

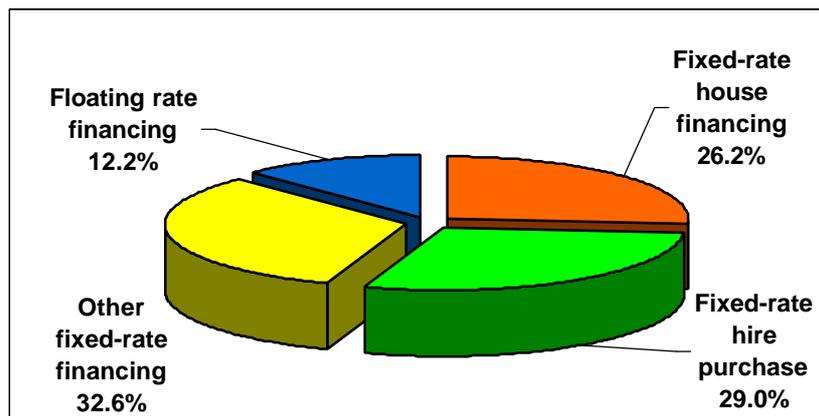
## **Introduction of Islamic Variable Rate Mechanism**

A significant achievement was made in 2003 in the area of risk management when the first variable rate financing product was developed for the Islamic banking industry under the concept of *bai' bithaman ajil* (deferred payment sale), or in short, BBA. This Shariah-compliant product was structured by a working group comprising representatives from Bank Negara Malaysia and the industry to enable the Islamic financial institutions which operate in a dual banking environment to constantly match the current market financing rate in order to give matching returns to their depositors, thereby alleviating any mismatch risk. By doing this, the Islamic financial institutions are able to receive varying income stream from their financing activities which will be distributed to the depositors at a more competitive rate.

The new instrument is an alternative to the existing mode of financing portfolio which is predominantly fixed-rate in nature. In recent developments, the high leverage on fixed-rate financing became a topical issue in Islamic banking as there has been an inadequate hedging mechanism through which Islamic financial assets could grow and be protected from exposure to fluctuating financing rate. As at end-December 2003, total fixed-rate financing accounted for 87.8% of the total Islamic financing and a large proportion of this financing, namely, house and other property financing-i and term financing-i, were predominantly on a longer term tenure, constituting 58.8% of

the total Islamic financing as shown in Graph 1. (The current method of variable rate financing offered by a few Islamic financial institutions was impractical as it involved multiple sub-agreements to reflect a change in the rate.)

**Graph 1: Total financing by mode of financing (as at end-2003)**



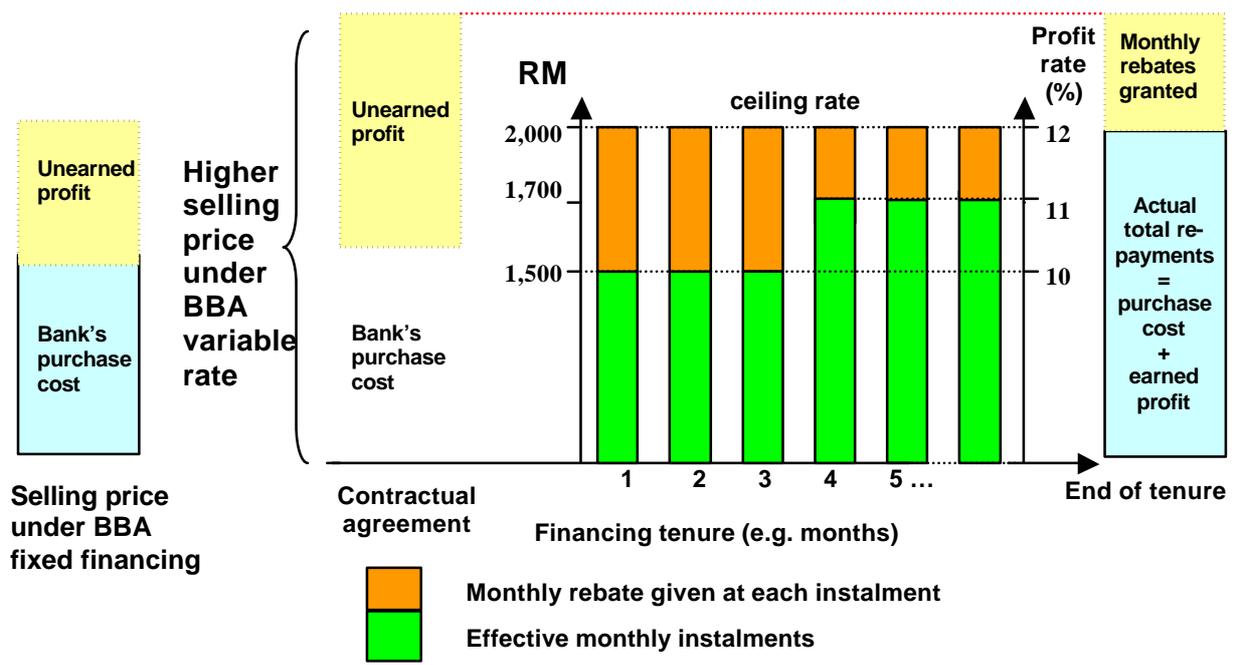
This fixed-rate regime has resulted in a funding mismatch to the Islamic financial institutions because their long-term financing was funded by short-term bank deposits which can give variable returns. As the banks had locked in their profit rates for the financing over a long period, any upward movement in the market rates, therefore, may result in the Islamic banking institutions finding it difficult to give a satisfactory return to their depositors. This is because the constant income stream from the financing is tied to a fixed profit rate which is relatively lower when compared to a conventional floating rate loan whose rate has risen. Inevitably, this situation would cause a switching of Islamic funds to conventional funds.

The variable rate financing is designed to mitigate the mismatch risk currently faced by the Islamic financial institutions by allowing them to vary the profit rate for the

financing in order to raise the deposit rates. As a result, the depositors will obtain satisfactory returns *vis-à-vis* that in the conventional banking market and hence would not switch their deposits which otherwise could adversely affect the Islamic banking operation. This new option reduces the vulnerabilities of the Islamic financial institutions to exposure in market risk in a banking environment where the Islamic banking system and conventional banking system operate side-by-side.

The variable rate financing is an innovation to the existing BBA financing concept which is fixed-rate in nature. Under the BBA, the selling price of the asset sold to the customer on deferred terms would be fixed at a profit rate known as the ceiling profit rate which is higher than the profit rate under the fixed rate BBA financing where, in principle, the contractual selling price and instalments would be higher. However, rebate known as *ibra'* (a waiver of right to claim unearned profit) is required to be granted at every instalment, for example on a monthly basis, in order to reduce the monthly instalments to match that of the current market level.

**Diagram 2: BBA variable rate financing**



As illustrated in Graph 2, the financing is created upon the bank purchasing the asset from the customer for cash which will be immediately sold back on deferred terms. Computed at a ceiling rate of 12% per annum as in the example, the selling price (which is higher than under BBA fixed financing) will be agreed upon and the contractual repayment is to be made in equal monthly instalments of RM2,000 over the agreed period. If the base lending rate (BLR) plus margin used as benchmark in the pricing calculation is 10% per annum for the first month, the bank would give a monthly rebate of RM500, which represents the difference between the ceiling profit rate of 12% per annum and effective profit rate of 10% per annum. If in the fourth month, the market rate rises to 11% per annum, the bank would then only grant a monthly rebate of RM300.

In practice, the rebate would be varied so that the effective profit rate (ceiling profit rate less rebate) reflects the fluctuating market financing rate. Accordingly, the bank would be able to raise the financing rate when there is a rise in market rate; hence, it can give better returns to its depositors. As such, this justifies the setting of a high ceiling profit rate to buffer any rise in the market rate. However, if the market rate rises beyond 12% per annum, the effective profit rate would remain at the ceiling rate. The ceiling rate would provide some comfort to the customer that the effective profit rate would be capped at that rate.

To govern this mode of financing, such rates are subject to a ceiling profit rate to four percentage point above the market's BLR unless supported by findings that the market rate is forecasted to be volatile and escalating. In setting the effective profit

rate, the banks are required to observe the maximum profit spread of 2.5 percentage point above the BLR. However, as a matter of policy, the effective profit rate cannot transgress the ceiling profit rate even if the market rate rises above the latter, while any change to the effective profit rate would need to be communicated to the customer prior to the change.

At maturity, any difference in amount between the selling price and the total repayments plus the monthly rebates granted would be rebated. In addition to the rebates on instalments and at maturity which have been made mandatory to be included in the financing agreement, rebates must also be granted in the event of early settlement or redemption, or termination of contract. Bank Negara Malaysia has allowed rescheduling of the financing (where the period of financing can be extended) if the bank wishes to grant the option that the effective monthly instalment need not be increased if the effective profit rate rises, on the condition that the financing agreement contains a rescheduling clause and the total repayments are not in excess of the original selling price. The computation of capital adequacy for the BBA variable rate financing will be accorded the same risk-weight as under the BBA fixed-rate financing.

Currently, this new mode of financing is applicable to house, property and term financing only and would be extended to other types of financing in due course. Undoubtedly, this new product is expected to grow significantly as it is a natural hedging product in particular in view of the risk exposure issues prevalent in Islamic banking today.