Islamic Finance Mini Pupillage Programme

Case Studies
June 2019
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Global Islamic finance continues to gain momentum as a driver for sustainable development, and Malaysia stands tall in the vanguard of international Islamic finance markets. According to the Thomson Reuters Islamic Finance Development Report 2018, the global Islamic finance industry recorded year-on-year growth of 11% to US$2.4 trillion in assets in 2017 or a compound annual growth rate (CAGR) of 6% from 2012, based on data reported for 56 countries, mostly in the Middle East and South and Southeast Asia. This same report ranked Malaysia first out of 131 markets assessed by its proprietary Islamic Finance Development Indicator score, ahead of Bahrain and the UAE.¹

But how can Malaysia sustain this pace in a highly competitive global Islamic finance landscape? Equally imperative, how can Malaysia share and capitalise on its expertise to uplift the global economy and strengthen the global ummah?

One pivotal strategy is to nurture talent and knowledge, in order to build the capacity and competency required to support nation building and drive international development of the Islamic finance sector. Leveraging on our accumulated expertise as the developer and regulator of the accounting profession, MIA continuously seeks to enhance the knowledge and value of accountants who are able to drive and support Islamic finance growth, especially in our core specialities of standards and governance of the public interest.

One of our core Islamic finance initiatives is the MIA Islamic Finance Mini Pupillage Programme, spearheaded by our Islamic Finance Committee and intended to upskill specialised talent in Islamic finance. This programme was held from August 2017 to September 2018 and comprised three modules: Module 1 - Training Sessions, Module 2 - Tutoring Sessions and Module 3 – Case Study Development.

This e-publication is a compendium of those case studies, which have been diligently reviewed by a panel of experts to assure their quality and relevance. We take great pleasure in presenting the 13 completed case studies on a diverse range of topics, including conceptual theory, waqf, sukuk, shariah governance, and financial reporting frameworks and standards, among others.

It is our intention that this e-book be employed as an educational tool to upskill talents and deepen local and global talent pools, and furthermore to reinforce Malaysia's position as a role model and centre of excellence in global Islamic finance. At the same time, we trust that these well-researched case studies will enrich the international corpus of IF knowledge and catalyse knowledge sharing within the global IF industry in order to strengthen and unite the ummah.

Thank you.

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Malaysian Institute of Accountants

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¹ https://repository.salaamgateway.com/images/iep/galleries/documents/20181125124744259232831.pdf
ACKNOWLEDGEMENTS

We wish to record our appreciation to the parties that have made the publication of this e-book possible namely the Panel of Reviewers.

We also wish to thank the Islamic Finance (IF) Committee members for their guidance and the IF Unit Secretariat of the Professional Practices and Technical (PPT) Division for their hard work in the compilation of this e-book.

To the authors who participated and contributed their time and effort in writing the case studies, we thank you.

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THE CONCEPTS OF RIBA, GHARAR AND MAYSIR IN ISLAMIC FINANCE

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THE CONCEPTS OF RIBA, GHARAR AND MAYSIR IN ISLAMIC FINANCE

EXECUTIVE SUMMARY

This paper discusses the concepts of riba, gharar, and maysir that are prohibited in Islamic financial transactions and their negative effects on the economy at the global scale. Initially, the original definitions of the elements are provided based on the original verses of Al-Quran and records of As-Sunnah of the Prophet Muhammad (PBUH). The research reveals that the elements of interest (riba), ambiguity (gharar), and gambling (maysir) in transactions have a negative impacted the global economy as demonstrated by the Asian financial crisis 1997 and the United States subprime mortgage crisis 2007. A number of issues related to riba, gharar, and maysir, and comparisons between the Islamic and conventional finance practices are explored in this paper which include (i) qardh hasan contract against conventional loan with interest; (ii) takaful against conventional insurance; and (iii) conventional against murabahah credit card. In conclusion, the vast increase of demand for Islamic financial solutions is attributed to its proven performance in bringing stability and social justice to the economy. Nonetheless, a lot of measures must be done to improve the Islamic finance sector’s delivery system and to increase its profits, especially within the conventional economic atmosphere. Such measures include remarkable innovations and sound governance.

1. INTRODUCTION

For the past three to four decades, the world has seen a robust growth in the Islamic financial industry through both the demand for and the provision of products and services. The Islamic finance industry in Malaysia as manifested by the Bank Negara Malaysia 2017 report outlines significant performance of the Islamic banking sector. Shariah compliant financing grew by 9.4% to RM605.5 billion during the year, compared to the moderate growth of only 1.3% in conventional loans. Additionally, Islamic deposits and investment accounts expanded by 11.7% to RM672.6 billion in the same period. Furthermore, Islamic banks recorded higher pre-tax profits that were driven mainly by an increase in net financing income derived from term financing for the purchase of properties.
Notably, Muslims make up to 25% of the world’s population where approximately 60% are living in Asia, while 20% reside in the Middle East and North Africa. The rising developments in Islamic finance have allowed Muslims to invest their savings and raise financing through ways that do not compromise their religious or ethical beliefs. On the contrary, conventional finance is seen as too depending on its interest and non-risk-sharing natures which are prohibited under the Shariah law. This study examines three main elements prohibited in the Islamic financial system, namely riba, gharar, and maysir. Moreover, it highlights the existence of those elements in the current financial environment and their effects on the economy at a global scale.

This study aids to comprehend the core factors in Islamic financial teachings derived from classical and modern studies of Islamic jurisprudence. It is envisioned to observe the vital role played by Islamic finance in bringing stability to the economy. On top of that, the study aims to determine the negative impact of riba, gharar, and maysir elements on the economy as a whole.

In this study, the prohibition of interest (riba), ambiguity (gharar), and gambling (maysir) elements are explored based on the original textual understanding from the Quran and hadith of Prophet Muhammad (PBUH). Throughout the study, the interest elements on loans, ambiguous transactions, and speculative investments or sales are assumed to contribute to financial crises. In contrast, the existing features in financial products offered by the Islamic finance sector are assumed to be much more resilient, responsible towards mankind, and stable compared to the conventional man-made financial system.

2. **FUNDAMENTALS**

The modern financial system has grown along with the trade and corporate sectors and consequently, plays a vital role in modern civilisation. As explained by Baskin and Miranti (1997), during the first four decades of the twentieth century, the interest in the growth of corporate common stock lead to the emergence of equity-share trading in many centres worldwide. Apart from that, “managerial capitalism” also turns more dominant in the economy. As a result, the activities of large-scaled hierarchical business enterprises that are controlled by professional managers have become the source of high economic efficiency in both the manufacturing and utilities sectors.
Jensen and Smith (1984) suggested throughout the early 1950s, ad hoc theories and various policy decisions emerged as a result of the birth of corporations and their development where the main concerns of the theories developed were optimal investment, financing, and dividend policies, while little consideration was given on individual incentives, or to the nature of equilibrium in financial markets.

The world has experienced a series of economic crises due to the decline in the financial sectors. In the context of the Malaysian economy, the Asian financial crisis in 1997 and the United States’ subprime crisis in 2007 were the most significant global phenomena which had negatively impacted our national economy. In 1997, within days of the Thai Baht devaluation, the Malaysian Ringgit (MYR) was heavily traded by speculators. This led to the then prime minister, Mahathir Mohamad, to impose strict capital controls and introduce the MYR3.80 peg against the United States Dollar (USD). Sufian and Habibullah (2009) found that the crisis had severely impacted the Malaysian economy, especially the performance of the banking sector. Even though both conventional and Islamic banks were affected, Abdulle and Kassim (2012) suggested that the Islamic banks were less exposed to the liquidity risks due to the financial crisis as they were holding more liquid assets than their conventional counterparts.

The United States’ subprime crisis in 2007 had caused a vigorous blow on the global economy. The collapse of the housing bubble all over the United States led to mortgage delinquencies, foreclosures, and the devaluation of housing-related securities. Housing speculation using high levels of mortgage debt drove many investors with prime-quality mortgages to default and enter foreclosure on investment properties when housing prices fell. In 2009, the International Monetary Fund (IMF) estimated the cumulative global losses of banks and other financial institutions to exceed USD4 trillion. Although both Islamic and conventional banks were equally impacted by this crisis, Islamic deposits were never affected due to its profit-sharing nature which was not influenced by external policies, interests, and banking instability risks (Karim et al., 2012; Lee, 2012).

The prohibition of riba (interest), gharar (ambiguity), and maysir (gambling) elements in financial transactions are derived from the teachings and understanding of Islamic traditional literature including the Quran, Sunnah, and early scholarly texts. These elements make up the fundamentals of Islamic finance which distinguishes it from conventional finance.
2.1 Riba

Riba, or simply known as interest, is an Arabic word which means excess. The word refers to any unjustified excess over and above the capital that occurs either in a loan transaction or an exchange of commodity. Shariah law demanded for total prohibition over the receipt and payment of interest, regardless of its amount. This is reflected in the following provisions of the Quran and hadith of Prophet Muhammad (PBUH) which clearly indicates the need of Islamic accounting that rejects any element of usury or riba.

According to the Al-Quran, in Surah Al-Baqarah, verse 275, Allah has declared riba (usury) as work of evil, a sin and nothing close to permissible trading activities. In Surah Ali Imran, verse 130, Allah repeated His prohibition of riba and prosperity for those who avoid. In Surah An-Nisa’, verse 161, Allah guarantees a grievous punishment for those who disobey and involved in riba transactions.

According to a Hadith of the Prophet Muhammad (PBUH), as reported by Ibn Mas’ud, the prophet himself cursed the consumption, charges, witness and recorded riba transactions and contracts.

2.2 Gharar

Gharar, or literally translated as ambiguity, is an Arabic word that refers to uncertainty over the existence of the subject matter of sale. The abolishment of gharar implies the importance of clear terms and conditions of contract such as the price, deliverability, quantity, quality, and existence of the goods and services as to minimise the risk of uncertainty and accordance to the teaching of Al-Quran and As-Sunnah.

In Surah Al-Baqarah, verse 282, Allah demanded the believers to record loan transactions and contracts in such clear and detailed directions, where the witness and the writer involved has to meet certain level of credibility and just. This is followed by the affirmation of the Prophet Muhammad (PBUH) through a Hadith reported by Abu Hurairah where he prohibited Hasah (throwing pebbles) along with gharar sale.

The understanding on prohibition of gharar in daily transaction activities indicates the crucial need of an accounting system and process based on Shariah law. Particularly, Islam advocates a system capable of avoiding the occurrence of contention among men.
2.3 Maysir

Maysir is an Arabic word which means gambling. Gambling elements in transaction here can be understood as an attempt to predict the future outcome of an event or simply conceding to a game of chance. The Shariah law prohibits such practices as they are often not backed by any analysis or interpretation of relevant information. This is illustrated in the following Quranic verses and hadith.

In Surah Al-Baqarah, verse 219, Allah has asserted the prohibition of gambling activities along with consumption of wine (khamr). In Surah Al-Maidah, verse 90 to 91, the prohibition of gambling is repeated again along with consumption of wine, worshipping idols and divining arrows, included all of these activities as the work of evil. Based on a Hadith collected in Sahih Bukhari, reported by Abu Hurairah, the Prophet (PBUH) is reported to encourage any gambling intention to be changed into an act of charity spending.

Investment activities is encouraged in Islam, provided that the risk environment is properly studied beforehand. Thus, to avoid any element of maysir, an investor needs a proper Islamic accounting system that provides sufficient information before making any decision on an investment.

3. DISCUSSION

Several papers written from 2011 until recently regarding riba, gharar, and maysir provided comparisons on the impact of recent economic crises between the conventional and Islamic financial systems. For instance, Shafique and Faheem (2012) pinpointed the factor for the survival of Islamic banking systems during the 2008 global financial crisis which had badly affected the conventional banking systems everywhere in the world. The Islamic banks survived because they are free of riba (interest), gharar (uncertainty), and maysir (gambling).
According to Musaeva & M. Sori (2015), in order to maintain the momentum which the Islamic finance sector has experienced an average of 15% to 20% annual growth rate in the last decade, the industry must improve several aspects such as the establishment of common regulatory, legislative, tax, and legal foundations; then to address cost efficiency and integration issues for all Islamic financial markets in general, and the Islamic banking sector in particular. Musaeva & M. Sori (2015) also note that Malaysia’s current share of Islamic banking assets is at a significant level of 16% and achieved the position of leading country in Islamic banking sector amongst its counterparts. Accordingly, one major area that needs to be emphasised is the codification and standardisation of the Shariah guidelines.

Studies promoting the prohibition of riba, gharar, and maysir are viewed negatively by several groups of people. Nevertheless, innovation may elevate the promising status of the evolving Islamic finance industry. The industry players may garner more support by introducing enhanced products and services that incorporate risk-sharing and offer benefits towards the economy. Such products and services are the opposite of the debt-based and excessively financialised conventional economy. The items below outlines some issues which involve the elements of riba, gharar, and maysir in the Islamic financial sector.

### 3.1 Qardh Hasan and conventional loan financing, with the issue of bay’ inah

Islamic teaching regarding any kinds of financing activities requires a compliance of free-interest transactions. Thus, the principle of Islam is against common conventional loan financing contracts where the borrower has to pay an unjustified profit on top of the capital borrowed from the lender.

Qardh hasan, or benevolent loan refers to a loan contract between two parties where the repayment is the same as the amount borrowed regardless of the loan period, whether it is short, medium or long-termed. In most cases, qardh hasan offered by Islamic financial institutions is considered a charitable loan with an intention for social welfare or for short-term bridging finance. Islam view loans (qardh) as an assistance to persons in need and a moral duty for the lender. In some cases, Islamic banks give qard hasan only to their holders of investment accounts, but some banks give it to all their clients. Likewise, some Islamic banks prioritise qardh hasan for the needy including students, small and medium producers, farmers and entrepreneurs who failed to get financial assistance from other sources.
On the contrary, all conventional financing loans available in the financial market, whether it is for commercial or social responsibilities purposes, has a pre-set rate of interest as profit over the amount loaned, calculated based on certain indicators including risks and operational costs. It is an open secret that the determination of the interest rates in most conventional financial systems are fully exposed to speculations, making the so-called profit over capital loaned by financial institutions unjustified. In this case, the borrower has to pay the capital borrowed plus interest based on a predetermined rate. Islam views the unjustified financial commitment over the loan as a form of injustice (zulm).

Even though Islamic teaching has ruled out any form of interest in Shariah compliant transactions, there has been a debate on an Islamic financing product, namely bay' inah. Bay‘ inah means loan or advanced payment where an arrangement is made between parties whereby the first party sells an asset to another for a deferred payment and buys the asset back from the buyer before the full payment which is of a lesser amount than the deferred price. The application of bay‘ inah in Islamic banking involves two sets of transaction that are executed consecutively, namely al-bay al-mutlaq (cash sale) and murabahah or bay bithaman ajil (deferred sale). However, to some extent, a few scholars have criticized bay‘ inah as backdoor riba.

Tita and Saim (2012) argued that the bay‘ inah transaction is associated to a number of issues, particularly about the existence of riba which is an illegal transaction violating Shariah principles. Most scholars view bay‘ inah as a legal trick (hiyal) that opens the opportunity for riba. On top of that, a majority of Shariah scholars except those from the Shafi‘i school, deem bay‘ inah to be prohibited. In the case of Malaysia, Tita and Saim (2012) concluded that the government has the authority to choose the opinion of Shafi‘i who permits the application of bay‘ inah based on the assumption that the transaction contributes a crucial benefit to the public (maslahah mursalah).

Nonetheless, recent developments in Islamic financial markets have led to the introduction of alternative financing products to substitute bay‘ inah such as bay bithaman ajil (BBA), musharakah mutanaqisah, and al-ijarah thumma al-bay (AITAB).¹

3.2 Takaful and Conventional Insurance

Under conventional insurance, policy holders pay an agreed premium to the insurance company. The cumulative amount held by the company is invested in any profitable portfolio without any consideration of Shariah compliance, including making investment related to riba. Subsequently, the interest and profit gained from the investments are retained by the company without distributing them among the policy holders. Only eligible claims will be paid out from the policy. The uncertainty, or gharar, in the contract is evident as one party has a definite benefit while the other party is uncertain about their benefit or loss. On the other hand, the element of maysir can be seen as the policy holders invest small amounts of premium without knowing whether the payments will benefit them or not.

On the contrary for Takaful, for participants who contribute their money into a formulated pool of money, the cumulative amount is invested in Shariah compliant investments that are clean from any element of riba. The profit earned is then added back into the money pool and then distributed among the participants after satisfying their eligible claims. The Takaful operator only benefits by receiving wakala (agency) fee. Thus, there is no element of riba, gharar, and maysir in the Islamic Takaful system.

4. CONCLUSION

The demand for Islamic financial products and services all over the world has vastly expanded. They are considered as an equivalent alternative to the current conventional finance system mainly due to their interest-free and non-speculative features. The development of Islamic corporate finance can improve operational aspects and risk avoidance, while eliminating elements of ambiguity in the transactions. Moreover, various studies had proven that the main elements prohibited in the Islamic finance sector, riba, gharar, and maysir, contributed to numerous financial crises around the world.
5. RECOMMENDATION

In order for Islamic finance to compete with the mainstream finance system at the global level, the industry needs to improve its transparency. A high standard of corporate governance that covers advanced accounting standards may be established specifically for Islamic financial institutions. This is necessary to foster the industry’s credibility by harmonising the standards and practices among regions and institutions. Besides, regulatory oversight for the sector needs to be sharpened as well in order to further promote Islamic finance and bridging the gap with its conventional counterpart. Furthermore, the Islamic finance industry also needs to work on innovations, especially in adopting the recent concepts of block chain and financial technology.
6. REFERENCES


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SUUKUK DEFAULTS IN THE MALAYSIAN CAPITAL MARKET

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SUKUK DEFAULTS IN THE MALAYSIAN CAPITAL MARKET

EXECUTIVE SUMMARY

Sukuk is the most popular Islamic financing instrument in the rapidly growing Malaysia capital market. Since the first sukuk issuance in 1997 until 2016, there have been a number of sukuk default cases recorded which have tarnished the credibility of sukuk as a practical and viable Islamic financing instrument. What are the causes of Islamic sukuk defaults? Are these sukuk defaults unique or similar to conventional bonds? What are the lessons that can be learned from sukuk defaults? What are the impacts of sukuk defaults to the Malaysian Capital Market? These questions are important academic and policy concerns for Islamic banking.

1. INTRODUCTION

The term Sukuk is, broadly, translated as “Islamic bonds” although the correct translation is “Islamic Investment Certificates” (Tahmoures, 2013). The Accounting, and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) defines sukuk as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or in the ownership of the assets of particular projects or special investment activity.

Generally, sukuk just like any other Islamic financial instrument needs to comply with Shariah, which prohibits the receipt, and payment of interest, and stipulates that income must be derived from an underlying real business risk rather than as a guaranteed return from a financing (Andreas, 2008). Sukuk usually refinances the assets of one or a combination of these three basic forms of Islamic finance: synthetic financing (“murabaha”), sale-leasebacks (“ijara”), or profit-sharing arrangements (“musharaka” or “mudharabah”) (Iqbal, and Mirakhor, 2006).
Over the years, due to the tax neutrality and attractive fiscal incentives given by the government, and the competitive pricing from leveraging on the increasing number of investors seeking Shariah-compliant investments, sukuk has gained popularity as compared to conventional bonds. The key factors for the strong growth of sukuk acceptance in the Malaysian capital market are mainly due to the flexibility of sukuk structures, well developed legal and regulatory frameworks and the Shariah governance framework that facilitates product innovation, as well as a facilitative tax framework with strong governmental support.

However, there is always misinterpretation that sukuk is default-free due to the reason that it is based on Shariah principles. In fact, sukuk also faces risks in the forms of default, call, and market risks just like conventional bonds (M. Faizal, 2014). There are a few similarities between sukuk and bonds; as in the similar process of regulation, supervision, and enforcement; common regulatory approach – due diligence, and representation, as well as the same disclosure, transparency, and governance.

There are two sukuk discourse classified as “asset-backed” and “asset-based” and all the sukuk defaults were confined to the “asset-based” type. Despite, Malaysia being the leader in the sukuk market globally, it has also recorded cases of sukuk defaults (Balkish, 2012). Year 2009 has been described as the “default year” for the global sukuk market as the year ended with at least 15 cases, and rising to at least 31 defaults as officially reported globally in early 2012 (Khinfer, 2011).

In this study, we are focusing on the causes of sukuk defaults in Malaysia; are these unique or similar to the conventional bonds and other questions like the implication on the Malaysian capital market, and the lessons that can be learned from these episodes of sukuk defaults.
2. FINDINGS

2.1 Sukuk Defaults

When there is a breach of any binding obligations under the original terms of the agreement between the two parties, issuer and the sukukholders, a default occurs (Hafizi, 2015). Studies show that poor credit risk management by the issuer is the main reason of sukuk defaults. Credit rating is a process of assessing the likelihood of timely payment of the principal, and profit over the duration of a particular debt (Balkish, Azwan, & Rabiatul, 2012). It is always important to have credit ratings which provide a gauge of the risk of defaults because the lower the rating, the higher the probability of a default. It means that it will tend to increase in the likelihood of defaults when there is an increase in the riskiness of the issuer's financial performance or cash flow. In other words, the performance of the sukuk issuer highly affects the final rating on the sukuk itself (Hafiza, 2015). Secondly, the global economic crisis in 2008 has put a lot of pressure on the global economy and has had a negative impact on the capital market, and following with the sukuk default due to such financial distress (Saadi & Rafiq, 2015).

Sukuk defaults could be avoided in the future with recommendations made in the studies by Haider, J., & Azhar, M. (2011). Haider & Azhar’s recommendations include Shariah special credit rating, risk management consultancy firms, education, and training institutions should be established to generate expertise in Islamic economics, finance, and sukuk.

2.2 Asset Based versus Asset Backed

In an asset-based sukuk structure, the sukukholders typically rely on the credit-worthiness of the issuer rather than the return or performance of the underlying assets. In an asset-backed sukuk, the profits and return on investment are based on the asset’s performance where sukukholder can expect assessment of the assets’ value and the underlying transaction.
Based on the sukuk defaulted cases, all are asset-based types which replicate the conventional bond’s structure, and the risk of default which requires issuers to pay sukukholders a specified amount of profits on specific dates. Most of the default cases are partly due to the economic downturn or financial crisis that triggered the issuer not earning enough to make the scheduled payments. Hence, the default happened when the issuer failed to repay the principal and profits.

However, there are nil sukuk default cases with asset-backed types. The reason being that the asset-backed assets were structured to share the profits and losses which offered sukukholders neither income nor capital guarantees. In asset-backed types, sukuk issuers pay profits to sukukholders only when the underlying assets earn profits.

2.3 Islamic Sukuk versus Conventional Bonds

In conventional bonds, the debt instrument guaranteed both the payment of principal and interest. The bondholder can actually bring lawsuit against the issuer and collect their rights, if the issuer defaults on payment. Tahmores (2013) claims that in the structure of conventional bonds, the underlying asset is money, and in sukuk it is an asset, which has great religious differences but virtually no financial differences.

Sukuk does not pay interest, but generates returns through actual transactions, such as profit sharing or leasing (Andreas, 2008). Islamic Law prohibits interest payment; sukuk issuer can raise funds from investors based on an asset, and the profit or loss from the asset is then shared among the issuer and sukukholders. If the issuer defaults, the investors can actually sell the underlying assets to recover their initial invested funds. Sukuk is claiming to be safer than a conventional bond as it theoretically transfer ownership of the underlying assets to the holders, who will earn a return on holding that asset (Othman, and Kamarudzaman, 2012).

The potential defaults of sukuk were not caused by the fact that they are Islamic financial products, but driven by the market, and credit risks (Tariq, and Dar, 2007). In other words, a sukuk can default not because of failure in the sukuk structure but actually due to the credit deterioration of the issuer. However, Zhamal (2010) in his writing suggested that by the creation of appropriate legislative basis, any possible default can be measured and solved.
2.4 Impact on the Malaysian Capital Market

Studies found that the default problem will lead to financial distress followed by the extreme default of bankruptcy at a micro level (Samsuddin, Tafri, Mohd Nawawi, and Aziz, 2011). With the continuous default event, this phenomenon will lead to an economic crisis at a macro level (Altman, Brady, and Andrea, 2005). Godlewski et al. (2013) studied the reaction of Malaysian market investors towards the announcements of conventional bonds and sukuk issues. The study shows that an investor is neutral to announcements of conventional bonds issues, but reacts negatively to announcements of sukuk issues (Fadma, 2014).

Hafizi et al. (2015), sees that there is a necessity for an analysis to be made on credit risk, and rating performance of the sukuk default. In the Malaysian capital market, there are several sukuk default cases recorded such as Nam Fatt Corporation Bhd, Tracoma Holdings Bhd, and Ingress Sukuk Bhd. Although, these default cases might not give a significant threat to the Malaysian capital market, but somehow it will have a negative impact on Malaysia’s reputation as a hub for global Islamic finance (Nurasyikin, 2013).

3. DISCUSSION / ANALYSIS

In the Malaysian capital market, there are two main reasons of sukuk default; firstly due to credit management, and secondly due to the economic financial crisis. The defaulted cases are driven by market and credit risks which means that the sukuk's rating directly reflects the credit worthiness and the stability of the sukuk. In addition, the rating changes on sukuk give significance to the possibility of sukuk default to a certain extent, i.e. sukuk with a higher rating is unlikely to default, and vice versa (Balkish, 2013).
One of the Malaysian defaulted sukuk, Nam Fatt Corporation Berhad's RM250 million sukuk shows a significant correlation between the reduction in credit rating and probability of default. This RM250 million Murabahah ICP/IMTN structured as a secured financing of an asset on a deferred payment basis with a pre-agreed payment period (Hafizi, 2015). Table 1 below shows the timeline and rating of Nam Fatt's sukuk from its first issuance until it defaulted in 2010. Nam Fatt was assigned with AID rating but subsequently downgraded to DID rate and defaulted in April 2010.

<table>
<thead>
<tr>
<th>Timeline</th>
<th>Rating</th>
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<tr>
<td>Dec 2005</td>
<td>MARC-1\textsuperscript{ID}/A+\textsuperscript{ID} Assigned</td>
</tr>
<tr>
<td>Dec 2006</td>
<td>MARC-1\textsuperscript{ID}/A+\textsuperscript{ID} Affirmed</td>
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<tr>
<td>Aug 2007</td>
<td>MARC-1\textsuperscript{ID}/A+\textsuperscript{ID} Reaffirm</td>
</tr>
<tr>
<td>Nov 2008</td>
<td>MARC-1\textsuperscript{ID}/A+\textsuperscript{ID} Affirm</td>
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<tr>
<td>Dec 2009</td>
<td>MARC-3\textsuperscript{ID}/BBB+\textsuperscript{ID} Downgraded</td>
</tr>
<tr>
<td>Mar 2010</td>
<td>MARC-4\textsuperscript{ID}/C+\textsuperscript{ID} MARCWATCH negative</td>
</tr>
<tr>
<td>Apr 2010</td>
<td>MARC-D\textsuperscript{ID} Downgraded. (Defaulted)</td>
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Table 1: Nam Fatt Corporation Rating Timeline

Tracoma's RM100 million Bai Bithaman Ajil Debt Securities ("BaIDS") is another Malaysian defaulted sukuk with an asset-based structure. The sukuk turned default due to credit events when the issuer delayed in depositing the profit payments which failed to meet its first tranche of RM50 million original scheduled maturity and then postponement of its maturity scheduled principal. This indicated that the company was facing financial distress where it could not even make the profit payment as per the schedule. Its AID rating assigned was downgraded by MARC to DID, and subsequently defaulted on July 2010.

Besides Nam Fatt and Tracoma, the sukuk issued by Ingress is another default case in the Malaysian capital market. But it was the only defaulted sukuk structure based on ijarah contract where the sukuk holders possessed undivided proportionate beneficial ownership of the assets, and the rights, titles, interests, and benefits under all the transaction documents (Hafizi, 2015). On December 2007, the Ingress sukuk was downgraded from AID rating to A-IS rating after a few times of reaffirmation due to the deteriorating liquidity and declining profitability. Subsequently, it was downgraded to DIS rate after a few downgrades due to the failure of its first tranche of sukuk payment on July 2019 (Hafizi, 2015). On July 2010, MARC withdrew its DIS ratings immediately after the full redemption of the sukuk and cancellation of the program.
Based on these sukuk default cases it is concluded that there is poor credit management of the issuer, which could be due to the lack of proper knowledge and skill with regards to issuing a sukuk. Most of the sukuk default cases show that credit risk should not be a worry at the initial rating stage but after the sukuk has been rated (Nurasyikin, 2013). It is crucial to maintain the initial rating so that it will not be downgraded at the next rating assessment (Nurasyikin, 2013). Hence, the credit management of the issuer plays an important role in monitoring the financial performance, its credit rating and the sukuk rating.

However, there is always less transparency of sukuk data post-issuance on the credit risk and pricing. Most of the time, large institutional investors tend to have access to the data as compared to the smaller investors. There are some information that must be disclosed for investors’ better decision making, like risk scoring, default criteria, statistics on late payment or default rate as well as the contingency arrangement.

For market transparency and to spur further growth in the market, it is important to have a central information repository which can be readily accessible by investors. Most of the firms are highly dependent on the advanced analytics to facilitate quantitative research, investment decision-making, performance attribution, and tracking purposes. These are mostly with advancements in analytics capabilities, such as big data, machine learning, and improved scalability.

The sub-prime mortgage that happened in the US which shook the world’s economic financial system is another reason a sukuk turned default (Nurasyikin, 2013). The economic financial downturn reflected the increased price of goods and affected the interest rate in the market. Hence, any financial activities that involved the use of interest rate will definitely be impacted. The economic downturn has triggered the issuer not earning enough to make the promised payments in the crisis.

Although there are 26 defaulted sukuk cases reported in the Malaysian capital market since the first issue in 1997, it is insignificant in comparison with the amount of sukuk issued in the Malaysian capital market. Malaysia’s share of the annual sovereign sukuk remains the largest Islamic issuer with an estimated 43% of total sovereign sukuk outstanding in 2016 (The Edge Market, 2017). The Edge Market reported that the Malaysian capital market will remain as the top sukuk issuer with continuous innovative Islamic capital market development. For example, in July 2017, the world’s first green sukuk was issued in Malaysia by Edra Power Holdings Sdn Bhd’s Tadau Energy Sdn Bhd for funding a large solar project in Kudat, Sabah (The Edge Market, 2017).
4. CONCLUSION

Over the years, none of the Islamic financial instruments has gained popularity as much as sukuk as there are additional advantages possessed by sukuk. In fact, sukuk generally just like any other financial instrument, will also face risks in the forms of default, call, and market risks (M. Faizal, 2014). The main reason for sukuk defaults are poor credit management and economic financial crises. These risks can be well managed if there is skill and expertise in credit risk management. What is the impact on Malaysia's capital market? Although sukuk may not pose any significant impact on Malaysia’s capital market, it will somehow have an impact on Malaysia's reputation as the international Islamic finance hub. Malaysian sukuk defaults tend to receive less criticism due to the robust supervisory structure, established governance, disclosure standards, a highly developed legal framework, and the court system which provides the necessary protection, and comfort to investors (Hafizi, 2015). Without the regulator’s support on the issuance of sukuks, it is going to be a challenge to evolve as an alternative instrument to bond in Malaysia's capital market.

5. RECOMMENDATIONS

5.1 Strong Regulatory Framework

In Malaysia, Bank Negara Malaysia (“BNM”), the Securities Commission (“SC”) and the Shariah Advisory Council are playing an important role in promoting Islamic Finance, and developing Malaysia’s market as the Islamic hub. Apart, from being well-regulated by various standards, and guidelines, Malaysia is also the only country that makes it compulsory for all sukuks to be rated. This is to enhance investors' confidence and also to help in the investment decision-making process. Another distinguishing factor for the Malaysian sukuk market is the establishment of a centralised, national level Shariah supervisory board, which ensures that every sukuk issued in Malaysia, is in full compliance with the Shariah (Hafizi, 2015). Hence, a strong regulatory framework that plays the roles as effective gatekeeping, supervision, education, awareness and enforcement drives the further growth of sukuk in Malaysia’s capital market.
5.2 Knowledgeable Investor

However, skill, knowledge, and experience are very important, and this is where we are still lacking even though we are the centre, and source of information on the subject of sukuk (Nurasyikin, 2013). It is also important to educate the investor, either by the regulators or institutions by providing informative handbooks or guidelines to equip the investor with the basic knowledge required to invest in Islamic financial instruments.

5.3 Quality Information and Disclosures

A comprehensive and detailed disclosure of information, as well as effective communication channels is another important point that can spur the growth of the Malaysian capital market. As to enhance investors’ confidence, and to assist in the investment decision-making process, it is crucial to make it compulsory for sukuk to have annual or quarterly rating reviews, and comprehensive disclosure (Hafizi, 2015). Prospectuses and disclosure documents which are prepared using clear and concise language will encourage investors to use these documents for investment decisions.

5.4 Digital Platform

As market and investor sophistication evolve, it is vital to have a central information repository of the financial performance status, and credit rating of the sukuk issuers that is readily accessible by market participants, and serve as one single digital platform. The digital platform will provide transparency of the market and spur the growth of Islamic capital market which will then further amplify Malaysia’s position as the leader in Islamic finance hub globally.

5.5 Risk Management Model

It is important to have the identification of default risks in sukuk for better monitoring and risk management purposes. As markets are faced with the challenges of economic financial crisis, it is crucial to have a smart risk management in the Islamic capital market. This model has to be able to detect the issuer’s financial performance and cash flow as well as to predict the future market risk, credit risk and default risk which will also help regulators to ensure the market stability and efficiency. It has to be able to validate the important role of interest coverage, and leverage in determining default risk (Moody’s Investor Service, 2004).
6. REFERENCES


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THE SUCCESS FACTOR OF ISLAMIC FINANCE IN MALAYSIA

BENYAMIN JAMIL
NUR ATIQAH HALEME
EY Malaysia
SUCCESS FACTOR OF ISLAMIC FINANCE IN MALAYSIA

Malaysia is one of the leading Islamic Finance in the Global Islamic Finance Industry with an asset base of approximately 139 billion USD after Iran and Saudi Arabia. (Islamic Financial Services Industry (IFSI) Stability Report 2017 (April 2017) by Islamic Financial Services Board)

EXECUTIVE SUMMARY

The total Islamic finance asset base in Malaysia is currently recorded at RM180.3 billion, which is the biggest in Asia Pacific and third in the world (Islamic Financial Services Industry (IFSI) Stability Report 2017). The question is how did Malaysia make it as the leading Islamic finance in Asia Pacific? What is the causal factor to the growth of the Malaysian Islamic Finance industry i.e. was the growth in the Malaysian Islamic Finance market driven by governmental support or due to the fundamental market demand in Malaysia being a Muslim country? Besides, is the growth experienced by Malaysia in the Islamic Finance market sustainable moving forward? In this case study we explore the historical background of the Malaysian Islamic finance history followed with a brief financial analysis of one of the Islamic Banks in Malaysia, Maybank Islamic Berhad (MIB). We will describe the success factors of Islamic finance in Malaysia followed by the potential challenges that Malaysia may face to sustain its growth in the global market.

1. INTRODUCTION

The initial development of Islamic finance in Malaysia was instilled from the demand of the Muslim community to save money in order to perform Haj. Therefore, Tabung Haji (TH) was established to cater to the needs of the Malaysian Muslims to save funds in order to perform Haj. The success of the TH establishment had encouraged the Malaysian government to perform a market study engaging the National Steering Committee in 1981 to perform a study on the worthiness of Islamic Finance in Malaysia which resulted in the establishment of the first Islamic bank in Malaysia, Bank Islam Malaysia Berhad in July 1983 (Jaffar, 2017).
Later in 1993, Bank Negara Malaysia, who governs the operational banking in Malaysia, allowed commercial banks to offer Islamic products in the market using its current infrastructure, staff and branches under the window program called “Skim Perbankan Tanpa Faedah” (interest-free banking system) in an effort to increase the access and viability of Islamic Finance (IF) in Malaysia. This resulted in a promising participation from the local banks allowing access to Islamic finance products by the Malaysian depositors, which predominantly were Muslims (Al Naseer and Muhammed, 2013).

In 2004, the government announced its ten-year vision for the liberalisation of its financial markets to enhance the Malaysian IF infrastructure. This included several strategic steps such as allowing the entry of foreign banks into the financial industry, adding new local players, a tax neutrality policy and the passing of the Central Bank of Malaysia Act in 2009 by the Malaysian parliament to allow the growth trajectory and internalisation of Islamic finance i.e. solidifying domestic and international positioning of Islamic finance in the global Islamic finance market.

Post 2010, the Malaysian government aimed to achieve the diversification of IF products in the market and enhance the financial linkage with other jurisdictions internationally. Hence, the introduction of the financial sector blueprint (2011-2020) by Bank Negara Malaysia (“BNM”) in allowing local banks to operate internationally for example Maybank Islamic Berhad being one of the leading Islamic banks in Malaysia has embraced the opportunities to expand its market share into Singapore and Indonesia (Darren Stubing, 2017).

2. FINDINGS

2.1 Financial Ratio Analysis

We will be benchmarking the financial ratio of Maybank Islamic Berhad (MIB) coupled with comparisons of the Islamic banking industry and conventional Islamic banking industry in order to understand the trajectory of Islamic banks in Malaysia.
**Liquidity risk ratio**

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</thead>
<tbody>
<tr>
<td>Net Advances/Total assets</td>
<td>NA/TA</td>
<td>0.800</td>
<td>0.817</td>
<td>0.833</td>
<td>0.790</td>
<td>0.689</td>
<td>0.671</td>
<td>0.695</td>
<td>0.757</td>
<td>0.744</td>
<td>0.776</td>
</tr>
<tr>
<td>Liquid assets*/ Deposits &amp; short term loans</td>
<td>LA/DSTL</td>
<td>0.112</td>
<td>0.136</td>
<td>0.087</td>
<td>0.132</td>
<td>0.160</td>
<td>0.183</td>
<td>0.195</td>
<td>0.170</td>
<td>0.159</td>
<td>0.137</td>
</tr>
<tr>
<td>Net Advances/Total deposits + borrowings</td>
<td>NA/TDB</td>
<td>0.848</td>
<td>1.065</td>
<td>0.884</td>
<td>0.837</td>
<td>0.779</td>
<td>0.720</td>
<td>0.755</td>
<td>0.845</td>
<td>0.831</td>
<td>0.860</td>
</tr>
</tbody>
</table>

*Cash & short term funds and statutory deposit with BNM.

Local regulator’s, Bank Negara Malaysia (“BNM”) capital adequacy ratio:

|------------------------|-----|-------|-------|-------|-------|-------|-------|-------|-------|-------|------|

* After deducting proposed dividend

Liquidity risk defines the risk of an adverse impact to the bank’s financial condition or overall safety and soundness that could arise from its inability or unexpected higher cost to meet its obligation.

Overall, NA/TA of MIB indicates an increasing trend from 0.777 in 2008 to 0.800 in 2017. The reason is due to the increase in financing and advances disbursement to customers by MIB. This could be due to the growth of customer demand in the market. However, MIB LA/DSTL indicates a stable trend ranging from 0.137 to 0.112 during the ten year period from 2008 to 2017. This indicates the intention by the Bank to maintain a certain level of liquid assets at par to meet short term obligations by the Bank i.e. to ensure its ability to meet an unexpected mass withdrawal made by customers (Nathie, 2010) and also as part of the compliance to the local regulation by BNM Section 26 (2 and 3) on the Central Bank Act 2006. MIB’s NA/TDB indicates a stable range of 0.860 to 0.848 from 2008 to 2017 where the Bank maintains the level of total deposit from customers and borrowings to meet the increasing financing and advances disbursement.

Given the increasing financing and advances disbursement i.e. market demand for IF products and also the increase in total deposits and borrowings by the Bank to meet the demand, the Bank has also increased its TCR with BNM from 9.67% to 20.78% from 2008 to 2017. This is above the minimum requirement set by BNM which is currently at 8% indicating a prudent approach taken by the Bank to ensure that they are able to meet any unexpected obligation (BNM Capital Adequacy Framework, 2018).
Credit risk is the risk of loss principal or income arising from the failure of an obligor or counterparty to perform their contractual obligation in accordance with agreed terms.

MIB’s E/TA and E/NA ratios have been decreasing from 0.063 to 0.046 and 0.081 to 0.057 respectively from 2008 to 2017. This may indicate an increase in risk on the inability of the Bank’s equity to absorb the losses from asset or losses from customer financing and advances. However, the Bank has been managing its credit risk effectively as indicated from the low IMP/GA ratios improving from 0.051 to 0.01 from 2008 to 2017. Hence, there is no concern of the equity’s inability to absorb the losses from asset nor financing and advances.

Performance ratio measures the rate of return on capital employed, and analyses this into profit margin and use of assets i.e. assessing the management’s effectiveness in utilising the resources under the Bank’s control.
MIB has indicated an improvement in its PBT/TA and PBT/NSE increasing from 0.006 to 0.011 and 0.007 and 0.012 respectively from the year 2008 to 2017. This has demonstrated a promising business growth of the Bank in the IF banking market despite the decrease in gross profit margin from 61.02% to 44.64%. This may be due to increase in competition with other local and foreign Islamic banks in the market i.e. market saturation due to the promising market prospect of IF in Malaysia and globally.

2.2 Overall comparison of the Islamic and Conventional Banking Industry in Malaysia
There is, however, relatively little empirical analysis on the role of Islamic banks in financial stability. A number of papers discuss risk in IF institutions but do so in theoretical terms instead of through analysis of data (Cihak et al., 2008). Hence, in this case study we can only comment on the financial strength and growth prospect of the Malaysian Islamic banks. We then elaborated on the Malaysian Islamic banks’ key success factors that have contributed to its accreditation as one of the leading Islamic Finance in the Global Islamic Finance Industry (Stubing, 2017).

3. SUCCESS FACTORS OF ISLAMIC FINANCE IN MALAYSIA

3.1 Product Inclusiveness

One of the main success factors of Islamic finance in Malaysia was the Islamic product’s inclusiveness attribute, catering to the demand of the market as a whole i.e. the products were developed for the entire market regardless of the consumers’ religious belief (Allawala, 2018). Islamic banks are continuously undertaking product development and innovation to develop new Islamic products to attract their customers for example, MIB has recently launched a home financing program (namely Houzkey) which is based on a lease agreement using the Islamic concept of Ijarah (lease) that includes an option to purchase (via cash or mortgage) after servicing 12 months rental with a minimum tenure of 5 years, and a maximum of 30 years. The lease agreement entered is based on Shariah of Ijarah Muntahiyah Bi Tamlik, which is a lease contract that ends with ownership. It allows the applicant as the lessee to acquire the property from MIB (since the legal title is under MIB) by exercising his option to purchase at a pre-agreed purchase price or the ownership of the property to be transferred to the applicant at the end of the tenure by the Bank after fulfilling terms and conditions (Maybank Islamic Berhad: What is Houzkey).

The approach adopted has been appealing to both Muslim and non-Muslim customers in the local market, who are currently renting a house and wanting to purchase a property, yet does not have a huge capital (cash) for the initial property down-payment (which is usually at 10% of the property purchase price).
3.2 Sound Regulatory and Governance

Based on the annual Global Islamic Finance Report (GIFR) (2017), the global Islamic financial services industry is reported to stand at US$2.2 trillion at the end of December 2016 in comparison to US$2.1 trillion reported at the end of 2015. This illustrates an additional stock of US$150.01 billion over the last reporting year with approximately 7% growth in 2017.

With 75% of total global Islamic financial assets held by Islamic banks and conventional banks via their Islamic window operations, banks continue to dominate the industry which is mainly driven from assets under management (AUM) and financial institutions (IBFI). Pure (full-fledged) Islamic banking model continues to be a preferred option relative to a dual banking model built on hybridization of Islamic and conventional banking and about 60% of the Islamic banking assets are held by full-fledged Islamic banks (Dubai Islamic Bank, 2017). All the top four countries namely Malaysia, Bahrain, the UAE and Oman remain as the top four countries in the Islamic Finance Development Indicator (“IFDI”) 2017 over the last 3 years since 2015, while Malaysia had ranked first in IFDI 2017 (ICD-Thomson Reuters, 2017).

The regulatory initiative from the government drawing the roadmap of the IF development is empirical to the Islamic finance industry in the Malaysian market (Allawala, 2018). Individual financial institutions cannot survive in the absence of active support from the financial system and enabling environment from the legal system and other institutions. This is evident by the collapse of an Islamic bank in Turkey, IHA Finans, due to a lack of active support and indifferent treatment towards Special Finance Houses by their governing institutions following the introduction of the new banking laws (Salman, 2007).

Being the pioneer in Islamic finance, development of the Islamic banking industry in Malaysia started in 1983 to 1993 for Phase 1 and Phase 2 started in 1994 (Shafii and Abdul Ganiyi, 2015). To date, 5 out of 16 Islamic banks in Malaysia are foreign banks (BNM, 2018) subsequent to Malaysia’s liberalisation policy which allowed foreign entities to set up Islamic banks in the local market (Shafii and Abdul Ganiyi, 2015).
Malaysia adopts a dual banking system where both Islamic and conventional banking operate side by side and are regulated under BNM. BNM holds the highest authority to control, monitor and regulate all banking operations in Malaysia including both conventional and Islamic banking. Operation of Islamic banking business was primarily governed by the Islamic Banking Act 1983 (IBA), now replaced by the Islamic Financial Services Act 2013 (IFSA 2013), the Banking and Financial Institutions Act 1989 (BAFIA) which has been replaced by Financial Services Act 2013 (FSA 2013) (Shafi'i and Abdul Ganiyi, 2015).

The IFSA 2013 introduced a more risk-focused and integrated approach to the regulation and supervision of financial institutions aiming to safeguard financial stability by highlighting stricter Sharīah compliance by the Islamic finance institutions with the inclusion of a specific part on Sharīah requirements and other specific provisions on Sharīah compliance. Additionally, IFSA also introduced the power of the BNM via the Sharīah Advisory Council (SAC) with the objective to specify standards on Sharīah matters and requirements. It also emphasises the need of Islamic financial institution to comply with the Sharīah standards issued by BNM. FSA 2013 which had replaced BAFIA 1989, governs all financial institutions namely conventional banks that have Islamic banking business operations. This FSA enables the banks to monitor the financial holding companies from engaging in activities that may pose a threat or risk to the soundness of the financial institution. (Shafi'i and Abdul Ganiyi, 2015) Subsequent to the policy, many conventional banks set up their Islamic windows and at the same time appointed selected Muslim scholars to be members of the Sharīah Board.

Following the recommendations made by the Steering Committee of Islamic Banks in 1982 that highlighted the need for Islamic banks to operate under Sharīah principles and the need for a Religious Supervisory Council to ensure proper Sharīah compliance within the banks’ operations, IBA 1983 was established. The IBA 1983 stated that it was compulsory for Islamic banks to have their own religious supervisory council with a minimum of three Muslim religious scholars. The Council is responsible to provide advice on the operations and transactions of the Islamic banks. Subsequently, many conventional banks had appointed selected Muslim scholars as their Sharīah Board and started setting up their Islamic windows (Shafi'i and Abdul Ganiyi, 2015). Later in 1997, the establishment of the Sharīah Advisory Board by BNM helped to harmonise the views among

38
Islamic financial institutions to established transparency and standardisation of the local players to gain consumers' confidence (Allawala, 2018). The SAC of BNM is considered as the highest Shari'ah authority pertaining to ascertainment of Islamic law for purposes of Islamic banking, finance and Takaful in Malaysia (Shafi'i and Abdul Ganiyi, 2015). This helped to mitigate the differences in the Shari'ah principles interpretation in the industry and facilitate the common understanding between the Shari'ah advisory bodies.

In addition to a comprehensive and sound legislation governing the Islamic finance industry, another milestone had been achieved by Malaysia in 2002 through the launching of the Financial Sector Master Plan by BNM (Mohamad and Md Nor, 2016). The 10 Year Master Plan is a collaboration between the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB), which aims for the development and evolvement of the global Islamic financial industry. While The Master Plan outlines the strategic direction for Malaysia and other countries in developing the Islamic financial services industry, it can also be used as a key reference document to guide countries in charting and the orderly development of the Islamic Finance system (BNM, 2001).

3.3 Market Demand

Another success factor that led to the sustainable growth of Islamic finance in Malaysia, is the sizeable demand for Islamic products by customers, who favor a more ethical and fair adoption of banking practices (Amir, 2017). To date, there are 16 Islamic banks in Malaysia; 11 of them are local-owned and the remaining 5 are foreign-owned Islamic banks (Ching and Chee, 2014).

As a result, from its holistic and integrated approach especially the strength of its dual banking system, the Malaysian Islamic finance system enjoys a competitive advantage as compared to other Islamic financial centers. This dual banking system allows and enables the Islamic banking sector to cross-promote Islamic banking products to the existing conventional banks’ captive customers especially for the non-Muslim banking customers who have limited knowledge of Islamic banking products. Further to this, the present Islamic banking products offered by most Islamic banks in Malaysia have been designed and innovated for the consumer markets with similar functions or features like the conventional banking products but are differentiated by its structure to ensure compliance with the Shari'ah law. The range of products offered by the Islamic banks include Mudharabah (profit-sharing), Musyarakah (joint venture), Murabahah (cost plus), Al-Ijarah (leasing) and Al-Kafalah (bank guarantee) (Ching and Chee, 2014). As the concept of
products offered are similar to the conventional banks, it promotes better customers’ understanding following their familiarisation with conventional products.

Despite Malaysia being a multiracial country with a predominant population of Malays, Chinese and Indians, Islam is the official religion of the country. To date, the customer-base of Islamic banking consists of both Muslim and non-Muslim customers, thus indicating a positive perception towards Islamic banking. While demand by Muslim customers is mainly due to greater awareness of Sharīah requirements in banking, comfort and preference of being involved in Shariah-compliant businesses, non-Muslim customers’ demand is mainly driven by the benefits of the products for example attractive features of Islamic products, reasonable treatment for penalties on financing, fair terms and conditions thus helping to maximise their financial benefits and no inclination to religion but purely on the product features and benefits (Ching and Chee, 2014).

From the above graph, total assets have gradually increased over the years with a 12% growth recorded in the financial year ended (FYE) 2017 from RM 573 billion in FYE2016 to RM643 billion in FYE2017. Being the largest Islamic bank in Malaysia, we observed that MIB’s performance moved in tandem with the industry. MIB’s total assets for example had increased by 12% from RM181 billion in FYE 2016 to RM203 billion in FYE 2017. Further to this, from its audited financial statements, deposit from customers had also shown a significant increase of 21% from RM107 billion in FYE 2016 to RM129 billion in FYE2017 (Maybank Islamic Berhad, 2017). This result demonstrates a growing and positive demand in the Islamic finance market.

Despite three decades of its establishment, the Malaysian Islamic banking market share is still relatively low in comparison to conventional banking which is still far from the 40% target set by BNM for Islamic banking assets by 2020. Malaysia’s current population is 31.6 million as at end of 2017 (World Bank, 2018) and forecasted to reach 33.86 Million in year 2020. Out of the total forecasted population, it is estimated that a quarter of the population will fall within the middle-income group and 60% of them will earn a higher real annual income of RM36,000 in 2020 (BNM, 2011). This will help to boost overall consumption and investment in tandem with rising income and middle class population. A banking support system is required to cater to the economic activities whereby Islamic banking can leverage and capitalize on moving forward (Ching and Chee, 2014).
4. POTENTIAL CHALLENGES IN THE FUTURE OF ISLAMIC FINANCE FOR MALAYSIA

Global Islamic finance comprises existing markets namely Malaysia, the United Arab Emirates (UAE), Bahrain, Qatar, Indonesia, Pakistan, Brunei and Sudan while the potential new markets include the United Kingdom, Hong Kong, Singapore, Thailand, Japan and the United States of America (USA). Currently, most of the Islamic financial institutions are mainly concentrated in the Middle East and Southeast Asia. However, these Islamic financial institutions have started to gain popularity in Europe and the United States (Mohd Zaid, Saurdi, Abdul Razak & Mohamad Syahiran, 2011). From the IFID 2017 report, Global Islamic financial assets stood at US$2.2 trillion at the end of December 2016 and estimated to grow to US$3.8 trillion by 2022 (ICD-Thomson Reuters, 2017).

Other key challenges besides product innovation and maintaining unique features of the Islamic financial system, are efforts to penetrate the global market (Mohd Zaid, Saurdi, Abdul Razak & Mohamad Syahiran, 2011). Some factors to ensure sustainability of the internationalisation of Islamic finance include; (1) a wide range of globally accessible and high quality Islamic financial products and services; (2) diversification and dynamics of the intermediaries and market participants, including Islamic banking, Takaful and capital market players to venture beyond domestic boundaries and penetrate global opportunities; and (3) effective legislation and regulation within global financial markets (The Malaysian Reserve, 2017).

However, this section focuses on the legislation and regulation challenges with regards to the internationalisation of Islamic finance. One of the issues is the difference in interpretations of Sharīah among countries involved which put a restrain to collaborations between countries because unlike Malaysia, many countries still do not have provisions on the Sharīah advisory services. Each country has its own set of rules and regulation to cater to its local environment, where some of these laws and regulations need to be amended prior to the implementation of the Islamic finance system. Hence, a collective effort between all the countries involved to form a global shariah advisory together to minimise the gaps in the Sharīah concepts and hopefully to pave the way for the globalisation of Islamic finance in the future (Mohd Zaid, Saurdi, Abdul Razak & Mohamad Syahiran, 2011).
Despite its main role to be the oversight body, regulators do not always have the capacity or willingness to ensure proper Shariah compliance by the industry players thus undermining the consistent approach of Shariah law within and across borders. Thus, it is deemed important to harmonise the existing standards especially for Shariah governance through the establishment of central boards at the national level (Alfred, Mohamed, Marco, Ananthakrishnan, Christopher, Zeine & IMF, 2015) similar to the Malaysian current practice i.e. SAC of BNM has the highest authority in relation to any Islamic finance matter. Another way to ensure effectiveness of regulatory function is by imposing stricter criteria for membership in the Board of Directors of Islamic banks. Selection of the board members should be only those who have a sense of responsibility towards improving corporate governance and who are keen to promote Islamic finance. They should also have knowledge of the financial and economic facts and working experience in the financial sector plus are well versed with the country’s specific and international regulatory rules and laws which the banks operates in including Islamic finance (Alfred, Mohamed, Marco, Ananthakrishnan, Christopher, Zeine & IMF, 2015).

Through the harmonisation of the Shariah laws and standardisation of Shariah governance locally and globally, this may ease the cross-border collaboration and have a positive outlook on the internationalisation of Islamic finance as well as boosting the confidence of the participating countries including Malaysia. This can also create more opportunities for the Malaysian local market to expand its market internationally.

Besides legislation and regulation challenges, Al Nasser and Muhammed, (2013) highlighted five other challenges of the Islamic banking industry in the future especially to compete with the established conventional banks. They are:

i. Product development and innovation to compete with the competitive products offered by conventional banks;

ii. The operational excellence of Islamic banking to compete with conventional banks which may offer a low pricing to customers;

iii. Liquidity management of the Islamic banks given the rapid demand growth of Islamic banking products especially in the majority of Muslim countries;

iv. Managing the talent pool in ensuring compliance to the Shariah law once a bank is in operation and

v. Addressing the local and global legislation on whether it should allow a favorable environment for Islamic banks to operate including the local tax laws of the respective countries.
All of the factors mentioned above would definitely need to be considered in terms of the respective countries in which Malaysian Islamic banks may plan to grow its Islamic finance business. Hence, this requires a comprehensive study and market research of the country’s political, legal, customer base and also internal factors of the bank i.e. requirements in terms of risk and reward monitoring, talent and capital requirement to be able to expand into other global markets.

5. CONCLUSION

The evidence presented in this paper shows that Islamic finance in Malaysia has generally experienced growing demand from the market which is reflected in the growth of the financing and advances balances. Overall, the success of Islamic finance in Malaysia is contributed by the regulatory initiative from the government drawing the roadmap of the development of Islamic finance in the Malaysian market coupled with product innovation that has the inclusiveness attribute catering to the demand of the market as a whole. Besides the strength of the local market, Malaysia is offering a dual banking system which enjoys a competitive advantage as compared to other regions in the world and caters to a wide customer-base i.e. Muslim and non-Muslim customers. Moving forward, Malaysia’s Islamic finance including local Islamic banks may face challenges growing into other regions outside Malaysia, Indonesia and Singapore which may pose a gap in terms of foreign legislation and regulation, as well as product development to cater to foreign demand, operational excellence to offer competitive pricing, liquidity management, and local talent to operate in the foreign region. This would require a thorough study to understand the viability of the bank to expand given all the potential challenges coming from the variable demands of Islamic finance in other global markets.
6. REFERENCES


SHARIAH COMMITTEES AND ITS RELEVANCE IN THE ISLAMIC FINANCIAL SYSTEM

HALIMATON MOHAMAD
Bank Negara Malaysia
1. GLOBAL ISLAMIC FINANCE FOOTPRINT AND DOMESTIC DEVELOPMENT

The Islamic financial system is a financial system that complies with Islamic law, and has grown tremendously since it first emerged in the 1970s. The Islamic Finance Development Report 2017 reported that the total Islamic finance assets in 2016 were USD2.2 trillion, a 7% growth in the total Islamic finance assets from last year\(^1\). To date, there are over 1,407 Islamic financial institutions (IFIs) worldwide across 131 countries, demonstrating the three-fold growth of IFIs and double-digit growth of participating countries from eight years ago\(^2\).

The Islamic finance industry of Malaysia, in particular, has been in existence for over 30 years and experienced an industry evolution which has led to its significant growth. Currently, Malaysia has hosted more than 69 Islamic finance players offering a wide range of Islamic finance products in banking, takaful and fund management\(^3\), all of which have contributed to 18% (USD 406 million) of the total global Islamic finance assets\(^4\).

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\(^1\) (ICD- Thomson Reuters, 2017)  
\(^2\) (Bank Negara Malaysia, 2000)  
\(^3\) (Faizal Jaafar, 2017). There are 16 Islamic banks, 12 Islamic windows, six development financial institutions, 20 Islamic fund management, 11 takaful operators and four retakaful operators. These numbers did not include the Islamic capital market players.  
\(^4\) (ICD- Thomson Reuters, 2017)
2. ALLIANCE OF SHARIAH SCHOLARS WITH THE FINANCIAL INDUSTRY

During the early establishment of Islamic banks in the world, there was no established alliance between Shariah scholars and finance or banking practitioners despite the introduction of Islamic banking products to the masses during that time. Faisal Islamic Bank introduced the practice of seeking the Shariah scholars' opinion and appointed them as advisors for an Islamic bank in 1976, the first Islamic commercial bank. In Malaysia, when the National Steering Committee drafted the Islamic Banking Bill to establish the first Islamic commercial bank in Malaysia, a provision on the need to establish a Shariah advisory body was included, and therefore five Shariah scholars were appointed as the Shariah Supervisory Council (SSC) for Bank Islam Malaysia Berhad (BIMB) in 1984. A year later, Syarikat Takaful Malaysia Berhad (STMB) imitated the Shariah governance structure by appointing four Shariah scholars to supervise them on Shariah matters, where three out of four SSC members were SSC members of BIMB. At the international level, the birth of Islamic banks was also mushrooming, and this drove the OIC Fiqh Academy to have comprehensive discussions on the status of innovations related to Islamic banking and finance since its inception in 1983. A large number of resolutions (51 out of 97 resolutions) published by the OIC Fiqh Academy relating to financial and economic fiqh have evidenced the latest evolution in fiqh at that time. Regarding the number of Shariah Committees to date, IFDR 2017 reported that 166 Shariah scholars are serving the IFIs in Malaysia out of 1075 Shariah scholars worldwide.

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5 According to Monzer Kahf, since the first few experiments i.e. Tabung Haji, Meet Ghamr and the effort to really introduce Islamic finance by Social Naser Bank, Dubai Islamic Bank and Islamic Development Bank ‘built on the principle of riba free’, people might overlook the complexity of financial products versus prohibition of riba and therefore, do not see the need to establish the Shariah boards to give advice on the Shariah compliance status of their contracts, procedures etc. with Shariah. As for Dubai Islamic Bank (DIB), the owner who is pious and exposed to the full range of business activities relied on his understanding of Shariah and management in operating the DIB.
6 (Monzer Kahf, 2001)
7 (Jawatankuasa Pemandu Kebangsaan Bank Islam, 1982)
8 (Bank Negara Malaysia, 2017)
9 (Kahf, 1999-2002)
10 (ICD- Thomson Reuters, 2017)
3. LIBERALISATION OF ISLAMIC BANKING IN MALAYSIA

The success of BIMB and STMB has encouraged the Central Bank of Malaysia to develop the Islamic finance industry effectively and efficiently through Islamic counters (or later known as Skim Perbankan Tanpa Faedah (SPTF) in 1993) whereby commercial banks and finance companies were permitted to conduct financial activities in compliance with Shariah. Given the need to review whether the operations of Islamic counters are following Shariah, the regulator proposed the establishment of a Shariah Advisory Council (SAC) to allow all Islamic counters to consult the SAC in operating the Islamic counters\(^\text{11}\). However, the idea of having SAC was postponed due to the pressing need to focus on flourishing the industry with more Islamic banking players and avoiding duplicating efforts at many ends\(^\text{12}\). The SPTF through the amendment of the Banking and Financial Act 1989 (BAFIA) among others was required to appoint Shariah consultants to advice on Shariah matters and set up a dedicated Islamic banking unit\(^\text{13}\). As a result, one SPTF established a Shariah council, 14 SPTFs appointed Shariah consultants and 18 institutions leveraged upon consultancy services on specific Islamic banking products from Bank Islam.

The strategy was successful, and the idea to establish the SAC was resumed in 1997 due to the disparity of Shariah opinion post SPTF\(^\text{14}\). Unofficially, Malaysia has driven the innovation to introduce a two-tier Shariah governance for the Islamic finance industry. The liberalisation continues with the transformation of Islamic counters of SPTF to Islamic subsidiaries in 2003.

\(^{11}\) (Bank Negara Malaysia, 1991)
\(^{12}\) (Bank Negara Malaysia, 2017)
\(^{13}\) (Bank Negara Malaysia, 1991)
\(^{14}\) (Bank Negara Malaysia, 2017)
4. TWO-TIER SHARIAH GOVERNANCE FRAMEWORK IN MALAYSIA AND ITS DEVELOPMENT

Due to the pressing need to ensure end-to-end Shariah compliance and proper conduct in all aspects of Islamic financial institutions (IFIs) business and operation, Malaysia officially introduced the two-tier Shariah governance in 2004 through the Guidelines on Shariah Governance for Islamic Financial Institutions. Proper Shariah governance requirement was first established under this Guidelines with the objectives to set out the rules in the establishment of a Shariah Committee, among others specifying the role, scope of duties and responsibilities of a Shariah Committee, and define the relationship between a Shariah Committee and the SAC of Bank Negara Malaysia at the national level. The Guidelines, among others, prohibit individuals from sitting in more than one committee within the same sector. While the underlying rationale for the prohibition is to avoid a conflict of interest, the rule catalysed expanding the pool of Shariah talent within the Islamic finance industry and at the same time, increasing its diversity concerning the experience and expertise of Shariah experts. As a result, from less than ten Shariah scholars serving the financial industry, the number grew to 100 Shariah scholars.\(^\text{15}\)

The birth of many Islamic subsidiaries and the expansion of Islamic finance has required the regulator to amend Shariah governance. Although the first Shariah governance structure increased the prominence of the role of the Shariah Committee within the Islamic financial industry, further enhancements to the Guidelines are needed to take into account the rapid developments in Islamic finance in these recent years. These include the enhancements relating to the governance arrangements of the board and management in respect of the Shariah compliance process, the independence and accountability of the Shariah Committee in the decision-making process, the strengthening of internal research capacity, compliance and the risk management processes.

The revised guidelines aim to provide comprehensive expectations on IFI’s Shariah governance structures, processes and arrangements in complying to Shariah and provide clear guidance on duties of the board, Shariah Committee and management on Shariah matters. The guidelines also outlines the bank’s expectation on the compliance functions of IFIs.\(^\text{16}\)

\(^\text{15}\) (Bank Negara Malaysia, 2009)
\(^\text{16}\) (Bank Negara Malaysia, 2010)
5. THE EXPECTATION ON SHARIAH COMMITTEES OVER THE YEARS

Over the years, the expectation of the roles, accountability and disclosure requirement has changed, as summarized below:

<table>
<thead>
<tr>
<th>State of the industry</th>
<th>Expectations on Shariah Committee (SC) and other supporting organs of an IFI related to SC</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Infant stage</td>
<td>• As the point of reference in Shariah matters for IF (not only for the banks they are serving in but also for the Central Bank in meeting liquidity needs/setting up infrastructure – and later, as the reference by Islamic windows as discussed earlier).</td>
</tr>
<tr>
<td>✓ before 1993 until the formation of SAC</td>
<td>• Instill public confidence on IFI by ensuring Shariah compliance of its operations.</td>
</tr>
<tr>
<td>✓ SC is independent (only two committees, BIMB's and STMB's)</td>
<td></td>
</tr>
</tbody>
</table>

Figure 1: Shariah Governance Framework Model for Islamic Financial Institutions
<table>
<thead>
<tr>
<th><strong>Liberalisation stage</strong></th>
<th><strong>No requirement on the qualification of SC's qualification and structured form of disclosure on Shariah opinions issued.</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ after the formation of SAC until 2010</td>
<td>To ensure Shariah compliance of IFIs’ operations and consistency with SAC opinions.</td>
</tr>
<tr>
<td>✓ the composition of SCs: three SC members for each Islamic subsidiary</td>
<td>Responsibility for Shariah views provided, observation of independence and no conflicts of interest, should not be stumbling blocks for IFIs’ productivity.</td>
</tr>
<tr>
<td>✓ Takaful Operator is not allowed to leverage on SCs of the financial group</td>
<td>Individual SC was not allowed to sit on more than one IFI.</td>
</tr>
<tr>
<td></td>
<td>SC must have sufficient Shariah knowledge and no explicit requirement to possess a degree in Shariah was mentioned.</td>
</tr>
<tr>
<td></td>
<td>Starting from 2004, SCs are expected to disclose their opinion on the state of compliance with Shariah in the Shariah Committee Report.</td>
</tr>
<tr>
<td></td>
<td>The board was required to disclose the roles of SC in the Directors’ report.</td>
</tr>
</tbody>
</table>
- **Growth stage**
  - from 2010 until today
  - The composition of SC increased from three to five and may have mix composition with experts from relevant background
  - Financial group is allowed to have a single committee for banking and takaful operations

- **SCs are expected to perform oversight role on Shariah matters.**
- **SCs are expected to continually equip themselves with relevant knowledge of Shariah and finance as well as attend relevant training programs and with strong proficiency in languages.**
- **SC may get the appropriate assistance from other professionals, especially regarding issues on law and finance.**
- The disclosure requirements were later revised to request for more disclosure among others, purpose of engagement, nature of work performed, description on Shariah Committee's work, management responsibility in ensuring compliance with Shariah, statement of non-Shariah compliance incidences and the detailed opinion on the state of Shariah compliance of the contracts and documentation, allocation of profit between shareholders (SH) and investment account holders (IAH), earnings generated from prohibited sources and disposal method and zakat calculation.
- **Establishment of Shariah compliance functions to support the role of SC and the Board.**
<table>
<thead>
<tr>
<th></th>
<th>Matured stage</th>
<th>Higher expectations on SC’s deliberations contributing to product innovation within IFIs etc.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>✓ will commence after the issuance of policy document on Shariah Governance. Currently, the discussion will be based on the requirement in the Exposure Draft on Shariah Governance</td>
<td>✓ SC is not required to perform an oversight role but the Shariah Committee is still held accountable for the quality, accuracy and soundness of its own decisions or advice which needs to be done based on robust methodology to guide its decision-making process.</td>
</tr>
<tr>
<td></td>
<td>✓ less complex IFIs are allowed to have three members of SC</td>
<td>✓ Chairman of SC must be a Shariah qualified person.</td>
</tr>
<tr>
<td></td>
<td>✓ Composition of SC remains but the ED required IFI to appoint a minimum qualified Islamic finance practitioner that possessed strong Islamic finance knowledge with 10 years of industry experience</td>
<td>✓ Boards should clearly articulate in the Directors’ Report its oversight accountability for Shariah governance implementation and the IFI’s overall compliance with Shariah.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>✓ SC is required to disclose information in the IFI’s annual report on its responsibilities relating to Shariah governance; and opinion on the state of the IFI’s compliance with Shariah. In providing its opinion, SC must form an opinion based on an effective and structured process, which needs to be approved by the board. In developing a policy to facilitate the SC in giving its opinion, IFIs may consider detailing out the SC’s planning, including the determination of materiality to determine</td>
</tr>
</tbody>
</table>
the state of Shariah compliance of an IFI, method to obtain evidence; consultation with IFIs, formation of opinion; and the manner in which the opinion is to be published.

6. THE VARIOUS STRUCTURES OF SHARIAH GOVERNANCE IN OTHER JURISDICTIONS

The Shariah governance framework is crucial in ensuring proper governance and it is in place to ensure IFI’s compliance with Shariah\textsuperscript{17}. Unlike the corporate governance structure or framework which has its uniformity or fixed structure, the Shariah governance framework varies from one country to another as shown in the table below:

<table>
<thead>
<tr>
<th>Type of Shariah governance system</th>
<th>Two-tier Shariah governance</th>
<th>Single tier at the central bank level</th>
<th>Single tier at institutions level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countries</td>
<td>Malaysia Pakistan Brunei Oman Bahrain UAE Djibouti Indonesia</td>
<td>Sudan Morocco</td>
<td>United Kingdom Kuwait Singapore Qatar</td>
</tr>
</tbody>
</table>

Source: Table 1: Author’s consolidation from a few reports\textsuperscript{18}

However, regardless of the forms of the Shariah framework, many practitioners questioned the competencies, commitment and credibility of Shariah Committees in efficiently and effectively discharging their duties and responsibilities.

\textsuperscript{17} (Thomson Reuters, 2015)
\textsuperscript{18} (Thomson Reuters, 2015) (Muhammad, 2015), (Mohd Akram & Hafas, 2016)
7. SHARIAH GOVERNANCE ISSUES

There are ongoing debates on a few issues related to the appointment of a Shariah Committee as an advisor to an institution among others (i) independence of Shariah Committee, (ii) competency and conflict of interest, and (iii) disclosure and transparency of the Shariah Committee report¹⁹.

Firstly, the issue of independence arises due to the payment received by the SC members' involvement in product structuring that may hamper the objectivity of its advisory role as well as reporting made to the Board. Besides, it is believed that management has also influenced the SC in deriving its opinion. However, this issue will be addressed through the new policy document on Shariah governance where SCs are required to have an established methodology in coming out with their opinion, and the management is required to abstain themselves during the Shariah deliberation process.

Secondly, SCs have been criticised on their competency level with regards to the finance and banking business. This criticism is expected based on the availability of Shariah scholars who are expert in finance and banking as well as the focus on fiqh research related to Islamic finance that is growing in size. Also, the Association of Shariah Advisors (ASAS) in Malaysia, reported in their 2016 annual report that many of their members are academicians and a survey of their members shows that many of them are looking for technical and leadership courses to complement their services. The ASAS is currently tackling this issue by introducing the Certified Shariah Advisors programme where the certification aims to upscale the competency of Shariah advisors locally and globally.

¹⁹ (International Shariah Research Academy for Islamic Finance, 2011)
Thirdly, the main focus of this case study which is the disclosure, where it arises due to the above two issues. SCs were questioned over the nature of work performed in coming out with the Shariah Committee report as well as the extent of transparency of disclosure due to the observation made on the absence of Shariah non-compliance income by the majority of IFIs. The disclosure of non-compliance income and method of purification, as well as the beneficiaries of the Shariah non-compliance income, has increased due to the requirement made by the central bank in 2010. However, only a few banks disclosed the information in their financial report. Through the future policy document, SC is expected to form an opinion on the Shariah Committee report based on a specific methodology that will be developed by the IFI. However, this may create a different methodology in coming out with a Shariah opinion and creating another debate in the industry on the methodology. Therefore, this issue may need ASAS’s attention to develop a set of transparent methodology in disclosing a Shariah opinion. In contrast, for the accounting environment, there are separate bodies such as the International Accounting Standards Board (IASB) responsible for setting the standards for accountants to prepare financial statements. Likewise, for auditing, the International Standards on Auditing (ISA) are the professional standards for the performance of a financial audit of financial information. These standards are issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB).

7. ARE THE ROLES OF SHARIAH COMMITTEES INDISPENSABLE TODAY?

Looking at today’s landscape, the SC’s role is still crucial in ensuring a Shariah compliance environment risk culture, regardless of the structure of the Shariah governance framework. A matured Islamic financial system will only exist when the practitioner and regulator in the industry can assimilate the Shariah component in the existing corporate governance framework without the need to have a separate Shariah governance framework and where Islamic finance can behave like a typical business organisation which evolves naturally in terms of the resources needed and product offered, i.e. employ or train talent on the necessary skills and appoint necessary competent individuals to sit on the board and have product uniqueness and differentiation in line with the business needs on the basis of the law of supply and demand. However, this is foreseen to only come as a reality when the industry has a sufficient pool of competent talent on Shariah, Shariah savvy board and management, robust regulations and highly educated consumers on Islamic finance.
8. REFERENCES


FINANCIAL REPORTING FOR ISLAMIC FINANCE IN MALAYSIA: FROM A SEPARATE ISLAMIC ACCOUNTING STANDARDS TO IFRS

MAZMI MOHAMMAD

Deloitte Malaysia
EXECUTIVE SUMMARY

As Islamic Finance practices continued its exponential growth in Malaysia, a financial reporting issue arose among the industry players some years back as to how best to account for the transactions undertaken from the Islamic Finance concept. This specifically calls into question the most appropriate financial reporting framework to be used to report the financial results of entities (e.g. Islamic banks, takaful companies) that undertake Shariah compliant transactions. The burning question back then was whether Malaysian business entities required separate Islamic accounting standards to account for its transactions or the then existing International Accounting Standards (“IAS”) could also be applied to Islamic Finance transactions.

The issue had been authoritatively concluded when the Malaysian Accounting Standards Board (“MASB”) issued “Statement of Principles i-1 (SOP i-1), Financial Reporting From An Islamic Perspective” on 15 September 2009. The said SOP i-1, states that MASB approved accounting standards shall apply to Shariah compliant financial transactions and events, unless there is a Shariah prohibition\(^1\). This meant that all transactions and events under the Islamic Finance concept are to be reported under the MASB standards, which were then based on the International Accounting Standards (“IAS”).

Bank Negara Malaysia (“BNM”) also through its Circular on the Application of Financial Reporting Standards and Revised Financial Reporting Requirements for Islamic Banks, which became effective on 1 January 2010, required Islamic banks to prepare financial statements in accordance with the financial reporting standards approved by MASB to the extent that the standards are consistent with Shariah principles.

In 2012, MASB approved accounting standards moved to full convergence with the International Financial Reporting Standards (“IFRS”) issued by the International Accounting Standards Board (IASB). With this, the financial reporting framework to account for transactions and events by an Islamic financial institutions under an Islamic Finance concept in Malaysia became fully integrated with the IFRS.

\(^1\) Malaysian Accounting Standards Board-Financial Reporting From Islamic Perspective
This paper shall analyse the development of the financial reporting framework for Islamic Finance transactions in Malaysia from the aspiration of having separate Islamic accounting standards to the full integration with IFRS in the present day.

1. THE GROWTH OF ISLAMIC FINANCE IN MALAYSIA

The Islamic Finance industry in Malaysia has been in existence for over 35 years. Bank Islam Malaysia Berhad was the first Islamic bank to be established in Malaysia in 1983 pursuant to the enactment of the Islamic Banking Act 1983. In 1984, Syarikat Takaful Malaysia Berhad was established as the first takaful company in Malaysia.²

Presently, Islamic finance practices in Malaysia include Islamic banking, takaful, Islamic capital market and Islamic asset management. Also in 2017, Malaysia had 16 fully-fledged licensed Islamic financial institutions.³

The Financial Stability and Payments Systems Report 2017 issued by Bank Negara Malaysia stated that in 2017, the market share of Islamic banks in Malaysia was 28% and Islamic financing accounted for 34.9% of the total loans and financing. Also in 2017, the market share of the takaful industry, in terms of premiums and contributions, rose to 15.2%.³

The said report also stated that in 2017, Malaysia ranked as the world’s third largest Islamic finance market by assets and the largest sukuk market with a 51% share of global sukuk outstanding, amounting to USD202.2 billion.³

The above commendable statistics are consistent with the government’s aim for Malaysia to become the global hub for Islamic finance. To achieve this aspirations, the Malaysian government has launched various initiatives which include amongst others, legal and regulatory frameworks, shariah governance, human capital development and market infrastructure to support the growth of Islamic Finance.

³ Financial Stability and Payment Systems Report 2017, Bank Negara Malaysia
Certain regulatory institutions like Bank Negara Malaysia and the Securities Commission have their own mandates and roles towards the development of Islamic Finance in Malaysia. Both institutions have developed policies and platforms that enhanced the Islamic Finance practices in Malaysia. Meanwhile MASB and MIA have the mandate to regulate the financial reporting framework to account for Islamic Finance transactions and its financial reporting.

2. ISLAMIC ACCOUNTING STANDARDS IN MALAYSIA

The Malaysian Accounting Standards Board (“MASB”) was established in 1997 with the primary role of developing accounting and financial reporting standards in Malaysia. Since its establishment, MASB had started a project towards developing separate accounting standards for Islamic Finance in Malaysia. The then Chairman of MASB, Raja Tan Sri Arshad Raja Tun Uda, had been quoted as saying, “MASB concluded that there was a need for the creation of Malaysia’s own genre of standards that would cater to the specific needs of Islamic financial institutions in the country.”

This is despite the existence of an international body, i.e. the Accounting and Auditing Organization for Islamic Financial Institution (“AAOIFI”) which was set up to formulate Shariah standards for Islamic financial institutions. However, Raja Tan Sri Arshad Raja Tun Uda said that AAOIFI does not address specific issues in Malaysia, i.e. Islamic banking regulatory framework, dual banking system and different Shariah interpretations of Islamic practices.

MASB in 2001 had issued its maiden Islamic accounting standards, i.e. ‘MASB i-1 (subsequently renumbered as FRS i-1), Presentation of Financial Statements of Islamic Financial Institutions’ as a source of reference for financial reporting for Islamic financial institutions in Malaysia. The issuance of MASB i-1 marked a significant milestone towards achieving MASB’s aspiration of having separate accounting standards to account for Islamic Finance transactions in Malaysia.

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4 Dodik Siswanto & Shahul Hameed Mohamed Ibrahim, Media Riset Akuntasi, Auditing & Informasi, Vol.13 No.1, April 2013
5 Muhammad, Rifqi. “The Disclosure Evaluation of Islamic Banking Reports : Evidences from Middle East and Other Regions in Asia”, Journal of Islamic Finance
In the said MASB $i-1$, MASB states that the main reason why an Islamic accounting standard is needed is, “the absence of a proper set of accounting standards for the recognition, measurement and disclosures of Islamic based transactions complicates or hinders attempt to compare financial performance among the banks or between periods for individual banks”. The standards also state that “the existing accounting standards based on International Accounting Standards (IASs) cannot address accounting issues within Islamic banking operations adequately........useful in providing a structural framework for reporting, but they are inadequate to accommodate Shariah precepts, which form the basics of all Islamic transactions$^{1}$.

However, MASB $i-1$ was the first and the last standard formulated from an ‘Islamic accounting’ perspective issued by MASB. In 2009, MASB issued ‘Statement of Principles $i-1$, Financial Reporting from an Islamic Perspective’ which stated that MASB approved accounting standards shall apply to Shariah compliant financial transactions and events, unless there is a Shariah prohibition. Accordingly, FRS $i-1$, was withdrawn$^{1}$.

As stated in MASB’s own staff research papers, the significant change in direction taken by MASB was due to the fact that the conventional accounting concepts and generally accepted accounting principles could significantly be applied to Islamic financial transactions. In fact, MASB $i-1$ still made reference to the existing conventional standards, such as MASB 1 (presentation of financial statement), MASB 3 (net profit or loss for the period, fundamental errors and changes in accounting policies), MASB 5 (cash flow statements) and MASB 8 (related party disclosure)$^{1}$.

Another factor that contributed to the change in position taken by MASB was the complexity in formulating a separate set of standards for Islamic accounting. This has somewhat hindered a speedy development of a complete separate set of Islamic accounting standards$^{5}$.

In 2012, MASB adopted the International Financial Reporting Standards (“IFRS”) issued by the International Accounting Standards Board (“IASB”). With this, all entities that undertake Islamic finance transactions in Malaysia are also required to adopt IFRS for their financial reporting.

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In 2005, BNM issued the Guidelines on Financial Reporting for Licensed Islamic Banks (GP i-8) which provide guidelines in presentation and disclosures for financial statements of Islamic banks. The GP i-8 also stresses that Islamic banks must ensure financial statements are prepared in accordance with MASB accounting standards. Since then, there has been subsequent updates to GP i-8 issued by BNM which eventually required Islamic financial institutions in Malaysia to adopt IFRS in their financial reporting.

3. THE SHARIAH PERSPECTIVE

The fundamental issue that needs to be answered when applying IFRS for Islamic Finance is what is the Shariah view on various accounting concepts used in IFRS to account for Islamic Finance transactions.

Proponents of separate Islamic accounting standards to account for transactions under Islamic Finance concepts have raised issues regarding several conventional accounting concepts that in their view are not aligned with Islamic views. These accounting concepts and its related Shariah view are as follows:

i. Substance over form

In conventional accounting, substance over form generally means that for accounting purposes, the measurement and reporting of a transaction or event is focused on its economic impact instead of its legal form. In Malaysia, many trade contracts designed for Islamic finance transactions are in substance a financing arrangement. The question is whether substance or form have priority from a Shariah perspective.

This issue was concluded when the Shariah Advisory Council of Bank Negara Malaysia in its 57th meeting dated 30 March 2006 and 71st meeting dated 26-27 October 2007, resolved that in principle, “substance” and “form” are equally important and highly taken into consideration by the Shariah. In this regard, the Shariah emphasises that ‘substance’ and ‘form’ must be consistent and shall not contradict one another. In the event of inconsistency between “substance” and “form” due to certain factors, the Shariah places greater importance on “substance” rather than “form”\(^7\).

\(^7\) Shariah Resolutions in Islamic Finance, Second Edition, Bank Negara Malaysia
ii. **Time value of money**

Time value of money is generally an economic principle that suggests present day money is worth less than money in the future because of its earning power over time. The concept of time value of money in conventional accounting forms the basis to recognise financing income in deferred payment transactions. The question is whether Shariah recognises the concept of ‘time value of money’.

This issue was concluded when the Shariah Advisory Council of Bank Negara Malaysia in its 71st meeting dated 26-27 October 2007, resolved that the application of time value of money principle in Islamic financial reporting is permissible only for exchange contracts that involved deferred payments. However, it is strictly prohibited in debt-based transactions (qard).

iii. **Fair value measurement**

Fair value measurement generally means an approach to measurement that seeks to capture changes in asset and liability values over time. This concept together with time value of money form a basis for recognition of financing income in conventional accounting. The question is whether Shariah acknowledged the concept of fair value measurement.

This issue was also addressed by the Shariah Advisory Council of Bank Negara Malaysia as mentioned in issue no. (ii) above.

Nurazleena Ismail and Zulkarnain Muhamad Sori opined that a review of classical fiqh literature reveals many instances where this principle was given consideration by jurists in deducing rulings. For example, the fair value benchmarked with the market price was used to determine the subsistence (nafaqah) of the agent-manager while travelling in a mudarabah contract. Scholars also agree on the role of experts and the use of estimation techniques in determining the fair value when there is no clear market price for a commodity.
iv. Recognition based on probability

Recognition based on probability generally means that there is a degree of uncertainty that the future economic benefits associated with the transaction will flow to or from the identified person/entity in reference to the recognition criteria. This concept is used in conventional accounting to recognise benefits and obligations associated with a transaction despite the contract has yet to be completely concluded.

This issue was answered by the Shariah Advisory Council of BNM in its 71st meeting dated 26-27 October 2017, which resolved that the application of the probability principle in Islamic financial reporting is permissible as it does not contradict the general fiqh principles.

The Shariah ruling by the Shariah Advisory Council of Bank Negara Malaysia has conclusively addressed the Shariah issues on the permissibility of applying the above conventional accounting concepts for Islamic Finance’s financial reporting from a Malaysian perspective.

4. THE OTHER ISLAMIC ACCOUNTING STANDARDS

The Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) is a not-for-profit organization that was established to maintain and promote Shariah standards for Islamic financial institutions. The AAOIFI was registered in 1991 in Bahrain and is regarded as a pioneer for Islamic standard settings.

Presently, the AAOIFI standards are adopted in Bahrain, Jordan, Oman, Qatar, Sudan and Syria.

AAOIFI has stated that its approach in formulating Shariah-compliant accounting standards is to begin with the objectives already established in conventional accounting, then testing these objectives against Shariah, and accepting those that are consistent with Shariah and rejecting those objectives that are not consistent with Shariah.

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This approach has resulted with three categories of accounting standards for Islamic financial institutions developed by AAOIFI over the years i.e.:

i. AAOIFI standards that are issued because conventional international accounting standards cannot be adopted in whole by Islamic financial institutions. This is due to Shariah compliance issues or to conventional international accounting standards that do not fully cover characteristics of Islamic Finance practices. In these cases, AAOIFI accounting standards are issued to apply to topics covered by the conventional international standards.

ii. AAOIFI standards that are issued for specific Islamic finance practices not covered by conventional international accounting standards. This is for financial transactions and practices unique to Islamic Finance. In these cases, AAOIFI accounting standards are issued to apply to topics not covered by conventional international accounting standards.

iii. Conventional international standards that can be adopted by Islamic financial institutions and therefore AAOIFI does not issue similar ones and allows adoption of these standards. These standards do not give rise to Shariah compliance issues and are adequate to cover practices of the Islamic financial institutions. In these cases AAOIFI does not issue equivalent standards. Islamic financial institutions adopting AAOIFI standards are allowed to also follow other standards if there are no equivalent AAOIFI standards.

The above approach undertaken by AAOIFI is seen to avoid redundancy in the current reporting system and is seen as harmonizing the accounting standards so that consistency with global accepted accounting standards is attained.

AAOIFI also appears to want to use accounting standards as a tool to determine the Shariah compliance status of a financial instrument or transaction.

MASB, however, does not adopt the AAOIFI standards. This is due mainly to certain weaknesses noted in standards issued by AAOIFI and MASB also does not use accounting standards as a tool to determine the status of Shariah compliance of a financial instrument as this is not the mandate of MASB.
MASB in its staff research papers has stated that even though AAOIFI aspires to converge with IFRS, certain underlying accounting concepts in IFRS were not embraced by AAOIFI i.e., ‘substance over form’ and ‘time value of money’. The omission of the ‘substance over form’ and ‘time value of money’ concepts may result in financial statements prepared under AAOIFI standards to be significantly different from another prepared under IFRS. An example of this is the vast difference in accounting treatment on leases between IFRS and AAOIFI. Under the current IAS 17 Leases, a lease should be classified either as a finance lease or operating lease. However, AAOIFI Financial Accounting Standard (FAS) No.8 Ijarah and Ijarah Muntahia Bittamleek, requires all Ijarah to be treated as operating lease as the lessee does not obtain ownership of the underlying asset\textsuperscript{10}.

However, MASB welcomes the inclusion of several additional disclosures required under AAOIFI’s standards, where appropriate which are not in IFRS.

AAOIFI’s accounting standards are also believed to be based on Shariah-compliant products of Middle East countries and may not address the accounting treatment of other Shariah-compliant products of Malaysia.

5. THE PRESENT DAY

Although it is has been concluded that Malaysian entities that undertake Islamic finance transactions have to adopt IFRS for their financial reporting as MASB is no longer pursuing a project to establish a separate set of Islamic accounting standards for Islamic Finance transactions, both MASB and IASB acknowledged that a platform is required for discussions on issues in Islamic Finance. Towards this, MASB has formed an Islamic Technical Unit and a Standing Committee on Islamic Financial Reporting.

As stated in MASB’s website, “the Islamic Technical Unit is part of the MASB secretariat that undertakes research and accounting issues relating to Islamic finance. Meanwhile, the Standing Committee is responsible for the development and maintenance of a robust financial reporting framework for entities engaged in Islamic finance”.

\textsuperscript{10} A Word About Islamic Finance: Part II, Malaysian Accounting Standards Board, 2012.
The Malaysian Institute of Accountants (MIA) has also established its Islamic Finance Committee in 2009. As stated in its website, “the primary objectives of the Islamic Finance Committee are to promote Islamic finance through various initiatives such as collaboration with relevant stakeholders and regional accountancy bodies in promoting the adoption of IFRS and the international convergence of standards”.

On the regional front, the Asian-Oceanian Standard Setters Group (AOSSG) is a grouping of accounting standards-setters in the Asia-Oceania region. AOSSG has formed a working group on Islamic Finance with MASB as its Leader. As stated in its website “the objective of the AOSSG Islamic Finance Working Group is to facilitate AOSSG members by providing input and feedback to the IASB on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events”.

In 2011, the IASB established a consultative group on Shariah-Compliant Instruments and Transactions. The Group is now called the Islamic Finance Consultative Group. In its website, IASB stated that “the Group does not judge whether products are compliant with the requirements of Shariah laws. Instead the Group focuses on challenges that may arise in the application of IFRS standards to instruments and transactions commonly referred to as Islamic finance. The topics discussed would usually be referred to the Board’s Interpretations Committee (IFRS IC)”.

6. CONCLUSION

After a period of researching including studying the AAOIFI standards, the MASB opted to adopt IFRS for Islamic Finance in Malaysia. Nonetheless, there are platforms within MASB, MIA, AOSSG and IASB for practitioners in the Islamic Finance industry to deliberate on matters relating to the application of IFRS for Islamic Finance. In addition, the Shariah Advisory Councils of Bank Negara Malaysia and Securities Commission are the platforms to deliberate on Shariah concerns over accounting concepts in Malaysia.
The World Islamic Banking Competitiveness Report 2016 issued by Ernst & Young stated that “a study in 2016 showed that 93% of international participation banking assets are based on nine core markets with Malaysia being ranked second (Saudi Arabia and the UAE ranked first and third, respectively). It is worth noting that these top three countries apply IFRS as their financial reporting framework”\(^{11}\).

The nation’s journey from attempting to establish separate Islamic accounting standards to eventually adopting IFRS for Islamic Finance, resonates well with Malaysia’s ambition to be the global leader for Islamic Finance.

However, while the debate on what would be the appropriate accounting framework to account for Islamic Finance transactions have ended, many accountants in Malaysia might not be conversant to articulate the accounting principles in IFRS and its applicability in Islamic Finance transactions. The effort to nurture a wider pool of accountants that are conversant in both IFRS principles and its applications in Islamic Finance needs to be intensified by the local accounting bodies, such as MIA and MASB. This is to place Malaysia’s accountants at the forefront to deal with issues that may arise from the creation of various new Shariah-compliant financial instruments and transactions in the coming years.

\(^{11}\) World Islamic Banking Competitiveness Report 2016, Ernst & Young
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TAWARROQ IN ISLAMIC BANKS

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1. INTRODUCTION/BACKGROUND

The foundation of Islamic finance is the prohibition of riba (usury) and encouragement of trade. This can be seen in Al-Quran Surah: 2 ‘Al Baqarah’, Verse: 275

"Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein."

As Islam encourages sale and trade, Tawaruq and Bai’ Inah as Islamic products offered by financial institutions have this element. Majorities schools jurist of Shafi’i, Hanafi and Hambali consider tawaruq and bai’ inah to be legally permissible. The terminology from the verse above according to the major scholars of usul fiqh clearly indicates the permissibility of all types of sale and also trade, except where a particular type of sale is specifically prohibited. By Shariah principles, both tawaruq and bai’ inah are valid but the application of bai’ inah and tawarruq contracts by financial institutions is questionable. Let’s see the difference in the application of bai’ inah and tawarruq contracts below.

The Inah and Tawarruq contract

1. Bank sells the Asset for RM 110k & customer agrees to pay the amount in instalments

2. Bank will buys the asset back at lower price of RM 100k & payment is made to the customer on cash basis
Repurchase sale (bai al-'e inah or bai' inah) is a contract in which a person sells goods for a deferred price and repurchases them immediately at a lower cash price from the same person and alternatively, he/she can purchase the goods for a cash price and sell the goods immediately at a higher deferred price to the same person.

In both cases, a person gets cash but is indebted to the other party for a deferred higher price and involves two parties. Thus, the basic 'inah contract in this definition is seen to comprise two transactions of sale, the first being at a deferred price, while the second is at a lower cash price. Imam al-Shafi‘i, has described his principle related to the 'inah sale in his book - al-Umm:

“When one purchases a commodity from another and takes its delivery, and the price happens to be on deferred terms, it is not objectionable for him to sell it to the person from whom he had purchased it or to someone else, for a cash price less than his purchase price or higher, or on credit, or against another commodity.”

The overwhelming majority of Muslim jurists have not agreed with the 'inah as a transaction on the basis that the transaction could involve riba. Although the exact format intended and the specific reasoning adopted could be different, the basic rationale in its condemnation apparently is its easy misuse for the purpose of disguising a riba contract.

Bay al-Inah has two contracts, one is the sales contract and the other is the repurchase contract. The issues raised are in terms of the existing two sales in one sale. In the hadith it is stated that the carrying out of two sales contracts in one sale contract is prohibited as well as that of relating to a sale with conditions contravening the requirements of that sale. There are no actual selling and buying transactions (bai’) and the assets never leave the bank which is also one of the issues pertaining to Bai inah.
In a classical tawarruq which is the original practice of the tawarruq process is where someone who needs cash urgently will buy assets from the seller by instalments and at a cash plus profit basis. He then needs to find another potential buyer which is a third party (other than the first seller) who is willing to buy the asset by cash but at a lower cost.

In today’s practice, tawarruq transactions can be defined as someone who buys a commodity at a deferred payment, and sells it to someone other than the seller for cash, at a lower price for him to get cash. In other words, buying is made on credit and selling to a third party for cash. This concept is similar to al ‘inah except there is the existence of a third party and does not involve the original seller of the commodities. The appointment of the bank upfront as an agent to deal with the third party (wakalah) is termed organized tawarruq or tawarruq munazzam. This is the current banking practice in Malaysia.

On 28 July 2005, Bank Negara Malaysia (BNM) had resolved that the financing and deposit products based on the concept of Tawarruq and also known as commodity murabahah is permissible. (BNM, 2007).
2. DISCUSSION

Tawarruq, or commodity murabahah, has become a favourable concept in the Malaysian Islamic banking system. This happened aggressively after the BNM circular on bay’ inah (sale and buy-back) issuance in 2012, which tightens the shariah requirements for bay’ inah. This, in turn, creates difficulties when practicing bay’ inah in the current financial situation. Since then, the Malaysian Islamic banking system started aggressively using tawarruq as an alternative to bay’ inah. Slowly, Islamic banking phased out bay’ inah-based products from their banking portfolios. As a result after a few years, Tawarruq has become the dominant concept in Malaysian Islamic banks. A survey conducted in 2015 revealed that the tawarruq concept represented more than 80 per cent of the total financing portfolio for three Malaysian Islamic banks, between 61 per cent and 80 per cent of its total financing portfolio for about six Islamic banks; and between 40 and 60 per cent in its total financing portfolio for two Islamic banks. Other Islamic banks applied tawarruq in smaller portions, about less than 40 per cent of their total financing portfolio.

Nevertheless, the aggressive move of using tawarruq in Islamic Financial Institutions (IFIs) has created doubt and queries from Muslim economists and shariah scholars. The fact that some say tawarruq is designed just to reflect the same characteristics of conventional products challenges the claims of Islamic finance proponents that IFIs offer a real alternative to conventional finance. The International Islamic Fiqh Academy, a subsidiary of the Organisation of Islamic Cooperation (OIC) in 2009 (its 19th meeting) in Sharjah, the United Arab Emirates stated that the modern practice of tawarruq is impermissible.

Their argument is mainly due to the absence of a true and genuine transaction — where a series of transactions between the bank and the customer is executed simultaneously in exchange of a financial obligation. The arrangements are said to be designed to offer quick cash to the customer and at a higher amount in the future, which they consider to contain the element of riba. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), under its Shariah Standard No. 30, Paragraph 5/1, 2008, clearly states that tawarruq should only be employed as the last resort when an institution faces a liquidity shortage that could harm its sustainability. Tawarruq should not be used as a mode of investment or financing for the purpose of profit making for the institution.
The BNM’s SAC (Shariah Advisory Committee) draws evidence from the Quran and the Sunnah to legitimise Tawarruq. The Quranic evidence was an excerpt from Surah Baqarah verse 275:

“Whereas Allah (SWT) has permitted sale and forbidden usury”

For this, Allah has permitted the sale whenever the purpose is right. Furthermore the Islamic scholars have adopted Tawarruq and consider it as an alternative to bai’ Inah. Practitioners in the banking industry see Tawarruq as a necessity because with its current structure, it provides liquidity management solutions to IFIs and also because of the need to provide Muslim customers with “Shariah-compliant” working capital with the absence of collateral. Tawarruq is very useful in situations when a bank customer does not have collateral to give his financial institution but urgently needs cash. The absence of an Islamic finance structure alternative that can provide cash to the customer when the customer does not have any valuable assets, Islamic bankers should continue to offer Tawarruq products. It is better to practise this rather than diverting the customer to choose a conventional banking product which is clearly involved in riba. The legal maxim used is that tawarruq satisfies the people’s needs and helps to meet their requirement of removing difficulties and as well as meeting Maqasid of Shariah for the protection of property. The structure has helped to address the liquidity requirement facing today’s world.

3. ISSUES WITH THE PRACTICE OF TAWARRUQ BY ISLAMIC BANKS

3.1 Validity of Intention

To be valid from a Shariah perspective, a sale contract must be valid in form and purpose. The seller must own and possess the sale object, except for the sale of something that can be acquired in the market under Salam or Istisna. The sale also must not be made with conditions and the contract must not be gharar (uncertainty), riba (interest rate) and devoid of cheating. The meaning of validity in form is also that either the delivery of the goods or its payment may be deferred and both aspects may be deliverable. Validity of purpose means that the contract must be for a valid purpose.
Perhaps the notion that obtaining cash from a transaction looks too much like a “loan” from the conventional banking space but this cash is derived from real trading. While the argument is that the “intention” of the tawarruq is not real trade, I tend to not agree as the customer does have a need to obtain cash which is through real trade, Let’s look at the following scenario; if a customer needs cash to meet his business opportunity where he can earn around 50% return a year but he requires RM100,000 as his working capital. He searches around the market for a commodity that he can trade and sell for cash. He manages to identify a few buyers who need rice. He will approach a rice supplier – paddy planter and negotiate with him. He offers to buy the rice (worth RM95,000 to RM100,000) for a price of RM110,000 to be finalised in 12 months’ time. This can be considered as a murabaha for purchasing a commodity and it is accepted as a Shariah compliant sale contract. Once the supplier agrees, he will take ownership of the rice which is worth RM95,000 to RM100,000. It is not his intention to own the rice but he needs cash for his business so he can sell the rice to ready buyers under a simple sale (Musawama) for RM100,000. Now he has RM100,000 and he needs to work on the business opportunity which can earn him 40%-50% profit per annum. In the end he earns RM150,000 from the capital of RM100,000. By the end of the contract he will pay the RM110,000 debt to the supplier - paddy planter. His net profit will be RM150,000 minus RM110,000 is RM40,000. Here we can see that all the underlying transactions are valid, real and the asset is deliverable which is approved by Shariah.

3.2 Tawarruq as Hilah to Give a Loan With Interest

It has been alleged that most contemporary Tawarruq structures are a hilah (trick) to legitimize or circumvent interest-taking (Meera (2015) and Noor & Azli (2009)). In fact, the notion of deception in the practice of modern Tawarruq was a major reason the OIC Fiqh Academy ruled it as impermissible.

In my view, tawarruq that is practiced by Islamic banks in Malaysia is not a hilah. It is a mechanism or process to facilitate Islamic products to meet the Shariah compliance needs of customers especially those without collateral. It helps to avoid the customer from going to conventional financing. The assets traded in Tawarruq can be identified individually by its ownership and the ownership can be transferred on paper.

IFIs can assist customers by explaining to them the process of tawarruq and its terms and conditions so that they will understand the purpose of using the tawarruq concept. Bank officers must be more proactive in explaining the concept although the customer’s main intention is to get cash financing.
3.3 The Bank as a Dual Agent

The Shariah Standards and Operational guidelines on Tawarruq issued by BNM’s SAC permits the implementation of a dual-agency in Tawarruq contracts. Dual agency here means that a bank is acting as an agent to buy the underlying asset on behalf of the customer while at the same time, being the agent to sell that asset on behalf of the customer or in term deposit accounts to sell it to the customer.

As not everyone has the skills to obtain cash by way of going into the market, finding buyers and negotiating the price with the supplier, the customer who requires cash financing, i.e. working capital or liquidity, will approach people who have the skills to conduct such work.

As such, the bank sees the need for such services or facilities whereby they have a stable infrastructure to support the processes for the customer.

With the existing infrastructure, Shariah audit can be performed to regulate and monitor the implementation of tawarruq transactions to ensure its validity. The bank can also manage the risks accordingly as the "arranged" processes will be designed to minimise risks such as valuation, ownership and market risks.

3.4 On Physical Commodities

One of the main disagreements is the ability to assure the availability of commodities. Evidence can be shown on paper but it is a challenge to ensure the commodity is identifiable and deliverable according to quantity. Commodities such as crude palm oil (CPO) are much easier to be allocated as efforts have been made by the institutions to split and break down into smaller denominations whenever needed.

The SAC of BNM has proposed that the operational structure of commodities like CPO is allowable on the condition that the CPO traded can be precisely determined and identifiable in terms of quantity and quality, and also its location for it to meet features of a real transaction. SAC of BNM also came out with recommendations that the execution of the transaction should be random for it to better meet the original features of tawarruq.
Furthermore, efforts have been made by the scholar to visit the location where the commodities are stored to verify and authenticate the existence of those commodities used. This further helps to ensure the commodity’s deliverability by building a mechanism to prove the existence of the commodities and provide comfort to Shariah scholars.

3.5. Resembling Bai` `inah?

Long before modifications were made to the structures commonly used by the IFIs for personal finance, the common practice was bai` `inah where the bank will make a pre-arrangement with the customer to sell the asset or commodity back to them. The bank used their asset as the underlying where the bank will sell its asset to a customer to create a debt and later on will “buy-back” the same asset from them for an immediate cash settlement. It is considered as a pre-arrangement transaction for the purpose of debt creation and without economic value. Most scholars did not agree to the conditionality clause inside the agreement documents to ensure the buy-back contract. Due to much criticism, BNM disallowed this sort of structure. This structure has been replaced mainly by banks acting as an agent to sell a commodity under a tawarruq structure to a third party.

Under a tawarruq arrangement, it is assumed that the conditionality aspect of “buy-back” contracts has become immaterial and minimal. This is because the bank has no interest on the commodity being traded, as it is not the bank’s asset being traded by third parties in the open commodities market. For that reason, the bank has no interest to buy back the asset or put the commodities in their bank books. Therefore, it is an actual economic transaction between two parties and as the transaction itself does not value-add to the commodity, it facilitates the creation of debt for the customer.

3.6. Accounting Risk

There is accounting risk, as when one party trades with another on the underlying commodity, the monetary value right may not be reflected in the books of the parties involved. However, when a detailed audit takes place on the IFIs books, this problem can be solved.
4. CONCLUSION

Islamic finance or banking will continue to serve the needs of the mass market to meet their working capital facilities and liquidity management. The processes of governing these product structures can be further improved so that it can be more acceptable to more scholars today and for going internationally as promoted by the Malaysian government. Islamic banking from a theoretical perspective is based on the principle of profit and loss sharing in place of the interest based deposit lending found in conventional banks but in reality and in practice Islamic finance still needs to make profit and minimise their risk. Tawarruq as is practised in Malaysia is very different from a loan involving riba which is prohibited in Islam. The use of tawarruq seems to reflect the tendency of modern IFIs. It is a powerful tool in Islamic finance that has to fulfil the needs of mass customers for working capital with the absence of collateral. It should also be Shariah compliant i.e. removing difficulty as well as the Maqasid of Shariah for protection of property. Before we can find an alternative to tawarruq in the future, it will continue to prosper together with other Islamic products.
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A COMPARISON BETWEEN NEGATIVE INTEREST RATES POLICY & MUDARABAH INVESTMENT DEPOSITS

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A COMPARISON BETWEEN NEGATIVE INTEREST RATES POLICY & MUDARABAH INVESTMENT DEPOSITS

EXECUTIVE SUMMARY

This paper discusses through literature studies the negative interest rates policy in conventional finance and its alternative of Mudarabah investment deposits in Islamic finance. It is found that any kind of interest financing, be it positive or negative rates, has a negative impact on the economy. Islamic financing instruments especially the one offering real-asset backed and profit-risk sharing features are robust facilities which are able to guarantee financial security against economic downturn. The improvements in Islamic financial institutions' operational aspects will be able to reduce the cost of financing, thus offering a more attractive profit rate.

1. INTRODUCTION

Today, we are living in a world with a very sophisticated economy where the financial sector plays a vital role in most of its aspects. The days when humans used the barter system as their medium of transaction has long become history. Since the declination of gold coins usage as currency and the fall of the Bretton Wood system and vast globalization, the financial sector in the world economy has become more complex.

Conventional economy and its financial sector expanded based on its money-lending nature. Financial institutions generated their profit through money lending activities by imposing interests for each dollar given as a loan to the market, be it a retail user, corporate or even the government. Interest rate refers to a percentage of loan amount charged on the principal by a lender to a borrower for the use of assets.

From an Islamic Shariah point of view, the interest imposed on loans are prohibited and considered as riba. Islamic teaching does not permit profit generating on riba items – in this case, currency which is used widely by the public as a necessity of life. Riba refers to unjustified gains above and over the capital that occur either in a loan transaction or an exchange of commodity.
The development of the financial sector has become more interesting and crucial to be observed in more detail and guided methodology from the Islamic Shariah perspective. The introduction of a new negative interest rate policy in the economy by some of the heavyweights of the world economic players such as Sweden, Denmark, Switzerland, Japan, and the European Central Bank, which is intended to stimulate their economies through money lending activities and to attract more local and international borrowers has raised concern among experts.

While most policymakers who took the path of the interest rate below zero policy are looking forward to its positive impact on their economy, some scholars have voiced out their fear of the potential negative impact it will cause not only to their domestic economy, but also on the global scale. As far as Islamic Shariah is concerned, the concept of riba prohibition does not differentiate between positive or negative interest rates if unjustified excess exists in money lending transactions. While most research is done on positive interest rate by the Islamic finance researchers, there are not many studies done on the below-zero interest rate and its impact on the economy.

Islamic Shariah promotes sales transactions as a definite alternative to riba transactions. The mudarabah investment deposits offered by Islamic banks is seen as the most similar model to interest based money lending transactions. The mudarabah concept of profit and risk sharing on the other hand, is seen as incapable of offering attractive profit rates to the depositors due to its non-speculative nature.

The intention of this case study initially is to understand the impact of negative interest rates on the economy, then to distinguish advantage and disadvantages between conventional interest rates in loan transactions and Islamic mudarabah investment deposits. As part of the Islamic finance community, we hope that we are in the position to promote Islamic financial instruments as a competitive alternative to the conventional financial products.

To achieve these objectives, the approach used in this case study is to review previous literature written on the impact of interest-based conventional financing compared to Shariah-compliant profit-based mudarabah investment deposits.

Prior to this study, there is an implied assumption that negative interest rates loans have a negative impact on the economy despite the optimism shown by the countries imposing the policy to their financial sector which is contrary to a positive impact on the economy through mudarabah investment deposits regardless of its unattractive return due to its non-speculative form.
2. FINDINGS

Money lending activities have played an important role in the economy. The establishment of various financial and banking institutions focusing on comprehensive processes including funds collection, savings, legal documentation etc. has become one of the profit-making sources and stimulator of the economy. Financial institutions gain profit from money lending transactions through interest rates, a certain percentage of excess over principle, will be paid over an agreed period.

In the case of the Malaysian economy, the determinants of interest rate charges are set by Bank Negara Malaysia. Generally, a high level of interest rates initially means higher cost of debt, contributing to lower demand for borrowings. Interest rates are also used as a tool to measure and to control the whole economy. For example, when the inflation rate increases, banks are required to hold a higher reserve, ensuing tighter money supply, or greater demand for credit, resulting in higher interest rates. In this situation, depositors prefer to save their money with the banks as they gain more profit from the savings rate. On the other hand, the investors in the stock market would sell their stock holdings to take advantage of the higher rate from savings than the lower returns from the stock market causing the stock market to fall. Limited access to capital funding through debt will impact most businesses and lead to a slump in the whole economy.

On the other hand, low interest rates initially indicate economic stimulation as borrowers have access to loans at a more affordable rate. As interest rates on savings are low, the private sector is more likely to allocate its funds on riskier investment vehicles. This development then stimulates spending in the economy and capital markets, leading to an expansion and economic growth.

The utilization of interest rates by policy makers to control the economy should be done in a discreet manner because any irresponsible move in setting the interest rate will cause a catastrophic disaster. Most governments prefer low interest rates, which eventually are able to lead to a market disequilibrium in which the demand rises higher than the supply, causing increase of the inflation rate, thus increasing the interest rates as well.
In Malaysia, under the supervision of Bank Negara Malaysia, an official indicator of the conditions in the interbank money market known as Kuala Lumpur Interbank Offered Rate (KLIBOR) has been established in 1987, similar to the global use of LIBOR (London Interbank Offered Rate). KLIBOR plays an important role as the benchmark reference rate for financial products including all debt instruments, government and corporate bonds, mortgages, student loans, credit cards; as well as derivatives, such as currency and interest swaps.

The interest rate is determined based on the calculation of the risk exposure, such as inflation-risk, default-risk, business-risk, liquidity-risk etc., where most of the risks calculation are speculative in nature. As we observe more, we will find that the rate charged on loans is volatile and unstable. A financial institution gains its profits based on the concept of time value of money, where the element of time actually plays a main role in multiplying the amount loaned to depositors.

The negative interest rates policy is a financial policy practiced by central banks by cutting interest rates to a below zero rate as a measure to demotivate savings among commercial banks and depositors by charging them for all the amount kept with banks. Ideally, most policymakers took this path to reduce borrowing costs for companies and households and later driving demand for loans.

The declining phenomenon of the global interest-based conventional economy has encouraged policymakers including the central banks in Japan, Denmark, and Switzerland to lower the interest rates to below zero and now it has become negative.

The European Central Bank (ECB) move by reducing its interest rate in June 2014, at which it lends to commercial banks, to 0.15% and its deposit rate, which it pays to banks on their reserves, to -0.1% and three months later to -0.2%. In the meantime, the Central Bank of Denmark set its main policy rate below zero for much of the past three years to repel capital inflows. In January 2015, the Swiss National Bank resorted to negative interest rates to deter investors from buying francs. In February 2015, Riksbank of Sweden set its main policy rate to negative to weaken the krona. In January 2016, the Bank of Japan followed the same approach by introducing 0.1% charges on banks for keeping additional reserves with the Bank, to encourage banks to lend and prompt businesses and savers to spend and invest.
Empirical studies done by Heider et al (2016) and Eggertsson et al (2017) suggest that even though its early intention was to stimulate the lending transactions in the economy, negative rates are less accommodative, could pose a risk to financial stability if lending is done by high-deposit banks, causes the usual transmission mechanism of monetary policy break down due to lesser profits for banks and could contract the total effect on aggregate output. It is concluded based on empirical evidence and scholarly studies that the implementation of a negative interest rates policy is an unfavorable approach.

Islamic finance, also known as interest-free finance, does not allow the existence of any kind of riba elements. Riba (usury or unjust), is defined as exploitative gains made in transactions. It is mentioned and condemned in the Holy Qur’an and various hadith of the Prophet (PBUH). Even though there is continuing debates on some of its technical details, all Muslim scholars throughout history have come to a collective agreement (Ijma’) on the prohibition of riba in Islam based on its whole textual Shariah jurisdiction.

There are two kinds of riba as described by most Islamic jurists, which are: (i) Riba An-Nasiya: referring to an excess charged for a loan in cash or kind and, (ii) Riba Al-Fadl: referring to the simultaneous exchange of unequal quantities or qualities of a given commodity. Some scholars have suggested a few reasons behind the prohibition of riba including its effect by corrupting one’s personality, but the most obvious reason is because of the unjust it causes.

In this regard, similar to positive interest rate, the negative interest rate falls under the definition of riba because it still bears the actual meaning, essence and causes of typical riba.

3. DISCUSSION AND ANALYSIS

The issues with interest-based financing facilities offered by conventional banking are intimidating and attractive, where the facilities are typically easier to be accessed by most consumers but are considered non-permissible by Islamic Shariah due to its speculative nature, that has the potential to bring instability into the economy.

Economic turmoil in the past few years due to the fall of crude oil prices in the global market has caused a few advanced economies to introduce the negative interest rate policy to attract more money lending from the banks, to stimulate the economy. Studies done by experts show that such a move has its own negative impact on the economy at a domestic and global scale.
As we explore Islamic finance for an equivalent alternative for interest-based loan transactions, we would find several Shariah compliant models such as zero-profit-loan qard al-hasan, cost-plus-profit of murabahah sale contract, and risk-and-profit-sharing contracts of mudarabah and musharakah. In this paper, we would like to seek solutions through the mudarabah investment model over interest-based loans.

Hassan & Bello (2014) indicate that a majority of Shariah scholars unanimously agree that mudarabah contract is permissible in Islamic law based on evidences from the Qur’an, Hadith, and Ijma’ (consensus).

In the Holy Qur’an, Allah said,

“…and others travelling in the earth in quest of Allah’s bounty.”

He also said, “Then when the prayer is finished, then disperse through the land (to carry on with your various duties) and go in quest of Allah’s bounty and remember Allah always (under all circumstances), so that you may prosper (in this world and the Hereafter).”

The word “mudarabah” was extracted from the Quranic verses, which means permissibility to travel in managing wealth to seek the bounty of Allah, and to disperse on the earth in an effort to seek wealth and bounty provided by Allah, including through joint ventures and trading means.

In a hadith reported by Solih bin Shu’ayb from his father, he said: The Prophet (PBUH) once said,

“There are three blessed things; deferred sale, muqaradah and mixing barley and wheat (for household consumption) and not for sale.”

The term “muqaradah” in the hadith which is derived from the word “qiradh”, means loans, is a common term used by scholars in Hijjaz, while ‘Iraqi scholars used “mudarabah” for the same meaning.

According to Shariah Resolutions in Islamic Finance of Bank Negara Malaysia (2010), there was no dissenting view among the companions of the Prophet (PBUH) regarding the permissibility of mudarabah and thus, it is considered as ijma’ (consensus).

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1 ‘Abdullah Yusuf ‘Ali, English Qur’an Translation, 73:20
Hassan & Bello (2014) have given a comprehensive explanation of the whole concept of mudarabah. In Islamic finance, a mudarabah contract is defined as a contract between two parties, where one party will provide the capital to the other party to run a business by based one profit-and-loss-sharing according to certain agreed upon conditions. The main purpose of a mudarabah contract is cooperation between the owner of the asset which will be regarded as their capital, with another party who has the skills but does not have the capital. Through a mudarabah contract, the skills and wealth can be benefited by both contracting parties. Through the mudarabah Investment Deposits, the bank offering the financing facility becomes an entrepreneur or ‘mudarib’ and the savings account customers become investors or ‘Sahib al-Mal’, or ‘Rabbul al-Mal’. In this case, the bank then deploys the deposited funds into various business activities and shares any profit gained based on a pre-agreed ratio. In the case of losses, the entire loss will be borne by the depositors. There are two types of mudarabah investment deposits account: (i) restricted investment deposits account, where the bank has the freedom to utilize the funds without any restrictions, and (ii) unrestricted investment deposits account, where it is limited by how the bank can deploy the funds, such as limitations on the period of time, the type of business location or the kinds or services. The mudarabah is highly recommended in Islamic finance.

There are a few concerns which downside its attractiveness to the investors or depositors which is low profit rates. Hifzur Rab (2004) added that the inflation rate has a significant effect on the profit rate of mudarabah investments. Hamzah et al (2014) suggest that the Islamic investment deposit product is an alternative to conventional interest-based facilities as a significant tool to increase the capital source of the Islamic financing facilities.

Based on the Shariah regulations on mudarabah contracts, in the case of mudarabah investment deposits, the goods purchased by the mudarib (Islamic bank), are solely owned by rabbul-mal (depositor), and the mudarib can earn his share of the profits only in case he sells the goods profitably. However, as soon as the partners mix up their capital in a joint pool, all the assets become jointly owned by all of them according to the proportion of their respective investments and all partners benefit from the appreciation in the value of the assets even if profit has not accrued through sales (Hamzah et al, 2014).

In my opinion, the mudarabah facility is seen as a more promising financing instrument despite it having much less to offer in terms of profit. In terms of benefit to the consumers, the underlying real assets offer security against speculations in the market. While the profit-risk sharing feature guarantees a lesser shock on the economy during any downturn events.
4. CONCLUSION

Global economic crises throughout the history of mankind have been caused by irresponsible and unjust economic activities. The implementation of interest-based transactions (riba), ambiguous contracts (gharar) and gambling (maysir) has cost humankind not only their wealth, but also stability in the community, which I believe in most events affect innocents lives.

The development of loan facilities for financing purposes from positive interest rates to below zero rates to bring back stability in certain economies has been forecasted to bring more failures rather than intended gains.

The Islamic finance point of view sees any form of interest-based facilities to never bring stability in the economy. With much more to offer, mudarabah investment deposits in Islamic finance has the potential to be the equivalent alternative for financing purposes.

5. RECOMMENDATION

Despite a less attractive profit rate offered in mudarabah investment deposits instruments, it is seen as a suitable alternative for interest-based loans. There is more to be done in improving the operational aspects of Islamic financial institutions in order to increase the efficiency and lower the cost of financing, thus increasing the potential profit.
6. REFERENCES


HOUZKEY: A NEW DIMENSION IN ISLAMIC BANKING

ABSTRACT

HouzKEY\(^1\) is the first rent-to-own (RTO) home financing product offered by an Islamic bank in Malaysia. It was launched in November 2017 by Maybank Islamic Berhad (MIB), the largest bank in ASEAN and one of the largest in the world with market share of the global Islamic finance assets around 5% in 2016\(^2\). It was subsequently opened to the public in the middle of January 2018\(^3\) and was the first of its kind to have an end-to-end digital banking experience, starting from choosing the properties to connecting potential home buyers with the developers.

HouzKEY is the first innovation in a Shariah-compliant banking product that extends MIB’s role further from being purely the financial intermediary, to also looking into its social developmental goal (SDG) which is home ownership. Arguably, this is seen as a breakthrough in what Bank Negara Malaysia (BNM) labelled as value-based intermediation (VBI) where the Islamic banking industry is expected to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders’ sustainable returns and long-term interests\(^4\). The paper looks at the distinct features of HouzKEY and analyses whether such an innovation is a competitive advantage or a threat to MIB specifically and the Islamic banking industry generally.

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In doing so:

- firstly, the paper introduces the policies introduced by Bank Negara Malaysia (BNM) from inception of Islamic banking in Malaysia until recently;
- secondly, the paper will look at market acceptance of the product;
- and last but not the least, the analysis on this innovation in the Islamic banking industry.

1. THE WAVES IN THE ISLAMIC BANKING INDUSTRY

The Malaysian Islamic banking industry is undergoing a wave of change that is driven by BNM’s initiatives for Islamic banks to be more than just credit or financial intermediaries. Instead, Islamic banks must realise its full potential to support the overall well-being of social and environmental goals which is consistent with the overall objectives of Shariah.

1.1. First: Islamic Financial Services Act 2013

After about 30 years of success in being the alternative to conventional banking – that is mirroring conventional products but in a Shariah-compliant way – the industry received its first wake-up call when Islamic Financial Services Act 2013 (IFSA) was introduced in July 2013. IFSA replaced the Islamic Banking Act 1983\(^5\) – the first legal provision which had resulted in the establishment of the first Islamic bank in Malaysia, Bank Islam Malaysia Berhad in the same year. IFSA is seen as the stepping stone in reshaping the Islamic banking environment.

One of the biggest changes in the IFSA is the differentiation between Islamic deposit and investment accounts. Since then, Islamic banks have undertaken steps to ensure that markets are not shocked by the move – especially the fact that Islamic banks are not obliged to repay any money (principal and or profit) of an investment account. The transition was rather smoothly done where customers did not feel the drastic change from deposit to investment account mainly because the latter was structured to be similar to the then deposit. For example, customers could still use the automatic teller machine (ATM) facility to withdraw their ‘investment’.

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\(^5\) Islamic Financial Services Act 2013 repealed both the Islamic Banking Act 1983 and the Takaful Act 1984. Section 282, IFSA.
1.2. Second: Realigning Shariah and Business Conducts

After IFSA, the second wake-up call was the issuance of a series of shariah policy documents by BNM. There are altogether 14 Shariah policy documents whereby the final one of Rahn was issued on 18 July 2018. These policy documents set out not only shariah requirements but also operational requirements which explained how the Shariah requirements should work in practice. The policy documents are expected to produce a level playing field for all Islamic banks through consistency in product offerings. The policy documents reintroduced or reemphasised the existing shariah contracts although some of them may have impacts towards product offering. For example:

- In ijarah policy document, Islamic banks as lessors are required to bear all risks and rewards relating to the underlying assets, including risk of force majeure events; and

- When an asset under construction is acquired using musyarakah mutanaqisah financing, failure of the developer or manufacturer to deliver the asset at the agreed time shall not be a trigger event for the Islamic banks to invoke a wa’d.

Initial responses indicated that banks may shy away from doing ijarah and musyarakah financing in the future and will opt for commodity murabahah structure as that best suits their current risk profile. Therefore, compliance with the regulations does not come in handy as there will be additional costs such as system changes and personnel costs. These operational costs will then have an effect to the end user and may challenge the competitiveness of Islamic banking products versus those offered by conventional banks. Customers are generally not ready to pay premium prices for Islamic banking products when the conventional banks’ products are cheaper. Although there has not been any research on customers’ behavior, the author is of the view that a lay customer is not ready to pay more for a Shariah-compliant product when conventional banks can offer the same product at a cheaper rate.
1.3 Third: Going Beyond Financial Intermediation Into Social and Environmental Responsibilities

The final wave seems to be the introduction of Value-Based Intermediation (VBI) by BNM. VBI is meant for Islamic banks to go beyond financial intermediation and to recognise their full potential to support the social and environmental goals that is aligned with the overall objectives of Shariah. The intended objectives of Shariah are mainly to increase the well-being of the community through preservation of wealth, faith, lives, posterity and intellect. Therefore, VBI is not a completely new concept as it brings about the element of Sustainable Developmental Goals (SDG) and Environmental, Social and Corporate Governance (ESG), Ethical Finance and Sustainable, Responsible, Impact Investing (SRI) into play. For example, the world debut green sukuk issued by Tadau Energy Sdn Bhd to finance the construction of large-scale solar photovoltaic power plants in Kudat Sabah was approved by the Securities Commission Malaysia under its SRI sukuk framework. Sukuk Ihsan by Khazanah Nasional Berhad is another example of an SRI sukuk to raise funding to improve the accessibility of quality education in Malaysian government schools.

While those are the examples of VBI in the capital market segment, *HouzKEY by Maybank Islamic Berhad (MIB) is the first of its kind in the Islamic banking industry*. MIB has taken up the challenge and innovate its products to facilitate Malaysians' issue of home ownership. The question now is whether HouzKEY is a step in the right direction and could HouzKEY be the game changer in home financing products in Malaysia.

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8 www.khazanah.com.my
2. **HOUZKEY’S VALUE PROPOSITION**

The main objective of HouzKEY is to provide financial assistance to first time home buyers. It is targeted at a certain segment of the population, particularly those who have little to sacrifice for the minimum 10% deposit to enable them to own a house. The idea started about two years after IFSA came into effect where MIB realised that there was a need to create a different structure to serve the unserved market, i.e. the population with either not enough down payment to own a house or those who prefer to keep the down payment for rainy days and hence are not able to own a house. *Its overarching objective is to take Islamic banking into the mainstream and to fulfil part of the sustainability agenda.* In doing so, a property division was established within MIB to manage this portfolio and particularly to choose the best properties in the market for customers to choose from. This division also connects the potential home buyers with the property developers for house viewing, panel of lawyers and valuers through an integrated digital platform such that an application status can be created within 24 hours from the time of application.

Within one and a half months after opening it to public, the web platform hosted 16 property developers, 27 projects and garnered more than 200,000 viewers. These numbers were encouraging and to add to the volume, HouzKEY was opened to the secondary market on 16 May 2018. Since then, it has attracted 200 real estate agents who discovered the scheme via the Malaysian Institute of Estate Agents.  

In summary, the main attractive feature of HouzKEY is the zero down-payment and a customer could walk-in to the house subject to paying 3 months rental in advance. However, whether this feature would excite the market or otherwise remains unknown. The fact that the product is offered to the secondary market implies that MIB is working hard to sell the product.

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9 Ideas and concepts written in this part of the Paper are summarised from BFM’s radio interview sessions with Dato’ Mohamed Rafique Merican, CEO of Maybank Islamic Berhad and Sally Lye, Managing Director, Real Estate Venture, Group Global Banking, Maybank Group on 14 February 2018 and 2 March 2018 respectively.

10 [https://www.edgeprop.my/content/1331419/phase-2-maybank%E2%80%99s-houzkey-focus-secondary-market](https://www.edgeprop.my/content/1331419/phase-2-maybank%E2%80%99s-houzkey-focus-secondary-market)
3. HOUZKEY VERSUS HOME FINANCING

3.1 Eligibility

The first criterion is household income. HouzKEY requires a minimum household income of RM5,000 and the individual must not have more than one home loan/home financing at the time of application. \textit{RM5,000 is arguably a good starting point since the median household income in 2016 was RM5,228 and the statistics show that the biggest household expenditure was for housing, i.e. 24\% (including water, electricity, gas and other fuels))^{11}}. In contrast, there is no minimum income requirement for Maybank’s Commodity Murabahah Home Financing\(^{12}\) but the customer would be screened for his/her debt service ratio for each financing application.

3.2 Price

Structured using the ijarah contract, MIB as the lessor allows customers to choose the properties from its website at www.maybank2own.com. At the time of writing, there are about 1,400\(^{13}\) properties to choose from with monthly rental ranges from RM1,275 to RM5,280 per month. When the price is set to be within the range of RM1,275 to RM1,650, the system displayed 5 items. This price range is set mainly because the idea of HouzKEY was to serve the unserved market. The author is of the view that the range is suitable for an individual with a RM5,000 household income who will spend about 24\% of that for housing; and that is RM1,200. Using the price range above, the cheapest unit is priced at RM1,280.50 per month for a unit of Verdi Residence in Cyberjaya with an average built up space of 700 sq. ft.\(^{14}\). For this unit, the customer is required to pay 3 months advanced rental deposit amounting to RM3,841.50.

In contrast, under home financing, the customer needs to pay at least RM31,500 for down payment, based on the market price of RM315,000 for a 699 sq. ft. listed property on i-property.com. \textit{Additionally, under HouzKEY, the customer will have extra savings on legal fees and other associated costs as opposed to a home financing. This marks a huge difference in terms of the initial investment one needs to make in owning a home.}

\(^{12}\) Based on the information on Maybank Islamic Berhad’s website.
\(^{13}\) Based on the HouzKey’s portal: Developer seller (13) and individual seller (1386).
\(^{14}\) https://www.maybank2own.com/portal/index.php?id_product=82&controller=product
3.3 Product Structure

As a lessor, MIB is the landlord during the rental period until the customer exercises the option to purchase the property. Under the rent-to-own structure, MIB will purchase the house and rent it for a maximum of a 30-year period using the ijarah contract with the first five years being the lock-in period. Therefore, a customer could choose to walk away after the fifth year without any penalty. The ijarah rental paid during the lock-in period will then be used to set off against the purchase price if the customer wishes to purchase the house. Therefore, the customer will be in a worse-off position to walk away after the fifth year, unless market value of the property exceeds the price of the house. If the customer chooses to opt-out during the first year of the rental period or before the lock-in period expires, there will be a penalty charge imposed which is equivalent to the sum of the remaining rentals of the locked-in period.

Structurally, this is similar to a home financing structure where customers will bear the differences if proceeds from the sales of the house is insufficient to cover the outstanding financing amount upon default or dissolution of the contract.

On the flip side, if a customer walks away from the scheme after the lock-in period, the customer pockets any capital appreciation that the bank makes from selling the property. Again, this feature is similar to home financing whereby any excess in sale proceeds will be returned to customers.

Hence, there is no major difference, economically, between HouzKEY and home financing and due to its main objective of being the financial provider to home ownership, credit risk remains the key element in pricing. Therefore, it seems that it is priced and sold in a way that the bank will get its estimated return (or profit) to cover costs\(^\text{15}\).

Full comparison of home financing versus HouzKEY is detailed in Appendix 1.

\[^{15}\text{Arguably incidental costs will be minimal as the Government is allowing full exemption for stamp duty on the sale and purchase agreement and memorandum of transfer. In addition, the Government would also be reviewing the real property gains tax (RPGT) for sales of properties before the fifth year.} \]

\[\text{http://www.theedgemarkets.com/article/100-stamp-duty-exemption-spa-bankinitiated-rto-schemes}\]
3.4 Initial Responses

It seems premature to gauge the success or any lessons-learnt with HouzKEY at this juncture\(^{16}\). Furthermore, it was recently launched to the secondary market and hence, it may be some time before one can see the full effect of the product. The author is unable to get the statistics on the take-up rate for HouzKEY but initial discussion with staff of MIB indicated that the product received lukewarm response from the market. Based on a desktop research, the responses were mixed. The housing developers’ association welcomed the idea as a means to boost sale of properties especially in the vicinity of Klang Valley. *On the other hand, the workers’ union\(^{17}\) felt that the units listed in the HouzKEY portal were completely unaffordable taking into consideration the increased costs of living.*

As far as MIB is concerned, HouzKEY was not designed to solve the issue of affordable housing in Malaysia. Affordable housing and home ownership remain the agenda of the government. MIB is merely providing an alternative to home ownership; and this does not necessarily mean affordable home ownership.

To a layperson, owning a home is accustomed with the concept of a ‘mortgage’ and the differences in value proposition brought by HouzKEY seems to create a level of disparity between the conventional and Islamic bank’s product. Therefore, they may take some time to understand how it works. To astute customers, HouzKEY may be something that they are looking forward to; especially to upgrade their properties through renting-first-then-owning formula of the product.

3.5 Pricing and Gaining Competitive Advantage

Generally, a bank prices its product to include consideration for credit risks and the effect of time value for money. *Because HouzKEY is changing the way MIB does business, such as being a landlord with its own property division, it is likely that a fraction of this ‘operational cost’ is included in the price.* In contrast, a home financing may not have the last element of operational costs as they are borne by the customer.

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\(^{17}\) Congress of Unions of Employees in the Public and Civil Services (CUEPACS) commented that HouzKEY is expensive and simply unaffordable. [https://www.malaymail.com/s/1556265/with-rent-above-rm2300-unions-say-rent-to-own-scheme-unaffordable](https://www.malaymail.com/s/1556265/with-rent-above-rm2300-unions-say-rent-to-own-scheme-unaffordable)
In a net position, a customer may be economically similar but HouzKEY will result in a slightly higher rental than an average home financing; mainly because:

- HouzKEY finances 100% of the house price plus the operational costs (such as stamping and legal fees) – that may make up to 105% financing; and

- Home financing product finances 90% of the house price (assuming a 10% deposit).

Clearly, one is cheaper than the other and hence, one would argue that HouzKEY may not be a perfect solution to home ownership as the customer will end up paying more in rentals than instalments for financing. The key to this pricing is that HouzKEY provides solutions in the following ways:

- Zero upfront costs, except for the 3 months’ advanced rental; therefore, it is targeted to customers with nil or insufficient initial investment.

- Easy to shift from renting to owning after one year and this option remains open until the end of the 30-year maturity period (full term).

Included in operational costs could also be a fraction of probability of other business and market risks that MIB as the lessor has to bear. For example, the cost of the asset in a force majeure event is the responsibility of the lessor, as resolved by BNM Shariah Advisory Council at its 181st meeting dated 27 October 2017\(^\text{18}\).

Arguably, HouzKEY needs to include in its pricing the above considerations and hence, it is not parallel to home financing as well as conventional home loans. This puts the bank’s competitive advantage at risk because customers would not generally pay for premium when cheaper alternatives are available. An exception to this is those who do Islamic banking because of faith and religion; instead of seeing it as an alternative to conventional banking.

\(^\text{18}\) In the event where the damage caused by force majeure is beyond the available takaful/insurance plan offered in the market, it is the responsibility of the IFI as asset owner to bear the loss. Nevertheless, the burden of proof shall be upon the lessee. If the lessee fails to provide proof against his negligence, the lessee will be responsible for the damage of the ijarah asset. Available at: \(\text{http://www.bnm.gov.my/documents/SAC/SAC%20181st%20Meeting%20Statement%20EN.pdf}\)
4. THE ANALYSIS

So, we have seen HouzKEY as an innovation in the Islamic banking industry. Why an innovation? That is mainly because under this structure, MIB is the landlord and not merely a financier. One may then ask; shouldn't that happen in all Islamic finance transactions that require assets to underlie them? Whilst the answer is always a 'yes' in theory, it does not always translate in practice. For example, under HouzKEY, MIB owns the assets (houses) for customers to choose from. In contrast, in other types of ijarah financing, a customer always goes to the bank only after an asset has been identified. For example, in a vehicle ijarah financing, the current model used by most banks is that the customer would choose the vehicle from the dealer and then arrange for financing with the bank. Although the bank is the legal owner during the ijarah period under both circumstances, the difference is that HouzKEY allows customer to choose only from MIB’s list of assets. Therefore, the structure is clearer and one could relate to the theory of an ijarah.

HouzKEY seems to be the way to move forward, at least from the perspective of policies and BNM initiatives such as VBI. Additionally, IFSA allows Islamic banks to do more than just financial intermediation and this seems to be an added competitive advantage for Islamic banks to venture into other types of activities which the conventional banks are restricted by its Financial Services Act 2013 (FSA). In this case, conventional banks may be restricted to hold houses in doing businesses such as HouzKEY.

That said, the cold responses on HouzKEY may indicate that the market is not ready, coupled with other factors such as increases in cost of living that consumers tend to spend on small ticket items rather than home financing. One could argue that customers largely want the same from Islamic banks of what conventional banks have to offer, in terms of pricing and product. Therefore, education is key for customers to appreciate that Islamic banks could be distinct in its own way and that the days where Islamic products mimic conventional products may soon be gone.
5. CONCLUSION

Reshaping Islamic banking into an ideal way of banking as purported by the VBI initiative requires considerable amount of time and effort. It involves a key group of stakeholders, namely the regulators, the players (supply side) and the customers (demand side). With strong support and commitment from the regulators such as BNM, Islamic banks will need to take the quantum leap to innovate new products to ensure that the full potential of Islamic banks are achieved. The effort includes educating investors and customers about the change in the Islamic banks’ role. Striving in an environment that works parallel with conventional banking adds on pressure for Islamic banks to remain competitive and continue to be at the forefront in the global footprint.

The dynamic shift in the GCC countries should not be ignored and statistics prove that the market share of GCC states continues to increase with Saudi Arabia at 20.6% (19% in 2015) of the global Islamic banking, asset as of 2016; leaving it to be the second largest after Iran and followed by Malaysia at 9.3% (no change)\(^\text{19}\). *Focusing too much on innovation may steer away the focus to meet customers’ demand and if customers are not ready to accept banks as being more than just financial intermediaries, there needs to be a paradigm shift at the national level to allow for the rebirth of the industry into what BNM purported it to be.* HouzKEY is successful in terms of its design, whereby it is closely aligned to the concept of ijarah in the Shariah policy document but there is a conundrum between realising the full potential of an Islamic bank and at the same time gaining customer’s demand for a seamlessly ‘same but different’ home financing product.

Appendix 1: Comparison of a mortgage and HouzKEY as illustrated by Maybank Islamic Berhad.

Below is the difference between rental amount under HouzKEY vs. instalment amount under Mortgage:

<table>
<thead>
<tr>
<th>Year</th>
<th>HouzKEY</th>
<th>Mortgage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>31,972</td>
<td>31,972</td>
</tr>
<tr>
<td>2</td>
<td>31,972</td>
<td>31,972</td>
</tr>
<tr>
<td>3</td>
<td>31,972</td>
<td>31,972</td>
</tr>
<tr>
<td>4</td>
<td>31,972</td>
<td>31,972</td>
</tr>
<tr>
<td>5</td>
<td>31,972</td>
<td>31,972</td>
</tr>
<tr>
<td>6</td>
<td>32,611</td>
<td>31,972</td>
</tr>
<tr>
<td>7</td>
<td>33,263</td>
<td>31,972</td>
</tr>
<tr>
<td>8</td>
<td>33,929</td>
<td>31,972</td>
</tr>
<tr>
<td>9</td>
<td>34,607</td>
<td>31,972</td>
</tr>
<tr>
<td>10</td>
<td>35,299</td>
<td>31,972</td>
</tr>
<tr>
<td>11</td>
<td>36,005</td>
<td>31,972</td>
</tr>
<tr>
<td>12</td>
<td>36,725</td>
<td>31,972</td>
</tr>
<tr>
<td>13</td>
<td>37,460</td>
<td>31,972</td>
</tr>
<tr>
<td>14</td>
<td>38,209</td>
<td>31,972</td>
</tr>
<tr>
<td>15</td>
<td>38,973</td>
<td>31,972</td>
</tr>
</tbody>
</table>

B. Comparison between HouzKEY and Mortgage cash flow

Table 1: Comparison on the Potential Costs To Be Borne by Customer

<table>
<thead>
<tr>
<th>Property Amount</th>
<th>HouzKEY</th>
<th>Mortgage</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPA Purchase Price</td>
<td>RM500,000</td>
<td>RM500,000</td>
</tr>
<tr>
<td>Financing Amount / Lease Value</td>
<td>RM517,500</td>
<td>RM450,000</td>
</tr>
</tbody>
</table>

Initial Costs

| At Year 0: | | |
| Deposit (10%) | N/A | RM50,000 |
| Transactional Costs (Legal, Stamp Duty, etc) | N/A | RM17,500 |
| Security Deposit (3 months rental) | RM8,192 | N/A |
| Total Initial Cost per Customer | RM8,192 | RM67,500 |
| Initial Cost as a % of SPA Purchase Price | 2% | 14% |

Total Payment for the first 5 years

| Monthly Rent/Installment | RM2,731 | RM2,280 |
| 5 Years Accumulated Payments | RM163,848 | RM136,805 |
| Total Payments in 5 Years | RM172,041 | RM204,305 |
| Initial Savings Under HouzKEY | RM32,264 |

Note: The above costs does not include any other expenses related to the individual properties such as quit rent, assessment fee, maintenance fee that would vary from one property to another.

1 Lease Value for HouzKEY includes transaction costs on the property value
2 Transactional costs of 3.5% above is based on the average cost for individual title property
3 Mortgage Profit Rate @ 4.50%.
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REVIVING TAKAFUL-WAQF PRODUCTS IN MALAYSIA:
ISSUES AND CHALLENGES

Nurul Hidayah Zailani
Malaysian Institute of Accountants
ABSTRACT

The growth of the takaful industry together with the value-based intermediation (VBI) initiative warrants an intellectual discussion on how the waqf concept can be utilised and revived in the modern Islamic economy of Malaysia. The waqf concept has been used in takaful products in other jurisdictions and hence, this paper aims at a thought-provoking discussion on the potential of a waqf concept to be reintroduced in the Malaysian takaful market. Among others, this paper proposes a wakalah-waqf model to be explored by takaful operators in Malaysia.

1. INTRODUCTION

Waqf or endowment is believed to have started as far back as during Prophet Muhammad’s (PBUH) time. During Prophet Muhammad’s (PBUH) time, waqf was created to address the pressing needs of the society. Encouragement to do waqf is deduced from the Hadith Riwayat Muslim (1631) of the Prophet Muhammad (PBUH) which states:

“When the son of the Prophet Adam a.s. passes away, his good deeds will be cut off except for three things: endless charity (sadaqah jariah), knowledge which benefits mankind and a pious offspring, who always pray to both his father and mother.”

Although the term waqf was never explicitly stated in the Quran or Hadith, Muslims believe that the creation of waqf is one of the ways for the founders to attain continuous rewards from Allah even after his death. For the purpose of attaining continuous rewards and to gratify Allah, the founder bequeaths his/her property to be used or utilised by the ummah.
Waqf was also the most powerful economic tool during the Islamic civilisation. Waqf was used to cover almost all service sectors, such as health, education, basic infrastructures, business and commercial activities, job creation, food provision for the hungry and the animals, shelter provision for the poor and needy, in addition to supporting agricultural and industrial sectors without any cost to the government. Despite significant contributions and achievements of waqf in the past, the potential of the waqf system seems to be under-utilised in today’s modern Islamic economies.

Acknowledging the fact that waqf is under-utilised in modern Islamic economies and the rapidly growing takaful industry in Malaysia, this paper believes that utilising the waqf concept in takaful products would be able to drive the takaful industry in Malaysia to a higher level and at the same time, support the value-based intermediation (VBI) initiative introduced by the Central Bank of Malaysia (CBM). The VBI initiative aims to deliver the intended outcomes of the Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders’ sustainable returns and long-term interests. Both waqf takaful and VBI in principle focuses on the enhancement and well-being of the people which include generating, accumulating and distributing wealth in a just and fair manner.

2. WHAT IS WAQF?

There are various literature in the market that discuss and deliberate the term waqf. One of the literature defines waqf as the holding and preservation of a certain sadaqah jariah; a continuous charity with the intention of prohibiting any use or disposition of the property outside the specific purposes to which the property is dedicated and in a way that it cannot be bequeathed or sold. The four Islamic schools of law had also provided a definition and/or view on waqf as follows:

- Imam Abu Hanifah – the detention of a specific property from the ownership of the founder of the waqf and dedicating its revenue to charitable purposes in the manner of a loan.
- Imam Malik – the confinement of property for the cause of Allah.
- Imam al-Shafi‘i and Imam Ibn Hanbal - the confinement of a property and the pledge of its usufruct in perpetuity for the cause of Allah.

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In general, there are three key restrictions of waqf which are as follows:

(1) Irrevocability – The founder cannot revoke the dedication of the property that has already been declared as waqf. Thus, ensuring that neither the founder nor the heirs have the right to take it back or change the status of the waqf property.
(2) Perpetuity – Waqf must be perpetual once it is created such that there would be no confiscation of the property either by government or by individual or institutions.
(3) Inalienability – as property for waqf is transferred to Allah and it is in a form of ‘frozen property’ and cannot be subjected to any sale, disposition, mortgage, gift, inheritance or any alienation².

3. WHAT IS TAKAFUL?

The term ‘takaful’ is derived from the Arabic root word Kafalah which means ‘to guarantee’. The takaful business is built based on an Islamic concept of brotherhood or mutual assistance, mutual protection and solidarity among the participants. Under this concept, the participants mutually agree to guarantee and provide assistance to other fellow participants who are inflicted with a specific risk from an unfortunate event. In this way, the burden of the inflicted participants become lighter. In takaful, participants contribute a sum of money into the takaful fund and through tabarru’ principle, participants are committed to donate money to be used to compensate inflicted participants. The concept of brotherhood or mutual responsibility is deduced from verse 2 of Surah Al-Maidah which states:

‘… And cooperate in righteousness and piety, but do not cooperate in sin and aggression. And fear Allah; indeed, Allah is severe in penalty.’

The first evidence of resemblance to the practice of takaful was believed to be by Al-Ash‘arys where they pooled all the food that they had in times of starvation and divided it among all members of the pool. Although this practice is slightly different from the current practice of takaful where the benefits are given to those who are afflicted by an unfortunate event, the principle of cooperation is applied in takaful operation.

² Wealth Planning and Management Waqf by INCEIF. Retrieved on 6 August 2018 from https://www.slideshare.net/emailtoshahed/lecture-08-12627708.
4. WAQF: THE PREFERRED CHOICE

One of the pertinent questions is perhaps ‘why waqf?’ and not other vehicles/legal entities such as trust and foundation. The preference is perhaps because the term ‘waqf’ is more acceptable and closer to the heart of Muslims as compared to trust company and foundation. A high level summary of differences between waqf, trust and foundation in Malaysia are as follows:

<table>
<thead>
<tr>
<th>Acts and regulations</th>
<th>Waqf</th>
<th>Trust Company</th>
<th>Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Islamic Law statues or respective state enactments</td>
<td>Trust Companies Act 1949</td>
<td>Either under:</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Trustees Act 1952; or</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Companies Act 2016</td>
</tr>
<tr>
<td>Governing body</td>
<td>State Religious Councils (SRCs)</td>
<td>Companies Commission of Malaysia (SSM)</td>
<td>Either under the purview of:</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Prime Minister’s Department (those under Trustee Act 1952); or</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Companies Commission of Malaysia (SSM) (those under Companies Act 2016)</td>
</tr>
<tr>
<td>Initial fund</td>
<td>No fixed amount</td>
<td>RM500,000</td>
<td>No fixed amount (under Trustees Act 1952)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>RM1 million cash (under SSM)</td>
</tr>
<tr>
<td>Management</td>
<td>SRCs or mutawalli as approved by SRCs</td>
<td>Chief Executive Officer/Directors/Officers/Employees</td>
<td>Board of Trustees</td>
</tr>
</tbody>
</table>
5. WAQF TAKAFUL IN MALAYSIA: WHERE ARE WE?

Takaful is not a new industry in Malaysia where the Takaful Act itself was enacted in 1984. A year after the enactment of the Takaful Act 1984, the first Malaysian takaful company, Syarikat Takaful Malaysia Sendirian Berhad, was established. Since then, Malaysia has proactively driven the growth of takaful businesses in Malaysia, from 1 takaful operator in 1985 to 11 takaful operators as at 31 December 2016 with total takaful fund assets that stood at RM26,792 million as at 31 December 2016³.

![Takaful indicators (2011 - 2016)](chart.png)

**Chart 1: Takaful indicators from 2011 to 2016**

Waqf takaful was first introduced in Malaysia by Syarikat Takaful Malaysia under the mudarabah-waqf model called the ‘Takaful Waqf Plan’. The plan was in existence from 2002 until 2009 and received strong support from participants throughout the period. The plan had successfully attracted approximately 5,000 participants (from 2002 to 2004) with a total contribution of RM7.5 million. The plan allowed people from all walks of life to participate and at the same time maximise their contribution to charity while having other financial commitments.

The operation of Takaful Waqf Plan introduced by Syarikat Takaful Malaysia is depicted in the diagram below:

![Diagram 1: Takaful Waqf Plan issued by Syarikat Takaful Malaysia](image)

The model introduced by Syarikat Takaful Malaysia allows participants between the age of 18 to 70 years old to participate in the establishment of a future waqf through regular savings or contributions as minimal as RM10 over a certain period of time. The product offered allows participants to contribute the desired waqf amount even if the participant dies prior to the maturity of his/her plan.

A summary of the model is as follows:

1. Contributions received from participants are divided into two accounts – i.e. Participant Account and Special Participant Account (based on tabarru’ concept) according to the agreed proportion.
2. Participants appoint a takaful operator as their wakil or agent to manage the waqf fund. The takaful operator is remunerated with a wakalah fee for managing and administrating the fund.
3. Participants also allow the takaful operator to invest the fund in Shariah compliant instruments in order to generate returns. The return generated from the investment is shared based on an agreed ratio between the fund and takaful operator.
4. In the case where a participant dies before his/her plan matures/reaches maturity, the Special Participant Account is used to pay for the deceased participant’s balances in order to fulfil his/her wish on the targeted waqf fund.
5. Participants are required to determine the beneficiaries of the donated waqf which are limited to institutions that have registered with Syarikat Takaful Malaysia.
The following are some of the beneficiaries of the Takaful Waqf Plan:

a) Mosques as approved by State Religious Affairs;

b) Orphanage centres;

c) Educational funds;

d) Yayasan Pembangunan Ekonomi Islam Malaysia (YPEIM); and

e) Tabung Kebajikan Jemaah Haji⁴.

Various research was conducted to understand the limitations of the Takaful Waqf Plan. Among the research that discussed the challenges and limitations of mudarabah-waqf model as introduced by Syarikat Takaful Malaysia was by Asmak Ab Rahman and Wan Marhaini Wan Ahmad in their research titled “The Concept of Waqf and Its Application in an Islamic Insurance Product: The Malaysia Experience”. The research highlighted the following issues:

1. It is unclear from the mudarabah contract on who should bear the loss of the investment as it was not sufficiently mentioned in the contract;

2. Some of the procedures conducted by takaful operators in performing the waqf deeds are unclear;

3. No appropriate maximum limit for the waqf amount, which exposes the model to the risk of insufficient accumulated fund from the Special Participants Account; and

4. The power and mandate to manage waqf is only given to state religious affairs.

Dr Ezamshah Ismail and Dr Magda Ismail A. Mohsin in their paper titled ‘Towards Integrating Trust in Takaful Model’ states that the Takaful Waqf Plan was withdrawn due to the complexity of existing rules on waqf in Malaysia as the State Religious Councils (SRCs) have the right to manage it. This reason stands as one of the obstacles for the continuation of Takaful-Waqf⁵.


⁵ Towards Integrating Trust in Takaful Model
6. WAQF TAKAFUL: PRACTICES IN OTHER JURISDICTIONS

This study noted that waqf takaful products are commonly used in Pakistan and South Africa. The waqf takaful products offered in these jurisdictions are mainly based on wakalah-waqf model. Under this model, takaful operators (being the shareholders) will first create the waqf fund through a waqf donation. Participants who participate in this waqf takaful policy would then contribute to the waqf fund based on a tabarru’ concept. The waqf fund is then used to help and assist participants who are in need whereby all claims are paid through the waqf fund. Takaful operators play two roles in the wakalah-waqf model which are (i) takaful operators are appointed as wakil or agent to manage and operate the waqf fund and receive a wakalah fee which will be paid from the waqf fund itself; and (ii) takaful operators receive a wakalah fee upfront for the investment service of the waqf fund. Any investment profit from the waqf fund would normally be kept or channelled back to the waqf fund to cover future losses and deficits, distributed among the participants or donated to charitable organisations.

Example 1: Wakalah-Waqq Model by Takaful Pakistan Limited\(^6\)

Example 2: *Wakalah-Waqf* Model by Dawood Family Takaful

Example 3: *Wakalah-Waqf* Model by Pak-Qatar Family Takaful Limited

The main challenge on the wakalah-waqf fund adopted by other jurisdictions mainly arises from the risk of whether there is sufficient waqf fund to cover takaful claims from participants. As the fundamental set up of a wakalah-waqf in other jurisdictions is to help and assist participants who are in need, large takaful claims may jeopardise the waqf fund from continuing in perpetuity.

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7. **WAQF TAKAFUL: WHAT’S NEXT FOR MALAYSIA?**

This study acknowledges the limitations identified in the previous mudarabah-waqf model by Syarikat Takaful Malaysia and the success of a wakalah-waqf model used in other jurisdictions such as Pakistan and South Africa as mentioned in earlier sections of this paper. This study believes that the wakalah-waqf model can be applied by takaful operators in Malaysia for their products with some improvements as follows:

![Diagram 2: Proposed wakalah-waqf product](image)

Under this proposed wakalah-waqf product,

a. Takaful operator donates seed fund to establish a waqf fund for the product/policy.

b. On a monthly basis, premium contributions made by participants are split into two portions – a portion for tabarru’ contribution to waqf fund and a portion to participants’ risk account. The appropriation (based on percentage of premium contributed) shall be decided and agreed upfront between the takaful operator and participants.

c. Any takaful claims will only be paid/deducted from the participants’ risk account while any surpluses will be credited back into the same account.

d. Both waqf fund and participants’ risk account will be invested in Shariah compliant instruments to generate returns where the return from the participants’ risk accounts will be credited back to the account. Return from the waqf fund however, will be channelled to the waqf beneficiaries as approved by the takaful operator’s Shariah Committee.
e. In the event of death, the deceased’s beneficiaries will be compensated with the takaful benefit from the participants’ risk account. No further amount is paid on behalf of the deceased to the waqf fund (hence, the contribution to waqf fund is limited to the amount contributed while the participant is alive).

As compared to the wakalah-waqf model used in Pakistan and South Africa, the proposed wakalah-waqf model above has the following advantages:

1. Except to pay for administrative expenses and wakalah fee of managing the waqf fund, the waqf fund is relatively stable as it cannot be used to pay for participants' takaful claims, even in the event of death. The waqf fund belongs to neither any of the participants nor the takaful operator. As such, it ensures the perpetuity of a waqf fund towards charitable and good causes as intended by the participants.

2. A Shariah Committee has the discretion and flexibility to channel waqf benefits to selected beneficiaries based on current needs at any point in time. For instance, the waqf benefits can be channelled to hospitals to support purchases of medical equipment, education loans, schools, water and electricity supply or micro-financing for under-privileged communities.

This study also recognises that the proposed wakalah-waqf model above comes with some practical challenges which among others are as follows:

1. Taking into consideration the current laws and legislation in Malaysia, waqf is still under the purview of the SRCs – be it for public waqf, family waqf or combination of the two as provided by the Ninth Schedule of the Malaysian Federal Constitution which states: “except with respect to the Federal Territories of Kuala Lumpur, Labuan and Putrajaya, Islamic law and personal and family law of persons professing the religion of Islam, including the Islamic law relating to …wakafs and the definition and regulation of charitable and religious trusts, the appointment of trustees and the incorporation of persons in respect of Islamic religious and charitable endowments, institutions, trusts, charities and charitable institutions operating wholly within the State…” SRCs however, are allowed to appoint any organisation as their mutawalli/nazir to manage and administer the waqf asset/fund as well as to execute what is intended by the donor (waqif).
For example, as stated in Section 8 of Wakaf (State of Selangor) Enactment 2015:

“The Majlis may, by resolution, and subject to the conditions and restrictions as the Majlis deems fit, delegate to the Corporation the discharge of any of its duties or the exercise of any of its power under this Enactment.”

Creation of waqf is rather straightforward whereby it is created by way of sighah between two witnesses according to Hukum Syarak and such waqf to be registered as soon as practicable with the SRCs\(^9\). However, one of the practical hurdles that takaful operators in Malaysia need to address is whether the SRCs would allow takaful operators to be their mutawwali to manage and administer the waqf fund embedded in the takaful product, particularly in the absence of specific laws and regulations to govern the rights and duties of mutawalli in waqf matters. This could probably be one of the concerns to appoint mutawalli as there are some irresponsible parties who misuse waqf fund/properties, assuming that waqf is the public domain that can be abused and dominated, ignoring the ultimate intention of donors. Unless such permission is given/granted by SRCs, takaful operators may not be able to maximise the concept of waqf in their takaful products.

\(^{(2)}\) In Malaysia, takaful products are normally distributed through direct or indirect channels. Direct distribution channel refers to distribution of takaful products through either their head office and branch premises or an online platform while indirect distribution channel refers to other types of distribution channels including agency distribution and bancassurance. There is a need for takaful operators to consider the pricing structure of the wakalah-waqf product to balance between the cost of takaful risk and takaful premium pricing in order to ensure profit margin is maintained at an acceptable level and thus, will not hurt shareholders in the long run.

\(^{(3)}\) Another key consideration that takaful operators need to analyse is on selecting the participants for such products. For instance, participants with low risk and within certain age groups. Takaful operators may also need to consider whether the premium contribution of such products should be increased to cater to the takaful risk and continuous participation of the programme in the long run.

\(^9\) Wakaf (State of Malacca) Enactment 2005, Wakaf (State of Perak) Enactment 2015 and Wakaf (State of Selangor) Enactment 2015
(4) It is noted that the waqf fund itself belongs to neither the participants nor the takaful operator. The waqf fund should be carefully managed by the takaful operator, being the agent appointed by participants and shareholders. The takaful operator, being the agent shall demonstrate full transparency and adhere to high governance standard to ensure that the waqf fund is properly managed and utilised as intended.

8. CONCLUSION

As there is an increasing awareness in society with regard to Islamic finance, especially to strike the balance between religious and social goals, it is imperative for takaful operators to consider the suitability of a takaful-waqt to drive takaful businesses in Malaysia to greater heights and to tap the untapped market among Muslims.
WAQAF SAHAM LARKIN SENTRAL: PIONEERING INITIAL PUBLIC OFFERING OF WAQF SHARES

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Securities Commission Malaysia
WAQAF SAHAM LARKIN SENTRAL:
PIONEERING INITIAL PUBLIC OFFERING OF WAQF SHARES

1. INTRODUCTION TO WAQF

Under waqf, an owner donates and dedicates an asset (movable or immovable) for permanent benefit. The beneficiaries will enjoy its usufruct and/or income perpetually. In the contemporary application of waqf, it can be established either by dedicating real estate, furniture or fixtures, other movable assets and liquid forms of money and wealth like cash and shares (Shaikh et al). Shariah places four (4) pillars in establishing a waqf, as follows:

(a) wakif (a party who waqf the asset or also referred to as a founder);
(b) maukuf (asset);
(c) maukuf a’la’ih (beneficiaries); and
(d) hujjah waqf (declaration for the creation of waqf).

As a waqf may have many beneficiaries, the wakif will need to make arrangements beforehand by appointing an administrator, called nazir, who has no beneficial interest in the waqf property, and lay down the rules for appointing successive administrators.

In Malaysia, each state Islamic religious council (SIRC) would be appointed as the sole trustee of waqf property and is referred to as nazir am. However, there are situations where a private nazir is appointed to manage and administer the waqf property, which is referred to as nazir khas. The appointment of a nazir as a trustee is vital as they are responsible for managing, maintaining, protecting and developing the wakif’s estate for the benefit of the public. The nazir is also responsible for the distribution of benefits of the waqf property according to the directions laid down in the waqf. Apart from its legal duties, the nazir has religious and moral obligations to take care of the waqf property (Prospectus, 2017).
2. TYPES OF WAQF

The revival of Islamic economics has encouraged several Muslim countries, including Malaysia, to pursue a waqf reform with many scholars accepting and introducing new fatwa or ruling deemed necessary. This has seen waqf developing into more contemporary modes such as cash waqf and waqf shares from general modes of waqf, for example land waqf. (Prospectus, 2017).

There are two types of waqf namely public or charity waqf and private waqf. Public waqf refers to a dedication in perpetuity of the capital and income from the waqf asset for religious or charitable purposes recognised by Shariah for the benefit of the public. Whereas private waqf refers to a dedication in perpetuity of the capital of an asset for religious or charitable purposes recognised by Shariah. The income from the waqf asset will be paid to specific persons or for purposes of the waqf. (Prospectus, 2017)

3. WAQF SHARES MODEL

There are two forms of properties that can be endowed which are immovable such as land and building, and movable such as cash and shares. For movable properties, there is a difference of opinion among the scholars because it is not permanent and can easily be damaged or destroyed. Nevertheless, according to the jumhur ulama’ such as Imam al-Shafi’i, Imam Malik and Imam Ahmad Ibn Hanbal, the movable property can be endowed with conditions that it is not depleted if used (Asmak, 2009). Based on Imam Hanafi’s view, the movable property can be endowed if it is attached with the immovable property permanently because it will also contribute to the purpose of waqf. One of the movable properties that are practiced today is waqf shares. From the legal perspective, waqf shares are permissible in Shariah since it is in line with the principles and concept of waqf in Islam. (Khairil et al, 2014).
As waqf shares are similar to cash waqf (i.e. it is a movable property), for the purpose of this case study, the findings from research on cash waqf is used as reference due to the limited availability of research on waqf shares itself. In general, cash waqf vis-à-vis waqf shares can be illustrated as follows:

Shareholders/founders buy waqf shares from specified religious institution/non-profit organisation (NPO)

The purchased waqf shares are endowed as waqf to the religious institution/NPO

Mutawalli - religious institution/NPO manages the collected funds

The funds/revenue generated are used for charitable purposes

Source: Cash Waqf – A New Financial Product

4. WAQAF SAHAM LARKIN SENTRAL (WSLS)

In June 2017, Larkin Sentral Property Berhad (LSPB), a wholly owned-subsidiary of Waqaf An-Nur Corporation Berhad (WANCorp) made an offering of waqf shares of up to 850 million ordinary shares to institutions and individuals at RM0.10 per share which will be subsequently endowed (via waqf) to WANCorp. This is the first public offering of waqf shares in the world which has been approved as Shariah-compliant by the Shariah Advisory Council of the Securities Commission Malaysia.

The objectives of the offering are to:

i. Create awareness on the concept of waqf among the public;

ii. Raise proceeds primarily for the upgrading and refurbishment of Larkin Sentral and the acquisition and development of the surrounding land for the benefit of the public.

iii. Provide an opportunity to the public regardless of race or religion to participate in the noble effort of contribution to society.
This offering is considered as a public waqf. Muslims and non-Muslims can participate in the offering of WSLS and can benefit from the proceeds raised from the offering, which is primarily to fund the upgrading and refurbishment of Larkin Sentral as well as to fund the acquisition of land for the proposed development of a seven-storey car park. Individual and institutional subscribers will enjoy tax deductions up to 7% and 10% of aggregate income respectively (Prospectus, 2017).

In establishing the waqf, LSPB has satisfied the following four pillars as required under Shariah as set out earlier:

<table>
<thead>
<tr>
<th>Pillar</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wakif</td>
<td>Wakifs/subscribers</td>
</tr>
<tr>
<td>Maukuf</td>
<td>Ordinary shares of LPSB</td>
</tr>
<tr>
<td>Maukuf a'laik</td>
<td>WANCorp</td>
</tr>
<tr>
<td>Hujjah waqf</td>
<td>WANCorp will undertake the formal hujjah waqf on behalf of the wakifs/subscribers before 2 witnesses appointed by WANCorp</td>
</tr>
</tbody>
</table>

*Source: Prospectus on Waqaf Saham Larkin Sentral*

In addition, WANCorp has been appointed by Majlis Agama Islam Johor as nazir khas to manage and fulfil the objectives of the waqf for religious and charitable purposes in accordance with Shariah as instructed by the wakifs (Prospectus, 2017).

The arrangement of the waqf is illustrated below.

*Source: Prospectus on Waqaf Saham Larkin Sentral*
The dividends receivable by WANCorp from the issuance of the ordinary shares will be used as follows:

(a) 90% of the dividends receivable will be used to:
   (i) provide reasonable rental rates (i.e. lower rental rates compared to normal market rental rates) for selected tenants of Larkin Sentral; and
   (ii) charge minimal rental rates for small shop lots created in Larkin Sentral for single mothers and lower income group (i.e. approximately half of the market rate per square foot).

(b) the remaining 10% of the dividends receivable will be channelled to MAIJ where;
   (i) 5% will be retained by MAIJ as its entitlement, being the sole trustee of waqf in the State of Johor; and
   (ii) remaining 5% will be distributed for charitable purposes involving education, entrepreneurship and healthcare sectors (Prospectus, 2017).

5. LATEST UPDATE ON WSLS

The amount of proceeds raised as at July 2018 was less than the targeted proceeds of RM85 million since its offering in June 2017 and the offering has been extended to May 2019. In addition to the extension of the subscription period, the Supplementary Prospectus dated 17 May 2018 includes the following:

- inclusion of non-Malaysian citizens, foreign companies and institutions to participate in the offering;
- addition of debit cards as a payment method; and
- additional subscription method which is directly through WSLS’s website.
6. ANALYSIS OF SUBSCRIPTION OVER ORIGINAL AND EXTENDED SUBSCRIPTION PERIOD

Analysis of the cumulative proceeds raised on a quarterly basis over the total amount of proceeds i.e. RM85 million are as follows.

<table>
<thead>
<tr>
<th>Cut-off date</th>
<th>Proceed Raised (RM million)</th>
<th>Percentage collection</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 August 2017</td>
<td>1.397</td>
<td>1.64%</td>
</tr>
<tr>
<td>30 November 2017</td>
<td>2.648</td>
<td>3.12%</td>
</tr>
<tr>
<td>28 February 2018</td>
<td>3.728</td>
<td>4.39%</td>
</tr>
<tr>
<td>30 April 2018</td>
<td>4.401</td>
<td>5.18%</td>
</tr>
<tr>
<td>31 July 2018</td>
<td>5.069</td>
<td>5.96%</td>
</tr>
</tbody>
</table>

Source: New Straits Times Press

Based on the above table, within the first 10 months of the offering (18 June 2017 to 30 April 2018), LSPB managed to raise up to RM4.401 million which is only 5.18% out of the targeted amount. On a monthly average, LSPB managed to raise RM0.44 million per month which is far below the initial monthly target of RM7.73 million (RM85 million divided by 11 months). The average monthly gap is RM7.29 million or 94.31%.

After obtaining an extension of the subscription period from 17 May 2018 until 17 May 2019, with additional methods of subscription being introduced, the cumulative amount of proceeds raised was RM5.069 million as at July 2018 or 5.96% of the overall targeted collection. The proceeds raised grew to RM0.67 million or 15.18% within the 3-month period from April to July 2018.
Since the launching of the prospectus, based on a quarter-to-quarter performance as shown in the chart above, there was a significant increase of 89.55% in Quarter 2 (from 30 August 2017 to 30 November 2017). The significant drop in collection was seen in Quarter 3 (30 November 2017 to 28 February 2018) and Quarter 4 (28 February 2018 to 30 April 2018) from 40.79% and 18.05% respectively. The collection dropped even further in Quarter 5 (30 April 2018 to 31 July 2018) even with additional approaches introduced in the Supplementary Prospectus. The downward trend in the overall collections from Quarter 2 onwards suggests that LSPB would be struggling in achieving its target in the remaining quarters as well as the overall target.
7. POSSIBLE FACTORS AFFECTING THE LEVEL OF SUBSCRIPTION

Based on the above analysis, a number of possible factors have been identified that may have affected the level of subscription of WSLS. These factors are as follows:

7.1 Purposes and Beneficiaries of WSLS

As mentioned earlier, the amount raised from the offering will be used to fund the upgrading and refurbishment of Larkin Sentral and the acquisition and development of a land that will be developed into a car park. This overall development will benefit an estimate of 26,000 visitors including Muslims and non-Muslims to Larkin Sentral on a daily basis and the number will increase during weekends, school holidays and festive periods. In addition, as Larkin Sentral is a transportation hub, non-Johoreans may also use the facilities in Larkin Sentral as connecting points.

A study that explores cash waqf donor’s priority shows that education and health sectors become the first and second priority respectively due to the present necessity and challenges of education and health sectors in Malaysia (Pitchaya et al, 2014), in comparison with the commercial sector in the case of WSLS. Accordingly, the purposes and/or beneficiaries of WSLS may be a factor that has resulted in the lack of subscription of WSLS.

7.2 Minimum Amount of Contribution

The lowest amount for a first-time subscription permitted by the offering of WSLS is RM100 and any subsequent contribution is in multiples of RM10 (Prospectus, 2017). The minimum contribution of cash waqf by various SIRCs is compared against the median monthly household income by state issued by the Department of Statistics Malaysia. Household income refers to total income received (accrued) by members of households, both in cash or in kind which occur repeatedly within the reference period (within a year, or more frequently) (DOSM). The comparison is as follows:
<table>
<thead>
<tr>
<th>State</th>
<th>Minimum waqf contribution (Zakaria et al, 2017)</th>
<th>Median monthly household income (DOSM, 2016)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>RM</td>
<td>RM</td>
</tr>
<tr>
<td>Johor</td>
<td>10</td>
<td>5,652</td>
</tr>
<tr>
<td>Melaka</td>
<td>10</td>
<td>5,588</td>
</tr>
<tr>
<td>Pahang</td>
<td>10</td>
<td>3,979</td>
</tr>
<tr>
<td>Penang</td>
<td>5</td>
<td>5,409</td>
</tr>
<tr>
<td>Selangor</td>
<td>10</td>
<td>7,225</td>
</tr>
<tr>
<td>Terengganu</td>
<td>10</td>
<td>4,694</td>
</tr>
</tbody>
</table>

Given the median monthly household income of Johor is much lower than Selangor, the lowest amount for the first-time subscription of WSLS may need to be lowered to make it more affordable as well as to attract subscribers from various income groups.

7.3 Awareness of Waqf and WSLS

The level of awareness of waqf in general as well as of WSLS specifically may have contributed to the lack of subscription of WSLS. A study found that 70% of Malaysian Muslims were not aware of the benefits of waqf in contributing to the economics and community well-being (Ab Fatah et al, 2017). Another study by Adeyemi, Ismail and Hassan (2016) also found that the awareness level of waqf generally among Malaysian Muslims is still low. The study also revealed that the factors that explain the phenomena of low awareness about cash waqf in Malaysia include a lack of understanding, a lack of promotion and the influence of social culture. Both studies are supported by a study on the opinions of SIRCs on the awareness and understanding of Muslims in Malaysia regarding the development of waqf property where it found that the understanding of waqf still needs to be improved in order to encourage public participation in waqf development (Mohamad Suhaimi et al, 2017).
This particular study also highlighted that it is important to design suitable awareness programmes on the cash waqf scheme. The study identified that the following should be considered in designing the awareness programmes:

a. The importance and benefits of waqf in general;

b. The potential benefits and long-term milestones of the specific waqf scheme should be clearly explained and be publicised regularly so that the public is assured of the use of their donated assets; and

c. The target audience of the specific waqf scheme (Mohamad Suhaimi et al, 2017).

Based on the review of WSLS’s website, it does provide progress updates of Larkin Sentral. It was observed that the latest update was only made up to March 2018. As stated in the Prospectus, LPSB will update the progress of each phase of the upgrading and refurbishment works, the amount of proceeds raised over the duration of the subscription period and the corresponding use of the proceeds on a quarterly basis in widely circulated Bahasa Malaysia and English daily newspapers within Malaysia.

7.4 Target Subscribers

A study on demographic variables and individual perceptions on cash waqf by Abdul Shukor et al found that the profiles of waqf contributors are as follows:

i. married individuals were more likely to donate than single individuals;

ii. older individuals were found to be more involved in charitable behaviour;

iii. individuals with higher incomes tend to be more involved in charity than those earning a lesser income;

iv. individuals that are knowledgeable about cash waqf were more likely to donate cash waqf. This is where understanding the concept and function of cash waqf is crucial in determining cash waqf participation (Abdul Shukor et al).

Accordingly, the awareness programme should be designed in a way that will attract individuals with the above profiles. This may also be applied to attract non-Muslim subscribers.
7.5 Incentives

As mentioned earlier, individual and institutional subscribers of WSLS enjoy tax deduction up to 7% and 10% of the aggregate income respectively under Section 44(6), 44(11B) and 44(11C) of the Income Tax Act 1967. This is consistent with tax incentives available for other cash waqf schemes by the SIRCs such as in Selangor and Johor (Mohsin et al, 2015).

As mentioned earlier, the waqf offering has been extended to non-Malaysian citizens, foreign companies and institutions. Unfortunately, the tax incentive is not applicable to foreign participants.

7.6 Collection and Subscription Methods

A study on collection methods of waqf shares in Malaysia (Mohsin et al, 2015) shows that a number of optional methods give huge opportunity and convenience to the public by making waqf donations available anytime and anywhere. Another study also found that the attitude of individuals toward participation in cash waqf is determined by the convenience in contributing. If cash waqf endowers feel that there are many channels for them to contribute cash waqf, this will engender a more positive attitude towards participation in the practice (Abdul Shukor et al, 2017).

The Supplementary Prospectus sets out the additional payment and subscription methods of the waqf offering. Payment via debit card is a way to provide convenience to potential subscribers who do not have access to the internet. Any transaction fees incurred from the subscription of issue shares via debit card will be borne by LSPB. The use of debit card is conveniently proven nowadays as many banks offer their customers for daily financial transactions. However, a manual form is still required for subscribers to provide their details. This may deter potential subscribers from subscribing.

In addition, the subscription now can be done through WSLS’s website. Potential subscribers can access the website at https://waqafsahamlarkin.com and payment for the shares can be made via Financial Process Exchange online payment system (“FPX”) with access to 17 participating banks. As the transaction cost is borne by the LSPB and the ease of such a payment mode, it would persuade potential subscribers to subscribe to the waqf shares.
8. RECOMMENDATION AND LESSONS LEARNED

As the offering is still ongoing until May 2019, certain initiatives can be taken to increase the subscription by addressing the possible issues such as lack of awareness and difficulty of subscription by:

i. increasing awareness on waqf and WSLS such as utilising social media platforms to create and develop a good content on waqf shares to disseminate information to the masses such as Facebook, Instagram, Twitter, Whatsapp and others;
ii. designing appropriate awareness programmes to attract targeted group of subscribers;
iii. collaborating with mosques in Johor to collect donations and the mosques could then recommend its name as a representative for the donors of “tabung waqf” to subscribe to the waqf shares;
iv. leveraging on digital technology. For instance, LSPB could develop an application on WSLS which can be downloaded from both Android and Apple Store. It can come together with the QR Code which will facilitate registration and payment processes. This would certainly give a new experience to donors as it is very simple to use.

Despite the above initiatives, this case study provides a number of lessons learned which could be studied further for future consideration:

- Whether waqf shares offer is the appropriate mechanism of collecting funds for such projects. A simple mechanism such as donations may have attracted more people to donate to the development of Larkin Sentral.

- It is noted that the top five subscribers of WSLS are Johor Corporation related entities which suggests that the waqf shares attracted subscribers who are directly related to or impacted by the waqf asset i.e. the people of Johor themselves. Therefore, the whole WSLS arrangement should consider to focus on the people of Johor.
9. REFERENCES

Prospectus on Waqaf Saham Larkin Sentral dated 18 June 2017.
Supplementary Prospectus on Wakaf Saham Larkin Sentral dated 17 May 2018.
GOLD INVESTMENT PRODUCTS: ISSUES OF APPLICATION IN GOLD ACCOUNTS

Saiful Benedick @ Mohd Faizal
Bank Muamalat Malaysia Berhad
1. INTRODUCTION

Gold is now gaining popularity among investors, especially after a series of recession and economic crises hit the world. Although previously investors see currency as a safe haven for investing activities, but as the strength and soundness of the currency is subject to economic and political situations of a country, investors are beginning to realise the risks involved in the investment of currencies, and look for other alternatives that guarantee protection, among them gold investment. The phenomenon of gold investment fueled by rising gold prices over the years is believed to give good returns to investors, especially for long term investments.

Historically, people need to purchase physical gold whether gold bars, bullions or coins. Malaysia has been offering investors a unique way in gold investment. Financial institutions and banks permit customers to invest in gold by depositing their fund in the gold savings account (GSA) or gold investment account (GIA). This paper-based account is measured in units of gold grams instead of Ringgit Malaysia (RM). This is a great platform for gold investors since they do not have to deal with the issue of storage as if they are investing in physical gold. However, this investment method may lead to the issue of riba’ transaction due to the status of gold as a ribawi item; although getting great response from Muslim investors. From the Islamic perspective, products and techniques of gold investment should be ensured that it meets the principles and laws of Islam; in order to finance the activities of the Muslim community and not stray from the path of Islam.

However, this concern abated somewhat when the 96th Discourse of the Fatwa Committee of the National Fatwa Council for Islamic Religious Affairs Malaysia at its meeting from 13 to 15 October 2011 recommended 'Gold Investment Parameters' which contains a number of guidelines to be observed by Muslim investors in gold investment activity.¹ The recommended parameters covering the basic general and specific terms either for purchasing or selling gold. Applying these parameters on gold investment products is not an easy one to look at due to the diversity of investment plans available, and the vagueness of some of the transactions carried out.

¹ See: JAKIM, the Guidelines recommended by Fatwa Committee, National Council for Islamic Religious Affairs Malaysia (MKI), 2011. These parameters can be accessed online via: http://e-muamalat.islam.gov.my/ms/bahan-ilmiah/fatwa-muamalat/113-parameter-pelaburan-emas
This case study carried out the objective of examining a number of operations and gold investments/savings accounts in the market at this point, as well as reviewing the extent of the accuracy and compliance of such activities on the rulings of Islam. The case study will use ‘Gold Investment Parameters’ as a basis for determining compliance with Islamic law.

The case study is divided into two main parts. Part 1 of this paper will present the types of gold investments available in Malaysia, whether offered by gold trading companies or banks doing gold business. Generally it can be divided into three main types, namely, physical investment, investment through gold accounts, and virtual gold investment. Part 2 of this paper will present some of the products i.e. on gold investments/savings accounts for analysis according to the Islamic Gold Investment Parameter.

2. TYPES OF GOLD INVESTMENTS IN THE MARKET

In the context of gold investments, availability of various types of plans and techniques are offered to investors. However, roughly, gold investments can be divided into three main categories based on the type of subject that is traded or invested. These categories are as follows:

2.1 Physical Gold

Physical gold is available from suppliers, distributors or gold producers in Malaysia in two forms:
(a) The shape of gold coins and gold bars. Gold coins usually with a purity of 24 carat gold or 999 and is available in sizes such as 1 oz., ½ oz., ¼ oz., and 1/20 oz. Gold bars with the same purity can also be found in units of grams such as 5g, 10g, 50g and 100g.
(b) Jewellery. Gold quality and specific weight in the form of necklaces, bracelets and so on. In the context of investments, typically a 24-karat gold jewelry purity or 999 is more interesting to investors, compared to the 916 gold.
2.2 Gold Investments/ Savings Accounts

Now, there are gold investment products based on gold savings accounts offered by some banks and among its advantages is that the account holder can make a profit with the rising price of gold without having to purchase and store physical gold.

By opening an account, the customer is not given physical gold, but the quantity of gold purchased and their values recorded in the books of the customers’ account.

Purchases of gold by the account holder are based on the current selling price of the bank, while the sale of gold is based on the current purchase price of the bank.

2.3 Virtual Gold

Virtual gold is gold traded for investment in a non-physical form. Virtual gold business uses electronic platforms, such as those offered by some forex brokers. Investors who have an account at a certain forex broker can purchase and sell orders with the current price of gold displayed on the platform, but investors cannot claim the physical gold. Instead of purchasing gold (open position), the transaction will be concluded with a resale (close position), where investors only make a profit or incur a loss in the form of currency units.

3. FINDINGS AND ANALYSIS OF GOLD PRODUCTS

3.1 Gold Investments/ Savings Accounts

3.1.1 Gold Account Which Does Not Provide Withdrawal Facility into Physical Gold - Conventional Bank

Among the gold investment products that are increasingly popular these days is investing through opening a gold account. Based on an overview of the gold accounts product in several banks in Malaysia, it was found that there are certain concepts used. The paper will present certain concepts and products that are offered either by Islamic financial institutions or conventional banks, and will analyse its operations from the point of fiqh.
Below is a table that describes the modus operandi of an investment gold account.

<table>
<thead>
<tr>
<th>Features</th>
<th>Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum initial purchase</td>
<td>1 gram</td>
</tr>
<tr>
<td>Minimum next purchase</td>
<td>1 gram</td>
</tr>
<tr>
<td>Minimum sales</td>
<td>1 gram</td>
</tr>
<tr>
<td>The minimum balance in the account</td>
<td>1 gram</td>
</tr>
<tr>
<td>Backup gold</td>
<td>The investment is backed by gold physically stored in Produits Artistiques Metaux Precieux (PAMP S.A)</td>
</tr>
<tr>
<td>The method of payment when purchasing</td>
<td>- Cash</td>
</tr>
<tr>
<td></td>
<td>- Debit from savings or current accounts.</td>
</tr>
<tr>
<td></td>
<td>- Local cheque</td>
</tr>
<tr>
<td>Method of withdrawal</td>
<td>- Cash (according to the current purchase price)</td>
</tr>
<tr>
<td></td>
<td>- The value of gold according to the current purchase price credited to current or savings account</td>
</tr>
</tbody>
</table>

Analysis of Shariah

The main question in the plan above is the absence of physical gold purchased by investors. Although the bank said that it was based on the existence of physical gold, the bank does not provide an option for investors to get the gold physically. Thus, from the point of Shariah:

(i) Reservations that gold will not be physically delivered to the investor but will be converted to value and presented in the form of cash is against one of the conditions relating to the sale and purchase of goods. It is also not in compliance with Gold Investment Parameter No. 5.

(ii) The absence of taking possession of the gold when purchasing. This is because the absolute submission during the gold purchasing process has not happened. This violates the basic conditions of purchasing usury items and not in compliance with Gold Investment Parameter No. 13.
When investors cannot demand for physical gold during the investment in the gold account, then a withdrawal is made when the price has risen, and the profits earned by investors are prohibited in Shariah due to taking profits from sales which are not yet guaranteed.

This is based on the prohibition of the Prophet (PBUH) in the following hadith:

*Meaning: "It is not lawful debts and purchase, (the imposition of) two terms in the (transaction) purchase, (gain) benefits (of) something that is not guaranteed, and purchasing and selling something that you do not have."*

### 3.1.2 Gold Accounts Which Provide Withdrawal Facility into Physical Gold (in certain amounts only) - Conventional Banks

<table>
<thead>
<tr>
<th>Features</th>
<th>Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum initial purchase</td>
<td>5 grams</td>
</tr>
<tr>
<td>Minimum next purchase</td>
<td>5 grams and in multiples of 1 gram</td>
</tr>
<tr>
<td>Minimum sales</td>
<td>5 grams and in multiples of 1 gram</td>
</tr>
<tr>
<td>The minimum balance in the account</td>
<td>1 gram</td>
</tr>
<tr>
<td>The method of payment when purchasing</td>
<td>Debit from savings or current accounts.</td>
</tr>
<tr>
<td>Method of withdrawal</td>
<td>• The value of gold according to the current purchase price credited to current or savings account.</td>
</tr>
<tr>
<td></td>
<td>• Physical gold can be claimed with a minimum of 100 grams and in multiples of 100 grams.</td>
</tr>
</tbody>
</table>

**Analysis of Shariah**

If viewed from the perspective of taking possession, this plan is better than the first because of the withdrawal facility. The bank gives investors a choice of whether to make withdrawal in the form of value, i.e. by selling gold to the bank at current prices and credited to the account of the investor; or by way of demanding physical gold from banks which will be taken from certain Bank branches.
However, when the minimum limit for physical gold withdrawal is set at 100 grams, and in multiples of 100 grams, then the issue of Shariah is for those who make a purchase of 100 grams gold and below. This is because investors who are purchasing gold that does not exceed 100 grams are definitely not allowed to withdraw physical gold. Then this will violate the terms of trading in gold and also be against Gold Investment Parameters No. 5.

For investors who buy gold in excess of 100 grams and not in multiples of 100 grams, i.e. 120 grams, 140 grams, 260 grams, this raises the question of the surplus that is not a multiple of 100 grams of gold which cannot be converted physically. Thus it is against the same parameters.

### 3.1.3  Gold Accounts in Islamic Bank- Based on Wakalah, Bai’ Sarf, Wadiah & Wa’d.

<table>
<thead>
<tr>
<th>Features</th>
<th>Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum initial purchase</td>
<td>1 gram or RM 10</td>
</tr>
<tr>
<td>Minimum next purchase</td>
<td>RM 10 or its equivalent in gram</td>
</tr>
<tr>
<td>Minimum sales</td>
<td>1 gram or RM 10</td>
</tr>
<tr>
<td>The method of payment when purchasing</td>
<td>Debit from savings or current accounts.</td>
</tr>
<tr>
<td>Method of withdrawal</td>
<td>• The value of gold according to the current purchase price credited to current or savings account.</td>
</tr>
<tr>
<td></td>
<td>• Physical gold can be claimed with the 1, 5, 10, 20, 50 and 100 grams.</td>
</tr>
<tr>
<td>Concept</td>
<td>The underlying contract for this Islamic Bank Gold Account are Bai’ as-Sarf and Wadiah. Bai’ as-Sarf refers to the exchange of one monetary form for another in the same or different form on a spot basis. In this case, it refers to the exchange of the money with gold.</td>
</tr>
<tr>
<td></td>
<td>Gold that is bought by customers can be saved at the Bank based on the Wadiah concept.</td>
</tr>
</tbody>
</table>
Analysis from the point of Shariah

(i) The bank gives investors a choice of whether to make withdrawal in the form of value, i.e. by selling gold to the bank at current prices and credited to the account of the investor; or by way of demanding physical gold from the bank which will be taken from certain Bank branches. This is in compliance with Gold Investment Parameter No. 5.

(ii) From the point of taking possession, the above plan on purchasing gold complies with Shariah because the bank gives customers a choice whether to keep the gold in the bank or make a physical withdrawal of a minimum of 1 gram. Thus, customers who buy gold through this plan can claim as little as 1 gram of physical gold. This complies with the basic conditions of purchasing usury items and compliance to Gold Investment Parameter No. 13.

(iii) The issue on bay’ wa salaf (purchase and sale in bundled or required by debt) also does not arise in the plan above, because the bank gives customers the option to make a claim by either physical gold or storing physical gold in the bank by wadiah contract. The issue on bay’ wa salaf will only arise if the bank does not give the option, otherwise every gold buyer is required to keep the gold in the bank on the basis of wadiah.

3.2 Summary of Shariah Issues in Gold Accounts

According to the 96th discourse of the National Shariah Council, the purchasing and selling transactions of gold must be done immediately or hand to hand. According to the experts, this account is subjected to several rulings. Firstly, the transaction is viewed to be harmful and void in cases where the physical gold is not in the bank’s possession during the execution of the contract. This is due to the fact that the bank has sold the underlying subject matter without it having a rightful ownership. In this event, it seems that the contracting parties, the bank and the investor, have committed riba due to the missing element of offer and acceptance during the same event.
The investor is expected to ensure that the bank has the rightful ownership of the gold prior to the execution of the contract. Moreover, the contract is viewed harmful and void if the bank, upon request, is unable to deliver the gold. On top of that, the contract must be properly recorded in the form of a passbook or statement to indicate the investor’s ownership on the underlying subject matter. The issuance of the evidence signifies sales and gold investment account opening. Thus, the contract is permissible and valid when ownership of the subject matter has been transferred to the investor though it is considered as a non-physical delivery.

As one would expect that for the investment in gold account to be Shariah compliant it must not involve any element of riba. Therefore, the gold must be in a physical form that can be kept by the bank on behalf of the investor. However, the bank is not allowed to use the gold for any of its other banking activities. Also, for this product the bank is expected to specify the underlying contract such as qard, wadiah, etc. In addition, the bank is obliged to have an adequate amount of gold during the transaction period.

4. CONCLUSION

The variety of gold investment products offered in the market today should be considered by the Muslim community from the standpoint of Shariah compliance. This is because the benefits of such investments that do not meet the demands of Shariah would spawn a source of illegal income and not be blessed by Allah. Thus, the role of the clerics and Islamic scholars is to always be aware of the existence of a wide range of gold investment products, in order to provide guidance to Muslims who want to engage in this activity. Furthermore, this investing activity involves usury items that have conditions that are more stringent than in other commodity investments.

From the analysis of some of the gold investment products offered in the market, this case study finds that there are many investment plans that do not meet the basic conditions of the sale and purchase of gold. Hence, the Muslim consumers should be careful in choosing a gold investment product and not merely be influenced by promises of huge returns when its legal status is not confirmed.

Gold trading companies that target Muslims or subscribed by many Muslim consumers should be sensitive to Islamic law related to gold investment. Hence, for any gold investment company owned by Muslims or subscribed by the Muslim consumers should establish its own Shariah committee to ensure that the products offered do not violate Islamic law.
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Website
CHALLENGES IN LISTING ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA

Sarina Mohd Ali
BIMB Holdings Berhad
CHALLENGES IN LISTING ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA

ABSTRACT

As of November 2018, despite 76% of the 902 total securities listed in Bursa Malaysia are shariah-compliant, only two are from the financial services. The listing of more Islamic financial institutions on Bursa Malaysia would boost the Islamic fund and wealth management industry and also strengthen Malaysia’s position as a global hub for such funds. This paper is to explore the challenges in the listing of Islamic financial institutions in Bursa Malaysia.

1. INTRODUCTION

The Malaysian Islamic financial institutions have come a long way since the setting up of a full-fledged Islamic bank, Bank Islam Malaysia Berhad (“BIMB”) and full-fledged takaful company Syarikat Takaful Malaysia Keluarga Berhad formerly Syarikat Takaful Malaysia Berhad, (“STMKB”) in 1983 and 1984 respectively. At present, there are 16 full-fledged Islamic banks (including two foreign Islamic financial institutions) and 11 takaful companies and 4 retakaful companies operating in Malaysia. Of the 16 full-fledged Islamic banks, nine are Islamic banking subsidiaries of listed banking groups in Bursa Malaysia.

As of November 2018, despite 76% of 902 total securities listed in Bursa Malaysia are shariah-compliant, only two are from the financial institutions namely BIMB Holdings Berhad (“BHB”) and STMKB which is the parent company of both BIMB and STMKB. The listing of more Islamic financial institutions on Bursa Malaysia would boost the Islamic fund and wealth management industry and also strengthen Malaysia’s position as a global hub for such funds.

The former Group Chairman of Permodalan Nasional Berhad (“PNB”), Tan Sri Abdul Wahid Omar in his keynote speech at the International Islamic Fund and Wealth Management Forum 2017, said that the shortage of listed Islamic finance institutions could pose big challenges to the industry as there are many shariah-compliant funds that need to be invested in shariah–compliant financial services stocks. One of his suggestions was the creation of a separate listing of “Islamic” or “i-share”

1. Bank Negara Malaysia
2. List of Shariah-Compliant Securities by Shariah Advisory Council of the Securities Commission Malaysia – 30 November 2018
among banking groups that have sizeable Islamic finance activities embedded within them such as Maybank, CIMB and RHB.

This case study would like to explore the challenges in listing Islamic financial institutions in Malaysia.

2. MALAYSIA’S ISLAMIC BANKING BUSINESS

The following tables provide a closer look at the contributions of Islamic banking entities to the Malaysian banks’ total assets and net profit as at 30 September 2018 and 31 December 2017.

<table>
<thead>
<tr>
<th>As at end September 2018</th>
<th>For the period</th>
<th>Islamic Banking Operation</th>
<th>Overall Group</th>
<th>% of Islamic over the Group</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Asset RM million</td>
<td>Net Profit RM million</td>
<td>Asset RM million</td>
</tr>
<tr>
<td>Maybank</td>
<td>9 mths Sept 18</td>
<td>212,094.9</td>
<td>1,318.9</td>
<td>789,772.9</td>
</tr>
<tr>
<td>CIMB</td>
<td>9 mths Sept 18</td>
<td>115,943.6</td>
<td>808.8</td>
<td>522,852.3</td>
</tr>
<tr>
<td>Public Bank</td>
<td>9 mths Sept 18</td>
<td>61,597.1</td>
<td>343.1</td>
<td>414,717.5</td>
</tr>
<tr>
<td>RHB Bank</td>
<td>9 mths Sept 18</td>
<td>50,382.4</td>
<td>562.0</td>
<td>237,465.2</td>
</tr>
<tr>
<td>Affin Bank</td>
<td>9 mths Sept 18</td>
<td>24,611.0</td>
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<table>
<thead>
<tr>
<th>As at end December 2017</th>
<th>For the period</th>
<th>Islamic Banking Operation</th>
<th>Overall Group</th>
<th>% of Islamic over the Group</th>
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<tr>
<td></td>
<td></td>
<td>Asset RM million</td>
<td>Net Profit RM million</td>
<td>Asset RM million</td>
</tr>
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<td>Maybank</td>
<td>FYE Dec 17</td>
<td>203,461.2</td>
<td>1,846.2</td>
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<td>Affin Bank</td>
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<td>9,888.4</td>
<td>58.2</td>
<td>52,330.5</td>
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</table>

The above comparison excludes BIMB which is a pure Islamic banking group.

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4 Respective financial institutions quarterly and annual reports
Among the local banks, Maybank is the undisputed leader in terms of assets for Islamic banks. Its assets are RM212.1 billion, more than double that of CIMB’s Islamic Banking Operation which stood at RM115.9 billion, the second biggest, as at end September 2018.

3. PROPOSED ISSUANCE OF MAYBANK’S ISLAMIC SHARES

In 2017, PNB, the major shareholder of Malayan Banking Berhad (“Maybank”) announced that it is in the midst of studying the potential issuance of Islamic shares, which will be linked to the Islamic banking business of the banking group. The proposal was to carve out 20% of Maybank shares into Islamic shares.

If successful, this can create access to billions in value of a previously closed sector and truly widen the investment opportunities for shariah funds. The move would create a new shariah-compliant equity instrument worth RM20 billion on Bursa Malaysia and will be thrice the market value of BHB.

However, the proposal was not for Maybank to list its Islamic arm, Maybank Islamic separately on Bursa Malaysia. Maybank adopted an ‘Islamic First’ strategy where Maybank Islamic is an integral part of Maybank with common infrastructure and distribution channels and is part of the group’s total growth. The group is comfortable with the leverage approach that it has for Maybank Islamic whereby it has grown to be the fifth biggest in the world.

The proposed strategy was to designate a certain percentage of Maybank shares, say 20%, as Islamic shares where the dividend income can be traced or “ring-fenced” from Maybank Islamic and Maybank’s other shariah-compliant activities.

As at end of September 2018, Maybank Islamic contributed 58.3% of Maybank’s total loans and financing in Malaysia. In terms of profit contribution, some 22% of the Maybank Group’s earnings come from shariah-compliant products and services.

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5 Various newspaper articles on former PNB Chairman Tan Sri Abdul Wahid Omar’s luncheon talk with the media jointly organised by Malaysian Press Institute and PNB on 15 August 2017
6 Shariah Investing: Faith meeting opportunities, Eastspring Investments Berhad, Malaysia
7 www.theedgemarkets.com/article/maybank-will-not-create-different-classes-shareholders-ishare-proposal
8 Maybank’s Investor Presentation Financial Results 3Q FY2018 & 9M FY2018 ended 30 September 2018, page 42
It is not known when the proposal will materialise as its execution is subject to the approval by the relevant authorities. On 2 July 2018, Maybank Islamic hosted an investors’ day for analysts and fund managers to share its high growth targets for Islamic banking business and its plan to expand its Islamic banking businesses overseas.

4. SHARIAH COMPLIANT LISTED EQUITIES

The Securities Commission Malaysia (“SC”) is the statutory body entrusted with the responsibility to regulate and develop the Malaysian capital market. The SC has established a sound shariah framework to govern activities in the Islamic Capital Market (“ICM”) executed by the Shariah Advisory Council (“SAC”). The SAC approves and updates shares classified as shariah-compliant securities that are listed on Bursa Malaysia. The list shall, among others, facilitate investors seeking investment in shariah-compliant shares, promote the development of Islamic Capital Markets and encourage the development of Islamic instruments. The list is published twice a year in May and November.

Shares are screened based on a certain methodology which comprises both quantitative and qualitative assessments. As a preliminary screening, companies whose activities are not contradictory to shariah principles will be classified as shariah-compliant securities. There is a two-tier approach to the quantitative assessment which applies the business activity benchmarks and the financial ratios benchmarks.

For business activity benchmarks purposes, the SC’s SAC assesses the level of mixed contributions from permissible and non-permissible activities towards turnover and profit before tax of a company. Where contribution from non-permissible activities, exceed the benchmark, the securities shall be deemed as shariah non-compliant. Subsequently, the company’s financial management is assessed against the financial ratio benchmarks, to determine riba and riba-based elements within the company’s balance sheets. The ratios are Cash over Total Assets\(^9\) and Debt over Total Assets\(^11\). Both ratios must be lower than 33%.

In addition, the SAC of SC will also take into account the qualitative aspect which involves public perception or image of the company’s activities from the perspective of Islamic teachings.

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\(^9\) www.bursamalaysia.com/market/islamic-markets/products/islamic-capital-market

\(^10\) For calculation purposes, only include cash placed in conventional accounts and instruments

\(^11\) For calculation purposes, only include interest-bearing debt
5. CHALLENGES IN LISTING ISLAMIC FINANCIAL INSTITUTIONS IN BURSA MALAYSIA

One of the main benefits of listing Islamic banks, is that it will provide access to increase its capital and ultimately widen the investment opportunities for shariah funds. However, there are a few aspects to be considered which may be challenges for the owner of the Islamic banks in Malaysia to list their Islamic banking subsidiaries in Bursa Malaysia.

5.1 Legal Aspect and Gaining Approval from Regulatory Authorities

Currently, most of the Islamic banks in Malaysia are 100% owned Islamic banking subsidiaries of the listed banking group. The parent banking company is the one listed on Bursa Malaysia. These Islamic banks are mostly on shared services with its parent company with a few stand-alone branches set up among them.

The direct listing of an Islamic banking subsidiary in Bursa Malaysia as a shariah-compliant share will be the easier approach as it is a separate entity from its parent company and principally engaged in Islamic banking business. However, though it is a separate entity, most of these Islamic banking subsidiaries are on leverage approach with their parent banking company where they share common infrastructure and distribution channels.

Another approach is via dual listing of the parent banking company. The parent banking company will offer a share structure which, for example, consists of Class A for the conventional banking business and Class B for the Islamic banking business. It will provide additional liquidity to the shares and allow investors greater choice to trade. The parent banking company will then use a ring-fencing mechanism to funnel income from their shariah-compliant activities and use it to pay dividends for the Class B shares.

Section 69(a) of the Companies Act 2016 allows a company to issue shares in different classes and Section 71(1) (c) further stipulates that each share shall have one vote on a poll. Thus in this case, provides equal opportunities for both classes of shareholders.

However, Bursa Malaysia had issued a statement that there are no current plans to facilitate the listing of dual class shares (TheStar, 12 August 2017).
5.2 Satisfying Existing Shareholders of the Listed Banking Group

The proposal for the creation of a different class of shares for the listed banking group may not be favourable to their existing shareholders. The creation of the dual class shares structure would result in a possible lower dividend income for these existing shareholders as the pot is smaller. This would be a disadvantage to the existing shareholders as they would not be able to benefit from the tremendous growth in the Islamic banking business. Hence, this would prove to be a challenge for the parent banking company to satisfy them.

5.3 Higher Cost for the Banking Group

While the potential benefit of a separate listing of the Islamic banking subsidiary will provide opportunities to increase capital to further expand its business, the cost will increase as well. Besides the obvious increase in listing costs, there are other costs such as separate reporting and disclosure requirements. The Islamic banking subsidiary may no longer be able to depend on the current leverage approach with their parent banking company where they share common infrastructure and distribution channels. Hence, more cost will be incurred to run the business.

6. CONCLUSION

It is an interesting proposition to list Islamic banks in Bursa Malaysia so as to unlock a previously closed sector and widen the investment opportunities for shariah funds. This will boost the Islamic fund and wealth management industry and also strengthen Malaysia’s position as a global hub for such funds.

However at the current juncture, as most of these Islamic banking subsidiaries are on a leverage approach with their parent banking company, it is unlikely that the listing of Islamic banks in Bursa Malaysia will occur.
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Zarina Zakariah, PNB to create RM20 billion of new Islamic shares for Maybank

Ahmad Naqib Idris, PNB mulls introduction of Islamic shares for Maybank

Neily Syafikah Eusoff, Maybank will not create different classes of shareholders for i-share proposal

PNB to work on issuance of Maybank Islamic shares

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PROFESSIONALISING WAQF IN MALAYSIA – ISSUES AND CHALLENGES

Zharif Agil
PwC Malaysia
EXECUTIVE SUMMARY

Governance is a key aspect for the development of waqf in Malaysia. It provides for public trust in waqf institutions and therein be a platform for greater participation from society on waqf initiatives. However, there are several key issues in the governance of waqf institutions and these key issues can be summarised into the following areas.

The first issue is on the lack of independence between the trustee and the manager of the waqf assets. Currently, a department within the state religious council called Majlis Agama Islam manages all aspects of waqf. This structure creates a conflict of interest given that the Majlis Agama Islam is both the sole trustee and manager to the waqf assets. Independence is a critical aspect of the governance of the waqf as it provides a check and balance on the management of the waqf.

The second issue is the lack of accountability by the trustee. The role of the Majlis Agama Islam as the sole trustee of waqf is prescribed in the waqf enactment of each state. This enactment provides descriptions on the powers and responsibilities of the Majlis Agama Islam. However, it does not provide for the liability of the trustee on any mismanagement. Liability of the trustee is important in driving the behaviour and manner of management of the waqf.

The third issue is the lack of competency of the waqf managers. The management of waqf requires specific competencies in asset management, real estate and finance. However, given that waqf is managed within the Majlis Agama Islam, the backgrounds of the waqf managers are in religious studies. The lack of competency may result in under performance of the economic returns of the waqf assets.
The fourth and final issue is the lack of transparency and disclosure by the waqf institutions. The financial statements and reports on the performance of the waqf assets are not reported to the contributors. Contributors will not be able to ascertain if the waqf assets are being utilised appropriately. Transparency on the management of the waqf assets would provide confidence and trust to the public on its utilisation.

These issues may be resolved by creating a separate entity dedicated towards the management of waqf. This separate entity should have a board of directors that comprises both independent and non-independent directors. The management of the separate entity that looks after the day-to-day operations of the waqf must comprise individuals with the right competency and background.

The management of waqf in Singapore is one that can be modelled after. Similar to Malaysia, the Majlis Ugama Islam Singapura handles all aspects of waqf. However, a subsidiary called Warees Investments Pte Ltd (“Warees Investments”) was established with the task of managing and investing in waqf properties. The employees of Warees Investments comprise individuals with backgrounds in architecture, project management and construction. The company includes both independent and non-independent directors in the Board of Directors.

This new structure will professionalise the management of waqf to maximise the social and economic benefits of waqf to Malaysia.

1. INTRODUCTION/BACKGROUND

Based on a report by Jabatan Wakaf, Zakat dan Haji (“JAWHAR”), as of 2013, waqf land in Malaysia amounted to 76,000 acres in land space. Despite the large number of waqf land in Malaysia, a large proportion remains undeveloped. This is quite disappointing considering the potential benefits to the economy and society should this land be further developed.

In addition, the general public is generally not familiar with the concept of waqf. (R.H Mahmood, N. Mustaffha, L.B.M. Hameed, N. Johari, 2017). They would prefer donating in the form of sedekah or zakat.

These two issues could be attributed to a multitude of factors. However, there is a general view that these issues stem from the fact that there is a lack of governance in waqf institutions.
Before we dive into the governance issues of waqf institutions, we should define the concept of governance. The World Bank defines governance as, “the manner in which power is exercised in the management of a country’s economic and social resources for development”. The Malaysian Code on Corporate Governance issued by the Securities Commission highlights that governance is critical in supporting organisations in achieving its goals whilst preventing unwanted conflicts.

A clear governance framework on waqf would allow for a strong foundation for the development of waqf in Malaysia. This paper dives into the different aspects of governance in waqf which is on independence, accountability, competency and transparency.

2. DISCUSSIONS/ANALYSIS

2.1 Independence

In a paper written by the global body of professional accountants, the Association of Chartered Certified Accountants (ACCA), describes independence as a critical element in corporate governance and professional behaviour. It goes on to explain as below:

“Independence is a quality that can be possessed by individuals and is an essential component of professionalism and professional behaviour. It refers to the avoidance of being unduly influenced by a vested interest and to being free from any constraints that would prevent a correct course of action being taken. It is an ability to ‘stand apart’ from inappropriate influences and to be free of managerial capture, to be able to make the correct and uncontaminated decision on a given issue.”

In Malaysia, the management of waqf is under the supervision of each state’s jurisdiction that is the State Islamic Religious Council (Noor Ali, Abdullah & Tahir, 2014). These state Islamic religious councils are the sole trustee for all waqf matters in Malaysia (R.H Mahmood, N. Mustaffha, L.B.M. Hameed, N. Johari, 2017).

Based on the review of existing waqf structures in Malaysia, a department within the state religious council called Majlis Agama Islam manages all aspects of waqf. The Head of the religious council oversees amongst others the management of the waqf. Hence, they are both the trustee and manager of the waqf assets.
It is clear that there is no independence between the role of the trustee and manager. The Majlis Agama Islam should not be involved in the day-to-day management of the waqf. Their role as the trustee should entirely be in the form of overseeing that the objectives are met in the development of the waqf.

2.2 Accountability

The role of the Majlis Agama Islam is prescribed in the waqf enactment of each state. This enactment provides descriptions on their powers and responsibilities.

Hence, the Trustees (Incorporation) Act 1952 or Companies Act 2016 which is applicable to all trust or company structures in Malaysia does not apply to waqf. This is a problem given that there are specific clauses in these acts which ensure accountability of the trustee or the directors of a company which is absent in the waqf enactment. The following are the accountability clauses:

**The Trustees (Incorporation) Act 1952**

“…all trustees of the body or association of persons, notwithstanding their incorporation, shall be chargeable for such property as shall come into their hands, and shall be answerable and accountable for their own acts, receipts, neglects and defaults, and for the due administration of the body or association of persons and its property…”

**Companies Act 2016**

“A director of a company shall at all times exercise his powers in accordance with this Act, for a proper purpose and in good faith in the best interest of the company.

A director of the company shall exercise reasonable care, skill and diligence with –

(a) the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and

(b) any additional knowledge, skill and experience which the director in fact has.

A director who contravenes this section commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding five years or to a fine not exceeding three million ringgit or to both.”
These clauses are critical in ensuring accountability on the management of waqf and drive the behaviour and manner of management of the waqf.

Each state should look into amending the waqf enactment to include such provisions. Alternatively, Majlis Agama Islam could look into creating a separate entity in the form of a trust or a company which would then apply the Trustees (Incorporation) Act or Companies Act 2016.

2.3 Competency

The third issue is the lack of competency of the waqf managers. The management of waqf requires specific competencies in asset management, real estate and finance.

For example, the management of the largest and most successful endowment fund in the world, Harvard University endowment, is done by professionals from the financial services industry. They manage about USD37.1 billion and generated an 8.1% return in 2017. In addition, the management of the endowment fund is treated no differently from any other asset management company.

The management on waqf on the other hand is done by employees of the Majlis Agama Islam who tend to have backgrounds in religious studies. It is clear that there is a lack of technical expertise in the management of waqf. (R. H Mahmood, N. Mustaffha, L.B.M. Hameed, N. Johari (2017).

The solution for this may not be as simple as hiring competent individuals to manage the waqf. This is because attracting the right talent is highly dependent on the compensation that the waqf will be able to award.

However, the Majlis Agama Islam could look into rewarding the managers of the waqf based on the performance of the waqf assets which is similar to the model applied to asset managers. For example, the management could be rewarded with 5% of the returns of the rental income of the waqf land.
2.4 Transparency

The Principles of Corporate Governance published by the OECD describes disclosure and transparency as follows:

“A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders’ ability to exercise their shareholder rights on an informed basis. Experience shows that disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in the capital markets. By contrast, weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole.”

Hence, transparency is a key element in giving confidence to the society in waqf.

However, there is a lack of transparency in the management of waqf institutions (C. Z. Ismail, N. J. Salim, N. J. A Hanafiah, 2015). Based on the review of the waqf institutions in Malaysia, the financial statements and reports on the performance of the waqf, assets are not reported to the contributors. Currently, the waqf assets are embedded together with the assets of the Majlis Agama Islam which may include zakat and ‘sedekah’ money.

This is further supported based on the Malaysia Accounting Standards Board paper which highlights that waqf institutions do not prepare separate financial statements (MASB research paper, 2014).

Contributors will not be able to ascertain if the waqf assets are being utilised appropriately.

The Majlis Agama Islam should look at preparing an annual report or a set of financial statements on the waqf based on international accounting standards. The report or statements should also be audited and made publicly available.
3. RECOMMENDATIONS

Perhaps, Malaysia might consider modelling its management of waqf based on the Singapore model. Similar to Malaysia, the Majlis Ugama Islam Singapura handles all aspects of Waqf. However, a subsidiary called Warees Investments Pte Ltd (“Warees Investments”) was established with the task of managing and investing in waqf property. The employees of Warees Investments comprise individuals with backgrounds in architecture, project management and construction. The company includes both independent and non-independent directors in the Board of Directors.

This new structure will professionalise the management of waqf to maximise the social and economic benefits of waqf in Malaysia.
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