COMMODITY MURĀBAḤAH AS AN UNDERLYING CONCEPT FOR DEMAND DEPOSIT STRUCTURE

BY

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A dissertation submitted in fulfilment of the requirements for the degree of Master of Science (Islamic Banking and Finance)

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ABSTRACT

Malaysia is the leading Islamic finance hub, but has a dual-banking system that needs to be addressed by Islamic financial institutions (IFIs). And although IFIs in Malaysia have been resilient and competitive against its conventional counterpart, the enactment of the Islamic Financial Services Act 2013 (the Act) has made a huge short-term impact on IFIs, particularly with respect to its liquidity and liability management. The case is due to the restrictions imposed by *Wadīʿah* and *Qarḍ*-based deposits, where promising returns or any kind of benefit will tantamount to *ribā* which is prohibited in Islam. This has made IFIs in Malaysia unable to compete with the conventional counterparts, in terms of attracting low cost funds. As the method of attracting low cost funding is vital for IFIs to remain competitive in Malaysia's dual-banking system, this research attempts to structure a demand deposit product based on Commodity *Murābaḥah* which will enable IFIs to command back the market share of deposits.

خلاصة البحث

ماليزيا هي مركز التمويل الإسلامي الرائدة, ولكن لديها نظام ثنائي المصرفية التي تحتاج إلى معالجة من قبل المؤسسات المالية الإسلامية. و على الرغم من أن المؤسسات المالية الإسلامية في ماليزيا كانت مرونة و قدرة على المنافسة ضد نظيره التقليدي, قامت بسن قانون الخدمات المالية الإسلامية 2013 تأثير كبير على المدى القصير على المؤسسات المالية الإسلامية، لا سيما فيما يتعلق بإدارة السيولة ومسؤوليته. ويرجع ذلك إلى القيود التي تفرضها على الودائع على أساس وديعة والقرض ,حيث العوائد واعدة أو أي نوع من الفائدة سوف يرقى إلى ربا وهو محظور في الإسلام. وهذا ما جعل المؤسسات المالية الإسلامية في ماليزيا غير قادرة على المنافسة مع نظيراتها التقليدية، من حيث جذب الأموال منخفضة التكلفة. كما أن طريقة لجذب التمويل منخفض التكلفة أمر حيوي للمؤسسات المالية الإسلامية لتظل قادرة على المنافسة في نظام ثنائي المصرفية في ماليزيا، يحاول هذا البحث لهيكلة منتج demand deposit على أساس Commodity Murābaḥah مما سيمكن المؤسسات المالية الإسلامية لقيادة الظهر الحصة السوقية من الودائع.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

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Rusni binti Hassan
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

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Examiner

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Suhaib Torla

Signature…………………………….. Date…………………..

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TRANSLITERATION

Arabic	Roman	Arabic	Roman
ح	ḥ	ع	ʿ
ط	ṭ	ء	ʾ
ظ	ẓ	ى,ا	ā
ص	ṣ	و	ū
ض	ḍ	ي	ī

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

Modern Islamic finance has been around for only a few decades whereas its conventional counterpart has been around for hundreds of years. And although Islamic finance is accounted for just a small fraction of the world's financial system, it has been garnering enormous attention and a constant high growth rate of approximately 10 – 20 percent per annum (Hancock, 2013). There are various reasons as to the sudden interest on Islamic finance, such as it being the banking solution for Muslims, but Islamic finance has also caught the attention of non-Muslims who wish to find alternative solutions to a highly speculative system.

Despite many reasons can be attributed as to why Islamic finance is different from the conventional finance, Islamic finance differs mainly due to its compliance with Shariah. The added advantages that Islamic finance brings can always be adopted by conventional finance, but it can never be Islamic finance so long as it does not comply with the rules of Shariah (Moore, 1997). The challenges faced in providing Shariah compliant solutions to financial institutions have not been easy but can be considered successful with what has been achieved today.

1.2 BACKGROUND OF STUDY

In virtue of the operations of Islamic finance in Malaysia, Islamic financial institutions ("IFIs"), particularly Islamic banks, have a business operation model similar to their conventional counterpart that mainly focuses on obtaining funds and channelling the funds to financings and other investments. Such operational workflow is similar for any banks regardless of its place of origin. As such, IFIs are not to be considered as charitable organizations as some would speculate, but are profit-seeking businesses operating on a system which does not go against Islamic teachings.

A research on cost and profit efficiency of Malaysia commercial banks discusses the variables used in measuring for cost and profit equations (Tahir et al., 2010). Two main variables utilized in the study were price of labour or overhead expenses, and price of deposits or better known as cost of funds. Therefore, it is vital for an IFI to not only have a Shariah-compliant demand deposit product, but a product that is able to attract more deposit funds in order to reduce the respective cost of funds and increase profitability. Moreover, these requirements are needed for IFIs to remain competitive in an industry dominated by an interest-based financial system. So the main question surfaces, do Islamic banks need a new Shariah-compliant demand deposit product?

In the light of the above discussion, it is only logical that every industry player of the Islamic financial sector attempts to safeguard both its short-term and long-term competitive advantage. To add, IFIs need to compete with conventional financial institutions as well. Financial institutions ("FIs") like any other firms will need to be continually innovative and create new marketable products (Kelly and Storey 2000). Such product innovation takes its meaning particularly relevant to the Islamic finance industry. It indicates the effort of IFIs to utilize all known Shariah-compliant contracts to create new ideas and innovation in order to meet the changes in demand as well as each IFI's required internal product development so as to ensure sustained growth and profitability for the business.

1.3 PROBLEM STATEMENT

In 2013, Malaysia introduced the Islamic Financial Services Act ("IFSA" or the "Act") 2013 through its enactment in the Parliament. With the enforcement of IFSA 2013, preceding Acts such as the Banking and Financial Institution Act ("BAFIA") and Islamic Banking Act ("IBA") are deemed as obsolete. One major concern that has arisen from this was the definition given on "Islamic deposits" in the Act, where:

> *"Islamic deposit" means a sum of money accepted or paid in accordance with Shariah—*
>
> *(a) on terms under which it will be repaid in full, with or without any gains, return or any other consideration in money or money's worth, either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and person accepting it; or*
>
> *(b) under an arrangement, on terms whereby the proceeds under the arrangement to be paid to the person paying the sum of money shall not be less than such sum of money,*

The concern arises as all deposit products (including demand deposits and term deposits) need to adhere to the meaning of "*it will be repaid in full,*" and, "*the proceeds under the arrangement to be paid....shall not be less than such sum of money,*" This meant that Shariah concepts which are loss-bearing to the capital provider in nature, such as *Muḍārabah*, *Mushārakah* and *Wakālah*, did not fall under the definition of Islamic deposits as interpreted in IFSA 2013.

Malaysia, being a country practicing a dual-banking system, means that the Islamic banking system and conventional counterpart are always competing against each other. While the imposition of IFSA 2013 has reduced the number of Shariah concepts for Islamic deposits, the Financial Services Act (FSA) 2013 has created no changes in terms of concepts used for deposits under conventional banking. In fact, conventional banks have been using only one (1) concept for deposits which is loan with interest. As such, limited options on Shariah concepts are available for IFIs to structure deposit products. A greater concern is the Shariah concept used to structure demand deposit products since demand deposits are regarded as the cheapest source of funds a particular IFI is able to obtain, as suggested previously.

The direct effect from the limited options on Shariah concepts available for IFIs is that these remaining options have features that are a requirement from Shariah, which make Islamic deposits inferior to conventional deposits, in terms of marketability and attractiveness.

1.4 RESEARCH OBJECTIVES

The main objective of this research is to propose a viable solution by structuring a demand deposit based on *Murābaḥah* via a *Tawarruq* arrangement, or commonly known as Commodity *Murābaḥah*. In addition to this, this research attempts to solve various issues which are a result of the implementation of Commodity *Murābaḥah* structure into a demand deposit product. In respect to the above, the objectives of this research are:

1. To analyse the issues and challenges of existing products used by Islamic banking institutions in Malaysia;
2. To examine the viability of Commodity *Murābaḥah* as a demand deposit product; and
3. To recommend a structure that is in tandem with the findings.

1.5 RESEARCH QUESTIONS

In furtherance to the research objectives directed, this paper will deliberate and conclude the objectives of this research by answering few questions. The research questions posed are:

1. What are the problems, challenges and issues with the existing products?
2. Is Commodity *Murābaḥah* suitable to be structured as a demand deposit product?
3. What are the issues that would arise from structuring a Commodity *Murābaḥah* demand deposit product?
4. What are the recommendations to structure a demand deposit product based on Commodity *Murābaḥah*?

1.6 RESEARCH METHODOLOGY

This paper will be based on a qualitative research methodology. The research will be examined by way of two (2) main methods, which are:

1. Collection of Information via Library Research, Textual Study and Internet Browsing.

   This research collects relevant information by referring to academic journals, articles, reports, websites, and other types of publications. In the context of Islamic studies or Shariah, reference is made to the *Qur'ān*, the *Sunnah* as well as other writings by Islamic jurists and contemporary Islamic scholars. This is translated as the textual references made throughout this research by way of textual citations and footnotes.

2. Interview

   This research also collects information on the practice within the Islamic finance industry in Malaysia by conducting an interview with three (3) respondents from the Shariah, product and legal departments of a local Islamic bank. The Islamic bank currently offers relevant products based on Commodity *Murābaḥah* and is in the midst of offering a deposit product based on Commodity *Murābaḥah*, similar to the research conducted. The questions posed are as per Appendix 1 and the responses have been embedded into this research in relevant chapters.

1.7 SIGNIFICANCE OF STUDY

This study may be of assistance to various parties including academics, students, researchers, practitioners as well as regulators to a certain extent. Practitioners are able to use this paper as a guide in constructing a viable demand deposit product structure, considered to be Shariah compliant and assist in reducing the overall cost of funds of a particular IFI. Academics and students, on the other hand, are able to further comprehend the issues relating to Commodity *Murābaḥah* with regard to Shariah issues and other operational issues when implementing such structure, in practice.

1.8 SCOPE OF STUDY

This research covers the issues arising from the implementation of IFSA 2013 with regard to Islamic deposit products, particularly the implementation of Commodity *Murābaḥah*. Despite the background of this study arises from an Act which is specific to Malaysia alone, the issues relating to operations, Shariah and cost efficiency is relatable to any IFI around the globe which seeks to attempt to implement a Shariah-compliant demand deposit product based on Commodity *Murābaḥah* via the Shariah concept of *Tawarruq* and *Murābaḥah*.

1.9 CHAPTERISATION

Chapter 1 of this paper has been on describing the overview of the research paper, which includes the research paper's problem statement, objectives, research questions and methodologies, as well as significance and scope of the study made.

Chapter 2 will define what demand deposit generally means, its characteristics and objectives, and thereafter include its Islamic variety and application in the Malaysian market. It will also discuss on the effects and changes within the Islamic products due to change in legal environment in Malaysia. This includes the discussion on what is required of an Islamic demand deposit and why an alternative Shariah concept needs to be adopted as an Islamic demand deposit.

Chapter 3 will discuss on the legality and structure of Commodity *Murābaḥah* which is the underlying Shariah concept to be adopted into the new structure. The chapter will also discuss the practice of Commodity *Murābaḥah* in the Malaysian market as well as the known issues relating to it; these issues become precedence to the proposal as numerous similarities will be found between them.

Chapter 4 will then attempt to assimilate the structure of Commodity *Murābaḥah* as a demand deposit product in the context of Malaysia. This includes issues of structuring Commodity *Murābaḥah* to fit into the characteristics of demand deposit as well as discuss adherence to guidelines that are compulsory issued by regulator(s). This chapter will only discuss and suggest general solutions rather than the researcher's own recommendation to the issue.

Finally, Chapter 5 will summarize the materials discussed and explain the researcher's recommendation by way of a structure that can be implemented by an IFI in Malaysia, as it is operationally viable and is Shariah compliant, after taking into account the information discussed in earlier chapters.

CHAPTER TWO

DEMAND DEPOSIT PRODUCTS IN ISLAMIC BANKING

2.1 INTRODUCTION

All (or most) IFIs have similar operational structures whereby these institutions provide services such as accepting deposits, giving financings and offering other investment products. Each IFI will be able to provide these services to the retail segment, commercial segment, corporate segment, or all depending on their purpose or business strategy. As most would know, financial institutions (both interest-based and Islamic) are profit seeking organizations and most would have profits as their main objective (Reed and Gill, 1989). Some IFIs which are development financial institutions, of course, may have objectives in supporting development rather than pure profit-inclined goals. However, profit will always be one of the objectives and serve as a measure for performance of any FIs by their shareholders and board of directors.

Hence, for an IFI to obtain profits they are to provide Shariah-compliant products and services which enable them to charge a certain amount of profit or fee in return for their products and services. One of IFIs' main contributions to profits is by giving out financing to customers, naturally. The financings can be provided by way of several Shariah concepts such as *Murābaḥah*, *Mushārakah*, *Muḍārabah*, *Ujrah*, etc. as long as permitted by Shariah.

However, for an IFI to be able to provide financings to customers, the IFI must secure funds for such purpose. And although financial and banking institutions are commonly equated with having abundant if money, this fund us not theirs entirely. IFIs – just like conventional FIs – only own a fraction of the funds by way of shareholders' equity. The remainder are accumulated by way of deposit placements (for both conventional and Islamic) or even investment accounts (for Islamic only).

These deposit placements are accumulated via different segments of banking such as retail banking, commercial banking, corporate banking and also through the money market. And for most of these segments, different types of deposits are utilized to cater to the depositors' needs, such as current accounts, savings accounts and fixed deposits (Madura, 2012).

When these funds are collected, a certain amount of returns is expected by the depositors and will formulate part of the FI's cost of funds. A cost of fund is – to put it in layman terms – the cost for obtaining the funds i.e. the interest paid back for borrowing that fund (Chorafas, 1989). With the acceptance of the deposits from the depositors and the obligation to give returns to these depositors, FIs will utilize the funds for its banking operations such as providing financings. By doing so, FIs are able to reap profit from the difference between the profit charged in financing and the returns liable to depositors. This is commonly known as leveraging.

Leveraging is "the use of various financial instruments or borrowed capital to increase the potential return of an investment" according to Investopedia. As such, a FI uses borrowed capital expecting that the profits made to be greater than the returns payable to the capital lender. This concept is in tandem with the results and expectations of an IFI, although with different contracts involved.

The idea of such concept to use others' money to fund other people is currently used by FIs around the world, both conventional and Islamic. This is also why these institutions are known as financial intermediaries. A financial intermediary is a company that obtains funds from a group with "surplus funds" and make them available to another group with "deficit funds" (Kolb and Rodriguez, 1992).

The terminology "surplus" and "deficit" must not be equated with being rich and poor. Surplus here means that the individual or corporation has money which it does not wish to use yet, while deficit means to want more funds to finance a certain purpose regardless of whether the individual or corporation has no money or is cash rich.

Thus, why is there a need for this financial intermediation? This is to smoothen or make more efficient the process of channelling the funds from surplus to deficit by matching the needs of users and suppliers of funds. This mismatch basically occurs due to unwillingness to accept the level of risk when directly involving with the users of funds. Therefore, financial institutions choose to fill this gap by intermediating the funds and absorbing the risks. Of course, FIs will not just take away risk blindly. The FIs will assess the credit risks of the applicants and provide financings and other services to those with lesser risk.

Not only that, but FIs also act to assist time intermediation on aspects related to maturity and liquidity (Kolb and Rodriguez, 1992). Not many would invest their money for 30 years straight if a business man wanted funds to finance the purchase of a building. Most would prefer short maturities, on average up to 3 months, the longest 12 months, or perhaps require a callable instrument enabling them to recoup their money on demand.