

Syari'ah Compliance and Lawful Profit Making Dilemma in Malaysian Islamic Banks

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ABSTRACT

The significant roles of syari'ah and Islamic banking undeniably critical in order to ensure about compliances to the Islamic principle this in turn provide a very conclusive picture whether Islamic banks truly concerns about Islamic requirement when introducing any type of product that might have any significant effect on its marketability, however the terms used in Islamic banks currently are highly suspicious of being involved in unlawful practices as mentioned in the holy text Al-Quran, this has triggers the increased concerned about the strength of relationship between syari'ah compliance and profitability. The trade-off between profit and syari'ah compliance has remained one of very important issues which they must be addressed to ensure that Islamic banks are not only profit making financial institution but it also very concerns about the roles of Islam and the way that profit is gained to avoid making any profit that against the principle of syari'ah.

Keywords: Islamic banking, financing concept, profit and loss sharing, *Maqasid al-syari'ah* and theory of profit.

1. INTRODUCTION

Islamic banking institution has been given a complete right to make profit according to Islamic banking act 1984, this act authorizes Islamic banks to generate profit through Islamic banking services such as providing services to accept deposit money and using them as fund to finance borrower who wish to use the fund to cover their financial needs. These services are provided with some charges imposed by the bank in the form of profit which uses conventional banks interest rate as benchmark to determine profit rate. The charges are calculated based on predetermined formula, which ensured the maximum level of profit to be gained by Islamic banks.

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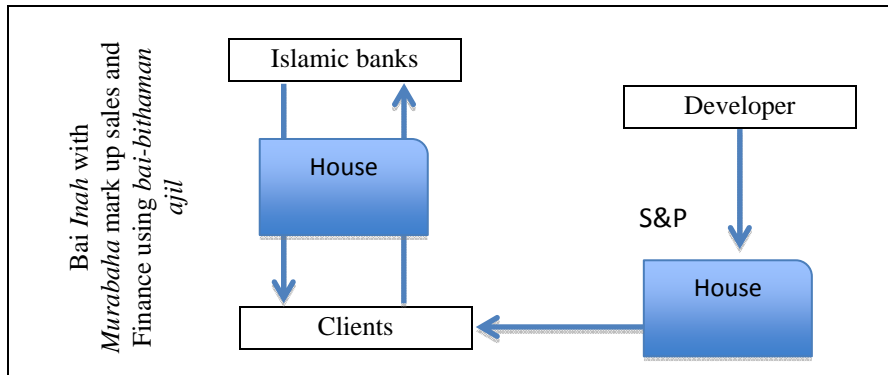
2. ACCRUED PENALTY ON HOUSING FINANCE

The Islamic banks today imposed some advance penalty charges on house buyer which assume maximum tendency to default on buyer as a result this has caused higher premium on financing value on the house which in turn promised the buyer that no additional charges will be imposed in the future when the prices of houses might increase with effect of bad economic condition whereas conventional banks use market rate to determine the interest rate Islamic banks however calculate base on ceiling rate in calculating its profit. This charges is determined based on an assumption that home buyer will default the instalment money in the future which make them charge higher price to cover in case of default. The question arises whether this charges is permissible in Islam with merely a speculative nature of assessing on credit quality of Islamic banks customer. (Rosly, 2010) the fact that an Islamic bank can freely imposed a selling price that surpassed the evils of riba when the customer is required to pay up all unearned (i.e accrued) profits when he defaulted on the financing facility.

2.1 Issues Facing By Islamic Banks Clients

There are numbers of challenges facing by Islamic bank clients when trying to revive the spirit of Islam by providing supports as depositors as well as financing applicants for financing package provided by Islamic banks. However such feeling has day by day declined due to their bad experience faced by these clients, Islamic banks policy today's is to maximise profit without considering its fundamental principle which supposes to provide financing package that aim to improve the social economic states in society in much ethical manner, they shouldn't mimic the conventional counterpart where interest rate is the focal consideration when approving loans. Therefore such policies has further burdened its clients which encourage them to choose conventional banks loans as their financing solution because they has made comparison in term of total finance cost with additional profit rate which far higher comparing with conventional banks which is lower.

Figure 1: Islamic Banks House Financing In Malaysia



The issues arises when the process of assets acquisition was seem to have element of tricks when ownership of property does not seem to appear the absence of *al kharaj bil daman* and *al guhrm bil ghurm* especially when the acquired property is then immediately sold to the seller using *bai-inah* along with *murabahah* mark up profit and then uses deferred payment sales *bai bithaman ajil* that uses ceiling price to value the assets price above market rate with consideration of worse financial crisis situation for instance the value of the house RM220,500 which is 90% of actual price was sold to the bank at the same price and Islamic banks then resells the acquired asset through sale and buy back arrangement at the price of RM831,431 which appeared on the sale and purchase contract, though the instalment amount is calculated at two stages first with current market price and then it is also calculated with the worse crisis condition where the highest rate is calculated. This could encourage speculative activities in which there is no element of moderation as the basis in the finance quality assessment that led to overprice on the assets.

2.2 Innovation in Islamic Banking

There always some innovations take place in Islamic banks that is considered as new, which has not been known before such as the introduction of hedging tools, and financial engineering which is increasingly more complex from time to time. The most prominent is when Islamic banks uses *murabahah* and *Bia-bithaman ajil* sales concept as financing tools further raises many questions among Islamic scholar on whether this application is complied to *syar'ah*. These two concept is widely used by Islamic banks due to its low risk in nature of the financing tools especially when all risk is borne by the Islamic bank client as what has been assume by some Islamic banks especially its ability to generate substantial profit to Islamic banks from its inception until present. The conformability in using these questionable concepts hindered the struggle to search for concrete financing tools that can truly materialise the ultimate objective of Islamic banks toward

using profit and loss sharing as primary concept in carrying out all banking activities. This can be achieved when Islamic banks shift its financing from debt based to profit and loss sharing especially by altering its balance sheet structure on the assets side the banks that it should have used more profit and loss sharing concept instead of over relied on debt based which is known as *murabahah* and *bai-bhithaman ajil* sales agreement. Then only Islamic bank would be able to fully utilise its potential by extending its roles from merely acting as lender to becoming partners in conducting the business so that both borrower and financier can progress in building strong and sustainable economic environment by adding values to the available financial resources combining man and material in an optimum uses. This is highly encouraged especially Islamic banks which are acting as very important intermediation roles that extend beyond traditional banking roles.

2.3 Impractical Competitive Advantage Adopted By Islamic Banking during Financial Turmoil

Fixed rate policies which might works well during the crisis, however financial turmoil is rarely happen in every 20 year on average. Therefore, by using exorbitant profit rate as ceiling rate is unreasonably and inappropriate when imposing on its clients to determine cost of financing. Therefore a more equitable credit assessment should be used to ensure that prevention from any possible involvement in prohibited practices.

2.4 Profit Making Financing Mode

Islamic banks in Malaysia actively use *Murabahah* and *Bi-Bithaman Ajil* as financing mode which is questionable when *Murabahah* is actually sales contract (Rosly, 2011) the practice of *Murabaha* has not actually shown its legitimate colour especially *Bai-Bithaman-Ajil* is widely used as assets financing.

The property sales agreement was required to be signed by the customer by the price that is four times higher than actually price whereas conventional banks charge the price twice higher than actual price of the house which is still lower compared to Islamic banks.

Table 1: House Loans and Price of Conventional Banks

Conventional Banks				
Cost price	Tenure	Monthly installment	Interest rate per year	Loan price is determined by using current market rate
RM 220,500	33 years	RM1, 059	BLR 6.6% - 2.2% = 4.4%	RM 419,315

Calculated: using public bank BLR -1 as on January 2013

Table 2 Housing Finance And Price Of Islamic Banks

Islamic banks				
House Price	Tenure	Monthly installment	Profit rate	Sale Price as appeared in PSA sales contract
RM 220,500	33 years	RM1,116	6.65%	RM 831,841

Sources: Bank Islam Malaysia S&P agreement

2.5 Islamic Compliance Mode of Financing

The idea of establishing equitable Islamic banks was the primary motivation when early scholars pioneered it; however in practice Islamic bank depart from these noble aims. Profit is the primary motive to many Islamic bank managers in which they engage themselves in *shari'ah* noncompliance activities. The first phase of eliminating interest was achieved successfully with the overwhelming support from primarily oil rich gulf countries. It was then embraced by numbers of non-arab *muslim* nations such as Malaysia, Brunei and Indonesia these countries were quickly embrace, promote and develop the product of Islamic banks to much advanced and more practical application. The concepts were mainly developed to substitute the existing interest based products that is available from conventional banks. Availability of printed and online materials concerning Islamic banking products and service especially opinions from very prominent scholars allows the *muslim ummah* to seek for the most reliable banks that can ensure they comply with the *Maqasid shari'ah*.

3. PROFIT MAKING IN ISLAMIC PERSPECTIVE

According to (Hasan, 2008) Profit making in Islam is determined based on various grounds as Muslim is determined to excel for Allah's blessing in this world and hereafter which mainly the act of submission to Allah because as in the Holy *Quran* stated that "Allah creates human and *Jins* for no other but to worshipping him" [zariyat 56]. This explains that all activities and business transaction should be conform to Islamic principle as stated in the holly *Quran* that Allah permits trade and prohibited *Riba* [2:275]. Profit is generally the motive of any business which in turn maximizing profit is permissible only if taking risk is part of the undertaking under the concept of *al-kharaj bil-daman* and *al-gunm bil-ghurm* the former is to ensure continued ownership of the good possessed and later profit is permissible when there is elements of liability for losses (Monzer and Khan, 1992; Ismail, 2007). However, the messenger of Allah said the best in every matters is moderate which can be applied to the level of

profit that the Islamic banks should price its assets based on moderation as stated in the hadith “*The best of all dealings is the one which is moderate*” [reported by *Baihaqi*]¹ rather than maximizing profit without considering the burden of Islamic banks client. (Adelabu, et al 2011) Islamic banks’ making profit from the business is acceptable, the accumulation of profit without utilisation for the betterment of the community is forbidden. (Paino, et al 2011) elimination of brutality among human is highly praised through expelling of inequality, exploitation and wrongdoing. (Arshad and Ismail, 2010) *Hanafis* school of thought did not permit the one who worked less to collect a larger profit share, and did not permit one of the partners to collect the entire profit. (Hasan, 1983) just distribution of profit through using moderation as basis to ensure fairness between all parties involves is a very critical factors to ensure legitimate profit according to Islamic principle. (Rosly, et al 2001) any form of profit derived from the application of Islamic modes of finance using the contract of sale such as *bay’ muajjal* or credit-based *murabahah*, *mudarabah*, *ijarah*, *salam*, *istisna’* and others must be able to exhibit the existent of ‘*iwad* in order to ensure its legitimate profit in any trade transaction.

4. ELEMENT THAT LEADS TO ILLEGITIMATE PRICING ON ISLAMIC BANKS HOUSE FINANCING CONTRACTS

The Holy Quran has clearly prohibited any elements of usury and cheating that occurred as a result of gambling, ambiguity, and cruelty. (Mohd Yatim, 2009) the appearance of multiple pricing elements in a single contract of deferred payment sales (*Bai-Bithaman-Ajil*) which leading to violating of contract and ambiguity (*Gharar*). (Muda and Jalil, 2007) *Al-Interest & usury (Riba)*, Ignorance (*Al-jahalah*), mistake (*Al-Ghalat*), defect (*Al-ayb*), Gambling (*Al-maisir*), Unjustifiable/ unreasonable price (*Al-Ghabn*), Helping on unlawful purpose (*Al-I’nah ala al-munkar*), Violation of shari’ah sanctity (*Intihak Al-Hurmah al-Shar’iyyah*), legal device (*Al-hilah*), Impairment (*Al-dharar*), oppression; injustice and unfairness (*Al-zulm*), Corrupting Conditions (*Al-Shuruth al-Mufsidah*), artificial price hiking (*Al-Najsh*) and Coercion; compulsion (*Al-Ikrah*). It is very obvious that Islamic banks today is facing with most of the above mentioned shari’ah issues which is mainly due to the fact that its operations is currently based on the basis of necessities (*Darurrah*) using markup sales (*Murabahah*) and deferred payment sales (*Bai-bhitaman-ajil*) and (*Bai-Inah*) that raises various shari’ah issues especially when some scholars claims that this mode of financing allows usury (*Riba*) to sneak in from the back door moreover the nature of its pricing also raises the issues of ambiguity (*Gharar*) which is prohibited in Islamic and render the contracts to be void. Moreover, in practice Islamic banks in Malaysia leave no room for the implementation of freedom to choose (*khiyar-al syart*) this is especially when house purchaser in particular is given no other option but to accept the Islamic bank financing

ceiling price offer with substantially high price especially when setting the ceiling rate without considering the morale and ethical aspect in its pricing (Mohd. Dahlan, et al 2011) sale and buy-back agreement (*Bay al-Inah*) remains subject to debate due its presents of usury of (*Riba'*) in the process of borrowing transactions of differences in prices or a trick. As consequences the loyal clients may consider an alternative option to Islamic banks especially present days when numbers of new bank participate in offering Islamic finance products. Therefore Islamic banks should come up with prudent mechanism that able to eliminate and prevent any prohibitive elements that may render the contract to void. Therefore, careful exercise of Islamic banking mode of finance is extremely important to ensure that it is free from any prohibited elements.

Islamic bank that is operating side by side to full stream Islamic banks with strong assets, which is derived from interest, based baking activities. This is considered as important rival that has a very strong financial background.

5. CONCLUSION

Emphasis on short term profit maximization with the expense of sustainability and credibility is considered as very inefficient decision making by Islamic banks especially when choosing the core product such as *murabahah* mode of financing which is not by nature a financing tool but a sale contract and using *bai-bithaman ajil* or deferred payment sales as asset financing. The accrued penalty based on asset pricing could lead to overpriced of assets that eventually reduce bank Islam competitive advantage against its conventional counterpart. Better pricing can be determined on the basis of profit and loss sharing concept, which is based on *musyarakah mutanaqisah*, and other partnership based financing that can be found in many forms of partnership contract according to *syari'ah* approved concept. This could prevent from involving in unjust activities due to misuse and manipulation in the concept of finance that would eventually destroy the confidence of Islamic banks customers.

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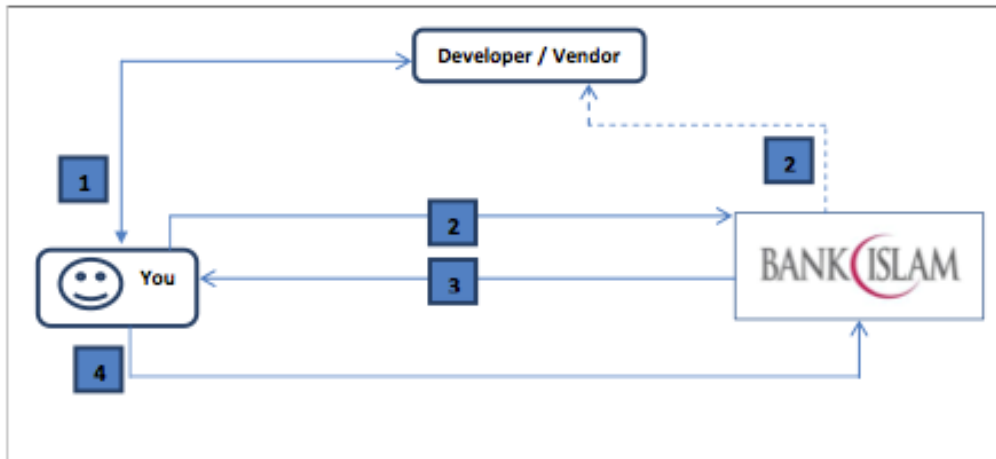
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APPENDIX

Figure 2: Bank Islam House PPA and PSA Contract



Source: Bank Islam Website (www.bankislam.com.my)

1. You purchase the property from the developer/vendor by executing the Sale & Purchase Agreement. At this juncture, the ownership of the property passes to you.
2. You enter into a sale transaction with the Bank and the Bank will purchase the property through the execution of the Property Purchase Agreement. The Bank will pay the developer/vendor for the purchase price on cash basis.
3. The Bank sells the property to you by executing the Property Sale Transaction based on the Bank's Sale Price which consists of the financing amount and Bank's profit. The property will be charged to the Bank to secure the payment for the financing under this Facility.
4. You pay the Bank for the Sale Price on a deferred payment basis by way of monthly instalments within an agreed period.