International Journal of Economics, Commerce and Management
United Kingdom Vol. V, Issue 11, November 2017
http://ijecm.co.uk/ ISSN 2348 0386

ISLAMIC FINANCE OPERATIONAL TRANSACTION FRAMEWORK: A NEW INSIGHT OF ISLAMIC FINANCE IMPLEMENTATION IN MALAYSIA AND JAPAN

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Abstract

Currently Islamic financial system has emerged as one of the platform in comprehensive market, consistently with the conventional financial system. Although, in the early stage of development Islamic financial system in Malaysia in 1963 shown steadily growth, but now Islamic finance is seeing growth aggressively with the demand coming not only from Muslim countries but also from non-Muslim countries like Japan. Japan is the latest global financial hub competing for a slide of this lucrative industry. Therefore, this study provided a new insight on developing of Islamic financial industry in Malaysia and Japan. This study has concluded from the observation of the selected literature. As will be evident in this study, Islamic financial system has its own opportunity in the global market with attract more investors and companies to invest and participant in Islamic financial market.

Keyword: Islamic financial system, Malaysia, Japan, Profit, Islamic Bank

INTRODUCTION

Islamic financial system is one of the tools that provided sufficient financing product and services according to *Shariah* law. *Shariah* law is a fundamental rule of established Islamic financial system. All the transaction in Islamic financial system must follow Al-Quran and As-Sunnah. Al-Quran and As-Sunnah is the main sources in Islamic financial contracts (Abu Bakar, Rosbi, 2017). According to the *shariah* law, *riba* (interest) is one of main prohibited element in Islamic financial contracts. *Riba* means to increase or to grow. In the conventional financial system, it is a form of return or contractual profit derived from lending and borrowing (Theory and Practice of Islamic Finance, 2008).

The Quran prohibit the charging of *riba* (interest) as mention in the first ever verse in Surah Ar-Rum, verse 39, where Allah says: “And whatever *Riba* you give so that it may increase in the wealth of the people, it does not increase with Allah.”

Thus, this verse totally condemn that *riba* is prohibit in *shariah* law. Due to this verse all the Islamic banks must avoid offering interest to their customers. Even thought, is does not mean that Islam not allow to get a profit. We should remember that, Allah encourage people to make a business in order to get a profit. In other verse in Surah Al-Baqarah, verse 275, Allah mentions that: “But God hath permitted trade but forbidden *riba*.”

Hence, we should understand that the main basic rule in Islamic financial transaction is profits are permissible, while *riba* are prohibited. Implication by rejecting *riba* in financial transaction give a significant value to social responsibility that may bought Islamic banks to achieve the socio-economic prosperity of the *ummah*. Table 1 shows the different between *riba* and profit.

Table 1: The different between *riba* and profit.

Characteristics	Islamic finance	Conventional finance
Principle	Prohibition of *riba*, *gharar* and *maisir.*	Interest- based transaction.
Objective	Religious objectives, i.e. deal with zakat.	Only focus on profit.
Sources	The main sources are Al-Quran and As-Sunnah.	The main source is central bank’ regulation (human law).
Relationship of customer	Profit divided according to the agreed ratio.	Relationship of lender and borrower.

According to Saif Al Nasser and Muhammed (2013) current practices of Islamic banks around the world separate in several ways from the ideal of conventional banks. The first differences is all deposits, including investments are always explicitly or implicitly assured, in some cases the amount of capital guarantees is formally written in laws and regulations; in other cases, it is based on the implicit understanding among the authorities. Secondly is profit and loss sharing principle is never strictly applied because there are various degrees of noncompliance with respect to the profit and loss sharing principle in current practices of banks.

Table 2 show the breakdown of Islamic finance segments by region report in 2016. In comparison to values reported in the Islamic Financial Services Industry Stability Report, 2015 the global *sukuk* outstanding (based on par value at issuance) has declined by 1.4% to USD290.6 billion from USD294.7 billion. Next column is Islamic funds' assets have contracted by 6.3% to USD71.3 billion from USD75.8 billion. In contrast, the *takaful* sector is estimated to have expanded by 8.4% to USD23.2 billion from USD21.4 billion.

Table 2: Breakdown of Islamic Finance Segments by Region

REGION	BANKING ASSETS	SUKUK OUTSTANDING	ISLAMIC FUNDS' ASSETS	TAKAFUL CONTRIBUTIONS
ASIA	209.3	174.7	23.2	5.2
GCC	598.8	103.7	31.2	10.4
MENA (exc. GCC)	607.5	9.4	0.3	7.1
SUB-SAHARA AFRICA	24.0	0.7	1.4	0.5
OTHERS	56.9	2.1	15.2	-
TOTAL	1496.5	290.6	71.3	23.2

Sources: Islamic Financial Services Industry Stability Report 2016

CONTRACTS IN ISLAMIC FINANCE

Contracts in Islamic finance are very important part. A contract (*'aqd*) is referred to an obligation which arises from a bilateral relationship between two parties. A valid contract in *shariah*, must meet a conditions. The majority scholars hold that there are three elements of a valid contract namely the form (*sighah*) which comprises of offer (*ijab*) and acceptance (*qabul*); the contracting parties (*al-'aqidayn*) and the subject matter (*al-ma'qud 'alayh*), i.e. the commodities and the considerations (e.g. deposits)(Islamil, Tohirin, 2010).

Ismail (2010) highlight that the principles in Islamic finance are;

i. Money as capital
ii. *Rabbul mal* and *Mudarib* relationship
iii. Risk sharing
iv. Markets set prices and generate profits
v. Islamic banking stability
vi. Islamic banks as agents for economic growth

Islamic scholars (*fuqaha*) permit a wide range of contracts to be designed and implemented. Some of the contracts are discussed in this paper such as *mudharabah*, *murabahah*, *ijarah*, *musyarakah* and *qadhulhassan*.

Mudharabah (Profit Sharing) contract

Mudharabah is derivative from the Arabic word “*dharib*” means travel. Literally, *mudharabah* means “travel” for undertaking business. *Mudharabah*is an agreement contract between two parties that is capital provider (investors) and entrepreneur who will manage the capital for business. Both parties are shares the profits at a pre-agreed ratio. Losses, if any, are the liability of the former, and the latter loses his share in the expected profits. If, however, the Mudarib is proven to be guilty of willful negligence, fraud, or a breach of trust in handling the funds, he/she is totally responsible for the losses. Funds are to be used for Islamic permitted activities.

Mudharabah is a form of Islamic equity-based partnership contract. *Mudharabah* is the contract where the capital provider contributes the capital while the manager provides managerial skills to manage the *Mudharabah* capital accordingly. In practice, the *Mudharabah* contract could be categorized into unrestricted/general and restricted/specific *Mudharabah* contracts. It could involve a one-tier or multi-tiered *Mudharabah* arrangements. The parties involved in a *Mudharabah* contract share the profit between them. However, the loss will be borne solely by the capital provider. Hence, the element of trust based on the fiduciary relationship between the parties is the foundation of this contract. Figure 1 shows the *Mudharabah* contract framework.

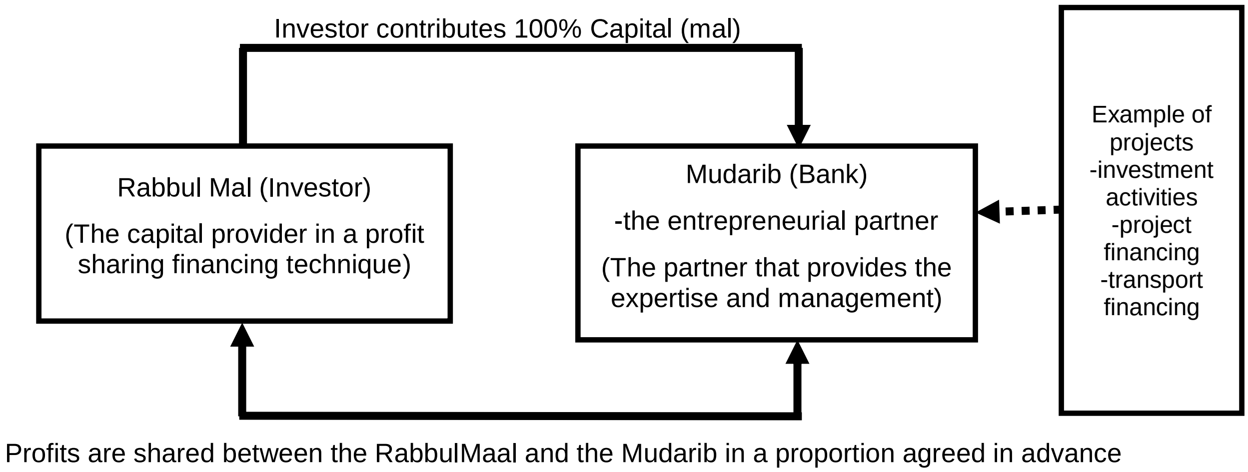
The *Mudharabah* contract is set out below:

(i.) *Mudharabah* is an optional contract, giving either of the parties the right to revoke the agreement unless a condition to the contrary has been included in the agreement. It is a short-term contract of up to a maximum of one year and solely for the expansion of commercial activities. The *Mudarib* is either a real person or a legal entity.

(ii.) Unlike the Principal-Agent theory, the roles of the *rabbulmal* and the *mudarib* are completely separate; and in this respect, the owner should only supply the capital and under no circumstances accept the responsibilities of the managing trustee, thus ruling out the possibility of Islamic banks acting as the *mudarib*. Even if, at the signing of the contract, the m*udarib* accepts responsibility for some of the costs, this does not constitute playing the role of the owner of the funds.

(iii.) The capital must definitely be in ready cash supplied in a lump sum or in parts, which means that a *mudharabah* in profits and dues is not correct. Except for those stipulated in the agreement, no other costs can be defrayed from the capital, and any such incidental costs are to borne by the mudarib.

Figure 1: Mudharabah contract framework



Murabahah (sale by deferred payment on short term basis) contract

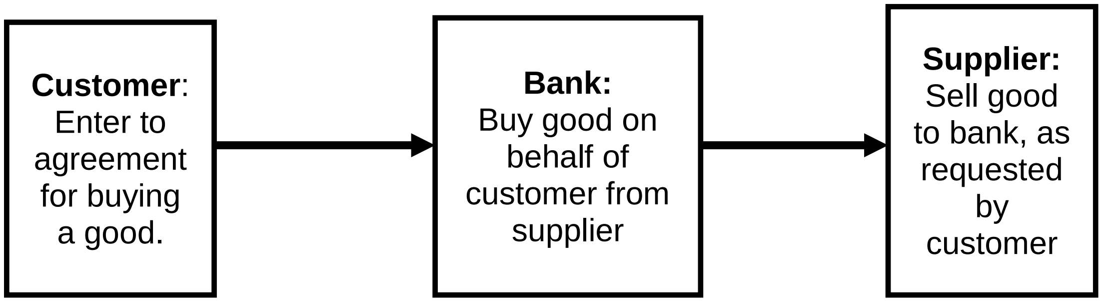
Murabahah contract involves a sale and purchase transaction. This means the price of the good comprises the cost of producing the good plus the profit, either in lump sum or based on percentage (Theory and Practice of Islamic Finance, 2008). Figure 2 shows the murabahah contract framework. The contract shall not be terminated unilaterally by any of the contracting parties. The specific inherent nature of the contract of *murabahah* is the sale contract which is based on the element of trust in disclosing the cost and mark-up. The common inherent nature of a sale contract is the transfer of ownership of the asset from the seller to the purchaser. Asset to be traded in a *murabahah* contract must following these conditions:

(i.) The asset is recognized by the *shariah*, valuable, identifiable and deliverable

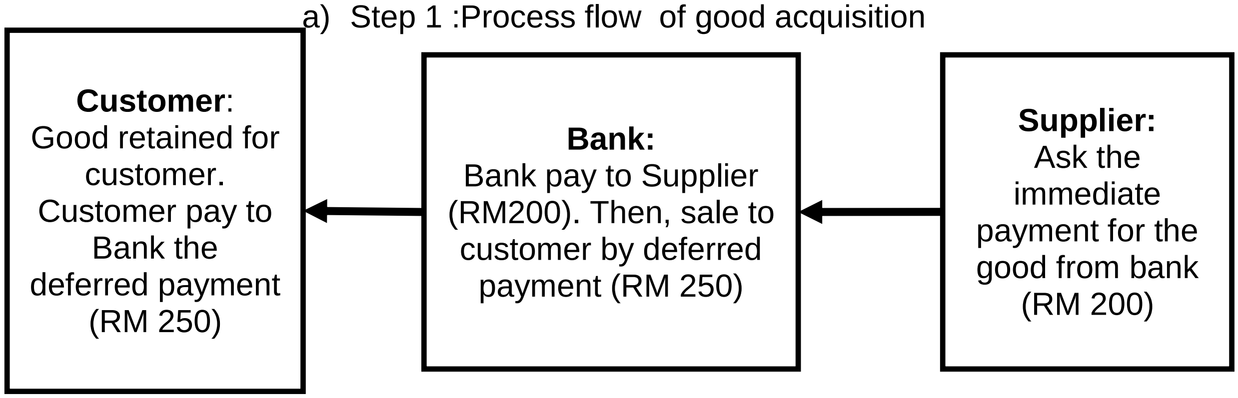
(ii.) The asset is already in existence and owned by the seller.

Therefore, the *murabahah* asset can be a tangible or intangible asset.

Figure 2:*Murabahah* contract framework



a) Step 1 :Process flow of good acquisition



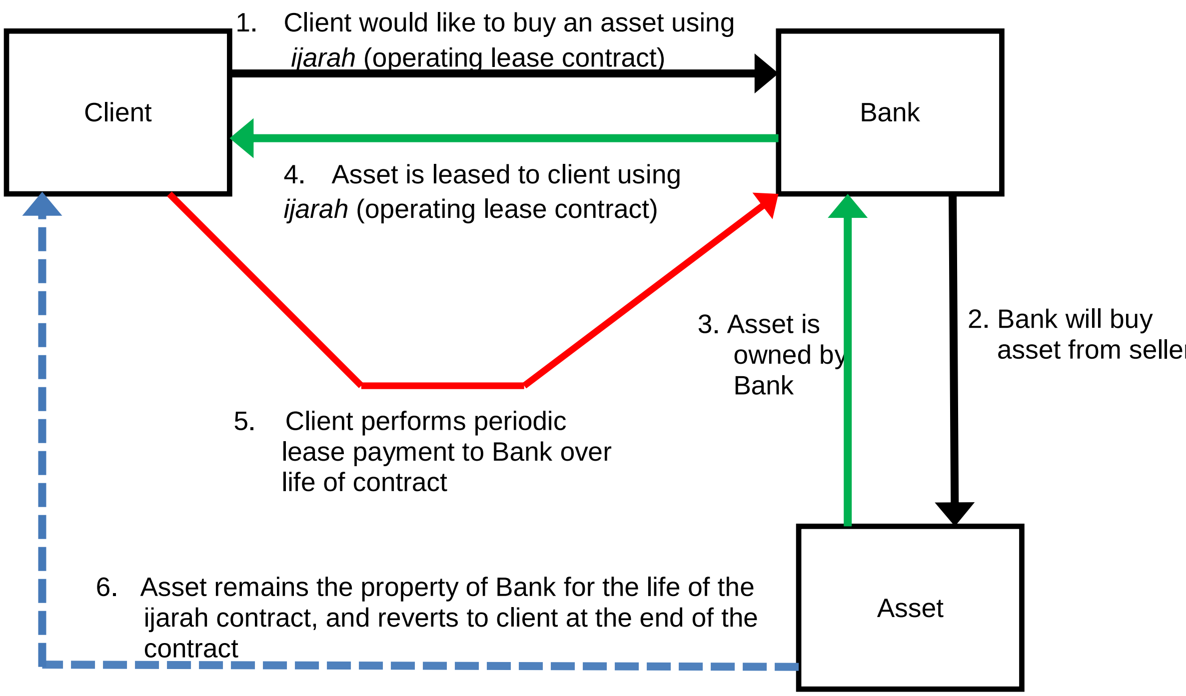
b) Step 2 :Process flow of payment acquisition

***Ijarah* (leasing) contract**

An*Ijarah* contract is derived from the Arabic words '*ajr'* and *ujrah* which means consideration, return, wages or rent. Generally, it means 'to give something on rent (Ismail, 2010). Under this transaction, a bank leases a particular good for a specific amount and period to leaser. This contract will transfer the use of benefit of an asset from one party to another party as determined agreed price.

An *Ijarah* contract is a form of contract which is permissible in Islam. Generally, it is a contract of exchange of counter values between usufruct and lease payment/rental rate. Figure 3 shows *Ijarah* (Operating lease contract) framework. This contract has permitted in Islam in order to facilitate the public who do not intend to own certain assets but need to use and benefit from the use of the assets. Like any other contracts, an *Ijarah* contract has to fulfill all the conditions of a valid contract stipulated by the *Shariah*. An *Ijarah* contract has emerged as a popular contract of financing among Islamic financial institutions for many of their financial products such as property financing, vehicle financing, project financing and others.

Figure 3: Ijarah (Operating lease contract) framework



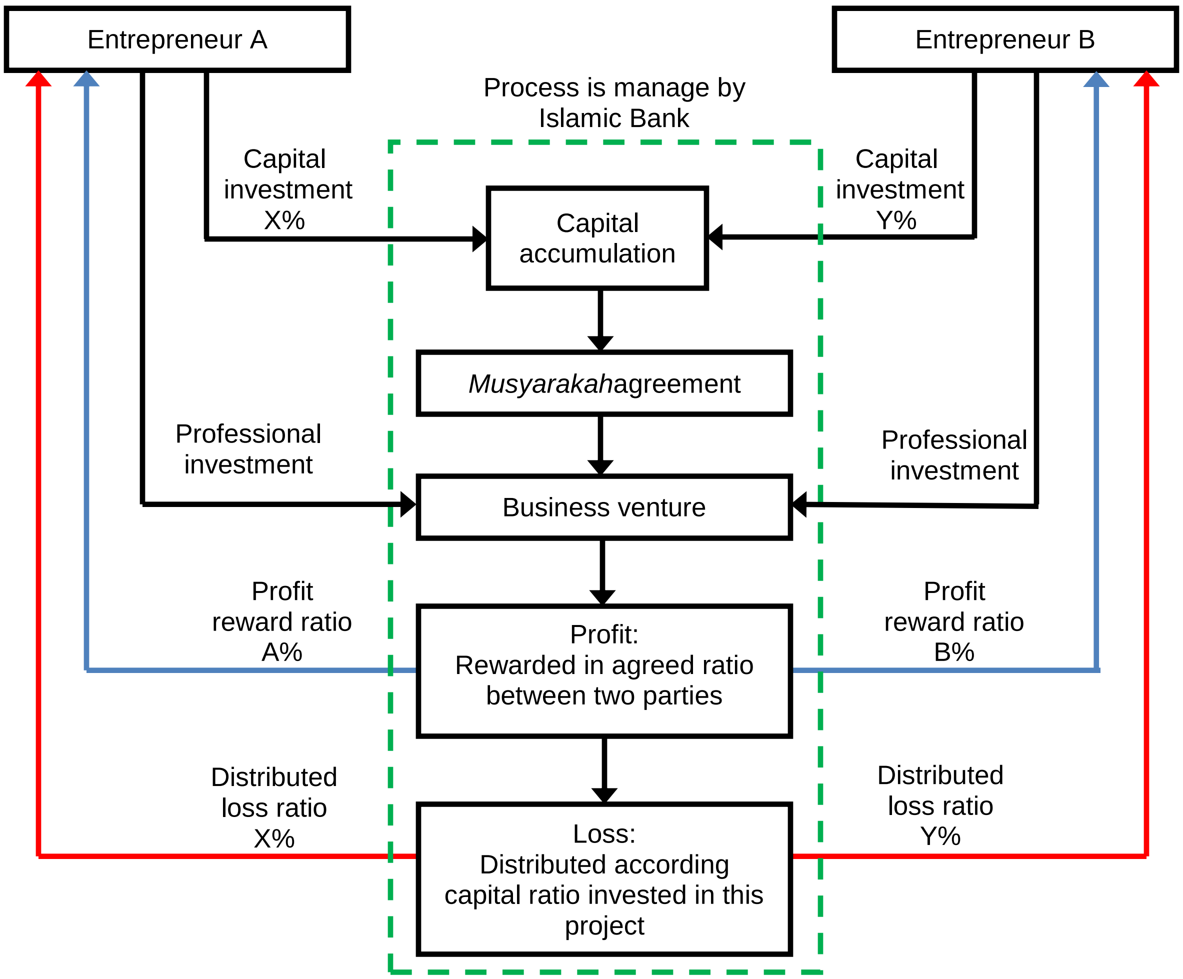
***Musyarakah* (joint venture profit sharing) contract**

Musyarakah can be defines as a contract of partnership between two or more parties. Under *musyarakah* contract, all the partners contribute funds and have right to participate in the management of the business. Profits are shared in an agreed ratio but losses are shared in the ratio of capital invested (MohdZin, et al., 2011).

Musyarakah is a joint enterprise or partnership structure with profit and loss sharing implications that is used in Islamic finance instead of interest-bearing loans. Figure 4 shows *musharakah* process flow. *Musyarakah* allows each party involved in a business to share in the profits and risks. Instead of charging interest as a creditor, the financier will achieve a return in the form of a portion of the actual profits earned, according to a predetermined ratio. However, unlike a traditional creditor, the financier will also share in any losses.

Technically, *Musyarakah* is a contract between the partners to contribute capital to an enterprise or a venture, whether existing or new, or to owner of a real estate moveable asset, either on temporary or permanent basis. Profits generated by that venture or real estate (asset) are shared in accordance with the terms of the *Musyarakah* agreement, while losses are shared in proportion to each partner of capital share.

Figure 4: *Musyarakah* process flow



Generally, there are two types of *musyarakah* that are:

1 *Shirkah al-Milk* (Partnership in joint ownership)

Shirkah al-Milk refers to possession of an asset by two or more persons with or without prior arrangement to enter into a sharing in joint ownership. Under *shirkah al-milk*, each partner's ownership is mutually exclusive. In this regard, one partner cannot deal with the other partner's asset without the latter's consent.

2 *Shirkah al-`Aqd* (Contractual Partnership)

Refers to a contract executed between two or more partners to venture into business activities to generate profit. Under *shirkah al-`aqd*, a partner is an agent for the other partners. In this regard, the conduct of one partner in the ordinary course of business represents the partnership.

Shirkah al-`Aqd can be divided into:

(i) *Shirkah al-Amwal*: An agreement between two or more persons to invest a sum of money as capital in a business and share its profit according to agreement.

(ii) *Shirkah al-A`maal*: A partnership in which the partners agree to share what they earn by their labor.

(iii) *Shirkah al-Wujuh*: An agreement between two or more persons of good reputation to form a partnership to purchase an asset or assets on credit for the purpose of making profit whereby the partners undertake to fulfill their obligation according to the percentages agreed by the partners.

There is another type of *musyarakah* transaction that named diminishing *musyarakah*. This transaction is a form of partnership, which ends with the complete ownership of a partner who purchases the share of another partner in that project by a redeeming mechanism agreed between both of them. Diminishing *musyarakah* is used mostly when one party who wants to own an asset or a commercial business which does not have adequate funds to pay the full price; and takes the assistance of financing from another party. The share of the financier is divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share till all the units of the financier are purchased by the client so as to make him the sole owner of the asset. In this kind of partnership, all partners are co-owners of each and every part of the joint property or asset on a pro-rata basis and one partner cannot make a claim to a specific part of the property or asset leaving the other parts for other partners.

Qadhul Hassan **(benevolent loan) contract**

Qardhulhasan is an interest-free loan (fungible, marketable wealth) that is extended by a lender to a borrower on the basis of benevolence (*ihsan* or *irfaq*). Loan or *qard*, from a *shariah* point of view, is a non-commutative contract, as it involves a facility granted only for the sake of *tabarru'* (donation).Therefore, benevolent loan (or in Arabic *qardulhasan*) is a gratuitous loan extended to needy people for a specified period of time. At the end of that period, the face value of the loan (*asl al-qard*) is to be paid off. In other words, shariah prohibits the stipulation of an excess for the lender, as it amounts to *riba*, whether the excess is expressed in terms of quality or quantity, or whether it is a tangible item or a benefit. However, it is permitted that the repayment of *qard* (loan extinguishing) is made with an excess (tangible item, benefit, service, etc.), provided that such an excess is neither expressly stipulated nor implicitly pre-arranged (through collusion or *tawatu'*) in the contract of loan.

Qardulhassan is a unique contract in which it refer to interest free loans. This contract involves the concept of a benevolent loan. Islam encourages the lender to write off the loan where there are difficulties in repayment, whereas in the conventional system, the lender will demand repayment of the loan regardless of the situation (Theory and Practice of Islamic Finance, 2008).

Qardhulhasan is a zero-return financing that Al-Quran urges Muslims to make available to those who need it. In addition, *QardhulHasan* is an example of a unique instrument offered by Islamic financial institutions due to non-involvement of interest (ZainalAbidin, et al., 2011). The borrower in *qadhulhassan* contract are required to repay the principal amount borrowed, but he may pay an extra amount at his absolute discretion, as a token of appreciation. In *shariah* law, *qadhulhassan* contract are in line with *shariah* principles.

ISLAMIC FINANCE DEVELOPMENT IN MALAYSIA AND JAPAN

The development of Islamic banking in Malaysia was started in 1963, when government of Malaysia was established Pilgrim Hajj (*Tabung Haji*). The main objective of Pilgrim Hajj is to provide a sufficient platform for Muslim people in Malaysia to perform hajj in Mecca. Pilgrim Hajj only provided a platform for Muslim people to perform hajj without any others products and services like conventional bank. Thus, in 1983 government of Malaysia take a strong initiative to establish Islamic bank.

Bank Islam MalaysiaBerhad (BIMB) becomes the first Islamic bank in Malaysia with the mission to continually develop and innovates financial solutions that meet the requirement of shariah principles. Now, Malaysia has 16 Islamic banks operated in Malaysian market. Table 3 shows the listed of Islamic bank in Malaysia.

Table 3: Listed of Islamic Bank in Malaysia

No	Name	Ownership
1	Affin Islamic Bank Berhad	Local
2	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	Foreign
3	Alliance Islamic Bank Berhad	Local
4	AmBank Islamic Berhad	Local
5	Asian Finance Bank Berhad	Foreign
6	Bank Islam Malaysia Berhad	Local
7	Bank Muamalat Malaysia Berhad	Local

Table 3...

8	CIMB Islamic Bank Berhad	Local
9	HSBC Amanah Malaysia Berhad	Foreign
10	Hong Leong Islamic Bank Berhad	Local
11	Kuwait Finance House (Malaysia) Berhad	Foreign
12	Maybank Islamic Berhad	Local
13	OCBC Al-Amin Bank Berhad	Foreign
14	Public Islamic Bank Berhad	Local
15	RHB Islamic Bank Berhad	Local
16	Standard Chartered SaadiqBerhad	Foreign

Source: Central Bank of Malaysia (cited on 3rd July 2017)

In 1993, Malaysian government was introduced dual banking system (Abu Bakar and Rosbi, (2017). Dual banking system means Islamic bank and conventional bank are operated side-by-side such as MaybankBerhad. MaybankBerhad provided two systems that are Islamic bank system and conventional bank system. Thus, customers can choose with system their want. The main reason for establishing this system is fulfill the customers' need toward Islamic bank. Due to high demand for Islamic banking system, Bank Islam Malaysia Berhad doesn't have enough capacity to fulfill the demand from customers. Therefore, government of Malaysia take initiative to establish dual banking system.

Japan is the country that has a unique financial system. Even, Japan is non-Muslim country but, its show that the financial system implemented by Japan are more similar with the Islamic financial system. For example, Japan provided a zero interest system. It shows that in Islamic contract the *Qardul Hassan* contract (interest free loan) is similar with zero interest system that implement by Japan.

In 1999, Japan was introduced zero interest rate policy. Since then, Japanese monetary policy has received much attention from the world as such a policy was unprecedented at that time. The zero interest rate policy has been effective in lowering and stabilizing interest rates to boost the economy in Japan (Kurihara, 2014).

Even the Muslim population in Japan is small, but it is substantial enough to present an opportunity for Islamic finance industry to growth. Therefore, In September 2015, Bank of Tokyo-Mitsubishi UFJ (BTMU) became the first Japanese commercial bank issue *sukuk* via its Malaysian unit. *Sukuk* is specially lucrative and accessible area of Islamic finance for banks across the world. It show that Malaysia have a significant relationship with Japan in term of Islamic financing system. Besides that, Japan is the latest global financial hub started introduces Islamic financial system. Other countries like Britain, Hong Kong and Luxembourg also have experience issued debut sovereign Islamic bonds.

Japan operates as the largest bond market in Asia in term of size, expertise and experience. Japan is a good place for expansion of Islamic finance because Japan can provide economic growth in the Asia. Malaysia also acts as Asian largest marketplace for *sukuk*. Therefore, the Japanese marketplace can offer a number of advantages over Malaysia such as size and stability. It's making the nation potential better choice longer term to be established as an Asian hub for Islamic-finance activity. It's also a good cooperation between Japan and Malaysia.

Japan also has resources, credibility and investor interest to participant with Islamic finance. Besides that, Japan also can be Islamic-finance hub because Japan has a stable in politic and economic. In addition, the business community in Japan is keen to apply new concepts and expand business into new innovation. Numerous Japanese businesses interested with Sukuk investment as part of their corporate-finance and for raising a capital. Therefore, Japanese businesses may increase their competitiveness within both global and domestic markets.

Islamic financial systems have big opportunities to develop due to the outstanding growth in the world. Even the development of conventional system is more excellent than Islamic financial system but Islamic finance system still have their own strength to growth. For example, the numbers of Muslim peoples in the world are more than 20%. Therefore, if all the Muslim peoples in the world participant with Islamic finance it also can increase the number of market shares for Islamic finance in the world. Therefore, Islamic finance has a big market in the worldwide.

CHALLENGES FACED BY ISLAMIC BANK

Islamic finance assets show aggressively increases from US$200 billion in 2003 to estimate US$1.8 trillion at the end of 2013, but if compare with global financial assets it shows that Islamic finance assets represents less than 1% market shares.

Thus, it is important for all Muslim in the world to support and participant with Islamic financial products and services. This is not only to increase the demand for Islamic financial product and service but the most important is the intention to get a reward from Allah. *Shariah* rule comes from Allah, and we as a *khalifah* in this world must follow His rules.

Besides that, lack of expertise in the field of Islamic finance is one of the major challenges faced by Islamic bank. Therefore, Islamic finance scholars and practitioners must have a good knowledge in term of finance, *shariah* and technology in order to get a high market shares and win among the competitive advantage. Currently, technology becomes inseparable part on human life. All the transaction and activities in banking industry are used technology. Thus, Islamic bank must take this advantage by using a high technology system.

CONCLUSION

Islamic financial contract has been established in Malaysia since 1983, more than 30 year ago. It shows that, Islamic banking system in the mature stage. Therefore, Islamic bank must have a good reputation and brand image.

In 1993, dual banking system was established in Malaysia in order to attract more customers to participant with Islamic banking products and services. Notwithstanding, Islamic finance and banking still faced with huge challenges from other competitors, because conventional bank also aggressively promote their product. Thus, Islamic bank must have their own business model in order to achieve competitive advantage among competitor.

Besides that, in the accelerating technology change also gives a significant impact on the development of Islamic finance market. Islamic finance must compete with other competitors in order to get high customers. Moreover, Islamic bank also must aggressively market their product and services.

FURTHER RESEARCH

The further research of this study can be extending to quantitative approach for determinants of Islamic banking performance that comply with shariah law. In addition, this research can be carrying out with the comparison of Islamic finance development in other developed countries, namely United Kingdom, Australia.

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