Abstract

This paper aims to identify the key factors that have contributed to the existence and the growth of Ar-Rahnu (Islamic pawn broking scheme) in Malaysia. Based on the previous studies and cost of borrowing analysis, this paper found that the need for interest (riba) free, transparent transaction and low cost short-term cash borrowing scheme is much preferred by the pawning customers. Besides that the cost of borrowing in this scheme is the lowest compared to the conventional pawn broking scheme. However, the Ar-Rahnu scheme needs to address central issues such as the marketing, public awareness and the locations of this scheme.

Key words: Syariah Principles, pawn Broking, cost of borrowing.
Introduction

Pawn broking is a form of secured money lending by pawnshops in the conventional pawn broking system. It has been a fast source for short-term cash borrowing. In the past generally Muslims all over the world and specifically in Malaysia did not have an alternative to access an interest-free and low cost short-term cash advance. This situation has improved after the introduction of the shariah based Islamic pawn broking system called Ar-Rahnu which is an interest free source of micro credit. The existence of the conventional and Islamic pawn broking services has given clients the choice to choose the best service provider in order to get fast and easy access to cash compared to getting loans from commercial banks or finance companies.

Pawn broking is a means where the lower income group and small scale traders could seek short-term financing to manage their cash flow problems. The word Ar-Rahn means a pledge or security for a loan. The Holly Quran refers to the idea of a mortgage, as a pledge with possession. Under the Ar-Rahnu concept the borrower (Ar-Rahin) is required to pledge or produce redeemable collateral (Ar-Rahn) in the form of gold or silver to ensure repayment of the loan. This collateral acts as an instrument of guarantee that the loan will be repaid (collateral redeemed) at the maturity of agreement. If the borrowed sum is not repaid at maturity then the lender (Al-Murtahin) has the right to sell the collateral to recover the loan. Collateral is an important instrument for the security of loan by providing a guarantee to the financial institution as it reduces the lenders risk and increases the borrowers cost of default (IMF working paper).

Pawn broking is basically a contract of pledging a security that becomes binding when possession of the pledge has taken place. Ownership of the collateral is not transferred to the pledge, the transfer occurs only under certain conditions (Haron, Sudin, Shanmugam B, 1997). Ar-Rahnu concept is different from the conventional pawn broking system where the latter imposes high interest rates (two percent per month or 24 percent per annum) and other unfair practices on the borrower. Ar-Rahnu suits the needs of lower income group as it bears non-interest pawn broking service to obtain short-term borrowing and in case of emergency.

Background of Pawn Broking in Malaysia

Pawn broking carries on a tradition with rich history. Pawn broking can be traced back to at least 3,000 years in ancient China. It also has been found in the earliest written histories of Greek and Roman civilizations. In Malaysia, pawn broking was introduced in the 15th century through the diplomatic relationship between the government of China and Malacca. To date, the conventional pawn broking business is still controlled by the Hakka clan people of Chinese descent (Shanmugam B, 1991). The conventional pawn broking business is governed by the Pawnbrokers Act 1972 in Malaysia. This Act outlines all the necessary guidelines and principles that have to be adhered by both pawners and pawnbrokers. Briefly, the number of conventional pawn broking licenses approved between 1985 and 2006 had increased by 21 percent. In 1985, the number of conventional pawn broking licenses was 194, while in 2006 the figure has increased to 234.
Among the states which have the most conventional pawn broking shops are Perak, Selangor, Johor, Kedah and Penang. The states with a high non Malay population have the tendency of having a larger number of conventional pawn broking service compared to states having a high Malay population. Since 1960 there has been an effort to establish interest-free credit firms for the well being of Muslim community in Malaysia as well as around the globe (Hamidullah, M. Ma’ Arif)

History of Ar-rahnu (Islamic Pawn broking) in Malaysia

In Malaysia, conventional pawn broking predates Islamic pawn broking by few centuries. Development in Islamic pawn broking began only in 1992, that is, when the first Islamic pawn shop was established by the Terengganu State Government by the name Muassasah Gadaian Islam Terengganu (MGIT). The establishment of MGIT provided an alternative to the people to make a choice in order to get speedy cash and at the same time adhere to methods which are considered halal by the sharia regulation. Business through MGIT has increased at a high rate since its first formation which started with 12,732 customers in 1992 to 26,632 customers in 2005. The value of pawned items has increased from RM9.85 million in 1992 to RM28.9 million in 2005.

It is obvious that the establishment of Islamic pawnshops or Islamic pawn broking was actually initiated in the East Coast states of Peninsula Malaysia. Rationally, it is discernable as these East Coast states have 95% population of Malay ethnic whereby almost 100% of them are Muslims. The Malaysian Islamic Economic development foundation (YPEIM) was the first to suggest the introduction of Ar-Rahnu concept. The first Islamic pawn broking institution was set up by Majlis Agama Islam by the Kelantan state government in January 1992. In March 1992, Kedai Al-Rahn (KAR) a subsidiary of Permodalan Kelantan Berhad commenced further operations of such activity. Consequently the minister of finance announced a scheme called “Skim Ar-Rahnu” (SAR) on 21st August 1993 through the collaboration of Bank Negara Malaysia (the central bank of Malaysia), Yayasan Pembangunan Ekonomi Islam Malaysia and Bank Kerjasama Rakyat Malaysia Berhad. Later during the year (SAR) was launched at six branches of Bank Rakyat Malaysia.

Another interesting turn of events that underlined the development of Islamic pawn broking in Malaysia is the legal barrier imposed on conventional practice in Kelantan. In 1995, the state government of Kelantan ordered the cessation of all riba or interest based conventional pawnshops in its jurisdiction. Nonetheless, the conventional pawnshops primarily owned and operated by non-Muslims may continue to operate if they were to deal in accordance with the Ar-Rahnu principles (Shaari and Azlina, 2003).

Thus, we can conclude here that the conventional pawn broking business has ceased to operate in Kelantan. This would help to spur the actual growth of Islamic pawn broking business in that region (state). It was reported that in 2004 the number of Ar-Rahnu clients stood at 1.22 million with an accumulated loan amounting to RM1.17 billion (ABAC Malaysia, 2008).
Objective of this study

This study aims to identify the factors that contributed the growth of Islamic pawn broking in Malaysia in a conceptual basis. Though the Islamic pawn broking is relatively new in Malaysia, its existence has influenced the end users of short term debt market. This study is also ambitious to identify the current and potential key challenges and opportunities that Islamic pawn broking has.

Background of the study

There are limited numbers of literature available on Islamic pawn broking in Malaysia. However, there are some specific studies which have researched on the existence and the operational system of the Ar-rahnu concept. Previous studies have documented on the importance of pawn broking system in our society (Sanusi and Johari, 2006; Mohammed et al., 2005; Lao, 2005; Ismail and Ahmad, 1997; and Rugayah, 1986). The authors of these studies have explored the issue of Shariah view in terms of the pricing system, assets pledged, customer service and the locality of Islamic pawn broking activity.

Ismail and Sanusi (2005) studied on the important of shariah rules in the implementation of Islamic pawn broking system. They argued that the Islamic principles such as wadiah, qardhul hassan and ujra must be given a careful consideration in establishing Islamic pawn broking. Similarly Mohammed et al. (2005) argued that wadiah, qardhul hassan and ujra makes Ar-rahnu clearly different from the conventional pawnshop. The element of riba and gharar are eliminated in Ar-rahnu system.

Studies by (Mohammed et al., 2005; and Ismail and Ahmad, 1997) have examined the important of the pricing associated with the pawn broking transactions. Specifically, Mohammed et. al. (2005) documented that the service charge imposed by Ar-rahnu is relatively cheaper than the conventional pawn broking system (imposed 2 percent). This would mean that the cost of borrowing cash in Islamic pawn broking system is lower than the conventional pawn broking. This evidence is also consistent with evidences documented by Ismail and Ahmad (1997). On the basis of these findings, it is important to have Ar-Rahnu shop which offered competitive rate, to reflect the average pricing system in the market.

There are also studies on Islamic pawn broking system that have researched on the types of items accepted as a pledge (Sanusi and Johari, 2006; Mohamemd et al., 2005 and Ismail and Ahmad, 1997). Sanusi and Johari (2006) claimed that Islamic pawn broking system only accepts gold and jewelry made of gold. Comparatively the conventional pawnshops accept items beyond the gold jewelry that includes Rolex watches, diamond and other valuable electronic items. In Islamic banking institutions which offer Ar-rahnu schemes such as Bank Rakyat, customers can only use gold as a pawn item.
There is no evidence that these institutions have accepted any other valuable items as a pledge for short term loans. This finding is similar with studies conducted by Mohammed et al., (2005) and Ismail and Ahmad (1997). Mohammed et al., (2005) mentioned that pawned items including gold and platinum while Ismail and Ahmad (1997) mentioned that the normal pawned items include jewelry and electronic assets. According to Ismail and Ahmad (1997), the gold items maintain their value over a reasonable period of time and have high liquidity.

Concept of Ar-Rahnu

Islamic pawn broking is based on a combination of four concepts.

(a)  **Qardhul Hasan (Benevolent loan)**

A financial institution will grant a benevolent loan (interest-free) to the applicant who wishes to pawn his valuable item. The loan issued under the concept of Qardhul Hasan requires the borrower to pay the same amount borrowed to redeem the valuable item at the maturity of the agreed period.

(b)  **Wadiah Yad-Amanah (Trustworthiness)**

The borrower is required to produce returnable collateral to ensure repayment of the loan. The borrower entrusted the lender to look after the belongings during the loan period. If an unthinkable event happens to the collateral item due to the lender’s negligence, the lender is not required to replace the item.

(c)  **Al-Ujrah (Safe keeping)**

Al-Ujrah concept states that lender is allowed to charge a reasonable fee for the services rendered in keeping the pawned items safe and in good condition. The financial institution accepts custody of the valuable asset on a Wadiah concept whereby the bank promises to keep the valuable asset in a safe place and return when the time comes. The lending institution takes the precautionary measure such as providing security and insurance to ensure its safe returns once the customer pays his debt. Under the Wadiah concept, the bank will charge the customer for the services rendered in keeping the valuable asset.

(d)  **Wadiah Yadomanah (Safekeeping with guarantee)**

The lender will be responsible to replace the missing or stolen items to the owner if lender fails to keep the agreement due to own negligence.

The benefits of Islamic Pawn broking system:

- Based on Syariah principles which are an interest free form of loan.
- Easier to apply, faster approval, and guaranteed safety of the jewellery.
- Cheaper fee than conventional pawn broking.
- Fixed storage fee.
Longer financing term.
- No penalties.
- Surplus auction receipts are returned to the customer.

Quantum of Financing and Composition of Collateral

Irrespective of the required amount, collateral in the form of gold or silver (different institution has their own specified levels of purity) is compulsory for borrowers. Generally cash advances are made less than the value of collateral. It appears that financing up to 75% of the gold value and maximum financing of RM5000.00 per day of up to a cumulative amount of RM25000.00 is done, with a maximum repayment of 6 months with an extension of not more than 4 months.

Table 1 illustrates the margin of credit facility and the maximum allowable loan amount in Islamic pawn broking in Malaysia. Table 2 illustrates the loan period and the maximum extended period allowed by Islamic pawn broking system in Malaysia. Based on table 2, generally the Arrahnu system allows 6 months period to redeem any collateral on money borrowed. This time period is similar to the conventional pawn broking system.

Table 1: Percentage of Available Loan to Collateral Value and Maximum Allowable Loan Amount offered by Islamic Pawn Broking Institutions

<table>
<thead>
<tr>
<th>Institution</th>
<th>Total Available Loan as a % of total collateral value</th>
<th>Maximum Loan Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Muassasah Gadaian Islam Terengganu (MGIT)</td>
<td>75%</td>
<td>RM 1,500.00</td>
</tr>
<tr>
<td>Bank Kerjasama Rakyat (Bank Rakyat)</td>
<td>60%</td>
<td>RM 5,000.00 per day or not more than RM 25,000 of accumulated loan amount.</td>
</tr>
<tr>
<td>Kedai Al-Rahn Kelantan</td>
<td>50%</td>
<td>RM 5,000.00 per Receipt</td>
</tr>
<tr>
<td>Bank Islam Malaysia Berhad</td>
<td>60%</td>
<td>RM 5,000.00 per day or not more than RM 25,000 of accumulated loan amount.</td>
</tr>
<tr>
<td>Kedai Al-Rahn Perlis</td>
<td>70%</td>
<td>RM 5,000.00 per day or not more than RM 25,000 of accumulated loan amount.</td>
</tr>
</tbody>
</table>
Table 2: Loan Period and Extended Period by Islamic Pawn Broking Institutions in Malaysia

<table>
<thead>
<tr>
<th>Institution</th>
<th>Loan Period</th>
<th>Extended Loan Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Muassasah Gadaian Islam Terengganu (MGIT)</td>
<td>3 Months</td>
<td>3 Months</td>
</tr>
<tr>
<td>Bank Kerjasama Rakyat (Bank Rakyat)</td>
<td>6 months</td>
<td>4 Months</td>
</tr>
<tr>
<td>Kedai Al-Rahn Kelantan</td>
<td>6 months</td>
<td>3 Months</td>
</tr>
<tr>
<td>Bank Islam Malaysia Berhad</td>
<td>6 months</td>
<td>3 Months</td>
</tr>
<tr>
<td>Kedai Al-Rahn Perlis</td>
<td>6 months</td>
<td>2 Months</td>
</tr>
</tbody>
</table>

Table 3 and 4 provides the summary of monthly safekeeping charges by the Ar-rahnu division of Bank Islam Malaysia Berhad and Kedai Ar-rahnu Kelanthan respectively. It can be observed that the safekeeping charges vary according to the value of the collateral item pledged. It should be noted that the safekeeping charges are imposed based on the collateral items value and not based on the loan amount.

Table 3: Monthly Safekeeping Rate Charged by Bank Islam Malaysia Berhad

<table>
<thead>
<tr>
<th>Collateral Item Value (RM)</th>
<th>Rate for every RM100 / month</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 1,000</td>
<td>RM 0.60</td>
</tr>
<tr>
<td>1,001 to 5,000</td>
<td>RM 0.70</td>
</tr>
<tr>
<td>5,001 to 10,000</td>
<td>RM 0.80</td>
</tr>
</tbody>
</table>

Table 4: Monthly Safekeeping Rate Charged by Kedai Al-Rahn Kelantan

<table>
<thead>
<tr>
<th>Collateral Item Value (RM)</th>
<th>Rate for every RM100 / month</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 400</td>
<td>RM 0.60</td>
</tr>
<tr>
<td>401 to 2,000</td>
<td>RM 0.80</td>
</tr>
<tr>
<td>2,001 to 10,000</td>
<td>RM 0.95</td>
</tr>
</tbody>
</table>

Consequence in case of default

If the borrower defaults to redeem the collateral by the maximum period allowed or did not extend the period, a notice informing the borrower that the pawned item will be auctioned will be sent. If there is no response then the pawned asset will be auctioned off to recover the amount outstanding and any surplus will be given back to the owner of the asset.
In the event the borrower’s whereabouts cannot be traced then it is Islamic institutions' responsibility to put aside the fund in the *Baitulmal* account for future savings for if any claims be made for the surplus by the owner or his heir, which is contrarian to the conventional pawn broking. Functioning of Muslim funds and their activities could also be found in the work of Khatkhatay (1997), and Bagsiraj (2003).

**Comparative Analysis on the Cost of Borrowing between Ar-rahnu and Conventional Pawn Broking**

The cost involved in borrowing from an Islamic pawn broking is calculated based on the safekeeping charges while the conventional pawn broking is calculated based on the monthly interest charges. For the comparative purpose item of an equal value is used and the loan margin is assumed to be 60 percent in both the systems. The safekeeping charges are adopted from Bank Rakyat Ar-rahnu scheme while the conventional pawn broking interest rate is the two percent per month rate. The graph in Figure 1 shows the annual cost of borrowing for the Ar-rahnu scheme and the conventional pawn broking scheme. It is observable that the Islamic pawn broking scheme (Ar-rahnu) have lower cost in percentage to loan amount than the conventional pawn broking scheme. The annual cost of borrowing in the Ar-rahnu scheme is just about half the cost of the conventional pawn broking scheme which has a flat rate of 24 percent. It is also evident that the cost of borrowing in the Ar-rahnu scheme is only 11 percent per annum when the collateral value is RM500.00, and it rises as the collateral value increases. However even at the collateral value level of RM 10,000.00 the cost is only 15 percent per annum while the conventional pawn broking has a flat rate of 24 percent per annum at all levels of collateral value.

**Figure 1: Annual Cost of Borrowing in Ar-Rahnu and Conventional Pawn Broking**
Challenges Faced by Ar-Rahnu

Besides the conventional pawn broking system, illegal money lending or the “Ah Long” activity has become another challenge for Islamic pawn broking. The Ah Long activity is carried out as an illegal (hidden economy) activity widely in Malaysia. This type of money lenders provide ready cash advance to small income individuals and also for small scale businessmen. They provide instant money lending service with very high interest (as high as 20 percent per month) and other unfair charges like agreement fees and stamp duty charges. The only attraction of such activity is that the borrower need not pledge any collateral but to sign some documents such as an “IOU” certificate. Such illegal activity has been growing in the form of large syndicates praying for borrowers who is in need of cash and do not have any gold to support their pledge. The challenge for Ar-rahnu specifically is that even people with gold jewelries sort for such borrowings as they can borrow almost up to 90 percent margin (but to pay heavy and unfair interest). In the event of a default the lenders will take drastic actions including harmful threats and even murder. Some borrowers with gold still prefer to borrow from illegal money lenders as the latter can provide higher margin to value of collateral and unlimited time to redeem.

The Future and the Prospect of Islamic Pawn Broking Business

Despite the availability and accessibility of illegal money lenders, banks for personal loans and also conventional pawn broking facilities, the growth of Islamic pawn broking facilities seems to have taken firmer inroads in the highly regulated and diverse financial market. This is evident as the Ar-rahnu concept has been introduced in many Islamic banks and state owned banks such as the Agro Bank in Malaysia. The Islamic pawn broking division in Bank Rakyat started with only 5 outlets in 1993; by 2003 it has grown to 106 outlets operating successfully in all over the country. Since the introduction of Ar-Rahnu scheme in 1993, Bank Rakyat alone has advanced RM844 millions up to September 2002 involving nearly 888,000 Ar- Rahnu account holders. By December 2001, the total accumulative safekeeping earned was RM44.37 million (since inception). (Mohd Sharif, 2002)

The average annual income derived from Ar-Rahnu scheme alone was more than RM10 million for Bank Rakyat. The annual reports of 2001 and 2002 revealed that the Ar-Rahnu financing and advances were RM81.165 millions and RM119.805 millions respectively. The deposits from Ar-Rahnu fund in 2001 and 2002 were amounting to RM38.223 millions and RM35.223 millions respectively. The total expenditure with regards to the scheme was RM3.330 millions and RM3.324 millions respectively (Annual Report of Bank Rakyat, 2001 & 2002). Despite the increased competition from so many financial institutions and conventional pawn brokers, the growth of Islamic pawn broking seems to grow consistently since its inception.
A number of reasons could be attributed to explain this notable accession. The reasons identified by the researchers are as follows

1. There is scarcity for credit especially for consumption purposes. Islamic pawn broking adheres to Syariah principles (Islamic Laws). This attracts the Muslim community to place their collateral items in exchange for credit facilities

2. Unlike financial institutions, pawnbrokers do not question the purpose for which credit is sought. Financial institutions requires pages of information, business projection income statement (if for business purpose), guarantor and many other strict requirements

3. Islamic pawn broking (like the conventional pawn broking) do not set restrictions or stipulations on the manner in which the fund has to be used

4. There are no extra fees or charges like stamp duty or legal fees

5. The process is immediate because as soon as the collateral items are verified, money is granted to the borrower. The normal waiting period is less than 30 minutes

6. In comparison to other sources of informal credit, example money lenders and conventional pawn brokers who may charge interest from 2 – 20% per month, Islamic pawn brokers are relatively very cheap where the charges are usually about 1percent per month

7. No other financial institutions (other than conventional pawn brokers) will provide credit for the type of collateral held by the customers

8. The credit can be used for long term purpose, since as long as the safekeeping fees are fully paid, the duration of the credit can be extended indefinitely.

Conclusion

It is a fact that Islamic pawn broking system has the capacity and capability to fill the gap in the short-term credit structure of the country. Islamic pawn broking is not a competition to the conventional pawn broking but it is compensating the rising demand. Ever since the introduction of Islamic pawn broking service, the demand for it is increasing continuously. Customers prefer Islamic pawn broking services to conventional pawn broking services because the former provide fast, hassle-free, riba-free and transparent micro credit facilities. As a catalyst for further growth of Islamic pawn broking in Malaysia, it is necessary for the operators to take aggressive measures especially in view of creating awareness among prospective customers.
The operators (pawn brokers) should take initiatives to disseminate the information about its operations, principles, and schemes through media, brochures and online FAQs. Malaysia has great opportunities and expertise to develop Islamic pawn broking business in this region. The government should encourage those who are in dire need for fast cash to approach Islamic pawn brokers rather than resort to illegal money lenders (Ah longs) who charge exorbitant interest rates and unfair recovery practices. More Islamic pawnshops should be opened in rural and over populated areas to avoid monopolization and control by a few pawn brokers.

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