SEMINAR ON ISLAMIC FINANCE

BROAD DISTINCTION BETWEEN ISLAMIC & CONVENTIONAL BANKING

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17 March 2010 / 1 Rabiulakhir 1431H
ISLAMIC FINANCIAL CONTRACTS
Islamic Banking is based on Shariah Laws.

Original meaning of Shariah is “the way to the source of life’.

and is now used to refer to the legal system – code of behavior

Governing principles:-

- The absence of interest-based (riba’) transactions
- Avoidance of speculations (gharar)
- Avoidance of oppression (zulm)
- Introduction of Islamic tax (zakat)
- Discouragement of the production of goods and services which contradict the Islamic value (haram)
GOVERNING PRINCIPLES - RIBA'

- Surah Al-Baqara verse 274 (excerpt):-

"Those who charge usury (riba’/interest) are in the same position as those controlled by the devil’s influence. This is because they claim that usury is the same as commerce. However, God permits commerce and prohibits usury. Thus, whoever heeds this commandment from his Lord and refrains from usury, he may keep his past earnings and his judgment rests with God. As for those who persist in usury, they will incur Hell, wherein they abide forever."
GOVERNING PRINCIPLES - RIBA’

- Riba’ literally means “increase” or “excess”
  - An increase in a loan transaction or exchange of commodity accrues to the owner (lender) without giving an equivalent counter-value or recompense in return.

- “Same exchange value” illustrations:-
  - Exchanging 1kg of grapes with 1.5kg of grapes that are of the same type, quality and value.
  - RM100 exchangeable for RM110.
  - Hence, if items are the same then any differences (incremental or otherwise) in their exchange value is riba‘.

- Other considerations:
  - A contractual difference in value of 2 (or more items) of different type, quality and value when exchanged is not riba’.
  - If agreed differences is changed post-transaction, the changed amount is riba‘.
Rationale for the Prohibition of Riba’

To promote economically just, socially fair and ethically and correct economic behavior. Inequality is exemplified in the situation where the lender is guaranteed a positive return without assuming any share of the borrower’s risk whilst the borrower takes upon himself all sorts of risks in addition to his efforts, skills and labour.

Riba’ violates the principle of property rights. Money lent on interest is used either productively that it creates additional wealth or otherwise. When money used (together with labour and entrepreneurial skills) to produce additional wealth, such money lent cannot have any property rights claim to the incremental wealth because there was no prior bargain over it. Instead ‘interest’, demanded a guaranteed return regardless of the enterprise.
GOVERNING PRINCIPLES - RIBA’

- Rationale for the Prohibition of Riba’

- Promotion of profit-and-risk-sharing. The sharing of risks and uncertainties of the enterprise is fundamental to Shariah contracts. Shariah condemns the act of guaranteeing (even by the entrepreneur) to restore the invested funds intact.

- Act of lending is an act of charity. Lending should be a benevolent act. If money is needed other than for commercial purposes (thus, risk-sharing), such need should not be exploited where the borrower is put under undue burden. Verse 57:11 “Who is he that will lend unto Allah a goodly loan, that He may double it for him or his may be a rich reward…”
GOVERNING PRINCIPLES - GHARAR

- **Gharar** generally means unqualified and unqualified uncertainty, hazard, deceit, chance or risk.

- Majority Islamic scholars view gharar as ‘both ignorance of the material attributes of the subject matter of a sale and also uncertainty regarding its availability and existence’.

- Gharar is prevented when transactions are transparent with:
  - all details agreed in advance; and
  - ownership undisputed.

- For gharar to invalidate a contract, it must not be trivial, must be relating to the object of contract and must prove specifically in conflict with (trade) custom. However, non-trivial gharar may be tolerated if there is an overriding maslahah or public benefit.
GOVERNING PRINCIPLES - GCHARAR

- Preventable uncertainty is present in any contract subject to risks in the ordinary course of business – Istisna’ or salam contracts.

- Prohibition of gharar is indirectly a risk management in Islam hence encouraging the exercise of due diligence and avoidance of contracts with high degree of information asymmetry with extreme pay-offs.

- Nonetheless, treating gharar as risk has its consequences i.e. trading of risks therefore is prohibited where the traded risks may have been transferable in derivative format.
GOVERNING PRINCIPLES - ZULM

- **Zulm** refers to all forms of inequity, injustice, exploitation, oppression and wrongdoing.

- A person either deprives others of their rights or does not fulfill his obligations towards them.

- Zulm also refers to trading in matters which are prohibited (*haram*) under Shariah such as:
  - alcoholic drinks/beverages; and
  - non halal poultry/meat, pork.

- An extension of the social justice and equitable economics.
A COMPARISON BETWEEN ISLAMIC AND CONVENTIONAL BANKING
FUNDAMENTAL

- Shariah laws are the tenets of Islamic Banking. As such, the comparison with that of the conventional are not exactly like-to-like.

- Conventional banking was build upon the fundamentals of debtor-creditor relationship with interest being the price of credit and reflecting the opportunity cost of money. Hence, money is a commodity somewhat.

- Financial relationship in Islam is generally participatory in nature. E.g. the principles of Musharakah and Mudharabah, or contractual transaction. In addition, risk and reward relationship is guided by the socio-economic principles.
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<tr>
<th>ISLAMIC BANKS</th>
<th>CONVENTIONAL BANKS</th>
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<tr>
<td><strong>1</strong></td>
<td>The functions and operating modes of Islamic banks are based on the principles of Islamic <em>Shariah</em>.</td>
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<td>The functions and operating modes of conventional banks are based on fully manmade principles (largely capitalism theory).</td>
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<td><strong>2</strong></td>
<td>It promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).</td>
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<td>The investor/lender is guaranteed of a predetermined rate of interest or returns.</td>
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<td><strong>3</strong></td>
<td>It also aims at maximizing profit but subject to <em>Shariah</em> restrictions.</td>
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<td><strong>3</strong></td>
<td>Unrestricted profit maximisation illustrated by derivatives trading.</td>
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<td>4 In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a <strong>Zakat</strong> Collection Centre and they also pay out their <strong>Zakat</strong>.</td>
<td>4 It does not deal with <strong>Zakat</strong>.</td>
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<td>5 Participation in partnership business is the fundamental function of the Islamic banks. Understanding the venture is therefore essential. Embedded know-your-customer orientation.</td>
<td>5 Lending money and getting it back with compounding interest is the fundamental function of the conventional banks. Money is a commodity and the motivation.</td>
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<td>6 Islamic banks have no provision to charge any extra money from the defaulters except for compensation (typically such proceeds is given to charity). Rebates early settlement at the Bank's discretion.</td>
<td>6 It can charge additional money (penalty and compounded interest) in case of defaulters.</td>
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<td>7</td>
<td>Due importance to the public interest/ maslahah. Its ultimate aim is to ensure growth with equity.</td>
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<td><strong>10</strong></td>
<td>The conventional banks give greater emphasis on credit-worthiness of the clients where credit equals to ‘commodity pricing’.</td>
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<td><strong>11</strong></td>
<td>Relationship is often defined as that of creditor-debtor.</td>
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<td><strong>12</strong></td>
<td>A conventional bank has to guarantee all its deposits.</td>
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**CHALLENGES**

- Shariah interpretation versus the financing commercial viability.
- Legal jurisdictions and governing laws.
- Transparency, accountability and governance for public and private sectors.
- Tax incentives, pervasive government intervention and controls.
- Supervisory and prudential regulatory framework.
- Lack in depth capital markets and liquidity funding.
- Accounting and auditing standards.
Thank You & Wassalam

The information contained in this presentation may be meaningful only with the oral presentation and are of the personal view of the presenter and does not necessarily represent an official opinion of Bank Islam Malaysia Berhad.

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