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ISLAMIC CREDIT CARD: A FRAMEWORK OF IMPLEMENTATION IN MALAYSIA

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ABSTRACT OF THE THESIS

One financial product that has not quite been on the menu offerings of Islamic banks is the credit card application. This is due to various religious principles that would put an Islamic credit card at a disadvantage competitively when compared with the conventional offerings. Thus the reason for the unfeasibility of an Islamic credit card. This paper examines in detail the credit card application, submits a comprehensive product solution, covering both the Syariah and commercial aspects, that can be called an Islamic Credit Card, presents some other alternative solutions of an Islamic credit card and the setbacks and issues that surround these structures. This paper also highlights some results of a market research conducted to position the Islamic Credit Card in the market for commercial use.

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Preamble

Innovation in Islamic finance has been very rapid and prosperous over the past few years. This is despite the debate and argument as to the validity and acceptability of these Islamic financial products by the various quarters of the Muslim world. However, Islamic finance could not simply sit idle and be proud of its achievements. There needs to be further improvements, refinements and more innovations to bring Islamic finance to a level where it would be a viable alternative solution for Muslims to transact.

One commercial application that has not quite got off the ground in Islamic finance is the credit card system. The mention of the word credit card causes a certain degree of apprehension and distaste among many Muslims. This is perhaps due to the high rates of interest charged by the credit card companies which is tantamount to riba'.

However, the growth of credit cards has had an enormous impact on the economy – changing buying habits by making it much easier for consumers to finance purchases for everyday needs or emergencies like pulling up at the nearest petrol station immediately even if there is no cash in the wallet. Moreover, credit-card expenditure in Saudi Arabia, a nation where 97% of consumers still use cash for personal financial transactions, reached SR42million in the first nine months of 2000, and expected to grow by 40% in 2001.[1] This is proof of the large and virgin market that awaits the Islamic credit card industry.

[1] Mushtak Parker, **"Al-Rajhi Credit Card Pass 1 million"**. *Islamic Banker.*(Issue 58/59) Nov/Dec. 2000, p.3

Motivation of Study

This paper is written between the periods of January 2001 to July 2001. During this period, the financial landscape in Malaysia is witnessing low interest rates and this has encouraged many consumers to withdraw funds from their savings and invest in various physical goods and services.[2] Islamic finance seems to be the biggest benefactor, simply because the effects of the stranglehold of conventional floating rates during the 1997-98 "Asian Financial Crisis" is still being felt among many consumers. Islamic finance was declared the solution for banks in Indonesia at that time[3], and in Malaysia, consumers are beginning to be more Islamic-finance-literate.

Looking at such an encouraging response to Islamic banking and finance, Islamic bankers are scrambling to introduce newer products and innovations. One of the product application in question that is about to take the market by storm is the Islamic credit card business. In March 2001, HSBC became the first bank in Malaysia to introduce the Islamic charge card. And between the months March and July 2001, word in the market was that several other banks would follow suit by offering the Islamic credit card.

The objective of this paper is to give the readers a deeper understanding of the instrument called credit cards, and to evaluate these instruments in the light of Syariah to be used for a commercial purpose, and thus to establish the meaning of an Islamic credit card. In addition to that, this paper serves as a manual for any bank that wishes to understand the accounting entries involved in the various transactions, or the computation of the selling price and rebates.

[2] Bank Negara Malaysia (BNM) Annual Report. 2000. "**Foreword**", pg.1

Having explained the mechanics of the credit card business, the paper also highlights results of a market research that would eventually indicate whether introducing an Islamic credit card is feasible and realistic for a multi-racial Malaysian market.

The paper is organized as follows; Section 1 examines the classification of cards, the basic structure and profit accrual scenarios in a credit card business. Section 2 is a detailed proposal for an Islamic credit card solution, which includes the Syariah framework, the accounting entries, profit computation methods and rebate methods shown through examples and scenarios. This section also highlights various issues in launching an Islamic credit card business especially legal, promotional and Syariah issues. Section 3 looks briefly at the various other alternatives for an Islamic credit card and highlights their setbacks in the light of Syariah. Finally, Section 4 presents the results of a market survey conducted to find out consumer behaviour in credit card utilization before concluding.

SECTION ONE: THE BASICS

1.1 Classification Of Cards

Credit Card is a device used to obtain consumer credit at the time of purchasing an article or service. Credit cards may be issued by a business, such as a department store or an oil company, to make it easier for consumers to buy their products. Alternatively, credit cards may be issued by third parties, such as a bank or a financial

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[3] Mushtak Parker, "**Six Indonesian Banks to Convert to IB**", *Islamic Banker*, May 1999(Issue No. 40), p.3

services company, and used by consumers to purchase goods and services from other companies.[4]

There are three types of cards that can be used as a mode of payment – debit cards, credit cards and charge cards. Debit cards are essentially cards issued to customers who have available funds in their accounts. The card confers on its holder the right to withdraw cash from his account or to pay for goods and services purchased up to the limit of the available funds on his account.[5]

Charge cards provides a credit facility up to a certain ceiling for a specified period of time, as well as providing a means of repayment.[6] While a credit card is a card that provides a revolving credit facility within the credit limit and credit period determined by the issuer of the card. Credit cards such as Visa and MasterCard allow the consumer to pay a monthly minimum on their purchases with an interest charged on the unpaid balance.[7] In Malaysia, most banks issue Visa and MasterCard credit cards. The following section will explain how a credit card transaction actually works.

1.2 How Credit Card Transactions Work

The typical credit card transaction begins when the customer hands the credit card to the cashier. The cashier's next action depends very much on the system in use and the technology that supports it. The cashier will either manually imprint the card onto the paper draft, which is the old technology, or swipes the card through an electronic

[4] http://kids.infoplease.lycos.com, **"Credit Card"**
[5] Draft copy Shari'a Standard, **"Debit Card, Charge Card and Credit Card"**, para 2/1, pg 32, Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), Shari'a Standard No. 2. 1421H/2000M
[6] Ibid
[7] Ibid

terminal, which is the current technology. At self-service petrol stations, the customer performs the swiping of card ritual all by themselves.

The next step in the typical transaction is for the cashier to obtain permission from the credit card company to process the sale with the credit card. Using the older technology, the cashier will have to call a special number to obtain an authorization code. But the current technology automates this process after the card is swiped. The final step to conclude the transaction is to obtain the signature of the customer on the receipt. For the customer, all he has to do next is wait for the monthly statement of his bill to arrive upon which he has to settle within a certain grace period[8].

As for the cashier at the store, she has to send the credit card sales receipts to the bank to get paid. Using the older technology, the receipt will have to be manually brought to the bank for redemption. But with the current technology, these receipts can be electronically sent to the bank – an end-of-the-day processing operation called "settling the accounts"[9].

For example, let us take Restoran Rasa Utara as the merchant. The customer holds a Maybank Visa Credit Card. After his meal, he pays using the credit card. The cashier at the restaurant swipes the card and punches in the codes imprinted on the card. This triggers an electronic transmission to Maybank to verify the code and check whether the customer has exceeded his credit limit or not. Upon clearance, the digitalized transmission sends back the message to the cashier at the restaurant to proceed with

[8] www.lycos.com/business/; **"How Credit Card Transactions Work"**
[9] Ibid

the sale. Restoran Rasa Utara shall redeem their payments minus charges the following day either by cheque issuance or deposit crediting.

1.3 Basic Structure of Credit Card Operations

The following diagram reflects the basic structure of a typical credit card operation. The table following the diagram outlines the roles of each player in the diagram[10].

DIAGRAM 1: BASIC STRUCTURE OF CREDIT CARD APPLICATION

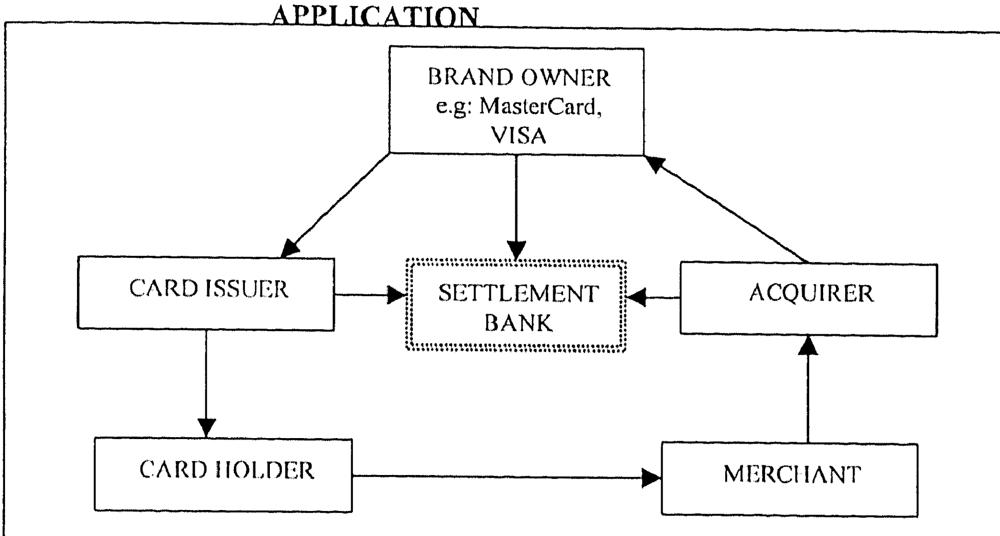


Diagram 1

Brand Owner:	This is the payment services company, who provides the brand, infrastructure, systems network to connect all related parties and also settlement services between the card issuer and the acquirer. Among the famous brand owners are VISA, MasterCard, American Express, etc.
Acquirer:	This is a licensed merchant acquirer who signs up merchants to

[10] Ibid

	accept payment of goods/services using the credit card. Therefore, when a customer walks into a merchant store that allows for payment via credit card, the acquirer's signage or logo can be seen in the swiping machine. In addition to that, the merchant will claim for their dues from the Acquirer, which is normally a licensed financial institution.
Card Issuer:	This is a licensed card issuer of the Brand Owner, who provides the credit card facility to their cardholders. The customer's repayment is made to the Card Issuer. In most cases, the card issuer is a licensed financial institution in the operating country. An example of card issuer is Citibank or Maybank in Malaysia.
Cardholder:	The customer of the card issuer who obtains the credit card facility based on the eligibility criteria set by the regulators and card issuer.
Merchant:	The merchant who signed up with the Acquirer to accept payments/charges of their goods/services using credit cards bearing similar Brand owner signage. The merchant's reimbursement will be done by the Acquirer.
Settlement Bank:	The Brand Owner, card issuer and Acquirer will maintain settlement accounts with the settlement bank. Based on the instructions given by the Brand Owner, the settlement process will

	take effect **every day** between the settlement accounts.

To get a better understanding of the above elaboration, let us analyze the following example. Ali is a Maybank Visa credit cardholder. During the month of July, he made only one purchase from Carrefour Hypermarket for RM400. He noticed that the receipt issued by the Carrefour cashier bore the HSBC Bank logo. However, Ali received his statement of balances at the end of the month from Maybank.

Based on the above example, this is how the roles are played;

Card holder:	Ali is the cardholder.
Merchant:	The merchant is Carrefour Hypermart. Carrefour will claim the RM400 transaction of Ali from the Acquiring Bank.
Acquirer:	HSBC is the Acquiring Bank because Carrefour is a selected merchant of HSBC. We know this because the receipt that Ali received from the cashier bore the HSBC logo. HSBC will settle the RM400 claim from Carrefour after deducting their service charges.
Brand Owner:	VISA is the Brand Owner. The Brand Owner will reimburse the RM400, after deducting charges, to HSBC.
Settlement bank:	VISA in return will claim the RM400 from the Settlement Bank. An example of the Settlement Bank is Chase manhattan in New York. The Settlement Bank will claim the funds from the issuing bank.
Issuing bank:	The Issuing bank is Maybank. Their funds maintained at the Settlement Bank is deducted to reimburse the Brand Owner.

	Eventually, the Issuing bank will claim their amount due by billing the customer. Therefore, eventually Ali will settle his outstanding dues to Maybank.

The above elaboration has been a typical example of how a credit card relationship works between the many players involved. The next section, shall highlight the various industry practices in accruing interest or profit as in Islamic finance.

1.4 Profit Accrual Scenarios

Profit will be accrued from a particular date onwards. This particular date could be any of the following:

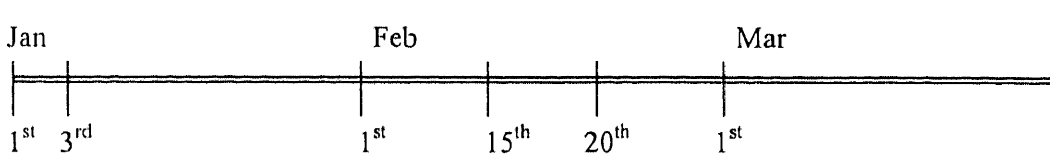
a) Transaction Date

b) Posting Date

c) Statement Generation Date

d) Payment Due Date

The common practice is to start accruing profit from the payment due date onwards. In addition, the payment due date is normally 20 days after the statement date. For example, if the statement date is 1st January, thus profit will start to accrue on any outstanding balance from 20th January onwards. The following timeline presents that example.



Scenario 1: Retail Purchase & Profit Accruing Date

1st Jan	: Customer makes a retail purchase of RM1,000. This is the ***transaction date.***
3rd Jan	: The transaction gets posted on this date. This is the ***posting date.***
1st Feb	: This is the ***statement generation date.*** The customer is billed for RM1,000. The customer will be given 20 days to make repayment.
1st Mar	This is the second statement date, which also serves as the date to capitalize profit accrual of the previous month's transactions. It is normal for credit card issuers to start accruing profit at the expiry of the grace period granted. However, profit can be accrued from either the transaction date, posting date or even the statement date. For the above example, the profit accrual is as follows: [RM1,000 x 9 days x 18%] / 365 = RM4.43 The billing to the customer is RM1004.43

Scenario 2: Payment of Principal Before Due Date

Following the above example, let us show the common practice when the customer makes a repayment before the next due date.

1st Feb	: Statement Generation Date with billing of RM1,000
15th Feb	: Customer settles the principal amount of RM1,000
20th Feb	: No profit accrual takes place.

The above scenario shows that as the customer has settled the principal amount of the credit line, there is no profit accrual on the profit outstanding. However, if there was only partial principal settlement, a different scenario emerges as shown below.

Scenario 3: Payment of Principal After Due Date Before Capitalization Date

1st Feb	: Statement Generation Date with Billing RM1,000
20th Feb	: Profit accrual starts to be computed.
25th Feb	: Customer settles RM1,000
1st Mar	: No profit accrual is capitalized. The profit accrual for five days between 20th and 25th Feb, is waived, because of full settlement. However, if the bank decides to charge the customer for the 5 days delay, it shall be generated on 1st March.

Scenario 4: Partial Payment of Principal

1st Feb	: Statement Generation Date with billing of RM1,000
15th Feb	: Customer makes repayment of RM500.00
20th Feb	: Profit is accrued on RM500 outstanding principal.
1st Mar	: Statement Generation Date with billing of RM502.22 : RM2.22 is the profit accrued between 20th Feb to 1st March (9 days).

The above is a sample of the various scenarios of customer repayment[11]. What is provided is basically a suggestion of how the bank shall accrue profits, according to

[11] The author is greatly indebted to a Mr.Chan Fuan Seng of Silverlake System for his indepth information on the above matter.

normal credit card operation. However, actual practice shall be based on each bank's policy requirement.

SECTION TWO: ISLAMIC CREDIT CARD – A PROPOSED SOLUTION

2.1 Conceptual Overview

There are several approaches that can be applied to materialize the Islamic credit card. However, the most viable solution would be the one that meets the objectives of all the parties. This section will highlight one of the proposed solutions. The next section shall highlight other alternative solutions. The first proposal to be submitted here uses a combination of Al-Hiwalah al-Mutlaqah, Qardhul Hasan and Ujr contracts.

During the course of this research, it was found that Islamic contracts can be used to conceptualize the model of an Islamic credit card. However, such a model cannot stand using only a single contract. The architecture must combine a hybrid of contracts. And thus, this proposal of an Islamic credit card uses three different contracts to serve the various purposes. For example, the contract of Hiwalah is proposed to handle retail purchases using the credit card. The contract of Qardhul hasan is proposed to handle the cash advance activities. And finally, the contract of Ujr is proposed to handle all the licensing and fee-based transactions. The detailed elaboration is presented below.

Firstly, the bank issues cards to qualified applicants. This card is issued on the basis of al-Ujr, where the bank charges a fixed amount of fee that is levied on an annual basis. Al-Ujr is a contract of exchange between two parties where one party renders services to be exchanged for cash payments.[12] In this case, the bank provides various services like processing the application, issuing cards, embossing cards, billing service and providing a line of credit for the customer to transact. In return a fixed annual fee is charged to the customer.

Secondly, the contract that allows the customer to utilize the fund is analyzed. The contract that is proposed here is al-Hiwalah al-Mutlaqah. Al-Hiwalah has all along been known as a contract of providing security However, this paper considers al-Hiwalah in the light of a financing contract.[13] Having said that let us now consider the salient features of a Hiwalah contract in the light of a credit card business.

Al-Hiwalah is a contract that transfers debt from one party to another. And the party that is allowed to transfer the debt is always the Principal Creditor. In a credit card scenario, there are three parties involved. The first is the customer, who makes a purchase on credit as he charges it to his card. The customer becomes a debtor. The merchant who takes credit as a payment mode is known as the Principal Creditor. Therefore, it is the merchant who is allowed to transfer the debt to another party who is willing to purchase the debt from the Principal Creditor. And that party is the bank. Therefore the bank, shall assume the role of the new Principal Creditor.[14]

To proceed with the model, there are a few submissions to be made in this proposal. The first submission is to treat this Hiwalah as a financing arrangement, whereby the

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[12] Mohd. Daud Bakar, "**Contracts Pertaining to the Utilization of Usufruct**", *classnotes*. International Islamic University Malaysia 2000.

[13] The notion that al-Hiwalah al-Mutlaqah can be explored as a financing instrument is inspired by Dr. Mohd.Daud Bakar, because the scholars of the past have not deliberated in detail on this aspect of al-Hiwalah.