tied to dedicated investment project, it is then called 'Specific Investment Account (SIA)'.
- Profit generated by the entrepreneur (Islamic bank) from the investment will be shared with the capital provider (depositors) according to pre-determined PSR.
- The profits are calculated and distributed at the end of the investment period that may vary from one year to years.
- Should losses arise, these will be borne by the capital provider (depositors). The agreement must not incorporate provisions for loss-sharing.
- The capital provider is not allowed to participate in the management of the investment of the funds.
- The deposits will have to be for a specified period.
- The agreement on PSR between the Islamic bank and the capital provider is made at the beginning of the deposit and cannot be amended during the tenure of the deposits unless with the consent of both parties that is the entrepreneur (Islamic bank) and capital provider (depositors).

Modus Operandi of the Mudharabah General Investment Account

DEPOSITOR

CAPITAL PROVIDER

1) Depositor invests a certain amount of money e.g. RM100,000 for a specific period e.g. 1 year. Both parties agree on PSR (say 70: 30) i.e. 70% = Gross profit to be distributed to depositor and 30% to Islamic Bank.

BANK

ENTREPRENEUR

2) Bank utilizes the deposit for investment in financing i.e. house, car, project

70%

100%

30%

3) PROFIT

4) LOSS

Example of Calculation of Profit under General Investment Account

Capital (P)	**RM100,000**
Actual Profit Rate (r)	8% per annum (declared at the end of the invesment period)
Profit Sharing Ratio (PSR)	70%: 30% (Capital provider: Entrepreneur)
Tenor (t)	6 month

Capital Provider Profit Amount (RM)	=	Capital (P) x Tenor x PSR x Actual Profit (r)
	=	
Entrepreneur/ Islamic Bank Profit Amount (RM)	=	Capital (P) x Tenor x PSR x Actual Profit (r)
	=	

Investment Deposit

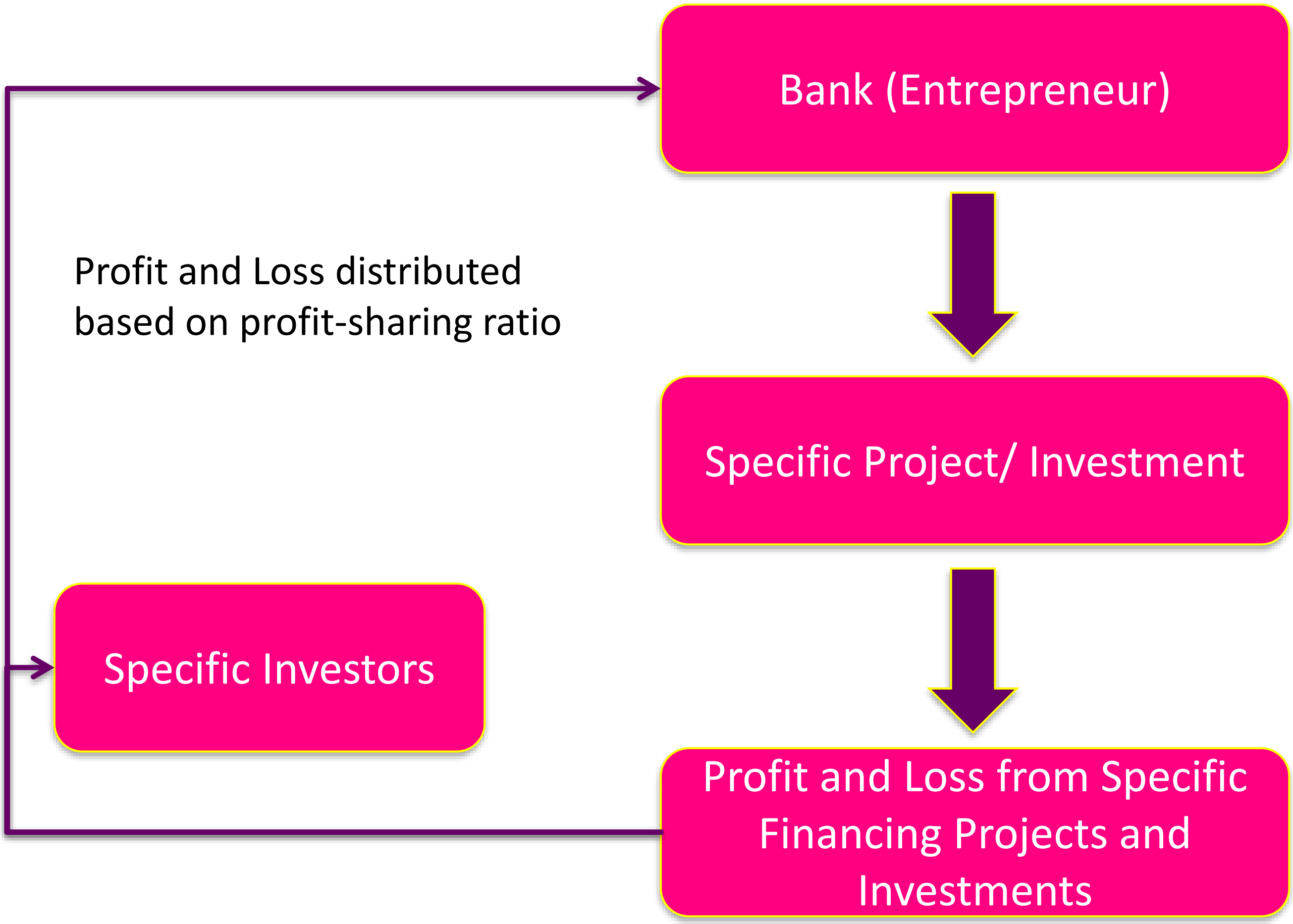
Wakalah Restricted Investment Deposit

- Wakalah is a form of agency contract in which the customer assigns the bank as his wakil (agent) to invest the money on his behalf.
- Both wakalah restricted and unrestricted investment account share the same characteristics except the former only allows the wakil to use the invested funds within the restriction of the fund schemes, e.g. the existence of investment parameters, the types of investments to be made by the scheme etc.

Mudharabah Special Investment Account

- In a mudharabah special investment account, the rabbul mal (property owner) will be advised on where the funds will be invested, what is the minimum amount that they can invest in, the projected return and what is the loyalty risks that come with it.
- Returns on the special investment account are generally much higher than the general investment account.
- The rabbul mal is usually a government institution or large corporate customer that is involved in specific investments, e.g. project financing or repurchase agreements in the Islamic money market.

Mudharabah Special Investment Account



Specific Project/ Investment

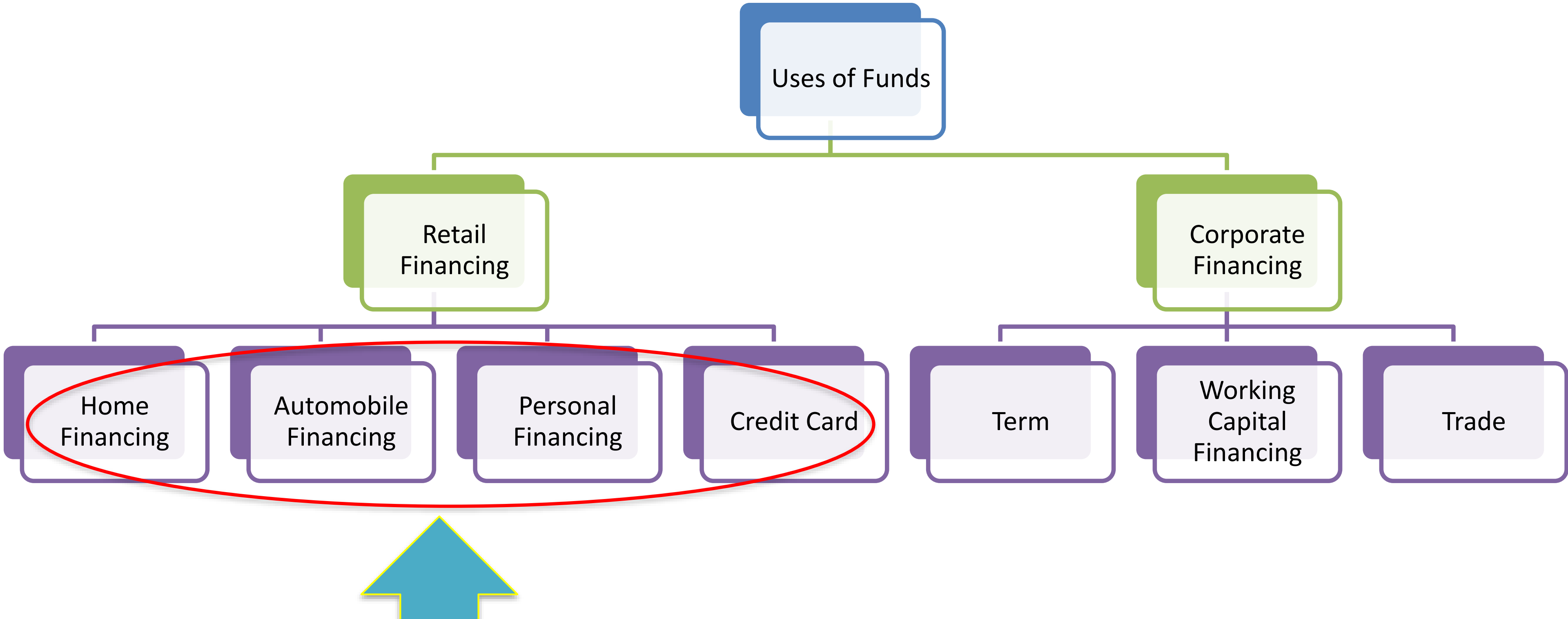
- Unspecified period
- Periodic updates
- Transparency of cash flow
- Early termination clause
- Zero capital charge
- Endorse the agreed profit-sharing ratio

Islamic Retail Financing

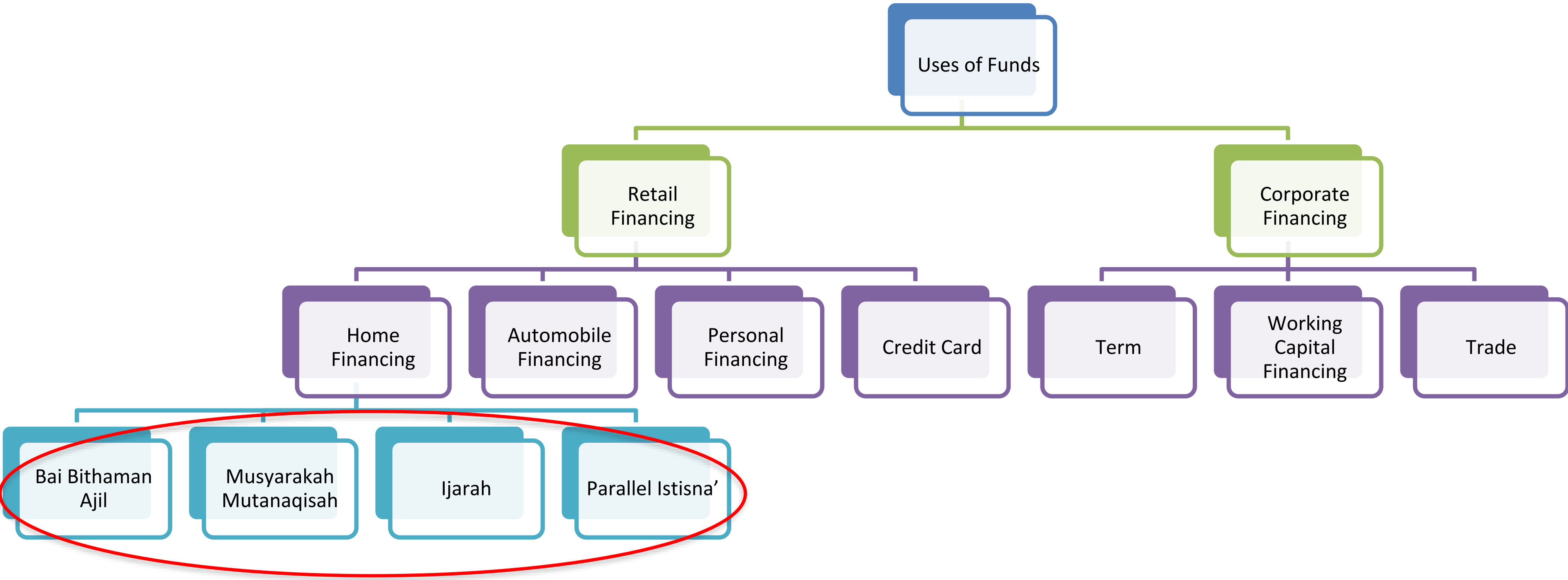
Corporate Financing

Working Capital Financing

USES OF FUNDS



Financing activities where the main emphasis is on service for individuals rather than businesses and corporate entities.

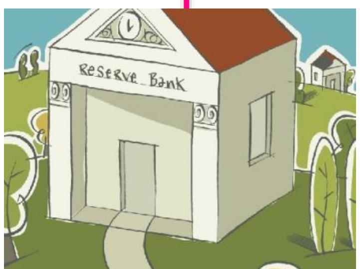


Uses of Funds
Retail Financing
Corporate Financing
Home Financing
Automobile Financing
Personal Financing
Credit Card
Term
Working Capital Financing
Trade
Bai Bithaman Ajil
Musyarakah Mutanaqisah
Ijarah
Parallel Istisna’

Home Financing: Bai-Bithaman Ajil

- BBA means **deferred installment sale**.
- Under this contract of sale, the Islamic bank may finance its customers who intend to acquire an asset (house) and to defer the payment of the asset to a specific period by paying installment based on the agreed financing period.

Modus Operandi of BBA House Financing



5) The customer will pay the sale price on an installment basis.

4) The bank then sells the house to the customer at a marked-up price.

Bank

Financing Customer

2) Customer pays the deposit and approaches the bank for financing of the remaining balance

3) Bank, as agreed by the customer, purchases the qualified asset from the owner on cash basis

1) Customer identifies the asset to be purchased

Owner of Asset i.e. House

Calculation of Total Selling Price under BBA

	Alternative 1	Alternative 2	
Financing details	Single-Tier Rate	Multi Tier Rate	
		Period 1	Period 2
a) Profit Rate	7.00%	3.00%	8.00%
b) Financing Amount	RM80,000	RM80,000	RM80,000
c) Period (Year)	20	5	15
d) No. of Month Due	240	60	180
e) Monthly Payment	RM620	RM444	RM670

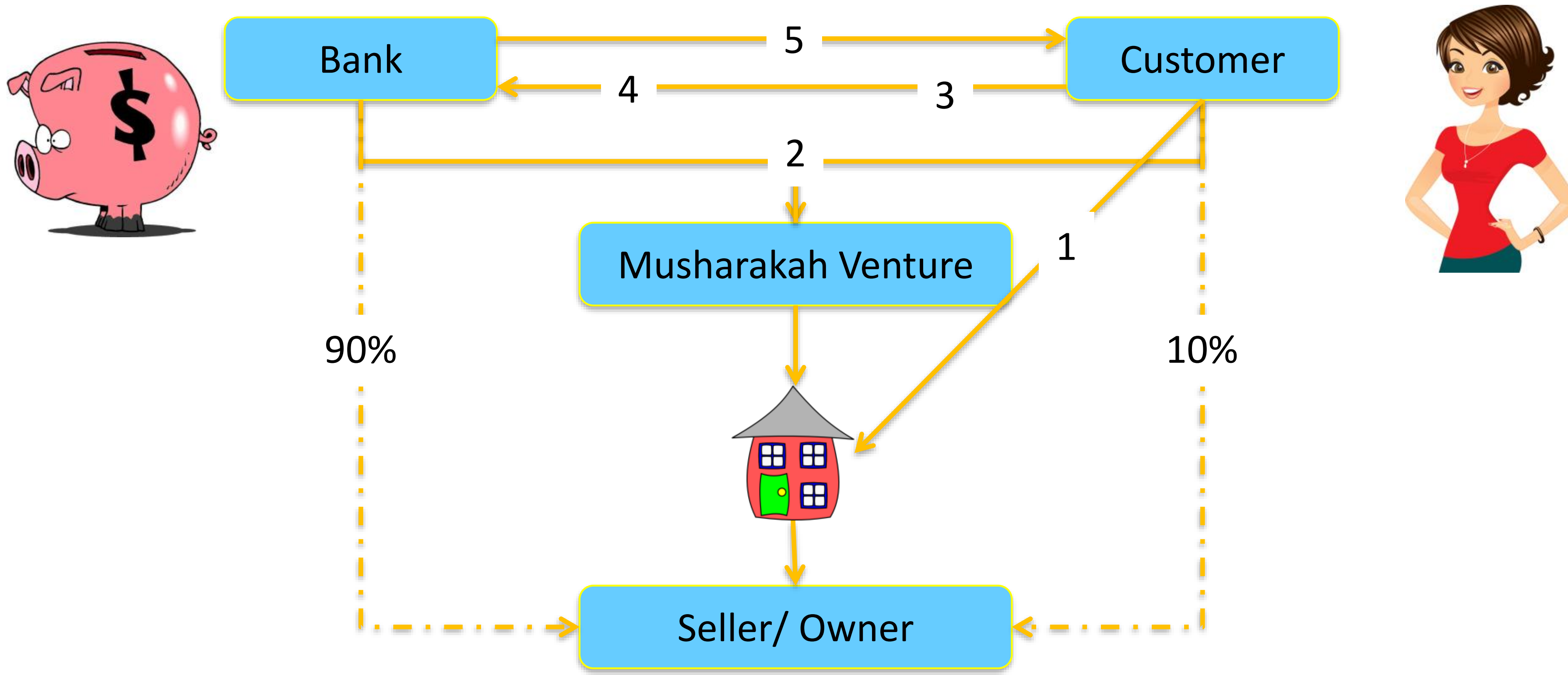
Calculation of Total Selling Price under BBA

Alternative	Period	Payment (RM)	No. of months	No. of years	Selling Price (RM)
1 (Single-tier profit rate)	1st – 20th year	620	12	20	
2 (Multi-tier profit rate)	1st – 5th year	444	12	5	
	6th – 20th year	670	12	15	

Home Financing: Musharakah Mutanaqisah

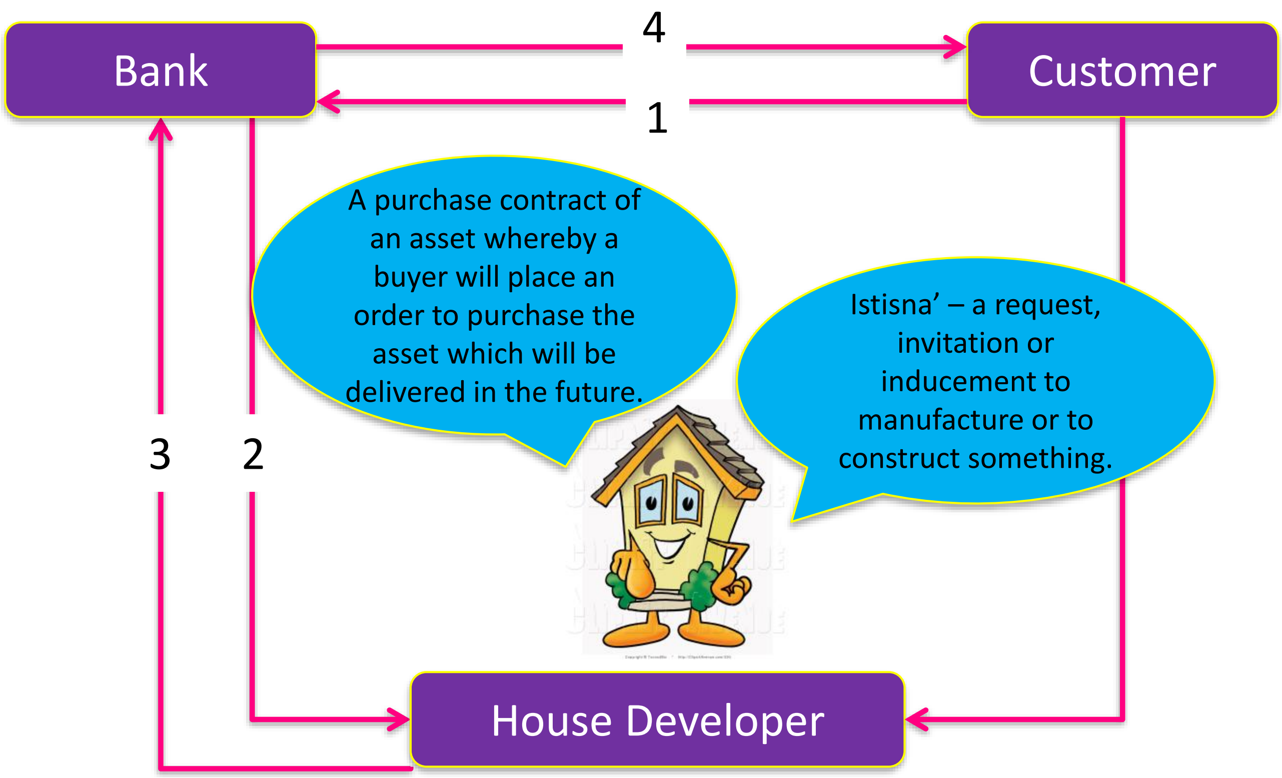
- Refers to diminishing ‘musyarakah’, which is co-ownership agreement between the Islamic bank and the financing customer.
- One of the partner promises to purchase the equity share of the other partner gradually until the title of the equity is completely transferred to him.
- The transaction starts with the formation of partnership after which buying and selling of the equity takes place between two partners.
- One partner leases his share of the asset to the other partner on Ijarah (lease) basis.
- The partnership will come to an end with one partner being the sole owner of the asset or business venture.

Modus Operandi of Musharakah Mutanaqisah House Financing



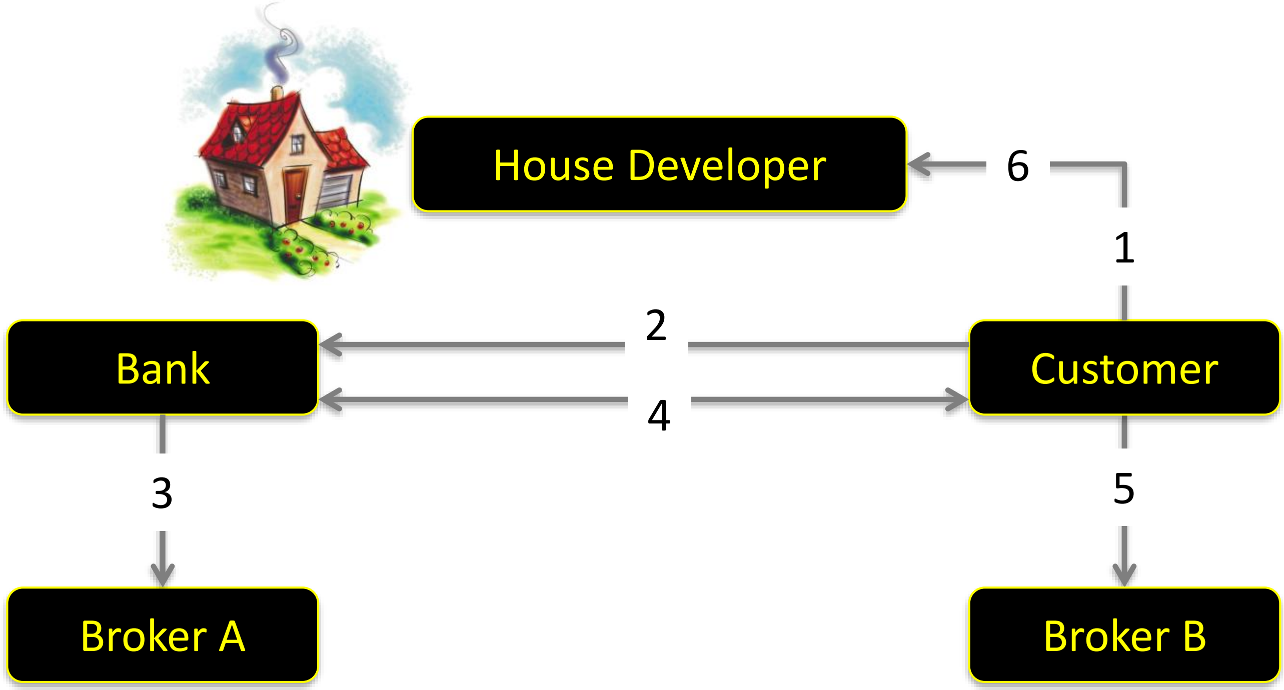
1. Customer identifies the property, signs the S & P agreement, pays deposit, and applies for the financing.
2. Once the application is approved, Bank enters into a Musharakah Arrangement with the customer.
3. Customer leases the Bank's share in the house.
4. Customer will pay an amount in addition to the rental to buy the Bank's units in the property.
5. The partnership will be terminated with the customer owning 100% of the house and the title will be transferred to him/ her.

Home Financing: Parallel Istisna’

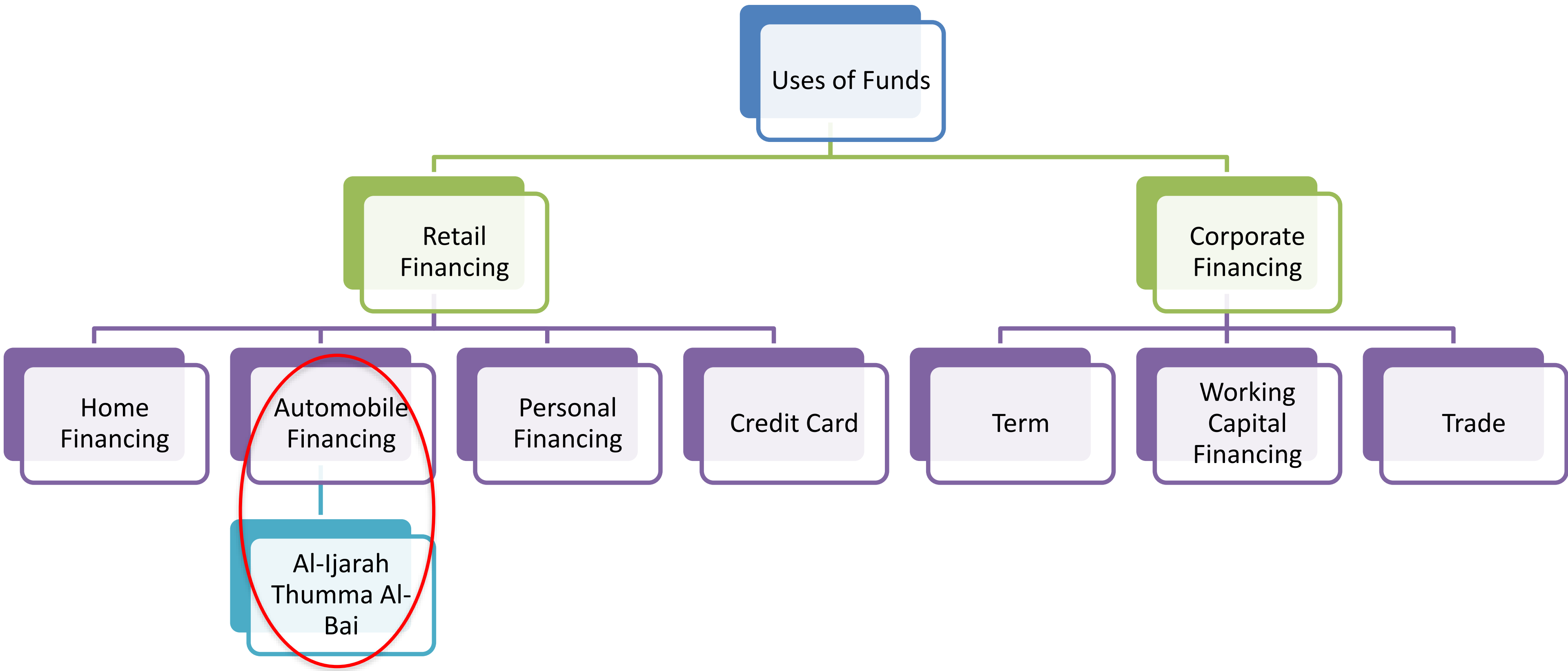


1. The customer appoints the bank (acting as contractor) to undertake the project. To undertake this task, the customer will sign an istisna’ agreement with the bank (principal + profit margin e.g. RM150,000).
2. The bank shall enter into another parallel istisna’ contract with a sub-contractor to construct the project (as specified in the first istisna’ contract between the bank and customer) and pays the cost of construction (principal e.g. RM100,000). The two istisna’ contracts must remain independent. E.g. any problems of non-performance shall not affect the other.
3. The developer will deliver the completed house to the bank.
4. The bank will deliver the house and the customer will pay the instalments.

Home Financing: Tawarruq



1. The customer identifies a house from the developer or house owner rand pays 10% down payment.
2. The customer approaches a bank to apply for financing and the bank will assess his credit worthiness.
3. The bank will buy a commodity from broker A, costing say RM100,000.
4. The bank sells the commodity to the customer for RM140,000. The customer will pay the amount of RM140,000 to the bank by instalment throughout the financing period.
5. The customer sells the commodity to broker B and gets cash.
6. The customer pays the remaining 90% balance to the house developer.



Uses of Funds
Retail Financing
Corporate Financing
Home Financing
Automobile Financing
Personal Financing
Credit Card
Term
Working Capital Financing
Trade
Al-Ijarah Thumma Al-Bai

Vehicle Financing: Al-Ijarah Thumma Al-Bay’

The purpose of the financing under this contract is to provide financing to customer to lease the required asset (i.e. car).

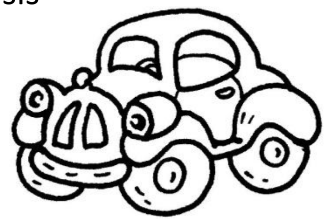
3) Bank leases the asset to the customer

Lessor (Islamic bank)

Lessee (customer)

4) Customer repays the financing via monthly lease payment.

2) Bank purchases the assets from owner on cash basis



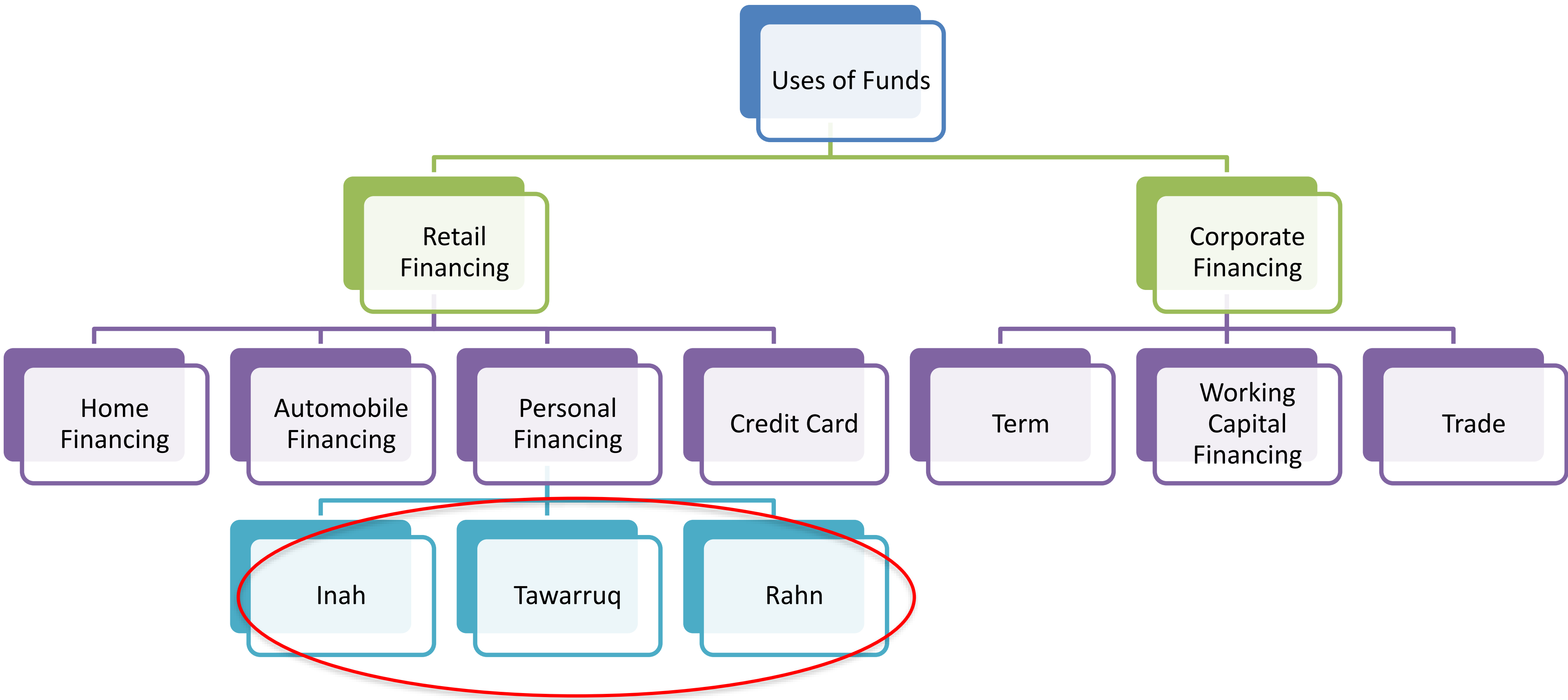
1) Customer identifies the asset to be leased

Owner of the Asset

At the end of the leasing period, a sale contract shall be executed with nominal price to effect the transfer of ownership of the vehicle to the customer.

Calculation of Total Leased Amount and Monthly Leased Amount under Ijarah Car Financing

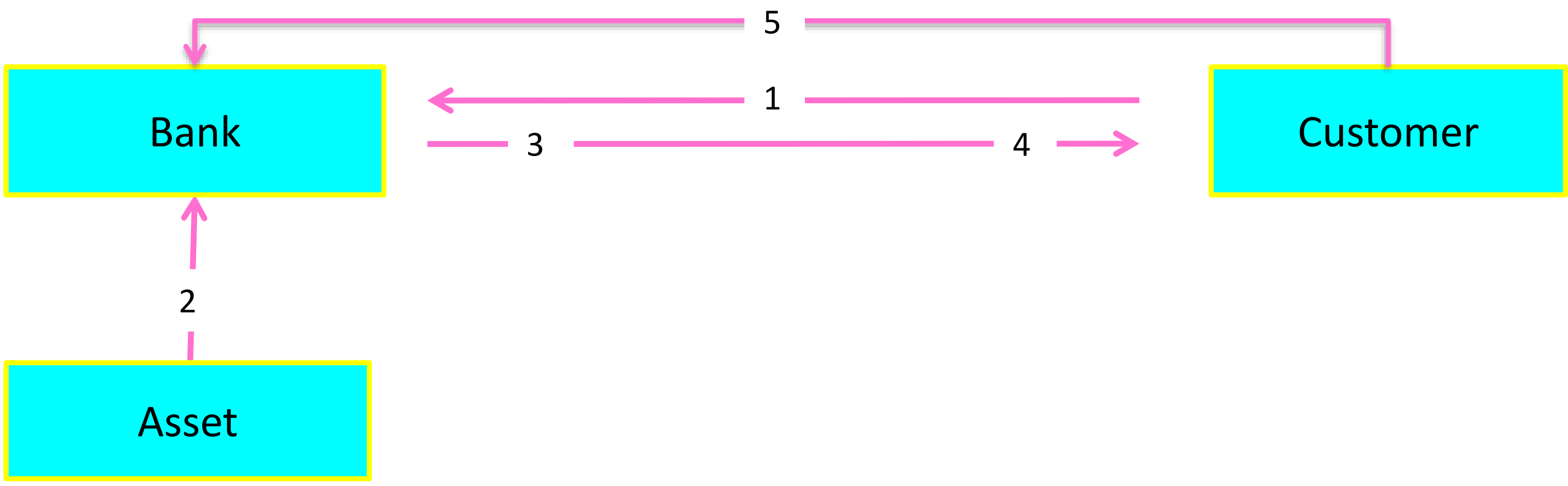
Financing Amount (P)	=	RM40,000
Profit Rate Charged (r)	=	5.0% per annum
Tenor (t)	=	7 years (84 months)
Total Leased Amount	=	P + [P(r x t)]
	=	
Monthly Lease Amount	=	P + [P(r x t)
		No. of months
	=	



Uses of Funds
Retail Financing
Corporate Financing
Home Financing
Automobile Financing
Personal Financing
Credit Card
Term
Working Capital Financing
Trade
Inah
Tawarruq
Rahn

Personal Financing: ‘Inah

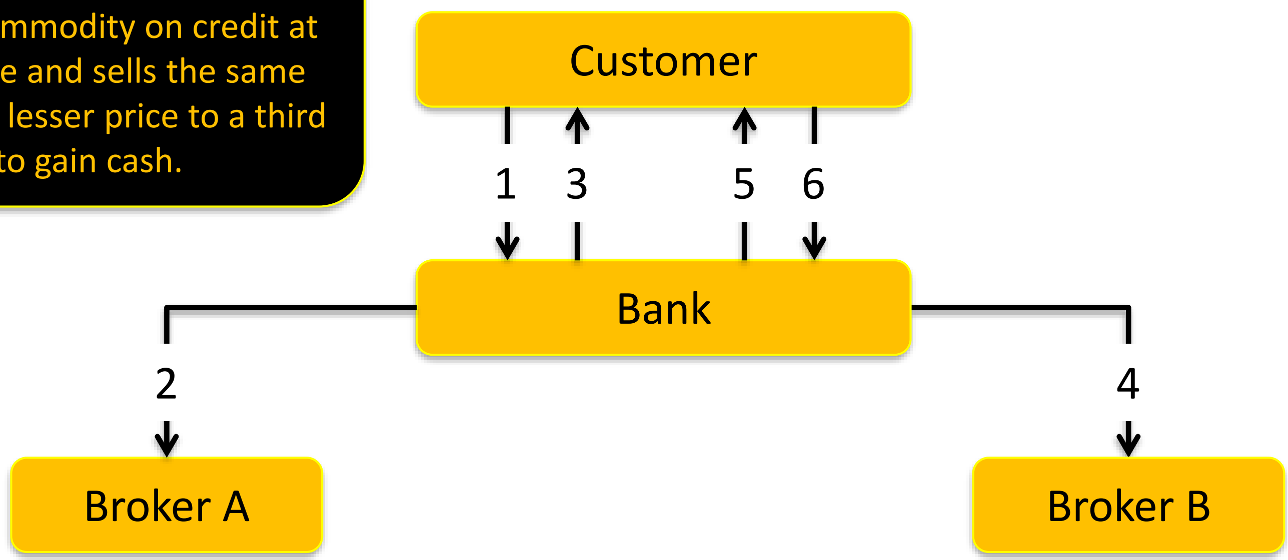
‘Inah – Sale with immediate purchase



1. The customer approaches the bank for financing.
2. The bank identifies the asset that will be traded under bay’ al-inah contract.
3. The bank and customer sign a first sales and purchase contract where the bank sells the asset at a selling price (financing amount + profit margin) on deferred terms and the ownership is transferred to the customer.
4. The bank and the customer sign a second sales and purchase contract where the bank buys back the asset sold by the customer at a cost price and pays on a cash basis.
5. The customer begins to pay his installments to the bank.

Personal Financing: Tawarruq

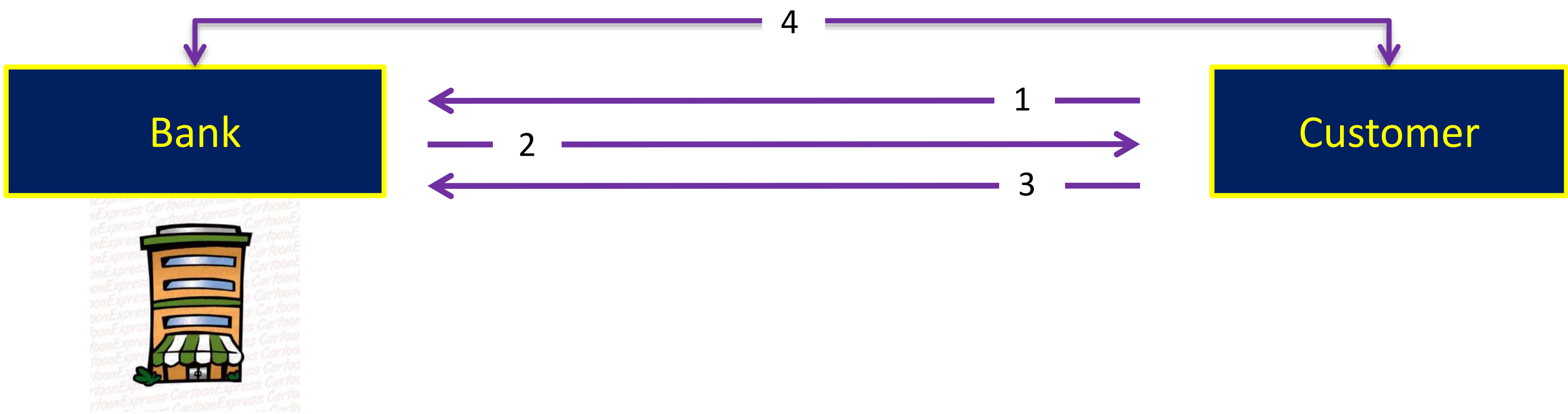
Tawarruq is a transaction where one party buys a commodity on credit at a mark up price and sells the same commodity at a lesser price to a third party to gain cash.



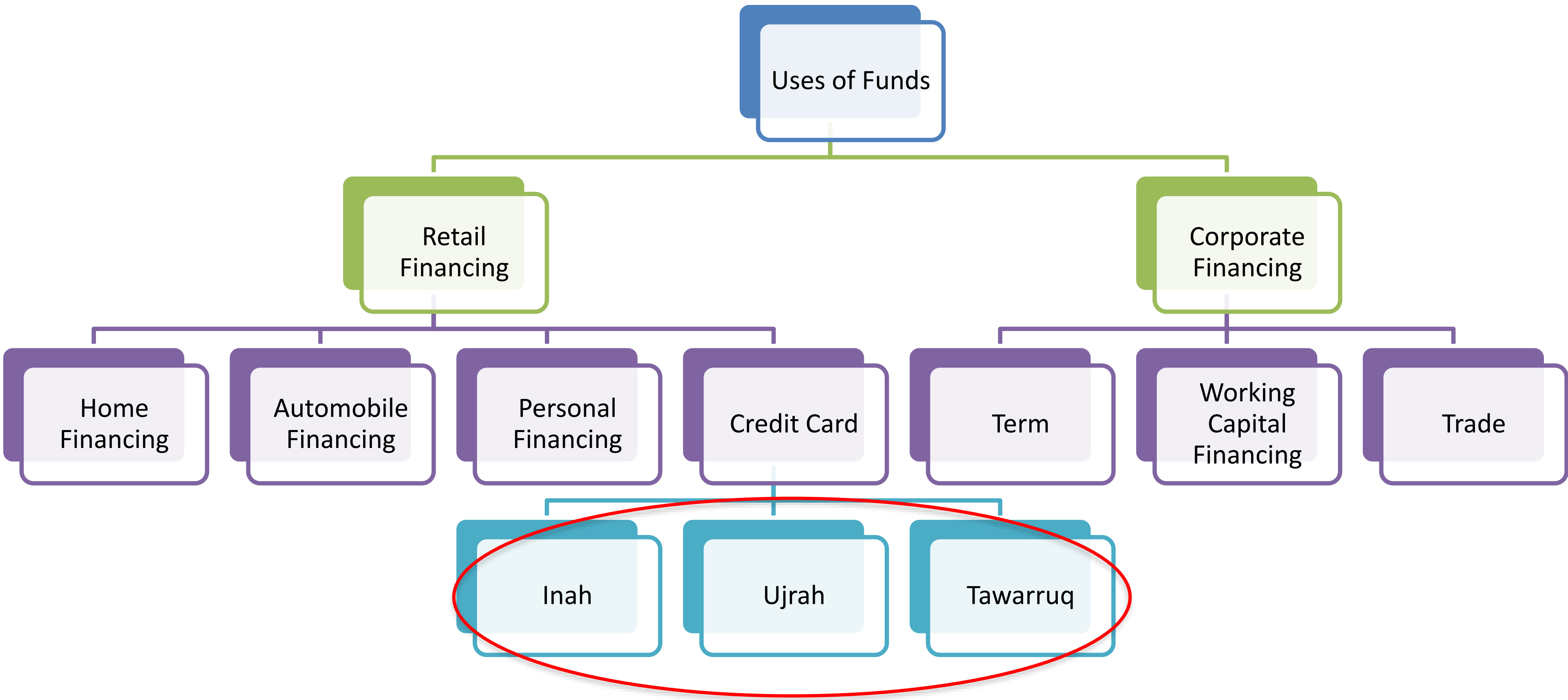
1. The customer and the bank enter into an arrangement where the customer promises to buy a specified commodity or asset from the bank. The customer also appoints the bank as his agent to sell the said commodity.
2. The bank buys a specified commodity from broker A on a spot basis.
3. The banks ells the same commodity to the customer on a deferred basis at cost plus profit.
4. As an agent, the bank sells the same commodity to broker B on a spot basis.
5. The bank pays the customer the sale proceeds in a lump sum.
6. The customer pays the bank the purchase price (cost plus profit) of the commodity on a deferred instalment basis.

Personal Financing: Rahn

Rahn is refers to an arrangement whereby a valuable asset is given as security for a debt.



1. The customer approaches the bank with a valuable item as collateral (e.g. jewellery worth RM10,000) for financing.
2. The bank accepts the pledged asset and grants an interest-free loan to the customer (e.g. RM8,000).
3. The customer pays a custodian fee for the service rendered in safekeeping the asset.
4. If the debtor is not able to repay the debt, the pawned asset will be sold to settle the outstanding debt and any surplus will be returned back to the customer.

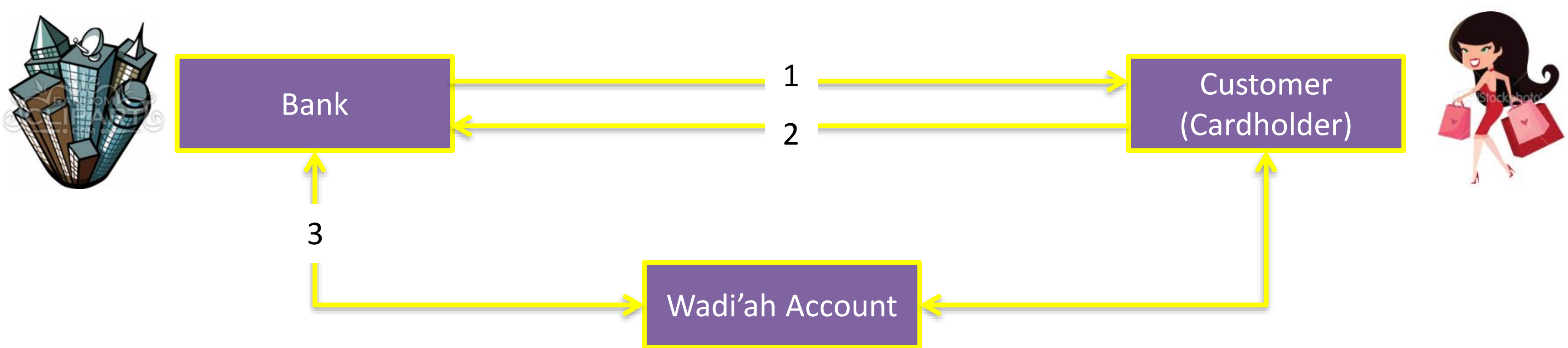

Uses of Funds
Retail Financing
Corporate Financing
Home Financing
Automobile Financing
Personal Financing
Credit Card
Term
Working Capital Financing
Trade
Inah
Ujrah
Tawarruq

Credit Card Financing: ‘Inah

Based on the combination of ‘Inah and Wadi’ah contract

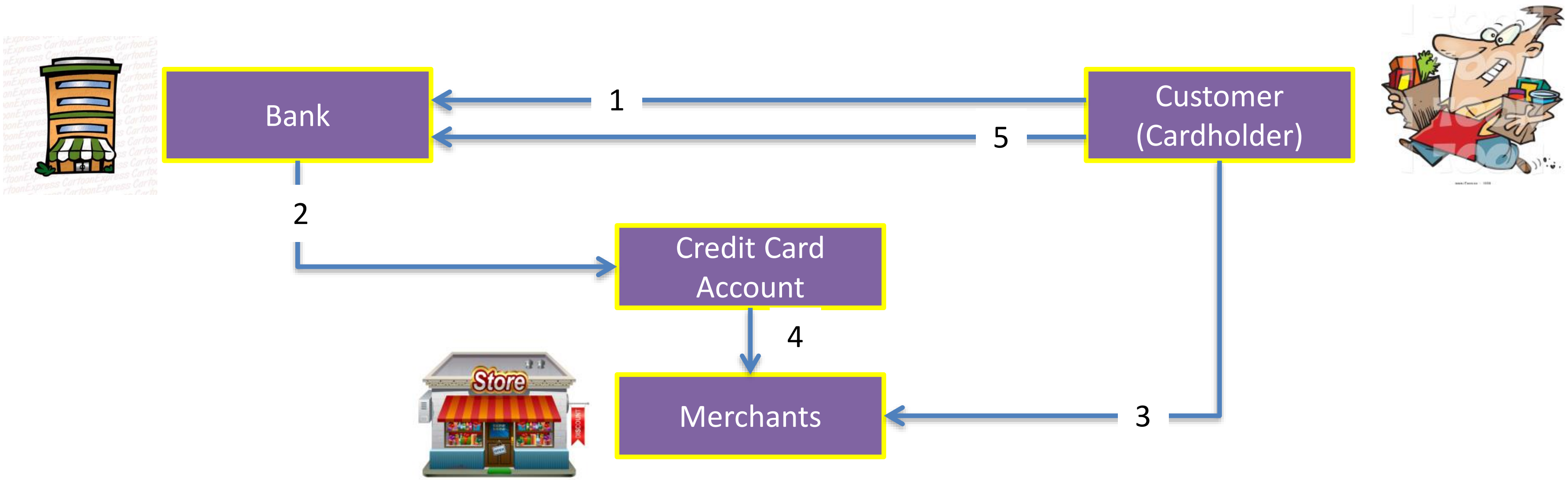
Bai’ Inah refers to a sale of asset i.e. by Islamic bank, which is later repurchased from its customer at a different price, whereby the deferred price paid is much higher than the cash price received during the sale of the asset. The difference between the sale and repurchase prices will be the profit amount earned by the Islamic bank.

E.g. The customer purchases an asset from the Islamic bank on deferred terms (the purchase price = cost + profit, i.e. RM11,800 = RM10,000 + RM1,800) to be paid within one year by the customer.



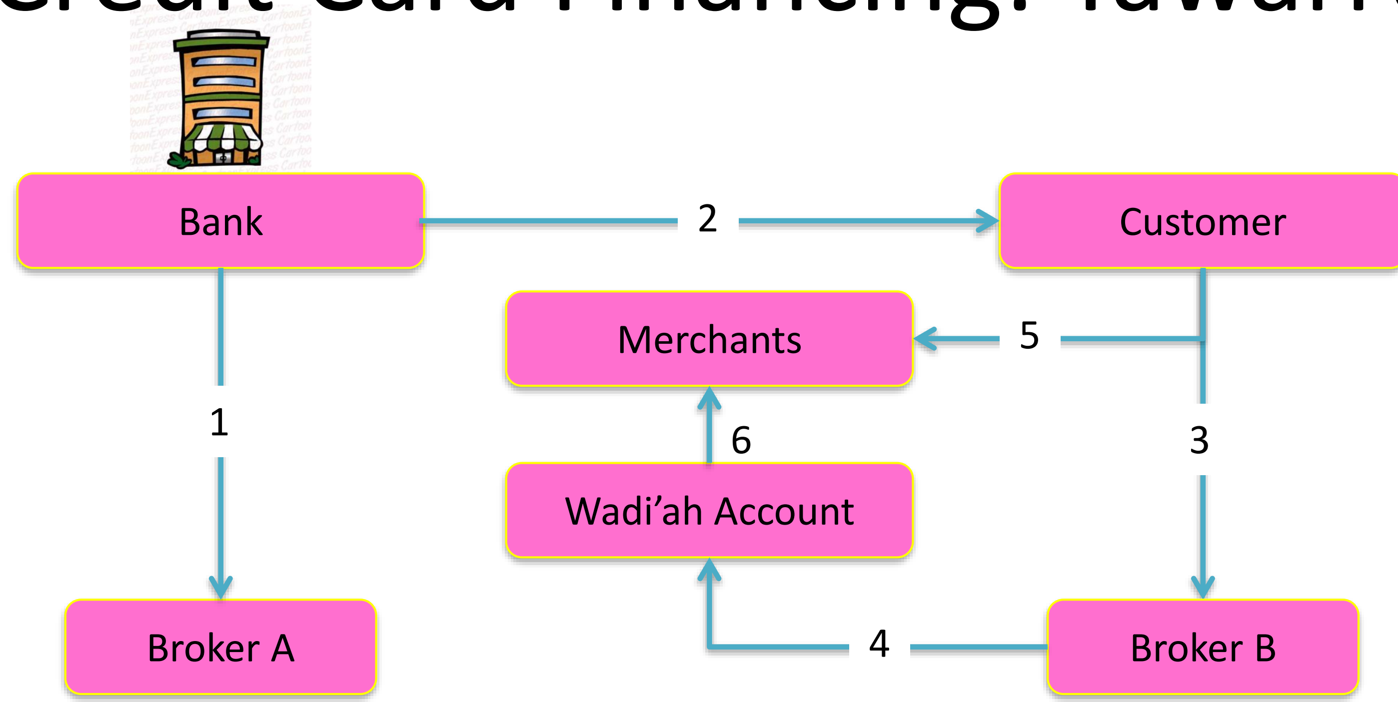
1. The bank sells an asset to the customer on deferred payment to be paid within a certain period of time (which is the credit card’s expiry date).
2. The customer subsequently sells the asset back to the bank for a lower amount (equivalent to credit limit) in cash.
3. This amount will be credited into a marginal wadi’ah account (also known as the customer’s special account) at the bank for the customer’s use. Whenever the customer uses the credit card, the amount shall be paid by the bank by deducting it from this account. Once the customer has made a repayment, the amount will then be topped up.

Credit Card Financing: Ujrah

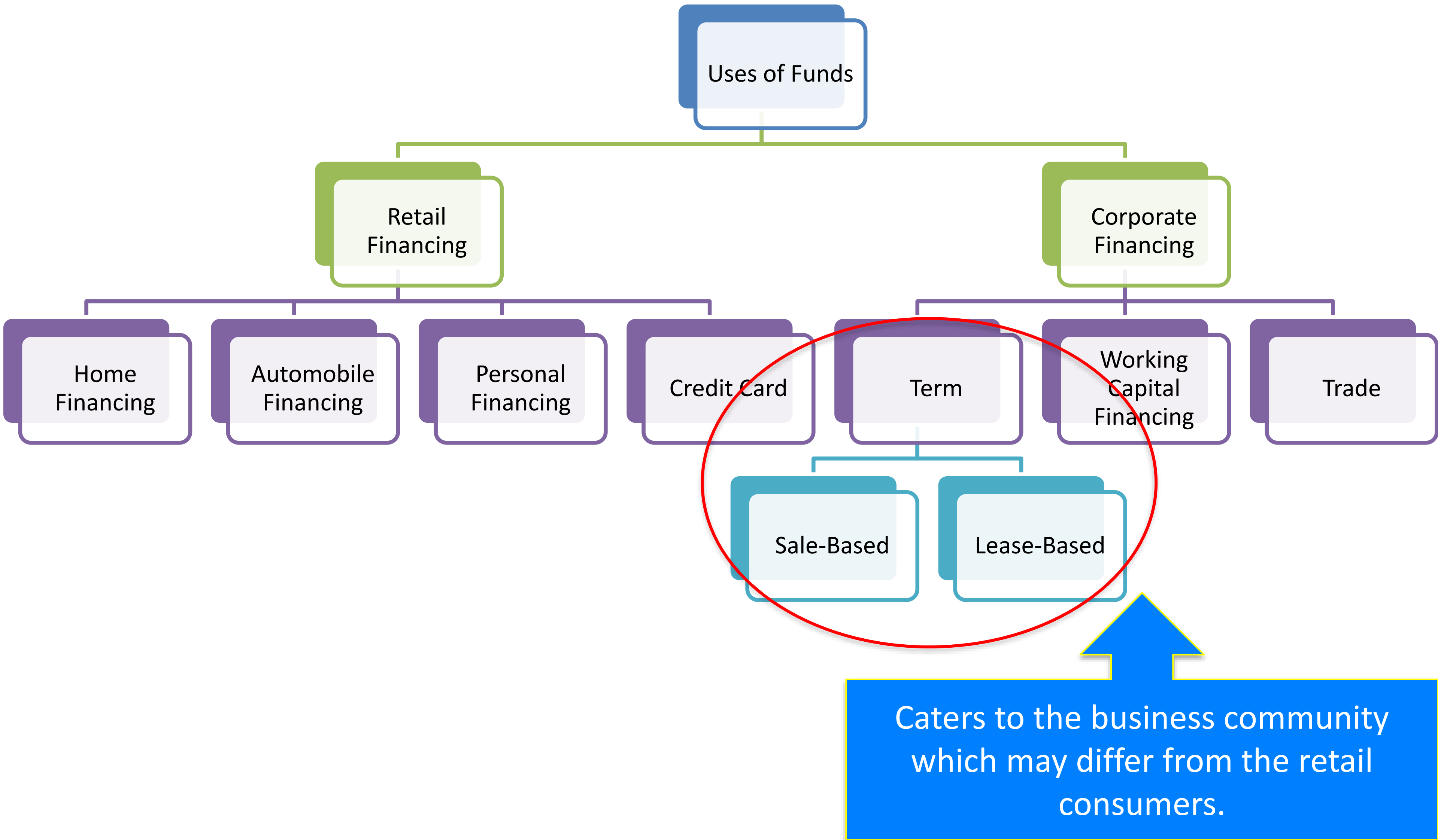


1. The customer applies for a credit card from a bank.
2. The bank provides a credit card account based on the customer's credit worthiness.
3. The customer pays the merchants for the goods from a credit card account.
4. The bank provides qard to the customer for the purchased goods.
5. The customer pays the purchase amount and the fee to the bank. The customer will be charged a fixed fee structure or other structures such as a monthly service fee which is based on the actual cost of managing the transaction and an annual service fee based on the benefit rendered by the bank. The bank earns profit from the service fee and also commission from the merchants, if any.

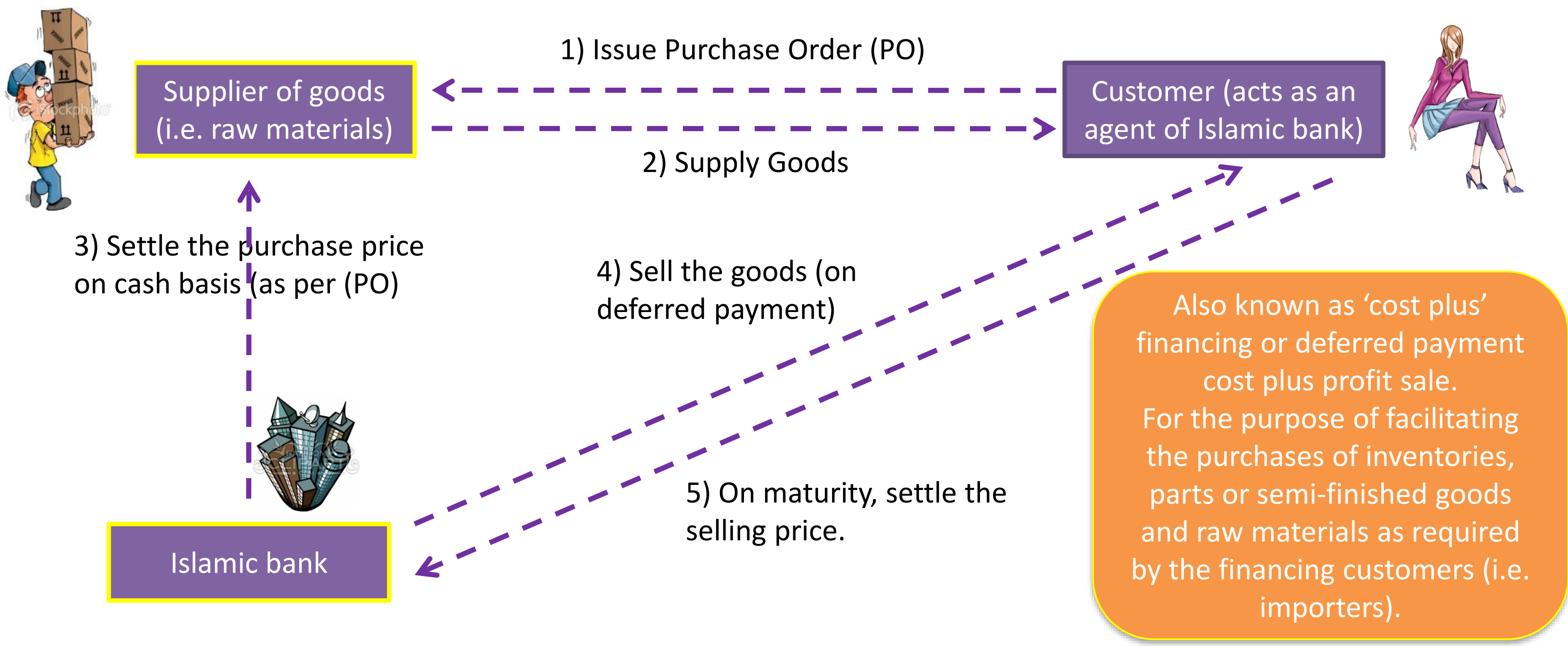
Credit Card Financing: Tawarruq



1. The bank purchases the commodity from Broker A.
2. The bank sells the commodity to the customer for deferred payment for a price equivalent to the credit limit plus profit.
3. The customer sells the commodity to Broker B.
4. Broker B deposits the cash into the customer’s wadi’ah account.
5. The customer buys the goods form the merchants using the wadi’ah account.
6. The purchase price is transferred to the merchants.


Uses of Funds
Retail Financing
Corporate Financing
Home Financing
Automobile Financing
Personal Financing
Credit Card
Term
Working Capital Financing
Trade
Sale-Based
Lease-Based
Caters to the business community which may differ from the retail consumers.

Sale-based Murabahah



1. Islamic bank appoints the customer as its agent to purchase the required goods on its behalf (under the contract of Wakalah).
2. Islamic bank settles the purchase price on cash basis by making payment to the supplier of the goods (i.e. raw materials).
3. Islamic bank, subsequently sells the goods to the customer at an agreed price (comprises the purchase price and the profit margin of Islamic bank) on deferred payment basis.
4. On maturity date (i.e. 3 months later), the financing customer pays the Islamic bank the total sale price of the financing.

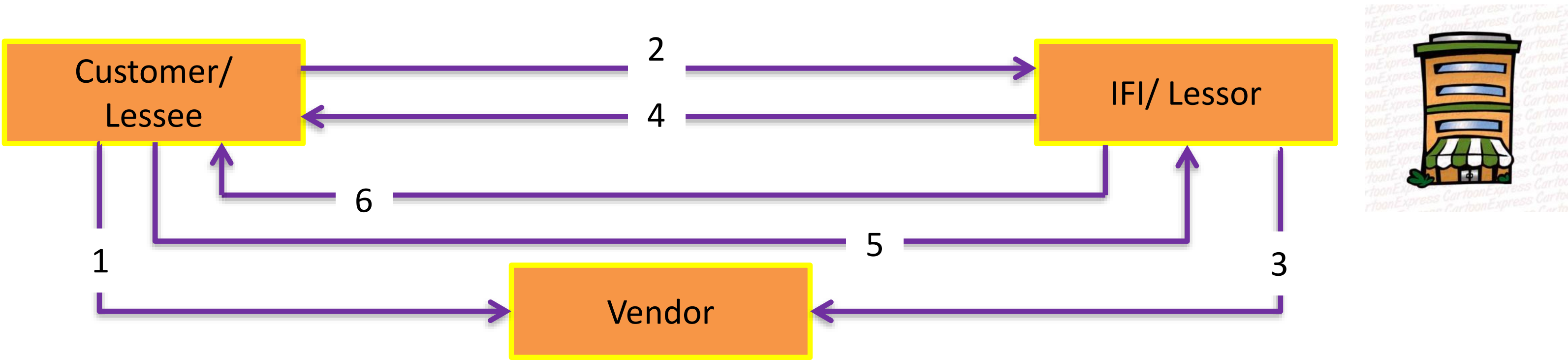
Calculation Sale-based Murabahah

Principal (P)	=	RM250,000 (buying price)
Profit Rate Charged (r)	=	5.0% p.a.
Tenor (t)	=	180 days (maturity period)

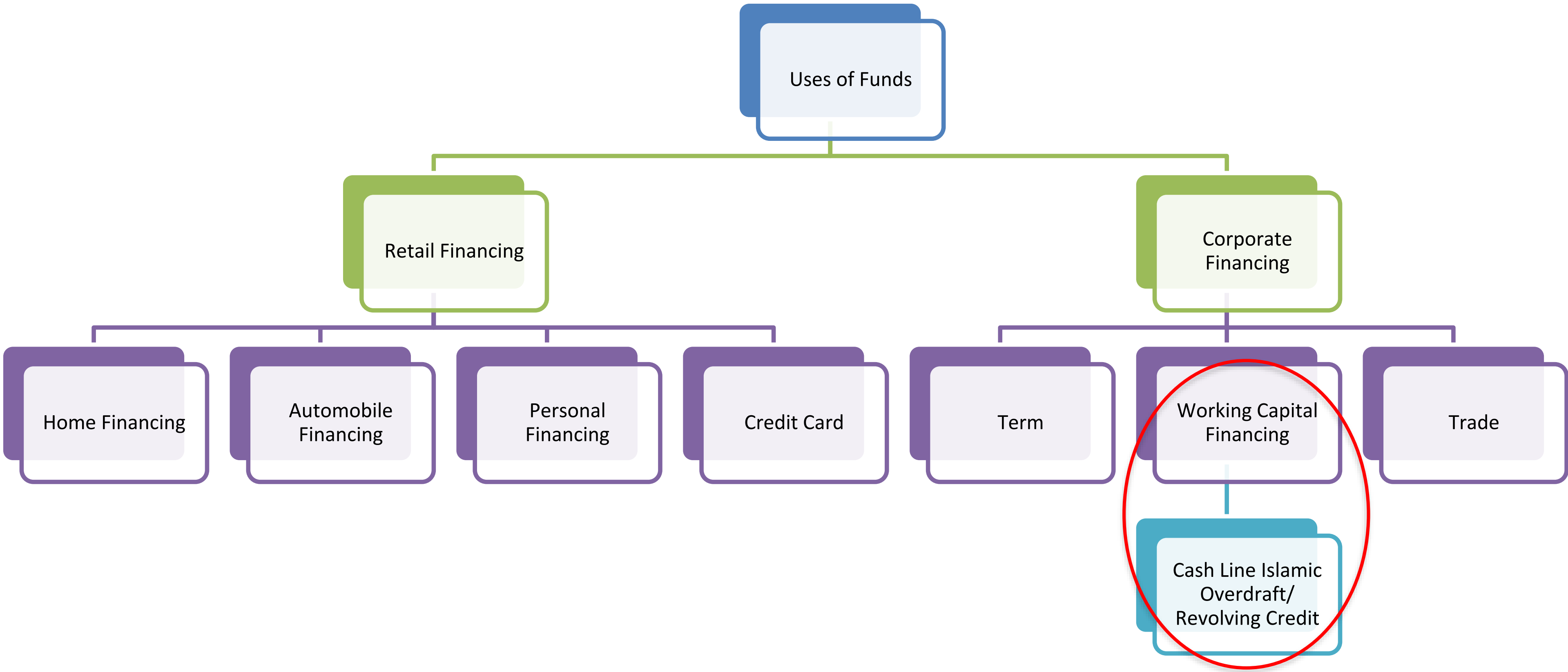
Selling Price (RM)	=	P	[1 +	(r x t)
				36500
	=			
	=			
Total Profit Earned by Islamic Bank (RM)	=	Selling Price – Buying Price		
	=			

Lease-based Ijarah Muntahiyah Bittamlik

There are various forms of ijarah contracts that can be used in structuring Islamic alternative contracts to conventional term financing. The most common structure is ijarah muntahiyah bittamlik whereby the leasing involves the element of transfer of ownership at the end of a leasing tenure.



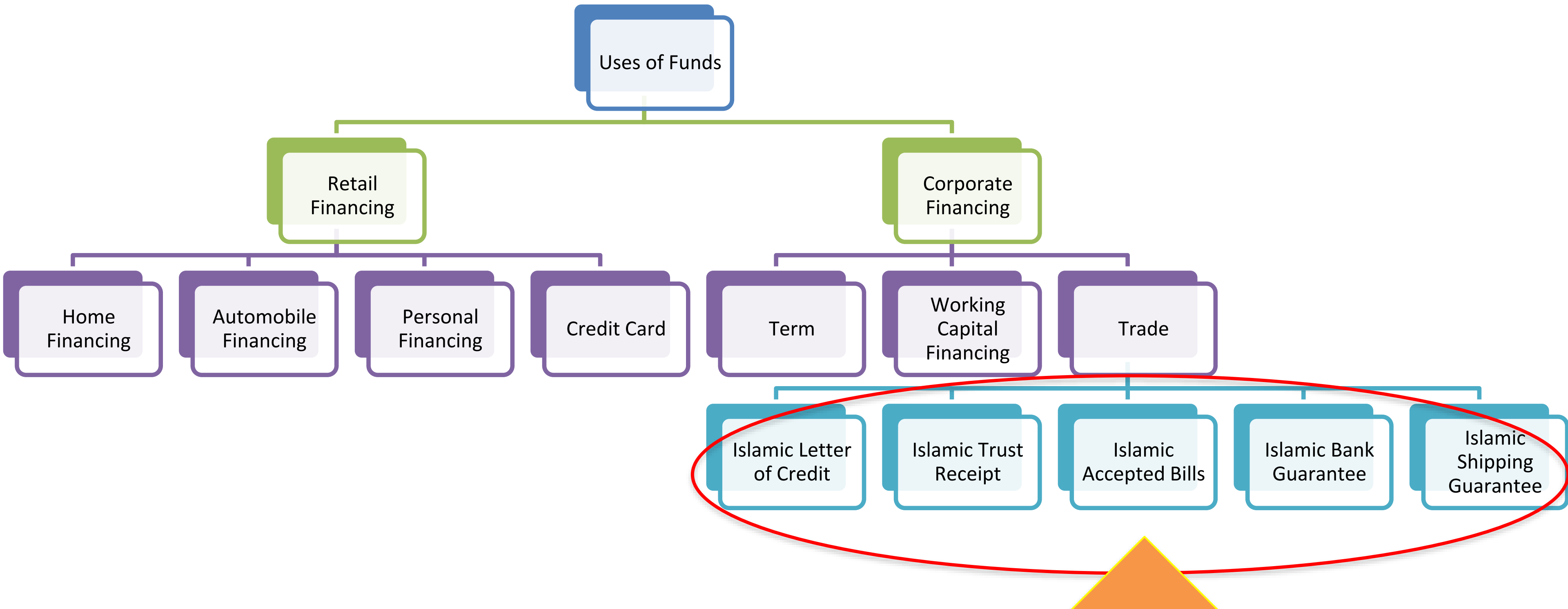
1. The customer finds a vendor and identifies a lorry that he wishes to lease.
2. The customer approaches the IFI. They both enter into an agreement where the IFI promises to purchase the lorry and the customer promises to lease the lorry from the IFI thereafter.
3. The IFI purchases the lorry from the vendor in accordance to the order of the customer. The ownership is transferred to the IFI.
4. The IFI rents the lorry to the customer for his usage at a rate agreed upon for a specified period of time.
5. The customer pays a monthly lease payment to the IFI for a specified period of time. The customer also agrees to pay for road tax, insurance coverage and maintenance.
6. At the end of the period, the customer receives the lorry as a form of hibah (gift). The ownership of the lorry is transferred to the customer in a separate contract.


Uses of Funds
Retail Financing
Corporate Financing
Home Financing
Automobile Financing
Personal Financing
Credit Card
Term
Working Capital Financing
Trade
Cash Line Islamic Overdraft/ Revolving Credit

Working Capital Financing: Cash Line Islamic Overdraft/ Revolving Credit

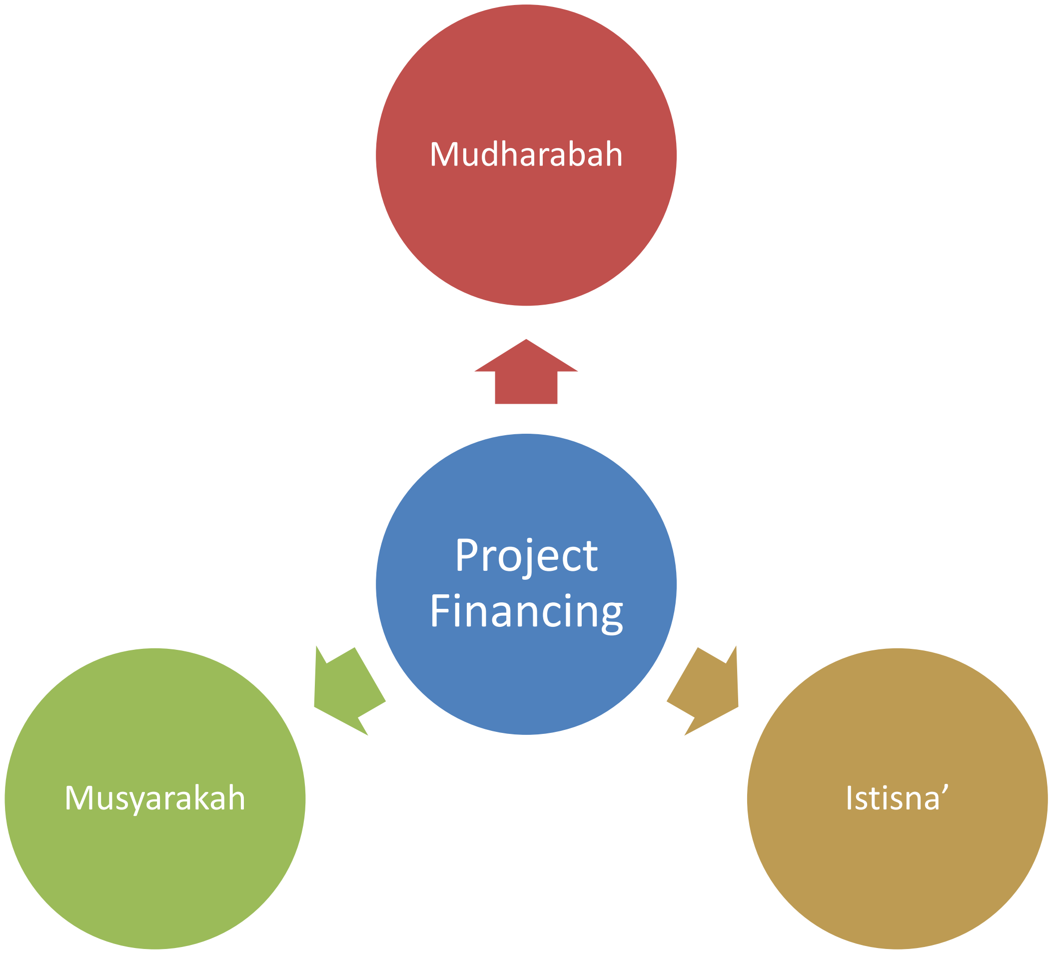
- Deals with the short-term needs of businesses.
- Usually structured based on either ‘inah or tawarruq.
- The financing tenure is usually up to a maximum number of five years only.

Under the concept of Bai al-Inah, the financial institution will first sell to the customer an identified asset belonging to the bank at a deferred price with a profit margin higher than the financing value as per requested by the customer. Subsequently, the customer will sell back the asset to the bank at a price equivalent to the value of the financing amount. The amount which is supposed to be disbursed to the customer as per the second sale execution will then be deposited into a suspense account. From this suspense account, the customer is allowed to overdraw his or her current account.



Addresses the needs of businesses involving in cross-border transactions. Can be categorized into domestic and international. Domestic trade involves the buying and selling of commodities in the country which includes retail trade and wholesale trade. International trade is the external trade of the country, and it encompasses the exchange of commodities between the country and other countries including import and export trade.

Project Financing



Project Financing under the Contract of Mudharabah

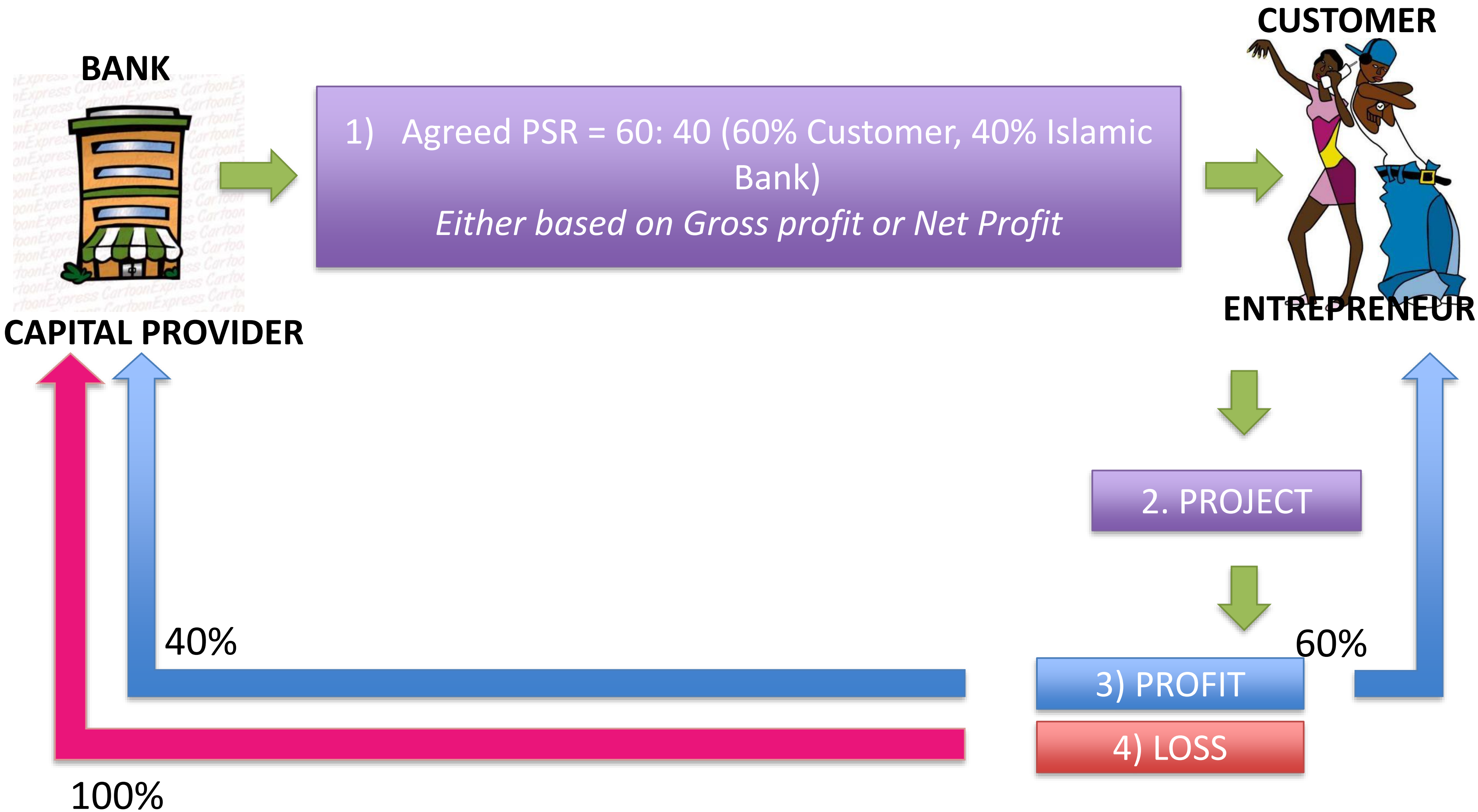
- Islamic bank, under this contract, acts as owner of capital/ capital provider to finance entrepreneurs/ customers’ projects/ requirements (i.e. housing development).

Mudharabah is a contract between two parties that is between the owner of capital (i.e. Islamic bank) and the entrepreneur (i.e. financing customer) of the proposed project where both agree to share the profits based on the agreed pre-determined profit sharing ratio (PSR), while the losses, if occurs, is to be borne solely by the owner of the capital (Islamic bank).

Project Financing under the Contract of Mudharabah

- Modus operandi
  - Islamic bank (the owner of capital/ capital provider) places a specified sum of money to the financing customer (entrepreneur) for a certain period of time with an agreed pre-determined PSR.
  - The financing customer (entrepreneur) is entrusted to utilize the capital for the proposed project without any intervention from the Islamic bank (owner of capital).
  - Profit earned from the project will be shared between the two parties (Islamic bank and entrepreneur) according to the agreed PSR.
  - Loss, if any, will totally be borne by the Islamic bank (owner of capital).

Modus Operandi of Project Financing under the Contract of Mudharabah



Project Financing under the Contract of Istisna’

- Contract of Istisna’ (purchase order) refers to an agreement between the Islamic bank and financing customer to sell or to buy from a customer a non-existent asset which is to be manufactured or built based on the specifications outlined by the ultimate buyers at an agreed predetermined selling price and to be delivered on a specific future date.
- Among suitable projects under this contract includes housing, building, and construction of houses, commercial and industrial building/ project.

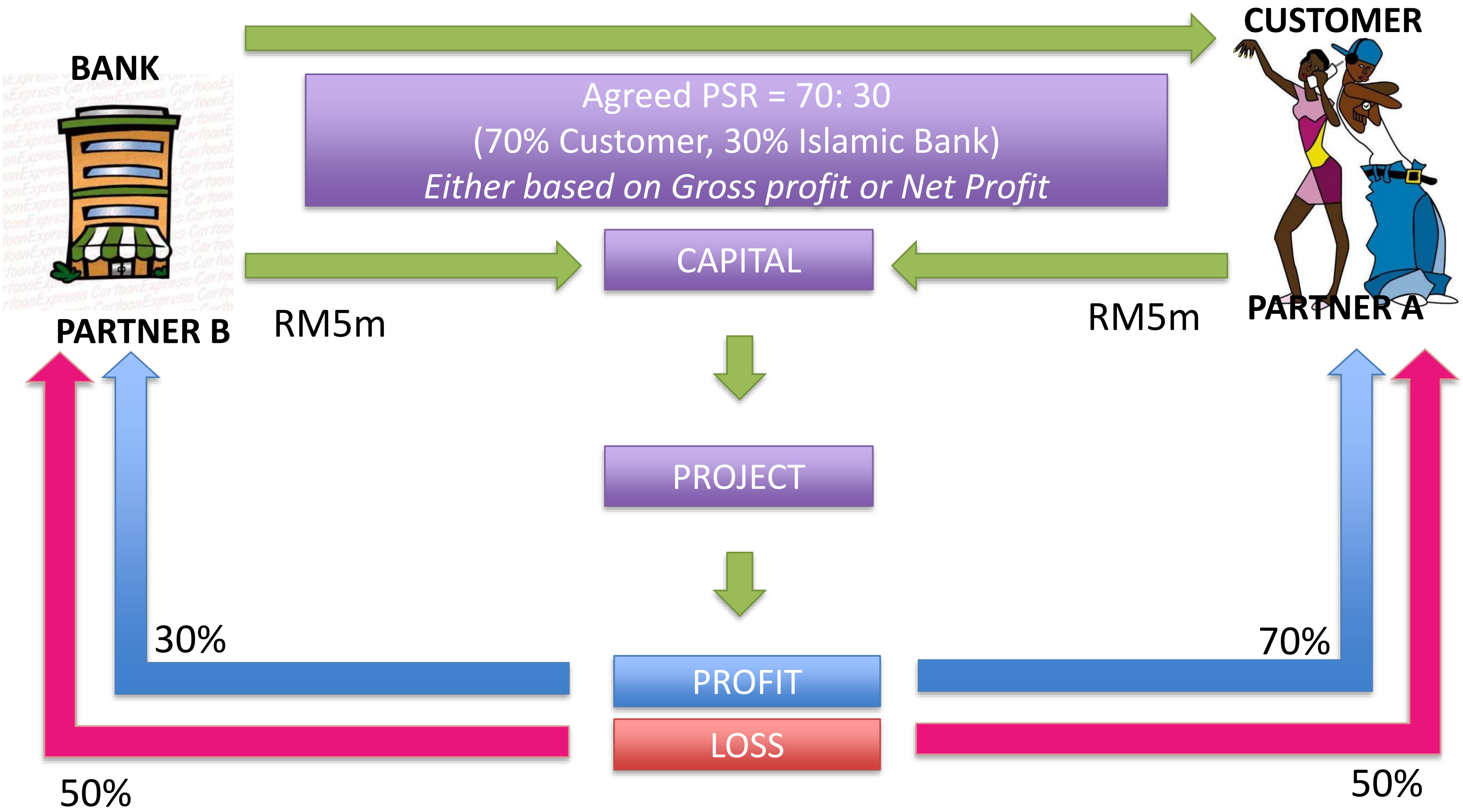
Project Financing under the Contract of Musyarakah (Partnership)

- Under this contract, each partner/ shareholders contributes the capital and share the profit of the project/ venture according to the agreed profit sharing ratio (PSR).
- The agreed PSR is not solely based on the shareholding percentage but subject to the agreement between partners.
- Should the project suffer losses, each partner will bear the burden according to their share holding percentage.

Necessary Conditions of Al-Musyarakah

- Each partner has a right to manage the project himself or as an agent on behalf of the other shareholders. Thus, each partner qualifies to act as an agent under the concept of Wakalah.
- Upon the execution of the contract, the PSR must be agreed by the partners and need not necessary identical to the shareholding percentage of each partner.
- Individual task/ skill performed by the partners for the benefit of the company/ project must be valued and considered into the PSR distribution among the shareholders.
- Each partner has the right to transfer his share to other parties and each shareholding under the contract is terminated due to the following reasons:
  - Partner decides to withdraw from the Musyarakah contract
  - Mental illness
  - Death of shareholder.
- Loss sharing ratio (LSR) is based on the percentage of shareholding of the partners, except for those caused by deceit or negligence.
- Management of the business can be handed over from one partner to another.
- Musyarakah project must be Shariah approved projects.

Modus Operandi of Project Financing under the Contract of Musyarakah



Calculation of Profit Earned and Loss Incurred by each Partner under Musyarakah Project Financing

Profit is Shared based on Agreed PSR

Partner	Capital (RM)	Equity Ratio	Agreed PSR	Project Profit Amount	Profit Earned by Each Partner
Mr. A	RM10,000	10%	50%	RM20,000	
Mr. B	RM20,000	20%	30%		
Mr. C	RM70,000	70%	20%		
	RM100,000	100%	100%		

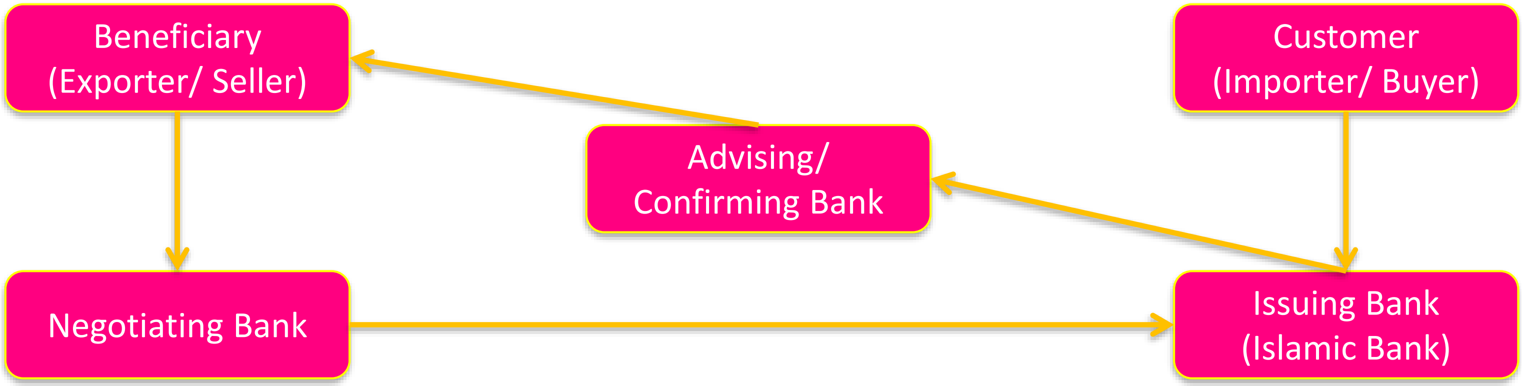
Calculation of Profit Earned and Loss Incurred by each Partner under Musyarakah Project Financing

Loss is Shared Based on equity Ratio of Each Partner

Partner	Capital (RM)	Equity Ratio	Agreed PSR	Project Profit Amount	Profit Earned by Each Partner
Mr. A	RM10,000	10%	50%	(RM14,000)	
Mr. B	RM20,000	20%	30%		
Mr. C	RM70,000	70%	20%		
	RM100,000	100%	100%		

Islamic Letter of Credit

An Islamic Letter of Credit is a written undertaking given by the Islamic bank, to the seller (the beneficiary) at the request and on the instructions of the buyer (the applicant), to pay at sight or at a determinable future date, a stated sum of money within a prescribed time limit and against stipulated documents which must comply with terms and conditions.



LC Wakalah

- The customer must pay in advance the full value of the item prior to the issuance of the ILC.
- The bank will receive a commission/ service fee upon the service rendered to the customer.

LC Murabahah

- The Islamic bank would import or purchase good and subsequently, resell them to customers at a markup price agreeable to both parties.
- The title to the goods will be transferred to the customer only on the arrival of the import documents.

LC Musharakah

- The Islamic bank requires the customer to deposit a certain percentage of money prior to the importation of goods.
- The Islamic bank will then issue an ILC and make the payment using both the customer’s and its own funds.
- The customer is responsible for selling the goods and returning the bank’s portion of capital together with a predetermined portion of the profit.

Comparison between ILC Advisory and ILC Confirmation

	ILC Advisory	ILC Confirmation
Feature	A trade service provided by a bank to check the authenticity of LC drawn in favor of its customer (exporter or seller) and to advise them whether to accept or reject the LC.	A trade service provided by a bank to promise payment to its customer (exporter or seller) in the event there is non-payment by the importer or buyer, or importer's bank or buyer's bank.
Shari'ah Principle	Ujr (Service fee) A payment for a service. It is also applied for salary, wage, pay, fee, charge, enrolment, honorarium, remuneration, rewards, etc.	Kafalah (Guarantee) A contract of guarantee where a person underwrites any claims or obligations when a supplier or contractor fails to fulfill his obligation.

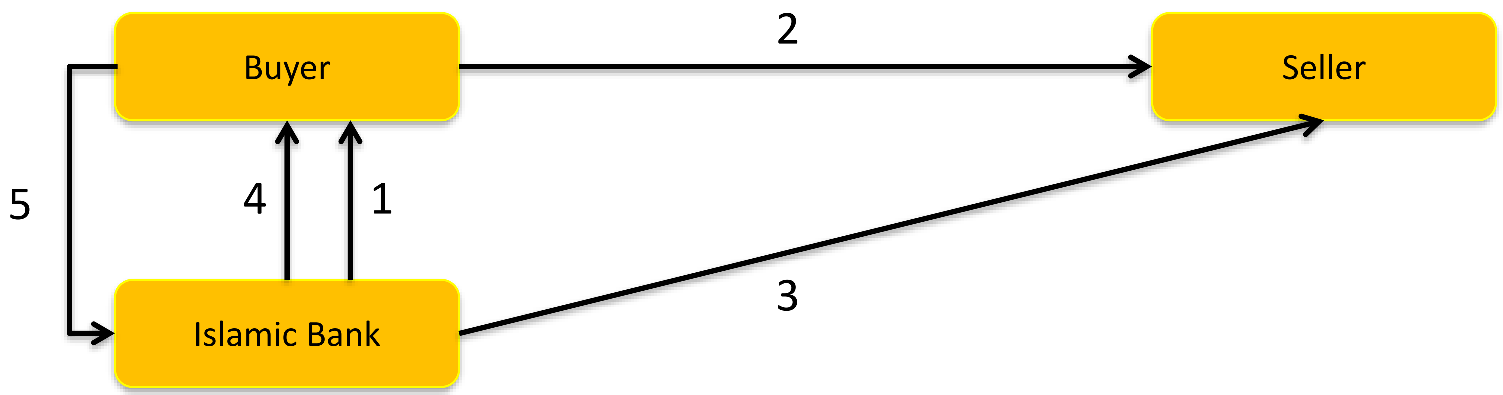
Calculation under LC Murabahah

Principal (P)	=	RM2,000,000 (buying price)
Profit Rate Charged (r)	=	5.0% p.a.
Tenor (t)	=	90 days (maturity period)

Selling Price (RM)	=	P	[1 +	(r x t)
				36500
	=			
Total Profit Earned by Islamic Bank (RM)	=	Selling Price – Buying Price		
	=			

Islamic Trust Receipt

A financing facility to finance domestic or international trade documents drawn against ILC or *wakalah* inward bills for collection. Islamic banks issue ITR facility to the customer based on the *murabahah* principle for financing the purchase of goods. It is a document of trust signed by the customer (importer); the strength on which the Islamic bank allows the customer (importer) to obtain release of the merchandise but makes a lump-sum payment at a later date.



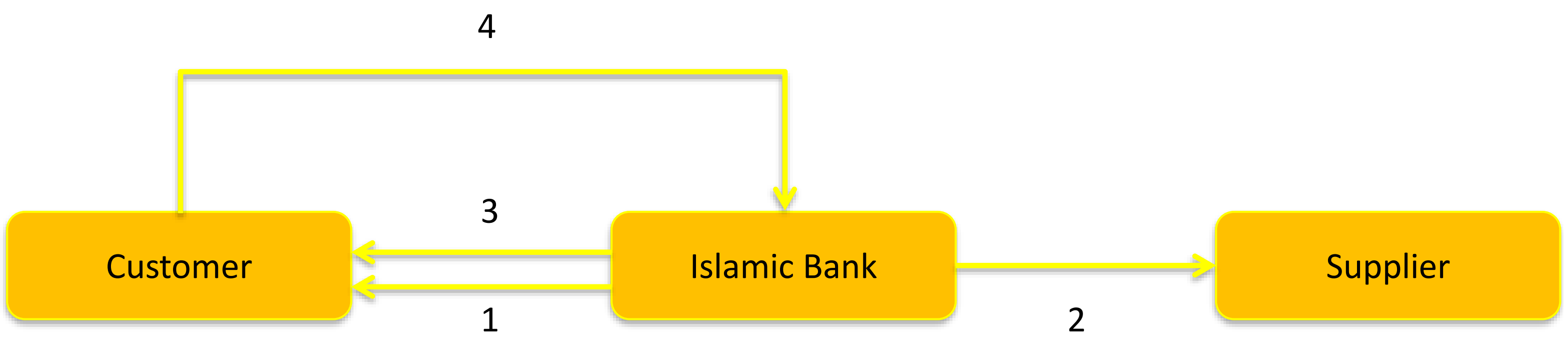
1. The Islamic bank appoints the customer (buyer/ importer) as the purchasing agent.
2. The customer purchases the required goods from the seller at the invoice price.
3. The Islamic bank pays the invoice price to the seller.
4. The Islamic bank then resells the goods to the customer at a new selling price i.e. invoice price plus the bank's profit margin.
5. The customer is allowed a deferred payment term of up to 365 days. Upon maturity of the murabahah financing, the customer pays the Islamic bank the cost plus profit margin in lump sum.

Islamic Accepted Bills (IAB)

- Islamic Accepted Bill also known as Interest-Free Accepted Bill (IAB), was introduced in 1991. The objectives of introducing IAB is to encourage and promote both domestic and foreign trade, by providing Malaysian traders with an attractive Islamic financing product. The IAB is formulated on the Islamic principles of Al-Murabahah (deferred lump-sum sale or cost-plus) and Bai ad-Dayn (debt-trading).
- Al-Murabahah refers to the selling of merchandise at a price based on cost-plus profit margin agreed to by both parties. Bai Al-Dayn refers to the sale of a debt arising from a trade transaction in the form of a deferred payment sale.
- There are two types of financing under the IAB facility, namely:-
  - Imports and local purchases
  - Exports and local sales.

Imports and Local Purchase

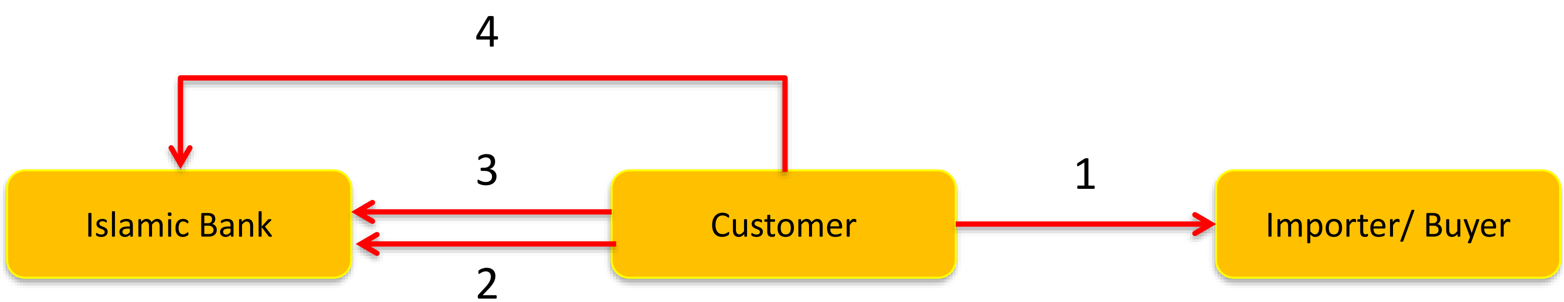
The financing would be financed under al-Murabahah working capital financing mechanism. If the bank decides to sell the IAB to a third party, then the concept of Bai al-dayn will apply whereby the bank will sell the IAB at the agreed price.



1. The customer draws an IAB on the Islamic bank. The commercial bank appoints the customer as the purchasing agent for the bank.
2. The customer then purchases the required goods from the seller on behalf of the bank, and the bank pays the supplier the purchase price.
3. The bank resells the asset(s) to the customer at an agreed selling price. The sale of goods by the bank to the customer on deferred payment term constitutes the creation of debt. The debt is securitized in the form of bills of exchange drawn by the Islamic bank and accepted by the customer for the full amount of the bank's selling price payable upon maturity of the IAB.
4. Upon maturity of al-Murabahah financing, the customer shall pay the selling price.

Exports and local sales

The bills created shall be traded under the concept of Bai al-Dayn.
An exporter who had been approved for IAB facility will prepare the export documentation as required under the sale contract or letter of credit. The export documents, shall be sent to the importer's bank. The exporter shall draw on the commercial bank a new bill of exchange as a substitution bill and this will be the IAB. The bank shall purchase the IAB at a mutually agreed price using the concept of Bai al-Dayn and the proceeds will be credited to the exporter's account. Domestic sales will be treated in a similar manner.



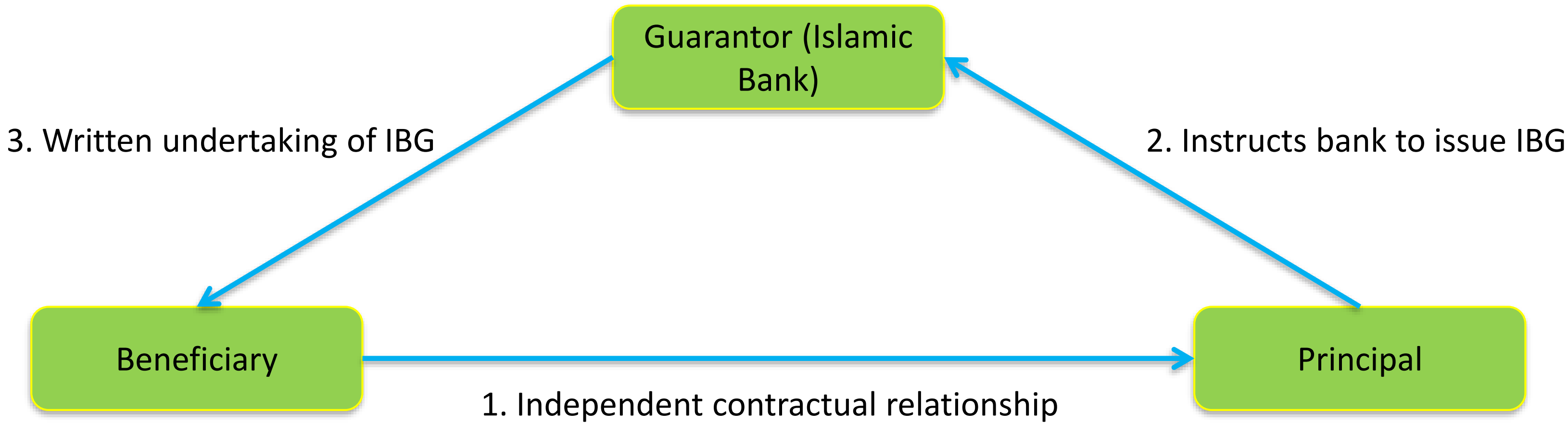
1. The customer sells the goods on credit and prepares the sale documents as required under the sales contract or letter of credit.
2. The customer draws upon the Islamic bank a new bill of exchange as a substitution bill that represents the IAB.
3. The Islamic bank will purchase the IAB at a mutually agreed price using the concept of bai al-dayn and credit the proceeds to the customer’s account.
4. Upon maturity, the customer pays the Islamic bank the face (maturity) value of the IAB.

Islamic Bank Guarantee

- A guarantee is a promise by a third party to carry out the obligations owed by one person to another in the event of default. Under the Shari'ah, and in accordance with the principle of kafalah, an Islamic bank may issue, at the request of the customer, an Islamic bank guarantee (IBG) to a beneficiary named by the customer.
- It is given by the Islamic bank (guarantor) in writing at the request of the customer (principal) to pay a stated sum of money to the beneficiary upon presentation of written demand. Under the IBG, the financier provides an undertaking in favor of the customer against the third party. The customer pays the fees and the financier pays pays the third party if the customer fails to honor his obligation and will claim from the customer to reimburse payment made (at par).
- One of its uses is when an Islamic bank wants a carrier to release a shipment which it has financed but the original bill of lading is not yet available for surrender to the carrier.
- IBG may fall into the following categories:
  - Tender guarantee
  - Performance guarantee
  - Guarantee of subcontracts
  - Guarantee in lieu of security deposits or Special Guarantee
  - Guarantee for exemption of custom duties
  - Guarantee for maintaining ledger accounts, for example with governmental agencies such as port authorities or railway authorities
  - Customs bonds.

Islamic Bank Guarantee

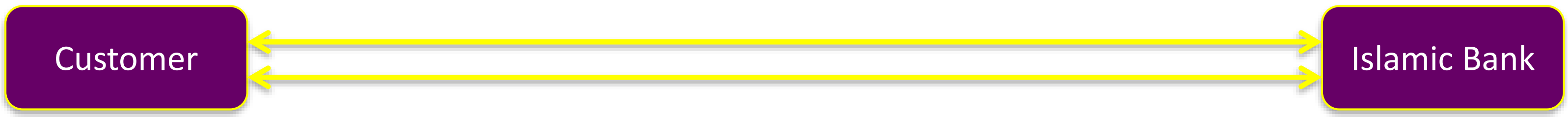
An IBG is an indemnity letter in which the Islamic bank commits itself to pay a certain sum if a third party fails to perform or if any other form of default occurs.



1. The customers must first have an approved IBG line. Request for financing must include submission of relevant documentary evidence of the underlying transactions and compliance to the terms of the facility.
2. The customer requests the issue of IBC (type depends on purpose). The IBG may be provided in respect of the performance of a task or the settlement of a commitment.
3. The Islamic bank issues IBG if the Shari'ah principles and other requirements are met.
4. The Islamic bank must honor and effect immediate payment in case a claim is made by the beneficiary on first demand, provided the claim meets all the conditions of the guarantee.

Islamic Shipping Guarantee

A letter of performance and indemnity issued by the Islamic bank on behalf of the buyer or importer. It is a contract where the Islamic bank agrees to discharge the liability of the third party in case of default by the third party.



1. The customer informs the bank of the ISG requirements and requests the bank to provide the facility.
2. The bank may require the customer to place a deposit to the full amount of the price of the goods to be purchased/ imported which the bank accepts under the principle of al-wadiah yad dhamanah.
3. The bank establishes the ISG and pays the proceeds to the negotiating bank utilizing the customer's deposit; and subsequently releases the documents to the customers.
4. The bank charges the customer fees and commission for its services under the principle of al-ujr (fee).

The Islamic money market is integral to the functioning of the Islamic banking system, firstly, in providing the Islamic financial institutions with the facility for funding and adjusting portfolios over the short-term, and secondly, serving as a channel for the transmission of monetary policy.
Financial instruments and interbank investment would allow surplus banks to channel funds to deficit banks, thereby maintaining the funding and liquidity mechanism necessary to promote stability in the system.

ISLAMIC MONEY MARKET

Chapter 9 in Textbook

Islamic Money Market

- The Islamic Inter bank Money Market (IIMM) was introduced on January 3, 1994 as a short-term intermediary to provide a ready source of short-term investment outlets based on Syariah principle.
- Through the IIMM, the Islamic banks and banks participating in the Islamic Banking Scheme (IBS) would be able to match the funding requirements effectively and efficiently.
- Bank Negara Malaysia (BNM) issued the Guidelines on the IIMM on December 18, 1993 to facilitate proper implementation of the IIMM.

Instruments in the Islamic Interbank Money Market

Treasury Bills (TBs)

Short term government securities traded on a yield basis; represents the short term debt obligations of the national governments.

Repurchase Agreements (REPOs)

Represents bilateral transactions encompassing the purchase and resale of securities by agreement; arranged by selling securities to an investor with an agreement to purchase them back from the investor at a fixed price on a fixed date.

Negotiable Certificates of Deposits (NCDs)

A bearer document which implies that whoever holds the instrument at maturity receives the principal and interest.

Commercial Papers (CPs)

Short-term, unsecured (promissory notes) debt instruments issued by corporations that mature in no longer than 270 days.

Banker's Acceptances (BAs)

Short-term, zero coupon debt papers issued by companies. Are guaranteed by the bank and therefore known as BAs.

Mudharabah Interbank Investment (MII)/ Mudharabah Interbank Deposit (MID)

- MII refers to a mechanism whereby a deficit Islamic banking institution (investee bank) can obtain investment from a surplus Islamic banking institution (investor bank) based on Mudharabah (profit sharing).
- The period of investment is from overnight to 12 months, while the rate of return is based on the rate of gross profit before distribution for investment of 1-year of the investee bank.
- The profit sharing ratio is negotiable among both parties.
- The investor bank at the time of negotiation would not know what the return would be, as the actual return will be crystallised towards the end of the investment period.
- The principal invested shall be repaid at the end of the period, together with a share of the profit arising from the used of the fund by the investee bank.

Wadiah Acceptance

- Wadiah Acceptance, is a transaction between BNM and the Islamic banking institutions.
- It refers to a mechanism whereby the Islamic banking institutions placed their surplus fund with BNM based on the concept of Al-Wadiah.
- Under this concept, the acceptor of funds is viewed as the custodian for the funds and there is no obligation on the part of the custodian to pay any return on the account.
- However, if there is any dividend paid by the custodian, is perceived as 'hibah' (gift).
- The Wadiah Acceptance facilitates BNM's liquidity management operation as it gives flexibility for BNM to declare dividend without having to invest the funds received.
- Under the liquidity management operation, BNM uses the Wadiah Acceptance to absorb excess liquidity from the IIMM by accepting overnight money or fixed tenure wadiah.

Government Investment Issue (GII)

- When the first Islamic bank in Malaysia began operations in 1983, the bank cannot among other things, purchase or trade in Malaysian Government Securities (MGS), Malaysian Treasury Bills (MTB) or other interest-bearing instruments.
- However, there was a serious need for the Islamic bank to hold such liquid papers to meet the statutory liquidity requirements as well as to park its idle fund.
- To satisfy both requirements, the Malaysian Parliament passed the Government Investment Act in 1983 to enable the Government of Malaysia to issue non-interest bearing certificate known as Government Investment Certificates (GIC) {now replaced with Government Investment Issues (GII)}.
- The GII was introduced in July 1983 under the concept of Qard al- Hasan.
- The concept of Qard al- Hasan does not satisfy the GII as tradable instruments in the secondary market.
- To address this shortfall, BNM opens a window to facilitate the players to sell and purchase the papers with the central bank.
- The price sold or purchase by the players is determined by BNM, which maintains a system to record any movement in the GII.

Government Investment Issue (GII)

- On 15 June 2001, the Government of Malaysia with the advice by Bank Negara Malaysia, issued a 3 -year GII of RM2.0 billion under a new concept of of Bai Al-Inah. The move therefore had added depth to the IIMM as the GII is now tradable in the secondary market via the concept of Bay ad- Dayn (debt trading).
- On 16 March 2005, the Government of Malaysia with the advice by Bank Negara Malaysia, issued first Profit-Based GII 5 -year tenure of RM2 billion. It is coupon bearing paper which the Government pay half yearly profit to the investors.
- On 17 June 2005 the Government has ammended the Government Funding Act 1983 (previously known as the Government Investment Act 1983) to increase the issuance size limit of GII from RM 15 billion to RM 30 billion. As at end of 2005, the outstanding amount of the GII issued is RM10.1 billion.

Bank Negara Monetary Notes – i (BNM-i)

- BNMN-i are Islamic securities issued by Bank Negara Malaysia replacing the existing Bank Negara Negotiable Notes (BNNN) for purposes of managing liquidity in the Islamic financial market.
- The instruments will be issued using Islamic principles which are deemed acceptable to Shariah requirement.
- The maturity of these issuances has also been lengthened from one year to three years.
- New issuances of BNMN-i may be issued either on a discounted or a coupon-bearing basis depending on investors' demand.
- Discount-based BNMN-i will be traded using the same market convention as the existing BNNN and Malaysian Islamic Treasury Bills (MITB) while the profit-based BNMN-i will adopt the market convention of Government Investment Issues (GII).

Sell and Buy Back Agreement (SBBA)

- Sell and Buy Back Agreement (SBBA) is an Islamic money market transaction entered by two parties in which an SBBA seller (seller) sells assets to an SBBA buyer (Buyer) at an agreed price, and subsequently, both parties entered into a separate agreement in which the buyer promises to sell back the said asset to the seller at an agreed price.

Cagamas Mudharabah Bonds

- Cagamas Mudharabah Bond was introduced on 1 March 1994 by Cagamas Berhad to finance the purchase of Islamic housing debts from financial institutions that provides Islamic house financing to the public.
- The SMC Mudharabah Bond is structured using the concept of Mudharabah where the bondholders and Cagamas will share the profits according to the agreed profit-sharing ratios.

Islamic Negotiable Instuments

Islamic Negotiable Instruments of Deposit (INID)

- Issued under the contract of Mudharabah.
- Refers to a sum of money deposited with the Islamic banks by the customer (capital provider).
- The nominal value (or principal) of INID and declared dividend (if any) will be repayable to the bearer (capital provider) on a specified future date as agreed earlier.

Negotiable Islamic Debt Certificate (NIDC)

- Issued under the contract of Bai Bithaman Ajil (BBA).
- The transaction involves the sale of banking institution's assets to the customer at an agreed price on cash basis. Subsequently the assets is purchased back from the customer at principal value plus profit and to be settled at an agreed future date.
- This certificate is tradable in the secondary market via the contract of Bay Ad-Dayn (debt trading).

Islamic Private Debt Securities

- Islamic Private Debt Securities (IPDS) has been introduced in Malaysia since 1990.
- At the moment, the IPDS which are outstanding in the market were issued based on the Shariah compliant concept of Bai Bithaman Ajil, Murabahah and al Mudharabah.

Sukuk Bank Negara Ijarah (SBNMI)

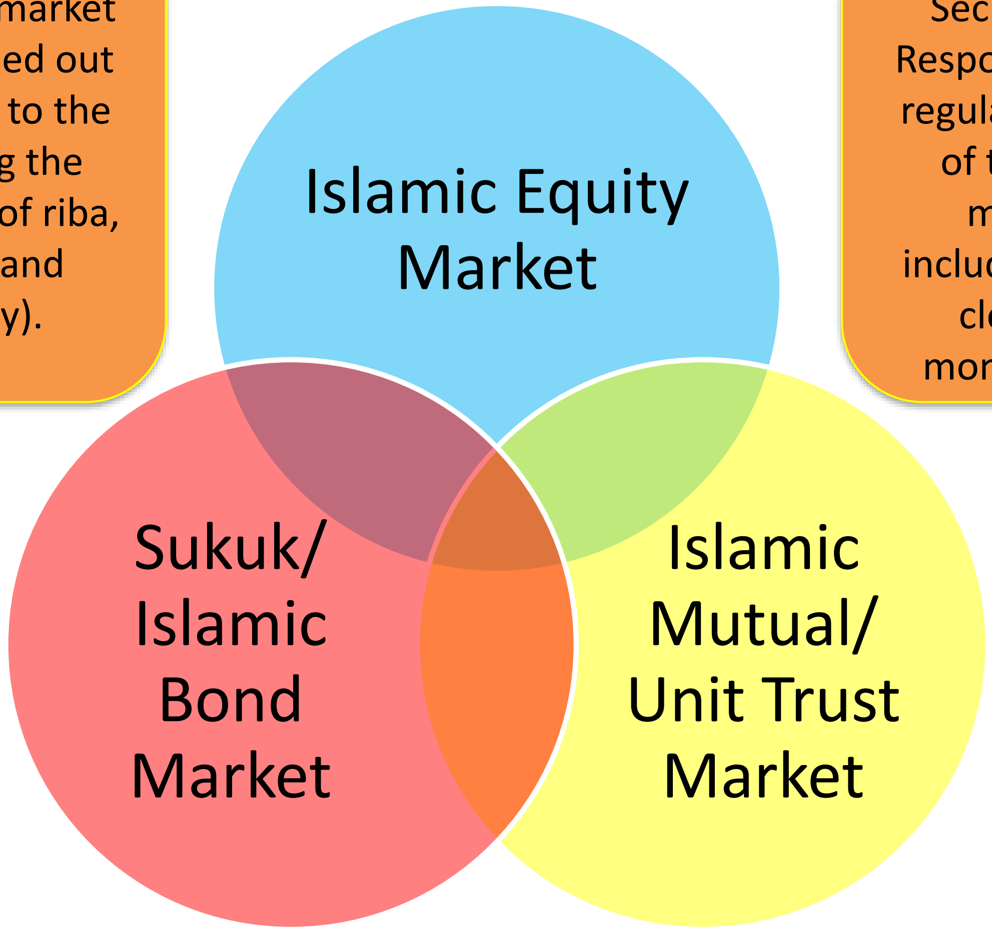
- This sukuk based on the Al-Ijarah or 'sale and lease back' concept, a structure that is widely used in the Middle East.
- A special purpose vehicle, BNM Sukuk Berhad has been established to issue the sukuk Ijarah.
- The proceeds from the issuance will be used to purchase Bank Negara Malaysia's assets.
- The assets will then be leased to Bank Negara Malaysia for rental payment consideration, which is distributed to investors as a return on a semi-annual basis.
- Upon maturity of the sukuk Ijarah, which will coincide with end of the lease tenure, BNM Sukuk Berhad will then sell the assets back to Bank Negara Malaysia at a predetermined price.
- The inaugural issuance takes place on 16 February 2006 with an issue size of RM400 million.
- Bank Negara Malaysia issues this instrument on a regular basis with subsequent issues ranging from RM100 million to RM200 million.

Malaysia is among the few countries which not only runs a dual banking system, but also a dual capital market system.
Dual capital markets exist when both Islamic Capital Market and the Conventional Capital Market operates parallel.

ISLAMIC CAPITAL MARKET

Islamic Capital Market

Refers to the capital market where activities carried out are not contradicted to the Shariah, eliminating the prohibited elements of riba, maisir (gambling) and gharar (ambiguity).



Regulated under the Securities Commission. Responsibilities include the regulation and supervision of the activities of the market institutions including stock exchanges, clearing houses and monitoring of licensees.

Types of ICM Instruments

- Ordinary Shares
- Warrants
- Call Warrants
- Non-cumulative preference shares
- Redeemable preference shares
- Crude palm oil futures contracts
- Crude palm kernel oil futures contracts
- Khazanah zero-coupon bonds
- Index futures contracts (if the underlying is Shariah compliant).
- Islamic asset securitization/ Islamic debt securitization.

ORDINARY SHARES

Ordinary Shares

- The total no of Shariah compliant shares listed on Bursa Malaysia were 853 companies (Nov, 2007).
- SAC uses both qualitative and quantitative approaches to classify the halalness of the Shariah compliant ordinary shares.
- Securities (ordinary shares/ equities) of a company listed on Bursa Malaysia which is classified as Shariah-compliant is permissible for investment.
- Primary business and investment activities that generate income for the company must conform with Shariah principles.
- In Malaysia, the body that gives Shariah endorsement is the Shariah Advisory Council (SAC) of the Securities Commission (SC).

SAC's Approach in Screening Listed Securities

- Based on Shariah criteria sourced from *Quran, Hadith, Qiyas, Ijma'* and general Shariah principles.

1. Determine income contribution from Shariah prohibited activities of listed companies using Shariah methodology and criteria set out by the SAC.

2. Classify the securities as Shariah-compliant if income contribution from the prohibited activities is within Shariah tolerable level.

Specific Processes Performed

- SC as secretariat to the SAC:
  1. Extract relevant information from audited financial statement of public listed companies
  2. Undertaking Shariah compliance review process to identify contribution from prohibited activities.
  3. Compare with Shariah financial benchmark set by SAC.

- List of Shariah-compliant Securities
  – SC compiles the result and issues the list of Shariah compliant securities
  – Announcement in May and November every year.

SAC is the final decision maker. Final decision based on quantitative method (financial benchmark) and/or qualitative consideration.

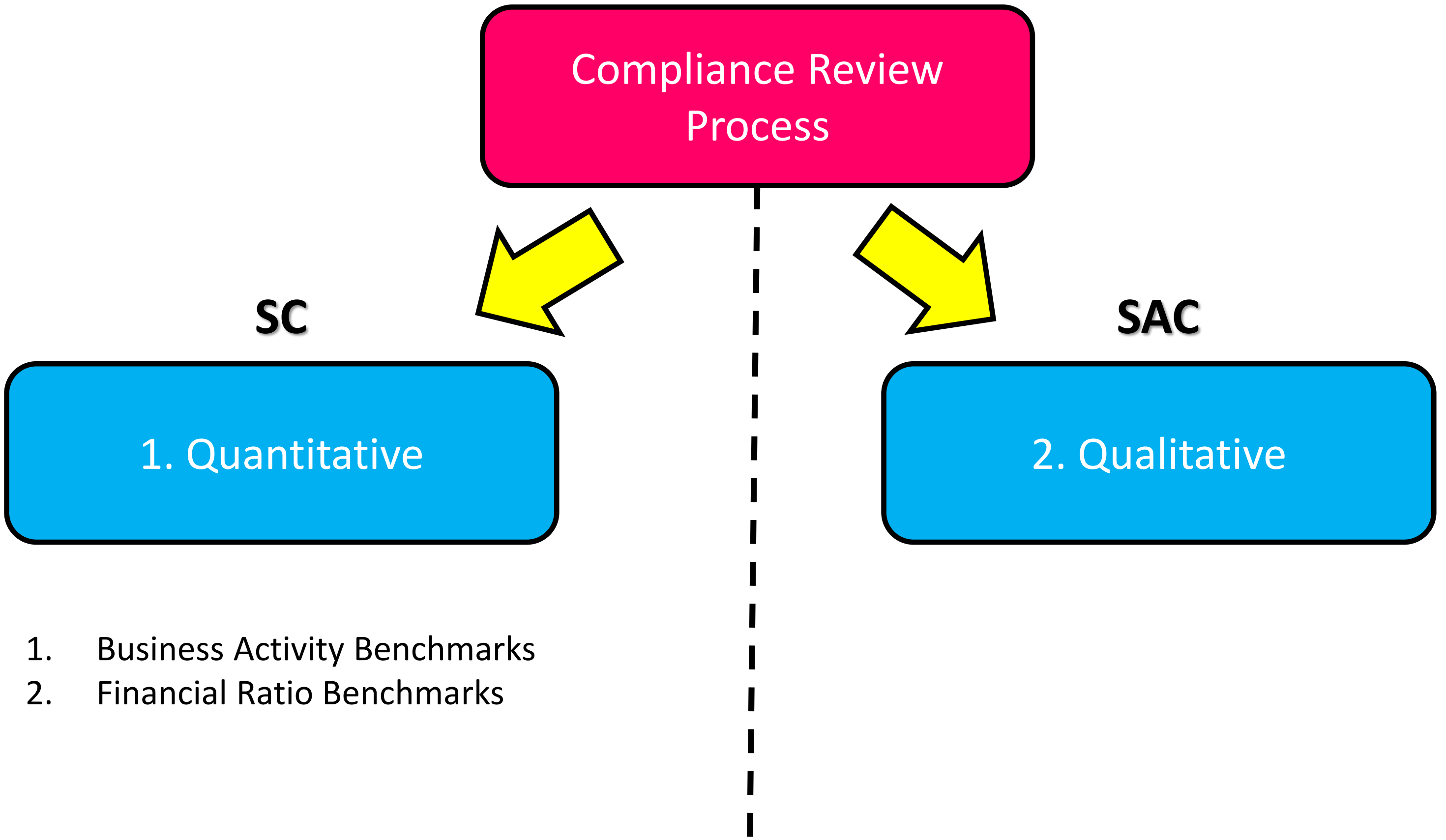
Based on Shariah Compliance Review Criteria

- Classified as Shariah-compliant if company's involvement in the following activities is minimal:

- Financial services based on riba (interest)
- Gambling
- Manufacturing or sale of non-halal products
- Conventional insurance
- Entertainment
- Manufacture or sale of tobacco-based products or related products

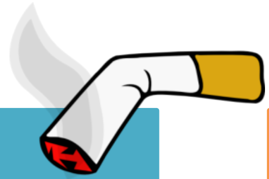
- Stockbroking or share trading in non-compliant securities
- Other activities deemed non-permissible
- Interest income from conventional fixed deposits/ interest bearing instruments.
- Dividend income from investment in non-approved securities.

Shariah Compliance Review Process: 2 Phases

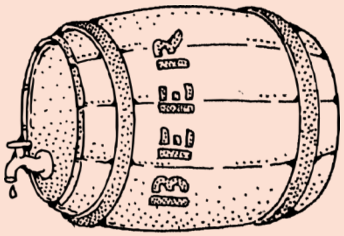


1. Business Activity Benchmarks
2. Financial Ratio Benchmarks

Business Activity Benchmarks



5%	20%
• Conventional banking; • Conventional insurance; • Gambling; • Liquor and liquor-related activities; • Pork and pork-related activities; • Non-halal food and beverages; • Shariah non-compliant entertainment; • Interest income from conventional accounts and instruments (including dividends from investment in Shariah non-compliant instruments and interest income awarded arising from a judgment by a court or arbitrator); • Tobacco and tobacco-related activities; and • Other activities deemed non-compliant according to Shariah.	• Hotel and resort operations; • Share trading; • Stockbroking business; • Rental received from Shariah non-compliant activities; and • Other activities deemed non-compliant according to Shariah.
For the above-mentioned businesses/activities, the contribution of Shariah non-compliant businesses/activities to the overall revenue and profit before taxation of the company must be less than five per cent.	For the above-mentioned businesses/activities, the contribution of Shariah non-compliant businesses/activities to the overall revenue and profit before taxation of the company must be less than 20 per cent.



Financial Ratio Benchmarks

Cash over total assets

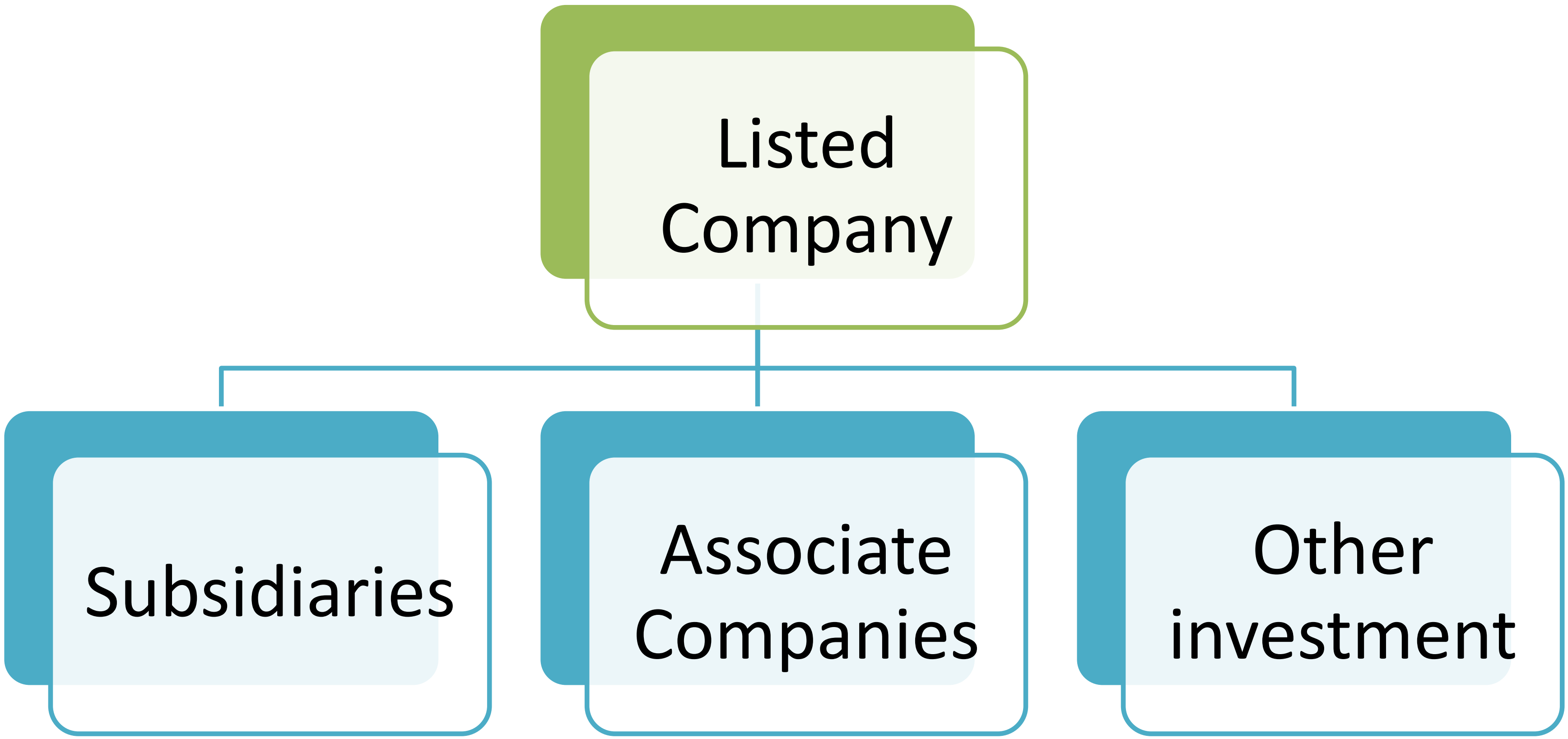
- Cash only includes cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments is excluded from the calculation.

Debt over total assets

- Debt only includes interest-bearing debt whereas Islamic financing or sukuk is excluded from the calculation.

Each ratio, which is intended to measure *riba and riba-based elements within* a company's statements of financial position, must be less than 33 per cent.

Compare contribution from non-Shariah Activities to Group's TO and PBT



Phase 1: Quantitative Analysis

Information gathering

1. Group's TO
2. Group's PBT

1. TO and PBT of non-Shariah compliant activities
2. Share of Profit (SOP) for non-Shariah activities
3. Interest income received
4. Dividend from non-Shariah investment

1. TO and PBT of non-Shariah compliant activities vs Group's TO and PBT
2. SOP for non-Shariah activities vs Group's PBT
3. Interest income vs Group's TO
4. Dividend from non-Shariah investment vs Group's PBT

Non-Shariah compliant if the percentage is above benchmark.

Quantitative Approach

- ‘Mixed companies’ as defined by SAC, is a company whose business comprises both permissible and non-permissible elements whereby the permissible elements represents the core activities of the company is permitted by Shariah.
- As for the non-permissible elements, it represents the non-core activities that may contain prohibited elements, but in a small scale.
- Under the quantitative approach, maximum benchmarks have been used to determine the Shariah compliant companies.

Shariah-Compliant Companies

- The list of Shariah-compliant companies/ shares is issued by the SAC of SC twice a year, in May and November.
- Local newspapers like The Star uses the symbol '□' to indicate Shariah-compliant shares whereas other local newpapers may use other symbols to indicate the same.

Case Study 1: Bina Bina Berhad

Bina Bina Berhad

Main activity: Construction

Relevant information:
Group's information:
TO : RM 10 mil
PBT : RM 5 mil
Info on non-Shariah compliant activity:
TO (tobacco): RM900,000
PBT (tobacco): RM400,000

Subsidiary

Rock Sdn. Bhd.

Cement Sdn. Bhd.

Smoke Sdn. Bhd.

Associate

Wood Sdn. Bhd.

Nails Sdn. Bhd.

Case study 1: Quantitative Analysis Results

Non-Shariah compliant	Calculation	Quantitative result
Percentage of tobacco activity to the Group's TO	RM900,000/ RM10 million	9%
Percentage of tobacco activity to the Group's PBT	RM400,000/ RM 5 million	8%

Benchmark for tobacco activity: 10% (to the Group's TO and PBT)

Quantitative result:
Non Shariah compliant (contribution of tobacco activity is above benchmark).

Case Study 2: Tanam Bina Berhad

Tanam Bina Berhad

Relevant information:
Group's information:
TO : RM 10 mil
PBT : RM 5 mil
Info on non-Shariah compliant activity:
TO (liquor): RM400,000
PBT (liquor): RM120,000
TO (gambling): RM200,000
PBT (gambling): RM100,000

Subsidiary

Arak Sdn. Bhd.

Serai Sdn. Bhd.

Judi Sdn. Bhd.

Associate

Star Sdn. Bhd.

Moon Sdn. Bhd.

Case study 2: Quantitative Analysis Results

Non-Shariah compliant	Calculation	Quantitative result
Percentage of liquor activity to the Group's TO	RM400,000/ RM10 million	4%
Percentage of liquor activity to the Group's PBT	RM120,000/ RM 5 million	2.4%
Percentage of gambling activity to the Group's TO	RM200,000/ RM10 million	2%
Percentage of gambling activity to the Group's PBT	RM100,000/ RM 5 million	2%

Benchmark for liquor and gambling activity: 5% (to the Group's TO and PBT)
Contribution of non-Shariah activity to the Group's:
TO : (4% + 2%) = 6%
PBT : (2.4% + 2%) = 4.4%

Gambling & liquor must be less than 5%.

Quantitative result:
Non Shariah compliant (contribution of non-Shariah activity is above benchmark).

Case Study 3: Easy Money Berhad

Interest income

Easy Money Berhad

Relevant information:
Group's information:
TO : RM 2 mil
PBT : RM 500,000
Info on non-Shariah compliant activity:
Interest income: RM220,000
Share of Profit (gambling): RM24,000

Subsidiary

Timba Sdn. Bhd.

Global Sdn. Bhd.

Center Sdn. Bhd.

Associate

Rado Sdn. Bhd.

Gamble Sdn. Bhd.

Gambling business

Case study 3: Quantitative Analysis Results

Non-Shariah compliant	Calculation	Quantitative result
Percentage of interest income to the Group's TO	RM220,000/ RM2 million	11%
Percentage of gambling activity to the Group's PBT (SOP)	RM24,000/ RM 500,000	4.8%

Benchmark for interest income : 10% (to the Group's TO and PBT)
Benchmark for gambling activity : 5% (to the group's TO & PBT)

Quantitative result:
Non Shariah compliant (contribution of interest income is above benchmark).

Case Study 4: Megamart Berhad

Interest income

Sale of liquor

Megamart Berhad

Principal activity:
Service of Hypermarket & other related activities

Relevant information:
Group's information:
TO : RM 10 mil
PBT : RM 5 mil
Interest income: RM 0.8 mil
Info on non-Shariah compliant activity:
TO liquor : RM 0.35 mil
PBT liquor : RM 0.12 mil
TO gambling : RM 0.19 mil
PBT gambling : RM 0.1 mil

Subsidiary

Beer Sdn. Bhd.

Pasar Ria Sdn. Bhd.

Aku Kaya Sdn. Bhd.

Gambling business

Associate

LP Resources Sdn. Bhd.

Hypermart Sdn. Bhd.

Case study 4: Quantitative Analysis Results

Non-Shariah compliant	Calculation	Quantitative result
Interest income to the Group's TO	RM0.8 mil/ RM10 mil	8%
Percentage of liquor activity to the Group's TO	RM0.35 mil/ RM10 mil	3.5%
Percentage of liquor activity to the Group's PBT	RM0.12 mil/ RM5 mil	2.4%
Percentage of gambling activity to the Group's TO	RM0.19 mil/ RM10 mil	1.9%
Percentage of gambling activity to the Group's PBT	RM0.1 mil/ RM5 mil	2%

Benchmark for interest income : 10% (to the Group's TO and PBT)
Benchmark for liquor and gambling activity : 5% (to the group's TO & PBT)
Contribution from interest income and non-compliant activities:
Interest income: 8%
Group TO: 5.4% (TO liquor + TO gambling)
Group PBt: 4.4% (PBT liquor + PBT gambling)
Quantitative result:
Non Shariah compliant (contribution of liquor and gambling is above benchmark).

Shariah Guidance on Investment in Non-Compliant Securities

Case 1: Investment in compliant securities subsequently reclassified as non-compliant

Price of non-compliant securities

On the announcement day

Price > original investment cost

❑Liquidate immediately.

❑Any capital gain from disposal can be kept by investors.

Price < original investment cost

❑Hold the price of securities until equal to original investment cost.

❑Dividends received can be used to expedite the disposal.

After the announcement day

Price > original investment cost

❑Liquidate immediately.

❑Profit (difference between original investment cost & closing price of announcement date) – can be kept.

❑Profit (difference between disposal price & closing price of announcement date) – channeled to charitable bodies.

Price < original investment cost

❑Hold the price of securities until equal to original investment cost.

❑Dividends received can be used to expedite the disposal.

Example

Investment Cost
(2 January)
5.50

Announcement Date
(25 April)
6.00

Disposal Price
(3 June)
7.50

Profit kept by investor (RM0.50)

Profit to be channeled to charitable bodies

Investment cost = RM5.50 per share.
Closing price on the announcement date = RM6.00 per share.
Disposal Price = RM7.50 per share

If investor disposes security on 3^{rd} June, the capital gain is RM2 per share. He is only eligible to keep the profit of RM0.50 per share while RM1.50 should be channeled to charitable bodies).

Shariah Guidance on Investment in Non-Compliant Securities

Case 2: Investment in (existing) non-compliant securities

- Investors to dispose their non-compliant securities within a month of knowing the status of the securities.
- Any gain made in the form of capital gain or dividend received during or after the disposal of the securities to be channeled to charitable bodies.
- **Investors are entitled to keep their original investment cost.**

Phase 2: Qualitative Analysis

- SAC will consider other factor or criteria before making a final decision.
- Company that is considered as Shariah compliant based on Quantitative analysis may change its status to non-Shariah company because of this qualitative analysis and also image of the company.

Qualitative

Public perception or image of the company must be good. In addition, other elements such as '*uruf* (custom) and *maslahah* ('benefit' in general) to the Muslim *ummah* (nation) and the country should also be considered.

Qualitative Approach

- The primary reason why some of the ordinary shares is being classified as Shariah non-compliant is due to the involvement of the company into the following core activites:

❖Financial services based on Riba (interest);
❖Gambling and gaming;
❖Manufacture or sale of non-halal or related products;
❖Conventional insurance
❖Entertainment activities that is non permissible according to the Shariah;

❖Manufacture or sale of tobacco-based products or related products;
❖Stock broking or share trading in Shariah non-compliant securities; and
❖Other activities deemed non-permissible according to Shariah

Qualitative Approach

Company deemed not Shariah-compliant due to **provocative advertisement.**

Islamic Banking Concepts

- Al-Wadiah Yad Dhamanah (savings with guarantee)
- Al-Mudharabah (profit-sharing)
- Al-Musyarakah (joint venture)
- Al-Murabahah (cost plus)
- Bai’ Bithaman Ajil (deferred payment sale)
- Bai’ al-Dayn (debt trading)
- Al-Ijarah Thumma al-Bai’ (leasing and subsequently purchase)
- Al-Ijarah (leasing)
- Al-Qardhul Hassan (benevolent loan)
- Bai’ as-Salam (future delivery)
- Bai’ Al-Istijrar (supply contract)
- Al-Kafalah (guarantee)
- Ar-Rahnu (collateralised borrowing)
- Al-Wakalah (nominating another person to act)
- Al-Hiwalah (remittance)
- As-Sarf (foreign exchange)
- Al-Ujr (fee)
- Al-Hibah (gift)

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End of Chapter 4

ANY QUESTIONS