Edge Weekly

Special Report: The shariah debate on Islamic financing

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30 Oct 2015, 07:00 pm

This article first appeared in *The Edge Malaysia Weekly*, on October 12 - 18, 2015.

ZAKI (not his real name) is a former civil servant who was declared bankrupt by the civil courts when he did not repay hundreds of thousands of ringgit to a bank.

It all started when he was offered a bai' bithaman ajil (BBA) scheme by a local bank to buy a new home costing RM90,485. He took up the Islamic facility and was expected to repay the bank over 25 years. When the unlicensed developer abandoned the project, Zaki stopped paying his monthly bank instalments.

As a result, the bank recalled the facility and filed a civil suit against Zaki. The claim amount was RM240,610.16, close to three times the buying price of the home, even though the bank had only disbursed RM36,000 to the errant developer.

His predicament is neither new nor uncommon. Many like Zaki signed up for the BBA — a home financing scheme that had been in existence for more than three decades until it was phased out in 2013 — and only learnt of the perils when they defaulted.

Under a BBA scheme, an Islamic deferred payment sale contract, the bank buys the property from the customer pursuant to a property purchase agreement at the purchase price. The bank then sells the same property back to the customer pursuant to a property sale agreement for a sale price.

In the event of a default, banks often sought from homebuyers the sale price and profit (for the bank) for the entire tenure of the facility, regardless of the amount they disbursed to errant developers and discounting the fact that no house will be delivered to the customer even if the facility was fully repaid. As a result, customers who opted for BBA and defaulted ended up paying much more than those who obtained a straightforward conventional loan. On top of that, the customer had no house to speak of.

When contacted, Bank Negara Malaysia says guidelines on ibra' or rebate were issued in 2011, spelling out the requirement for Islamic banking institutions to give ibra' for sale-based transactions, including BBA for repayments and for default cases.

It says, “In the case of abandoned projects [for housing], of which there is non-possession of asset by the customer and a portion of the principal amount has yet to be disbursed, Islamic banks are not allowed to claim the undisbursed amount. Instead, upon settlement by the customer, ibra’ will be granted on the undisbursed amount. Islamic banks may, therefore, only recover the disbursed cost of purchase and waive the profit portion.”

Zaki and many others like him have attempted negotiating with banks for a compromise and offered to repay the amount the banks had lost or disbursed to the developers. But, the banks have not been willing to settle for less than what the contract provides. The disappointment that Zaki and others like him have is that BBA, as a shariah-compliant product, actually transgresses the objectives of shariah and Islamic economic principles.

Shariah scholars who have been approached by The Edge do not disagree.

Nuarrual Hilal Dahlan, an associate professor at Universiti Utara Malaysia, explains, “The issues of gharar (inability of the vendor to deliver the promised subject matter to purchasers), profit commensuration with risks, reciprocal justice, justice and equity to purchasers and responsibility of the banks are all neglected. These elements, in my opinion, render Islamic home financing, particularly BBA, not a shariah-compliant product.”

Another academic, Ahamed Kameel Meera, who is a former professor at International Islamic University Malaysia, says, “BBA is not suitable for home financing when the building is not ready. Allowing banks to claim unearned profits for the entire term of the facility is contrary to shariah. It is the homebuyers who should be suing the banks for not delivering the homes, rather than being sued for not paying instalments. Of course, if you ask the banks’ shariah lawyers at the time, you will hear different opinions.”

The fact that Malaysia’s Islamic financing products like BBA have been called out for not making “shariah sense” is unsurprising. Malaysia’s finance industry has been dominated by conventional banks and a profit-driven school of thought. Industry players say Islamic contracts are often developed by modifying conventional products to fit regulators’ shariah-compliant standards. Whether a particular product ends up being shariah-compliant or reflective of its Islamic roots boils down to a matter of scholastic opinion and interpretation.

Malaysia has its own legal and contract-based regulatory framework pertaining to all sectors of the Islamic finance industry. In particular, the passing of the Islamic Financial Services Act 2013 (IFSA) is meant to strengthen shariah governance and help manage shariah non-compliance.

Under IFSA, "shariah-compliant" simply means that the product issued by an Islamic bank is endorsed by the Shariah Advisory Council of Bank Negara and the shariah advisory board of the particular bank.

The central bank also has its own set of shariah standards for Islamic financial products while Securities Commission Malaysia has formulated its own guidelines for screening stocks for shariah compliance. Both mechanisms were developed without following any one particular legal jurisprudence or other global standards-setting bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

As a comparison, countries in the Middle East such as Bahrain have chosen to adopt shariah standards set by AAOIFI while others like Indonesia, Pakistan and Nigeria leave shariah-compliance matters to their own national shariah councils or bodies. This means that discrepancies in the treatment of an Islamic product across different countries will exist.

Sceptics like Sheikh Abdul Kareem Said Khadaied, an officer with consumer group Persatuan Pelanggan Perkhidmatan Kewangan Malaysia, which has received over 400 complaints about BBA, argues that these standards give Islamic finance an Islamic seal but not Islamic zeal, and fail to protect end-users or investors.

"Banks and Bank Negara can approve products as shariah-compliant and sell them under the Islamic banner, based on its own standards without getting independent advice. Conventional products are usually modified to fit these standards and they do not reflect Islam. When there is a dispute like BBA, you have the civil courts ruling over shariah principles when they have no business doing so," says Sheikh Abdul Kareem.

"Islamic banking contracts are not adjudged by Islamic law [in Malaysia]. Products are not really scrutinised by independent scholars to ensure compliance [with Islamic principles]. With BBA, thousands of victims are suffering, cases are still being filed in courts and judgments are still being

handed down, giving banks the right to demand RM500,000 when they had only paid a developer RM50,000."

These criticisms are not exclusive to BBA. Newer home financing products based on murabahah, musyarakah and ijarah contracts, which technically comply with Islamic law, have been accused of leaving customers with all the risks and Islamic banks with all the profits, contrary to Islamic standards.

An Islamic finance adviser says such censure on Islamic finance or products while not necessarily misplaced, still highlights the difficulty banks face in reconciling the competing goals — protecting the interests of customers and staying profitable in a halal manner.

"As an Islamic bank, it would have the added responsibility to prioritise consumer protection and community service above profits. At the same time, banks are profit-chasing institutions and have shareholders to answer to. With BBA, it can choose to write off the loans according to Islam, but this will be done at the expense of depositors and shareholders. The banks are in a Catch-22 situation," he says.

To mitigate the conundrum, what Islamic banks can and ought to do is to have stricter compliance standards or due diligence processes, making sure that they give out financing responsibly, he adds.

Yet, in an industry where standards and practices are shaped mostly by fragmented opinions and ad hoc interpretations, Malaysia's regulated Islamic finance environment is ahead of the curve in offering investors and consumers protection compared with other jurisdictions.

The near default of the Nakheel sukuk back in 2009 during the Dubai debt crisis is a telling example. Recall that in November 2009, Dubai World's developer Nakheel, known for the construction of the Dubai Palm Island, sought an extension for the repayment of its US$4 billion sukuk. The sukuk was structured based on the Islamic sale and leaseback transaction — ijarah — but was based on English law concepts of trust and beneficial interest, which were not recognised in Dubai. Even though the sukuk was eventually restructured, sukuk-holders at the time were unsure if they had recourse should there be a default due to conflicting jurisdictions and jurisprudence.

In that sense, Monem Salam, a fund manager at Saturna Capital Corp, a licensed shariah-based asset management company, says, “Malaysia has one of the most advance regulations [for Islamic finance]. The Middle East doesn’t have any regulations. It is a matter of shariah boards approving products. That creates problems in the long run. Everywhere else in the world, they have a conventional system, and Islamic banks are trying to fit themselves into it.

“We actually have a separate regulatory system. If I invest in a fund that says it is shariah-compliant and it is not, I will have recourse in Malaysia.”

Many Islamic contract disputes have come to light in Malaysia over the years, and the civil courts, with the help of shariah expert opinions, have proved that they are able to resolve them. But, a few have tested them on the shariah nature and substance of Islamic contracts.

As an example, Salam asks, “Can you build an Islamic commodity contract on wheat for an alcohol company? The contract for the wheat is halal but the product is not. What about companies that come up with their own sukuk? For example, Goldman Sachs came up with their own sukuk for their commodity division. So, they ring-fence it and say that it will only be used for commodities, but the actual profits still end up with a financial institution like Goldman Sachs.”

What becomes apparent is that, even with Malaysia’s progressive regulations and frameworks, the fundamental issue raised by many shariah scholars and the issue that BBA revealed — that shariah-compliant contracts are not anchored to Islamic principles — have not been addressed. The soul-searching on where financial institutions and investors should draw the line in terms of what is permissible by Islamic law and operated based on Islamic principles still needs to go on.

As Salam puts it, “Basically, you can legally structure anything to make it look Islamic or make it Islamic. Does it make it right?”

That and other related questions are issues stakeholders in the industry will have to consider as Kuala Lumpur develops into an Islamic financial hub.

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