Chapter 14 – Islamic Banking

Content Outline

Learning Objectives

What you should achieve after completing this chapter:

- Be able to distinguish between various Islamic banking products and principles;
- Be able to distinguish between Islamic principles as applied to deposit and loan products;
- Appreciate the circumstances under which the various types of products are needed by borrowers; and
- Be able to distinguish the differences between conventional and Islamic banking system.

1. Islamic Banking Principles

Under Islamic banking, it should be emphasised that although most of the products and concepts appear to be similar, their nature is different. Several products can be given under the same concept while the same products can be provided under different concepts. For example, current and savings account can be extended under the Al-Wadiah concept while housing loan, hire-purchase or share financing can be given under the Bai' Bithaman Ajil concept.

1.1 (a) Savings deposit (Wadiah Yad Dhamanah)

This is a trust agreement, where the banker seeks customers who wish to place their funds under safe custody. The customers may withdraw at any time, with a possibility of earning some profits. As wadiah is a trust, the bank becomes the guarantor or custodian and therefore guarantees the amount's repayment. The bank provides the customer with a passbook. The bank requests the customer's permission to make use of the funds as long as the funds are with the bank. All profits generated from the use of the funds belong to the bank. However, the bank may, at its absolute discretion, reward the customer by returning a portion of the profits generated from the use of his fund.

(b) Savings deposit (Mudharabah)

The depositor gets a passbook and becomes the capital provider while the bank is the entrepreneur. Profits are shared. Losses, if any, are borne by the depositor. There is no restriction on the number of withdrawals that a depositor can make.

1.2 Current deposit (Wadiah Yad Dhamanah)

Similar to savings deposit, the bank provides its customers with cheque books as in conventional banking. The bank requests the customers' permission to make use of the funds as long as these funds remain with the bank. All profits generated are shared with the depositors.

1.3 Fixed Deposit

1.3.1 General investment account (Mudharabah)

The bank accepts investment amount from customers who are looking for investment opportunities for their funds. Under this principle, the bank provides the entrepreneurship and the customer acts as the capital provider. All profits are shared in accordance with pre-agreed profit sharing ratio, which is usually on a 70:30 ratio. Losses, if any, are borne entirely by the capital provider, i.e. the investor.

1.3.2 Special investment account (Mudharabah)

This is similar to the general investment account except that it is "special" because there is a minimum tenor of investment required as well as minimum amount of normally RM500,000. In view of the amount, the investors are usually government institutions or large corporate customers, for specific investments, such as repurchase agreements in the Islamic money market or project financing.

1.4 Deferred Payment Sale (Bai' Bithaman Ajil)

This principle governs the sale of goods under a deferred payment scheme. The bank will purchase the asset and sell it to the borrower at a price including an agreed profit margin and allow the sales price to be repaid over a deferred period. Although house and commercial property financing are common examples, cars, machinery or any other assets can be financed under this concept.

1.5 Hire-purchase (Al-Ijarah Thumma Al Bai [AITAB])

This principle is akin to conventional hire purchase. The bank will pay up to 90% of the purchase price and allow the hirer to hire the item at the pre-agreed rental for the pre-agreed period. The rental is ascertained and agreed at the outset. The period and other terms are agreed upon by both parties. Hirer enters into a hire purchase agreement with the bank. Ownership of the asset remains with the FI until the hirer settles all payments within the specified period.

1.6 Cost-Plus (Al-Murabahah)

The concept of Al-Murabahah, cost plus financing, refers to the sale of goods at a price which includes a profit margin as agreed to by both parties. In Al-Murabahah contracts, the price (costs) and the profit margin of the seller must be stated at the time of the agreement of sale.

This is suitable for working capital financing.

1.7 Share financing / unit trust financing

(a) Under Bai' Bithaman Ajil

The bank will provide finance to the customer who wishes to purchase shares. The bank will purchase shares and then resell them to the customer at an agreed price, taking into account:

(a) the cost of shares; and

(b) the profit margin of the bank.

The profit margin will take into account the duration and frequency of repayment. The bank may allow the customer to pay the "resell price" by instalments. As the resell price is fixed, the instalments are also fixed.

(b) Under Al-Mudharabah

Under this principle, the bank will act as the capital provider. The bank may provide 100% financing while the customer acts as the entrepreneur. When profits are made, they will be shared in accordance with a pre-determined ratio. Losses, if any, will be borne by the capital provider, i.e. the bank.

(c) Under Al-Musyarakah

Under this principle, it will be a joint venture financing to buy shares. Profits, if any, will be shared in accordance with a pre-determined ratio. Losses, if any, will be shared in accordance with the financing ratio.

1.8 Credit card (Bai' al-Inah)

In a Bai' al-Inah transaction (contract), the bank will sell an asset to the customer at a selling price comprising the financing amount plus profit margin on deferred terms. The bank will subsequently repurchase the asset from the customer on a cash basis, which is equivalent to the required financing amount. Therefore, the buying and selling of the Bank's asset is merely to comply with the underlying Syariah requirement for Bai' al-Inah contract.

In contrast to the Bai' Bithaman Ajil concept where the asset belongs to the customer, the underlying asset in a Bai' al-Inah transaction belongs to the bank.

1.9 Leasing (Al-Ijarah)

The concept of Al-Ijarah refers to an arrangement under which the lessor leases equipment, building or other facilities to a client at an agreed rental. In other words, this is an exchange transaction where a specified asset is made available in return for a payment. However, the ownership itself is not transferred. Therefore, it has the same design as an instalment leasing design.

2. Differences Between Conventional and Islamic Banking Systems

Conventional System	Islamic System
Depositors are paid interest.	Depositors are entitled to profit sharing.
The customer has no say where banker invest money.	Under special investment account, the customer can decide where banker invest the money.
Borrowers are charged interest.	Financing is done through purchase and resale to the customer, thus earning profit. If a loss is incurred under Al-Mudharabah, the capital provider will bear the loss, whereas under Al-Musyharakah, the loss will be shared according to the financing ratio.
Except for financing under leasing, margin of financing will be less than 100%.	Under Al-Mudharabah or Bai' Bithaman Ajil concept, 100% financing can be availed.
Repayment is not fixed.	Repayment price is fixed.
Legal relationship: • Debtor and creditor	Legal relationship: • Seller and buyer • Lessor and lessee • Partner and partner
Commodity, e.g. example house, becomes the security.	Commodity, e.g. house is the subject matter and major element.

3. Summary and Conclusion

The full-fledged Islamic banking system functions parallel to the conventional system. Therefore, credit officers must be clear with the concepts and products. Although these are two different systems, the credit considerations are the same. There are no two sets of credit rule under the two systems. Therefore, if a credit can be approved under the Islamic system, it can also be approved under the conventional system. By the same token if it is declined under one, it should not be considered under the other.

Practice Questions

1. Explain the concept of Al-Wadiah.

2. Explain the difference between general investment account and special investment account.

3. Explain how housing loan is granted under the concept of Bai' Bithaman Ajil.

4. State the differences between the conventional banking system and Islamic banking system.