FINANCIAL SECTOR TALENT ENRICHMENT PROGRAMME

fstep
enriching talent

ISLAMIC BANKING HANDBOOK

First Edition April 2010

Published by
Institut Bank-Bank Malaysia (35880-P)
Wisma IBI, 5 Ja;an Semantan
Damansara Heights, 50490 Kuala Lumpur
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The development and production cost for this handbook is subsidized by the Staff Training Fund

Foreword

The Financial Sector Talent Enrichment Program is an industry-driven post graduate initiative of the financial services industry. Deriving from an idea promulgated by the Governor of Bank Negara Malaysia, Tan Sri Dato' Seri Dr Zeti Akhtar Aziz, FSTEP was established in September 2007 to address the shortage of skilled talents in the financial services sector. The program aims to produce highly trained young professionals for the financial services industry.

Banking in Malaysia is a fast-changing and dynamic industry with new developments taking place all the time. The development the Malaysian domestic economy would also need to change to a more productive structure that is more innovation-driven and knowledge intensive. The role of the financial sector therefore will also evolve from being an enabler of growth to becoming an important catalyst and driver of economic growth and development. This will create increased demand for highly trained and competent workforce to serve the financial industry. FSTEP therefore was established as part of the overall talent development initiatives to contribute to the process of building and expanding a sustainable pool of talent to best serve the present and future needs of the industry.

FSTEP occupies a unique niche within the financial services industry, providing a training programme to equip participants with the essential knowledge and skills as well as to nurture them to become well-rounded individuals to support the growth of the industry. Through active collaboration of industry players, training modules were designed to blend technical knowledge and personal development insight, which enables participants to optimise their learning through a mix of classroom training based on case studies, complemented by hands-on exposure through on-the-job training.

In writing this handbook, the author adopted an approach to comply with the syllabus of the financial services stream, as outlined by FSTEP. As such, the handbook will serve to augment the teaching and learning process to bring about maximum impact on the participants of FSTEP. FSTEP participants should review the handbook material prior to every class to expedite and maximize their understanding of the subject.

We wish to register our appreciation to IBBM, the author, the reviewer and many others for the selfless contribution to this handbook and for their unwavering advice in steering the handbook to successful completion.

FSTEP Management

March 22, 2010

Islamic Banking

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1.0 FUNDAMENTALS OF SYARIAH

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1.2 Sources of the shariah
1.3 Prohibitions in Muamalat
1.4 Types of Contracts
1.5 List of Contracts used in Islamic Banking
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1.1 ISLAM AND SHARIAH

1.1.1 The Meaning of Shariah

The root Arabic word of Shariah is the verb "shara'a". The literal meaning of "shara'a" is to open upon a street, like to open a door upon a street. From "shara'a", comes the word "mashra'a" which means path to a watering place.
In legal term "shara'a" means to make or establish laws. From "shara'a" also comes the word "Shariah" which in legal term means "laws relating to all aspects of human life established by Allah s.w.t. for his servants". Laws relating to human life are divided into three, i.e. those relating to belief, those relating to deeds and those relating to ethics. As such one can deduce that Shariah is another word for Islam.

1.1.2 Fiqh

The laws governing human deeds are called "Fiqh", which is defined as understanding the laws relating to human deeds derived from their respective particular evidences. The respective particular evidences are the specific verses of the Quran and Hadiths concerning each of human deeds. In modern times Shariah is also applied to mean Fiqh.
Fiqh as Shariah which is referred to as Islamic Law is further sub-divided into four as follows:
(i) Ibadat (rituals)
(ii) Munakahat (marriage or family laws)
(iii) Muamalat (commercial transactions)
(iv) Jinayat (offences, crimes and punishments)

1.1.3 Muamalat

Muamalat is plural and the singular word is muamalah. Muamalah is from the verb "aamala" literally means to interact. Muamalat means interactions or transactions. Commercial transactions are concluded through contracts which are permitted by the Shariah as evidenced by the Quran, the Sunnah and other sources of Islamic Law.
Allah S.W.T. gives Islam as rohmah (mercy or compassion) to man and the world. Rohmah is manifested in three aspects, that is:
- educating the individual
- establishing justice, and
- realizing public welfare

Public welfare is maslahah and according to experts of jurisprudence, is synonymous with maqasid al-ahkam al-Shariyah (objectives of Islamic Law).

1.1.4 Objective of Islamic Law

Objectives of Islamic Law are the protection of:
1. faith
2. life
3. intellect
4. posterity and
5. property

These objectives are of three levels:
1. dharuriyyat (life and death)
2. hajiyyat (removing hardship), and
3. tahsiniyyat (beutifying)

The salient features of Shariah are as follows:
1. Rabbaniyyah (divine)
2. Reward in the world and hereafter
3. ‘Alamiyyah and umumiyyah (universal)
4. Permanent
5. Syumul (complete)

1.1.5 Schools of Islamic Law

In the beginning around 780 A.D to 850 A.D the differences in Islamic Law followed geographical regions:

1. Madinah School
2. Iraqi School (around Kufah, Basrah and Baghdad)
3. Syrian School (Damshiq or Damascus)

This period saw the beginning of the emergence of the jurists who attached themselves to the imams of the different schools.

The imams after whom the Sunni schools of Islamic Law were named were as follows:

1. Abu Hanifah an-Nu’man bin Thabit (Hanafi) (699 A.D-767 A.D)
   - Diciples of Imam Hanifah :
     (i) Abu Yusuf Ya’akub (c.732 A.D – 800 A.D)
     (ii) Muhammad bin Hassan ash-shaibani (c.750 A.D – 805 A.D)
2. Malik bin Anas (Maliki) (713 A.D – 795 A.D)
3. Muhammad bin Idris ash-Shafii (Shafii) (767 A.D – 819 A.D)
4. Ahmad bin Muhammad bin Hanbal (Hanbali) (780 A.D – 855 A.D)

The division of Islamic Law into schools according to geographical regions changed to schools according to teachings of certain imams (founders).

By 870 A.D. the Muslim people had become identified according to schools of Islamic Law following the imams.

Eight of the schools of Islamic Law (mazahib pl. of mazhab) which prevail until today are:

1. Hanafi (changed from Iraqi School)
2. Maliki (changed from Madinah School)
3. Shafii (changed from Iraqi School)
4. Hanbali (changed from Iraqi School)
5. Imamiyyah (Syiah)
6. Zaidiyyah (Syiah)
7. Dzahiriyyah
8. Ibadhiyyah

1.2 SOURCES OF THE SHARIAH

Scholars of jurisprudence (jurisconsults) divide the sources of the Shariah into main or primary sources, and secondary sources.

The primary sources are:
1. Al-Quran
2. Al-Sunnah
3. Qiyas (analogical deductions), and
4. Ijma'a (consensus of opinion).

The secondary sources are:
1. Revealed laws preceding the Shariah of Muhammad
2. The fatwa of Companions
3. Istihsan (equity in Islamic Law)
4. Maslahah Mursalah (consideration of public interest)
5. 'Urf (custom)
6. Istishab (presumption of continuity), and
7. Sadd al-Zara'ii (blocking of means)

The Hakim is Allah Taala. The rulings laid down by Allah are through al-Qur'an and al-Sunnah. Al-Qur'an is the words of Allah revealed to the Prophet Muhammad s.a.w in Arabic conveyed by the angel Jibrail.

Al-Qur'an and al-Sunnah are the main sources of Shariah.

1.2.1 Al-Qur'an

Al-Qur'an consists of 114 Chapters (surahs) and 6235 verses (ayats) and it is the greatest miracle given to Prophet Muhammad s.a.w. It is the proof of the prophethood of Muhammad s.a.w. It is a miracle in the following aspects:

1. Its language is in clear and pure Arabic of the highest standard. No one can surpass its linguistic excellence.
2. It contains information and stories about peoples of the past.
3. It foretells future events which really took place afterwards as foretold.
4. It tells about realities of nature: the creation of life and the universe, the orbits of the earth, the sun, the moon and the stars; and the formation of clouds and rains.
5. It contains laws and rules on how to regulate political, legal, economic, social and moral matters in society.

There are 350 legal verses (ayat ahkam) in the Qur'an:

- 140 verses concern ibadat
- 70 verses concern munakahat
- 70 verses concern muamalat
- 70 verses concern others

Al-Qur'an was first revealed at about 611A.D with the first verse revealed being Surah Al-Alaq verse 1 to 5. Al-Qur'an was revealed on a piecemeal basis over a period of 22 years and the last verse being Surah Al-Maidah verse 3 revealed in 632 A.D.

Al-Qur'an was revealed in two main periods of the Prophet's mission: when the Prophet lived in Makkah and in Madinah respectively.

During the life of the Prophet and until the middle of Khalifah Othman's rule, the Qur'an was memorized by the Prophet and many Sahabats (Companions) and the verses of the Qur'an were transcribed on flat pieces of stones, bones, wood and date palms.

In about 633 A.D. Khalifah Abu Bakar ordered Zaid b. Thabit to collect and compile these verses. Later at about 650 A.D., Khalifah Othman ordered Zaid to transcribe, compile and bind the Qur'an in a single volume.

Hafsah bt. Umar, Umm-ul-Mu'minin kept the earliest transcribed verses. Marwan b. Hakam former secretary of Othman and the 4th Khalifah of the Umayyah Dynasty ordered these earliest transcribed verses of the Qur'an to be burnt around 684 A.D. presumably fearing it might become the cause for new disputes.

The verses of the Qur'an as compiled by Zaid are mutawatir (successive narration) that is they were established by an indefinite number of people that it was impossible for them to tell a lie.

1.2.2 Sunnah

Sunnah is the sayings, deeds and approvals of Prophet Muhammad s.a.w. Sunnah is also referred to as Hadith.

Hadiths are grouped into 4 classes according to the nature of proof and the completeness of the chain of transmission:

(i) Mutawatir (successive narration)
(ii) Mashhur (conveyed by three or more narrators but is not considered mutawatir)
(iii) Ahad (singular narration)
(iv) Mursal (hurried) – i.e. the Sahaba link between a Successor and Prophet Muhammad is missing

Hadiths are also grouped according to the character of the transmitters i.e. in 3 classes:

(i) Sahih
(ii) Hasan
(iii) Daif

Six great collections regarded as authoritative by the Sunni Schools of Islamic Law are:

(i) Jami' As-Sahih Al-Bukhari (d. 869 A.D)
(ii) Jami' As-Sahih Muslim (d. 874 A.D)
(iii) Jami' At-Tirmizi (d. 892 A.D)
(iv) Sunan Abu Daud (d. 888 A.D)
(v) Sunan An-Nasai (d. 915 A.D)
(vi) Sunan Ibn Majah (d. 886 A.D)

1.2.3 Al-Ijma'

Ijma' is a consensus of opinion or agreement of Muslim jurisconsults in any particular age on a juridical rule.

1.2.4 Al-Qiyas

Qiyas is referred to as an application or extension of the law established by a binding authority to a particular case (individual deductions of jurists). Accord of a known thing by reason of the quality of the one with the other in respect of the effective causes of its law.

1.3 PROHIBITIONS IN MUAMALAT

Trade and commerce in Islam must comply with requirements of the Shariah, which broadly means the abstinence from prohibitions (haram matters), and observing that every contract possesses all its essential elements and that every essential element meet the necessary conditions.

There are many prohibitions, but these five will make aqads or contracts invalid. Among others are:

(i) Producing and selling impure goods;
(ii) Producing and selling goods that are of no use therefore of no value;
(iii) Riba;
(iv) Gharar, i.e. ambiguity or uncertainty; and
(v) Maisir (gambling), i.e. anything that involves betting.

Riba and gharar are prohibited and invalid. Riba is usury or interest and gharar is uncertainty.

1.3.1 Riba

The word riba means extra or excess and riba is divided into two main kinds namely:

- riba duyun: riba in lending and borrowing, and
- riba buyu': riba in trading of exchange of goods

Both kinds of riba are amongst great sins in Islam.

Riba is further subdivided into four kinds. Two kinds are sub-divisions of riba duyun and the other two are sub-divisions of riba buyu':

a) Riba Duyun (riba in lending and borrowing):
   i) Riba Qardh – riba (interest) that is imposed from the beginning of a loan contract.
   ii) Riba Jahiliyah – riba (interest) that is imposed after default.

b) Riba Buyu' (riba in trading or exchange of goods):
   i) Riba Fadl - happens when the ribawi materials exchanged are of different weights, measurements or numbers.
   ii) Riba Nasih - happens when payment of the price and delivery of the ribawi materials are made at two different times (not immediate).

Ribawi materials are divided into two bases and under each basis are the different kinds as follows:

Basis	Basis
Media of Exchange	Foodstuffs
→ Gold : 916,835, 750 → Silver → RM → £	→ Grains • Rice : Bathmati, A1 • Wheat • Corn → Meats • Beef : Australian, local • Mutton • Chicken • Fishes

Basis	Basis
Media of Exchange	Foodstuffs
→ USD → Singapore Dollar → Australian Dollar → Hong Kong Dollar → ¥	→ Vegetables • Tomatoes: highland, lowland • Beans → Fruits • Apples • Oranges: Sunkist, Chinese → Salts • Salt • Sugar • Condiments • Medicines

The rules of exchange of ribawi materials are as follows:

Rules of Exchange of Ribawi Materials

Exchanges	Rules
1. Ribawi materials of the same kind of the same basis. (5 grams of 916 gold for 5 grams of 750 gold; 10 grams of Basmathi rice for 10 grams of A1 rice)	1. Materials must be of the same weight, measurement or number of units. 2. Payment must be on cash terms.
2. Ribawi materials of different kinds of the same basis. (5 grams of gold for RM200; RM3,800 for USD1,000; 10 kgs of rice for 15 kgs of wheat; 1 tonne of palm oil for 2 tonnes of sugar.)	1. Difference in weights, measurements or number of units allowed, 2. Payment must still be on cash terms.

Exchanges	Rules
3. Ribawi materials of different kinds of different bases. (10 kgs of dates for 1 gm of gold; 30 kgs of wheat for USD10; 1 tonne of palm oil for RM1,500)	- No rules are imposed. (Difference in weights, measurements or number of units allowed.)

1.3.2 Gharar

Gharar is divided into three namely Gharar yasir, i.e. minor or slight gharar, Gharar fahish, i.e. major or excessive gharar and gharar that cannot be avoided. The Gharar that causes a contract to be invalid is major gharar**.**

In general terms major gharar is an uncertainty which is so great that it becomes unacceptable, or it is so vague that there is no means of quantifying it.

In short, major gharar may arise when the buyer or seller is not capable of taking responsibility i.e.

(i) not of majority age,
(ii) the buyer or seller is prohibited from disposing of his property due to him being declared bankrupt or prodigal,
(iii) the buyer or seller is coerced.

Insofar as asset is concerned, major gharar may arise if:

(i) the asset or property does not exist,
(ii) the asset is not free from encumbrances,
(iii) the asset is not specific or not according to its specifications.

Gharar on price takes the following forms:

(i) the price not mentioned in absolute amount,
(ii) two prices in one contract,
(iii) the mentioning of ibraa' in absolute amount or percentage of selling price.

Gharar on contract can take place if the contract is conditional (in sale) or not expressed in an absolute and decisive language (with "shall", "will" or "agree to"), it may caused major gharar as well.

Minor gharar or minor uncertainty is forgiven. Contracts involving minor gharar are permissible and valid. In contracts involving minor gharar, the uncertainty is taken into consideration in arriving at the price.

1.3.3 Maisir

Maisir (gambling) is betting or charging something that will be forfeited if one fails to obtain the greater gain that one hopes for. Speculation is not gambling. Some jurists say that speculation is prohibited, but contracts involving speculation are still valid.

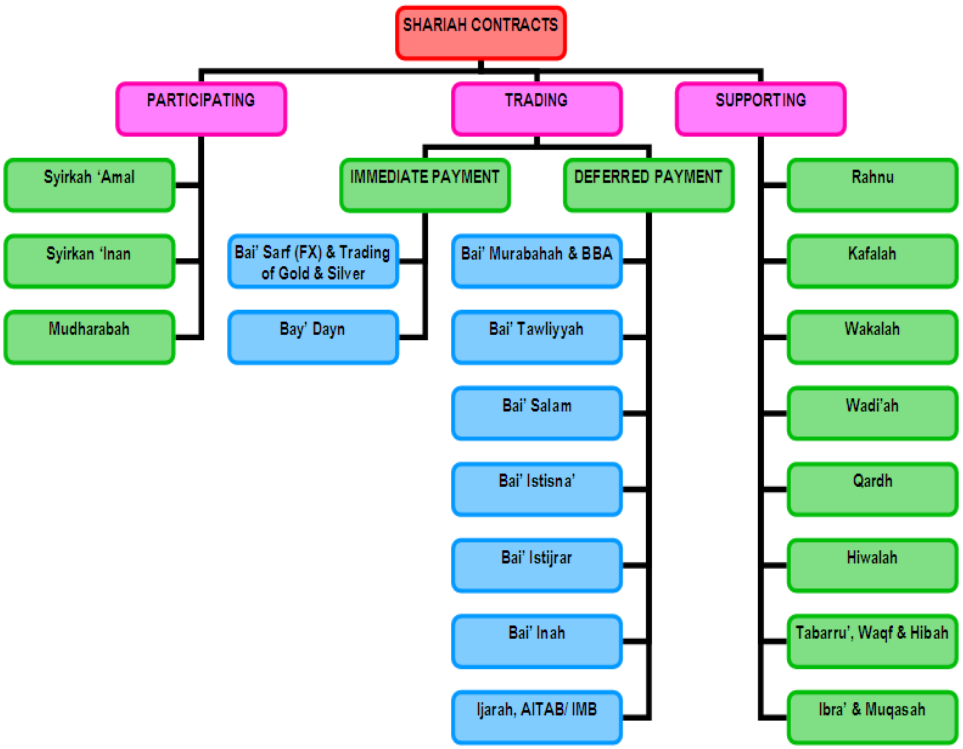
1.4 TYPES OF CONTRACTS

1.4.1 Based on Application

Shariah contracts in trade and commerce may be divided into three categories according to their applications:

(1) Trading contracts
(2) Participating Contracts
(3) Supporting contracts

The chart below illustrates the details of the categories:



For trading contracts, some of them are required by the Shariah to be carried out with immediate payment while others are permitted with deferred payment.

- Trading Contracts with Immediate Payment
  - (i) Sarf (foreign exchange)
  - (ii) Sale of gold and silver
  - (iii) Bai Dayn (debt trading)

- Trading Contracts with Deferred Payment
  - (i) Bai Murabahah (cost plus)
  - (ii) Bai Tawliyah (novation)
  - (iii) Bai Bithaman Ajil (deferred payment sale)
  - (iv) Bai Salam (advance payment sale)
  - (v) Bai Istisna'a (sale by order)
  - (vi) Bai Istijrar (supply, wholesale financing)
  - (vii) Bai Inah (sale and buy back)
  - (viii) Ijarah (leasing)
  - (ix) Ijarah Thumma Al-Bai (Islamic hire purchase, AITAB)

For participating contracts, there are three types of them which are possible in practice. Two are subdivisions of Musharakah as follows:

(i) Shirkah A'amal (pooling of expertise)
(ii) Shirkah 'Inan and (pooling of fund)
(iii) Mudharabah (trustee profit sharing)

Shirkah A'amal is a partnership in giving services where two or more professionals like lawyers, doctors, engineers, accountants or skilled workers enter into the contract. Shirkah 'Inan is the normal Musharakah with the pooling of funds as capital.

The Shariah also permits contracts to support and facilitate financial transactions. These contracts are:

(i) Rahnu (mortgage)
(ii) Kafalah (guarantee)
(iii) Wakalah (agency)
(iv) Wadiah (safe custody)
(v) Qardh (loan)
(vi) Hiwalah (transfer of debt)
(vii) Tabarru' (donation)
(viii) Hibah (gift)
(ix) Wakaf (endowment)
(x) Ibraa' (rebate)
(xi) Muqasah (set-off)

Contracts can be divided according to banking operations as follows:

Mobilization of Deposits

- Musharakah (shareholders)
- Mudharabah (customers)

- Wadiah (safe custody)
- Qardh Hasan (benevolent loan)

Application of Funds

Debt financing:

- Murabahah (cost-plus sale)
- Bai Bithaman Ajil (deferred payment sale)
- Istisna' (sale by order)
- Ijarah (leasing)
- Ijarah Thumma Al-Bai (leasing followed by purchase)
- Bai Inah (sale and buy back)

Equity Financing:

- Musharakah (joint-venture profit sharing)
- Mudharabah (trustee profit-sharing)

1.4.2 Based on Purpose

Contracts are also divided according to their **purposes** as follows:

1. For individual ownership (‘uqud tamlikat):
   (i) with exchanges (‘uqud mu’awadhat):
   - all trading contracts and
   - qardh

   (ii) without exchange (‘uqud tabarru’at):
   - hibah (gift)
   - tabarru’ (donation)
   - sodaqah (with reward from Allah s.w.t.)
   - waqf (with reward from Allah s.w.t.)

2. For shared ownership (‘uqud ishtirak) :
   - all contracts of participation

3. For save custody (aqad hifz) :
   - wadiah

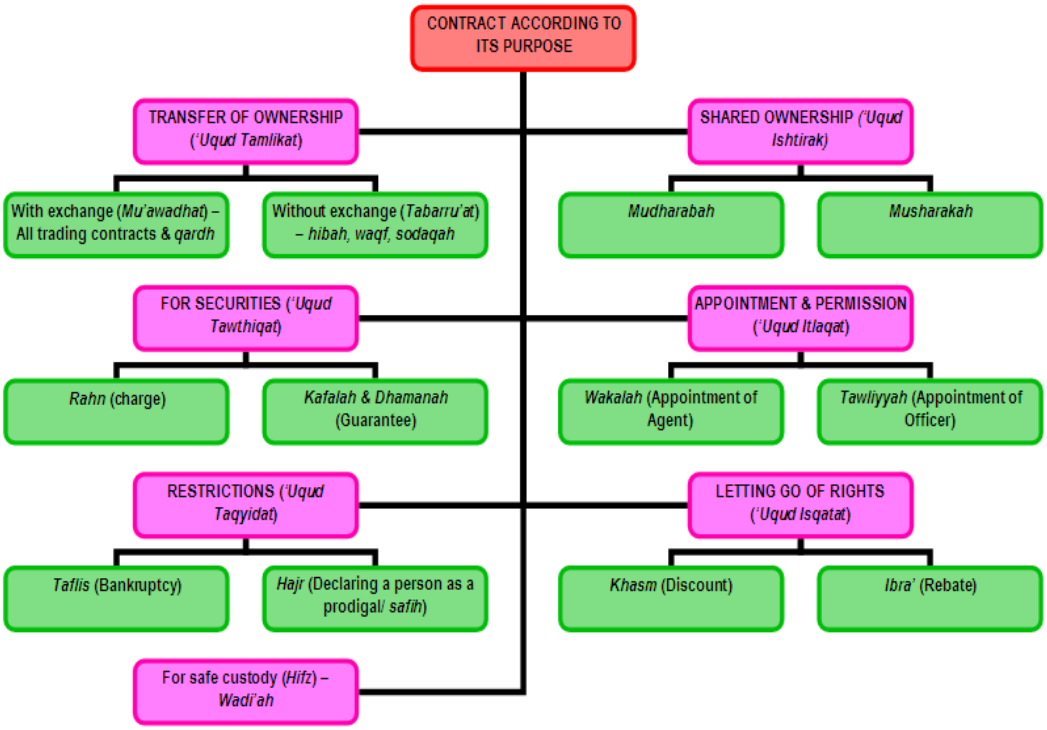
4. For securities (‘uqud tauthiqat) :
   - rahn (charge), and
   - dhaman or kafalah (guarantee)

5. For appointments and permission (‘uqud itlaqad)
   - wakalah (appointment of agent)
   - tauliyah (appointment of officer)

6. For restrictions (‘uqud taqyidat)
   - taflis (bankruptcy)
   - relating to safih (declaring a person as prodigal)

7. For letting go of rights (‘uqud isqatat)
   - khasm (discount)
   - ibraa’ (rebate)

The chart below illustrates the details of the categories:



1.5 LIST OF CONTRACTS USED IN ISLAMIC BANKING

The following are Shariah contracts used:

1.5.1 Murabahah

Definition: A sale based on the cost price plus profit

Practice :
- The cost price or profit must be known to the buyer.
- Payment of selling price is normally in lump sum (as practiced in Malaysia). In Murabahah, payment by can be made by instalment as well.

1.5.2 Istisna'

Definition: An order made by the buyer for the manufacture of an item according to specifications.

Practice: The item does not exist at the time of contract.

1.5.3 Bai Bithaman Ajil

Definition: A normal sale with the payment of the selling price deferred to an agreed later date.

Practice:
- The item to be sold exists at the time of contract.
- The Shariah does not require that the cost price be known to the buyer.

1.5.4 Ijarah

Definition: A sale of the use of another's property
Practice: - The property to be leased belongs to the lessor.
- The lessor has the right to repossess the property on a default of the lessee.

1.5.5 Ijarah Thumma Bai (leasing followed by purchase)

Simple leasing for the leasing period with an option for the lessee to purchase the property at the end of the leasing period through a contract of purchase.

1.5.6 Bai Istijrar (supply or wholesale financing)

A contract to supply one or more items on repeating basis over a long period.

1.5.7 Bai Salam (advance payment sale)

A contract with full advance payment for future delivery of an item.

1.5.8 Qardh

A sum of money lent to be returned without extra over and above the loan.

In giving a loan the following matters must be observed:
(i) The lender must not impose any extra payment in the contract.
(ii) The borrower must not promise to pay anything extra in the contract.

1.5.9 Bai Inah

Bai Inah is a financing facility that must meet the following requirements:

(i) There must be two separate contracts properly executed. First the contract of sale by a bank to a customer on deferred payment terms. Second the contract of repurchase by the bank from the customer on cash terms. This sequence must be followed.
(ii) The property must not be a ribawi item in the medium of exchange category (gold, silver or currency) because all payments for purchases are made in money.
(iii) Each of the two contracts must have the essential elements and each of the essential elements must meet the necessary conditions.

1.5.10 Bai Dayn

The requirements of the Shariah concerning Bai Dayn are:

(i) A debt must have been created through a contract of deferred payment sale of goods or services.
(ii) The goods must have been delivered or the service must have been rendered.
(iii) The trading of the debt must be on cash terms.

1.6 ESSENTIAL ELEMENTS AND NECESSARY CONDITIONS

1.6.1 Trading Contracts

To make a contract valid it must have essential elements and each essential element must meet the necessary conditions.

There are five essential elements of sale and six of Ijarah:

	Sale		**Ijarah**
(i)	Seller	(i)	Lessor
(ii)	Buyer	(ii)	Lessee
(iii)	Item sold	(iii)	Property
(iv)	Price	(iv)	Benefit (use or usufruct)
(v)	Contract - 14 necessary conditions	(v)	Rental
		(vi)	Contract - 17 necessary conditions

(1) Contract of Sale

(1) and (2) Seller and Buyer.

There are three necessary conditions for the seller and buyer.

(i) capable of taking responsibility. They must:
- be of sound mind, (aqil) i.e. not mad, not mentally retarded, not a child
- have reached the age of puberty (baligh), and
- have reached age of majority (rasheed/ 18 years old) i.e. able to manage their own affairs

(ii) not prohibited from dealing with their properties, i. e:
- not declared bankrupts, or
- not declared prodigals

(iii) no coercion is exerted on either of them.

(3) Item sold.

There are six conditions:

(i) It must exist

(ii) It must be pure (halal) according to the Shariah.
It must not be:
- a pig or its products
- a dog or its products
- a carcass
- an intoxicating drink
- blood

- vomit
- excreta i.e. faeces or urine

(iii) It must have a usage according to the Shariah.
- It must not be too little as to be of no use, such as a few grains of rice or half a date fruit.
- It must not distract from remembering Allah, like certain musical instruments.
- It must not be used for haram purposes like worshipping other things than Allah, facilitating riba or gambling.

(iv) It must be owned by the seller.

(v) It must be capable of being delivered; it must be free from encumbrances.

(vi) It must be known and specific by address, description or specification.

(4) Price

There are two necessary conditions of price as follows:

(i) in known currency and

(ii) in absolute amount

(5) Contract

Contract has three conditions which are:

(i) The offer and acceptance must be absolute and in definite and decisive language.
- It must not be conditional
- It must not be:
  - fixed to a certain time like a certain day or date, or
  - limited to a certain period of time like one year or ten years.
- It must be in the present or past tense; it must not be in the future tense, imperative or with the words “agree to”

(ii) The acceptance must agree with the offer.

(iii) The offer and acceptance must be made at the one and the same meeting.

(2) Contract of Ijarah

(1) and (2) Lessor and Lessee

There are three necessary conditions for the lessor and lessee as follows:

(i) capable of taking responsibility. They must:
- be of sound mind, (aqil) i.e. not mad, not mentally retarded, not a child
- have reached the age of puberty (baligh), and
- have reached age of majority (rasheed/ 18 years old) i.e. able to manage their own affairs

(ii) not prohibited from dealing with their properties, i. e:
- not declared bankrupts, or
- not declared prodigals

(iii) no coercion is exerted on either of them.

(3) Property

The four necessary conditions for the property are:

(i) It must be owned by the lessor.
(ii) It must be ready for use.
(iii) It must be delivered to the lessee.
(iv) It must be specific by address, description or specification.

(4) Benefit (use or usufruct)

There are five necessary conditions for the benefit:

(i) It must be permissible.
(ii) It can be fixed in value.
(iii) The lessor has the power and capability to provide the benefit and allow the lessee to use the property
(iv) It must be specified.
- For a single-purpose property the period of leasing must be known.
- For a multi-purpose property the type of use must also be stated clearly.
(v) The benefit must not be a material part of the property.

(5) Rental

There are two necessary conditions as follows:

(i) in known currency and
(ii) in absolute amount

(6) Contract

Contract has three necessary conditions which are:

(i) The offer and acceptance must be in a definite and decisive language. It must be in the present or past tense; it must not be in the future tense, imperative or with the words "agree to".
(ii) The acceptance must agree with the offer.
(iii) The offer and acceptance must be made at the one and the same meeting

6.1. Note on Bai Inah and Bai Dayn

Islamic financial practices in Malaysia apply all the contracts used overseas with the difference that Malaysia practices two other contracts i.e, Bai Inah and Bai Dayn. Malaysian Shariah experts view the contracts as permissible and valid, whereas some Shariah experts overseas view otherwise. Needless to say AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) does not provide any standards for these two contracts.

Bank Negara Malaysia's guidelines on Bai Inah states that, it is a facility where a bank sells a certain property to a customer for a known price on credit terms. Then the bank repurchases the same property from the customer for a price lower then its sale price on cash terms.

The operation of the facility is as follows:
(i) There must be two clear and separate contracts for the facility: first, the sale contract from the bank to the customer. Second, the purchase contract by the bank from the customer.
(ii) Payment of the price in the bank's purchase contract must be on cash terms.
(iii) The subject matter of the transactions must not be a ribawi item.
(iv) In each of the contracts there must be a real valid way of taking possession of the subject matter of the contract according to the Shariah and trade convention.
(v) The execution of the two contracts in Bai Inah must meet the conditions required by Imam Shafei i.e. fulfilling the essential elements and their conditions.
(vi) Allocation of the property as the subject matter of the contract must be real and the fixing of the price must also be real and reasonable vis-a-vis market price.
(vii) The first contract must be executed first (signal by both parties) before entering into the second contract, to avoid the sale of a property not owned by the seller.

The Shariah Advisory Council of Securities Commission (SC) unanimously agreed to accept the principle of bai dayn i.e. debt trading as one of the concepts for developing Islamic capital market instruments. This was based on the views of some of the Islamic jurists who allowed the use of this concept subject to certain conditions. In the context of the capital market, these conditions are met when there is a transparent

regulatory system which can safeguard the *maslahah* (interest) of the market participants.

1.6.2 Participating Contracts

Musharakah is a general partnership whereby two or more parties enter into a contract to exploit their labour and capital jointly and to share the profits and losses of the partnership.
Mudharabah is a contract where the owner of capital entrusts his funds to an entrepreneur who contributes skills in the business and the profits generated is to be shared between them.

There are five essential elements of Musharakah and six of Mudharabah as follows.

	Musharakah		**Mudharabah**
(i)	partners	(i)	owner(s) of capital
(ii)	capital	(ii)	entrepreneur
(iii)	business	(iii)	capital
(iv)	profit sharing and	(iv)	business
(v)	contract	(v)	profit sharing
		(vi)	contract

For Musharakah, there are 16 necessary conditions relating to its essential elements.

(1) Contract

There are three necessary conditions, i.e.:

(i) in definite and decisive language. In the present or past tense and not future tense nor imperative
(ii) acceptance must agree with offer and
(iii) offer and acceptance made at the one and the same meeting

(2) Partners must meet the following four necessary conditions:

(i) capable of taking responsibility, i.e.
- of sound mind
- have reached the age of puberty
- have reached the age of majority (18 years old)

(ii) not prohibited from dealing with their properties:
- not declared bankrupts or
- not declared prodigals

(iii) no coercion is exerted on them
(iv) capable of appointing agents and be appointed as agents.

(3) Capital

There are five necessary conditions:

(i) any asset valued in money
(ii) not debt
(iii) specific amount
(iv) from all partners
(v) paid into capital fund

(4) Business

There are two necessary conditions:

(i) halal and
(ii) managed by all the partners

(5) Profit/ Loss Sharing

There are two necessary conditions:

(i) according to proportion of shares or according to agreement in fraction, ratio or percentage, not in absolute amount.
(ii) loss born by all partners according to proportion of shares

For Mudharabah, there are 16 necessary conditions relating to its essential elements.

(1) Contract

There are three necessary conditions, i.e.:

(i) in definite and decisive language. In the present or past tense, not future tense nor imperative
(ii) acceptance must agree with offer and
(iii) offer and acceptance made at the one and the same meeting

(2) and (3)

Owner(s) of Capital and Entrepreneur must meet the following four necessary conditions:

(i) capable of taking responsibility, i.e.
- of sound mind
- have reached the age of puberty
- have reached age of majority (18 years old)

(ii) not prohibited from dealing with their properties:
- not declared bankrupts or
- not declared prodigals

(iii) no coercion is exerted on them

(iv) capable of appointing agents and be appointed as agents.

(4) Capital

There are five conditions:

(i) money only
(ii) not debt
(iii) specific amount
(iv) from owner(s) of capital only
(v) paid to entrepreneur

(5) Business

There are two necessary conditions.

(i) halal
(ii) managed by entrepreneur only

(6) Profit Sharing

The two necessary conditions are:

(i) profit shared is according to agreement in fraction, ratio or percentage, not in absolute amount.
(ii) loss is borne by owner(s) of capital only

Musharakah and Mudharabah contracts may be used by corporate as well as individuals. They may be applied in all sectors of industry i.e. agriculture, manufacturing, trading, banking, transportation and other services. In corporate sector they are used to create equity securities.

1.6.3 Supporting Contracts

Supporting contracts most often used in connection with debt financing are as follows:

(1) Rahn (pledge)

There are five essential elements of pledge as follows:

(1) Pledgor
(2) Pledgee
(3) Obligation or right to a claim (debt)
(4) Pledge (property pledged)
(5) Contract : offer and acceptance

Pledgor and Pledgee must meet three necessary conditions as follows:

(i) They must be capable of taking responsibility.
(ii) They must not be prohibited from dealing with their properties.
(iii) No coercion is exerted on them.

The obligation (debt) must:

(i) A debt must have been established.
(ii) The debt must be known.

Anything that can be bought and sold (property pledge) can be pledged and this must meet six necessary conditions as follows:

(i) It must exist (can be perceived by sense of touch).
(ii) It must be pure (halal) according to the shariah.
(iii) It must be of use according to the shariah.
- It must not be too little as to be of no use.
- It must not distract from remembering Allah.
- It must not be used for haram purposes.

(iv) It must be owned by the pledgor.
(v) It must be capable of being delivered; it must be free from encumbrances.
(vi) It must be known and specific by address, description or specification.

The two necessary conditions of contract of pledge:

(i) A pledge becomes a concluded contract by the offer and the acceptance of the pledgor and pledgee. The offer and acceptance must be absolute and in definite and decisive language.
(ii) The acceptance must agree with the offer.

Other features relating to the pledged property:

(i) One pledge may be exchanged for another.
(ii) It is lawful to increase the debt that is secured by the pledge.
(iii) One pledge can be taken as security for two different debts from two different creditors.
(iv) A borrowed property can be used as a pledge
(v) The pledgee has a right to possession of the pledge until its redemption.
(vi) A pledge does not become necessary to be returned when the debt is partly paid off. The pledgee has a right to hold it until the debt is paid in full.
(vii) It is invalid for the pledgor or pledgee to sell or pledge a pledged property without the others' consent.
(viii) The pledgor is forbidden from uplifting the pledge.
(ix) The pledgee may on his own accord, release the property from the pledge.
If on maturity of the debt and the pledgor refuses to make payment, the pledgee may apply to the court to compel the pledgor to sell the pledge in order to pay the debt. If the pledgor still refuses to make payment the court may sell the pledge to pay the debt.

(2) Dhaman (guarantee)

The term Dhaman is usually used in respect of debt (money or property) and there are five essential elements, namely:

(1) Dhamin (guarantor)
(2) Madhmun lah (creditor)
(3) Madhmun anh (debtor)
(4) Madhmun bih (debt)
(5) Contract

There are seven necessary conditions that must be met in Dhaman.

(1) Guarantor

Guarantor must meet two necessary conditions as follows:

(i) He must be capable of taking responsibility.
(ii) He must not be prohibited from dealing with his property.

(2) and (3) Creditor and Debtor

- Creditor and debtor must be known to the guarantor.

Debt

There are three necessary conditions of debt as follows:

(i) The debt must have been established and certain
(ii) It must be obligatory, i.e. an obligation on the debtor
(iii) It must be known in amount

(4) Contract

Contract must be absolute and in definite and decisive language.

(3) Wakalah (agency)

Wakalah has four essential elements as follows:

(i) Muwakkil (principal)
(ii) Wakil (agent)
(iii) Muwakkal bih (business or work for which the agent is appointed to do),
(iv) Contract

There are seven necessary conditions relating to the essential elements.

(1) and (2) Principal and Agent

There are three conditions relating to principal and agent as follows:

(i) They must be capable of taking responsibility
(ii) The principal must be competent and have the right to do in person what he authorizes his agent to do
(iii) The agent must himself be capable of doing on his own account what he is appointed to do for another

(3) Business or Work

The business or work that is to be done by the agent must meet three necessary conditions as follows:

(i) The property or right must belong to the principal
(ii) The business or work may be performed by another person
(iii) The property, right, business or work must be known

(4) Contract

There is only one necessary condition relating to contract.
- The contract must be in definite and decisive language.

Types of Agency include the property, right, business or work concerning which the agent is to perform may be general or specific. If it is specific, it must be specified in the contract. An agent may receive fees for his services.

The main duty of an agent is a safe custodian for the things that is entrusted to him before delivery to the principal or a third party.

A contract of an agent is incumbent on his principal in the following matters:

- Hibah (gift)
- Lending and borrowing
- Debt (deferred payment sale)
- Wadiah (safe custody)
- Rahn (mortgage)
- Musharakah, and
- Mudharabah

In these contracts the agent must mention that he acts on behalf of his principal.

(4) Wadiah (safe custody)

Wadiah has four essential elements, namely:

(1) Depositor
(2) Custodian
(3) Deposit, and
(4) Contract

There are four necessary conditions to the essential elements.

(1) and (2) Depositor and Custodian

- Depositor and custodian must be capable of taking responsibility.

(3) Deposit

- Deposit must meet two necessary conditions, namely:

(i) It must be capable of being managed by the custodian.
(ii) It must be capable of being stored; it must not be perishable.

(4) Contract

- It must be in definite and decisive language.

There are two types of Wadiah:

1. Wadiah Yad Amanah (trustee safe custody)
2. Wadiah Yad Dhamanah (guaranteed safe custody)

In Wadiah Yad Amanah the custodian must safeguard the deposit by these three ways:

(i) Not mixing or pooling the deposits of the different depositors under his custody
(ii) Not using the deposits; and
(iii) Not charging any fees for safe custody

If he failed in any of the above, Wadiah changes to Yad Dhamanah where he has to guarantee (return or replace) the deposits to the owners if they were lost or destroyed.

(5) Ibra' (rebate)

Ibraa' arises out of a deferred payment sale where the buyer makes an early redemption.

Ibraa' has five essential elements, namely:

(1) Creditor (seller)
(2) Debtor (buyer)
(3) Debt (deferred selling price)
(4) Ibraa' (the partial refund of money paid)
(5) Contract

(1) and (2) Creditor and Debtor

The necessary conditions of creditor and debtor are the same as those of buyer and seller in a contract of sale.

(3) Debt

The debt as the selling price must meet these two necessary conditions:

(i) Absolute in amount
(ii) Known currency

(4) Ibra'

There are two ways of dealing with Ibra', i.e:

(i) It must not be stated in absolute amount or percentage in the asset sale agreement; or
(ii) It may be stated in the Asset Sale Agreement (ASA) in an absolute amount and a known currency. When this is done there will be two prices in the contract and the seller (creditor) is entitled to the lesser of the prices only. It is then invalid and forbidden for the seller to withdraw the Ibraa'

(5) Contract
- It must be in definite and decisive language.

2.0 ISLAMIC DEPOSIT

2.1 Introduction
2.2 Savings and Current Accounts
2.3 Shariah Contract of Wadiah
2.4 The Shariah Contract of Mudharabah
2.5 Commodity Murabahah
2.6 Application of Islamic Deposit Products
2.7 Deposit Insurance System in Malaysia

2.1 INTRODUCTION

Savings account is an account maintained by a customer with a bank for the purpose of accumulating funds over a period of time. The types of account normally offered by financial institution are:

- Private individuals
- Joint Individuals
- Adult for minor's (Minor with/without I/C)
- Societies, associations and clubs

Current account is a demand deposit account, withdrawals from which may be made by a written, negotiable instrument. The types of account normally offered are:

- Private individuals
- Joint Individuals
- Companies, Sole Proprietorship
- Societies, associations and clubs
- Mandate

Fixed deposit is a deposit of funds in a bank under an agreement that the funds is kept for a stated period of time or the financial institution may require a minimum period of notification before a withdrawal is made. In Islamic banking the fixed deposit account is referred to Investment account.

The types of account offered are:

- Private individuals
- Joint Individuals
- Companies
- Societies, associations and clubs

2.2 SAVINGS AND CURRENT ACCOUNTS

According to normal practice, the customer must come personally to bank. The bank will identify him/her via his/her NRIC. For children, a trust account will be opened based on Birth Certificate.

In case of an Association, Society or Club, their respective identification documents and resolutions to open an account are required.

Customers are requested to fill in Application Form provided by the bank. The Application Form also serves as a Specimen Signature Card. It contains the Applicant's particulars.

Customers are required to complete and sign/thumb print the application form.
The bank is entitled to have its own Rules and Regulations governing all accounts as long as it is made known to the customer.

Once the customer acts inconsistently with or against the Rules and Regulations, he or she is considered to have breached the contract and the account can be closed.

Deposit into Mudharabah Savings Account can be in the form of cash, cheques or any other acceptable instruments such as drafts, money and postal orders, dividend warrants etc. The money received from the customer must be 'halal' as to satisfy the essential elements of the Shariah contract used. For instance, if the customer wants to deposit a "Winning Account" cheque issued by a gambling company, the bank should not accept it.

Cheques and any other acceptable instrument of deposits must be in the name of the Account holder.

For outstation cheques, a commission of RM0.50 or 0.03% of the amount of cheque, whichever is higher, will be deducted from the proceeds. Amount of commission is limited to a maximum of RM500.00.

To withdraw from Savings Account, the customer must come personally to the bank and produce the passbook. A standard withdrawal slip must be completed and signed (or thumb printed). For current account, the customer shall issue the cheque.

Cash withdrawals may also be made through the bank's chain of Automatic Teller Machine (ATM) by using the ATM card.
An account is stopped or frozen in the event of death, bankruptcy or insanity of the customer.

On the death of the customer, the Shariah contract is rescinded automatically. Balance outstanding, if the amount is small and the family members are well known to the branch, may be withdrawn upon proper identification with photocopy of I/C taken and the withdrawal duly authorized by the Manager.

This amount can be withdrawn by the deceased next of kin identified by his/her birth certificate/'surat nikah' or marriage certificate or any other identification document. The deceased death certification must be produced.

The account will be frozen until receipt of Letter of Administration/A Grant of Probate from beneficiary. The advance given will then be claimed back from beneficiary and the Debtor's Account be reversed accordingly.

Customers who have lost or destroyed their Passbook/ATM Card/cheque book are required to notify the bank immediately in writing. The Indemnity Form will have to be completed by the customer. The account will have to be closed and the last passbook balance will be transferred to a new account.

The account can be closed upon the request of a customer, by operation of law or at the discretion of the bank. Both parties can terminate the contract at any time.

A dormant account is defined as any account which has not been operated for a period of one year or more. This dormant Account will be considered as Unclaimed Monies if it continues to be dormant for the next six years or more. The account will then have to be closed and transferred to the registrar of Unclaimed Monies.

Under the Shariah contract although an account is left dormant, the customer is still the rightful provider of the fund. Under no circumstances is the bank or any other parties, allowed to claim or take over the ownership of the fund.

The bank is however allowed to comply with the requirements of the Unclaimed Money Act. 1965. It is not against the contracts of Shariah for the bank to transfer the balance of the account to Unclaimed Monies. Although the deposit is physically transferred, ownership of the fund is still retained by the account holder. The customers can claim the balance at any time they wish.

The bank, as the original entrepreneur (Mudaa'Al-Awal), must guarantee the fund that is transferred to another party (Mudaa' Al Thani, i.e. the Registrar of Unclaimed Money), upon any claims from customer. The bank is obliged to pay whatever amount due to customer and can later make its claim from the Registrar of Unclaimed Money, by requesting the customer to fill in the UMA7 form.

The bank will remind and inform customers accordingly of dormant accounts and the transfer to Unclaimed Monies.

For dormant accounts with minimal balance for example RM5.00 and below, the bank is allowed to take the balance as a service charge and have the account closed.

2.3 SHARIAH CONTRACT OF WADIAH

2.3.1 Introduction

Wadiah is a contract (akad) between the owner of goods and custodian of the goods. To protect the goods from being stolen, destroyed etc. In other words, the custodian is to ensure the safe custody of the goods.

There are two types of Wadiah, i.e. Wadiah Yad Amanah (trustee safe custody) and Wadiah Yad Dhamanah (guaranteed custody).

If the funds that are pooled together, being utilized and being charged for the service, the Shariah contract of Wadiah Yad Dhamanah is applied.

2.3.2 Essential elements of Wadiah

The essential elements of Wadiah are:

1. The goods
2. Owner of goods
3. Custodian of goods
4. Contract – Offer and Acceptance

Bank is not allowed to promise and the customer is not allowed to request for any return when accepting or depositing the funds. Any promise or request is equivalent to 'riba' which is strictly prohibited in Islam. However, the bank at its sole discretion may reward the customer with a certain amount of returns as a token of appreciation for depositing with the bank.

2.4 THE SHARIAH CONTRACT OF MUDHARABAH

2.4.1 Introduction to Mudharabah

Mudharabah is a contract between two parties, i.e. the owner of the capital and the entrepreneur.

The depositor, who is the owner of the capital places a specified sum of money with the Bank, (who acts as the entrepreneur) for the purpose of participating in the profits made from the utilization of the fund.

2.4.2 Categories of Mudharabah

In term of the powers / authority given to the entrepreneur, Mudharabah may be categorized into two categories -

1. Mudharabah Mutlaqah
   (Unrestricted Mudharabah)
2. Mudharabah Muqayyadah
   (Restricted Mudharabah)

2.4.3 Essential elements of Mudharabah

The essential elements of Mudharabah are:

1. The capital
2. Capital provider
3. Entrepreneur
4. Utilization of funds
5. Profit
6. Contract – Offer and acceptance

2.4.4 Conditions of Mudharabah Contracts

For investment account, the account normally operates under the contract of Mudharabah (Trustee Profit Sharing).The Bank accepts deposits from its customers who look for investment opportunities. The Bank acts as the "entreprenuer". Both parties agree with the profit distribution / sharing ratio.

The customer does not participate in the management of the funds. In the event of a loss, the customer bears all the losses. Profits generated from the use of the customers' funds will be distributed according to the predetermined ratio.

Only the distribution ratio is predetermined and not the actual amount of return. The return will only be known upon maturity or withdrawal of the investment. Profit must be distributed according to the agreed ratio and not less.

If the Mudharabah venture results in a loss, the owner of capital bears the loss entirely, i.e. the amount invested / principal amount. On the other hand, the entrepreneur does not get anything from the venture.

2.4.5 Calculation of profit

Calculation of profit is as follows:

Principal (P) X Time (T) X Rate (R)/1200

Where:

P	=	Capital by customer
T	=	Period (Month)
Rate	=	Monthly Rate of Profit

Example:

Principal	=	RM10,000-00
Tenure	=	9 months
Rate	=	4.00%p.a

Profit	=	10,000 X 9 X 4.0 / 1200
	=	300

Interim Profit is a profit given to an investment of 15 months and longer. The interim profit will normally be paid every 6 months. Profit due upon maturity will be the Total Profit less Total Interim Profit paid.

2.4.6 Options available upon maturity

Upon maturity the customer may:

1. Either come personally to the bank
2. Write a letter of instruction
3. Send a person bearing a letter of authority to renew or withdraw the deposits.

The customer is given options to:

1. Renew the principal and profit
2. Renew principal and withdraw the profit
3. Withdraw the principal and the profit

For the premature withdrawal:

1. For amount RM5,000 and above, profit will only be distributed if the investment has been made for at least 1 month; and
2. For amount less than RM5,000 and minimum RM500, profit will only be distributed if the investment has been made for at least 3 months.

2.5 COMMODITY MURABAHAH

The mechanism of commodity *murabahah* deposit involves the following transactions:

1. The customer (depositor) appoints the bank as an agent to purchase metal commodity from a metal/commodity trader A, on cash basis, in an established metal commodity market;
2. The bank will thereafter purchase the metal/commodity from the customer on a deferred sale, at a cost price plus profit margin; and
3. Next, the bank will sell back the metal/commodity to metal/commodity trader B in the metal commodity market.

   As an agent to purchase the metal/commodity on behalf of the customer, the bank receives cash from the customer, for the price of the commodity, which is deemed as deposit in the bank's account.

   As a result of transaction (2) above, the bank assumes liability (the cost price of the metal/commodity plus profit margin) to be paid to the customer, on maturity. The price of the metal/commodity purchased by metal/commodity trader A and the commodity's price when sold to metal/commodity trader B are the same.

   Resolution

   Shariah Advisory Council, Central Bank of Malaysia, in July 2005, resolved that deposit and financing products based on the concept of *tawarruq*, which is known as commodity *murabahah*, is permissible.

2.6 APPLICATION OF ISLAMIC DEPOSIT PRODUCTS

What are the differences with conventional deposits products?

- Prohibition of the 'haram' elements including interest in the products.
- Customer and bank relationship.
- Ensuring every contract applied possesses all essential elements and meets necessary conditions.

2.7 DEPOSIT INSURANCE SYSTEM IN MALAYSIA

Deposit insurance is a system that protects depositors against loss of their insured deposits placed with member institutions in the event a member institution is unable to meet its obligations to depositors. In such an event, depositors will be reimbursed immediately up to the coverage limit.

In 2001, Financial Sector Master Plan recommended the establishment of a deposit insurance system in Malaysia. Deposit Insurance Task Force was formed by Bank Negara (BNM). In designing the Malaysian deposit insurance system, Task Force studied & compared best practices of established deposit insurance systems in other countries.

Akta Perbadanan Insurans Deposit Malaysia 2005 (PIDM Act) was passed by Parliament in July 2005. Perbadanan Insurans Deposit Malaysia (PIDM) established to administer a deposit insurance system in Malaysia was launched on 1 September 2005. PIDM is a separate and independent entity from BNM.

PIDM is a statutory body that reports to the Parliament through the Ministry of Finance. Its Board members are appointed by the Minister of Finance and its composition reflects both private and public sectors:

- Chairman with relevant private sector experience
- Governor of Bank Negara Malaysia
- Secretary General of the Treasury
- 1 director from the public sector
- 3 directors from the private sector

PIDM mandate is that PIDM shall protect Islamic and conventional depositors, provide incentives for promoting sound risk management and contribute towards the stability of the financial system in Malaysia. The main functions of PIDM:

- Assess and collect premiums from member institutions
- Manage deposit insurance funds
- Undertake resolution of non-viable banks
- Reimburse depositors in the event a member institution is unable to meet its obligations to depositors
- Conduct on-going public awareness and education initiatives

PIDM administers both Islamic and conventional deposit insurance system under a single organization. PIDM member institutions are:

- Licensed commercial banks and Islamic banks
- Membership denoted by membership decal

As at 2008, the member commercial banks are:

- ABN Amro Bank Berhad
- Affin Bank Berhad
- Alliance Bank Malaysia Berhad *
- AmBank (M) Berhad
- Bangkok Bank Berhad
- Bank of America Malaysia Berhad
- Bank of China (Malaysia) Berhad
- Bank of Tokyo-Mitsubishi UFJ (Malaysia Berhad)
- CIMB Bank Berhad
- Citibank Berhad *
- Deutsche Bank (Malaysia) Berhad
- EON Bank Berhad
- Hong Leong Bank Berhad
- HSBC Bank Malaysia Berhad *
- J. P. Morgan Chase Bank Berhad
- Malayan Banking Berhad *
- OCBC Bank (Malaysia) Berhad *
- Public Bank Berhad *
- RHB Bank Berhad
- Standard Chartered Bank Malaysia Berhad *
- The Bank of Nova Scotia Berhad
- United Overseas Bank (Malaysia) Berhad

For member Islamic banks:

- Affin Islamic Bank Berhad
- Al-Rajhi Banking & Investment Corporation (Malaysia) Berhad
- AmIslamic Bank Berhad
- Asian Finance Bank Berhad
- Bank Islam Malaysia Berhad
- Bank Muamalat Malaysia Berhad
- CIMB Islamic Bank Berhad
- EONCAP Islamic Bank Berhad
- Hong Leong Islamic Bank Berhad
- Kuwait Finance House (M) Berhad
- RHB Islamic Bank Berhad

PIDM is funded by premiums paid by members. Premiums calculated was based on flat rate for 2006 and 2007 and a differentiated rate was used from 2008 onwards. Currently PIDM maintains two funds i.e.Islamic Deposit Insurance Fund and Conventional Deposit Insurance Fund. Most of its funds are invested in short term Government or BNM securities as follows:

- RM securities issued or guaranteed by the Government or BNM
- RM securities of high investment grade as rated by a reputable rating agency
- deposits with BNM or any financial institution
- any other investments as approved by the Minister of Finance, upon the recommendation of the Board of Directors of PIDM

What are covered?

- Depositors with RM deposits
- Automatic coverage – depositors do not need to apply

Among the features are:

- RM60,000 per depositor per member institution
- No purchase for additional coverage
- Separate coverage on:
  - Islamic deposits
  - Joint accounts
  - Trust accounts
  - Accounts held by sole proprietorship, partnership or professional practice

Insurable items:

✓ Savings deposits
✓ Current deposits
✓ Fixed deposits
✓ Investment deposits
✓ Banker's cheques, bank drafts & other payment instructions
✓ Other instruments as may be approved
✓ Resident & non-resident individuals & businesses

Items not insured:

x Deposits not payable in Malaysia
x FX deposits
x Money market deposits
x Negotiable instruments of deposits & other bearer deposits
x Repurchase agreements
x Other specified financial instruments

Illustration 1: Individual account

Owner	Type of Account	Amount (RM)
Ahmad	Savings	50,000
	Current	30,000
	Fixed deposit	30,000
	Total deposits	110,000
	Insured	**60,000**

Illustration 2: Conventional and Islamic accounts

Owner	Type of Account	Amount (RM)	Insured (RM)
Zuraidah	Conventional savings	30,000	
	Conventional current	50,000	
	Total conventional	80,000	**60,000**
	Islamic savings	70,000	
	Total Islamic	70,000	**60,000**
	Total deposits	150,000	**120,000**

Illustration 3: Joint account

Owner	Type of Account	Amount (RM)	Insured (RM)
Ali	Conventional savings	50,000	50,000
Ali & Wife	Conventional savings	40,000	
	Conventional current	40,000	60,000
Ali, Wife & Son	Conventional savings	100,000	60,000
Ali, Wife & Daughter	Conventional savings	80,000	60,000

Illustration 4: Sole Proprietorship, Partnership and Professional Practice

Owner	Type of Deposit	Amount (RM)	Insured (RM)
Leong	Savings	100,000	**60,000**
Leong, Rashid & Co (legal firm)	Current	80,000	**60,000**
Leong Trading	Current	30,000	**30,000**

Illustration 5: Trust Account

Account	Beneficiary	Amount (RM)	Insured (RM)
1 Hanim as trustee	Son	100,000	**60,000**
2 Hanim as trustee	Daughter	80,000	**60,000**

Illustration 6: Different trustees for same beneficiary

Account	Trustee	Beneficiary	Amount (RM)	Insured (RM)
1	Ramli & Co	Abu Ismail	100,000	**60,000**
2	Chew & Co	Abu Ismail	80,000	**60,000**
3	Gopal & Co	Abu Ismail	70,000	**60,000**

Illustration 7: Same trustee for different beneficiaries

Account	Trustee	Beneficiaries	Amount (RM)	Insured (RM)
1	Ramli & Co	Not disclosed	300,000	60,000

Illustration 8: Same trustee for different beneficiaries

Trustee	Beneficiary Code	Amount (RM)	Insured (RM)
Ramli & Co	#100	60,000	**60,000**
	#101	40,000	**40,000**
	#102	100,000	**60,000**
	#103	20,000	**20,000**
	#104	80,000	**60,000**

Illustration 9: Different branches of same member institution

Branch	Trustee	Beneficiary	Amount (RM)
A	Ramli & Co	Not disclosed	300,000
B	Ramli & Co	Not disclosed	50,000
C	Ramli & Co	Not disclosed	60,000
	Total deposits		410,000
	Insured		**60,000**

The obligatory payment upon the winding-up order of a member institution should not be later than 3 months. It is discretionary payments with MOF approval. Payments are done of Islamic and conventional insured deposits from Islamic or Conventional Deposit Insurance Fund respectively. The payment to **insured** depositors based on information obtained from member institution's records. As such, there is no need for depositors to file claims. The depositors are to file claims only for the **uninsured** deposits i.e. with liquidator.

Obligatory payment is made when a **winding-up order** is served to a member institution. PIDM is to pay depositors as soon as possible and **no longer than 3 months** from the date of the winding-up order.

Under *Section 56 of the MDIC Act*, discretionary payment is to be made if:

(i) Member institution is unable to make payment of insured deposits due to:
   (a) a court order;
   (b) action taken by a regulatory body or PIDM; or
   (c) action taken by the receiver and manager

(ii) A petition for winding-up presented to the court against the member institution;

(iii) Membership of the member institution is cancelled or terminated

Islamic Deposit Insurance operation:

- Based on Shariah principles & equal treatment between Islamic & conventional deposits
- Funded by premiums collected from Islamic banking institutions based on total insured Islamic deposits
- Based on concepts of *kafalah* (guarantee) and *tabarru* (donation)
- Islamic deposits are aggregated separately from conventional deposits for deposit insurance purposes
- Islamic deposits are covered separately from conventional deposits, up to RM60,000 per depositor per member institution
- Islamic Deposit Insurance Fund is managed separately and invested in accordance with Shariah principles
- Payments in the event of failure are separated & there is no transfer of funds between Islamic Fund and Conventional Fund
- PIDM can raise funds from the Government in accordance with Shariah principles

To sum up, deposit insurance protects depositors from the loss of their insured deposits in the event a member institution is unable to meet its obligations. Deposit insurance contributes to stability of the financial system. Its coverage limit is up to RM60,000. Islamic and conventional accounts are separately covered by the insurance scheme. There is separate coverage for individual, joint and trust accounts as well as for sole proprietorship, partnership and professional accounts.

3.0 ISLAMIC FINNACING FACILITIES

3.1 Human Need for Banking Services
3.2 Application of Muamalat Contracts
3.3 Essential Elements and Necessary Conditions in Contract
3.4 Asset Based Financing
3.5 Equity Based Financing
3.6 Supporting Contracts

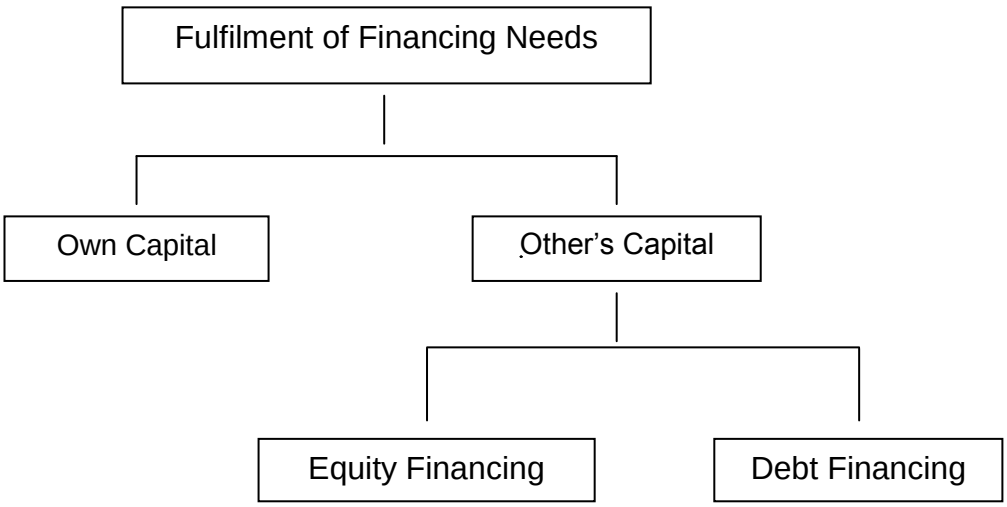
3.1 HUMAN NEED FOR BANKING SERVICES

The evolution in banking and financial services depends on the ever changing needs of the society. Banking and financial institutions emerged and endured to meet the human needs and this keeps on changing. Some old needs may fade away and others may be overtaken by more sophisticated ones. Some may have to be remodeled in order to remain relevant to the needs of society.

There are various types of banking and financial needs but our focus here would be the financing needs i.e. the need of an economic unit for fund or capital to carry out and economic activities. The economic unit can be a household, a firm or a government and the economic activities can be in relation to production, distribution or consumption.

3.1.1 Fulfilment of Financing Needs

The fulfillment of the financing needs can be visualized as follows:



3.1.2 Fulfilling External Financing Needs

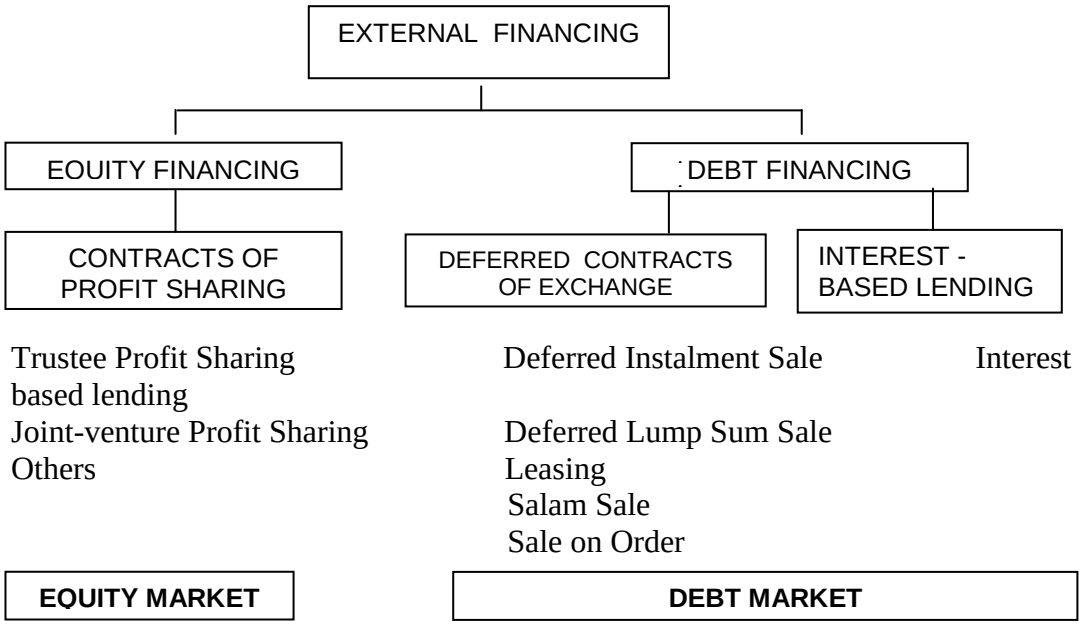
For our purpose, we shall only discuss on fulfilment of financing needs using Other's Capital. Other's Capital or External Fund emerged largely to cater human financing needs. They are in forms of Equity Financing and Debt Financing. It is considered a human nature or *fitrah* for fulfillment of behavioural financing need in either form. Equity Financing under the modern financial system can be in a form of operation whereby two or more parties pool their capital to carry out a required business or project.

On the other hand, Debt Financing can take many forms in fulfilling the financing needs of economic units. They can be as follows:

- Consumer financing
- Domestic trade financing
- International trade financing
- Corporate financing
- International financing
- Government financial operations

Sometimes, the external financing needs can be met by the combination of equity and debt financing. In all financing types, there will be modes of contract, instruments, securities and institutions involved. Hence the existence of two distinct but related markets side by side in the banking and financial system. From the Islamic perspective, this can be illustrated as follows:

Conceptual Framework Of Financing Needs



3.1.3 Various Debt Contracts

The Contracts of Partnership or *Uqud al-Ishtirak* involves contracts such as *Mudharabah* (trustee profit sharing) and *Musharakah* (joint venture profit and loss sharing). As for debt financing, it can either be in the form of *uqud al-muawadhat* (deferred contracts of exchange) and *qard al-hassan* (interest-free loan) which are allowed or interest-based lending which is prohibited. The deferred contracts of exchange include sale contracts such as *bai' bithaman ajil* (deferred instalment sale), *bai' al-murabahah*(deferred lump sum sale), *bai' al-salam* (salam sale), *bai' al-Istisna'* (sale on order) and *ijarah* (leasing).

The interest-fee loan or benevolent loan although rarely used is still being provided by banks at albeit on limited scale. This concept is more applicable for social-welfare sector of the economy involving the government rather than the commercial sector such as banking. As for interest-based lending which is the dominant feature in the conventional banking, Islamic banking should be totally free from it. Islam does not deny that capital, as a factor of production, deserves to be rewarded. However, investors in the Islamic banking have no right to demand a fixed rate of return since the surplus on the capital is uncertain. No one is entitled to any addition to the principal sum if he does not share in the risks involved. Islamic banking provides the avenue for sharing of profit between depositor and bank on one hand and the bank and financing customer on the other.

3.2 APPLICATION OF MUAMALAT CONTRACTS

3.2.1 Permissible Muamalat Contracts

After taking out the types of muamalat (transactions) that are prohibited, those that are permitted can be divided into three broad categories as follows:

- **Trading Contracts**

Trading contracts could be cash term or deferred payment term. For trading contracts based on cash term, there are few contracts which are allowed by Shariah, but strictly limited to cash term only;

a) Trading Contract - Cash Term Only:

i. Bai Sarf

Bai Sarf is Foreign Currency Exchange or any exchange of Ribawi items of different types in the same category such as an exchange between silver with gold, gold with money, USD with MYR, and so on.
In this type of transaction, the exchange must be made . at the one and the same meeting. If trading of this Foreign Currency is not made on the cash term, then riba Nasiah. occurs.

ii. Bai Salam

Bai salam is a sale by order whereby, the payment is made on cash term but the delivery of the asset sold is deferred to a specified time in the future.

iii. Bai Dayn

Bai dayn is defined as trading (buying and selling) of a debt whereby the debt traded is the price of an asset or a service, the payment of which is deferred to a specified time. The seller of the debt may be the original creditor or a third person who has bought the debt from the original creditor. The purchaser also may be a third person or the original debtor himself, that is the debtor settling his debt.

The debt which is purchased or sold must arise out of a trading transaction of a merchandise or asset that meets the necessary conditions for a valid sale and it must have been received by the purchaser. The debt must not arise out of trading transaction of a ribawi material under the category of medium of exchange such as gold, silver, foreign currencies and others. For service charges, it must arise out of the provision of a halal (permissible) service and the service must have been rendered. This debt trading as said earlier must be conducted on cash term to avoid riba Nasiah.

b) Trading Contract - Deferred payment sale:

i. Bai Murabahah

Murabahah is cost plus sale. In this type of transaction, the bank purchases and takes title to a merchandise or goods from the seller. This purchase can be done either directly or through an agent and may use its own funds or those of its customers. The bank then sells the merchandise or goods to its customer at cost plus a reasonable profit. Deferred payment terms may be agreed and the arrangement may be secured.

ii. Bai Bithaman Ajil

Bai Bithaman Ajil means deferred installment. sale, that is the sale of good on deferred installment basis at a price which includes a profit margin agreed by both parties. Under. this contract, the bank will purchase the asset concerned and then resell the asset to the customer at an agreed price. The price will take into account the cost of the asset and the profit margin earned by the bank.

iii. Bai Istisna’

Istisna’ is a sale by order contract whereby the bank funds the supplier for completion/delivery of the projects or equipments ordered by customers. Bank first purchases the project or equipment and immediately sells it to the purchaser on an agreed deferred payment term.

iv. Bai lstijrar

lstijrar is a wholesale contract or supply of goods to business outlets on regular basis i.e. daily, weekly or monthly basis but the price of the goods is based on

the price prevailing at the last supply date i.e. without establishing sale price at the time of akad or contract.

v. Ijarah

Sometimes known as Kira' which is rent or fee. It means selling of benefit or usage or services for a price or rental. Example of benefit and services is staying in a house or driving a vehicle and employing people to do office cleaning services.

vi. Bai Inah

Bai lnah is a contract to sell an asset to a customer on deferred payment term and repurchase the same asset on cash term.

- **Profit Sharing Contracts**

There are four main profit sharing contracts which are widely used:

i. Musharakah

A partnership contract between two or more individuals or bodies, each contributes capital, and profit or loss is shared between the partners. Musharakah is better known as Sharikat which is described as an accumulation of capital by shareholders to finance a particular project and the profit from the project is distributed based on an agreed ratio or based on shareholding if there is no agreed ratio. If the project incurs losses then they are to be borne by the shareholders according to their shareholdings.

ii. Mudharabah

Mudharabah is a joint venture between a owner of capital and an entrepreneur who provides the expertise. Any profit generated from the project is to be shared by both parties according to the agreed ratio and any loss incurred is to be borne by capital providers only.

iii. Muzaraah

Muzaraah is a leasing contract of land. Like mudharabah, it is a trustee profit sharing between the capital provider and the entrepreneur. But in the case of Muzaraah, the capital provided is both the land and the money. Muzaraah contracts normally involve agricultural-based projects only.

iv. Musaqat

Musaqat is watering of orchard contract. It is similar to Muzaraah but the entrepreneur involves in watering of orchard projects only.

- **Other Supporting Contracts**

The Shariah also permits contracts to support and facilitate trading and mobilisation of capital. They are:

i. Rahnu

It is a mortgage in the form of an asset. Among characteristics of rahnu are; sale of mortgaged property is invalid, mortgaged property can be sold by court order to pay for the debt which it is mortgaged. The balance, if any, after payment of debt is to be returned to chargor.

ii. Kafalah

It is a guarantee by a person or corporate body.

iii. Wakalah

Wakalah is an agency contract whereby the agent must mention the principal in the following transactions; hibah, lending and borrowing, deferred payment sale, wadiah, rahnu, musharakah and mudharabah.

iv. Wadiah

Wadiah is a safe custody contract There are two forms of wadiah; Yad Arnanah (Trustee Safe Custody) and Yad Dhamanah(Guaranteed Safe custody). Originally Wadiah is of Yad Amanah where the custodian has the duty to protect the property by not mixing or pooling the properties or money under his custody, not using the properties and not charging any fees for safe custody. If he failed any of the above, Wadiah changes to Yad Dhamanah where he has to return (replace) the properties to the owners if they were lost or destroyed.

v. Hiwalah

Hiwalah is a debt transfer contract. In Hiwalah, the debt is transferred in full amount and at maturity.

vi. Ibra'

Ibra' is a release contract where a creditor lets go of his right to a debt. Normally it is granted in lieu of an early settlement of a debt. Two of the most important characteristics of ibra' are;

(i) the amount of ibra' must be known and specified and
(ii) when the ibra' has been given and accepted it is forbidden and invalid for the party who gives it to withdraw it.

3.3 ESSENTIAL ELEMENTS AND NECESSARY CONDITIONS IN CONTRACT

To ensure a permissible contract valid, it must have essential elements and each essential element must meet the necessary conditions.

3.3.1 Contract of Sale

The essential elements and the necessary conditions in a contract of sale are:

i. Contract : Offer and Acceptance

- In definite and decisive language and absolute. (The Majelle — Majallah al-Ahkam al-Adliyah —complete code of Islamic Civil Law, provides as follows:

  Art. I69: For the offer and acceptance the past tense is generally used.

  Art. I7O: By aourist tense like "Alirim and Satarim" if the present tense is meant, the sale is concluded, and if the future is meant, the sale is not completed.

  Art. l7l:A sale is not concluded by words in the future tense, such as "I will take", "I will sell" which means a mere promise.

  Art. 172: A sale is also not concluded by words in the imprative tense, such as "sell", "buy". But a sale is concluded by an imperatie which of necessity indicates the present.

- The acceptance must agree with the offer.
  (Mjl.ArL177: If one of the contracting parties make an offer for something in any manner whatsoever, the other party must make the acceptance of it, so as exactly to correspond with the offer. (He has no right to separate either the price or the subject matter of the sale).

- The contract must be made at the one and the same meeting.
  (Mjl.Art.183: After the offer and before the acceptance, if one of the two parties gives an indication of dissent, whether by word or act, the offer becomes void, and there is no longer room for an acceptance.

  Art. 185: On new offer being made before acceptance, the first offer becomes void, and consideration is paid to the second offer.

ii. The Thing Sold

- It must exist
  (MjI.ArLI77: The existence of the thing sold is necessary)

- The thing sold must be capable of being delivered.
  (Mjl.Ar1198: It is necessary that the delivery of the thing sold be possible).

- The thing sold must be of value, and . it must be of pure substance.
  (MjLArLI99: It is necessary that the thing sold should be "mal mutaqawwim".

  Art.126: Mal is a thing which is naturally desired by man, and can be stored for use in time of necessity.

  Art. I27: Mal Mutaqawwim is a thing the benefit of which is permissible by law to enjoy.

- The thing sold must be known.
  (MjI.ArL200: It is necessary that the thing sold should be known to buyer.

  Art. 2OI: The thing sold becomes known by a description of its qualities and state, which will distinguish it from other things).

- The thing sold must be owned by the seller.
  (Mjl.Art.365: ln order that a sale may be "nafiz", it is a condition that the seller should be the owner of the property sold, or agent, or natural or appointed guardian of the owner of the property, and that there should be no right in any one else).

iii. The Price

- It must be known in currency and the absolute amount.
  (Mjl.Art237: It is necessary that the price should be known at the time of the sale.

  Art 238: It is necessary that the price should be known.

  Art.239 : The knowledge of the price comes by a statement of its description and amount if it does not come by seeing it when it is shown).

iv. The Seller

v. The Buyer

- The two parties to the contract must be capable of taking responsibility.
  (Mjl.Art.361: in the making of the sale, there is a condition, that the essence of the contract, should emanate from intelligent persons, that is to say, from reasonable persons, who possess judgement, and that they should attach to a subject of sale, which admits of the consequences of a sale.

Art. 957: Infants, madmen and people of unsound mind are of themselves prohibited from dealing with their property).

- The two parties to the contract must not be prohibited from dealing with their property, that is they must not be bankrupts and prodigals(safih).
  (MjlArt.958: a person who is prodigal can be prohibited by the judge.

  Art.959: A debtor also, on the application of his creditors, can be prohibited from dealing with his property by the judge).

- There is no coercion or compulsion exerted on either of the two parties to the contract.
  (Mjl.Art.949: "lkrah" is of two sorts. The first sort is "ikrah mulgi". lt leads to destruction of life in loss of a limb or one of them. It is the compulsion, which is by a hard blow. The second sort is "ikrah ghair mulgi". This causes only grief and pain. It is compulsion which is by things like a blow or imprisonment)

  Art.1006: When they (transactions take place in consequence of compulsion which is taken into consideration, an exchange of property, and a purchase, and a letting, and a conveyance, and a compromise about property, and an admission, and a postphonement of a debt and causing of a right of pre-emption to cease, are not held good, whether the compulsion be "mulgi" or "ghair mulgi". But if the person compelled give his consent after the compulsion has ceased, in that case they are held good).

3.3.2 Contract of Leasing

The essential elements are:

i. Lessor
   (The necessary conditions are the same as those for buyer seller in the contract of sale).

ii. Lessee
   (The necessary conditions are the same as those for buyer and seller).

iii. Contract
   The necessary conditions are:

- In definite and decisive language.
  (MjI.Art443: Like sale, letting becomes a concluded contract by a proposal and acceptance.

  Art.435: Hiring like sale becomes concluded contract by the past tense, it does not become a concluded contract by the future tense).

- Acceptance must agree with offer.

- Offer and acceptance must be made at the same meeting.
  (MjI.Art.445: As in sales, so also in making a contract of hire, the agreement of the proposal with the acceptance, and the unity of the meeting for making the contract is a condition).

iv. Asset

- Belongs to lessor.
  (Mjl.Art.446 : The letter who makes a contract of letting must be the absolute owner of the thing, or the agent of the owner, or his natural or legal guardian).

- Specified and known.
  (Mjl.Art.449: the designation of the thing given for rent is necessary. Therefore, if a letter be made of one of two shops, without giving the choice or designating one of them, the letting is not valid).

- Delivered to lesse
  (Mjl.Art.474: In case there is a condition for a deferred payment of the hire, it becomes necessary for the lessor to make delivery of the thing hired ,.... first. The payment of the hire is only necessary on the expiration of the time of the payment agreed upon.

  Art.475: When there is a hiring without condition for payment in advance on afterwards,...the delivery of the thing let by the letter. . . must be made first.

  Art.582: The delivery of the thing hired to the person who hires it, is the giving of leave and permission by the letter, in a way that the hirer can derive benefit from it without hindrance.

  Art.583: When a good contract of hiring has been made for a time or distance, it is necessary that delivery be made to the hirer, for the thing to remain constantly and continuously in his possession, until the completion of the distance on the end of the time.

  Art.478: If the benefit from the thing hired ceases to exist, then the rent becomes no longer payable).

v. Benefit

It must meet the necessary conditions:

It can be fixed in value.

- The lessor has the power and capability to use and lease the asset

- The benefit must be permissible.

- It is known
  (Mjl.Art.451: In a contract of hire, it is necessary to make known the use to which the thing hired is to be put, in such a way as to put a stop to dispute.

  Art.452: As regards things like houses, shops, and a wet nurse, the benefit is known by a statement of the time of the hiring.

  Art.454: When land (Arazi) is taken on rent, together with the time fixed, it is necessary to say for what business it has been hired, and if it is for agriculture, to fix what will be sown, or to make it general, saying for sowing whatever the hirer wishes.

  Art.457: It is a condition that the benefit must be able to be received.

- The benefit must not be in the form of any material thing.

vi. Rental

Its necessary condition is that:

- lt must be known.
  (Mjl.Art.450: It is a condition that the rent be known

  Art.464: If the consideration for the letting is cash, it is known by fixing its quantity — like a price of a thing sold.

  Art.465: If the consideration (bedel) for the letting is composed of merchandise (Aruz) or the thing measured (Mekilat) or things weighed (Meozunat) or things numbered which are alike (Adediat Muteqarribe) it is necessary to declare the description as well as the quantity.

  Art.477: As regards, the obligation to pay the hire, it is a condition that the thing hired should be delivered, that is to say, the rent is considered to run from the time of delivery).

3.3.3 Bal Inah

Bai lnah must meet the following requirements:

i. There must be two separate contracts properly executed. First The contract of sale by bank to customer on deferred payment term. Second the contract of repurchase by bank from customer on cash term.

ii The merchandise or the asset must not be a ribawi material in the medium of exchange category (gold, silver or currency) because all payments for purchases are made in money.

iii Each of the two contracts must have the essential elements and each of the essential element must meet the necessary conditions.

3.3.4 Bai Dayn

The requirements of Shariah concerning Bai dayn are:

i. A debt must have been created through a contract of deferred payment sale of goods or service.

ii. The goods must have been delivered or the service must have been rendered.

iii. The trading of the debt must be on cash term.

3.3.5 Mudharabah

The essential elements and necessary conditions of Mudharabah are:

i. Owner of capital (Conditions are similar to buyer and seller)

ii. Entrepreneur (Conditions are similar to buyer and seller)

iii. Capital

- Money only (not debt)
- Specific amount
- Paid to entrepreneur
- From owner of capital only

iv. Business .

- Halal
- Managed by entrepreneur

v. Profit Sharing

- Profit shared according to agreement in fraction, ratio or percentage, not in absolute amount.
- Loss borne by owner of capital only

vi. Contract .

- In definite and decisive language
- Acceptance must agree with offer
- Offer and acceptance made at the one and same meeting

Other Characteristics:

- Based on trust of owner of capital in entrepreneur
- Capital cannot be used for overheads
- Sharing of profits at gross
- Profits shared after realisation.

3.3.6 Musharakah

Essential elements as follows:

i. Shareholders (Conditions are similar to seller and buyer)

ii. Capital
- Cash or other goods can be valued with cash
- Pooled together and owned by business entity
- Shareholder can transfer his capital to others

iii. Project

- Halal
- Managed by business entity

iv. Profit

- Profit sharing to be determined at the time of contract
- Profit sharing can be determined using the percentage of shareholding or any other ratio.
- Any loss incurred is to be borne by shareholders according to their shares.

v. Contract (Conditions similar to Mudharabah)

3.4 ASSET BASED FINANCING

3.4.1 Overview

The financing activities of the Islamic banking system grew further in 2004; approximately 75 percent of the financing is in assets based financing categories. Bai Bithaman Ajil concept remained dominant, constituting 49.9 percent of total financing while Ijarah constituted 24 percent. Other types of assets based financing are Murabahah, Bai Istisna' and Bai Inah. The main difference between this type of financing and conventional credit is the trading activities i.e. asset based in order make the contract valid.

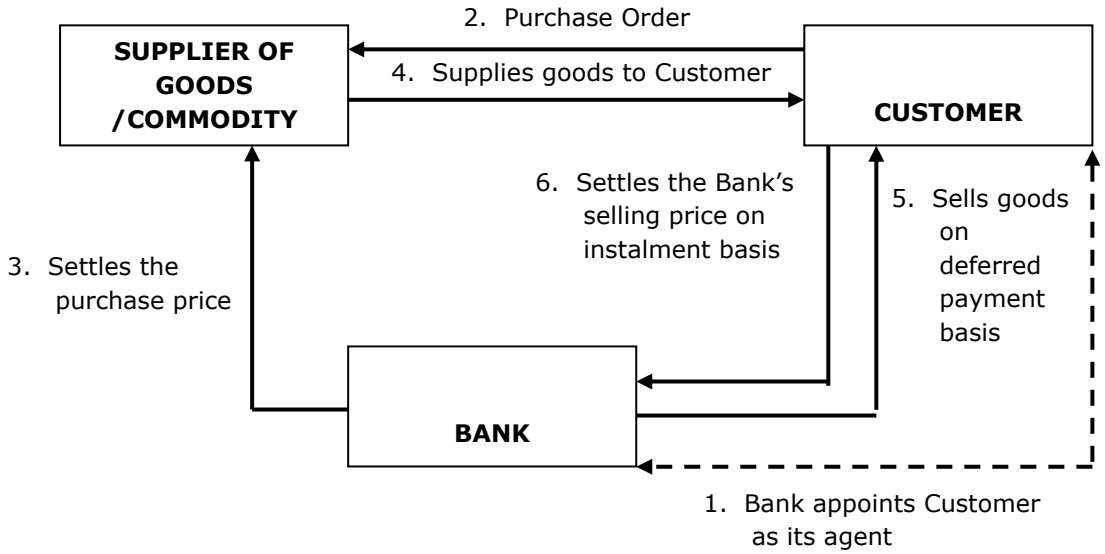
3.4.2 Murabahah (Cost Plus)

Definition

Technically, it is a sale of commodity for the price at which the seller has purchased it, with the addition of stated profit known to both the buyer and seller.

1. Cost price is known
2. Profit is known

Modus Operandi



1. The Customer identifies the goods and requests the Bank to purchase the goods. The Bank appoints the Customer as its agent to purchase the required goods on its behalf.
2. Customer purchases the goods from the Supplier on behalf of the Bank.
3. The Bank settles the purchase price.
4. Supplier supplies the goods to Customer.
5. The Bank sells the goods to Customer at a price comprising of cost and profit margin known as selling price on deferred payment basis.
6. The Customer settles the Bank's selling price.

Checklist

1. Essential Elements

- Buyer
- Seller
- Object of Contract / Merchandise
- Price
- Contract (Offer and Acceptance)

***2.* Necessary Conditions**

Buyer & Seller

- Capable of accepting responsibilities
- Of sound mind.
- Attains the age of puberty (matured).
- Intelligent.
- Not restricted from dealing in business transactions
- Not a bankrupt.
- Not a "safih" (prodigal/an extremely extravagant person)
- Not being forced to enter into a contract

Object of Contract / Merchandise

- Must be in existence at the time of sale.
- The seller must own the object of sale and it is in his/her possession when the transaction takes place.
- The object of sale must be a property of value and of pure substance (halal).
- The delivery of the object of sale must be certain and is not by chance.
- The object of sale is known to the seller and buyer.

Price

- The price must be made known to the buyer and the type of currency is specified.
- The cost price and the profit margin must be made known to the buyer. The mere mention of the total selling price is not sufficient.
- The original price is fungible (*mithli*).
- The price must be determined and agreed by both parties.
- A deferred payment sale is allowable provided that:
  - The tenor or period of payment is specified.
  - The tenor would be effective from the date the object/merchandise is delivered to the buyer.

Contract (Offer & Acceptance)

- In definite and decisive language.
- Acceptance must be consistent with the offer made by the seller.
- Offer and acceptance must be made at the one and the same meeting.

Application

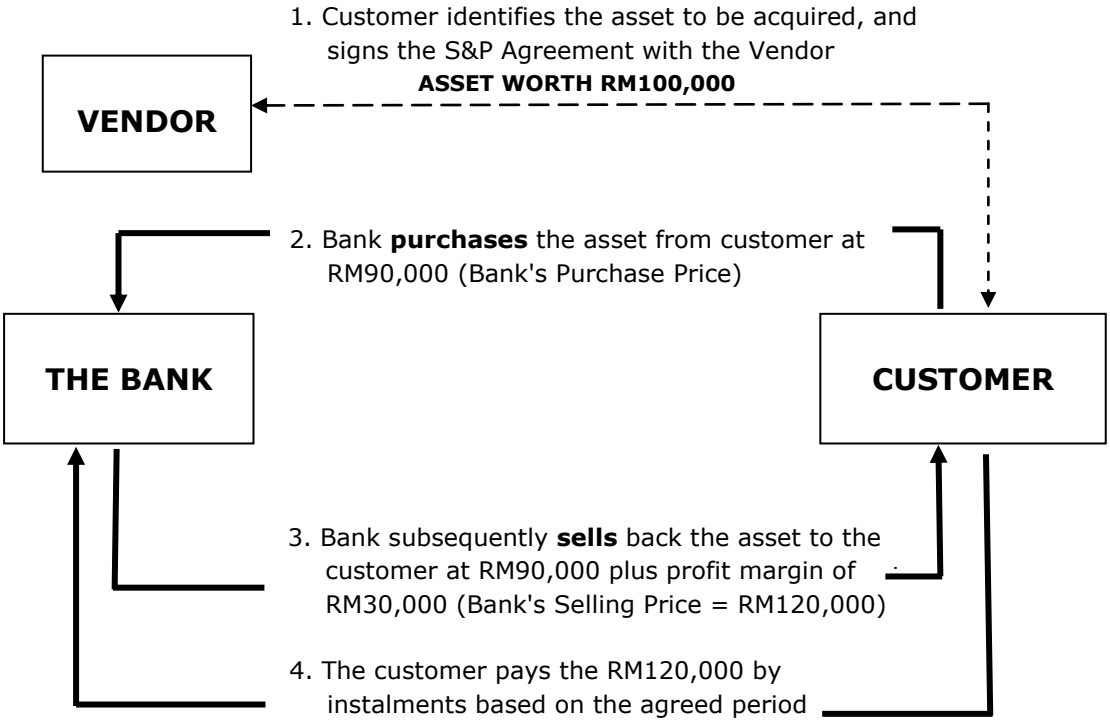
- Murabahah Working Capital Requirement
- Murabahah Letter of Credit
- Murabahah Trust Receipt
- Murabahah Bankers Acceptance
- Murabahah Securitisation
- Murabahah Islamic Card (Debit Card vs. Credit Card vs. Charge Card e.g. Jordan Purchasing Card)

3.4.3 Bai Bithaman Ajil (BBA), (Deferred Payment Sale)

Definition

It refers to the manner of payment – deferred payment sale. Also known as Bai Muajjal or Bai Taqsit.
Technically, it is a sale of commodity on deferred payment basis whether on the basis of lump sum or instalments. It applies to both *musawamah* and *murabahah* sales.

Modus Operandi



1. Customer identifies the asset to be acquired, and purchase the asset by signing the S&P Agreement with the Vendor.
2. The Bank then **purchases** the asset from Customer at RM90,000 (Bank's Purchase Price)
3. Bank subsequently **sells** back the asset to the Customer at RM90,000 plus profit margin of RM30,000 (Bank's Selling Price = RM120,000)
4. The customer pays the RM120,000 by instalments based on the agreed period

Checklist

1. **Essential Elements**
   - Buyer
   - Seller
   - Object of Contract / Merchandise
   - Price
   - Contract of Offer and Acceptance (Aqad)

2. **Necessary Conditions**

Buyer & Seller

- Capable of accepting responsibilities
- Of sound mind.
- Attains the age of puberty* (matured).
- Intelligent.
- Not restricted from dealing in business transactions
  - Not a bankrupt.
  - Not a "safih" (an extremely extravagant person)
- Not being forced to enter into a contract

Object of Contract / Merchandise

- Must be in existence at the time of sale.
- The seller must own the object of sale and it is in his/her possession when the transaction takes place.
- The object of sale must be a property of value and of pure substance (halal).
- The delivery of the object of sale must be certain and is not by chance.
- The object of sale is known to the seller and buyer.

Price

- The price must be made known to the buyer and the type of currency is specified.
- The price must be determined and agreed by both parties.
- A deferred payment sale is allowable provided that:
  - The tenor or period of payment is specified.
  - The tenor would be effective from the date the object/merchandise is delivered to the buyer.

Contract of Offer and Acceptance (Aqad)

- In definite and decisive language.
- Acceptance must be consistent with the offer made by the seller.
- Offer and acceptance must be made at the one and the same meeting.

Application

Financing a customer to purchase commodities:- houses, shop houses, land, motor vehicles, consumer goods, shares, education packages and other asset-based financing activities.

Refinancing of assets for the purpose of redemption, construction, renovation, project financing, bridging facilities, end-financing, contract financing etc.

BBA Securitisation.

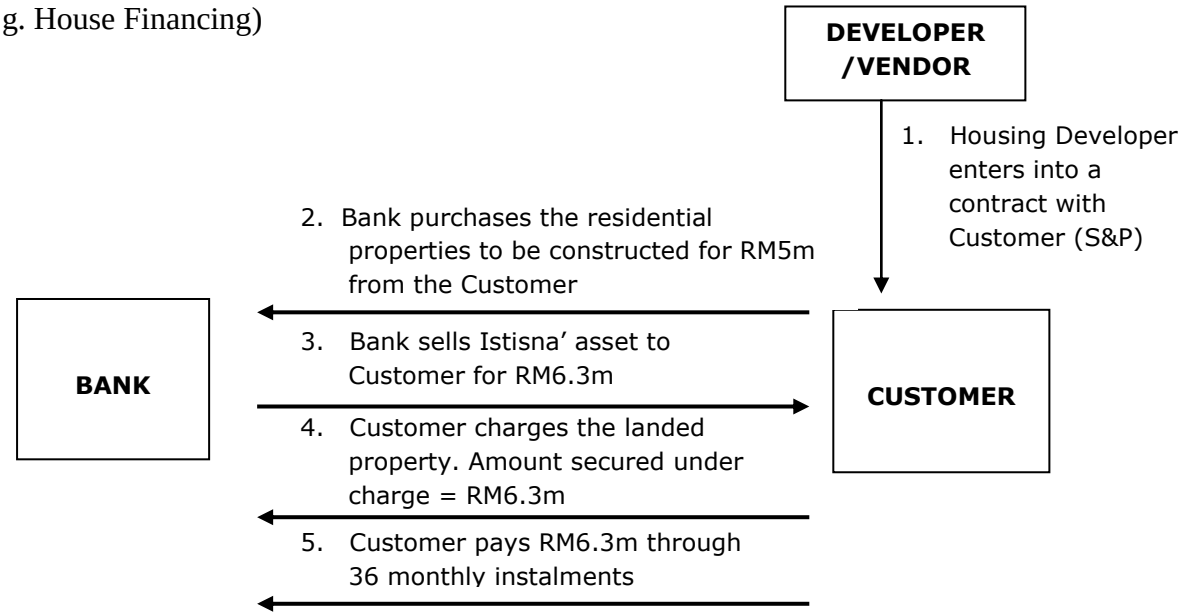
3.4.4 Bai Istisna' (Sale by Order)

Definition

Istisna' means sale on order i.e. the sale of goods by way of ordering where the price is paid in advance or progressively but the assets are manufactured and delivered at a later specified/defined date.
In other words it is a contract where the commodity exchanged against price is delivered immediately or paid in instalments, whilst the commodity is to be being manufactured and delivered at a later specified/defined date.

Modus Operandi

ISTISNA' FINANCING
(e.g. House Financing)



1. Housing Developer enters into a contract with Customer to construct residential properties.

2. Bank enters into Istisna' contract in the capacity of a seller to Customer who demand a purchase of a house. The Bank draws a parallel Istisna' contract in the capacity of a buyer with another party (Developer) to construct a house as agreed upon in the first contract.

It should be noted here conceptually in Istisna' financing, it is not necessary to have the Bank and the Customer in the above described form of transaction. It can also be in the form where the Bank purchases the residential to be constructed directly from the vendor or through the Customer as the Bank's agent and subsequently the Bank sells the subject to the Customer on the basis of parallel Istisna'.

Checklist

1. Essential Elements

- Buyer
- Seller
- Object of Contract / Merchandise
- Price
- Contract (Offer & Acceptance)

2. Necessary Conditions

Buyer & Seller

- Capable of accepting responsibilities.
- Not restricted from dealing in business transaction.
- Not forced to enter into a contract.

Object of Contract / Merchandise

- To be delivered according to the specification, otherwise the purchaser has the option to terminate the contract.
- Raw materials must be provided by the manufacturer.
- Cannot be a ribawi material.

Price

- Must be determined at the point of contract.
- Must be specified in terms of currency.

Contract (Offer & Acceptance)

- To order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods, the transaction of Istisna' comes into existence.
- Must be done in a definite and decisive language.
- Acceptance must be in consistent with the offer made by the seller.
- Offer and acceptance must be made at the one and the same meeting.

Application

Financing to construct a house, fixed asset

Project financing, property financing, syndicated financing

3.4.5 Bai Inah (Cash Facility)

Definition

A sale in order to get cash, not property or a sale in which a commodity is sold for a deferred payment (*thaman mu' ajjal*) and then resold to the seller on cash basis (which is cheaper than deferred payment price). The owner of the commodity will get the commodity back plus the payment which is deferred whilst the customer will get 'cash' and settle the payment obligation on instalment basis.

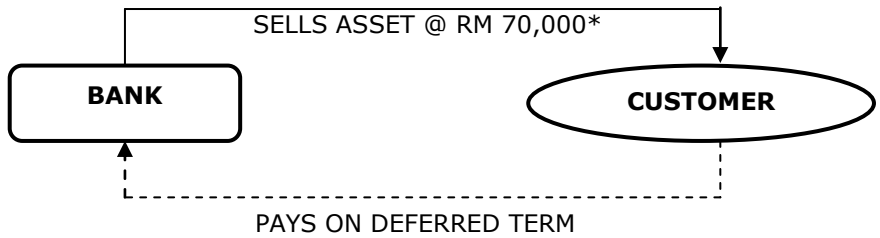
Modus Operandi

There are two contracts involved:

1. Contract of Sale

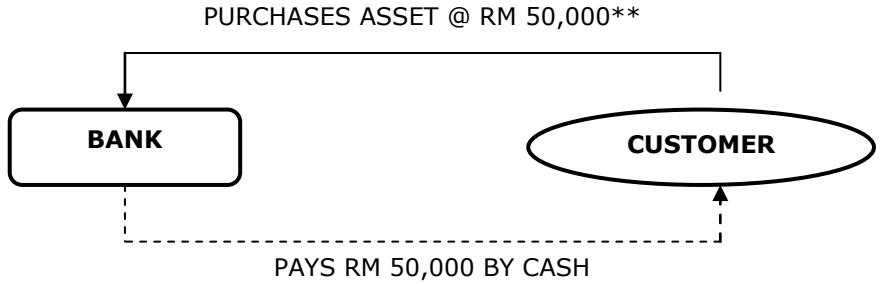
2. Contract of Purchase

1st Contract : Bank sells certain asset to a customer on deferred term.



**RM 70,000 = Financing amount + profit margin = Bank' selling*

2nd Contract : Bank subsequently purchases the asset back from the customer on cash basis.



***RM 50,000 = Financing amount = amount of cash needed by the customer*

Checklist

1. Essential Elements

- Buyer
- Seller
- Object of Contract / Merchandise
- Price
- Contract (Offer & Acceptance)

2. Necessary Conditions

Buyer & Seller

- Capable of accepting responsibilities.
- Not restricted from dealing in business transaction.
- Not forced to enter into a contract.

Object of Contract / Merchandise

- Must be in existence at the time of contract.
- Can be delivered.
- Halal and valuable.
- Owned by the seller.
- Known to the seller and buyer.
- Cannot be a ribawi material.

Price

- Must be determined at the point of contract.
- Must be specified in terms of currency.

Contract (Offer & Acceptance)

- Must be done in a definite and decisive language.
- Acceptance must be in consistent with the offer made by the seller.
- Offer and acceptance must be made at the one and the same meeting.

Application

Personal financing facility for own consumption

Refinancing of asset/commodities

Islamic debit card

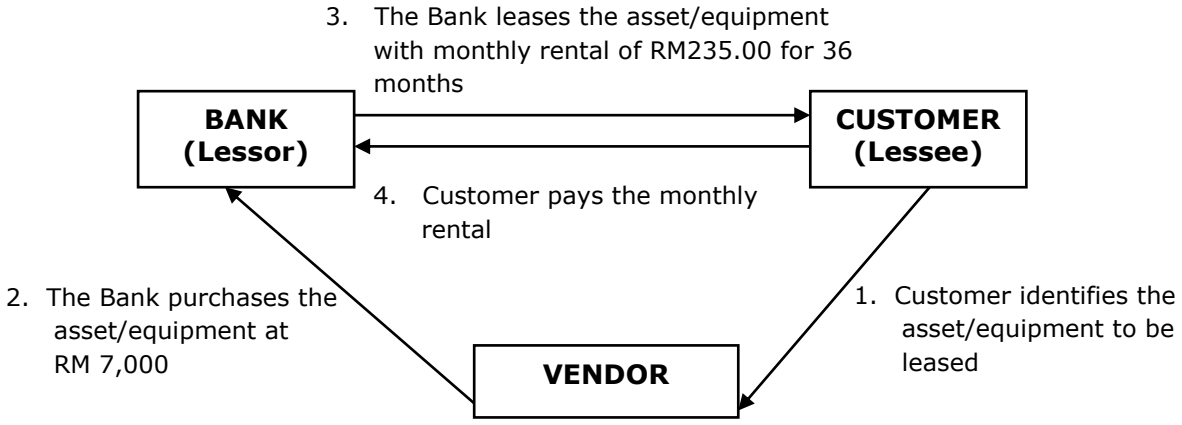
Islamic overdraft facilities

3.4.6 Ijarah (Leasing)

Definition

A sale of the use of another's property. The property rented belongs to Lessor. The Lessor has the right to repossess the property when the Lessee defaults.

Modus Operandi



Checklist

1. Essential Elements

- Lessor
- Lessee
- Asset / Equipment
- Benefit or Usufruct
- Price / Rent
- Contract (Offer & Acceptance)

2. Necessary Conditions

Lessor & Lessee

- Able to carry out responsibilities
  - Aqil (of sound mind)
    - Baligh (attains the age of puberty)
    - Rusyd (intelligent)
- Not restricted in dealing with business transaction
    - Not a muflis (bankrupt)
    - Not a safih (extraordinary extravagant)

Asset / Equipment

- Owned by the Lessor
- Known and has been identified by both Lessor & Lessee
- Can be delivered to the Lessee for usage & remain with the Lessee throughout the duration of the lease
- Can be used by the Lessee for the intended usage

Benefit or Usage

- Can be valued with money
- Must not be in the form of any material thing
- Usage for purposes not contradicting to Shariah
- Benefit is known and has been identified
- Lessee is able to fully utilize the benefit/usage

Price / Rent

- Rental shall be known in amount
- Type of currency is specified
- Rental can be collected in advance

Contract (Offer & Acceptance)

- In definite and decisive language
- Acceptance must be consistent with offer
- Offer and acceptance must be made at the one and the same meeting

Application

Short to medium term financing to lease the following types of assets: Equipment, machineries, consumer goods, computers, motor vehicles, and other suitable assets.

Syndicated financing (Ijarah Munthahiah Bit Tamlik)

3.4.7 Ijarah Muntahia Bittamleek

Definition

Ijarah Muntahia Bittamleek or Ijarah Wa Iqtina is a form of lease contract that offers the lessee an option to own the asset at the end of the lease period. In other words, the Ijarah contract that ends up with the transfer of ownership of leased assets to the lessee.

Ijarah Muntahia Bittamleek can be in the following forms:

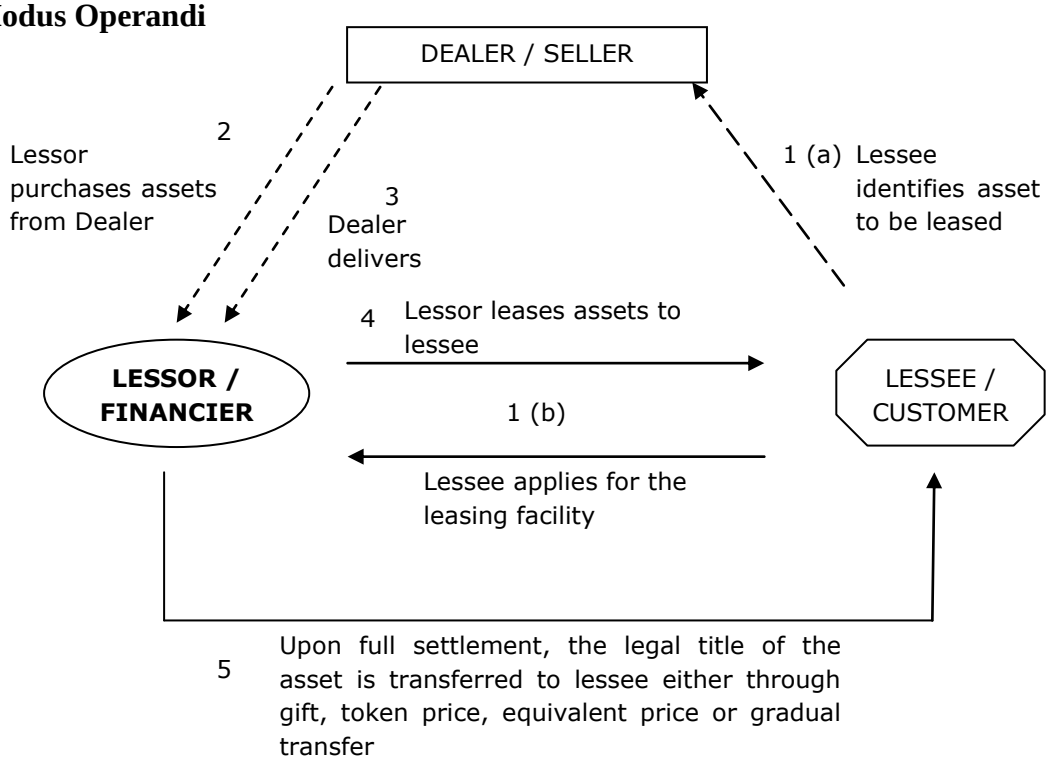
a. Ijarah Muntahia Bittamleek through gift, i.e. the transfer of legal title for no consideration.

b. Ijarah Muntahia Bittamleek through transfer of legal title at the end of a lease for a token consideration or other amount as specified in the lease.

c. Ijarah Muntahia Bittamleek through transfer of legal title prior to the end of the lease term for a price that is equivalent to the remaining Ijarah instalments.

d. Ijarah Muntahia Bittamleek through gradual transfer of legal title of the leased asset.

Modus Operandi



- The lessor determines the requirement of the lessee in relation to the lease and use of the assets and the leasing period.
- The lessor purchases the assets from the dealer selected by the lessee.
- Thereafter, the lessor leases the assets to the lessee at an agreed sum of monthly rental over an agreed period of time.
- The total sum of monthly rentals comprise of:
  - Actual cost of the assets paid by the lessor (less down payment made by lessee, if any)
  - The lessor's profit margin
- The lessor retains the title to the assets during the period of leasing and the lessee has the rights to use the assets.
- Upon full settlement of the rental, the title of the asset is transferred to the lessee either through gift, token price, equivalent price or gradual transfer of ownership.

Checklist

1. **Essential Elements (Ijarah / Leasing)**
   - Lessor
   - Lessee
   - Asset / Equipment
   - Benefit or Usurfruct
   - Price / Rent
   - Contract (Offer and Acceptance)

2. **Necessary Conditions (Ijarah / Leasing)**

   Lessor & Lessee
   - Able to carry out responsibilities
     - Aqil (of sound mind)
     - Baligh (attains the age of puberty)
     - Rusyd (intelligent)
   - Not restricted in dealing with business transaction
     - Not a muflis (bankrupt)
     - Not a safih (extraordinary extravagant)

   Asset / Equipment
   - Owned by the Lessor
   - Known and has been identified by both Lessor & Lessee
   - Can be delivered to the Lessee for usage & remain with the Lessee throughout the duration of the lease
   - Can be used by the Lessee for the intended usage

   Benefit /Service
   - Can be valued with money
   - Must not be in the form of any material thing
   - Usage for purposes not contradicting to Shariah
   - Benefit is known and has been identified
   - Lessee is able to fully utilise the benefit/usage

   Price / Rent
   - Rental shall be known in amount
   - Type of currency is specified
   - Rental can be collected in advance

   Contract (Aqad) of Offer and Acceptance
   - In definite and decisive language.
   - Acceptance must agree with offer.
   - Offer and acceptance must be made in the one and the same meeting.

3. Essential Elements (Bai / Sale)

- Buyer
- Seller
- Object of Contract / Merchandise
- Price
- Contract (Offer & Acceptance)

4. Necessary Condition (Bai / Sale)

Buyer & Seller

- Capable of accepting responsibilities.
- Not restricted from dealing in business transaction.
- Not forced to enter into a contract.

Object of Contract / Merchandise

- Must be in existence at the time of contract.
- Can be delivered.
- Halal and valuable.
- Owned by the seller.
- Known to the seller and buyer.
- Cannot be a ribawi material.

Price

- Must be determined at the point of contract.
- Must be specified in terms of currency.

Contract (Offer & Acceptance)

- Must be done in a definite and decisive language.
- Acceptance must be in consistent with the offer made by the seller.
- Offer and acceptance must be made at the one and the same meeting.

Application

Ijarah Muntahia Bittamleek financing facility provide customers with short to medium term financing rental of items which may include:

- Vehicles
- Equipment
- Machinery
- Other suitable and acceptable assets

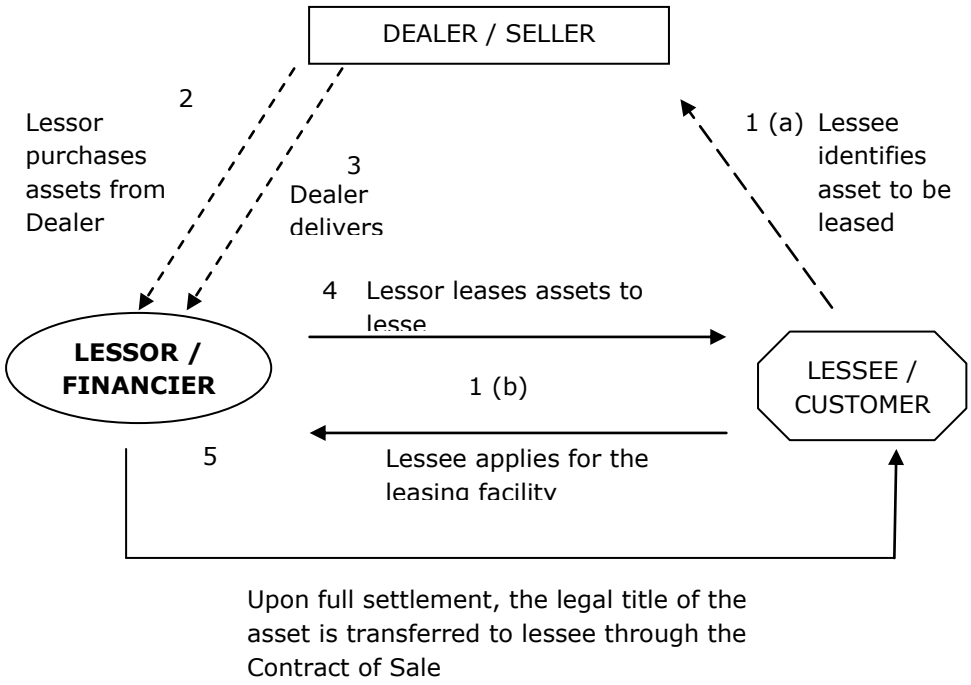
3.4.8 Ijarah Thumma Al-Bai (AITAB)

Definition

Ijarah Thumma Al-Bai (AITAB) is one of the categories of lease, which ends with the sale of the asset, where the legal title of the leased asset will be transferred to the Customer upon full settlement or early settlement of the contract value. AITAB consists of two different contracts:

- Contract of Leasing or Ijarah
- Contract of Sale or Bai

Modus Operandi



- The lessor determines the requirement of the lessee in relation to the lease and use of the assets and the leasing period.
- The lessor purchases the assets from the dealer selected by the lessee.
- Thereafter, the lessor leases the assets to the lessee at an agreed sum of monthly rental over an agreed period of time.
- The total sum of monthly rentals comprise of:
    - Actual cost of the assets paid by the lessor (less down payment made by lessee, if any)
    - The lessor's profit margin
- The lessor retain assets. s the title to the assets during the period of leasing and the lessee has the rights to use the
- Upon full settlement of the rental, the title of the asset is transferred to the lessee through the Contract of Sale.

Checklist

1. **Essential Elements (Ijarah / Leasing)**
   - Lessor
   - Lessee
   - Asset / Equipment
   - Benefit or Usufruct
   - Price / Rent
   - Contract (Offer and Acceptance)

2. **Necessary Conditions (Ijarah / Leasing)**

   Lessor & Lessee
   - Able to carry out responsibilities
     - Aqil (of sound mind)
     - Baligh (attains the age of puberty)
     - Rusyd (intelligent)
   - Not restricted in dealing with business transaction
     - Not a muflis (bankrupt)
     - Not a safih (extraordinarily extravagant)

   Asset / Equipment
   - Owned by the Lessor
   - Known and has been identified by both Lessor & Lessee
   - Can be delivered to the Lessee for usage & remain with the Lessee throughout the duration of the lease
   - Can be used by the Lessee for the intended usage

   Benefit /Service
   - Can be valued with money
   - Must not be in the form of any material thing
   - Usage for purposes not contradicting to Shariah
   - Benefit is known and has been identified
   - Lessee is able to fully utilize the benefit/usage

   Price / Rent
   - Rental shall be known in amount
   - Type of currency is specified
   - Rental can be collected in advance

   Contract (Aqad) of Offer and Acceptance
   - In definite and decisive language.
   - Acceptance must agree with offer.
   - Offer and acceptance must be made in the one and the same meeting.

3. Essential Elements (Bai / Sale)

- Buyer
- Seller
- Object of Contract / Merchandise
  - Price
  - Contract (Offer & Acceptance)

4. Necessary Conditions (Bai / Sale)

Buyer & Seller

- Capable of accepting responsibilities.
- Not restricted from dealing in business transaction.
- Not forced to enter into a contract

.

Object of Contract / Merchandise

- Must be in existence at the time of contract.
- Can be delivered.
- Halal and valuable.
- Owned by the seller.
- Known to the seller and buyer.
- Cannot be ribawi material.

Price

- Must be determined at the point of contract.
- Must be specified in terms of currency.

Contract (Offer & Acceptance)

- Must be done in a definite and decisive language.
- Acceptance must be consistent with the offer made by the seller.
- Offer and acceptance must be made at the one and the same meeting.

Application

AITAB financing facility is to provide customers with short to medium term financing to rent such items which may include:

- Vehicles
- Equipment
- Machinery
- Other suitable and acceptable assets

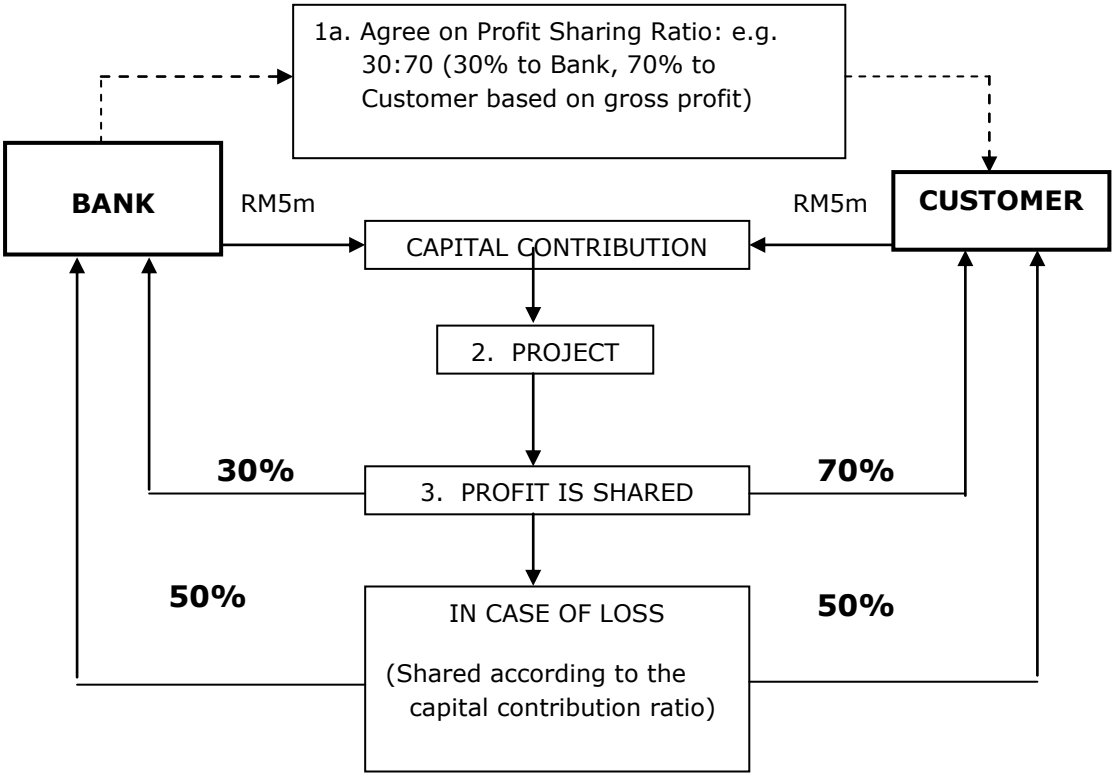
3.5 EQUITY BASED FINANCING

The profit or loss sharing financing (equity financing) is recognised as an ideal and universal mode of financing. Two commonly practiced Shariah contracts for equity financing are Mudharabah and Musharakah.

3.5.1 Musharakah (Joint Venture Profit Sharing)

Definition
A general partnership whereby two or more parties enter into a contract to exploit their labour and capital jointly and to share the profits or losses of the partnership. The liability of the partners is normally unlimited. All the assets are jointly owned.

Modus Operandi
MUSHARAKAH FINANCING



Checklist

1. Essential Elements

- Shareholders or Partners
- Capital
- Project / Business
- Profit Sharing
- Contract (Offer & Acceptance)

2. Necessary Conditions

Shareholders or Partners

- Capable of accepting responsibilities
  - Of sound mind
  - Attains the age of puberty (matured)
  - Intelligent
- Not restricted from dealing in business transactions
  - Not a bankrupt
  - Not a "safih" (an extremely extravagant person)
- Not being forced to enter into a contract

Capital

- Cash or other goods that can be valued with cash
- Not debt
- Pooled together and owned by business entity
- Shareholder can transfer his capital to others

Project

- Must be Halal in nature according to Shariah
- Managed by business entity

Profit

- The profit sharing ratio (which need not be the same as percentage shareholding) shall be determined at the point of contract
- Any loss incurred is to be borne by shareholders according to their shareholding

Contract (Offer & Acceptance)

- In definite and decisive language
- Acceptance must agree with offer
- Offer and acceptance must be made in the one and the same meeting

Application

Can be used for project financing and bridging finance.

Practice of Sudanese Islamic Bank which provides the farmers with ploughs, tractors, pumps, sprayers, working capital, fuel, seeds, pesticides and fertilizers. The farmer provides land, labour and management.

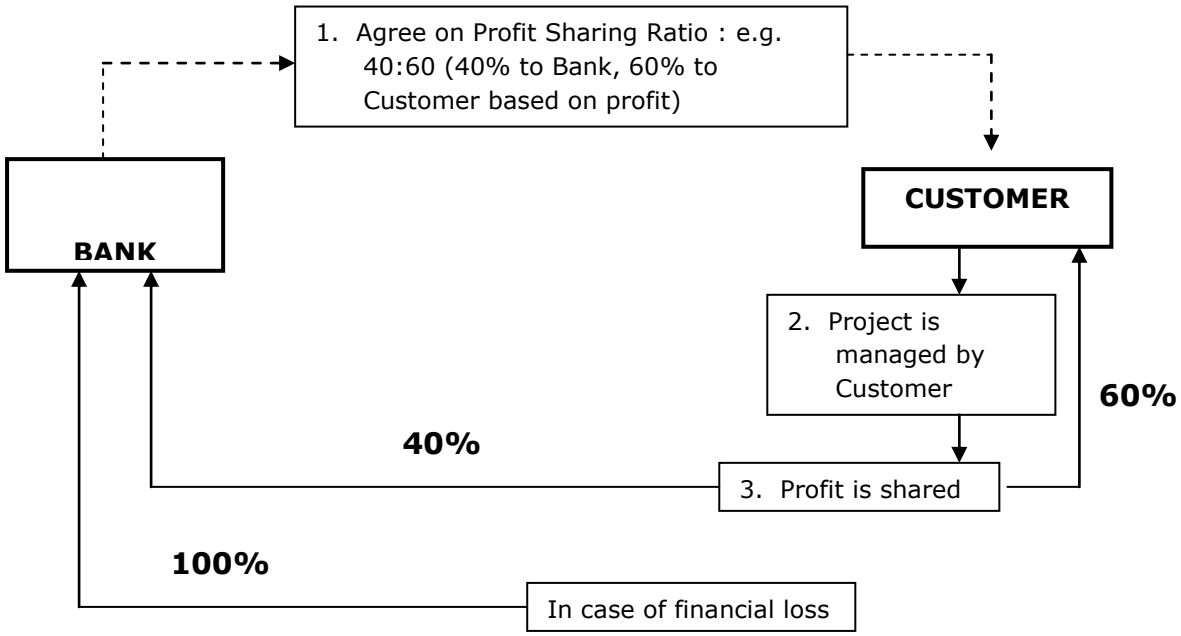
3.5.2 Mudharabah (Trustee Profit Sharing)

Definition

A contract where the owner of capital entrusts his funds to an entrepreneur who contribute skills in a business and the profit generated is to be shared between them. In case of loss, the loss is borne by capital provider only.

Modus Operandi

MUDHARABAH FINANCING



Checklist

1. Essential Elements

- Owner of Capital
- Entrepreneur
- Capital
- Project / Business
- Profit Sharing
- Contract (Offer & Acceptance)

2. Necessary Conditions

Owner of Capital & Entrepreneur

- Capable of accepting responsibility
- Not restricted from dealing in business transaction
- Not forced to enter into contract

Capital

- Money only
- Not a debt
- Specific amount
- Paid to entrepreneur
- From owner of capital only

Project

- Must be Halal in nature according to Shariah
- Managed by entrepreneur

Profit

- Profit shared according to agreement in fraction, ratio or percentage; not in absolute amount.
- Loss borne by the owner of capital only

Contract (Offer & Acceptance)

- In definite and decisive language
- Acceptance must agree with offer
- Offer and acceptance must be made in the one and the same meeting

Application

1. Applicable in savings account, current account and investment accounts.

2. Financing side: for single transaction such as day-to-day needs of small traders, or single export or import activity.

3. Long term investment, such as building an airport, real estates, highway, etc.

3.5.3 Muzara'ah (Leasing of Land for Agriculture)

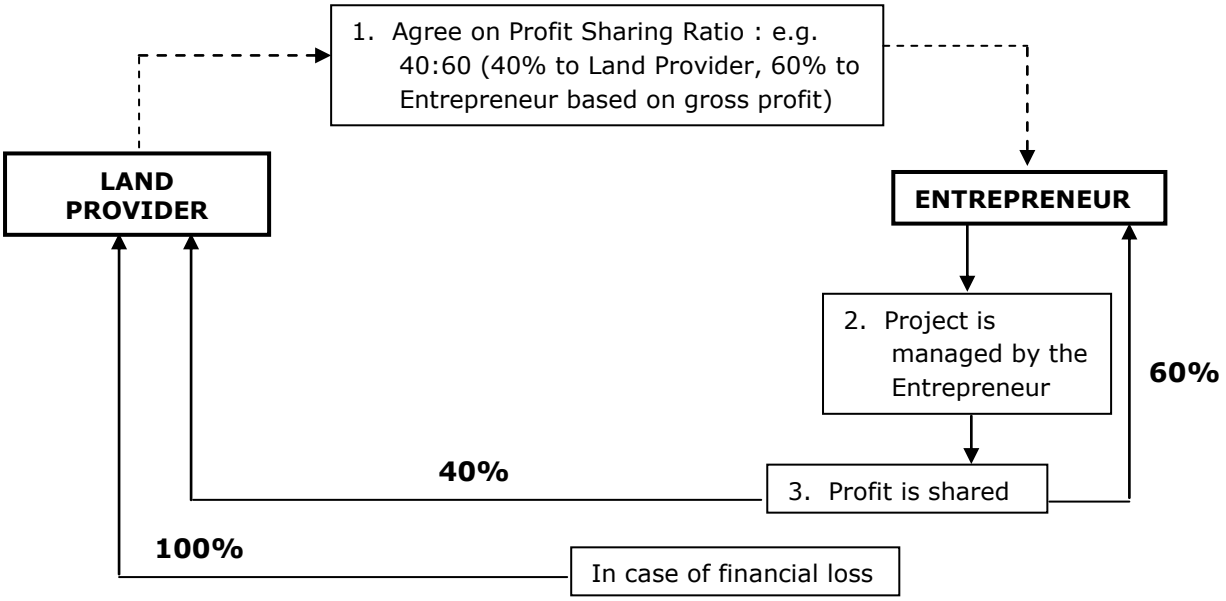
Definition

This contract refers to partnership in farming whereby one party provides the land and the other provides work management. The rule of Muzaraah is similar to mudharabah and it is suitable for agricultural country.

In summary, Muzaraah is an investment contract involving agricultural land. The two parties to the contract are the landlord and the worker/farmer. The contract specifies that crop is to be shared between the parties according to agreed-upon shares. [i.e. the harvest is shared between the land provider and the entrepreneur. The Bank may provide funds (or land if the law and other regulations permit)]

Modus Operandi

MUZARA'AH FINANCING



Checklist

1. Essential Elements

- Contracting Parties
- Crop
- Plant
- Produce
- Agricultural Land
- Object of Contract
- Means of Production
- Contract Period

2. Necessary Conditions

Contracting Parties

- Must be sane & discerning
- Not an apostate male

Crop

- Must be known to all parties

Plant

- Must be eligible in standard agricultural condition

Produce

- Nature of the produce must be specified in the contract
- The produce must be shared between the contracting parties
- Shares in the produce must be specified

Agricultural Land

- The land must be fertile
- The land must be known for the Muzaraah to be valid
- The worker/farmer must be given full access to the land

Object of the Contract

- Must be legally and conventionally accepted as an agricultural activity

Means of Production

- The usage tools or livestock in agricultural production must be derivative of the contract, and not its purpose

Contract Period

- Must be known

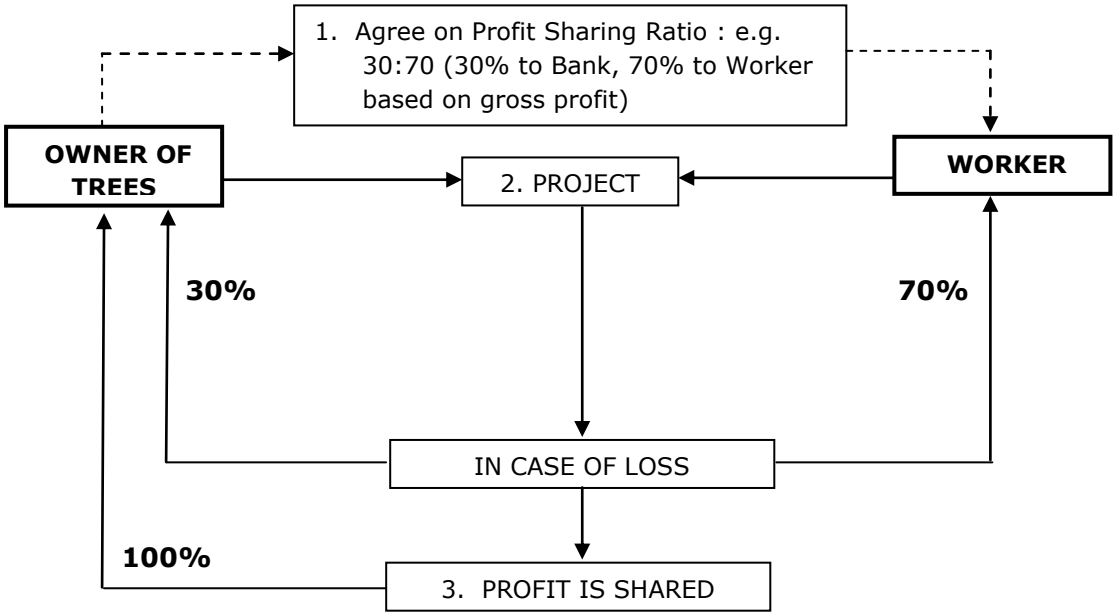
3.5.4 Musaqah (Watering of Orchard)

Definition

Musaqah is literally derived from the *Arabic* verb *saqa* (to water). It refers legally to giving a worker access to trees that he maintains and waters, with the fruits being shared between the owner of the trees and the worker. In other words, it is a contract exchanging work for a specified ratio of the output of trees. The *Shafie* restricted the contract specifically for palm trees and grapevines, whereby the worker will maintain the palms or vines and water them, and share the fruits with the owner.

Modus Operandi

MUSAQAH FINANCING



Checklist

1. Essential Elements

- Contracting Parties
- Object of Watering & Tending
- Fruits
- Work
- Contract (Offer & Acceptance)

2. Necessary Conditions

Contracting Parties

- Must be sane & discerning
- Not an apostate male

Object of Watering & Tending

- Shafie : restrict to palm trees and grapevines
- Hanbali : all planted and observable trees with edible fruits

Fruits

- All fruits must be distributed between the owner of the trees and the worker, and no portion may be given to a third party
- The fruits are observable but not yet ripened
- A fixed capital of trees to already be in place i.e. planting such trees would not be part of the labour of musaqah

Work

- The worker must provide labour, and must be given full access to the trees to work as he sees fit.
- The amount of work must be known by stipulating the contract period for a year or more.

Contract (Offer & Acceptance)

- In definite and decisive language.
- Acceptance must agree with offer.
- Offer and acceptance must be made in the one and the same meeting.

3.6 SUPPORTING CONTRACTS

Islamic Financial Institutions adopt the supporting contracts which are complied with Shariah to facilitate their financing either on asset-based (debt) financing and equity- based financing. The supporting contracts include Wakalah, Hiwalah, Ibraa', Rahn, Kafalah and Khiyar.

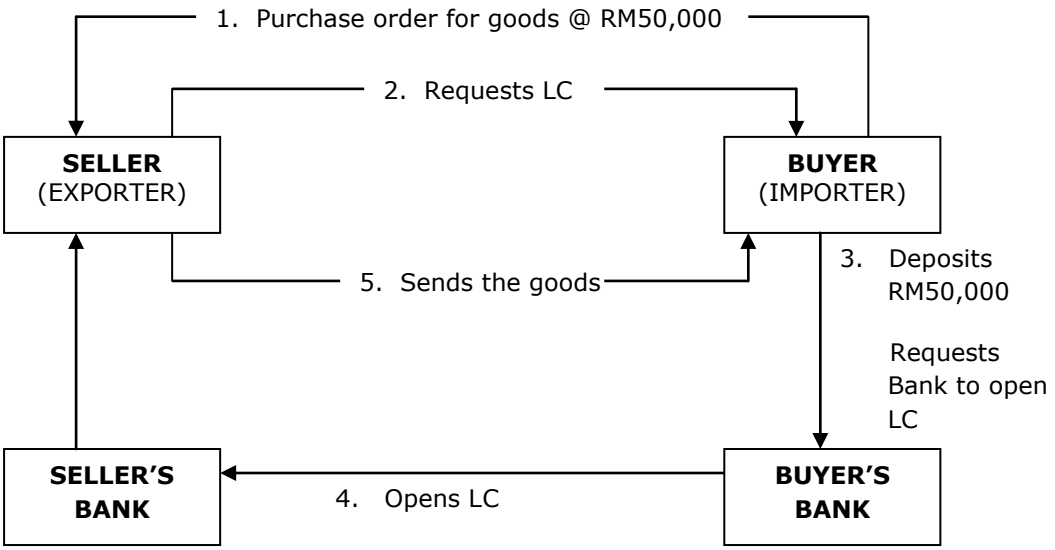
3.6.1 Wakalah (Agency)

Definition

A contract of appointment of an agent where a person appoints another as his agent to act on his behalf.

Modus Operandi

LC – WAKALAH
(the Bank acts as the agent to the Customer)



The activities under the contract of Wakalah are:

- The buyer/customer informs the bank of his LC requirements and requests the bank to provide the facility.
- The bank may require the buyer/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 Wadiah Yad Dhamanah.
- The bank establishes the LC and subsequently releases the documents to the customer.
- The bank charges the customer fees and commission for its services under the principle of Ujr (Fee).

Checklist

1. Essential Elements

- Principal
- Agent
- Object of Contract
- Contract (Offer & Acceptance)

2. Necessary Conditions

Principal & Agent

- Capable of accepting responsibility
- Not restricted from dealing in business transaction
- Not forced to enter into contract

Object of Contract

- Must belong to the principal
- Must be sufficiently known
- Cannot be the utilization of public contracts

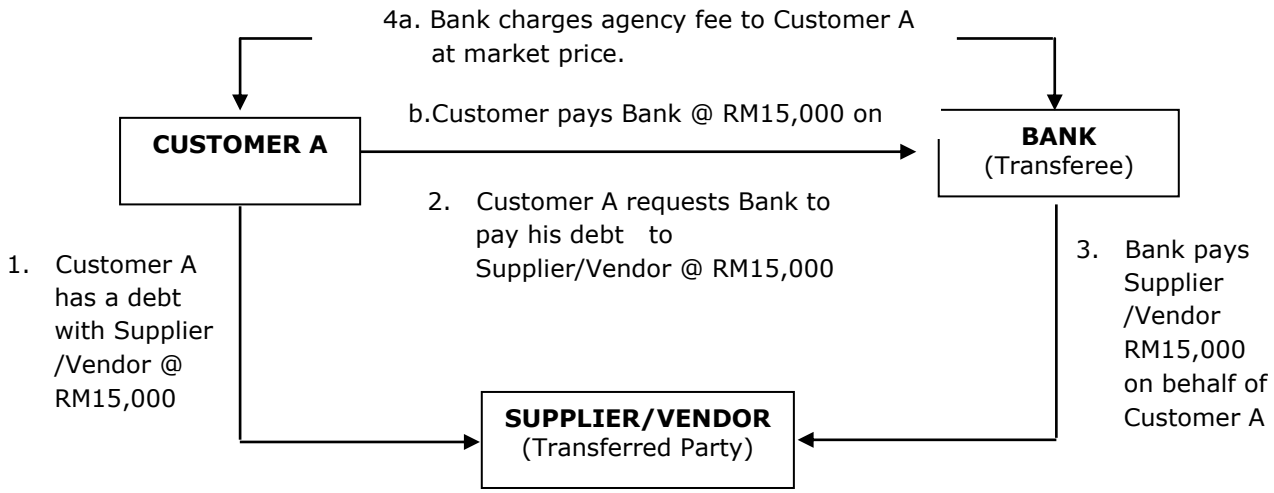
Contract (Offer & Acceptance)

- In definite and decisive language
- Acceptance must agree with offer
- Offer and acceptance must be made in the one and the same meeting
- Hiwalah (Transfer of Debt)

Definition

The transfer/assignment of a claim of a debt by passing the responsibility from one person to another.

Modus Operandi



- Customer A has a debt with Supplier/Vendor amounting to RM15,000.
- Customer A assigns the debt (evidenced by invoices, etc) to the Bank.
- Bank acts as agent to Customer A (it becomes the transferee), pays the Supplier/Vendor for RM15,000.
- The Bank, acting as agent to Customer A, is entitled to the agency fee.
- Upon maturity Customer A shall pay RM15,000 plus agency fee to the Bank.

Checklist

1. Essential Elements

- Principal Debtor
- Transferor
- Transferee
- Subject Matter
- Contract (Offer & Acceptance)

2. Necessary Conditions

Transferor / Principal Debtor

- Capable of accepting responsibility
- Not restricted from dealing in business transaction
- Not forced to enter into contract

Transferred Party & Transferee

- Must be eligible for the contract
- Must consent to the transfer of debt
- Acceptance must be issued by the transferred party during the contract session

Transferred Item

- Must be a debt – the transferor must be a debtor to the transferred party
- The debt must be binding

Contract (Offer & Acceptance)

- In definite and decisive language
- Acceptance must agree with offer
- Offer and acceptance must be made in the one and the same meeting

Application

Revolving Credit (pre & post), Trade Payable

Remittances

3.6.2 Ibra' (Waive the right)

Definition

An act by a person to withdraw his rights i.e. his rights to collect payment from a person who has the obligation to pay the amount borrowed from him.

Application

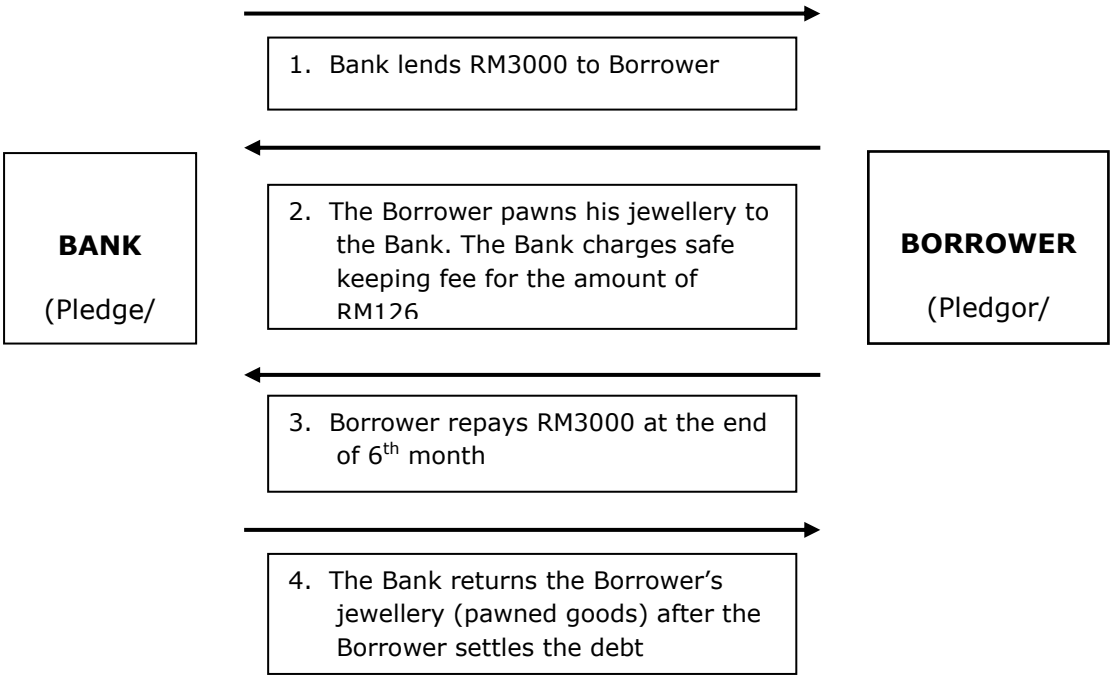
- It is **not mandatory** for Ibra' to be given by a bank. It is given at Bank's absolute discretion. Ibra' is a unilateral contract and only creditor / financier can grant Ibraa'
- A Bank may grant Ibra' to Customer who do early settlement
- Ibra' may be given on unearned profit charged by the Bank
- In the case of multi-tier financing, the Bank may grant Ibra' through reducing the unearned income (as settlement figure) subject to proper wording in legal documentation

3.6.3 Rahn (Pledge)

Definition

Rahnu means Islamic pawning. It refers to an arrangement whereby a valuable asset is placed as collateral for a debt. The collateral may be disposed off in the event of default.

Modus Operandi
AR-RAHNU SCHEME



Shariah concepts in Islamic Pawning:

- Bank grants benevolent loan (Qardh Hasan) to borrower
- Borrower/Debtor delivers goods to be pawned. Bank guarantees the safety of the pawned goods under the principle of Wadiah Yad Dhamanah (Guaranteed Safe Custody)
- Under the principle of Wadiah Yad Dhamanah Bank is entitled to a fee for safe keeping

Checklist

1. Essential Elements

- Chargor (Debtor)
- Chargee (Creditor)
- Asset (Pledged Property)
- Debt
- Contract (Offer & Acceptance)

2. Necessary Conditions

Chargor & Chargee

- Capable of accepting responsibility
- Not restricted from dealing in business transaction
- Not forced to enter into contract

Asset (Pledged Property)

- Gold jewellery
- Belongs to the borrower (or his/her close family members)

Contract (Offer & Acceptance)

- In definite and decisive language
- Acceptance must agree with offer
- Offer and acceptance must be made in the one and the same meeting

Application

Pawn-broking

3.6.4 Kafalah (Suretyship)

Definition

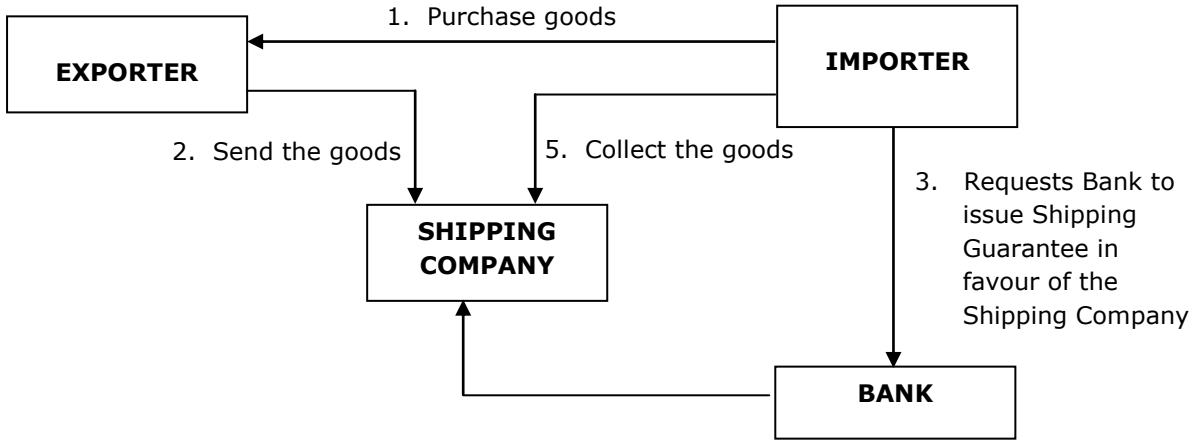
Literally it means; Responsibility, Suretyship (Q.3:37)

Technically it means an obligation in addition to the existing obligations in respect of a demand (claim) for something.

In other words, it is a surety given by one party who agrees to discharge a liability of a third party in case the third party defaults in fulfilling its obligation.

Modus Operandi

SHIPPING GUARANTEE-i - KAFALAH



A Shipping Guarantee-i (SG-i) is a facility granted by the Bank to importers for the clearance of goods [purchased under Wakalah Letter of Credit-i (LC-i)] at the port, without the original Bill of Lading (BL) being presented. The Bank will issue a Shipping Guarantee-i (SG-i) in favour of the Shipping Company/Agent to enable the customer (the importer), consignee or buyer to take delivery of the merchandise in the absence of the original BL.

Checklist

1. Essential Elements

- Guarantor
- Debtor
- Creditor
- Guaranteed Object
- Contract (Offer & Acceptance)

2. Necessary Conditions

Guarantor

- Must be eligible for making voluntary contributions
- Free to perform transactions – not a slave

Debtor

- Not a deceased individual
- Must be known to the guarantor

Creditor

- Must be known
- Must be sane & attain the age of puberty
- Must be present during the guarantee contract session

Guaranteed Object

- Must be an established liability, guaranteed by the debtor
- Must be possible to collect from guarantor
- Must be valid & binding liability

Contract (Offer & Acceptance)

- In definite and decisive language
- Acceptance must agree with offer
- Offer and acceptance must be made in the one and the same meeting

Application

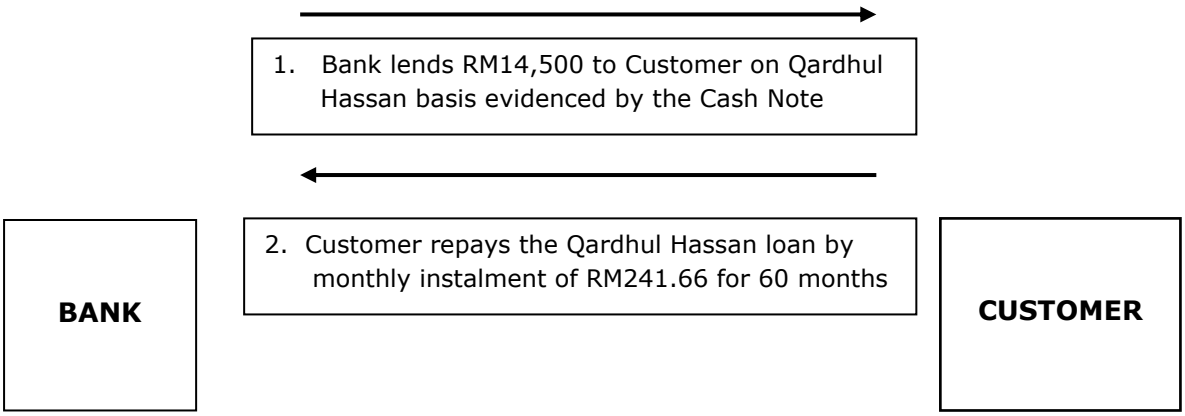
Letter of Guarantee, Shipping Guarantee, Performance Guarantee

3.6.5 Qardh Hasan (Benevolent Loan)

Definition

A contract of loan between two parties on the basis of social welfare or to fulfil financial needs of borrower. The amount of repayment must be equivalent to the amount borrowed.

Modus Operandi



Cash Note Facility Contract involves two (2) contracts, (i) Qardh Hassan Contract, (ii) Bai Inah Contract.

The above modus operandi is an example of the application of Qardh Hassan contract, which can be found in Cash Note Facility offered by Bank Islam Malaysia Berhad

Checklist

1. Essential Elements

- Lender
- Borrower
- Object to be borrowed
- Contract (Offer & Acceptance)

2. Necessary Conditions

Lender & Borrower

- Ikhtiar
  - There is no coercion or compulsion exerted on the lender
- Capable of taking responsibilities
  - Attained the age of puberty
  - Attained the age of majority
  - Possess sound mind
  - Not a bankrupt
  - Able to donate

Objective

- Can be quantified. It can be in the form of food stuff, clothes, gold, silver, money, etc.
- Delivery must be made in the one and same meeting.
- If the venue of delivery is not suitable, the lender is obliged to notify the borrower the change of venue to hold delivery of the borrowed object.

Contract (Offer & Acceptance)

- In giving Qardh Hasan the two following matters must not be contravened:
  - The lender must not impose any extra payment in the contract
  - The borrower must not promise in the contract to pay anything extra
- Must be done in a definite and decisive language.
- Acceptance must be in consistence with the offer made by the seller.
- Offer and Acceptance must be made at the one and the same meeting.

Application

Personal financing, pawn-broking.

4.0 FINANCING DOCUMENTATION

4.1 Regulatory Framework
4.2 Legal Framework Governing Islamic Banks
4.3 Documentation
4.4 Common Mistake & Issues in Islamic Legal Documentation
4.5 Process and Reason for Rescheduling and Restructuring
4.6 Good, Delinquent and Default Account
4.7 Theory of *Mal* (Property) in Shariah
4.8 Theory of Milkiyyah (Ownership) in Shariah
4.9 General Prohibitions in Muamalat Contracts
4.10 Theory of 'Aqd (Contract) in Muamalat
4.11 Types of Contract
4.12 Essential Elements of Contract
4.13 Necessary Conditions of Each Essential Element

4.1 REGULATORY FRAMEWORK

4.1.1 Overview

Currently there are 3 main laws governing the operations of Islamic banking and financial institutions.

1. Companies Act 1965 (CA)
2. Islamic Banking Act 1983 (IBA)
3. Banking and Financial Institutions Act 1989 (BAFIA)

Companies Act 1965 governs all companies registered and incorporated in Malaysia including banking and finance institutions. Full-fledged Islamic banks and Islamic subsidiaries of conventional banks are licensed under the Islamic Banking Act 1983 (IBA) as such governed by IBA, whilst banking and financial institutions operating Islamic banking windows fall under the jurisdiction of the Banking and Financial Institutions Act 1989 (BAFIA). Under Section 55 of IBA & Section 122 of BAFIA, if there is any conflict or inconsistency between provisions of CA and those of IBA & BAFIA, IBA & BAFIA will prevail for Islamic Banks and Islamic subsidiaries and Islamic banking windows respectively.

4.1.2 Related Provisions in Respect of Financing

IBA was drafted principally based on the old Banking Act 1973 which is inoperative and has been repealed by the BAFIA. Due to this, provisions in BAFIA are more comprehensive compared to IBA. Although Islamic banks are governed by IBA and there is no mention they are bound by BAFIA as stipulated under Section 124, in practice however, the latter is always referred to by the regulators whilst monitoring the operation of Islamic banks.

It is to be noted that although there are sections in IBA relating to offences by directors, managers, employees and agents of the bank, there is no specific section which provide that

the effect of any loan, security or arrangement shall not be void solely by reason of any contravention of its provision. In other words, a borrower shall not be allowed to raise any such contravention as a defence to any claim made against him in any litigation. This subject is however, clearly spelt out in Section 125 of BAFIA.

In this chapter relevant sections of IBA will be discussed first followed by comparison with BAFIA. Through this way, the provisions of the two laws will be easily understood.

Other than the above laws, all banks and financial institutions are also governed by the following:

1. Bank Negara Malaysia Guidelines, i.e. Garis Panduan (GP)
2. Exchange Control Notices of Malaysia (ECM)
3. Foreign Investment Committee Guidelines (FIC)
4. Anti-Money Laundering Act 2001 (AMLA)

For the purpose of this manual, AMLA will be discussed alongside BNM/GP9.

4.2 LEGAL FRAMEWORK GOVERNING ISLAMIC BANKS

(i) <u>Overview of Legal Framework Governing Islamic Banks</u>

(a) Islamic Banking Act 1983

Section 2 of the Islamic Banking Act provides, inter alia, the following definitions:

'Islamic bank' means any company which carries on Islamic banking business and holds a valid license and all the offices and branches in Malaysia of such a bank shall be deemed to be one bank; and

'Islamic banking business' means banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam.

Section 3(1) stipulates that *'Islamic banking business' means banking business hose aims and operations do not involve any element which is not approved by the Religion of Islam*.

(b) Banking and Financial Institutions Act 1989

Section 124 of the Banking and Financial Institutions Act provides that:

(1) Except as provided in section 33, nothing in this Act or the Islamic Banking Act 1983 shall prohibit or restrict any licensed institution from carrying on Islamic banking business or Islamic financial business, in addition to its existing licensed business, provided that the licensed institution shall consult the Bank before it carries on Islamic banking business or any Islamic financial business.

(2) *For the avoidance of doubt, it is declared that a licensed institution shall, in respect of the Islamic banking business or Islamic financial business carried on by it, be subject to the provisions of this Act.*

(3) *Any licensed institution carrying on Islamic banking business or Islamic financial business, in addition to its existing licensed business may, from time to time seek the advice of the Syariah Advisory Council established under subsection (7), on the operations of its business in order to ensure that it does not involve any element which is not approved by the Religion of Islam.*

(4) *Any licensed institution carrying on Islamic banking business or Islamic financial business shall comply with any written directions relating to Islamic banking business or Islamic financial business, carried on by such licensed institution, issued from time to time by the Bank, in consultation with the Syariah Advisory Council.*

(5) *Any licensed institution carrying on Islamic banking business or Islamic financial business shall be deemed to be not an Islamic bank.*

(6) *This Act shall not apply to an Islamic bank.*

(7) *For the purpose of this section-*

(a) *there shall be established a Syariah Advisory Council which shall consist of such members, and shall have such functions, powers and duties as may be specified by the Bank to advise the Bank on the Syariah relating to Islamic banking business or Islamic financial business;*

(b) *"Islamic banking business" has the meaning assigned thereto under the Islamic Banking Act 1983*; and

(c) *"Islamic financial business" means any financial business, the aims and operations of which, do not involve any element which is not approved by the Religion of Islam.*

(ii) Fundamental Differences in Documentation between Conventional and Islamic Financing including Basic Elements involving Islamic Banking Documentation

(a) Trade and commerce in Islam must conform to requirements of the Shariah, which broadly refers to:

(aa) Avoidance of prohibitions.

(bb) Observing that every contract possesses all its essential elements and that every essential element meets its necessary conditions.

(b) Under the conventional banking, interest is an indispensable part of conventional banking as it's activities are mainly based on lending and borrowing.

(c) In Islam, interest or riba is prohibited and condemned. Allah says in the Holy Qur'an:

"Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: 'Trade is like usury', but Allah hath permitted trade and forbidden usury…" (al-Baqarah: 275)

(d) As interest through lending and borrowing is prohibited in Islam, financing activities in Islamic banking are done mainly through trading/hiring/partnership/agency as the underlying transactions.

(e) Documentation is the process by which:

(aa) the terms and conditions of the granting of any financing facility by the bank to the customer are formally written down or set out in legal documents and signed by both parties, these documents are called the "facility documents"; and

(bb) securities taken for the payment of the amounts due to the bank are documented and signed by both parties and where necessary, registered (e.g. at the land office/land registry, Companies Commission of Malaysia, High Court etc). Securities include land charges, debentures, pledges etc. These are called "security documents".

(f) Pertaining to documentation, Allah says in the Holy Qur'an:

"O ye who believe! Hen you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties. Let not the scribe refuse to rite: as Allah has taught him, so let him rite. Let him ho incurs the liability dictate, but let him fear his Lord Allah, and not diminish (reduce) aught (anything at all) of what he owes. If the party liable is mentally deficient, or weak or unable himself to dictate, let his guardian dictate faithfully. And get to witnesses out of your men, and if there are not to men, then a man and to omen, such as ye choose, for witnesses, so that if one of them errs, the other can remind her. The witnesses should not refuse hen they are called on (for evidence). Disdain not to reduce to writing (your contract) for a future period, whether it be small or big: it is just in the sight of Allah…more suitable as evidence, and more convenient to prevent doubts among yourselves. But if be a transaction which ye carry out on the spot among yourselves there is no blame on you if ye reduce it not to writing. But take witnesses whenever ye make a commercial contract; and let neither scribe nor witness suffer harm. If ye do (such harm), it would be wickedness in you. So fear Allah; for it is Allah that teaches you. And Allah is well acquainted with all things." (al-Baqarah: 282)

(g) In Malaysia, Islamic law is part of the law of the land. So, both Islamic law and civil la apply to Islamic banking (Muamalah) transactions. Accordingly, it is important to ensure that Islamic banking documents comply with both these laws.

(h) Since Islamic financing facilities are done by means of transactions, the proper sequence in the documentation process is very important. For example, when a party sells an asset he must first be the owner of the asset. Otherwise he would not have a title to the asset. If a party has no title to the asset he cannot enter into a valid contract for the sale of the asset.

(i) So, in a BBA transaction, for example, before the Asset Purchase Agreement is entered into, it must be ensured that the seller (the customer) is the owner of the asset and has its title. As such he has the right to sell it.

(j) The Asset Purchase Agreement must be entered into first and then only the Asset Sale Agreement. The bank must buy first and become the owner of the asset before it can sell it. It cannot be done the other way round. If the sequence is not observed, a party can challenge the validity of the transaction in court. If it can be shown in court proceedings that the seller had no title to the asset at the time of the sale or that the proper order of signing was not followed the transaction may be set aside, resulting in loss to the bank.

(k) Also, if the seller (customer) has no title the Asset Purchase Agreement would be invalid. In that case, the bank that bought it would also have no title to the asset. So, the subsequent Asset Sale Agreement would also be invalid. And if a charge is created based on the Asset Sale Agreement, that would also be invalid.

4.3 DOCUMENTATION

4.3.1. Documentation for Bai' Bithaman Ajil (BBA) / Murabahah/ Istisna' – On Inception including Letter of Offer (plus Terms and Conditions), Primary Documentation

Letter of Offer

(i) This is the first document that goes out from the bank to the customer by which the bank agrees to grant or make available to the customer the facility. The Letter of Offer is an offer from the bank to the customer.

(ii) If the customer accepts the offer, then there is a contract (subject to any reservation or conditions imposed in the Letter of Offer). The Letter of Offer therefore must be carefully worded. All relevant terms and conditions should be inserted.

(iii) The terms of the Letter of Offer must be included in the facility documents. Generally, they cannot be changed, e.g., the Sale Price in a BBA transaction must be the same in the Letter of Offer and the Asset Sale Agreement.

(iv) There are two views on whether to annex the Letter of Offer to the Facility Documents or not:

(a) First view – it is advisable in order to ensure that no terms are left out.

(b) Second view – it is not advisable as there may be conflict between the two. Therefore, all the terms in the Letter of Offer should be included in the Facility Documents.

(v) The customary contents of the Letter of Offer are as follows:

(a) offer;
(b) the facility;
(c) purpose of financing;
(d) concept;
(e) purchase price;
(f) selling price;
(g) profit margin;
(h) tenure;
(i) payment of selling price;
(j) security;
(k) Ibra';
(l) compensation;
(m) availability period;
(n) disbursement;
(o) documentation;
(p) conditions precedent;
(q) other terms and conditions; and
(r) acceptance.

4.3.2 Secondary Documentation, Guarantee – Personal/ Corporate, Charge documents – National Land Code, Code/ Companies Act

(i) In a normal financing transactions, including those under Islamic banking, the bank will require the customer to provide security for the payment of the Bank's Selling Price/Indebtedness. The security may be one security or more than one. The documents providing the security are known as the "security documents".

(ii) Examples of securities are as follows:

(a) <u>Land charge over landed property</u>

This form of security is taken when the secured landed property has been issued with legal title.

This land charge needs to be registered at the relevant land office/land registry and satisfy the provisions of National Land Code 1965.

A statutory charge is created once the charge is registered at the relevant land office/land registry – section 243, National Land Code.

Charge documents consist of Form 16A of the National Land Code and Charge Annexure.

(b) Deed of Assignment over landed property

This form of security is taken when the secured landed property has yet to be issued with legal title.

Unlike land charge, this assignment needs not be registered at the relevant land office/land registry and satisfy the provisions of National Land Code 1965. Nevertheless, power of attorney provisions that are associated with the assignment need to be filed at the high court.

(c) Guarantee

This form of guarantee can be either individual guarantee or corporate guarantee.

If there is default by the customer, the bank can have legal recourse against the guarantor.

(d) Debenture and Memorandum of Deposit

If the customer is a company, the security may also include a debenture, pledge of shares and other securities.

A debenture is a floating security over all the assets (including for example, book debts) and undertaking of the company.

A debenture is an instrument, usually a deed, issued by a company, as acknowledgement of a debt. Under section 4(1) of the Companies Act 1965, "debenture" includes "debenture stock, bonds, notes and any other securities of a corporation whether constituting a charge on the assets of the corporation or not."

The debenture may incorporate fixed or floating charges. Fixed charges may cover plant and machinery, including its goodwill and its uncalled capital. A floating charge may also be created over motor vehicles and stock-in-trade of the company.

In a pledge of shares, a Memorandum of Deposit of shares is entered into under which the customer pledges the shares as security. If there is a default by the customer the bank will sell the shares or part of them to recover the amount due to it.

Form 34 of the Companies Act on statements of particulars of charge are to be accepted for registration under section 108, Companies Act 1965.

4.3.3 Sharing of Security with Conventional Loans

Generally, there are no restrictions on the sharing of securities between Islamic facilities and conventional loans.

In such cases and at the time of enforcement, the legal enforceability of the securities will be determined according to the rankings: which facilities rank first.

There is however exception to the general rules. In the case of pledge of shares, Islamic banks cannot accept non-Shariah compliant securities.

4.3.4 Documentation for Bai' Bithaman Ajil (BBA) / Murabahah/ Istisna' – During Facility Period, Peculiarities in Murabahah Utilisation, Changes to Terms and Conditions, new/ supplementary documents, additional facility and Temporary Rebate

(i) Bai' Bithaman Ajil (BBA)

(a) In a typical BBA transaction, the customer first sells an asset to the bank. This is done by means of an Asset Purchase Agreement. The purchase consideration (Bank's Purchase Price) is satisfied by the bank by way of cash.

(b) After the Asset Purchase Agreement is entered into, the bank becomes the owner of the asset. It can then sell the same asset to the customer. This is done by means of Asset Sale Agreement. The sale consideration (Bank's Selling Price, comprising of the Bank's Purchase Price and the Bank's profit) will be satisfied by the customer on deferred payment terms.

(c) The two documents (Asset Purchase Agreement and Asset Sale Agreement) are the facility documents. The Shariah requirement is complete when these documents are signed.

(d) There is also a tendency among the banks to ask the customer to execute facility agreement which governs the terms and conditions of the relevant financing facility. A simple Asset Purchase Agreement and Asset Sale Agreement to satisfy the underlying trading transactions are annexed to the facility agreement and will be executed when the customer wishes to utilize the facility.

(ii) Murabahah

(a) This transaction is used mainly to finance working capital requirements. The customer may need to purchase goods for use in his trade and may not have the cash to pay for the same immediately. He approaches the bank for financing. If the bank agrees to finance, the transaction will be done in the following way:

(aa) The Customer identifies and selects the goods. The bank will then pay the purchase price to the seller from its own funds.

(bb) The bank will then sell the goods to the customer at an agreed price comprising the cost price plus the bank's profit. The amount of profit will depend on the period for which the bank grants the credit to the customer, i.e., 30, 60 or 90 days or other agreed period. The customer will pay the selling price within the credit period.

(b) The documentation that is involved in typical Murabahah financing is as follows:

(aa) Purchase Agreement/Invoices – under which the bank buys the goods or item to be sold to the customer. If the goods/items have already been bought in the name of the customer, a purchase agreement between the customer and the bank is necessary to show ownership in the name of the bank.

(bb) Sale Agreement or evidence of sale by the bank to the customer. This will evidence the sale and contain terms of payment of the sale price, remedies for breach etc.

(cc) Sometimes, a series of Murabahah agreements may have to be entered into as the customer may purchase goods from time to time. In such cases, a master Murabahah facilities agreement will be entered into under which the bank will agree to grant to the customer Murabahah facilities of an agreed amount in total. Form of Murabahah agreement to be entered into from time to time will be annexed to the master Murabahah facilities agreement.

As and when the customer needs to use a part of the facility, it will enter into a Murabahah agreement with the bank in respect of that amount.

(iii) Istisna'

(a) This is a contract for the acquisition of goods by specification or order. The specifications are set out in the contract and payment is made according to the progress of the work.

(b) This form of contract is suitable, for example, for houses under construction.

(c) The documentation that is involved in typical Istisna' financing is as follows:

(aa) First an Istisna' contract between the bank and the customer is entered into under which the bank will agree to build, say, a house.

(bb) Then a parallel Istisna' contract is entered into between the bank and the contractor (who would have been selected by the customer) under which the bank will require the contractor to build the same house according to the specifications in the Istisna' contract.

(cc) If the customer had already entered into a construction contract with the contractor then a novation agreement would have to be entered into between the customer, the bank and the contractor pursuant to which the bank will replace the customer as the contracting party. The bank will then enter into the Istisna' contract with the customer.

(iv) Rescheduling

(a) Rescheduling occurs where the amount of the installments or the period for payment of the sale price is varied but:

(aa) the amount of the sale price cannot be increased;

(bb) the period for payment cannot be shortened except with the consent of the customer; and

(cc) the period can be extended but customer cannot be asked to pay a higher amount in return of such extended period. Otherwise, riba nasiah will occur.

(b) But, where the customer is required to pay an additional sum for the extension of the payment period and/or reducing the amount of the installments, a separate contract would have to be entered into between the bank and the customer under which the bank will be paid the additional amount by way of profit without altering the existing agreements.

(v) Restructuring

(a) Restructuring occurs where the nature of the existing facility is converted from one form to another, e.g., Islamic Accepted Bills to BBA or Letter of Credit to Murabahah.

(b) This will require the termination of the existing facility and entering into new documentation for the new facility will be initiated. Additional costs will be involved here.

(vi) Supplementary Agreements

(a) Care must be exercised in the use of supplementary agreements in Islamic financing documentation.

(b) Supplementary agreements cannot be used to change the nature of a transaction, e.g., from BBA to Ijarah or to increase the sale price in a BBA transaction. These will operate to change the nature of the 'aqad and so will be invalid.

(c) They may be used to amend other terms of the agreements, such as representations and warranties and negative covenants.

(vii) Default

(a) If a customer has defaulted in the payment of installments in, say, a BBA transaction, what is the amount that should be claimed?

(b) The BBA is a sale transaction and the customer has to pay the sale price under the contract. So, the amount to be claimed is the balance of the sale price, not the balance of the purchase price (facility amount) plus profit, etc.

(c) In this respect, the position differs from a conventional loan situation. Nevertheless, the bank may in its absolute discretion grant Ibra' (rebate) to the customer for any unearned profit.

(viii) Early Settlement

(a) If the customer wishes to settle the amount due earlier than the due date, he may do so.

(b) Although strictly under the contract the bank is entitled to payment of the balance outstanding, the bank will grant Ibra' (rebate) at its discretion for early settlement.

(c) This should be stated in any letter sent out by the bank to the customer, without prejudice to the bank's right under the agreement.

4.3.5 Follow-up Documents for Delinquent Accounts – N.O.D/ O.S, Foreclosure Proceedings, Documentation for Bai' Bithaman Ajil (BBA) / Murabahah/ Istisna' – On Expiry/ Settlement

(i) In the event there is a default on the part of the customer, the bank will first send a Reminder Letter to the customer, reminding the customer to settle the arrears. If the customer still defaults, legal proceedings will be instituted against the customer with solicitors will be appointed to handle the case.

(ii) As soon as receiving the instruction from the bank, the solicitors will issue a Legal Notice of Demand to the customer (and the guarantor, if there is any) demanding payment of arrears with a certain period (10 or 14 days) from the date of the Legal Notice of Demand.

(iii) If the customer still fails to comply with the Legal Notice of Demand, the solicitors will then file summons and statement of claims in court.

(iv) See below for the court procedure:

(a) When summons is filed in court, the court will fix a date for mention of the case. If the customer defaults in appearing in court after the summons and statement of claims have been served on him, judgment in default will be given against the customer.

If the customer appears in court and acknowledges the demand, consent judgment will be recorded. Otherwise, the court will fix date for mention/trial of the case.

(b) If court judgment has been obtained and the customer still fails to settle the demand, the bank will then proceed for enforcement. The bank can also proceed to foreclosure proceedings to foreclose the secured property.

(v) <u>Expiry/Settlement</u>

Upon the expiry of the financing (with no default on the part of the customer) or settlement of the facility, the bank will normally issue release letter to the customer, informing that the facility has been fully settled. The bank will then proceed with the discharge documentation.

4.3.6 Bank's Release Documents, Discharge Documentation and Liabilities

(i) After the release letter has been issued by the bank, the bank will then proceed with the discharge documentation.

(ii) Solicitors will normally be appointed by the bank to prepare and attend to the discharge documentation.

(iii) Among the discharge documentation includes the following:

(a) discharge of charge at the relevant land office/land registry;

(b) deed of reassignment and discharge of power of attorney;

(c) discharge of guarantee; and

(d) discharge of debenture and memorandum of deposit.

(iv) The bank will also release to the customer the documents relating to the security in its possession, like share certificates etc.

4.3.7 Security

Upon completion of the discharge documentation, the bank will then release all the securities it holds..

4.4 COMMON MISTAKES & ISSUES IN ISLAMIC LEGAL DOCUMENTATION

Lack of description of nature of transactions e.g. whether the financing is under the Shariah concept of BBA, *Ijarah* or *Murabahah* etc

In order to enable first time readers to understand the Islamic concept adopted in the financing documents, it is strongly encouraged that a brief description of the Shariah concept applied be inserted in the recital clause.

Documentation does not accurately reflect the Shariah concept applied

The terminologies used in the documentation must reflect the particular Shariah concept applied or the specific product in question.

For example, it is not appropriate to use the term "commission" in the documentation for a product using the Shariah concept of *Murabahah* (cost-plus sale) as in the concept of *Murabahah*, there is no element of services rendered by the financier.

Likewise, different Shariah concepts used for a particular Islamic financing product will result in different terms and conditions to be used.

For example, there are three (3) Shariah concepts normally applied for letter of credit-i facility, i.e., *Musyarakah*, *Murabahah* and *Wakalah*.

Under the *Musyarakah* principle, the financier together with the customer share the profit from the venture (purchase of goods) whilst under the concept of Wakalah, the customer shall pay the financier fees and commission for services rendered by the financier. On the other hand, under the concept of *Murabahah*, the financier will sell the imported goods to the customer at a sale price comprising its cost and profit margin.

Terminologies wrongly used

The following terminologies are normally associated with conventional banking and must be avoided:

Conventional Terminologies	**Connotation**	**Recommended Islamic Terminologies**
Interest	It connotes the increase in the principal amount borrowed, with such increase is stipulated and calculated upfront at the beginning of the borrowing	Profit/ Fee/Commission (depending on the nature of the underlying transactions used)
Default interest	It connotes the increase in the principal borrowed upon the default by the borrower to settle the principal according to the schedule, with some more time given to the borrower. The increase will however only trigger upon the occurrence of the default	Ta'widh (compensation)
Loan	It connotes the activities of lending/borrowing	Financing
Loan Amount	It connotes the principal amount in lending/borrowing	Financing Amount
Loan/Repayment Period	It connotes the tenure for the repayment of the loan	Financing/Payment Period
Repayment	It connotes the repayment of the principal amount in lending/borrowing together with the interest	Payment
Borrower	It connotes person who borrows the money from lender	Customer
Lender	It connotes person who gives out the money to borrower in lending/borrowing activities	Financier

4.5 PROCESS AND REASON FOR RESCHEDULING AND RESTRUCTURING

(i) Reasons for rescheduling/restructuring

For the bank, rescheduling/restructuring can help the bank to reduce non-performing facility; have immediate write-back of specific provision (SP); and maximize credit recovery.
For the customer, rescheduling/restructuring can help ease cash flow; allow continuity in business and avoid legal action.

(ii) Rescheduling

Rescheduling has the following features:

(a) principal terms/conditions of the contract have not changed significantly;

(b) no change in the form of financing facility; and

(c) can be in the forms of: lengthening of tenor; change of installment amount; change in payment pattern etc.

(iii) Guidelines for Rescheduling:

(a) Rescheduling can be done while the account is still performing or non-performing.

(b) If the rescheduling occurs while the account is still performing:

(aa) the account is still classified as performing;

(bb) it will be classified as Non-Performing Financing (NPF) when in aggregate, the customer fails to settle his monthly payment for 6 months or more from first day of default (for term financing).

(c) Where rescheduling occurs after an account has been NPF the account will continue to be classified as NPF.

The rescheduled account can be reclassified as Performing Facility (PF), if:

(aa) payment has been compiled for a continuous period of 6 months

(bb) when the financing is well secured by cash or cash substitute.

(d) Banks are permitted to reschedule a financing account 2 times a year (otherwise, banks need to seek approval of Bank Negara Malaysia)

(e) Banks must make full credit evaluation before a financing can be rescheduled to avoid “ever-greening”.

(iv) Restructuring

Restructuring has the following features:

(a) terms/conditions of the contract have been modified significantly

(b) restructuring includes change in the type/structure of the facility

(v) Forms of Restructuring

Restructuring	Convert to new structure	Combine new facility & reschedule
No change in financing contract Example: • BBA to BBA • Cash Note to Cash Note • Bai' Inah to Bai Inah	Change of contract Example: • BBA to Cash Note • Murabahah to Cash Note	• Reschedule existing facility • Granting a new facility
Can be implemented for expired or unexpired facility		
Requires execution of new Letter of Offer & agreement		
Requires new Aqad		

(vi) To Reschedule/Restructure: Suggestions

Following are suggestions when considering rescheduling/restructuring:

(a) customer's request is genuine;

(b) proposal for rescheduling/restructuring is accompanied with upfront cash payment;

(c) tenor preferably within the financing period;

(d) proposal shall not dilute security coverage;

(e) customer to propose minimum payment to service at least the profit portion followed by principal payment;

(f) disposal of asset is not allowed during the period unless proceeds is for settling the debt; and

g) existing security shall not be released until full settlement of the rescheduled/restructured account.

4.6 GOOD, DELINQUENT AND DEFAULT ACCOUNT

(i) Financing Accounts can be classified into good (current), delinquent and non-performing (NPF) accounts.

(ii) BNM GP3 sets out the criteria for classification of NPF as follows:

(a) Definition of NPF

(aa) principal of profit is due but unpaid for 6 months (mostly cap at 3 months overdue) or more from the 1st day of default;

(bb) for cash line facility (IOD)

(aaa) when account is dormant for 6 months or more and outstanding is in excess of approved limit;

(bbb) an active account which has breached the approved limit for more than 6 months (unadvised line is not considered as approved limit);

(ccc) if IOD is recalled, account classified as NPF immediately (Once reinstated, without full settlement of the amount outstanding, the facility shall be regarded as rescheduled facility);

(cc) for AB-i, Trust Receipt, Bill of Exchange etc, when instrument is due and unpaid for 1 month after maturity date;

(dd) for credit card-i, when the cardholder failed to settle minimum monthly payment for 3 consecutive months from date of default; and

(ee) for term financing-i, revolving credit-i, leasing-i, hire purchase-i and others, when principal and profits unpaid for more than 6 months.

(b) Other Treatment

(aa) NPF if due and unpaid for 3 months or 6 month – for repayment with interval such as quarterly, bi-yearly etc;

(bb) NPF if due and unpaid for 12 months – for facility fully secured (covering principal, profit & cost of collection) by cash or cash substitute (e.g. GIA or sinking fund with set-off rights, securities issued by Federal Government, irrevocable guarantees or step-in-rights by Federal Government); and

(cc) NPF if payment is received partially – secured portion of cash or cash substitute is 12 months while unsecured portion is as per normal NPF treatment.

(c) Reclassification as Performing

All overdue installment in arrears fall below 6 months (or 3 months whichever applicable) e.g. if account is 8 months overdue but customer paid-up 3 months, account can be reclassified as performing since account is below 6 months in arrears.

4.6.1 Application of Bank Negara Malaysia's Guideline: GP3 During Rescheduling and Restructuring of Default Islamic Financing Accounts

(i) Reschedulement

(a) In reschedulement, payment terms (including payment period) are modified but principal terms and conditions have not changed significantly.

(b) Reschedulement cannot exceed 2 times a year to avoid "ever-greening". If banks need to reschedule 3 time or more, bank needs to sought approval from Bank Negara Malaysia.

(ii) Restructured

(a) In restructuring, payment terms are modified principally (facility structure change to assist customer with longer term prospect still deemed viable).

(b) If restructuring occurs before account is classified as NPF (arrears zerorised), account ill be NPF if the new restructured installment is 6 months in arrears.

(iii) If restructuring occurs after NPF, account shall remain NPF until 6 payments are received or facility become well secured by cash or cash substitutes.

4.7 THEORY OF *MAL* (PROPERTY) IN SHARIAH

(i) *Mal* (Property) is defined as tangible things to which human nature inclines.

(ii) For something to be the subject of a contract, it must be mutaqawam, meaning that its use is lawful under the Shariah. For example, wine is not mutaqawam for Muslims, although it is *mal*, since non-Muslims may buy and sell it.

(iii) There is dispute whether uses or usufructs (*manfa'ah*) are *mal*.

(iv) Hanafis require that mal be *physically* possessable and preservable. They do not consider usufructs to be property, since they fail this test, and presumably because, it exists only instant-by-instant over time, they involve *Gharar*.

(v) The Hanafis admit, however, as an exception to strict doctrine, that usufructs have legal value after that value is fixed by a lease contract.

(vi) Other schools differ and consider usufructs fully mal, on the *apparent* ground that existence and custody of the underlying things suffice as a token for the existence and custody of the usufruct.

(vii) *Mal* may be divided into fungibles (*mithliyat*) and non-fungibles (*qimiyyat*), and into movables (*manqulat*) and immovables (*'aqar*). While the latter distinction is important in practical details, it does not fundamentally shape the contract law.

4.8 THEORY OF MILKIYYAH (OWNERSHIP) IN SHARIAH

(i) *Mal* is owned (milk) as either *'ayn* or *dayn*.

(ii) *'Ayn* is a specific existing thing, considered as a unique object and not merely as a member of a category ("this horse" not "thoroughbred mare").

(iii) *Dayn* is any property, not an *'ayn*, that a debtor owes, either no or in the future; or it can refer to such property only hen due in the future. Property owned as *dayn* is usually a fungible, such as gold or wheat. Sometimes, non-fungible manufactured goods defined by specification are treated as *dayn*.

(iv) Although *dayn* literally means "debt", in *fiqh* it refers not to the "obligation" per se, but rather to the property the subject of the obligation, which is considered to be already owned by the creditor. Clearly, since such property is not yet identified and may not even exist (it is not an *'ayn*), referring to dayn as present property is fictive.

(iv) Indeed, Islamic law takes the fiction one step further, by imagining *dayn* property as subsisting "in the *dhimma*" of the obligor. *Dhimma* means literally "compact", "bond", "obligation", "responsibility", "protection", or "security" but is used legally for the faculty or capacity in an individual by which he accepts duty and obligation. Its usage often employs a metaphor of a physical place (*mahallal*) in the individual.

(v) Thus, if one buys property generically or abstractly, such as so many bushels of a particular quality of wheat, one is said to have title to that wheat as a described thing in the *dhimma* of the seller (*mausuf fi dhimmat al-bai'*).

(vi) The fictions of *dayn* and *dhimma* indicate that Islamic law understands sale not as one or more obligations, but as the consenting present transfer of property.

4.9 GENERAL PROHIBITIONS IN MUAMALAT CONTRACTS

(i) No contract should be made for selling or buying forbidden products such as alcohol, pork, or any other forbidden substances. Allah says in the Holy Qur'an, "O you who believe, eat from good (lawful) foods that I gave you as sustenance. " [Al-Baqarah: 172]. The verse indicates that we are not allowed to have our sustenance from things or goods that are forbidden.

(ii) The Prophet Muhammad s.a.w. said, "Seeking lawful sustenance is obligatory for every Muslim."

(iii) Likewise, no contract should be made for any financial deal on the basis of riba. Riba is forbidden in Islam. Allah says in the Holy Qur'an, ""Allah has permitted trade and forbidden interest." [2:275].

(iv) Moreover, contract for gambling is forbidden in Islam. Allah SWT says in the Holy Qur'an, "They will ask thee about intoxicants and games of chance. Say: In both there is great evil as well as some benefit for man; but the evil which they cause is greater than the benefit which they bring." (2: 219)

(v) Contract that involves major gharar is also forbidden and the existence of the said major gharar will make the contract defective and Batil (void).

(vi) It is also forbidden in Islam to produce and sell goods that are of no use therefore of no value.

4.10 THEORY OF '*AQD* (CONTRACT) IN MUAMALAT

(i) The literal meaning of "aqad" is "join" or "tie".

(ii) The English word for "aqad" is "contract".

(iii) The Shari'ah term for "aqad" or "contract" as given by al-Inayah is "legal relationship created by the conjunction of two declarations, from which flow legal consequences with regard to the subject matter."

(iv) "Contract" can also be defined as being "an expression of the matching between a positive proposal made by one of the contractors and the acceptance of the other contractor in way which has an impact on the subject of the contract.

4.11 TYPES OF CONTRACT

Islamic contracts may be classified into trading contracts, contracts of participation and other supporting contracts like Hibah (gift), contracts of safe custody etc.

4.12 ESSENTIAL ELEMENTS OF CONTRACT

(i) Sale (*bai'*) is one of the main forms of trading contracts which can also be classified as financial exchanges contracts (*'uqud al-mu'awadat*).

(ii) Majority of the jurists require all sale contracts to satisfy three essential elements (*arkan*), namely:

(a) contractual expression (*sighah*);

(b) contractual parties (*'aqidan*); and

(c) subject matter of the contract (*mahallal al-'aqd*).

4.13 NECESSARY CONDITIONS OF EACH ESSENTIAL ELEMENT

Each of the above essential elements is further subjected to a number of conditions, briefly summarised as follows:

(i) Conditions for the contractual expression (offer and acceptance):

(a) Both offer and acceptance must be made in clear terms.

(b) Conformity of the offer and acceptance.

(c) Continuity between the offer and acceptance, actually or constructively.

(ii) Conditions for the contracting parties:

(a) Full legal capacity (*ahliyyah*) to undertake and execute the contract.

(b) Legal authority (*wilayah*) to undertake and execute the contract: either as the actual owner; or by delegation (such as the agent, guardian or administrator)

(iii) Conditions for the subject matter of contract:

(a) The goods should exist at the time of contract.

(b) The goods should be legal and capable of enforcement – by virtue of being a valuable property that is capable of ownership and possession (*mal mamluk mutaqawam*).

(c) The goods should be capable of delivery at the time of contract.
(d) The goods should be ascertained and known by both contracting parties

5.0 ISLAMIC TRADE FINANCE

5.1 The Needs for Islamic Trade Finance Products
5.2 General
5.3 Interpretation
5.4 Wakalah Letter of Credit (WLC)
5.5 Wakalah Inward Bills under Letter of Credit (WIB)
5.6 Kafalah Bank Guarantee (KBG)
5.7 Kafalah Shipping Guarantee (KSG)
5.8 Murabahah Trust Receipt (MTR)
5.9 Wakalah Inward Bills Collection (WIBC)
5.10 Wakalah Outward Bills Collection-Under LC/Not Under LC (WOBC)
5.11 Islamic Accepted Bill (IAB)
5.12 Bai' Al-Dayn Bills Purchased (BPP) Not Under LC
5.13 Bai' Al-Dyan Credit Bills Negotiation (BCBN)
5.14 Interest Free Export Credit Refinancing (IECR)
5.15 Wakalah Letter of Credit Advising (WLA)

5.1 THE NEEDS FOR ISLAMIC TRADE FINANCE PRODUCTS

"Skim Perbankan Islam (SPI)" is an Islamic banking scheme introduced with the objective of disseminating and promoting Islamic banking on a wider scope by utilizing the existing banking infrastructure in the conventional financial institutions. The SPI was launched on March 1993.

In line with the above objective, The Bank offers Islamic Trade Finance products, which are currently maintained manually. Moving forward, in order to better mobilize resources and upgrade efficiency, a proper computerized system would be outmost important. Such this functional specification is written to specify enhancement requirements in the existing system used for the Conventional Trade Finance facilities i.e. FITAS.

5.2 GENERAL

The operational aspects of the Islamic Trade Finance instruments are mostly similar to the conventional except that it must conform to the Shariah requirements.

This Section focuses on the products, which are currently being offered in the market. The following are the Islamic and conventional Trade Finance products:

Islamic Trade Finance Product	Equivalent Product
1. Wakalah Letter of Credit (WLC)	Letter of Credit (LC)
2. Wakalah Inward Bills Under LC (WIB)	Inward Bills Under LC (IB)
3. Kafalah Shipping Guarantee (KSG)	Shipping Guarantee (SG)
4. Kafalah Bank Guarantee (KBG)	Bank Guarantee (BG)
5. Murabahah Trust Receipt (MTR)	Trust Receipt (TR)
6. Islamic Accepted Bills (IAB)	Bankers Accepted (BA)
7. Wakalah Inward Bills Collection (WIBC)	Inward Bills Collection (IC)
8. Wakalah Outward Bills Collection (WOBC)	Outward Bills Collection (OBC)
9. Bai'al-Dayn Bills Purchased (BBP)	Bills Purchased (BP)
10. Bai'al-Dayn Credit Bills Negotiation (BCBN)	Credit Bills Negotiation (CBN)
11. Islamic Export Credit Refinancing (IECR)	Export Credit Refinancing (ECR)
12. Wakalah Letter of Credit Advising (WLA)	Letter of Credit Advising (LA)

5.3 INTERPRETATION

a) "Al-Wakalah" (nominating another person to act) refers to a situation, where a person nominates another person to act on his behalf (agent).

b) "Al-Kafalah" (guarantee) refers to the guarantee provided by a person to the owner of a goods, who had placed or deposited his goods with a third party, whereby any subsequent claim by the owner for his goods must be met by the guarantor and the third party.

c) "Al-Murabahah" (cost-plus) refers to the sales of goods at a price, which includes a profit margin as agreed to by both parties. Such a sale contract is valid on condition that the price, other costs and the profit margin of the seller are stated at the time of agreement of sale.

d) "Bai' al-Dayn" (debt-trading) refers to debt trading, i.e. the provision of financing required for production, commerce and services by way of sale/purchase of trade documents and papers. It is short-term facility with a maturity of not more than a year. Only documents evidencing real debts arising from bona fide commercial transactions can be traded.

e) "Al-Wadiah Yad Dhamanah" (guaranteed safe custody) refers to asset or deposits, which have been deposited with another person, who is not the owner, for safekeeping. Due to the nature of banking, the depository guarantees repayment of the whole amount of deposits, or any part thereof, outstanding in the account of the depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the deposits as a token of appreciation.

Abbreviations

The following are the abbreviation for the trade finance products:

Product	Abbreviation
Wakalah Letter of Credit	WLC
Murabahah Letter of Credit	MLC
Musyarakah Letter of Credit	SLC
Kafalah Shipping Guarantee	KSG
Kafalah Bank Guarantee	KBG
Murabahah Trust Receipt	MTR
Islamic Accepted Bills	IAB
Bai'al-Dayn Bills Purchased	BBP
Bai'al-Dayn Credit Bills Negotiation	BCBN
Islamic Export Credit Refinancing	IECR
Wakalah Letter of Credit Advising	WLA

5.4 WAKALAH LETTER OF CREDIT (WLC)

5.4.1 Description of WLC

WLC is a written undertaking by the bank, given to a seller at the request of the buyer, to pay at sight or a determinable future date up to a stated sum of money with prescribed time limit, and against stipulated documents and upon compliance of terms and conditions.

5.4.2 Tenets of WLC

There are four elements that must exist in the contract of WLC namely:

a) Agents (Issuing Bank)
b) Agent Representative (Advising/Negotiating Bank)
c) Object Been Transacted (description of goods/services)
d) Offer and Acceptance

5.4.3 Comparison between WLC and conventional LC

The main features of WLC and conventional LC are as follows: -

WLC	LC
a) Contract based on Agency	Contract based on Agency
b) Commission is charged	Commission is charged
c) Reimbursement instruction-by notification	Varies
d) Only "halal" goods may be transacted	No such restriction

5.5 WAKALAH INWARD BILLS UNDER LETTER OF CREDIT (WIB)

5.5.1 Description of WIB

WIB is a set of documents drawn in compliance with the terms of the seller (the beneficiary) on the bank (WLC issuing bank) for an amount, which represents full or part of the value of the goods shipped. These documents are presented to The Bank through the Negotiating Bank and are to be checked against the terms and conditions of the WLC.

5.5.2 Tenets of WIB

As WIB is the sub-product of WLC, the four elements that must be present in the contract of WLC remain namely:

a) Agent (Issuing Bank)
b) Agent Representative (Advising / Negotiating Bank)
c) Object Been Transacted (description of goods / services)
d) Offer and Acceptance

5.5.3 Comparison between WIB and conventional IB

The main features of WIB and conventional IB remain as per WLC / LC as follows : -

WIB	IB
a) Contract based on Agency	Contract based on Agency
b) Commission is charged	Commission is charged
c) Charge penalty for late payment	Charge penalty for late payment
d)Reimbursement instruction-by notification	Varies
e) No transit interest chargeable	Transit interest charged
f) No normal interest	Normal interest charged
f) Only “halal” goods may be transacted	No such restriction

5.6 KAFALAH BANK GUARANTEE (KBG)

5.6.1 Description of KBG

Al-Kafalah or other synonymous term, Al-Dhamanah, can be defined as a surety given by one party who agrees to discharge a liability of a third party in case the third party defaults in fulfilling his obligation.

In Islamic financial scheme the bank may provide a guarantee facility to its customers for certain purposes under principle of Al-Kafalah. The guarantee facility would cover Bank Guarantee and Shipping Guarantee.

5.6.2 General Principles of KBG

Five essential elements of Islamic Guarantee (Al-Kafalah) which cover KBG are as follows: -

a) Guarantor (Al-Kafalah)
b) Principle / Bailee (Al-Makful an-h)
c) Beneficiary (Al-Makfulleh)
d) Article in the guarantee (Al-Makfulbeh)
e) Offer and Acceptance (Sighah)

5.6.3 Comparison between Kafalah Bank Guarantee (KBG) and conventional Bank Guarantee (BG)

The main features of KBG and conventional BG are as follows: -

KBG	BG
a) Contract based on guarantee	Contract based on guarantee
b) Commission is charged	Commission is charged
c) Only "halal" goods may be transacted	No such restriction

5.7 KAFALAH SHIPPING GUARANTEE (KSG)

5.7.1 Description of KSG

KSG is an indemnity document issued by The Bank addressed to a shipping company on the instruction of an importer (customer) to take delivery of goods from the shipping company (or its agents) pending receipt of the Bill of Lading.

KSG is not a financing instrument but merely an indemnity.

5.7.2 Tenets of KSG

Five principles of Islamic Guarantee (Al-Kafalah), which cover KSG, are as follows: -

a) Guarantor (Al-Kafalah)
b) Principle / Bailee (Al-Makful an-h)
c) Beneficiary (Al-Makfulleh)
d) Article in the guarantee (Al-Makfulbeh)
e) Offer and Acceptance (Sighah)

5.7.3 Comparison between KSG and conventional SG

The main features of KSG and conventional SG are as follows: -

KSG	SG
a) Contract based on guarantee	Contract based on guarantee
b) Commission is charged	Commission is charged
c) Only "halal" goods may be transacted	No such restriction

5.8 MURABAHAH TRUST RECEIPT (MTR)

5.8.1 Description of MTR

MTR is a document signed by customer (purchaser/importer) on the strength of which the bank releases the shipping documents to the purchaser/importer who undertakes to land, store, insure, hold and deliver to his buyers the said merchandise and receive the proceeds of sales as trustee(s) from the The Bank. The Bank thus retains the legal title to the Shipping or Transport Documents/merchandise but relinquishes physical possession of goods to the purchaser/importer who acts as agent of The Bank, disposes them profitably and pays the bank the agreed selling price on or before due date.

For example, a customer, who is involved in trading or manufacturing may require to purchase a merchandise or raw materials in the course of his business. In this case, the customer may require the WLC together with financing facility over a certain period of time. The bank would offer the customer WLC / MTR facilities.

The bank, having made payment to the negotiating bank, will then sell the merchandise to the purchaser/importer at a sale price comprising its cost and profit margin under the principle of Al-Murabahah where settlement will be on deferred term. The Bank secures the transaction against the merchandise securities as deemed necessary. To enjoy such arrangement, the purchaser/importer would have applied and been granted a MTR. Under normal circumstances, the facility is approved only to customers enjoying WLC facility.

In the event that the customer settles the MTR facility prior to its settlement date, the customer will be entitled to a rebate (Ibra').

5.8.2 Tenets & Conditions of MTR

Tenets of MTR

There are five essential elements that must exist in the contract of Murabahah namely,

a) Seller
b) Buyer
c) Commodity
d) Price
e) Offer and Acceptance (Sighah)

Conditions of MTR

Condition of the contract under Murabahah are as follows:

a) The seller must reveal the cost of the merchandise.
b) The seller and buyer should agree on the selling price (mark-up price).
c) The contract can be revoked if there is any dispute against the price of commodity quoted by the seller.

5.8.3 Comparison of MTR and conventional TR

The main features of MTR and conventional TR are as follows: -

MTR	TR
a) Based on buy / sell concept	Lending / Borrowing
b) Profit or mark-up is created	Interest is created and accrued
c) Selling price is the contracted amount	No selling price
d) Profit margin or mark-up is fixed	Interest rate is subject to change (BLR + spread)
e) Ibra' (rebate) is given for early settlement	Interest is charged until repayment
f) Charge penalty for late payment	Charge penalty for late payment
g) Only "halal" goods may be transacted	No such restriction

5.8.4 Calculation

a) **Selling Price**: $\frac{\text{Invoice amount X (1 + Cost of Fund + Spread X Tenor)}}{36500}$

b) **Unearned Income**: Selling price – Invoice amount
Unearned Income is also called Mark-up Amount / Profit

c) **Monthly Amortization of Unearned Income**:
$\frac{\text{Mark-up amount X No. Of Days (in the month)}}{\text{Tenor}}$
Total Monthly Amortized Amount = Unearned Income

There should be 4 fields for the mark-up amount as follows: -

d) **Rebate** (if early settlement):
$\frac{\text{Invoice Amount X (1 + Cost of Fund + Spread) X (Tenor – Actual no. of days)}}{36500}$

e) **Early Settlement Amount**: Selling Price – Rebate

f) **Partial Settlement** is allowed. If partial settlement done prior to the maturity date are as follows:

i) Rebate given for settlement amount.

ii) Profit would be recalculated based on the outstanding financing amount.

5.9 WAKALAH INWARD BILLS COLLECTION (WIBC)

5.9.1 Description of WIBC

These are import bills that are not drawn under LC or WLC. They are sent to the Bank (agent) on a collection basis. The Bank must adhere strictly to the instructions stated in the Remitting bank's covering schedule, particularly on the payment instruction, disposal of funds and treatment of bills if they are dishonored or unpaid.

5.9.2 Comparison between WIBC and Conventional IBC

The main features of WIBC and Conventional IBC are as follows:-

WIBC	IBC
a) Contract based on Agency	Contract based on Agency
b) Commission is charged	Commission is charged
c) Only "halal" goods may be transacted	No such restriction

5.10 WAKALAH OUTWARD BILLS COLLECTION – Under LC/Not Under LC (WOBC)

5.10.1 Description of WOBC

WOBC is a method of export settlement by a buyer in one country to a seller in another country via banks. The process involves the seller (drawer) forwarding through the bank (agent – Remitting Bank) the documents, which represent the underlying goods with instruction to The Bank in the buyer's country (Collecting Bank) that the documents are to be released to the buyer (drawee) either against payment or acceptance of the bill of exchange.

5.10.2 Comparison Between WOBC and Conventional OBC

The main feature of WOBC and Conventional OBC are as follows:-

WOBC	OBC
a) Contract based on Agent	Contract based on Agent
b) Commission is charged	Commission is charged
c) Only "halal" goods may be transacted	No such restriction

5.11 ISLAMIC ACCEPTED BILL (IAB)

5.11.1 Description of IAB

An IAB is a Bill of Exchange, which is drawn by one party (bank / customer) and accepted by another party (customer / bank) where the drawer is the original creditor.

The product in interest free as its underlying contracts, *Murabahah* for IAB import / domestic purchase and *Bai' al Dyan* for IAB export / domestic sales, are based on the Shariah Principles.

IAB is an acceptance bill, which is unique when compared to the conventional BA. For the BA, the acceptance is always by the bank. However in the case of IAB, the acceptance could be either by:

a) the bank in the case of export / domestic sales, or,
b) the bank's customer in the case of import / domestic purchase.

The original creditor who is the bank in the case of IAB import / domestic purchase will draw the bill and customer will accept the bill.

5.11.2 Comparison Between IAB and BA

The main features between IAB and conventional BA are as follows : -

IAB	BA
a) A bill that could be accepted by the bank (IAB / Export) or customer (IAB/ import)	A bill that is only accepted by the bank
b) IAB-import /purchase has an underlying Murabahah (mark-up contract) c) IAB-export/sales is created from Bai'al-Dayn (sale of debt contract)	BA is based on lending
d) Penalty charged for late payment.	Interest penalty is imposed
e) Only halal goods may be transacted	No such restriction

5.11.3 Amount of Financing

An IAB may be drawn equal to but not exceeding the financial value of the trade transaction as indicated in the supporting documents.

The financial value of a trade transaction shall be determined as follows:

a) **In the case of IAB purchases**, that amount of money payable by the acceptor of the IAB for the full amount of the bank's selling price (calculated as per below), which includes payment to supplier, plus other separate payments to relevant parties (e.g. import duties and insurance premium etc.), if applicable, and the bank's profit margin.

The financial value of IAB in case of purchases is calculated using the formula as follows:-

$$FV : IV \ X \ \{1 + \frac{rt}{36500}\}$$

Where,

FV	=	Face or maturity value
IV	=	Invoice Value
r	=	Annual rate of profit (per cent per annum)
t	=	Number of days remaining to maturity

Example :

For RM1000000.00 IAB which is financed under IAB – Purchase for 90 days at 6.0% per annum, the financial value of the IAB is derived as follows : -

$$FV = RM1{,}000{,}000 \ X \ \{ 1 + \frac{6 \ X \ 90}{36500} \}$$

$$FV = RM1{,}000{,}000 \ X \ \{ 1 + 0.0147945 \}$$

$$FV = RM \ 1{,}014{,}794.52$$

b) **In the case of IAB sales**, the amount to be received by the drawer (of the IAB) from the buyer for the settlement of the trade is as follows:-

$$P = FV \ (1 - \frac{rt}{36500})$$

Where,

P	=	Market price
FV	=	Face or maturity value
r	=	Annual rate of profit (in per cent per annum)
t	=	Number of days remaining to maturity date of the IAB

Example :

For a RM1000000 IAB with 90 days to maturity is sold or purchased at 6.0% per annum, the price is derived as follows : -

$$P = RM1000000 \ X \ \{ 1 - \frac{6 \ X \ 90}{36500} \}$$

$$P = RM1{,}000{,}000 \ X \ \{ 1 - 0.0147945 \}$$

$$P = RM \ 985{,}205.50$$

5.11.4 Calculation of Acceptance Commission

The same computation for Acceptance Commission as per conventional BA shall apply. The computation of the Acceptance Commission is based on the Invoice Amount i.e.

AC=Invoice value X Acceptance commission X Tenor

Example :

$$AC = RM1{,}000{,}000 \times 1 \times \frac{90}{36500}$$

AC = RM2,465.75

5.12 BAI' AL-DAYN BILLS PURCHASED (BBP) NOT UNDER LC

5.12.1 Description of BBP

BBP is a facility provided by the bank to its customers whereby the bank will purchase the bill and immediately credit the proceeds into the customer's account. The Bank will send the bills for collection to the buyer's bank to obtain payment. When the bank purchases a Bill of Exchange, the bank becomes the owner of the bill, but maintain full right of recourse on the customer in the event the bill is dishonored.

BBP is a facility to finance domestic sales and export under documentary collection (without LC/WLC).

The Bank will purchase the bills in RM equivalent at an agreed price less the the bank's profit and charges (commission, postage, etc) and forward the bills to the buyer's bank. The bank then sells the bills to customer at invoice value payable on a specified future date. On maturity, the seller pays the bank.

5.12.2 Comparison of BBP and conventional BP

The main features of BBP and conventional BP are as follows: -

BBP	BP
a) Based on buy / sell concept	Lending / Borrowing
b) Profit or discount is created	Interest is created and accrued
c) Discount amount is fixed	Interest rate is subject to change (BLR + spread)
d) Charge penalty for late payment	Charge penalty for late payment
e) Only "halal" goods may be transacted	No such restriction

5.12.3 BBP in Foreign Currency

The same conditions that of conventional BP shall apply for sight and usance bills.

Overdue Financing
Penalty is charged on the discounted amount.

5.12.4 BBP in Local Currency

Customer will be credited with net proceeds less charges for sight and usance bills.

a) Calculation of Net proceeds as follows:

Net Proceeds =

$$\text{Invoice Value X } \{1 - \frac{(\text{Cost of Funds} + \text{Spread}) \text{ X Tenor}}{36500}\}$$

b) **Discounted Amount** = Invoice amount – Net proceeds

For sight and usance bills, the discounted amount is to be amortized.

c) **Monthly Amortization of Discounted Amount:**

$$\frac{\text{Discounted amount X No. of Days (in the month)}}{\text{Tenor}}$$

d) **Overdue financing**

The penalty is charged on the discounted amount.

5.13 BAI' AL-DYAN CREDIT BILLS NEGOTIATION (BCBN)

5.13.1 Description of BCBN

BCBN is a facility provided by the bank to its customers whereby The Bank will purchase the bill and immediately credit the proceeds to the customer's accounts. The bank will send the bills for collection to the buyer's bank to obtain payment. When The Bank purchases a Bill of Exchange, The bank becomes the owner of the bill, but maintain full right of recourse to the customer in the event the bill is dishonored.

BCBN is a facility to finance domestic sales and export under documentary credit (with LC/WLC).

The Bank will purchase the bills in RM equivalent at an agreed price less the bank's profit and charges (commission, postage, etc) and forward the bills to the buyer's bank. Then The Bank resells the bills to customer at invoice value payable at a specified future date. On maturity, the seller pays The Bank.

5.13.2 Comparison of BCBN and conventional CBN

The main features of BCBN and conventional CBN are as follows: -

BCBN	CBN
a) Based on buy / sell concept	Lending / Borrowing
b) Profit or discount is created	Interest is created and accrued
c) Agreed on buying and selling price upfront.	No agreed on buying and selling price upfront
d) Discount amount is fixed	Interest rate is subject to change (BLR + spread)
e) Charge penalty for late payment	Charge penalty for late payment
f) Only "halal" goods may be transacted	No such restriction

5.13.3 Overdue Financing

Penalty is charged on the Discounted amount

5.13.4 BCBN in Local Currency

Customer will be credited net proceeds less charges for sight and usance bills.

a) Calculation of net proceeds as follows:

Net Proceeds =

$$\text{Invoice Value X } \{1 - \frac{(\text{Cost of Funds} + \text{Spread}) \text{ X Tenor}}{36500}\}$$

- **Discounted Amount** = Invoice amount – Net proceeds

  For sight and usance bills, the discounted amount to be amortized.

- **Monthly Amortization of Discounted Amount:**

$$\frac{\text{Discounted amount X No. of Days (in the month)}}{\text{Tenor}}$$

- **Overdue Financing**

  Penalty is charged on the discounted amount.

5.14 INTEREST FREE EXPORT CREDIT REFINANCING (IECR)

5.14.1 Description of IECR

IECR is a financial incentive aimed at providing credit facilities to exporters and their local suppliers for the promotion of Malaysian goods.

The bank provides financing through IECR. Financing is securitised in the form of a Bill of Exchange, which will be sold to the bank at a special refinancing rate. The bank determines the rate of financing. Financing is limited to purchase of tangible goods such as raw materials, intermediate or finished goods. Financing will be in Ringgit Malaysia. Contracted values and payments in foreign currencies will be converted to RM using spot rate. Financing rate is the bank's funding rate + 1% (max. margin).

Types of IECR are as follows:

a) Pre-shipment Financing
The Bank appoints the exporter as its purchasing agent to buy the new materials required for production. Upon delivery of goods, The bank pays supplier for the cost of the goods based on invoice value. The bank as owner of the goods then sells the goods to the exporter at an agreed price (cost of goods plus mark-up) payable at a specified date.

b) Post-shipment Financing
The exporter as the owner of the export bill (debt instrument) draws a post shipment bill on the bank requiring The Bank to pay a certain sum of money on a specified future date. The exporter sells the bill (debt) to the bank at an agreed price i.e. value of the bill less The Bank's profit margin. The bank then sells at the price equivalent of the bill less the bank's profit margin. On maturity, The Bank resells the bill to The Bank at the face value of the bills. The Bank in turn resells the bill to the exporter also at the face value.

5.14.2 Comparison Between IECR and ECR

The main features between IECR and conventional ECR are as follows : -

IECR	ECR
a) Based on buy / sell concept	Lending / Borrowing
b) IECR-Pre-shipment has an underlying Murabahah (mark-up contract) c) IECR-Post-shipment is created from Bai'al-Dayn (sale of debt contract)	IECR is based on money lending
d) Penalty charged for late payment	Penalty charged for late payment
e) Only "halal" goods may be transacted	No such restriction

5.14.3 IECR pre-shipment

Similar conditions as per conventional ECR shall apply as follows:

a) Lodgement similar condition that of conventional ECR?
b) Draw down (Booking)
c) Draw down (Creation)

The screen should show as follows:

i) Financing amount
ii) Financing rate
iii) Tenor
iv) Selling Price
v) Mark-up amount. To be amortised daily.

$$\frac{\text{Mark-up amount X No. Of Days}}{\text{Tenor}}$$

Total Monthly Amortized Amount **=** Unearned Income

d) Early discharge – profit calculated until date of payment (similar to the conventional ECR).
e) Partial Liquidation – the outstanding financing used to recalculate the selling price and similar to the conventional ECR shall apply
f) Redemption – similar treatment as per the conventional ECR shall apply
g) Retirement – penalty charged for late payment and similar condition as per the conventional ECR shall apply.

5.14.4 IECR post-shipment

The same conditions as per the conventional ECR shall apply, as follows:
a) Registration
b) Booking
c) Refinancing
d) Early discharge
e) Redemption
f) Retirement

5.14.5 Calculation

IECR pre-shipment

SP for The Bank :

$$\text{Invoice value X } \left(1 + \frac{\text{(The Bank's profit margin x Tenor)}}{36500}\right.$$

SP for Customer:

$$\text{Invoice value X } \left(1 + \frac{\text{(1\% plus The Bank profit's margin X Tenor)}}{36500}\right.$$

IECR post-shipment

P (sales proceeds) for The Bank: $\frac{\text{FV(face value) X100}}{\text{(rate of financing X tenor)} + 100}$ 36500

P (sales proceeds) for Customer: $\frac{\text{FV(face value) X100}}{\text{(1\% plus rate of financing X tenor)} + 100}$ 365000

5.15 WAKALAH LETTER OF CREDIT ADVISING (WLA)

5.15.1 Description of WLA

WLA is an undertaking from the Issuing Bank to pay a seller (exporter) thus enabling the exporter to arrange the delivery of goods to the buyer (importer).

The Bank acts as Advising Bank when receiving the WLA from the Issuing Bank. Confirmation of WLA may require if a request from seller.

5.15.2 Comparison between WLA and conventional LA

The main features of WLA and conventional LA are as follows: -

WLA	LA
a) Contract based on Agency	Contract based on Agency
b) Commission is charged	Commission is charged
c) Only "halal" goods may be transacted	No such restriction

6.0 MARKETING OF ISLAMIC BANKING PRODUCTS

6.1 Islamic Principles in Marketing
6.2 The 4P's of Marketing

6.1 ISLAMIC PRINCIPLES IN MARKETING

Islam recognizes that one of the ways to satisfy man's wants is through buying and selling and not through stealing, robbing and taking people's properties by force.
Allah commands in the Qur'an, ,meaning:

> "O ye who believe! Eat not up your property among yourselves in vanities; but let there be amongst you traffic and trade by mutual goodwill….."

(Surah An-Nisaa', ayat 29)

Muslims must also strictly avoid satisfying their wants through loans with interest, following Allah's command, meaning:

> "…..but Allah had permitted trade and forbidden usury."

(Al-Qur'an, Surah Al-Baqarah, Ayat 275)

6.2 THE 4P'S OF MARKETING

Marketing decisions generally fall into the following four controllable categories:

- Product
- Price
- Place (distribution)
- Promotion

The term "marketing mix" became popularized after Neil H. Borden published his 1964 article, *The Concept of the Marketing Mix*. Borden began using the term in his teaching in the late 1940's after James Culliton had described the marketing manager as a "mixer of ingredients". The ingredients in Borden's marketing mix included product planning, pricing, branding, distribution channels, personal selling, advertising, promotions, packaging, display, servicing, physical handling, and fact finding and analysis. E. Jerome McCarthy later grouped these ingredients into the four categories that today are known as the 4 P's of marketing, depicted below:

- Product
- Price
- Promotion
- Place/ delivery channel

Nowadays, another P's is added

- People (+ 1)

6.2.1 Product

- ✓ **Product Components**
  - ❖ Brand
  - ❖ Features/ T&C
  - ❖ Contract
  - ❖ Benefits (USP)

- ✓ **Product Development Stages**
  - ❖ R&D/ feasibility study
  - ❖ Prototype – brand, features & benefits
  - ❖ System & testing
  - ❖ Soft launch/ proper launch

- ✓ **Product Categories**
  - ❖ Consumer
  - ❖ Commercial
  - ❖ Corporate
  - ❖ Cash Management
  - ❖ Electronic Banking, etc

- ✓ **Product Positioning**
  - ❖ Entry products
  - ❖ Complementary products
  - ❖ Star products
  - ❖ Product Packaging
  - ❖ Product Bundling

- ✓ **Deposit Products** – safe keeping & risk sharing
  - ❖ Savings
  - ❖ Current
  - ❖ Investment

- ✓ **Main Contracts**
  - ❖ Wadiah
  - ❖ Mudharabah

  (cite examples for each)

- ✓ **Financing Products** – Trading & leasing, primary contracts, BBA, Ijarah, Musharakah, Mudharabah, Inah, etc.
  - ❖ Home and fixed assets (land, shop house)
  - ❖ Personal (Cash & Non-Cash – education, travel, etc)
  - ❖ Automobile
  - ❖ Credit card

- ✓ **Other Products**
  - ❖ Wealth Management – Bancatakaful, Wills Writing, Financial Planning etc
  - ❖ SMS/ Internet Banking

6.2.2 Price

General principles of pricing in Islam:

- Sellers are free to set prices for their products
- But prices of Islamic banking products must be fair.
- The prices must not be oppressive.
- Islam does not limit the margin of profit in any sale.
- In principle, Islam does not like to control prices.

At one time in Madinah, the prices of goods went up so high that many of the sahabat requested the Prophet s.a.w. to control the prices but the Prophet s.a.w. declined, saying which means:

"Allah sets prices, withholds, extends and provides the means of living. I hope to meet Allah and I hope no one amongst you would sue me for any injustice in a criminal or civil matter."

- Overall industry such as trading, retailing, whole selling – odd or even strategies
- Banking – deposit, financing & fee-based (administration fee)
- Deposit – ROI, dividend, profit ratio, hibah (token)
- Financing – profit margin, rate (fixed/ variable (float)), tier, step-up; selling price, zero moving cost, ibra' etc

6.2.3 Promotion

- **A &P**
  - ✓ **Above-the-line** – tv, radio, press, magazine & billboard
  - ✓ **Below-the-line** – collaterals, literatures (leaflet, flyer), banner, bunting, hanging mobile & wobbler
- **Campaign/ promotion** – short term, capitalize on the USP
- **Direct marketing** - personal sales executives & sales agents
- **Telemarketing/ phone banking** – call center, outbound as well as inbound
- **Booth, trade, exhibition, road show, seminar & talk** – awareness as well as sales solicitation activities
- **Marketing campaign/ promotion:**
  - a) Theme/ name
  - b) Duration
  - c) Mechanics
  - d) Communication strategy – ATL/BTL
  - e) Reporting/ tracking
- **Launching**
  - a) Logistic – venue, date, vip
  - b) Program – itineraries
  - c) Speech
  - d) Gimmick/ gambit
  - e) Gifts – vip, attendees
  - f) Press conference
  - g) Ambiance – deco, concept, etc

6.2.4 Place / Delivery Channel

- **Traditional** – branch
- **Latest** – electronic banking center, internet banking, phone banking, sms banking etc
- **Personal or direct selling**
- **Combination of the above**

6.2.5 People

- ✓ **Sales Personnel (self preparation)**
- **Knowledge** – product & company
- **Communication** & its related skills (soft & hard) – negotiation, discussion, objection handling, closing etc
- Appearance – project strong brand and credibility, have gut feeling
- Understand your **competitors** well – know what they are doing
- Work as a team
- Have sufficient tools
- Self motivated – internal motivational power is crucial

- ✓ **Customers**
- **Who are our target customers?**
  - Muslims/ Non-Muslims
- **What do they want?**
  - The value for money of products and services
  - Personalised service
  - Automated services
- **What does the Bank want?**
  - Profitable business
  - Regulatory compliance
  - Finding a win-win solution

- ✓ **Target Market/ Market segmentation**
- Different products for different market needs, do research and customer profiling
- Normal segments – demographics (who), geography (where), behaviors (what) or combination
- Work more on captive market rather than mass market
- Market opportunity – analyze your SWOT and suit with the opportunity
- Differentiation – what can the bank do that is better than competitors? Why should customers go to you/ branch instead of going to competitors'?

- ✓ **Relationship Marketing**
- Know customers by name not account numbers
- Transaction customers focus on tangible product, features and price. Relationship customers focus on intangibles like strong friendship, sharing etc
- Convert transaction customers to relationship customers for psychological not financial commitment to the bank – more powerful
- Aim for relationship & lasting returns, not fast business & quick return
- Establish "institutionalized" not "personalized" business relations
- Use "AIDA" as a strong sales guide

AIDA is an acronym used in marketing describes a common list of events that are very often undergone when a person is selling product or service:

- A - Attention (Awareness): attract the attention of the customer.
- I - Interest: raise customer interest by focusing on and demonstrating advantages and benefits (instead of focusing on features, as in traditional advertising)
- D - Desire: convince customers that they want and desire the product or service and that it will satisfy their needs.
- A - Action: lead customers towards taking action and/or purchasing. Nowadays some have added another letter to form AIDA(**S**):
- S - Satisfaction - satisfy the customer they become a repeat customer and give referrals to the product.

Marketing today allows a diversity of products. Using a system like this, allows a general understanding of how to target a market effectively. AIDA however is a acronym that is necessary to learn in marketing.

The Uniqueness of Islamic Banking

	Islamic Banking	Conventional Banking
• **Function**	* Custodian * Entrepreneur * Financier * Capital provider	* Lender & Borrower
• **Deposit**	* Safe custody * Investment	* Interest based deposit
• **Loan**	* Debt financing * Equity financing	* Interest based loan

Islamic Banking – Profit

- PROFIT distribution is calculated based on the income of Islamic banking activities
- Payment of PROFIT is based on pre-agreed sharing ratio between depositor and the bank
- PROFIT allocation is entirely based on the profitability of the investment. Profit or loss are to be shared between the depositors and the bank
- PROFIT payable is determined on the overall income of the investment activities
- Acceptance / allocation of PROFIT is permissible in Syariah

Conventional Banking – Interest

- Payment of INTEREST is fixed i.e. without considering the actual income churned out by the conventional banking
- Rate of INTEREST is made known upon placement being made
- Rate of INTEREST is fixed without considering whether the investments make profit or not
- INTEREST payable will not be changed even if the bank incurs a loss.
- Collection / payment of INTEREST is not permissible under Syariah

Challenges

- ✓ Competition
- ✓ Ability to grow
- ✓ Globalization
- ✓ People's attitude/ willingness to accept changes
- ✓ Creative products & services

7.0 RESTRUCTURING AND RESCHEDULING OF ISLAMIC FINANCIAL FACILITIES

7.1 The Global Problem of Non-Performing Loans
7.2 Classification of Financing Accounts
7.3 Types Of Debtors & The Need For Resheduling &/Or Restructuring
7.4 Types of Debtors
7.5 Obligation to Repay Debt
7.6 Reason for Rescheduling and Restructuring
7.7 Differences Between Rescheduling and Restructuring
7.8 Credit Risk Management for Rescheduled and restructured Credit Facilities
7.9 Rescheduling
7.10 Restructuring
7.11 Suggestions for Rescheduling/Restructuring

7.1 THE GLOBAL PROBLEM OF NON-PERFORMING LOANS

At present, many banks across Asia and the world are saddled with non-performing loans (NPLs) or sub-performing loans, foreclosed real estate properties, and other non-performing assets (NPAs) for which they have neither the time nor the resources for proper resolution. Ultimately, this leads to a depletion of funds for banks, resulting in slower credit growth. Tighter credit restricts economic growth and development, as enterprises are unable to source capital.

To help banks resolve their NPL problems, there must special purpose vehicles (SPV) that acquire NPL from banks. This enables banks to focus on its core operations and continue to provide financing to productive sectors of the economy.

By shifting distressed assets to SPV, economic fundamentals could improve via new financing by banks.

7.2 CLASSIFICATION OF FINANCING ACCOUNTS

1. Current
2. Delinquent
3. Non-Performing
    - Substandard
    - Doubtful
    - Bad

In general, a loan is classified as non-performing when the principal or interest is due and unpaid for six months or more from the first day of default. This is illustrated as follows:-

NON-PERFORMING FINANCING (NPF)

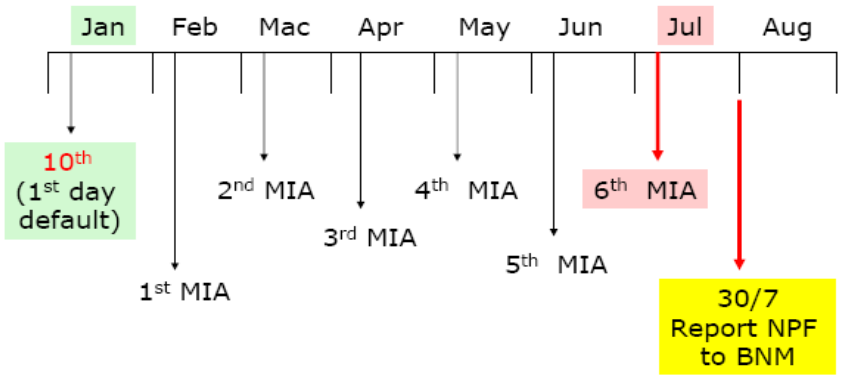
An account is classified as **NPF** when the PRINCIPAL or PROFIT has been in arrears :

Term financing (with monthly payment) Eg. - Home Financing - Car Financing	6 MIA**
• Term financing and Trade Finance (with quarterly; half-yearly; yearly; bullet payment)	3 MIA**

** Garispanduan BNM 3 (BNM GP3)

FINANCING ACCOUNT TURNS NON-PERFORMING

Example : Home financing



The various categories of credit facilities shall be classified as performing and non-performing as follows:-

For overdrafts facility, when accounts have been dormant for six months or more and the outstanding amount is in excess of the approved limit. For an active account which has breached the approved limit, the account shall be classified as non-performing only when the amount in excess of the approved limit is not fully settled within six months from the date the approved limit was breached.

Where the overdraft facility has been recalled, the account shall be classified as non-performing immediately. Subsequently, if the account is reinstated, without full settlement of the amount outstanding, the facility shall be regarded as a rescheduled facility. The 'approved limit' refers to the current approved line of credit granted to the borrower. A reduction in the limit would lower the 'approved limit' accordingly. An unadvised line of credit shall not be regarded as the 'approved limit'. In the case of overdrafts secured by shares, the 'approved

limit' would be the original approved pre-set limit and not the drawing limit (which fluctuates depending on the price of shares deposited).

For bankers acceptances, trust receipts, bills of exchange, other trade-related bills and other instruments of similar nature when the instrument is due and unpaid for three months or more from the first day of default., it is considered as non-performing. For credit card, when the credit card holder fails to settle his minimum monthly repayments for three months or more from first day of default.

For any term financing/loans, revolving credit facilities, leasing loans, block-discounting facilities, hire-purchase loans and other loans, the facility is considered as non-performing when principal or profit/interest is due and unpaid for six months or more from the first day of default.

Growth in gross financing to the private sector through the banking system and the capital market was sustained in March 2009, while non performing loans (NPFs) remained unchanged at 2.2 percent.
Strong capitalisation and stable non-performing financings in the banking system Capital ratios strengthened during the month supported largely by capital raising exercises by several banking institutions in an effort to further enhance their risk bearing capacity given the more challenging environment.

7.3 TYPES OF DEBTORS & THE NEED FOR RESHEDULING &/OR RESTRUCTURING

Maybank Islamic for example, has initiated a relief programme called the 3R Campaign for Auto & Mortgage financing/loans. This campaign aims at assisting deserving customers in Rescheduling, Restructuring and Rehabilitating their financing/loans, to ease their financial burden.
This relief programme will also help customers to better manage their financing/loan accounts to make their monthly installment more affordable.
Following are some frequently asked questions (FAQs).

1. **What is Rescheduling?**
   Rescheduling refers to the modification of financing/loan repayment terms where the principal terms and conditions of the contract are not changed significantly, i.e., lengthening the financing/loan tenure and revision of monthly installments.

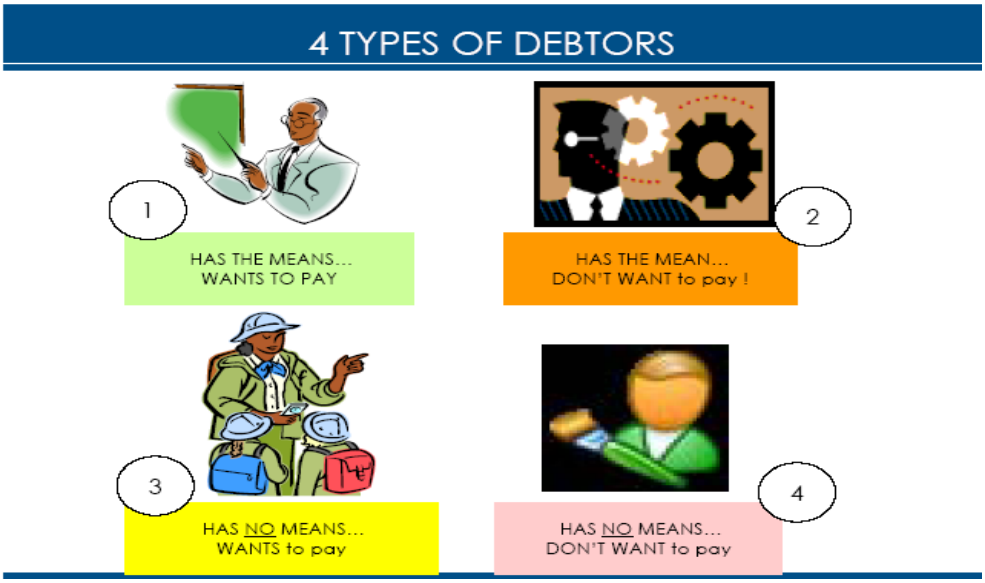
2. **What is Restructuring?**
   Restructuring is the modification of the principal terms and conditions of the facility, which includes change in the type or structure of the facilities or change to its terms, i.e., conversion of Overdraft to Term financing/Loan. However, costs will be incurred in terms of administrative and legal documentation.

3. **What is Rehabilitation?**
   Rehabilitation is a repayment programme tailored for the customer to regularise the financing/loan account.

4. **How will 3R benefit the customer?**
   - Lengthening the repayment tenure.
   - More affordable monthly instalments.
   - Subsequent financing/loan repayments can be made via Self Service Terminals such as ATMs, CDMs and Maybank2u.com.
   - Blacklist record in the CRISS will be updated to 'Performing' status.

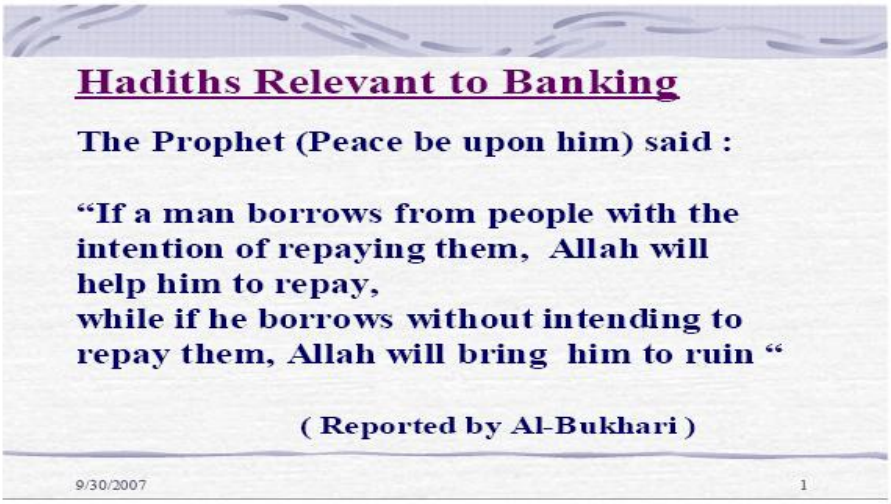
7.4 TYPES OF DEBTORS

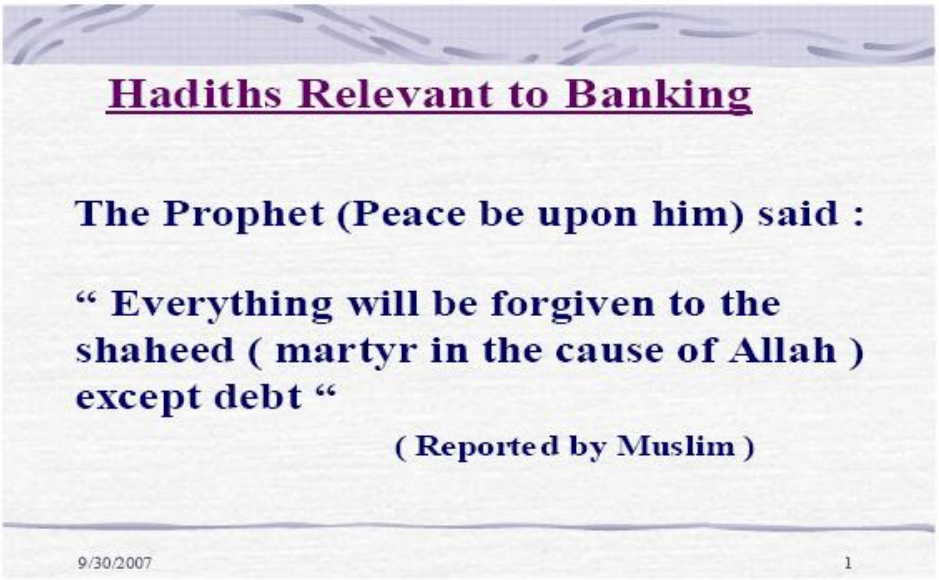
Basically there are 4 types of debtors in the finance industry. They are:
1. Capable and have intention to pay the debts
2. Capable but have no intention to pay the debts
3. Not capable and have intention to pay the debts
4. Not capable and have no intention to pay the debts



7.5 OBLIGATION TO REPAY DEBT

The followings are some reasoning for a Muslim to pay the debts if he or she claims himself or herself as a true Muslim:





7.6 REASONS FOR RESCHEDULING AND RESTRUCTURING

WHY RESCHEDULE/RESTRUCTURE ?

BANK

- Reducing NPF
- Immediate write-back of SP
- Maximise credit recovery

CUSTOMER

- Help ease cash flow
- Allowing continuity in business
- Avoid legal action

7.7 DIFFERENCES BETWEEN RESCHEDULING AND RESTRUCTURING

A rescheduled credit facility is one whose repayment terms have been modified but the principal terms and conditions of the contract have not changed significantly. This includes, amongst others, lengthening the repayment tenor of the facility. A change in the form of the credit facility for example conversion from a trade-related facility to an overdraft facility does not constitute a rescheduled facility as the principal terms of the contract have changed significantly.

A restructured credit facility is one whose terms and conditions have been modified principally. This may include a change in the type or structure of facilities or changes to other terms to assist the borrower overcome its shorter term financial difficulties particularly where the longer term prospect of the business or project is deemed to be viable. When the borrower enters into Schemes of Arrangement, the new facility will constitute a restructured facility.

Where banking institution incurs losses as a result of rescheduling or restructuring, the difference in value of the loan prior to and after the rescheduling/restructuring must be written off immediately.

The period in arrears in respect of a rescheduled and restructured financing may be zerorised upon completion of the relevant documentation in relation to the rescheduled and restructured exercise. Thereafter, the rescheduled or restructured account shall be classified as non-performing when the borrower fails to settle his repayments under the new terms for six months or more. Where a banking institution adopts more stringent terms for the classification of non-performing financing (e.g. three months in arrears), then such terms shall be applied consistently for the classification of a rescheduled or restructured loan as non-performing under the new rescheduled or restructured terms.

7.8 CREDIT RISK MANAGEMENT FOR RESCHEDULED AND RESTRUCTURED CREDIT FACILITIES

Banking institutions must have in place clear and comprehensive policies, approved by the Board, which define the circumstances and conditions under which a financing may be rescheduled or restructured. The policies should specifically address situations where loans may be rescheduled or restructured more than once, controls to avoid ‘ever-greening’ of loans, and provisioning policies with respect to such financing.

Banking institutions must reassess the borrower’s financial position and make a full credit evaluation of the borrower’s financial condition and prospects for repayments before the financing can be rescheduled or restructured. In addition, adequate resources must be allocated to closely monitor and follow up on the performance of rescheduled and restructured financing. Additional provisions should be made promptly where there is objective evidence of impairment of the financing.

Banking institutions should prepare periodic reports to the Board (or the Credit Committee or Executive Committee as appropriate) on the performance of rescheduled and restructured credit facilities. These reports should provide adequate information, including default status and the frequency of rescheduling or restructuring for the same borrower, to facilitate the

Board's (or relevant Committee's) oversight of compliance with the institution's internal policies on rescheduling and restructuring of financing.

The BNM may direct the Board of a banking institution to take appropriate remedial actions to address any deficiencies relating to controls and provisions for rescheduled and/or restructured financing if there is evidence to point towards "ever-greening" of financing..

7.9 RESCHEDULING

Rescheduling is an arrangement allowing the postponement of the principal amount of an instalment due or next falling due to a later date for payment together with or without a corresponding postponement of subsequent instalments of either existing or new terms and conditions.

For effective monitoring, the deferment of financing payments should generally not exceed 6 months and the management of a bank should review the financing again should the need for another deferment arise.
Financing deferments should be confirmed in writing by the client and guarantors.

RESCHEDULING – WHAT ?

- Principal terms / conditions of the contract have not changed significantly
- No change in the form of financing facility

INCLUDES :

- Lengthening of tenor
- Change of installment amount
- Change in payment pattern…etc

A long-term arrangement involving the rescheduling/restructuring of the payment of past due and not yet due instalments of the financing. It involves the consolidation of the outstanding capital and the entire or part of arrears of capital and profit into a new financing facility to be paid over a new amortisation schedule in order to provide for lower periodic payments on the financing.
Financing rescheduling/restructuring should be confirmed in writing by the client and guarantors.

RESCHEDULED FACILITY- GUIDELINE

(1) Rescheduling can be done while the account is still ;

i) performing, or

ii) NPF

RESCHEDULED FACILITY- GUIDELINE

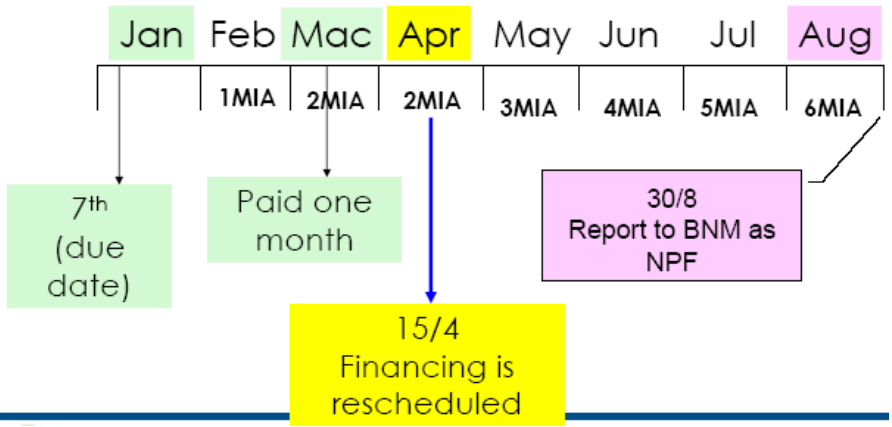
(2) If rescheduling occurs while the account still performing, the account is still classified as performing

It will be classified as NPF when in aggregate, the customer fails to settle his monthly payment for 6 months or more from first day of default (for term financing with monthly payment)

....see below

RESCHEDULED FACILITY becomes NPF

Example : *Term financing*



RESCHEDULED FACILITY- GUIDELINE

(3) Where rescheduling occurs after an account has become NPF, the a/c will continue to be classified as NPF

The rescheduled a/c can be reclassified as PF, if :

(i) payment has been complied for continuous period of 6 months

(ii) when the financing is well secured by cash or cash substitute

RESCHEDULED FACILITY- GUIDELINE

(4) FI permitted to reschedule a financing once in two years (otherwise seek BNM's approval)

(5) FI must make full credit evaluation before a financing can be rescheduled to avoid "ever-greening "

7.10 RESTRUCTURING

RESTRUCTURING – WHAT ?

- Terms / conditions of the contract have been modified significantly

INCLUDES :

- Change in the type/structure of the facility
  eg. Change of facility from MWCF to BBA

A restructured financing facility is one whose terms and conditions have been modified materially. This may include a change in the type or structure of facilities or changes to other facility terms to assist the customer to overcome its shorter term difficulties particularly where the longer term prospect of business. or project is still deemed to be viable.

Restructuring exercise as practised by bank can be by way of the following:

i) Refinancing

No changes in the type of financing, e.g. from BBA facility to BBA facility and from Cash Note to Cash Note facility.

Example: The bank refinances the asset of the existing financing facility to net-off the outstanding balance, with new terms and conditions.

Other features of refinancing may include the following:

1) It can be implemented for an account whose tenor has expired or yet to expire.

2) Changes in terms and conditions, for instance imposing a new repayment schedule, extension of tenure to suit the client's future cash flow, security enhancement etc.

3) Requires new 'akad' and execution of new documentations.

ii) Convertion into a New Structure

a) Applicable to accounts which is to be restructured into a new form of financing facility, for instance from BBA or Murabahah facility to Cash Note or from Cash Note into BBA etc.

iii) Combination of Granting New Facility and Rescheduling.

This method is applicable to accounts which are to be restructured by way combining 2 facilities i.e. maintaining the existing facility through rescheduling and granting a new facility with the repayments terms being combined together to suit the client's future cash flow.

Under normal circumstances, restructuring of this nature is applicable for a defaulted account which carries a collateral such as a landed property, with the main intention of avoiding the discharge the said collateral and thus avoiding the risk in relation to Section 293(1) of the Companies Act I 965 and Section 53(1) of the Bankruptcy Act. These Acts stipulate that if winding-up proceedings are commenced against the client within six months. from the date of the proposed charge and debenture, and the customer is eventually wound-up, the charge and debenture so created will be void due to the 'undue preference' element. Subsequently the bank will lose its rights on the asset secured against the said facility.

Other features of this method may include the followings:

1. It can be implemented for accounts where the tenor of facility has yet to expire or already expired.

2. New terms and conditions for a new facility, for instance by imposing a new repayment schedule, extension of tenure to suit the client's future cash flow, security enhancement etc.

3. Requires a new 'akad' and execution of new. documentations for the new facility.

4. Reschedulement of the existing facility, with the principal terms and conditions of the contract have not changed principally.

THREE TYPES OF RESTRUCTURING

TYPE ONE	TYPE 2	TYPE 3
No change in financing contract, maintain existing contract *Example :* •*BBA to BBA*	Convert to new structure - Change of contract *Example:* •*MURABAHAH to BBA*	Combine Rescheduling of existing facility and giving new facility *Example :* • *Reschedule existing BBA* • *Offer another BBA*

Since BBA is a buying/selling transaction, any restructuring which changes the selling price will attract new documentation, hence additional cost to the customer. The bank does not encourage rescheduling/restructuring of the BBA financing. Generally, customers are NOT allowed to restructure unless the account turns delinquent.

There are no special rules to be observed in a refinancing from a conventional loan to a financing under Al-Bai Bithaman Ajil from the same bank. This means that the procedure applicable would be similar to those applicable in any other refinancing exercise.

A new Letter of Offer shall be issued by the bank for the purpose of refinancing from a conventional loan to Al-Bai Bithaman Ajil. Tthe proceeds shall be utilized to redeem the conventional loan. The Letter of Offer will set out the Purchase Price (which is in fact the amount to be refinanced being the balance from the earlier conventional loan), the Sale Price, the purpose of refinancing facility, the tenure of the facility, the mode of payment and other terms and conditions applicable to Al- Bai Bithaman Ajil.

Fresh security documentation based on the new Letter of Offer shall be executed in relation to financing under Al- Bai Bithaman Ajil. The parties shall execute the Property Purchase Agreement, the Property Sale Agreement, the Charge (Property/House with Title) or the Deed of Assignment (Property/House without Title) and fresh presentation and/or registration shall be made at the relevant authorities or registries.

The bank shall also have to discharge the previous charge/assignment in relation to the conventional loan by executing a Discharge of Charge (Property/House with Title) or Deed of Receipt and Reassignment (Property/House without Title) and where applicable, fresh from 34 shall be filed with the Registrar of Companies.

Legal fee which include all relevant charges including disbursements are to be borne by the customer.
Any restructuring is the prerogative of the bank.

7.11 SUGGESTIONS FOR RESCHEDULING/RESTRUCTURING

TO RESCHEDULE / RESTRUCTURE : SUGGESTIONS

- Customer to propose minimum payment to service at least the profit portion followed by principal payment
- Disposal of asset is not allowed during the period unless proceeds is for settling the debt
- Existing security shall not be released until full settlement of the rescheduled/restructured account

7.12 CASE STUDY

RESTRUCTURING OF MWCF – SYKT ABC SDN BHD MURABAHAH FACILITY TO BBA

	Existing Facility	*Restructured Facility*
Facility	MWCF	BBA
Limit	RM5 million	RM6,275,247.72***
MIA	8 months	-
Total outstanding	RM4,792,285.30	-
Tenor	180 days	7 years (84months)

RESTRUCTURING OF MWCF – SYKT ABC SDN BHD MURABAHAH FACILITY TO CASH NOTE

	Existing Facility	*Restructured Facility*
Rate	7.5 %	10 %
Payment	Lump sum	RM74,705.33 per month
Contract	Murabahah	BBA
Collateral	• First charge on director's land • Directors' J&S guarantee	• First charge on director's land • Directors' J&S guarantee

COMPARISON

RESCHEDULING	*RESTRUCTURING*
• Principal terms / conditions of the contract have not changed significantly	• Terms/conditions modified significantly
• No new agreement	• New agreement
• No new aqad	• New aqad
• Existing account remains • Status – current, delinquent , NPF…	• Existing account closed • Status - fresh account

8.0 INTRODUCTION TO RISK MANAGEMENT IN ISLAMIC FINANCIAL INSTITUTIONS

8.1 Overview
8.2 Categories of Risk
8.3 Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)
8.4 Summary of Capital Requirement at Various Stages of the Contract
8.5 Qualitative Risk Analysis
8.6 Quantitative Risk Analysis

8.1 OVERVIEW

At present, Islamic financial institutions have to a large extend, been governed by the conventional regulatory framework, and reinforced by the Shariah framework and Islamic accounting standard. However Islamic investment and financing activities are distinct from conventional financing activities in term of underlying philosophy and the prohibition of interest and generating profit without any risk. This in turn shapes the nature of its financial transactions and its risk attributes.

A separate regulatory framework therefore needs to be developed to take into account the unique risks in Islamic financial transactions to provide for their effective assessment and management. Such a prudent regulatory design would further complement concurrent efforts that are underway to develop financial market and Islamic financial instruments. This architecture will contribute towards the development of a robust and resilient Islamic financial system that can effectively preserve financial stability and contribute to the balance growth and development.

In recognition of this need, the council of the Islamic Financial Services Board (IFSB) agreed, amongst others, to adapt two prudent standards, namely:

1. Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)

2. Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)

This decision was made at the 7th meeting held in December 2005 at the Islamic Development Bank, Jeddah. The two prudent standards are recommended to be fully implemented by the end of 2007.

Principles of Risk Management

IFSB sets out 15 principles of risk management that give practical effect to managing the risks underlying the business objectives that IIFS may adapt. The principles are designed to complement the current risk management principle issued by the BCBS (Basel II) and other

international standard-setting bodies. In cases where the existing applicable international principles are Shariah compliant, these principles are retained and far expanded.

Apart from general requirement principles, the others are grouped into six categories of risk and shall be used as a basis for the IIFS's risk management and reporting process.

8.2 CATEGORIES OF RISK

The six categories of risk are:

1. Credit risk
2. Equity investment risk
3. Market risk
4. Liquidity risk
5. Rate of return risk
6. Operational risk

General requirements

Principle 1: IIFS shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risk and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate step to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

8.2.1 Credit Risk

Principle 1
IIFS shall have in place a strategy for financing, using the various Islamic instruments in compliance with Shariah, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements

Principle 2
IIFS shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an Islamic financing instrument.

Principle 3
IIFS shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

Principle 4
IIFS shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.
Credit risk is usually defined as the potential that counter-party fails to meet its obligations in accordance with agreed terms. This definition is applicable to the IIFS managing the financing exposures of receivables and leases (for example, Murabahah and Ijarah) and working capital financing transactions/projects (for example Salam, Istisna or Mudharabah) The IIFS need to manage credit risks inherent in their financing and investment portfolios

relating to default, downgrading and concentration. Credit risk includes the risk arising in the settlement and clearing transactions.

The following premises relate to the sound processes of credit risk management in IIFS:

- The role of IIFS can embrace those of financiers, suppliers, Mudarib and Musharakah partners. The IIFS concern themselves with the risk of a counterparty's failure to meet their obligations in terms of receiving deferred payment and making or taking delivery of an asset. A failure could relate to a delay or default in payment, or in delivery of the subject matter of Salam or Parallel Istisna, entailing a potential loss of income and even capital for the IIFS.

- Due to the unique characteristics of each financing instrument such as the non-binding nature of some contracts, the commencement stage involving credit risk varies. Therefore, credit risk shall be assessed separately for each financing instrument to facilitate appropriate internal controls and risk management systems.

- IIFS will consider other types of risks that give rise to credit risk. For example, during the contract life, the risk inherent in a Murabahah contract is transformed from market risk to credit risk. In other example, the invested capital in a Mudharabah or Musharakah contract will be transformed to debt in case of proven negligence or misconduct of the Mudarib or the Musharakah's managing partner.

- In case of default, IIFS are prohibited from imposing any penalty except in the case of deliberate procrastination. In the latter case, IIFS are prohibited from using the amount of the penalty for their own benefit; they must donate any such amount to charity.

8.2.2 Equity investment risk

Principle 1
IIFS shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudharabah and Musharakah investments.

Principle 2
IIFS shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IIFS and the Mudarib and/or Musharakah partners.

Principle 3
IIFS shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudharabah and Musharakah investments, subject to the approval of the institution's Shariah board.

- The type of equity investment risk dealt with in this section may be broadly defined as the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk.

- The characteristic of such equity investment include considerations as to the quality of the partner, underlying business activities and ongoing operational matter. By nature, this type of equity investment is exposed to a confluence of risk associated with Mudarib or Musharakah partner, business activity and operations.

- In evaluating the risk of an investment using the profit sharing instruments of Mudharabah or Musharakah, the risk profiles of potential partners (Mudarib or Musharakah partner) are crucial considerations for the undertaking of due diligence. Such due diligence is essential to the fulfilment of IIFS's fiduciary responsibilities as an investor of Investment Account Holder (IAH) funds on a profit-sharing and loss-baring basis (Mudharabah) or a profit and loss sharing basis (Musharakah). These risk profiles include the past record of the management team and quality of the business plan of, and human resources involved in, the proposed Mudharabah or Musharakah activity.

8.2.3 Market risks

Principle 1
IIFS shall have in place an appropriate framework for marketing management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

- Market risk is defined as the risk that arises from fluctuations in values in tradable, marketable or leaseable assets (including sukuk) and in off-balance sheet individual portfolios (for example restricted investment accounts). The risk relate to the current and future volatility of market values of specific assets (for example, the commodity price of a Salam asset, the market value of a sukuk, the market value of Murabahah assets purchased to be delivered over a specific period) and of foreign exchange rates.

- In operating Ijarah, a lessor is exposed to market risk on the residual value of the leased asset at the term of the lease or if the lessee terminates the lease earlier (by defaulting), during the contract. In IMB a lessor is exposed to market risk on the carrying value of the leased asset (as collateral) in the event that the lessee defaults on the lease obligations.

- In Salam, IIFS are exposed to commodity price fluctuations on a long position after entering into a contract and while holding the subject matter until it is disposed of. In the case of parallel Salam, there is also the risk of failure of delivery of the subject matter, leaving the IIFS exposed to commodity price risk as a result of the need to purchase a similar asset in the spot market in order to honour the parallel Salam contract.

- When IIFS are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyse and assess the factors attributable to changes in liquidity of the markets in which the assets are traded and which give rise to greater market risk. Assets traded in illiquid markets may not be realisable at prices quoted in other more active markets.

- IIFS are also exposed to foreign exchange fluctuations arising from general FX spot rate changes in both cross-border transactions and the resultant foreign currency receivables and payables.

8.2.4 Liquidity risk

Principle 1
IIFS shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

Principle 2
IIFS shall undertake liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risk.

- Liquidity risk is the potential loss to IIFS arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

- There are two major types of fund providers: (a) current account holders, (b) unrestricted IAH and restricted IAH. Current accounts are based on Qardh contracts. The investment accounts utilise Mudharabah or Wakalah contracts whereby fund providers are passive partners. These account holders require a degree of liquidity to be maintained by the IIFS to meet their requirements for withdrawals.

Rate of return risk

Principle 1
IIFS shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

Principle 2
IIFS shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

- IIFS are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in Investment Account Holders (IAH) having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that IIFS are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

- A consequence of rate of return risk may be displaced commercial risk. IIFS may be under market pressure to pay a return that has been earned on assets financed by IAH when the return on assets is under-performing as compared with competitors' rates. The IIFS may decide to waive their rights to part or their entire Mudarib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced

commercial risk derives from competitive pressures on IIFS to attract and retain investors (fund providers).

- A Profit Equalisation Reserve (PER) is the amount appropriated by IIFS out of their gross income, before allocating the Mudarab share, in order to maintain a level of return on investment for IAH and increase owners' equity.

- An Investment Risk Reserve (IRR) is the amount appropriated by IIFS out of income of IAH, after allocating the Mudarib share, in order to cushion the effects of the risk of future investment losses on IAH.

8.2.5 Operational risk

Principle 1
IIFS shall have in place adequate systems and controls, including Shariah board, to ensure compliance with Shariah rules and principles.

Principle 2
IIFS shall have in place appropriate mechanisms to safeguard the interest of all fund providers. Where IAH funds are commingled with the IIFS's own funds, the IIFS shall ensure that the bases for asset, revenue, and expense and profit allocations are established, applied and reported in a manner consistent with the IIFS's fiduciary responsibilities.

- IIFS shall consider the full range of material operational risks affecting their operations, including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. IIFS shall also incorporate possible causes of loss resulting from non-Shariah compliance and the failure in their fiduciary responsibilities.

8.3 CAPITAL ADEQUACY STANDARD FOR INSTITUTIONS (OTHER THAN INSURANCE INSTITUTIONS) OFFERING ONLY ISLAMIC FINANCIAL SERVICES (IIFS)

8.3.1 Objectives of the standard

- To address the specific structure and contents of the Shariah compliant product and services offered by the IIFS that are not specifically addressed by the currently adapted and proposed international capital adequacy standards and Shariah compliant mitigation.
- To standardise the approach in identifying and measuring risk in Shariah compliant products and services and in assigning risk weight (RW) thereto, thereby, creating a level playing field amongst the IIFS, in adapting and developing risk identification and measurement practices that meet international acceptable prudential standard.

8.3.2 Principles for minimum capital adequacy requirements

- There are two formulas applicable to calculate Capital Adequacy Ratio (CAR)

1. **The Standard Formula**

Eligible Capital

{ Total Risk-weighted Assets[1] (Credit[2] + Market[2] Risks) Plus Operational Risks
Less
Risk-weighted Assets funded by PSIA[3] (Credit[2] + Market[2] Risks) }

2. **Supervisory Discretion Formula**

This formula is applicable in jurisdictions where supervisory authority considers the IIFS to smooth income to the investment account holders (IAHs) as part of a mechanism to minimise withdrawal risk and is concerned with systemic risk.

Eligible Capital

{ Total Risk-weighted Assets[1] (Credit[2] + Market[2] Risks) Plus Operational Risks
Less
Risk-weighted Assets funded by PSIA[3] (Credit[2] + Market[2] Risks)
Less
Risk-weighted Assets funded by Restricted PSIA[3] (Credit[2] + Market[2] Risks)
Less
(1 - α)[4] [Risk-weighted Assets funded by Unrestricted PSIA[3] (Credit[2] + Market[2] Risks)]
Less
α [Risk-weighted Assets funded by PER and IRR of Unrestricted PSIA[5] (Credit[2] + Market[2] Risks)] }

[1] Total Risk WA include those financed by both restricted and unrestricted PSIA.
[2] Credit and market risks for on and off-balance sheet exposures.
[3] Where the funds are commingled, the RWA funded by PSIA are calculated based on their pro-rata share of the relevant assets. PSIA balances include PER and investment risk reserve (IRR) or equivalent reserves.
[4] **α** refers to the proportion of assets funded by Profit Sharing Investment Accounts (PSIA) which is to be determined by the supervisory authorities. The value of **α** would therefore vary based on supervisory authorities' discretion on a case-by-case basis
[5] The relevant proportion of risk-weighted assets funded by the PSIA's share of PER and by IRR is deducted from the denominator, because these reserves have the effect of reducing the displaced commercial risk.

- The minimum capital adequacy requirements for IIFS shall be a CAR of not lower than 8% for total capital. Tier 2 Capital is limited to 100% of Tier 1 Capital.
- In calculating the CAR, the regulatory capital as the numerator shall be calculated in relation to the total risks weighed asset (RWA) as the denominator. The total of RWA is determined by reciprocal of the minimum CAR of 8% to convert into risk-weighed equivalent assets and adding that resulting figure to the sum of RWA computed for credit risk.

8.3.3 Credit risk

- Credit risk exposures in Islamic financing arise in connection with accounts receivable in Murabahah contracts, counter-party risk in Salam contracts, accounts receivable and counter-party risk in Istisna contracts and lease payments receivable in Ijarah contracts and Sukuk held to maturity in banking book. In the standard, credit risk is measured according to the standardised approach of Basel II, except for certain exposure arising from investment by means of Musharakah or Mudharabah contracts.
- The assignment of RW shall take into consideration the following:
  1. The credit risk rating of a debtor, counterparty or other obligator, or a security, based an external credit assessment.
  2. Credit risk mitigation techniques adopted by the IIFS.
  3. Types of the underlying assets that are sold and collateralised or leased by the IIFS.
  4. Amount of specific provisions made for the overdue portion of accounts receivable or lease payment receivable.

8.3.4 Market risk

- Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in the market prices. The risk in IIFS that are subject to the market risk capital requirement are:
  1. Equity position risk in the trading book and market risk on trading positions in Sukuk.
  2. Foreign exchange risk.
  3. Commodities and inventory risk.

8.3.5 Operational risk

- Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people and system or from external events, which includes, but is not limited to, legal risk and Shariah compliance risk.
- The proposed measurement of capital may be based on either the Basic Indicator Approach or Standard Approach as set out in Basel II.

8.3.6 Profit Sharing Investment Accounts (PSIA)

- PSIA commonly referred to as ‘investment accounts’ or ‘special investment accounts’ can be further categorised into Unrestricted PSIA and Restricted PSIA.
- The IIFS has full discretionary power in making investment decisions for unrestricted PSIA but in case of the restricted PSIA the placement of funds by IIFS is subject to investment criteria specified by IIFS in the Mudharabah contract as agreed between the Investing Account Holders (IAH) and the IIFS at the time of contracting.

8.3.7 Minimum Capital Requirement for Islamic Financing Assets

- The following are the summary of minimum capital requirements for the seven classes of Islamic financing assets, taking into account both credit risk and market risk as appropriate.

8.4 SUMMARY OF CAPITAL REQUIREMENT AT VARIOUS STAGES OF THE CONTRACT

(a) Murabahah and Non-binding MPO

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)*	Not applicable	15% capital charge (187.5% RW)
Asset is sold and delivered to a customer, and the selling price (account receivable) is due from the customer	Based on customer's rating or 100% RW for unrated customer	Not applicable
Maturity of contract term or upon full settlement of the purchase price, whichever is earlier	Not applicable	Not applicable

* Also includes an asset which is in possession due to cancellation of PP by a non-binding MPO customer. Any HJ taken, if any, is not considered as eligible collateral and shall not be offset against the value of the asset.

(b) Binding MPO

Applicable Stage of the Contract	Credit RW **	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)*	Asset acquisition cost less market value of asset as collateral (net of any haircut less any HJ x 100% RW)	Not applicable
Asset is sold and delivered to a customer (accounts receivable is due from a customer)	Based on customer's rating or 100% RW for unrated customer	Not applicable
Maturity of contract term or upon full settlement of the selling price, whichever is earlier	Not applicable	Not applicable

* Also includes an asset which is in possession due to cancellation of PP by a customer.
** This Credit RW is applicable only when IIFS will have recourse to any HJ paid by the customer, and (depending on the legal situation) may have a right to recoup from the customer any loss on disposing of the asset, after taking account of the HJ.

(c) Salam with Parallel Salam

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Payment of purchase price by the IIFS to a Salam Customer	Based on customer's rating or 100% RW for unrated customer No netting of Salam exposures against Parallel Salam exposures	<u>Two approaches are applicable</u> <u>Maturity Ladder Approach</u> <u>The Simplified Approach</u> 15% capital charge (187.5% RW equivalent) on net position (i.e. netting of Salam exposures against Parallel Salam exposures Plus 3% capital charge (37.5% RW equivalent) on gross positions (i.e. Salam exposures plus Parallel Salam exposures)
Receipt of the purchased commodity by the IIFS	Not applicable	
The purchased commodity is sold and delivered to a buyer	Not applicable	

(d) Salam without Parallel Salam

Application Stage of the Contract	Credit RW	Market Risk Capital Charge
Payment of purchase price by the IIFS to a Salam customer (seller)	Based on customer's rating or 100% RW for unrated customer	<u>The Simplified Approach</u> 15% capital charge (187.5% RW equivalent) on long position of Salam exposures
Receipt of the purchased commodity by the IIFS	Not applicable	
The purchased commodity is sold and delivered to a buyer	Not applicable	Not applicable

(e) Full Recourse Istisna

(i) Istisna with Parallel Istisna

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled work-in-process inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer No netting of Istisna exposures against Parallel Istisna exposures	Nil provided that there is no provision in the Parallel Istisna contract that allows the seller to increase or vary the selling price
Amounts receivable after contract billings		
Maturity of contract term or upon full settlement of the purchased price by an Istisna buyer, whichever is the earlier	Not applicable	Not applicable

(ii) Istisna without Parallel Istisna

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled work-in-process inventory	Based on ultimate buyer's rating or 100% RW for unrated buyer	1.6% capital charge (equivalent to 20% RW) on work-in-process inventory
Progress billing to customer	Based on ultimate buyer's rating or 100% RW for unrated buyer	Not applicable
Maturity of contract term or upon full settlement of the purchased price by an Istisna buyer, whichever is the earlier	Not applicable	Not applicable

(f) Limited and Non-Recourse Istisna

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Unbilled work-in-process inventory	Based on buyer's ECAI rating, if available, or supervisory slotting criteria that ranges from 70% to 250% RW No netting of Istisna exposures against Parallel Istisna exposures	Not applicable
Amounts receivable after contract billings		
Maturity of contract term or upon full settlement of the purchased price by an Istisna customer, whichever is the earlier	Not applicable	Not applicable

(g) Operating Ijarah

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for lease (prior to signing a lease contract)	<u>Binding PL*</u> Asset acquisition cost Less (a) market value of asset fulfilling function of collateral (net of any haircuts) and (b) any 'hamish jiddiyyah Multiply with the customer's rating or 100% RW for unrated customer	<u>Non-binding PL</u> 15% capital charge (equivalent to 187.5% RW) until lessee takes possession
Upon consigning a leasing contract and the lease rental payments are due from the lessee	Total estimated value of lease receivables for the whole duration of leasing contract shall be risk-weighted according to the lessee's rating. 100% RW for an unrated lessee. Less recovery value of the leased asset	The residual value will be risk weighted at 100%
Maturity of contract term and the leased asset is returned to the IIFS	Not applicable	15% capital charge of the carrying value of the asset

(h) IMB

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for lease (prior to signing a lease contract)	**Binding PL** Asset acquisition cost Less (a) market value of asset fulfilling function of collateral (net of any haircuts)m and (b) any hamish jiddiyyah Multiply with customer's rating or 100% RW for unrated customer	**Non-Binding PL** 15% capital charge (187.5% RW equivalent) until lessee takes possession
Upon consigning a leasing contract and the lease rental payments are due from the lessee	Total estimated value of lease receivables for the whole duration of leasing contract will be risk-weighted according to the lessee's credit rating.100% RW for an unrated lessee Less recovery value of the leased asset	Not applicable
Maturity of contract term and the leased asset is sold and the asset ownership is transferred to the lessee	Not applicable	Not applicable

The following table set out the Musharakah categories that attract capital charges

Musharakah Category	Credit RW	Market Risk Capital Charge
Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity	Not applicable	Depends on the underlying asset as set out in the applicable market risk section
Private commercial enterprise to undertake business venture OTHER THAN trading activities in the foreign exchange, share and/or commodity	(a) **Simple risk-weight method** 400% RW of the contributed amount to the business venture less any specific provisions (If there is a third party guarantee, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee) Or (b) **Slotting method** Between 90-270% RW of the contributed amount to the business venture based on the four categories	Not applicable
Joint ownership of real estate and movable assets (Musharakah with Ijarah sub-contract, Musharakah with Murabahah sub-contract)	Based on lessee's (for Ijarah sub-contract_ or customer's (for Murabahah sub-contract) rating or 100% RW for unrated lessee or customer	Please refer to the market risk capital charge requirements as set out under the sub-contracts

The following tables set out the Mudharabah categories that attract capital charges:

Mudharabah Category	Credit RW	Market Risk Capital Charge
Private commercial enterprise to undertake trading activities in the foreign exchange, share and/or commodity	Not applicable	Depends on the underlying asset as set out in the applicable market risk section
Private commercial enterprise to undertake business venture OTHER THAN trading activities in the foreign exchange, share and/or commodity	(a) **Simple risk-weight method** 400% RW of the contributed amount to the business venture less any specific provisions ***Or*** (b) **Slotting method** Between 90-270% RW of the contributed amount to the business venture based on the four categories	Not applicable

Mudharabah Investment In Project Finance

Applicable Contract Stages	Credit RW	Market Risk Capital Charge
Prior to certification where funds are already advanced by the IIFS to the Mudarib	Risk weight is based on the rating of either the ultimate customer or the Mudarib. Otherwise, 400% RW is applied to unrated Mudarib	Not applicable
After certification where amount receivable by the IIFS from the Mudarib in respect of progress payment due to the Mudarib from the ultimate customer	Based on the credit standing of the ultimate customer on the amounts receivable, the IIFS from the Mudarib or 100% customer – only if a risk mitigation structure is used (collateralisation of cash flows from the ultimate customer by the use of a project account held in the IIFS into which the ultimate customer makes the progress payments and from which the Mudarib cannot withdraw funds without the IIFS's permission	Not applicable

The following table set out the Sukuk categories that attract capital charges:

Sukuk Category	Credit RW	Market Risk Capital Charge
Externally rated	Applicable risk weight will be based on the ECAI rating in accordance with the Standardized Approach	Not applicable
Non-rated	Applicable risk weight will be based on the underlying contract or on that of the issuer if there is recourse to the issuer	Applicable capital charge will be based on the underlying contract

8.5 QUALITATIVE RISK ANALYSIS

8.5.1 Overview

Risk evaluation in Islamic Business Financing involves a systematic step by step analysis of all events that have direct or indirect impact on investment and financing relationship and comply with Shariah rules and principles.

Evaluation in both qualitative and quantitative factors with clients and transactions is a fundamental imperative for financing efficient. When properly executed, there will be an enhancement of the quality of the bank's financing and investment portfolios.

8.5.2 Qualitative Analysis

Qualitative analysis is the first step that a financing officer must do efficiently on each proposal. This analysis focuses on the following 6 main areas.

8.5.2.1 Shariah Compliance

Financing officer must ensure that the investment and financing activities should not involve any elements not approved by Islam. This includes the following:

a. Production of goods and services which contradict the value pattern of Islam Shariah (haram).
b. Economic activities involving gambling (maysir) and uncertainty (gharar).
c. Financial transactions involving interest (riba).

8.5.2.2 Compliance to the financing parameters

Financing officer must ensure their financing comply with both external and internal parameters. External parameters include the law of the country, Islamic Banking Act (IBA), Bank Negara Malaysia (BNM) directives, whereas internal parameters include Islamic Banking Institutions (IBI) respective financing policies and procedures.

8.5.2.3 Know your customer

Steps should be taken to ensure that a business relationship with the client should comply with IBI's ''Know Your Customer Policy''. The identity of a potential customer must be satisfactorily established. If the potential customer refuses to produce the required documents / proof of identity etc., any relationship should be terminated.

8.5.2.4 Facts analysis

Financing officers need to assess the facts about the borrower such as:

a. Memorandum and Articles of Association.
b. Bank borrowings including conduct of account checks with Central Credit Information System (CCRIS) managed by the Credit Bureau of BNM.
c. Check with Biro Maklumat Cek (BMC).
d. Check with Credit Tipping-Off Services (CTOS) / Financial Information System (FIS) for any leading information.
e. Litigation records of the borrower as defendant and plaintiff.

8.5.2.5 External Analysis

An external analysis focuses on two closely related areas:

a. The economic and political environment in which the IBI does business.
b. The demand dynamics of the market that impacts the business operations.

Economic and political factors

This information will help the financing officer to identify the business opportunity and strategy. These factors include:

a. Inflation
b. Growth in Gross Domestic Product(GDP)
c. Growth GDP by business sectors
d. Interest rate
e. Balance of Trade and Balance of Payment
f. Tariff and other protections
g. Stability of political situation

Market factors

We analyse these factors to grasp an understanding of market size and growth, market demand and the competition. The key areas of focus include:

a. Bargaining power of buyers and suppliers
b. Can the product be substituted
c. Who are the key players i.e. competitors in the industry
d. Barriers to entry to the industry
e. Economy, industry and product cycle
f. Generic competitive strategy adopted

These external factors are critical to the present and future success of the business. The main focus of this analysis is to enable the financing officer to understand the external factors that create a business opportunity for a client and the risks present in the market.

8.5.2.6 Internal analysis

To complement external analysis of the business, we also focus on the following internal issues.

Business operations

An important aspect of financing analysis is to understand the customer's business. This means understanding why the business exists and how it is being conducted. Areas of focus include:

1. Ownership

Identify the owners and understand their commitment to the business. As it is not always easily identified especially when shell or holding companies are sometimes used to maintain ownership for a group of companies, you should always obtain the following information:

a. legal structure and type of business organisation
b. major shareholders and concentrations
c. privately held, or traded on a stock exchange
d. restrictions on ownership, if any
e. independent, or part of a business group
f. proof of ownership
g. relationship with other affiliates

2. Background and brief history

Information about the company's years in business, historical performance, relative success over the years, and major changes must be checked including:

a. length of time in business
b. number of years in present field
c. major historical changes or problems
d. length of relationship with the bank

3. Financial relationship

Consider types of financial services used and relative amounts provided by other financial institutions. Find other institutions' experience with the customer as it is extremely important within the overall risk equation of dealing with the customer. Also look into:

1. other banks / financial institutions involved
2. amount and type of facilities for each bank
3. bank references
4. relative position with customers

4. Production

Find out the link between market demand to plant infrastructure and financial operations as shown on the income statement. Important information includes:

a. suppliers
b. type of products
c. percentage breakdown of sales by product line
d. breakdown of sales by major customers
e. volume of production
f. break-even volume
g. seasonality of production
h. perceived quality in the market
i. ranking with competitors

5. Facilities

Use information on location, age, status, degree of modernisation and other information about the physical plant, its production capabilities, and capacity utilisation to judge the ability of the company to produce for its market now and in the future. Validate the followings:

a. location and adequacy of industrial infrastructure
b. owned or leased
c. age and quality of plant and equipment
d. quality, capabilities of maintenance and degree of dependency on outside maintenance
e. informal appraisal value of facilities
f. insurance coverage
g. number of employees, labour contracts and relations (esp. if there are a number of foreign workers)
h. liens (i.e. the right to take and hold or sell the physical plant given as security for payment of financing)

6. Suppliers

Do the company depend on outside sources of goods for production and / or sales? Find out breakdown of key suppliers, location of key suppliers (domestic or foreign), quality of domestic vs foreign raw materials, reliance on foreign exchange for purchases, dependence on key suppliers, affiliations with suppliers, trade terms granted and trade references.

7. Distribution and marketing

What are the company sales relative to production? Use this information to interpret the sufficiency or quality of balance sheet items such as account receivable and stock. Key data includes:

a. direct sales, or sales through distributors
b. percentage of cash sales
c. credit terms granted
d. percentage of exports and domestic sales
e. sales to affiliates, if any
f. dependence on key customers
g. key marketing arrangements, especially exports
h. reputation for quality, punctuality and service.

8. Management

Assessing a company's management is the most important criteria as they are the people who manage our investment or financing. We are more successful when we meet regularly with the customer and visit the different people in the organisation. Focus your analysis on the areas listed below. Please note they may not all be appropriate for every customer.

9. Ownership

Determine if the company is family owned and managed, or owned by many shareholders and run by professional managers. The goals and strategies may differ as for e.g. family firms have less incentive to report high profits since this would increase tax liabilities, whilst a publicly traded firm may intentionally maximise profits despite taxes to reflect better stock price.

Do the company rely too much on a "one-man show"? Or do the company belong to a business group and to what degree do the company's policies and strategies are dictated by those in the group? Things to consider include:

a. the inter-company ownership structure
b. is long term planning done
c. what are their goals and policies
d. are there expertise in key positions or are posts filled out of family obligations
e. their tax strategies and impact on profits
f. is the manager replaceable in times of need
g. is the manager open to objections from others
h. is there a succession plan
i. are managers family members or outside professionals
j. is there inheritance issue
k. is there group identification and will this be a plus or minus for the company

10. Goal orientation and commitment

It is vital for management to set goals, targets and specific objectives to meet the goals and develop strategies for achieving them. The overall goals and strategies should be consistent and realistic given the environment, resources and constraints facing the company. Questions to ask include:

a. does the management have a clear vision of the company and market
b. is there a realistic strategy
c. how is the goals / strategies communicated
d. how are performance measured against these goals
e. does the management understand or underestimate their competitors
f. can they cope with change
g. are they committed to excellence
h. are the company goal-oriented

a. Organisational characteristics

Is the company a centralised or decentralised business organisation? We should try to understand characteristics of the organisation to get a sense for:

i. who the decision makers are
ii. how defined are their responsibilities
iii. who has influence over decision makers
iv. what motivates the decision makers
v. is there a realistic back-up people system in key areas
vi. do the organisational structure promote staff initiative
vii. what is the degree of centralisation / decentralisation
viii. is it appropriate for the company and function
ix. is the organisational structure appropriate or over-dimensioned

b. Background and compensation level of managers

Effective and efficient managers are vital in order to ensure the company's ability for repayment is not impaired. Issues to review include the company's commitment to hiring and retaining top people, years of experience in business and specialised field, if applicable, age of key managers, sophistication of the management compared to complexity and scope of the company, experience outside of company, internal promotions vs outside hirers and whether compensation is at high or low end of the market.

c. Work habits and market reputation

Understanding work habits and market reputation of managers will enable you to 'read between the lines' and form an educated deduction of their management capacity and capability. Investigate into the managers' reputation for integrity, punctuality and preparedness for meetings and ability to manage time during meetings and avoid distractions, motivational ability, quality and on time delivery as well as reputation for innovative solutions and flexibility. Also find out about general morale of the company and their commitment to training.

d. Management Information System

MIS assists managers with making decisions such as any deficiency or weakness in the system may cause problems. Scrutinise the quality of financial information given – how precise are their budgets, forecasts and internal cost allocations, what are profits used for, how effective is their cost accounting, do they use a reputable external auditor. Other information to consider include whether the company have security system to safeguard assets and workers, effectiveness of their quality control etc.

e. Access to technology

This is especially important for companies that rely on technology to compete in the market. Determine whether the company can develop or manage their own technology or are they dependent on outside help.

Source of information

Now that you know the types of information that is useful for qualitative analysis, let's look at possible sources for obtaining it.

Sources within the company

Although the applicant or owner is often your major point of contact, a visit to the company should include discussion with other management members as well. This enables you to gain greater insight to the degree of teamwork that exists, the effectiveness of the organisational structure, office politics and other areas.

Plant visits are especially useful because besides knowing the physical condition of the factory, informal conversation with plant and other process manager can provide valuable information about production process, quality control and skilled level required.

Other sources
Other sources of information outside the company include:

1. Trade references
2. Industry chambers or organisation
3. Other financial institutions
4. Internet

Using the information
An effective financing process utilises standard policies and procedures to achieve uniformity of focus and judgement. Standardise reporting formats are essential to this goal because they summarise the information, screen out unimportant or irrelevant data, and check for and reconcile discrepancies.

The basic forms for recording qualitative information include:

1. Basic Information Report (BIR)
2. Call Plan Report
3. Financing Request Memo

8.6 QUANTITATIVE RISK ANALYSIS

8.6.1 Overview
Risk decisions must be based on a detailed analysis of the business past performance, the value of the business projected cash flow and supporting collateral. The captioned analysis involves both qualitative and quantitative data. Even though we are examining these two broad categories of analysis separately, we must consider both data within one integrated framework to achieve meaningful results.

8.6.2 Framework for Analysis
Quantitative Analysis usually referred to as Financial Analysis. Many of the numbers derived in this analysis process may mean very little by themselves but very useful when compared over time and industry benchmark. For this reason, a comparative framework for analyzing financial statements is one of the most important aspects of financial analysis.

We can make comment and judgment based on the following findings:
- Results
- Causes
- Solutions

From results, we can make comparisons for the same business with regard to the financial performance over the periods, improving, declining or steady. We can also compare the results with the industry norms and to general macroeconomics indicators to measure adequacy of performance within the market.

Knowing the results, we may want to further discuss with the customer, to find out the possible causes of the adverse results and to come out with possible solutions.

Comparative Financial Statements Spreadsheets
IBI commonly use spreadsheets to perform standard financial analysis. Spreadsheets are standard forms with several columns for capturing data for several periods. Business financial numbers are loaded into the form, which provide sections for:

1. Balance Sheets
2. Income Statements
3. Ratio Analysis
4. Cash Flow Statements
5. Supplementary Information

With the advent of computerization, financial analysis has been greatly facilitated with electronic spreadsheet models.

8.6.3 Ratio Analysis

Ratio analysis is traditional form of financial analysis that goes beyond looking at absolute numbers and considers relationship that exist within various financial accounts, and between the balance sheet and income statement. Several ratios must be analyzed together and compared over the years and even with other companies in the same industry to reach appropriate conclusion.
There are several types of financial ratios which are categorized as:

1. Liquidity Ratios
   Measure the ability of a company to meet its short term financial obligations in a timely manner.
2. Debt – Service Ratio
   Measure the ability of a company to service its debt obligation.
3. Gearing Ratios
   Measure the solvency or financial commitment of the shareholders.
4. Efficiency Ratios
   Measure the performance of operations such as the speed for conversion of stocks to sales, etc.
5. Profitability Ratios
   Measure the degree of profitability in relation to sales and investments.

The following are the most common financial ratios used by financing officers in financial analysis.

Ratio	Formula
LIQUIDITY	
Current Ratio	Current Assets / Current Liabilities
Quick Ratio	Current Assets – Stock / Current Liabilities
DEBT – SERVICE	
Interest Coverage	Earning Before Interest & Tax / Interest Expense
Interest and Principal Repayment Coverage	Earning Before Interest & Tax / Interest Expense + Principle Repayment / 1 – Tax Rate
GEARING	
Debt – Equity Ratio	Total Liabilities / Total Equities
EFFICIENCY	
Average Stockholding Period	Average Stock / Cost of Goods Sold x N
Average Collection Period	Average Trade Debtors / Credit Sales x N
Average Payment Period	Average Trade Creditors / Purchases x N
Assets Turnover	Net Sales / Average Total Assets * N = number of days in financial period, ie 365 days
PROFITABILITY	
Gross Profit Margin	Gross Profit / Sales x 100 %
Net Operating Profit Margin	Net Operating Profit / Sales x 100 %
Return on Assets	Earning Before Interest & Tax / Average Total Assets x 100 %
Return on Equity	Net Profit After Tax – Pref Dividend / Average Ordinary Shareholders Equity x 100%

Note: When comparing ratio, replace interests by financial cost or profit margin

SMALL MEDIUM AUTOMOBILE INDUSRY (SMAI)
COMPARATIVE BALANCE SHEET AS AT 31ST DECEMBER (IN RM'000)

	2003	2004	2005
Cash	200	180	185
Trade Debtors	6,735	6,187	5,602
Stocks	7,472	5,697	5,547
Other Current Assets	747	465	552
Prepaid Expenses	302	265	246
Total Current Assets	15,456	12,794	12,132
Net Fixed Assets	4,476	4,112	3,841
Other Non-Current Assets	298	524	611
	20,230	17,430	16,584
Short Term Borrowing	3,962	3,254	1,506
Trade Creditors	2,672	2,047	1,900
Accrual	1,043	807	839
Tax Payable	23	212	344
Current Portion LTD	712	543	526
Total CL	8,412	6,863	5,115
Long Term Debt	3,325	1,645	1,123
Other LT Liabilities	1,978	1,273	1,297
Total LT Liabilities	5,303	2,918	2,420
Total Liabilities	13,715	9,781	7,535
Share Capital	3,000	3,000	3,000
Retained Profit	3,515	4,649	6,049
Total SHF	6,515	7,649	9,049
Total Liabilities & SHF	20,230	17,430	16,584

SMALL MEDIUM AUTOMOBILE INDUSRY (SMAI)
SUPPLEMENTARY INFORMATION

	2003	2004	2005
Net Fixed Assets			
Land	672	672	672
Building	2,152	2,152	2,404
Machinery and Equipment	4,135	4,352	4,456
Vehicles	177	136	163
	7,136	7,312	7,695
Less :			
Accumulated Depreciation	2,664	3,200	3,854
Net Fixed Assets	4,472	4,112	3,841
Stocks			
Finished Goods	2,363	1,603	1,938
Work in Progress	442	246	386
Raw Material	4,667	3,848	3,523
	7,472	5,697	5,547

9.0 ISLAMIC TREASURY OPERATION

9.1 Roles and Function of Treasury
9.2 Statutory Reserves Requirements
9.3 Liquid Assets Requirement
9.4 Management of Clearing Account
9.5 Islamic Money Market: Shariah Perspective
9.6 Islamic Money Market (IMM)
9.7 Interbank Mudharabah
9.8 Trading of Islamic Financial Instruments
9.9 Government Investment Certificate (GIC)
9.10 Islamic Accepted Bills (IAB)
9.11 Islamic Accptance Bill (AB-i)
9.12 Bon Mudharabah Cagamas (BMC)
9.13 Islamic Commercial Papers (ICP)
9.14 Islamic Negotiable Instrument (INI)
9.15 Islamic Bond (Sukuk)/Private Debt Securities (PDS)
9.16 Foreign Exchange Market
9.17 Conclusion

9.1 ROLES AND FUNCTION OF TREASURY

Treasury Department is primarily responsible to manage a pool of bank's excess fund. This fund comprises of Customers Deposit (CD), Shareholders Fund (SHF) and any other sources after being utilized in statutory requirements, financing and investment.

From a simple and direct approach of managing fund during the bank's inception, role of reasury has since grown with the introduction of more new instruments and the establishment of a full-fledged independent Islamic money market.

The functions of treasury can be broadly divided into the following:

1. Maintenance of Statutory Reserves and Liquidity Requirement
2. Management of Clearing Account with BNM
3. Management of Bank's excess fund
4. Trading of Islamic financial instruments
5. Management of nostro accounts with oversea agents
6. Foreign exchange trading
7. Fixing and negotiating daily trade finance, foreign exchange and NIDC/SIA rate to branches and corporate customer.

9.2 STATUTORY RESERVES REQUIREMENTS

Section 37(1) of Central Bank of Malaysia Act 1958 (rev 1994) states that all commercial banks, merchant banks and financial companies are required to maintain a certain percentage of their eligible liabilities with Bank Negara Malaysia (BNM) in the form **of Statutory** Reserves Account.

The Ministry of Finance will recommend to the BNM on the percentage of statutory reserves that need to be placed with them.

Eligible liabilities comprised of customer deposit and amount due to other financial institution less amount due from the other financial institution.

The bank's statutory reserve requirement is calculated by using the following formula:

Statutory Reserve = e x r

where:

e = Eligible Liability
r = Percentage of reserve

Adjustment in the amount of Statutory Reserve is made every fortnightly i.e on the 15th day based on eligible liabilities as at the end of preceding month and on the last business day of the month based on eligible liabilities as at 15th day of the same month.

9.3 LIQUID ASSETS REQUIREMENT

BNM requires all banks to maintain daily a minimum liquid assets to meet customer demand.

BNM may from time to time notifies the banks the amount of liquid assets that need to be maintained based on a percentage eligible liabilities.
Currently determination of liquidity requirement are as follows:

i) 10% of total eligible liabilities excluding investment account liabilities
ii) 5% of bank investment account liabilities

The bank's liquid asset comprise of the following:

i) Notes and coins which are legal tender in Malaysia
ii) Balance with BNM excluding balance in Statutory Reserves Account
iii) Government Investment Certificates (GIC)
iv) Islamic Accepted Bills and Bankers Acceptance below 3 month.
v) Bon Mudharabah Cagamas
vi) Other asset as may be approved by the Ministry of Finance on the recommendation by BNM.

Adjustment of the bank's liquidity requirement is made on fortnightly basis**.**

9.4 MANAGEMENT OF CLEARING ACCOUNT

1. Islamic Clearing System was introduced on 3rd Jan 1994.

2. Involving commercial banks only, BIMB and SPI banks are required to maintain a clearing account with BNM under the concept of Al Wadiah.

3. This account is used to facilitate all outward and inward cheque clearing, to and from the banks.

4. The squaring of all position will be done at midnight clearing settlement. Any surplus or deficit positions by respective banks will be carried forward to the following day.

5. Treasury will fund the deficit or invest the surplus position through the Islamic Money Market using Interbank Mudharabah on intra day basis early in the morning.

9.5 ISLAMIC MONEY MARKET: SHARIAH PERSPECTIVE

9.5.1 Introduction

From the Shariah perspective the contracts applied in the activities of the Islamic Money Market can be divided as follows:

- The profit sharing contract of Mudharabah, and
- The trading contracts of
  - Murabahah
  - Bai Bithaman Ajil
  - Bai al-Dayn, and
  - Bai Inah

9.5.2 Deposit Taking

Mudharabah contracts are used in deposit taking and investments in the inter bank market, which is the Islamic alternative to the conventional inter bank deposit trading. Mudharabah refers to an agreement between two parties: the provider of funds, who provides 100% capital for the financing; and the entrepreneur who manages the business using this expertise.

The Mudharabah deposit taking are practised by Islamic banks and commercial banks, finance companies, merchant banks and discount houses participating in the Islamic Banking Scheme (hereafter referred to as IBS banks). As evidence of the deposits the Islamic banks and the IBS banks issue Islamic Negotiable Instruments of Deposits (NIDs-i) following the guidelines on Islamic Negotiable Instruments issued by Bank Negara Malaysia (BNM).

The National Shariah Advisory Council for Islamic Banking and Takaful at BNM resolved that the certificates of Mudharabah deposits (NIDs-i) are not ribawi materials. They can be traded for money at a price less than their face values.

According to the Shariah Mudharabah deposits are termed as capitals and among their requirements are as follows:

- they must be in cash (customers must posses the cash)
- they must be in specified amounts
- they must be delivered to the entrepreneurs (the banks)
- the profit sharing must be known at the points of contracts
- they must not be used in prohibited activities, namely:
  - conventional banking which involves riba
  - conventional insurance which involves gharar (uncertainty)
  - gambling, and
  - trading haram materials, foods and beverages

There is no objections from the Shariah to BNM laying down the guidelines that:

- the maturity dates of the NIDs-i must not be less than 90 days from the dates of issue, and
- the nominal values are in amounts not less than RM50,000 and in multiples of RM50,000 up to a maximum of RM10 million.

Following the guidelines discount houses are allowed to accept deposits of less that one month.

9.6 ISLAMIC MONEY MARKET (IMM)

Islamic Money Market (IMM) was introduced by BNM on January 3rd 1994

Market players/participants are commercial banks, merchant banks and finance companies with SPI department licenses under BAFIA 1989 and Islamic Banks licensed under IBA 1983.The example of activities include:

i) Interbank Mudharabah
ii) Trading of Islamic Financial Instrument.

9.7 INTERBANK MUDHARABAH

Inter bank investments based on Mudharabah are for the purposes of:

- meeting financing given out to customers, and
- balancing the clearing accounts and the statutory reserves accounts with BNM.

The profit sharing between the bank depositing the money and the bank accepting the deposit is based on the ratio indicated by BNM, which is the current profit rate of Government Investment Issue plus 0.5%.

1. A system where an SPI obtains investment from another SPI on the basis of Al Mudharabah to source, invest and square their short term fund.

2. An alternative to the conventional money market, the activities are based on profit sharing principle as compared to interest on borrowing/lending activities in the conventional money market.

3. Al Mudharabah is a joint venture between two parties i.e one party with fund and the other party who is the entrepreneur. Both parties will then negotiate and agree on the amount, tenor of investment and profit sharing ratio. Any loss must be borne by the investor.

4. The period of investment ranges from overnight to 12 months

5. The minimum amount of investment is RM50,000-00

6. The rate of return shall be based on the gross profit before distribution for investment of 1 year of the receiving bank (Gross rate).

7. The profit sharing ratio on all period is negotiable

8. The profit of MII is calculated based on the following formula:

$$\text{Profit} = \frac{prt\,(k)}{36500}$$

where :

p = Principal investment
r = Rate of Gross Profit (The SPI receiving the Investment)
t = Number of Day Invested
k = Profit sharing Ratio of the investing SPI

9. To the receiving bank, fund received is termed Mudharabah Interbank Deposit (MID) and Mudharabah Interbank Investment (MII) for the investing bank.

Example

IRHB invests RM1,000,000 with BIMB for 30 days.

Profit sharing ratio is negotiated at 75:25. Based on the prevailing gross profit rate, i.e. 5.50%.

IRHB is expected to receive a net profit of 4.125%. Upon maturity of the investment, BIMB's effective gross profit rate has increased to 6%.

Therefore, profit payable to provider of fund

$$= \frac{1{,}000{,}000 \times 6\% \times 30 \times 0.75}{365}$$

= 3,698.63 i.e a return of 4.5% p.a

9.8 TRADING OF ISLAMIC FINANCIAL INSTRUMENTS

Interbank Islamic Money Market (IMM) create a secondary market where participants trade all the available Islamic financial instruments.

IMM allows:

i) Easy access to Islamic financial instruments
ii) Provide liquidity in the market for the financial instruments
iii) Trading and Abitraging
- between instruments with same tenor
- between tenor of the same class of instruments

Each instrument is different from one another in terms of risk profile, yield, tenor, marketability and liquidity.

9.9 GOVERNMENT INVESTMENT CERTIFICATE (GIC)

- Issued under the Government Investment Act 1982 (amended 1990) with authorised limit of RM5 billion.
- Investment in GIC constitutes a loan to the government under the principle of Al Qardh Al Hassan.
- Loan under Al Qard Al Hassan must be made on interest free basis. The borrower (Govt) may however at its own discreation decides on the dividend that may be added into the principal.
- The dividend based on discreation is paid annually on the anniversary date of GIC.
- GIC eligible for computation of liquid asset requirement.
- Pricing of GIC is determined by the following formula

$$\text{Price of GIC} = 100 + \frac{r \times t}{365}$$

where r = Dividend rate p.a
t = Number of days from issuing / anniversary

Example

If r = 5%, then price of GIC after 30 days from the issuing date is:

$$= 100 + \frac{5 \times 30}{365}$$

$$= 100.41$$

In other words, after 30 days, the Bank may receive RM1,004,100 on sale of GIC with nominal value RM1,000,000.

Income earned from GIC will be recorded as RM4,100.

9.10 ISLAMIC ACCEPTED BILLS (IAB)

- IAB is created out of trade related transactions under the concept of Al Murabahah.
- Al Murabahah financing can be classified into:
  - import / purchase
  - export /sale
- Debt created under the above financing is then traded in the secondary market as IAB.
- IAB is a bill of exchange drawn by the bank and accepted by the importer / purchaser or drawn by the exporter /seller and accepted by the bank.
- Debt trading in the secondary is based on the principle of Bai Al Dayn.
- Price of IAB is calculated based on discounting formula as follows

$$\text{Proceed} = FV \left(1 - \frac{r \times t}{365} \right)$$

where FV = Face value
r = Discounting rate
t = Number of days remaining to maturity

Example

An IAB with a face value of RM1,000,000 is sold at a discount of 4%.
It has 60 remaining days to maturity.

$$\text{Proceed} = 1{,}000{,}000 \left(1 - \frac{4\% \times 60}{365} \right)$$

= RM993,424-65

9.11 ISLAMIC ACCEPTANCE BILL (AB-I)

An AB-i is created when an importer orders a bank to purchase an asset it needs. The bank purchases the asset and sells it to the importer with payment being deferred (under Bai Bithaman Ajil) for, say 180 days.

The importer issues a bill based on Shahadah al-Dayn which is accepted by the bank.

An AB-i can also be created when an exporter who has a deferred payment bill based on Shahadah al-Dayn sells the bill on cash terms to a bank and the bank accepts it.
All matters pertaining to the import and export must meet the requirements of the Shariah for a halal and valid sale. Among the requirements relating to the asset are:

- it must exist in corporeal form
- it must be owned by the seller
- it must not be a haram material or an asset used for a haram purpose
- it must be free from encumbrances
- it must be specified
- it must not be a ribawi material, i.e. gold, silver or currency (because an AB-i, as all Islamic Negotiable Instruments, involves deferred payment. Payment in a sale of ribawi material cannot be deferred)

- AB-i is Islamic Bankers Acceptance issued by the conventional banks which are considered 'Halal'
- AB-i is guided by the BNM Interest Free Accepted Bills Guidelines 1993
- Conventional bank's BA must meet the following requirement to qualify as Halal.

  a) It must be an export or sales AB-i
  b) The AB-i is drawn to finance Halal goods and commodities
- Calculation for the proceed of AB-i is based on discounting formula (similar as IAB)

9.12 BON MUDHARABAH CAGAMAS (BMC)

- BMC are bonds issued by Cagamas Berhad under the Islamic Principle of Al Mudharabah.
- BMC allows the bondholder and Cagamas Berhad to share profit generated from the issuer operation in purchasing the Islamic house financing and other Islamic investment from Bank Islam / SPI based on a specified profit sharing ratio.
- Based on the concept of Al Mudharabah the bondholder will bear any loss of dimunition in the principal amount of the bond.
- BMC issues range between 3 to 7 years.
- Profit on BMC is payable semi-annually based on the actual income received on dividend date

Price and proceed of BMC is based on the following formula:

$$P = 100 \quad \frac{100 + \frac{C \times E}{365}}{100 + \frac{r \times T}{365}} - FV \quad \frac{C \times t}{36500}$$

$$\text{Proceed} = \frac{NV \times P}{100} + NV \times \frac{C \times t}{36500}$$

where :

P = Price per RM100 face value
C = Indicative coupon for current coupon period
E = No. of days in current coupon period
T = No. of days from transaction date to next coupon payment date
r = Yield to maturity
t = No. of days from last coupon payment date to the value date
NV = Nominal value of BMC transacted

Example

SHARIAH Bank bought RM15million BMC from the market with details as follows:

Issuance date : 25/03/1999
Maturity date : 25/03/2002
Transaction date : 22/06/1999
Next coupon Date : 25/09/1999
Indicative coupon : 5.63%
Yield to maturity : 5.73%

$$\text{Price} = \frac{100}{100 + \frac{5.63 \times 184}{365}} - 100 \frac{5.63 \times 89}{36500}$$

$$= \frac{10{,}283.8137}{101.491370} - 100\,(0.013728)$$

$$= 101.326977 - 1.3728$$

$$= 99.954177 \text{ (round up to 2 decimal places)}$$

$$= 99.95$$

$$\text{Proceed} = \frac{15{,}000{,}000 \times 99.95}{100} + 15{,}000{,}000 \times \frac{5.63 \times 89}{36500}$$

$$= 14{,}992{,}500 + 205{,}919.18$$
$$= 15{,}198{,}419.18$$

9.13 ISLAMIC COMMERCIAL PAPERS (ICP)

- ICP are debts issued by a corporation to fund its capital requirement
- It is issued under the concept of Al Murabahah
- The tenor of issuance are normally 3 months, 6 months or 1 year.
- Prior to issuance of ICP the corporation must obtain approval from Securities Commission and BNM and to be rated by a Rating Agency.
- Type of ICP:
  - Murabahah Notes Issuance Facility (MUNIF)
  - Islamic Revolving Underwritten Facility (IRUF)
  - Guaranteed Revolving MUNIF (GRUNIF)
- Debt arises from the Murabahah transaction is then traded in the secondary market
- Price of ICP is based on discounting formula
- Example: Petronas Gas Bhd and Midcity Resources Sdn Bhd

9.14 ISLAMIC NEGOTIABLE INSTRUMENT (INI)

- INI is an investment / debt arising from a transaction which represent deposit received by an Islamic bank and it is negotiable.
- Issuers of INI are FI's licensed under BAFIA 1989 with SPI and Islamic bank licensed under IBA 1983
- INI is issued for a minimum period of 90 days and maximum of 60 month
- Minimum nominal value is RM50,0000 and maximum is RM10 million per certificate

8.14.1 Type Of INI

a) NIDC

- Issued based on the Islamic concept of Al Bai Bithaman Ajil or BBA (deferred payment sale)
- Islamic bank (IB) needs to identify its asset to facilitate the BBA transaction
- Under BBA, IB will sell its asset for cash based on the funds placed by the customer (purchase price). The customer then sells back the asset to IB on deferred payment basis at a future date for the principal and profit (selling price)
- IB will issue s NIDC certificate as evidence of debt
- The debt can be traded in the secondary market before maturity under the concept of Bai Al Dayn

Formula to calculate price of NIDC is as follows:

i. For NIDC with maturity less than 1 year

$$\text{Price} = \frac{RV}{1 + \frac{T \times Y}{36500}}$$

(price are rounded up to 4 nearest decimal points)

Where :

RV = Redemption value per RM100 nominal value
T = No of days from settlement date to maturity date
Y = Yield /Profit rate

Example:

An NIDC was purchased by Bank LMN with nominal value of RM10 million with the following details:

Issuance Date	:	20th April 2000
Maturity Date	:	20th October 2000
Transaction Date	:	20th May 2000
Yield	:	3.50%

$$\text{Price} = \frac{100}{1 + \frac{3.50 \times 153}{36500}}$$

$$= 98.5541$$

$$\text{Proceed} = \frac{10{,}000{,}000 \times 98.5541}{100}$$

$$= 9{,}855{,}410\text{-}00$$

For NIDC with maturity exceeding 1 year

The formula is:

$$\text{Price} = \frac{Rv}{1 + \frac{Yld}{m}\ n\text{-}1+DSC/DCC}$$

Where

Rv	=	Redemption value per RM100 nominal value
Yld	=	Yield in % p.a
DSC	=	Number of days from settlement date next quasi coupon date (as if the instrument pay semi annual profit
DCC	=	Number of days in quasi coupon period
n	=	number of remaining quasi coupon profit periods
m	=	number of dividend payment per year

Example

Bank JKL purchases a long term NIDC from the market as follows:

Issuance Date	: 15/05/1999
Maturity Date	: 15/05/2001
Transaction Date	: 15/08/2000
Maturity Value	: RM1,000,000
Yield	: 3.00%

$$\text{Price} = \frac{100}{1 + \frac{3.00}{2} \; 2\text{-}1+92/184}$$

$$= 97.7915$$

$$\text{Proceed} = \frac{1{,}000{,}000 \times 97.7915}{100}$$

$$= 977{,}915\text{-}00$$

INID

- Issued under the Islamic concept of Al Mudharabah
- INID represent the amount invested with SPI and to be repaid on a fixed future date consisting of principal plus the dividend.
- An extension of GIA/SIA issued by SPI but is negotiable status.
- For INID with tenor less than 1 year, dividend is payable every Quarter. For INID that exceeds 1 year, dividend is paid on semi-annual basis. Formula to calculate the dividend payable for INID

$$\text{Dividend} = NV \times (R \times k) \times \frac{D}{36500}$$

where :

NV	=	Nominal Value of the INID
R	=	Prevailing Gross Rate of the Issuer
k	=	Profit Sharing Ratio of the Investor/Depositor
D	=	No of days in dividend period

Example

Customer approaches Bank ABC with RM1 million as placement in INID

Tenor	: 2 years
Profit sharing	: 80:20
Dividend payment	: Semi annual payment
Issuance Date	:15/01/1999
Maturity Date	: 15/01/2001

Assuming on the first dividend date 15/07/99, the bank gross rate is 10% the dividend payable is:

$$\text{Dividend} = 1{,}000{,}000 \times (10\% \times 0.8) \times \frac{181}{365} = 39{,}671\text{-}23$$

The price of INID in the secondary market is based on the following formula :

$$\text{Price} = \frac{a \times b}{36500} + 1 \times 100$$

where

a = Indicative Net Dividend

b = Number of days from the issue date/last dividend date to the transaction date

and

$$\text{Proceed} = \frac{NV \times \text{Price}}{100}$$

Example

A 2 years INID was purchased at the indicative dividend rate of 7.2 on 15/02/00. The particulars are as follows:

Issuance Date	: 15/01/1999
Maturity Date	: 15/01/2001
Nominal Value	: 1,000,000

$$\text{Price} = \frac{7.2 \times 31}{36500} + 1 \times 100$$

$$= 100.6115$$

$$\text{Proceed of INID} = \frac{1{,}000{,}000 \times 100.6115}{100}$$

$$= 1{,}006{,}115\text{-}00$$

9.15 ISLAMIC BOND (SUKUK)/PRIVATE DEBT SECURITIES (PDS)

- Islamic bonds (IB's) are debts issued by the multinational or big corporation to raise funds for their operations

- IB is a long term in instrument with minimum period of 3 years and maximum of 20 years

- Like ICP, the corporation must acquire the necessary approval from the Securities Commission and BNM and unless it is a government bond, it must be rated by a Rating Agency

- IB can be traded in the secondary market under the Islamic concept of Bai Al Dayn

IB can be divided into 2 types of bonds:

a) Zero Coupon Islamic Bond

- Issued at a discount from the face value
- This bond does not have any inward cash flow in term of profit payable every semi annual and bond holder only received the face value upon maturity of the bond
- This bond can be originated from a few Shariah concepts among which are:

  a) Al Murabahah
     - Khazanah Bond

  b) Al Qardh Al Hassan
     - Petronas Dagangan Bond
     - Petronas Gas Bond

- Price of Bond is calculated based on the following formula:

$$PB = \frac{FV}{\left(1 + \frac{i}{m}\right)^{mn}}$$

$$\text{Proceed} = \frac{NV \times PB}{100}$$

Where

PB	=	Price of Bond
FV	=	Face value per RM100 nominal value
i	=	Yield to maturity
m	=	Number of coupon payment per year
n	=	Number of years to maturity

Example

A RM30 million Khazanah 2/98 bond was purchased as follows:

Issuance Date	: 18/06/1998
Maturity date	: 18/06/2003
Transaction Date	: 18/06/1999
Yield to maturity	: 6.00%

$$\text{Price of Bond} = \frac{100}{1 + \frac{0.06}{2}^{4x2}}$$

$$= \frac{100}{(1.03)8}$$

$$= \frac{100}{1.2668}$$

$$= 78.94$$

$$\text{Proceed} = \frac{30{,}000{,}000 \times 78.94}{100}$$

$$= 23{,}682{,}000$$

Coupon Islamic Bond

- Issued at nominal value which is equivalent to the face value (amount payable upon maturity)
- A series of coupon (annual or semi annual) is paid based on an agreed fixed rate
- This bond can be issued either at a discount, at par or at premium depending on it's dividend and the prevailing market yield
- The underlying Shariah concept is BBA
- Examples are KLIA Bond, Hualon , KFC, TNB, Midcity Resources, Encorp Systembilt and SAJ Islamic Bond
- Price of Bond is calculated based on the following formula:

$$PB = \sum_{t=1}^{mn} \frac{c/m}{(1 + i/m)t} + \frac{FV}{(1 + i/m)^{m*n}}$$

$$\text{Proceed} = NV \times \frac{PB}{100} + NV \frac{P}{200} \times \frac{T}{E}$$

Where PB = Price of Bond per RM100 nominal value
FV = Face Value per RM100 nominal value
i = Yield to maturity
m = Number of dividend payment per year
n = Number of years to maturity
c = Annual dividend payment
P = Profit rate per annum
T = Number of days from last dividend payment to value date
E = Number of days in current dividend period
NV = Nominal value of bond transacted

Example

Bank Islam bought RM50 million of KLIA 1/97 bond with the following details:

Issuance Date : 30/1/1997
Maturity Date : 30/1/2002
Transaction Date : 30/10/2000
Coupon payment Date: 30/1 and 30/7
Coupon rate : 7.60% p.a
Yield to maturity : 4.00%

$$\text{Price of Bond} = \frac{7.6/2}{(1+4/2)\ 92/184} + \frac{7.6/2}{(1+4/2)2} + \frac{7.6/2}{(1+4/2)3} + \frac{100}{(1+4/2)3}$$

$$= \frac{3.8}{1.3227} + \frac{3.8}{1.0404} + \frac{3.8}{1.0612} + \frac{100}{1.0612}$$

$$= 2.8729 + 3.6524 + 3.5809 + 94.2329$$

$$= 104.34 \text{ (Round up to 2 decimal point)}$$

$$\text{Proceed} = \frac{\text{RM}50{,}000{,}000 \times 104.34}{100} + \text{RM}50{,}000{,}000 \times \frac{7.6}{200} \times \frac{92}{184}$$

$$= 52{,}170{,}000 + 950{,}000$$

$$= 53{,}120{,}000\text{-}00$$

9.16 FOREIGN EXCHANGE MARKET

Apart from the local Islamic money market instruments, Treasury is also involved with activities relating dealing in Islamic foreign exchange activities which conform to Shariah.

The activities are:

9.16.1 Interbank Trading Of Foreign Exchange

- Exchange of one currency against another is permissible in Islam under the concept of Al Sarf
- However such transaction must be under the following condition
  a) involving two different currencies
  b) delivery of currencies must be done concurrently

Interbank trading which accounts for more than 90% of the total foreign exchange volume worldwide can be classified as follows:

i) Investment - Fundamental / Long term in nature
ii) Speculation - Technical / Short term in nature
iii) Gambling - No basis / information

Transaction acceptable is for investment and speculation

Trading is subject to the net open position permissible by BNM and internally approved daylight and overnight exposure of the respective financial institutions.

9.16.2 Islamic Foreign Exchange Instruments

- Islamic foreign exchange instruments are investment avenue denominated other than the local MYR. Example are instruments denominated in USD, EUR, JPY and GBP.

- Instruments are issued in accordance with Shariah requirements in the respective place of issues.

9.16.3 Foreign Ijarah

- Involves purchase of personal and real property for subsequent leasing at a mutually agreed periodic rent
- Can be either operating lease and finance lease
- Medium term in nature (1 to 3 years)
- Some Ijarah offers detached lease rentals for subsequent securitization in the secondary market

9.16.4 Foreign Murabahah

- Financing of trade related and commercial activities by providing funds for working capital and purchase assets and goods.
- The goods are purchased from third party at the request of client and resell them to the customer on deferred payment basis.
- The deferred payment term are between 3 months to 1 year.
- Profit rate is determined and agreed at the time on the transaction date.
- The financial intermediaries will bear the risk should the customer fail to repay the selling price upon maturity.

9.16.5 Foreign Mudharabah

- The bank is also involved in investment to other foreign financial institution under the concept of Mudharabah.
- Period of investment ranges from 1 week to 1 year.
- Both parties have to agreed on the amount, tenor and profit sharing ratio
- Profit payable is based on the prevailing profit rate.
- Any loss will be borne by the investor

9.16.6 Bullion Trading

- Bullion trading entail purchase/sale of commodity (Gold/Silver).
- Transaction can be based on outright, forward and purchase with arrangement to sell back at a fix future date
- Income is earned from the appreciation value of the commodity

9.16.7 Islamic Fund

- Pool of funds managed by fund managers in activities that include Islamic financing and investment in Shariah approved shares.
- Minimum investment is 1 week and price is based on the prevailing Net Asset Value.

$$NAV = \frac{\text{Gross Profit less expenses}}{\text{No of outstanding share}}$$

- Different between purchase price and sale price is profit/loss to the provider of funds.
- There are cases where an agent will guarantee the principal amount the investment.

9.17 CONCLUSION

A lot more effort need to be to be done for Islamic treasury to compete with the more established conventional money market in term of product and services.

With the commitment from all relevant parties it is not impossible for it to become a reality in the near future.

10.0 ACCOUNTING FOR ISLAMIC FINANCIAL INSTITUTIONS

10.1 General Accounting Principles
10.2 Understanding Financial Statements

1.1 GENERAL ACCOUNTING PRINCIPLES

Accounting Doctrines, Principles and Policies

1.1.1 Accounting Doctrines

These are the widely accepted accounting principles which are valid and authoritative in nature. These doctrines cover all the relevant principles and standards which are to be applied in financial reporting to ensure a meaningful and reliable presentation, disclosure and measurement of accounting information.

1.1.2 Accounting Principles

These are basic rules which regulate financial accounting. Also, often referred to as conventions, concepts, assumptions and best accounting practice. There are many concepts that can be applied in formulating financial reports, of which the basic conventional concepts are the matching, prudence, going concerns and the historical cost convention.

1.1.3 Accounting Policies

"A set of accounting principles used by an entity as a basis in the preparation of financial statements."
Examples : Basis of accounting – the historical cost convention as opposed fair value accounting. Revenue recognition – under the cash basis as opposed the accrual basis. Fixed assets – depreciable under straight line basis as opposed the reducing balance basis.

1.1.4 Islamic Accounting Standards

Accounting standards are part of the regulatory framework introduced by the authority as well the profession to standardize the accounting practice used by companies in preparing the financial statements. These encompass various rules and regulations as prescribed under the Companies Act, KLSE Listing Requirements, International Accounting Standards Committee (IAS), Malaysian Accounting Standards Board (MASB), Bank Negara Malaysia Guidelines, and the Islamic financial standards by the AAOIFI.

The Islamic Accounting Standards after taking into account the various practices and regulations intend to provide guidance to those who prepare the accounts to follow a prescribed set of rules in accordance with the locally and internationally approved Shariah conventions.

The aims of the standards are as follows:

- To harmonies accounting practices in areas of accounting where the Shariah interpretation allows different treatments.
- To ensure comparability of financial and operational performance of all IFIs.
- To provide guidance to all users of accounts on concept used by preparers of accounts for their decision-making.
- To bridge the gap between on areas not addressed by IAS and AAOIFI standards.

10.2 UNDERSTANDING FINANCIAL STATEMENTS

10.2.1 Components of Annual Reports

There are few basic components of the Annual Reports as prescribed by the MASB as follow:

- Financial Information – Balance Sheet, Income Statement, Cash Flow Statement and the Statement of Changes in Equity

  A complete set of financial statements includes the following components such as the sheet, the income statement, a statement showing changes in equity, a cash flow statement and accounting policies and explanatory notes.

  The financial statements should be prepared and disclosed in accordance with the standards issued by the MASB. In particular, MASB 1 on the Presentation of the Financial Statements prescribed specific formats for all enterprises to follow in order to produce a uniform set of financial statements for the purpose of comparisons.

  The various standards issued by the MASB are intended to enhance the quality of financial information to be published to users of account under the current disclosure based regime.

- Non-Financial Information – Chairman's Report, Directors Report, Activities Report, Statements on Corporate Governance, Auditors Report

  The various non financial information are prescribed by the Bursa Malaysia Listing Requirements, pronouncements by the Malaysian Code of Corporate Governance and Statement of Internal Control Guidance, and various sections of the Companies Act, 1965. Such information has to be disclosed in accordance with the prescribed format and guidelines.

- Detailed Financial Statements

a. Balance Sheet (BS)

MASB 1, i.e. Presentation of Financial Statements sets out the requirements with regard to the presentation of items in the BS.
The Balance Sheet (BS) provides information on the assets and liabilities which are represented by its equity or shareholder funds at a specific point in time. For example, the BS as at June 200X.

The assets and liabilities can be split further into the current or non-current distinction depending on the nature of their operations.

The BS aims to show how an entity's resources are being employed at any point in time as represented by its capital and reserves over the period.

b. Income Statement (IS)

MASB 1, i.e. Presentation of Financial Statements sets out the requirements with regard to the presentation of items in the IS.

The Income Statement (IS) intends to show the results of an enterprise's various operations/transactions over a period of time. The results are reflected in such a way as to net off all the revenue generated from the business against all the expenditure incurred during the period. Any surplus or deficit incurred after making various deductions is then transferred to reserves.

The normal accounting period for the purpose of reflecting the result of a company operation is one year. For example, the profit or loss for a period of 12 months to June 200X. However a company may have a shorter or longer period of accounting during its first year of operation subject to its application and approval from the relevant authorities.

The Income and Expenditure Statement relates to account of a non profit making enterprise. For others, this is widely known as the Profit and Loss Account.

c. Cash Flow Statement (CFS)

MASB 5, CFS sets out requirements for the presentation of CFS and the related disclosures.

The CFS aims to show the users of accounts an entity's cash receipts and payments in such a way as to reflect the cash balance at a certain interval.

This is useful for users to assess the ability of the enterprise to generate cash and cash equivalents which are distinct from profit (see below) as well as to highlight its ability to utilize those cash flows.

The cash flow is important for a company's short term survival such that the CFS is an important tool for the management to make forward planning for its immediate and future cash requirements. Neither the amount nor the timing of cash flow is influenced by the accounting concepts such as prudence, accruals etc. On the other hand, adequate profit is vital for long term survival. Profit can be measured and its timing can be influenced by the relevant accounting concepts used.

d. Statement of Changes In Equity

The statement intends to show all movement in capital/equity and to show the effect of changes resulting from fundamental errors or policy changes which have a direct effect on the equity.

The movement reflects the increase or decrease in the net assets or wealth during the period as a result of enterprise's activities.

This is useful for users to know whether the changes in the capital and reserves are due to operating activities or via the equity exercise undertaken by the company.

- Fundamentals of Balance Sheet (BS)

As a minimum, BS should include line items such as

a) property, plant and equipment,
b) intangible assets,
c) financial assets,
d) investments,
e) inventories,
f) trade and other receivables,
g) cash and cash equivalents,
h) trade and other payables,
i) tax liabilities/assets,
j) provisions,
k) minority interest,
l) issued capital and reserves.

Additional line items, headings and sub totals should be presented on the face of BS if required by MASB Standard or when such presentation is necessary to give a true and fair view of the financial statements.

Further sub classifications of the item presented can also be disclosed on the face of BS or in the notes to the accounts, based on the nature of the enterprise's operations.

The detail items to be disclosed in the sub classifications depend on the MASB Standard or other technical pronouncements and the materiality of the sum involved.

An enterprise should determine based on the nature of its operations on whether or not to present the balance sheet items as separate classifications on the face of the BS. If this is not done, assets and liabilities should be presented broadly in order of their liquidity.

An asset or liability can be classified as current asset or liability if it can be expected to be realized/held for sale/consumption or is expected to be settled in the normal course of enterprise's operating cycle, normally within the period of 12 months.

All the other assets or liabilities should be classified as non-current in nature. For example, the land and building held as fixed assets, and the term loan of more than 2 years.

The non-current tem includes tangible, intangible, operating and financial assets of a long term nature.

Current assets include inventories and trade receivables that are sold, consumed and realized under normal operating cycle even when they are not expected to be realized within 12 months of BS date.

Marketable securities are classified as current assets if they are expected to be realized within 12 months of BS date.

Trade payables, accruals which form part of working capital under normal operating cycle are classified as current liabilities even though they are due to be settled more than 12 months after the BS date.

Long term interest-bearing liabilities shall be classified as non current even though they are due within 12 months of BS date provided it is intended to be a long term form of liabilities. With respect to long term liabilities, further notes disclosing the interest rates, repayment terms etc have to be disclosed.

- Fundamentals of Income Statement (IS)

As a minimum, the IS should show

a) the revenue,
b) results of operating activities,
c) finance costs,
d) share of profits and losses of associates,
e) tax expense,
f) profit and loss from ordinary activities,
g) extraordinary items,
h) minority interest,
i) net profit/loss for the period.

Additional line items, headings and sub headings should be presented on the face of IS as required by relevant MASB or when such presentation is necessary to present fairly the enterprise's financial performance.

Factors to be taken into consideration when deciding on the additional line items include materiality, the nature and function of various components of income and expenses. Example: there are items included or modified to be comply with more specific requirements in line with BNM Guidelines.

An enterprise should present either on the face or in notes of IS the analysis of expenses according to its:-

a) nature or
b) function within the enterprise.

Enterprise classifying expenses by function should disclose additional information on the nature of expenses, including depreciation and amortization, and staff cost.

An enterprise should disclose either on the face or in the notes to the IS, the amount of dividends per share, declared or proposed for the period covered by the financial statement.

- Fundamentals of Cash Flow Statements

Cash receipts and payments have to be recorded in the period they are received or paid. They cannot be spread into the other periods.

The CFS highlights all the major cash movements and its effects on the cash and cash equivalents through the grouping of items in few main headings, particularly; Net cash flow from operating activities, Cash Flow from Investing activities, Cash Flow from Financing activities and the resulting cash and cash equivalents.

- Fundamentals of Statement of Changes In Equity

In terms of presentation, the statement can either show (1) all changes in equity or (2) changes in equity other than those arising from capital transactions with owners and distributions to owners.

For the former, the statement should reflect the composition of equity brought forward at the beginning of the year and any movement and changes thereof during the financial year.

For the later, a statement of recognized gains and losses may be used instead to show the movements in reserves and equity other than those transacted with the owners of the enterprise.

Any changes in the balance brought forward figures as a result of prior year adjustments or any other adjustments must be shown at the restated balance.

10.2.2 Limitations of Financial Statements

- Limitation in the balance sheet

  The standard does not prescribe the order or formats in which items are to be presented, but rather a list of items that are so different in nature such that they deserve separate presentation.

  As such, presentation of items on the face of balance sheet may differ from one enterprise to another depending on the nature of the business, thus making comparison between entities meaningless.

  Users have to rely on the notes to the account for detailed disclosure of items on the face of face of balance sheet for a better understanding of the accounts.

  Presentation of items on the face o BS may also differ for organizations under the purview of certain authorities. For example, for banking institutions, the format has to follow the BNM Guidelines which is different from the ones required by the MASB.

  Detailed disclosure of items in the BS and Notes may be disadvantagous to the entity if such information is known to its competitors.

  Too general a disclosure may result in the balance sheet position vaguely presented. This would disadvantage the genuine users of accounts or other stakeholders.

  Thus, there is a need to strike a balance between detailed disclosure and a good corporate governance pertaining to self disclosure of items to the general public.

- Limitations of the Income Statements

  Given the flexibility given by the MASB 1 on the ways the IS can be presented, i.e. by nature of expenses or their function within the enterprise, this may hinder a meaningful comparison of two similar enterprises' financial statements as they are using different methods of presentation.

- Limitations of the Cash Flow Statement

  Similar to the BS and IS, flexibility accorded by MASB as to the approach adopted by anterprise in presenting their financial statements may hinder meaningful comparison of financial statements of similar enterprises.

  For the CFS, an enterprise may adopt either the
  a) Direct Method
  b) Indirect Method

10.2.3 Understanding Financial Report

- **Overview**

Financial report is one of the main sources of information that a credit analyst cannot afford to ignore. Normally the main source of the financial report can be obtained from the company's annual report, which is normally given to shareholders and filed with Companies Commission of Malaysia (CCM) annually.

For public listed companies, they are subjected to extended requirements which require them to prepare quarterly financial reports that are to be lodged with Bursa Malaysia every three months. These reports can be downloaded at Bursa Malaysia website (www.bursamalaysia.com). For non public listed companies, their annual reports which are also known as statutory accounts can be obtained from CCM for a nominal fee.

- **Components of Annual Report**

The main components of annual report that are most useful for financial analysis are as follows:

1. Chairman/Managing Director's statement (not for non-public listed company)
2. Director's report
3. Report by auditors
4. Financial statements:
   - Balance sheet
   - Income statements
   - Statement of changes in equity
   - Cash flow
   - Notes to the account
6. Particulars of property (not for public listed company)

- **Chairman's report**

This report is required only for public listed companies. The chairman's report normally summarises the activities of the companies, financial performances and other issues which may include their future outlook. By going through these, financing officer may wish to keep an eye on the information such as:

- External events that may impact the company's performance.
- Internal changes, new strategies, products or activities.
- The confidence or outlook of company's future performance.
- Any adverse event during the year.

Financing officer may wish to query the company's management on any information that requires further clarification or may provide business opportunities. For example, a report stated that the company's machinery is running on full capacity may indicate an opportunity for the financier to offer new facilities for expansion.

Director's report

This is a statutory requirement for all companies as defined in the Companies Act 1965. The directors' report that needs to be signed by at least two directors is required to state:

- The company's principal activities and if there has been any significant change in the nature of the activities during the year.
- The financial result for the year, i.e. the net profit or loss.
- Whether there exists material transfer in the reserves or provision.
- Dividends declared during the year, if none it must be specified in the report.
- Name of all the directors since the last report, any changes to the director's listing and directors seeking for re-election.
- Directors interest in the company's shares and its related companies.
- Benefits received by the directors.
- Issue of shares and any movement during the year including options and share buy back.
- Assurance that reasonable steps have been taken to ascertain that bad debts have been adequately provided for, current asset has been properly valued and there is no other circumstances, unless that have been mentioned, would jeopardise the value of the assets/liabilities of the company.
- Subsequent events that happened between the financial statement date (e.g. year end 30 June 2005) and the date of the report (e.g. 19 Oct 2005) that have significant information to the user.
- Appointment of auditors.

➢ **Auditors Report**

All companies annual financial statements need to be audited by external auditors. Auditors Report is a written opinion of an independent certified public accountant that a company's financial statements are a fair representation of the company's financial performance and financial position. The auditor's report is required for each corporation. Based on their audit, the auditors will give their opinion on whether the statement gives a true and fair view of the company's state of affairs.
There are four types of auditor's opinion:

- Unqualified opinion
  A clear opinion, meaning that the statement presented is fair and confirm with applicable standards and Company's Act.

- Qualified opinion
  The statement presented a fair view and complies with the applicable standards and Company's Act, but with some reservations. The reservations however do not impact the fairness of the statement as a whole.

- Disclaimer opinion
  Due to some uncertainties or lack of sufficient information, the auditors cannot come to a conclusion on whether the statement is fair.

- Adverse opinion
  The statement does not represent a fair view of the company and therefore may mislead investors. It may be due to major non-confirmation of financial reporting standards or Company's Act.

Among reasons that causes auditors to qualify the report:

a. Non compliance with the accounting standards
   Financing officer needs to further examine the nature of the non-compliance and judge whether it poses any significant risks to the financing appraisal. For example, auditors may qualify their report due to non-disclosure of analysis on expenses and inventory based on the required accounting standards. The company may have good reasons to do this such as to protect the information from competitors or they are trying to hide something. Will the non-disclosure affect the financing analysis?

b. Insufficient evidence
   A good financial report needs to be reliable. Therefore the auditors will need to satisfy themselves that sufficient data are available to support the information.

c. Doubtful as a going concern
   This means that the auditors cannot satisfy themselves that the company has sufficient assets to meet its liabilities in the near future (usually 12 months). This is normally expressed when the current liabilities of a company are more than its current assets.

10.2.4 Financial Statements/Financial Reporting

Includes the main financial statements (income statement, balance sheet, statement of cash flows, statement of retained earnings, statement of stockholders' equity) plus other financial information such as annual reports, press releases, etc.

- **Balance Sheet**
  A balance sheet is a snap shot of a company's financial positions at a particular date. This presents the company's assets and liabilities.

  Assets can be classified as current assets and non-current assets. Current assets are generally classified as assets that are normally converted into cash within 12 months. On the other hand, non current assets are assets that will be used for a longer period of time and are not expected to be converted into cash within 12 months.

  Examples of non current assets are:

  a. Property, plant and equipment
     These are normally known as fixed assets. These consist of landed properties, buildings, machinery and other assets that are used to generate income for the company.

b. Investment

This represents the ownership of the shares in other companies. The long term asset category of a classified balance sheet which appears immediately after the current assets. Listed in this category would be a bond sinking fund, funds held for construction, the cash surrender value of a life insurance policy owned by the company, and long term investments in stocks and bonds.

c. Goodwill

It is derived from the excess of the purchase price over the fair value of the consolidated subsidiary companies.

d. Deferred tax assets

These are the benefits of expected lower tax charges in the future arising from past transactions.

e. Patents

It is a right to an intellectual property. E.g. copyright.

Examples of current assets are:

a. Inventory

Stocks of finished goods, work in progress and raw materials.

b. Trade receivables

Amount owes by credit customers.

c. Other receivables

Amount owes by other non trade related entity, for example a deposit with Tenaga Nasional Berhad. This also includes any prepaid expenses.

d. Investments

Short term investments that will mature within 12 months e.g. Malaysian government securities purchased.

e. Cash and cash equivalent

Cash in hand, current account, fixed deposits and foreign currencies.

Similar to assets, liabilities are also classified as current and non current. Current liabilities are obligations that need to be paid within 12 months, while non-current liabilities are obligations that need to be paid after 12 months.

Examples of current liabilities are:

a. Trade payable
   Owing to suppliers.

b. Other payable
   Owing to non trade entity, e.g. rental for director's bungalow.

c. Taxation
   A liability account that reports the amount of taxes that a company owes as of the balance sheet date.

Examples of non current liabilities are:

a. Long term loans (loans with tenor more than 12 months)
   Term loans from financial institution.

b. Deferred taxation
   Expected increase in tax expenses in future years arising from past events.

Equity

The last component of the balance sheet is equity, which consists of capital and reserves. Equity represents the owners or shareholders interest in the company. Capital is the amount the company obtained by issuing shares to its shareholders/owners. Reserves on the other hand are the excess arising from the profit made.

Examples of capital are:

a. Share capital
   The amount of money that the company raised the par value of its shares.
b. Share premium
   The excess amount of money raised over the par value of the shares, when the company issues its shares.

   Examples of reserves are:

a. Revenue reserves
   Also known as unappropriated profits or retained earnings. It arises from the profit generated by the company that has not been distributed to the shareholders as dividend. This can be distributed for dividend in later years.
b. Foreign exchange reserves
   Arising from the revaluation of foreign currency assets.
c. Revaluation reserves
   Increase in the value of properties held by the company.

- **Income Statement**

This is also known as Profit and Loss statement. An income statement shows the results of the company's business activities throughout the financial year. As the main reason for the formation of a business is to generate income, the income statement is therefore the most important component in the annual report that a financing officer needs to focus on.

Normally the items presented in the income statements are:

a. Revenue
Fees earned from providing services and the accounts of merchandise sold. Under the accrual basis of accounting, revenues are recorded at the time of delivering the service or the merchandise, even if cash is not received at the time of delivery. Often the term income is used instead of revenue.

b. Cost of goods sold
Cost of goods sold is usually the largest expense on the income statement of a company selling products or goods. This account or this calculation (depends on inventory system) matches the cost of the goods sold with the sales (revenue) of the goods that have been sold.
The cost of goods sold can be computed as follows:
Cost of beginning inventory + cost of goods purchased (net of any returns or allowances) + freight-in – cost of ending inventory

c. Gross profit
The excess of revenue over cost of goods sold. This is the income that the company makes before deducting its other expenses. If the amount is negative, it is a gross loss. A gross loss should definitely trigger an alarm to the financing analyst. If the company is not making money at this level, how can it service the financing?

d. Selling and distribution costs
The expenses incurred to deliver the finished products to the customers.

e. Administrative expenses
The cost for expenses that are not directly related to the production of the revenue. For example, rental of office space, electricity and salary of the HR manager.

f. Other income
Income generated from the non principal activities of the company. For example, rental of excess office space by a company involves in manufacturing of garments or sales of scrap metal by a shipbuilding company.

g. Interest income

Income by placing excess cash in fixed deposits or short term money market.

h. Profit before tax
Gross revenue less all the company's other expenses i.e. the company profit before deducting tax. This figure is useful for comparing the performance of the companies that are within the same industry but have different tax structure. The different tax regimes may due to companies operating in different countries or enjoying a tax incentive in relation to the pioneer status.

i. Tax expenses
The amount provided is to be paid to the Inland Revenue.

j. Net profit
Net profit is net income after overhead before tax and zakat.

- **Statement of Changes in Equity**

It is normal that during the year a company's assets may increase due to non-trade activities. For example, the value of the freehold factory land owned by a glove manufacturing company may appreciate due to a new development in the neighbouring area.

However, this gain is considered not 'realised' as the company have not sold the land to an external party. Therefore, this unrealised gain is reported as a revaluation reserves in the statement of changes in equity.

A loss can also be unrealised. For example, on 30 Sept 2005 a company sold a product for USD100 or RM380 equivalent to an overseas customer at an exchange rate of RM3.80:1USD. At the end of the financial reporting period e.g. 31 Dec 2005 the customer has not paid the debt but promised to pay within 30 days and the exchange rate has changed to RM3.60:1USD. Therefore the debt of USD100 is now worth RM360. The loss of RM20 is considered as unrealised foreign exchange loss and needs to be reported in the statement as changes in equity.

Apart from sharing the unrealised gain and loss for the year, this statement will also show changes in:

a. Share capital and share premium due to issuance of new shares, bonus shar issue, share cancellation and capital repayment.
b. Unappropriated profit or retained earnings due to the current net profit and payment of dividend.

- **Cash flow Statement**

A Balance Sheet is a snapshot of a company's financial position at a specific point of time. Income Statement is a cumulative summary of revenues and expenses compiled during specific period of time. These two statements are the basic instruments used by IBI to make a financial analysis. However, there are some fundamentals questions concerning the financial situation of a company that cannot be answered exclusively from these sources. Some of the questions are:

a. How much cash has been generated from operations?
b. Where has the cash been used?
c. Has the short term financing like murabahah or cash line been utilized as per intended purposes.
d. Is the firm able to replace fixed assets and to pay the Ijarah Thumma Al Bai (AITAB)?

To help answer these questions, the financing officer should be able not only to interpret but to also prepare the Cash Flow Statement.

Cash Flow Statement provides the cash flow implications of all the profit and loss activities and balance sheet events. To prepare a meaningful cash flow statement for Year 2, a balance sheet as at the end of Financial Year 1 and 2, and an Income Statement of Year 2 would be required.

Steps in preparing Cash Flow Statement

There are basically 4 steps in preparing Cash Flow Statements.

- Compute the changes in each balance sheet items.
- Identify whether each of the change is a source or an application of cash.
- Make adjustment on specific changes.
- Present the sources and application of cash in the required format.

Let us use the attached Financial Statements of SMAI for our illustration:

SMALL MEDIUM AUTOMOBILE INDUSRY (SMAI)
COMPARATIVE BALANCE SHEET AS AT 31ST DECEMBER (IN RM'000)

	2003	**2004**	**2005**	**Changes**
Cash	200	180	185	5
Trade Receivables	6,735	6,187	5,602	-585
Inventories	7,472	5,697	5,547	-150
Other Receivables	747	465	552	87
Prepaid Expenses	302	265	246	-19
Total Current Assets	15,456	12,794	12,132	-662
Property, Plant & Equipment	4,476	4,112	3,841	-271
Other Non-Current Assets	298	524	611	87
Total Assets	20,230	17,430	16,584	-846
Short Term Borrowing	3,962	3,254	1,506	-1,748
Trade Creditors	2,672	2,047	1,900	-147
Accrual	1,043	807	839	32
Tax payable	23	212	344	132
Current Portion LTD	712	543	526	-17
Total Current Liabilities	8,412	6,863	5,115	-1,748
Long Term Debt	3,325	1,645	1,123	-522
Other LT Liabilities	1,978	1,273	1,297	24
Total LT Liabilities	5,303	2,918	2,420	-498
Total Liabilities	13,715	9,781	7,535	-2,246
Share Capital	3,000	3,000	3,000	0
Retained Profit	3,515	4,649	6,049	1,400
Total Shareholder's Fund	6,515	7,649	9,049	1,400
Total Liabilities & SHF	20,230	17,430	16,584	-846

SMALL MEDIUM AUTOMOBILE INDUSTRY (SMAI)
INCOME STATEMENT FOR YEAR ENDED (IN RM'000)

	2003	**2004**	**2005**
Sales	27,787	27,023 2	4,351
Cost of Goods Sold	21,331	20,252 1	7,531
Gross Profit	6,456	6,771	6,820
General Expenses	3,897	3,257	3,090
Depreciation	512	537	654
Financing Expense	1,886	1,333	1,076
Profit before tax	161	1,644	2,000
Taxes	30	510	600
Net Profit After Tax	131	1,134	1,400

Step 1 : Changes in Balance Sheets items.
These changes can be computed by deducting items in Year 2004 from Year 2005. The changes can be positive or negative. To ensure our computation is correct, the total changes in Assets items will be equalled to the total changes in Liabilities items.

Step 2 : Identify whether each of the change is a source or an application of cash.
To identify sources or an application of cash, the financing officer may want to use this guideline.

Sources	**Application**
↓ Assets	↑ Assets
↑ Liabilities	↓ Liabilities

By applying positive changes as increase and negative changes as decrease; list out the changes into sources and applications of cash.

Based on the above balance sheets the changes are listed below:

Sources			Applications	
Trade Receivables	585		Cash	5
Inventories	150		Other Current Assets	87
Prepaid Expenses	19		Other Non-Current Assets	87
*Net Property, Plant & Equipment	271		Short Term Borrowing	1,748
Accrual	32		Trade Creditors	147
*Tax	132		Current Portion LTD	17
Other LTL	24		Long Term Debt	522
Retained Earnings	1,400			
Total	2,613		Total	2,613

To check our computation is correct, the total sources will be equal to total application. The above list can be considered as "crude" cash flow statements. Items like changes in Net Fixed Assets (NFA) and provision for taxation need to be adjusted.

Step 3 : Adjustment on specific changes.

To compute capital expenditure, changes in Net Property, Plant & Equipment need to be adjusted.

Capital Expenditure = Changes in NFA + Depreciation
= -271 + 654
= 383

Tax payment can be computed as below:

Opening Tax (BS 2004)	212
Provision for the year (IS 2005)	600
	812
Less:	
Closing Tax (BS 2005)	344
Tax Payment	468

Step 4 : Present the sources and application of cash in the required format.

Transfer all the above items into the required format which can be categorized into 3 main activities

- Operating Activities
- Investing Activities
- Financing Activities

1. Cash Flow from Operating Activities	('000)
Operating Profit Before Interest and Tax	2,000
Depreciation	654
Cash Flow From Operating Activities before reinvestment in working capital	2,654
Decrease in Trade Receivables	585
Decrease in Inventory	150
Decrease in Prepaid Expenses	19
Increase in Other Current Assets	(87)
Decrease in Trade Creditors	(147)
Decrease in Current Portion LTD	(17)
Increase in Accrual	32
Cash Generated From Operations	4,265
Interest Paid	(1,076)
Tax Paid	(468)
Net Cash Flow Provided by Operating Activities	2,721
2. Cash Flow from Investing Activities	
Purchase of Property, Plant & Equipment	(383)
3. Cash Flow From Financing Activities	
Decrease in Short Term Borrowing	(1,748)
Decrease in Other Non Current Assets	(87)
Decrease in Long Term Debt	(522)
Increase in Other Long Term Liabilities	24
Net Cash Flow in Financing Activities	(2,333)
Net Increase in Cash and Cash Equivalent	5
Cash and Cash Equivalent at the beginning of year	180
Cash and Cash Equivalent at the end of year	185

NOTE:

- To check whether our computation is correct, the cash and cash equivalent at the end of the year should equal to the cash outstanding in 2005 Balance Sheet.

➢ Notes to the Financial Statement

Notes to the financial statement are the most ignored component in the financial statements. However, the significant information and clarification of the financial statements can be obtained in the notes. Below are some of the main components of the notes that accompanied the financial statement.

Summary of significant accounting policies.

This explains briefly on the methods and basis of preparation of the financial statements. Some of the significant policies disclosed are:

Basis of accounting.

Generally company accounts are prepared on historical cost concept except certain revaluation of properties that will be disclosed in the other sections of the notes to the financial statement. Financing analyst should also beware with the issuance of new accounting standards and the use of fair value is expected to gain popularity.

Basis of consolidation

This is the basis of preparing the group accounts. Two main methods use in preparing the group accounts:

- Merger method
- Acquisition method

Merger method is rarely use and most companies adopted the acquisition method. The difference between the two methods is beyond the scope of this manual.

Good Will Policies

Goodwill is a long-term asset categorised as an intangible asset. Goodwill arises when a company acquired another entire business. The amount of goodwill is the cost to purchase the business minus the fair market value of the tangible assets obtained in the purchase. The amount in the Goodwill account will be adjusted to a smaller amount if there is an impairment in the value of the acquired company as of a balance sheet date.

Depreciation policies

This note will state the types of property, plant and equipment that are depreciated and the depreciation rate that was used.

Inventories valuation method

Inventories are stated at lower of cost and net realizable value. The First-in-first-out (FIFO) method is the most common method of valuation followed by the Weighted Average method.

Breakdown of property, plant and equipment

In this note, a more detail components of property, plant and equipment is disclosed. It includes:

i. Segregation of major classes e.g. freehold land, furniture and fittings and motor vehicles.
ii. Segregation of the cost, depreciation and net book value, and
iii. Detail additions, disposal, write-off and other movement (e.g. due to exchange fluctuation)

Commitments

This shows any commitments that the company has entered into. It can be segregated into two parts:

a) Authorised but not contracted for.

Example: The board of directors has approved the company to purchase new machine next year. However as at the end of the financial year, the company still has not agreed to buy the machine with any party.

b) Contracted but not provided for in the financial statement.

Example: The company has signed a contract to lease a building for 10 years by paying a lease of RM10, 000 per annum. At the financial year end, the remaining tenor for the lease has reduced to 9 years. Therefore the company has an outstanding commitment of 9 years times RM10, 000 per annum or equivalent to RM90, 000.

A credit analyst therefore needs to be mindful of the facts that the company may have committed to a big arrangement that may be costly to cancel.

Related party transactions

This summarise any transactions that the company has with its related party. A query should be made to the company if some of the transactions appear to be dubious.

Please refer to the followings:

- Sample Auditor Report (Appendix 2)
- Sample Annual Financial Statement (Appendix 3)
- Sample Quarterly Financial Statement (Appendix 4)

10.2.5 Financing Reporting Concept

- **Overview**

One of the most important sources of information for financing analysis is the clients Financial Reports. Therefore it is vital for us to understand the principles behind the preparing of the financial reports.

- **Types of Financial Reporting**

There are two main types of financial report:

1. Management Financial Reports

a. Better known as Management Accounts, are reports prepared periodically for internal organisation use.
b. These reports are normally prepared monthly for various purposes such as to assist management in decision making and monitoring its financial health.
c. These reports are also normally strengthened with non-financial indicators such as market share.
d. Further, some management report may also be forward looking, rather than historical. For example, yearly budget, cash flow forecast and a 5-year strategic plan.
e. Management reports can be requested from the company in order to assist lenders in making their decision.

2. Statutory Financial Reports

a. Better known as Financial Accounts, are periodic reports prepared for external users.
b. Prepared mainly based on information arising from past transactions.
c. The reports consist of mainly:
   i. Income Statement, i.e. Profit and loss account,
   ii. Balance Sheet, and
   iii. Cash Flow Statement
d. All companies in Malaysia are required to prepare and submit these reports to the Companies Commission of Malaysia annually. Therefore lenders may also obtain reports for their client's competitors in order to make comparison with their client's financial positions. Collecting few reports from companies in the same industry will also allow analyst to establish industrial benchmark.
e. These reports are prepared based on accounting standards approved by the Malaysian Accounting Standards Board (MASB).
f. At present, there are two sets of accounting standards in Malaysia, the Financial Reporting Standards (FRS) and the Private Entity Reporting Standards (PERS).
g. FRSs are mandatory for all companies except private entity.
h. Private Entity is a company that:

i. is not itself required to prepare or lodge any financial statements under any law administered by the Securities Commission or Bank Negara Malaysia; and

i. is not a subsidiary or associate of, or jointly controlled by, an entity which is required to prepare or lodge any financial statements under any law administered by the Securities Commission or Bank Negara Malaysia.

i. Private entities shall comply with either:
   i. PERS in their entirety; or
   ii. FRS in their entirety.

j. As existing Standards may be revised and new Standards may be issued, analyst need to keep their knowledge up dated with the recent development.

- **Financial Reporting Qualities**

In order to provide users with useful information, below are the qualities that good financial reporting is prepared upon:

1. **Relevant**
   The information stated in financial statement must be useful to assist users in decision making. Non-relevant information should not be use or included in the preparation of the reports. Further information must also be timely, that is provided before the decision need to be made, and up-to-date.

2. **Reliable**
   In order to be objective, Analyst must be aware that there is a trade-off between relevant and reliable. In order to be relevant, information must be timely, however, in order to obtain information quickly; its reliability may need to be compromised. For example, a company has an acre of land in an outskirt area. Based on the information gathered by a property valuer, for the past five years, there has been only one transaction of land within the proximate area for RM15 per square feet. How much should the company's land be valued at? In order to be timely, it should be valued at RM15 per square feet. However, in order to be reliable, the company should wait, for more transactions within the proximate area to make a better valuation.

3. **Comparable**
   The information must be measured and presented on similar method within the same industry to provide a fair comparison between companies.

4. **Consistent**
   Methods of preparation must be the same from the previous period to the current period in order to allow comparison between periods. Justifiable changes must be properly explained.

- **Financial Reporting Concepts**

In order to achieve the qualities above, the financial reports are prepared based on a few main concepts. **These main concepts can be divided into four assumptions, six principles and three constraints.**

The four main **assumptions** are:

1. **Economic entity**
   An accounting principle / guideline that allows the accountant to keep the sole proprietor's business transactions separate from the owner's personal transactions even though a sole proprietorship is not legally separate from the owner.

2. **Going concern**
   An accounting guideline which allows the readers of financial statements to assume that the company will continue on long enough to carry out its objectives and commitments. In other words, the accountants believe that the company will not liquidate in the near future. This assumption also provides some justification for accountants to follow the cost principle.

3. **Monetary unit**
   An accounting guideline where the Ringgit Malaysia is assumed to be constant (no change in purchasing power) over time. This allows an accountant to add one Ringgit from a transaction in 1990 to one Ringgit in 2004 and to show the result as two Ringgit. It also means that items that cannot be expressed in Ringgit do not appear in the financial statements. For example, how would you express on a company's balance sheet the value of loyal customers or a brilliant, aggressive management team?

4. **Periodic Reporting**
   Also known as the periodicity assumption. The accounting guideline that allows the accountant to divide up the complex, ongoing activities of a business into periods of a year, quarter, month, week, etc. The precise time period covered is included in the heading of the income statement, statement of cash flows, and the statement of stakeholders' equity.

The six main **principles** are:

1. **Historical cost**
   Most assets and liabilities are recorded at acquisition cost, rather than its current market value. However, the current trend in the industry appears to favour fair market value rather than historical cost.

2. **Revenue recognition**
   Revenue is recorded when they are realized, not when the actual cash is received. For example, a business sell goods to a customer who promise to pay within 30 days, the revenue is recognize now, not 30 days later.

3. **Matching**
   Expenses are matched with the revenue it generates, as much as possible to do so. For example, if a person purchases and paid for some wood in January, pay a carpenter who took 2 days to turn into a table in February, took 30 days to ship it to USA, and only sold the table in April, the expense or cost of the wood, carpenter and shipment should be matched with the sales revenue that it realised in April, even if the payment for such expenses was done few months earlier. Only if no direct connection can be established, than the expense is recorded in the period it incurs (e.g. office cleaning expenses).

4. **Full disclosure**
   Enough information should be disclosed in order to enable user to make decision subject to the reasonableness of the cost to provide the information.

5. **Substance over form**
   Financial reports are prepared based on the substance and economical benefits of a transactions rather than its legal form. A good example is in a Car Hire Purchase agreement, the financier (bank) is the legal owner of the car, but the economical benefits for the usage of the car falls to the hirer. Therefore the car will be reported as an asset in the hirer's book and not in the financier.

6. **Dual aspect**
   All transactions are recorded in the books twice, known as Debit and Credit. For example a business pays RM65,000 cash to buy a car. The transaction will be recorded as Debit Car RM65,000 and Credit Cash RM65,000. This also serves as a check to ensure proper recording have been made since at all time the total amount of Debits must always be the same as the total amount of Credits.

The three **constraints** are:

1. **Cost and benefits trade-off**
   Information should only be provided should the benefits of providing them out weight the cost of providing them. Gathering information involves monetary and time cost. Therefore, spending too much expense to provide less important information should be avoided. For example, to obtain a valuation of all machinery parts in a factory, will require time and cost to disassemble, inspect and reassemble small parts in a factory. The information if provided will not give more benefit to the user that the cost required.

2. **Materiality**
   The significant value of items should be considered when preparing the financial report. For example, even though a paperclip may provide benefits for a user for a few years, due to its insignificant value, the cost of a paperclip should be expensed in the period it is purchased, rather than capitalized as an asset and depreciated for few years. It is important to note that the materiality value will defer depending mainly on the size of the organization. For example, for a small Rojak stall business operator, the cost of a bundle of paper plates may be material for its reporting, but the same bundle of paper plates used in a Public listed company's family day gathering is definitely not material.

3. **Conservatism**
   In the event of uncertainty, the option that will understate assets and income should be picked. This only applies when objective data are not available, therefore subjectivity and judgment need to come into play.

11.0 SHARIAH COMPLIANCE AUDIT

11.1 Overview on Audit
11.2 Introduction To Shariah Compliance Audit
11.3 Objective of Shariah Audit
11.4 Example of Scope and Ducuments to be Audited for a Takaful Operator
11.5 General Shariah Copmliance
11.6 Shariah Compliance Risk Management Methodology
11.7 Implication of Non Shariah Compliant
11.8 Samples of Checklist

11.1 OVERVIEW ON AUDIT

An institution's internal audit program consists of the policies and procedures that govern its internal audit functions, including risk-based auditing programs and outsourced internal audit work, if applicable. While smaller institutions' audit programs may not require the formality of those found in larger, more complex institutions, all audit programs should include:

1. A mission statement or audit charter outlining the purpose, objectives, organization, authorities, and responsibilities of the internal auditor, audit staff, audit management, and the audit committee.

2. A risk assessment process to describe and analyze the risks inherent in a given line of business. Auditors should update the risk assessment at least annually, or more frequently if necessary, to reflect changes to internal control or work processes, and to incorporate new lines of business. The level of risk should be one of the most significant factors considered when determining the frequency of audits.

3. An audit plan detailing internal audit's budgeting and planning processes. The plan should describe audit goals, schedules, staffing needs, and reporting. The audit plan should cover at least 12 months and should be defined by combining the results of the risk assessment and the resources required to yield the timing and frequency of planned internal audits. The audit committee should formally approve the audit plan annually, or review it annually in the case of multi-year audit plans. The internal auditors should report the status of planned versus actual audits, and any changes to the annual audit plan, to the audit committee for its approval on a periodic basis.

4. An audit cycle that identifies the frequency of audits. Auditors usually determine the frequency by performing a risk assessment, as noted above, of areas to be audited. While staff and time availability may influence the audit cycle, they should not be overriding factors in reducing the frequency of audits for high-risk areas.

5. Audit work programs that set out for each audit area the required scope and resources, including the selection of audit procedures, the extent of testing, and the basis for conclusions. Well-planned, properly structured audit programs are essential to strong risk management and to the development of comprehensive internal control systems.

6. Written audit reports informing the board and management of individual department or division compliance with policies and procedures. These reports should state whether operating processes and internal controls are effective, and describe deficiencies as well as suggested corrective actions. The audit manager should consider implementing an audit rating system (for example, satisfactory, needs improvement, unsatisfactory) approved by the audit committee. The rating system facilitates conveying to the board a consistent and concise assessment of the net risk posed by the area or function audited. All written audit reports should reflect the assigned rating for the areas audited.

7. Requirements for audit work paper documentation to ensure clear support for all audit findings and work performed, including work paper retention policies.

8. Follow-up processes that require internal auditors to determine the disposition of any agreed-upon actions to correct significant deficiencies.

9. Professional development programs to be in place for the institution's audit staff to maintain the necessary technical expertise.

11.2 INTRODUCTION TO SHARIAH COMPLIANCE AUDIT

Financial products and services designed especially for the Islamic financial marketplace are distinguished from their conventional counterparts by their compliance with Shariah precepts and requirements. While these products and services may appear similar to conventional financial products and services, particularly from an economic perspective, the philosophical, contractual, and structural underpinnings of these products and services comply with the Shariah. Thus, while, for example, a Takaful contract may resemble a conventional insurance contract in many ways, the underlying structure is quite different. Simply stated, while the economics are almost the same, the mechanics are different.

Shariah compliance is what lends a financial product or service its legitimacy in the Islamic marketplace. Ultimately, Muslim consumers, investors and clients are concerned with compliance because the religion restricts consumption to that which is *halal* and *toyyib*, while prohibiting what is foul, harmful, unjust and sinful. A Shariah approval or fiqh resolution immediately relieves the ordinary consumer of the burden of having to make that determination for himself. It is from this perspective that the Shariah Adviser/s may be viewed as both a Shariah compliance auditor (for the company offering the financial service or product) and a Shariah consumer advocate (for the company's client).

It is now universally accepted without formal approval or endorsement through certification by means of Shariah resolution, approval or fatwa, no issuer or product provider will be able to market the financial service or product successfully to the Islamic financial community. Certification, therefore signifies to the Muslim client that a product complies not only with jurisdictional regulations, but that it has also been subjected to scrutiny by an authority on Islamic transactional law (*fiqh al-muamalat*), objectives of Shariah (*maqasid al-Shariah*), the ethical dimension of Shariah; and is therefore consistent with Shariah rules and standards.

11.3 OBJECTIVE OF SHARIAH AUDIT

The objectives of this Shariah compliance audit are to provide assurance that all financial institution's (FI) activities, transactions and governance are conducted in compliance with Shariah requirements and to make recommendations to improve control activities when Shariah compliance is not assured.

Through the Jointly-Established Committee of the Shariah Compliance Audit, the audit team have planned and executed our audit and assessment in a manner that allowed them to obtain all information and explanations that we deemed necessary for providing them with sufficient evidential matter and reasonable assurance that the company did not violate any Shariah requirements.

The review included examinations of the documentations and procedures adopted by FI on a sample basis, which covered all types of FI's activities, transactions and governance. To accomplish the Shariah compliance audit, the audit team performed the following steps and procedures:

Established Shariah Compliance Audit Criteria to Undertake the Audit -Specific Shariah Compliance Audit criteria were developed to assess the appropriateness of the Shariah governance framework (control mechanisms and processes) and whether the key elements of a sound Shariah governance framework are in place.

Interviewed FI's Personnel. - We conducted structured interviews with FI officials from all relevant departments to obtain information about the areas of Shariah compliance audit as per stipulated in FI's Shariah checklist. In addition, the team also randomly interviewed via telephonic conversation with FI's corporate agents and its clients to obtain feedbacks and views regarding FI's business activities.

Reviewed FI's Minutes of Meetings, Reports and Files. - At each relevant department, the audit team judgmentally reviewed certain number of documents and files. They sampled reports for the purpose of confirming that the information provided are in order.

Reviewed and Analyzed Statutory and Procedural Requirements - Reviewed and analyzed all relevant applicable laws and regulations to gain an understanding of FI policies, procedures, reporting, manuals and instructions governing FI's operations mechanisms as they related to financial and contracting practices.

Visited Departments/Units - We judgmentally selected several FI's departments/units inter alia Finance, Human Resources, Administration including their Shariah Compliance Department.

The Audit team then will come out with their finding and conclude that:

> "The administrative, operational, investment, placement and deposit of fund, the products and documentation matters in relation to FI, during the "Period" that were reviewed, mostly, in accordance with requirements of the Shariah, and appropriate steps have been taken to address any reservations and any consequences in their regard. In general FI also complies with Shariah requirements, fatwas, policies, guidelines and Shariah manual of FI although we identified some areas for improvement."

11.4 EXAMPLE OF SCOPE AND DOCUMENTS TO BE AUDITED FOR A TAKAFUL OPERATOR

❖ **Shariah Department / Committee**

1. List of Shariah Committee
2. Composition/ Reporting Structure
3. Approval Letter of Appoinment
4. Meeting Attendance
5. Shariah Compliance Manual Endorsement by SC
6. Record of Shariah Opinion
7. Budget Allocation

❖ **Family Takaful**

1. Representative Record
2. Agent Appointment Letter (Term and Conditions)
3. Placement of Agency Provident Fund
4. Investment
5. Underwriting Guidelines/ Policies
6. Commission Formula
7. Details of Loading
8. List of Activities / Functions
9. Approval Letters from Shariah Committee

❖ **General Takaful**

1. Representative Record
2. Agent Appointment Letter (Term and Conditions)
3. Placement of Agency Provident Fund
4. Investment
5. Underwriting Guidelines/ Policies
6. Commission Formula
7. Details of Loading
8. List of Activities / Functions
9. Approval Letters from Shariah Committee

❖ **Re- Insurance**

1. Details of Re-Insurance Transaction
2. Details of Inward Facultative Business From Conventional Insurance Operator
3. Details of Outward Business
4. Details of Treaty Business

❖ **Claim**

1. SOP
2. Requirement to be a Wasi

❖ **Product Development**

1. List of approved Takaful products being launched
2. List of approved Takaful products (to be launched)
3 Any Approval Letter/s / Related Documents from BNM, SC etc.

❖ **Marketing**

1. List of company's customers (during the auditing period)
2. List of marketing staffs / agents
3. Customers' details
   - Family Takaful
   - General Takaful
   - Retakaful
4. Contracts
5. Notice

❖ **Training**

1. Training Modules
2. Training To be Held
3. Training Held during the period
4. Dress Code Manual/s

❖ **Human Resource**

1. Code of Conducts
2. Number of FI staff (by rank)
3. Number of FI Agents Muslim, Non Muslim etc.
4. Section 28.0 (any case of breach / modes of handlings the case/s)
5. List of staff training programme/s

❖ **Corporate Communications**

1. Advertisement Materials etc.
2. Approval Letters from Shariah Committees
3. List of Activities / Functions
4. Approval Letters from Shariah Committee

❖ **Finance**

1. Investments, Placements
2. Zakat

5.0 GENERAL SHARIAH COMPLIANCE

Shariah compliance in Islamic banking covers:

a. Initiation of the Products and Services

Within the Shariah contracts, any products and services to the customers may be initiated. The initiation of the products and services must at all times comply with all Shariah requirements.

b. Documentation of the Products and Services.

Documents relating to the products and services should comply with the Shariah requirements and approved by Shariah Committee of the Bank.

c. Operation of the Products and Services.

In the operation of the products and services, any violation of the established principles in Islamic commercial laws *(fiqh mu'amalah)* must be avoided. These violations could render the operations null and void. Among these principles are:

i. Avoidance of transactions involving riba (interest based/usury).

Riba in its Shariah context can be defined as an unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to affect the exchange of two or more species which belong to the same genus and are governed by the same legal clause.

Deferred completion of the exchange of such species, or even species which belong to different genera but are governed by the same *'illah* (legal clause), is also *riba*, whether or not the deferment is accompanied by an increase in any one of the exchanged counter values.

Allah SWT says:
"Those who eat Riba (usury) will not stand (on the Day of Resurrection) except like the standing of a person possessed by Shaitan leading him to insanity. That is because they say: "Trading is only like Riba," whereas Allah has permitted trading and forbidden. Riba. So whosoever receives a direction from his Lord and stops eating Riba shall not be punished for the past; his case is for Allah (to judge); but whoever returns (to Riba), such are dwellers of the Fire - they will abide there in it." (Al-Baqarah :275)
Jabir RA has reported that the Messenger of Allah SAW cursed the devourer of usury, its payer, its scribe and its two witnesses. He also said that they were equal (in sin). (Muslim)

Abu Hurairah RA reported that the Holy Prophet SAW said: A time will certainly come over the people when none will remain who will not devour usury. If he does not devour it, its vapour will overtake him. (Ahmad, Abu Dawud, Nasai, Ibn Majah)

ii. Avoidance of transactions involving *gharar* (risk and uncertainty)

Literally, *gharar* means risk or hazard. *"Taghreer"* being the verbal noun of gharar is to unknowingly expose oneself or one's property to jeopardy.

Gharar is an element of deception either through ignorance of the goods, the price, or through faulty description of the goods, in which one or both parties stand to be deceived through ignorance of an essential element of exchange. As an example, gambling is a form of *Gharar* because the gambler is ignorant of the result of the gamble.

Abu Hurairah RA narrated that:
"The Prophet SAW prohibited the pebble sale and the gharar sale." (Muslim, Ahmad, Abu Dawud, and lbn Majah)

In business, *gharar* refers to uncertainty and ignorance of one party or both of the parties in a contract over the substance or attributes of the object of sale, or of doubt over its existence and availability at the time of contract. Thus, contract/transaction exists when its consequences are hidden and unknown to the contracting parties.

Gharar is divided into two, namely:

i. *Gharar fahish* (major or serious) such as cases involving the sale of an asset which does not exist; or cannot be delivered; or not according to *specifications. This gharar causes a contract to be* null and void. This type of gharar is therefore prohibited.

ii. *Gharar yasir* (minor or slight *gharar)* such as cases involving the sale of an asset which may not be available at the time of the contract but it may become available later and reference to the "market price" accepted by both parties. It is tolerated and *does not invalidate a contract.* This type of *gharar may be* allowed.

iii. Avoidance of transactions involving *maysir*(gambling).

Allah SWT says:
"O you who believe! Intoxicants (all kinds of alcoholic drinks) and gambling and al-Ansab (animals that are slaughtered for the idols), and al-Azlam (arrows for seeking luck or decision) are 'an abomination of Shaitan's handiwork. So *avoid (strictly all) that (abomination) in order that you may be successful)."* (Surah al-Maidah:90)

It is a transaction based on mere chance whereby an artificial or unnecessary risk is created and by its nature is unproductive, resulting in the gain of certain quarters on the loss of others.

iv. Avoidance of any transactions involving prohibited commodities.

For example liquor, pork and other non-halal foods and goods. Allah SWT says:

"0 you who believe! Intoxicants (all kinds of alcoholic drinks) and gambling and al-Ansab (animals that are slaughtered for the idols), and al-Azlam (arrows for seeking luck or decision) are an *abomination of Shaitan's handiwork. So avoid (strictly all)* that *(abomination) in order that you may be successful)."* (Surah al-Maidah: 90)

"Forbidden to you (for food) are: al-Maitah (the dead animals - cattle - beast not slaughtered), blood, the flesh of swine, and that on which Allah's Name has not been mentioned while slaughtering (that which has been slaughtered for idols) and that which has been killed by strangling, or by a violent blow, or by a headlong fall, or by the goring of horns - and that *which has been (partly) eaten by a wild animal - unless you are able to slaughter it (before its death) - and that which is sacrificed (slaughtered) on al-Nusub (animals that* are *slaughtered for the idols). (Forbidden) also is to use arrows seeking luck or decision; (all) that is Fisqun (disobedience of Allah and sin)."* (Surah al-Maidah: 3)

v. Avoidance of any transactions involving goods of no use to Muslims

Therefore these goods are of no value. For example idols or other materials use by non-Muslims in worshipping.

vi. Avoidance of any transactions involving cooperation (*ta`awun*) to the matter of *ithm* (sin) and *'udwan* (aggression).

Allah SWT says in the Quran:

"And help one another in goodness and piety, and do not help one another in sin and aggression; and be careful of (your duty to) Allah; surely Allah is severe in requiting (evil)." (Al-Maidah:2)

vii. Avoidance of any transactions involving *akl mal bil batil* (unjust enrichment).

Allah SWT says in the Quran:

"And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people's property." (Al-Baqarah: 188)

viii. Avoidance of contracts that do not satisfy the conditions of the particular contract.

Besides the avoidance of transactions mentioned above, the Bank shall also avoid Shariah prohibitions which are haram (prohibited) although they will not render the contracts invalid that are:

- Unfair gain or loss (*ghubn fahish*) resulting from unfair dealings. However, Islam does not put any limit to the profit gained by the seller if the business transactions are free from any unfair dealings including deceptions and deceits and any other forms of exploitation, monopoly and others.
- Contract of sale during the Friday prayers; which is limited to those who are obligated to perform Friday prayer.

- Other forms of contracts considered valid by Shariah, but are prohibited due to contradiction to moral values such as *najash* or whereby a buyer buys something from the seller not because of he wants the goods but because he was asked by the seller to do so in order to attract crowds to do the same or to increase the price of the goods.

11.6 SHARIAH COMPLIANCE RISK MANAGEMENT METHODOLOGY

The key components of the Shariah Compliance risk management methodology are:

1. Awareness and Identification

Awareness is a pivotal component in identifying and subsequently taking appropriate action to mitigate Shariah compliance risk. Ongoing training and communication about the Shariah requirement breaches and its negative impacts on the business are essential components of risk mitigating measures. As such, this policy with regards to Shariah compliance training and communication issues as highlighted below:

a. Instill, where appropriate, adequate training regarding Shariah in Islamic banking and reinforcement courses as and when required to be determined by the Bank from time to time.

b. Promote and ensure Shariah compliance risk awareness culture throughout the Bank.

2. Assessment and Evaluation

The assessment of Shariah compliance risk is based on the identification of potential breaches. This will be done by implementing the following:

a. Risk is assessed within a formal risk management standard methodology and procedures.

b. Shariah compliance checklists or undertaking statement from individual business functions and processes under their control are Shariah compliant.

c. Methodology is in place to assess the risk of changes to banking operations and activities i.e. new products/services.

d. Bank-wide audit is conducted regularly so as to ensure that the Shariah are implemented and complied by all Bank personnel.

3. Measuring and Quantifying

Measuring and quantifying Shariah compliance risk through the frequency and number of Shariah breaches and the impact of such breaches. The risk factors are generally qualitative and subjective.

4. Controlling and Improving

Managing Shariah compliance risk is continuous, and not a cone-off process. The Bank personnel must ensure that Shariah compliance risk policies, procedures and guidelines are reviewed on a regular basis.

5. Reporting, Monitoring and Follow-up

a. The reporting process is critical to ensure that the management of Shariah compliance is effective and that issues are escalated where necessary.

b. The relevant departments through the Islamic Banking Divisionn are required to report to the Shariah Committee any Shariah issues and breaches.

c. Shariah decision or ruling is made by the Bank's Shariah Committee which has to be established according to the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (BNM / GPS1).

11.7 IMPLICATION OF NON SHARIAH COMPLIANT

The Bank personnel must be aware that the compliance with Shariah is an integral feature in the Islamic banking, as it is their obligation toward the Religion of Islam.

Breaches of Shariah will lead to the following consequences:

1. Disobeying Commands of Allah SWT

Any breach of Shariah or non-Shariah compliant would be against the commands of Allah.

2. Impede From Allah's SWT Blessing or Barakah

Any breach of Shariah or non-Shariah compliant would impede the organization and/or personnel from Allah SWT's blessing or barakah. Thus, the banking activities would become useless (do not become ibadah) before Allah.

3. Contravene to the Provision of BAFIA/ IBA

Any breach of Shariah or non-Shariah compliant would contravene the provisions of BAFIA or IBA and upon conviction be liable to a fine and license may be revoked.

4. Business Reputation

Any breach of Shariah or non-Shariah compliant would jeopardize or affect the Bank's reputation in Islamic banking industry.

5. Invalidate Contract

Any breach of Shariah or non-Shariah compliant relating to contract documentations and its execution would cause the contract between Bank and customer become null and void. Any profit gained from this contract is considered non-halal.

6. Non Halal Profit

In case of non-Shariah compliant, the Shariah Committee is to decide on the proper treatment on the non-halal profit. In the event of receiving non-halal profit unintentionally, Shariah Committee should be advised and such profit shall be channeled to charitable bodies.

Therefore in order to avoid the above consequences, all personnel must ensure that the banking activities comply with the Shariah requirements at all time.

11.8 SAMPLES OF CHECKLIST

FACILITY AGREEMENT CHECKLIST

Client's :

Date received :

No	*ITEMS*	REMARKS		
	Is all the essential elements for a particular contracts used are included?	**YES**	**NO**	**N/A**
1	Facility Title ➢ Date of Agreement ➢ Parties involves ➢ Company • Image • Nature of business			
2	WHEREAS ➢ (A) … ➢ Interpretation ➢ The facility 1. Description of facility 2. Participation by financiers 3. Purpose of facility			
3	CONDITIONS ➢ Conditions for utilization ➢ Fees & Expenses ➢ Representations & Warranties			
4	Security ➢ Landed property ➢ Debentures ➢ Guarantee (joint/ severally) ➢ Security deposit ➢ Sinking fund ➢ Covenant to provide further security ➢ Continuing Security ➢ Liens and other securities not affected			
5	Cancellation events ➢ Non-payment ➢ Breach of obligations ➢ Misrepresentation ➢ Invalidity ➢ Disposal of assets ➢ Cessation of business ➢ composition/winding up ➢ Cross-default ➢ Repudiation ➢ Appointment of receiver, legal process ➢ Insolvency			

	➢ Licenses & Judgment passed ➢ Material Event ➢ Shariah compliant	
6	PAYMENTS ➢ By customer ➢ By Financiers ➢ Date ➢ Withholding tax ➢ Compensation Administration fees	
7	OTHERS ➢ Indemnity ➢ Liability ➢ The Agents ➢ Transfers by financiers ➢ Disclosure No assignment by customer	
8	FURTHER PROVISION ➢ Right cumulative, waivers ➢ Reconstruction of customer, facility agent & financiers ➢ Notices ➢ Variation of terms ➢ Currency Stamp duty	
9	SUMMARY ➢ Signatures ➢ Schedules Others	
10		

Prepared by : _____
Name:
Date:

Checked by : _____
Name:
Date:

Concurred by : _____
Name:
Date:

IJARAH AGREEMENT CHECKLIST

Client's Name : **IBFIM Bank**

Date received : **DD/MM/YY**

	ITEMS	REMARKS
1.	**ESSENTIAL ELEMENTS:**	
a)	**Lessor and Lessee**	
b)	**Contract**	
	- in present/past tense	
	- acceptance consistence with offer	
	- type of contract used	
c)	**Asset**	
	- specified and known	
	- own by the lessor	
	- free from encumbrances	
	- deliverable to the lessee	
	- can be used by lessee	
d)	**Benefit**	
	- fixed in value	
	- the benefit is permissible	
	- able to be received	
e)	**Rental**	
	- known and absolute	
2.	**WHICH TERMINOLOGY USED ?**	
a)	**Loan / Financing**	
b)	**Borrower / Customer**	
c)	**Interest / Profit**	
d)	**Insurance / Takaful**	
3.	**SPECIFIC CLAUSES :**	
a)	**Binding Laws**	
	- Islamic Law	
	- Civil Law	
b)	**Modus Operandi (appointment of the Customer as rep for the Bank)**	
c)	**Non-contravention among applicable laws**	
d)	**Takaful**	
e)	**Purpose of the leasing**	
f)	**Compensation Charges**	
g)	**Renewal Lease Rental**	

System Checklist on Shariah Compliance

Product Name : _____
Module : _____
Version : _____
Date of Review : _____
Reviewed by : _____
Duration : _____

FINANCING PRODUCTS

	Area	Y	N	REMARKS
	Contract used			
	Selling Price Calculation			
	formula used			
	rate(s) used			
	element of costs			
	monthly installment			
	(Lump sum/bullet)			
	amount of profit			
	Compensation charges			
	rate charged			
	(“R” Rate or 1% rate)			
	compounding / not			
	Matured a/c or not			
	Formula used			
	Other charges			
	type of charges			
	(Comm./admin)			
	(processing/booking)			
	basis of charging			
	compounding / not			
	Knock off sequences			
	Accounting entries			
	buy and sell of asset transaction			
	capping of selling price			
	selling price cannot be change			
	accrual concept			
	Advance payment			

	Settlements btw accounts			
	Islamic			
	Conventional			
		Y	**N**	**REMARKS**
	RENTAS/SWIFT			
	Mobilization of funds			
	Reminder Letter			
	Agreements			
	Types of required documents issued			
	Terminology			
	Essential elements			
	Necessary Conditions			
	Statement			
	Selling Price is consistent with Agreement			
	Outstanding SP			
	Terminology			
	Outstanding balance			
	History transaction			
	Reports			
	Segregations of accounts/funds			
	Terminologies			
	Screen/Display			
	Test script / scenarios			
	Products features / specs			
	Real life testing			
	Disbursement			
	Full disbursement			
	Partial disbursement			
	Temporary Overdraft			
	any charges			
	contract used			
	MICR code			
		Y	**N**	**REMARKS**
	Settlement			

		on schedule			
		early settlement			
	Partial settlement				
		when the ibra' given (if any)			
		any change in Selling Price			
	Advance installment				
		where keep it			
		revenue earned on the keeping			
	Calculation of ibra'				
		Formula used			
	Security codes				
	Overdrawn account				
		treatment			
		contract used			
		Charges (if any)			
	Zakat calculation for the bank				
		system able to do			
		accounting treatment			
		zakat schedule			
		zakat payment/provision			
	Schedules				
	Redemption				
	Tiers rate				
	Floating rate				
	Product code for Islamic accounts				
	Operating bank account				

<u>Recommendations:</u>

Prepared & Reviewed by: _____

System Checklist on Shariah Compliance

Product Name : _____
Module : _____
Version : _____
Date of Review : _____
Reviewed by : _____
Duration : _____

DEPOSIT PRODUCTS

	Area	Comply		REMARKS
		Y	N	
	Contract used			
	Essential elements			
	Necessary conditions			
	Calculation of hibah			
	Calculation of profit			
	Average daily balance			
	Weighted			
	SR/LR			
	Distribution of profit			
	Basis - as at @ ave bal.			
	Distribution of hibah			
	Basis – as at @ ave bal.			
	Premature withdrawal			
	Procedure			
	Profit calculation formula			
	Product code			
	Statement of Account			
	Notices			
	Distribution of profit			
	Reminders			
	Expiry of GIA			

			Comply		REMARKS
			Y	N	
	ATM / MEPS				
	Passbook				
	Internet banking				
	Phone Banking				
	Area				
	Terminologies				
	Funds transfer				
	Cheque clearing				
		Charges (follow BNM?)			
		Inward/Outward			
		Returned			
		Charges			
	Commission charged on product				
		the basis			
		Follow BNM guidelines			
		justification			
	Profit Sharing Ratio				
		Clearly stated			
		Printed PSR			
		Calculated PSR			
	Settlement				
		Islamic			
		Conventional			

<u>Recommendations:</u>

Prepared & Reviewed by : _____
Date : _____

GLOSSARY

Bai Al Dayn	-	debt trading
Fiqh	-	Islamic laws governing human deeds
gharar	-	uncertainty or ambiguity
Ijarah	-	leasing
Kafalah	-	guarantee
Muamalat	-	transaction
Mudharabah	-	trustee profit sharing
Maisir	-	gambling
Murabahah	-	cost-plus sale
Rahn	-	pledge (collateral)
Riba	-	interest or usury
Shariah or Syariah	-	Islamic laws governing a life of Muslims
Tawarruq	-	where a person buys an item to be paid for at a later date, then sells it to someone other than the person from whom he bought it – for cash at a lower price.
Wadiah	-	safe custody
Wakalah	-	agency

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2. **Workshop on Islamic Trading Contracts**: 9th March 2005

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5. **Fundamentals of Shariah**: 20th -22nd September 2005

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9. **Certificate in Introduction to Shariah Concept (CISC)**: 3rd – 5th August 2004

10. **Seminar on Islamic Banking for Legal Practitioners** *"Capitalising on the Vast Potential of Islamic Banking Business"*: 13th October 2004

QUESTIONS

1. What are 4 main sources of Shariah?
2. What are the 5 objectives of Islamic laws
3. What are the 8 schools of Islamic law?
4. What are 4 kinds of riba?
5. What are 5 essential elements of trading (buy and sell)
6. What are 6 essential elements of ijarah (leasing)
7. What are the essential elements of Wadiah?
8. What are the essential elements of Mudharabah?
9. What are the 2 types of Mudharabah?
10. What is the 4 P's of marketing?
11. What is the principle of AIDA in relation to marketing?
12. What are the differences between rescheduling and restructuring?
13. What are 3 types of Non-performing Account?

FINANCIAL SECTOR TALENT ENRICHMENT PROGRAMME
(*a programme managed by Institut Bank-Bank Malaysia*)
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