Islamic Financial Innovation: Pricing Via Variable Rate Financing in Malaysian Islamic Banks

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ABSTRACT

This article is written in order to respond the introduction of variable rate financing (VRF) by Bank Negara Malaysia (BNM). In general, this article aims at discussing the VRF from the theoretical and practical aspects. VRF is known as a dynamic way to improve the competitiveness concern in Islamic banks, as well as to meet the previous demand by Islamic financial institutions (IFIs). Basically, one may learn that VRF is a good technique for risk management in Islamic banks. It can match in accordance to the market rate. It is to be hoped by the researchers that BNM will provide a continuous assessment of VRF financing to evaluate its validity in the contemporary banking industry. One of the issues to address in this paper is referred to VRF and its relationship to the existing base lending rate (BLR). One may argue that VRF some kind follows the same rules as being practiced by BLR in conventional banks. This is has been discussed in details by Shaharuddin & Safian (2005), with the intention to highlight the various views of the VRF to allow the practice of VRF in commercial banks. Detail explanations have highlighted in terms of pro and contra regarding VRF to fulfill the demand from the unsatisfactory side. To extend the study conducted by Shaharuddin & Safian (2005), this present study tends to examine the concept of VRF and the basis of the VRF introduction in order to offer a further understanding on VRF. In sum, VRF has provided a new room of improvement to increase the quality of competitiveness of Islamic banks compared to conventional banks.

Article Type: Viewpoint
Keyword (s): Variable Rate Financing, BLR

I. INTRODUCTION

The need for financial innovation has been given a proper consideration by many researchers for survival purpose in a fierce banking competition (for example, Mishkin & Eatkins, 2006; Obaidullah, 2005; Iqbal, 2004; Noman, 2002; and Kotby, 1996). In this respect, financial innovation is a process to develop and construct a proper product in financial business with aims at meeting the market demand and to prove the profitability of financial institutions. In order to remain competitive, it is a must for Islamic banks to create a new product to fit into the market need. As a result, *sukuk* or Islamic bond plays a significant contribution for promoting Islamic based financing tailored from the conventional ones. This is not our intention to elaborate further for *sukuk*, but rather than looking deeply into VRF, it is a lucrative financial innovation for Islamic banks.

The objectives of the paper are to examine, first, the concept of VRF as introduced by some commercial banks in Malaysia recently. VRF can be defined as an Islamic bank product based on the concept of *Bay Bithaman Ajil* (BBA). Bank Islam Malaysia Berhad (BIMB), Bank Muamalat Malaysia Berhad (BMMB), Maybank to name a few has introduced such an application. Introduction for VRF has taken place due to competition among banking institutions as well as non- financial institutions in terms of financing. Secondly, the paper examines the basis for the introduction of VRF in Malaysia. There could be three possible reasons that have been used as the basis of arguments of this paper. First, it has developed to assist IFIs to compete with the conventional banking system via matching the Islamic financing rate to the conventional financing rate in a dual banking context. Second, it is also introduced in order to give a reasonable return to the depositors, subsequently reduces the fluctuation risk in financing rate. Third, it enables IFIs to get income flow from various types of financing activities, which can be distributed to the depositors at the competitive rate.

The rest of the paper is organized as follows: Section 2 discusses on the development of Islamic banks in Malaysia. Section 3 attempts to validate VRF as well as BLR. Section 4 argues the relationship between BLR and profit rate. The former is taken a priority for conventional banks whereas the latter is the rate imposed by Islamic banks. Section 5 attempts to elucidate how VRF is working. Section 6 presents an example of VRF and its application in Islamic home financing with a graph's help. Finally section 7 concludes this paper by explaining the objective and the benefits brought by the financial innovations to banks, depositors and buyers.

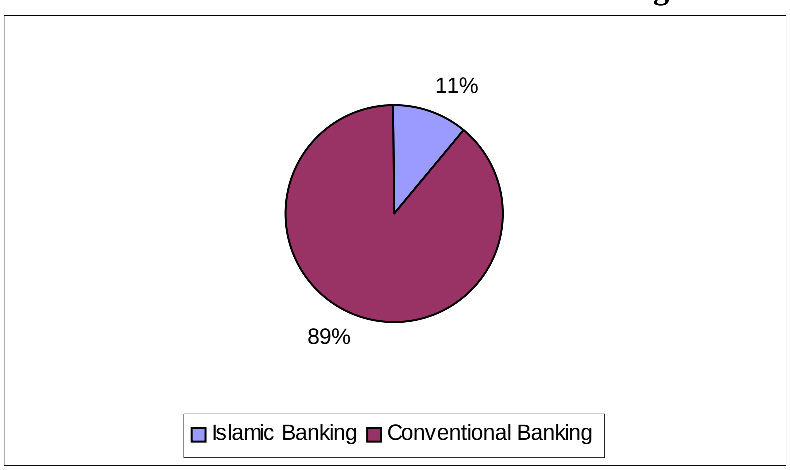
II. DEVELOPMENT OF ISLAMIC BANKS IN MALAYSIA

Islamic bank was introduced in Malaysia in 1983 with the aim to promote Islamic banking system in Malaysia. Initially, this bank was introduced under Islamic Banking Act 1983 to mobilize funds from Muslim and non-Muslim in Islamic banking transaction. This bank notably BIMB was devoted to create a sound of Islamic financial system by creating as many as possible products to be offered for public. For that purpose, the Malaysian government was let this bank operated for 10 year time without allowing other banks to offer Islamic banking products and services. There are two main reasons why the government taken this fruitful steps. First, an Islamic bank needs to create its own strength and to make them independent to ensure its performance is preserved. Second, at the same time the bank must work in a progress to develop as many as possible Islamic banking products to cater the market need, where financial innovation is involved.

In early 1990s, the government introduced a concept of “Islamic window” which allows the existing conventional banks to offer Islamic banking products and services to customers. The concept of “Islamic window” started in March 1993 when the Central Bank of Malaysia or BNM introduced the “Interest-Free Banking Scheme”. The foreign financial institutions also participated in this scheme namely the Standard Chartered, OCBC, HSBC, Citibank, to mention but few. As at end of 2004, the Islamic banking system in Malaysia was represented by three main Islamic banks namely BIMB, BMMB and RHB Islamic Bank whereas Public Bank and Maybank still use Islamic window rather than Islamic subsidiary.

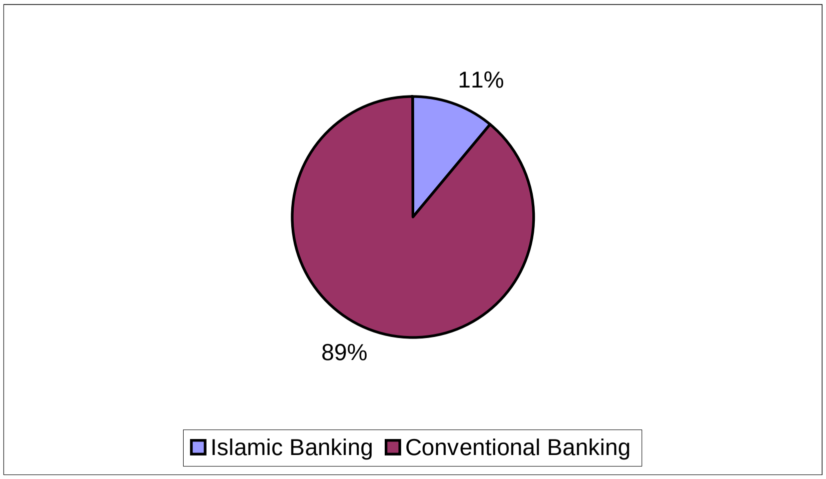
As mentioned earlier, the first Islamic bank namely BIMB was introduced in 1983. This is never ending story for Islamic banks, as a result in 1999, BMMB was introduced to increase the participation. It commenced operations on October 1, 1999 with combined assets and liabilities brought over from the Islamic banking windows of the Bank Bumiputra Malaysia Berhad (BBMB), Bank of Commerce (M) Berhad (BOCB) and BBMB Kewangan. BMMB to surrender license under BAFIA and re-licensed under IBA. BMMB absorb 1,000 staffs of BBMB, BOCB and BBMB Kewangan. Given 40 branches at commencement date and paid up capital amounting RM 337m (end June 2002). For third full-fledged Islamic bank, RHB Islamic bank is become the number 3 in the country to offer Shariah compliant products based on the full-fledged operation. In March 1, 2005 RHB Group officially received the license for its Islamic banking subsidiary --- RHB Islamic Bank Bhd --- today, making it the first commercial banking group in Malaysia to have a full-fledged Islamic bank.

Pie Chart 1: Market Share of Financing



Source: BNM (annual report 2004)

Pie Chart 2: Market Share of Deposits



Source: BNM (annual report 2004)

At end-2004, total assets of the Islamic banking sector increased to RM94.6 billion, which accounted for 10.5% of the total assets in the banking system. The market share of Islamic deposits and financing also increased to 11.2% and 11.3% of total banking sector deposits and financing respectively. In 2000, the Islamic banking deposit and financing constituted 7.4% and 5.3% respectively.

In terms of total number of Islamic banks, it shows that from 2000-2004; only 2 Islamic banks operated at that period namely BIMB and BMMB. This is due to the fact that no demand made to transfer commercial banks to operate based on full-fledged Islamic banks. Although RHB Islamic bank received its license for its transformation from Islamic window to Islamic subsidiary, some may argue this is the third Islamic bank, but basically due to the transformation still based on Islamic subsidiary, thus it does not incorporate as number 3 in Islamic banks in Malaysia.

In terms of automated teller machine (ATM) network, there are increments from 2001-2004. For example, ATM network equal to 130 in 2000, 178 in 2001, 185 in 2002, 212 in 2003 and 280 in 2004. Whereas for employment, also shows a similar pattern as ATM network. For instance, number of employed employees in 2000 is equal to 2,869, 2001 equals to 3,041, 2002 equals to 3,117, 2003 equals to 3,323 and last but not least 4,036 for year of 2004. As a way to be better a competed with other banks, it is necessary for IFIs to expand its ATM network, although Malaysian Electronic Payment System (MEPS) or Bankard can substitute the function of IFIs ATM machine.

III. VARIABLE RATE FINANCING, BASE LENDING RATE AND COMMERCIAL BANKS

This field of research is very relevant to add more literature the existing Islamic banking studies. The study conducted by Kotby (1996) was interested to highlight the importance of financial innovation. According Kotby (1996), financial innovation is an important tool in modern complex and risky business world. Hence, Islamic banks are required eventually to develop a new financial innovation. Meaning that, the innovation is capable to eliminate the market risk which is caused by interest rate fluctuation more than other institutions do. At this point, BNM has introduced VRF for the benefit of IFIs with aim at diversifying the asset portfolio for Islamic banks as well as to diminish the impact of market risk for the cash inflow generated by IFIs. Formerly, the flat rate as used by Islamic banks is not sensible if it compares to market rate. In contrast, conventional banks are benefit from the movement of the market rate such as increasing their cash inflow, thus strengthening their short-term funding. Consequently, the market rate enables to sweep out the competitiveness of Islamic banks from the banking industry. The potential solution is by initiating VRF to curb the market rate fluctuation.

New financial innovation may help to lock these issues by the two valid points. First, there is a concern to ensure the survival of Islamic banking in the banking market where they must particularly look at the profit they earn and compared it to their counterpart. If the rate their offer is higher than conventional banks, this is may helpful to generate a greater control over their profitability, if not certain financial innovation is needed to reduce the profitability gap between Islamic banks and conventional banks. Second, Islamic banks operation is limited into only *halal* activities, whereas their counterpart can offer both of the products. Hence, to offer VRF may one of the best practices to release this concern. Therefore, this new innovation enables to promote Islamic hedging for financing purpose. In addition, VRF is preferred since the Malaysian banking system is dynamic mainly to reduce the gap profits between conventional banks and Islamic banks.

The major concern of the VRF introduction is to create a competitive rate of return for Islamic banks, both for the depositors' side as well as the borrower's side. VRF is one of the new solutions to offer in Malaysian Islamic banks. It is an avenue to increase the liquidity of Islamic banks routine operation. This practice seems a motivation to preserve the performance of Islamic banks in Malaysia as well as a preparatory groundwork to face the liberalization of Islamic banking system in Malaysia. VRF is received pro and contra criticism of its validity from *Shariah*'s point of view. The study conducted by Shaharuddin & Safian (2005) claimed the following arguments;

> …VRF instrument is considered legal and lawful in Islam…it clearly indicates that the instrument is significantly different from the practice of floating rate in conventional lending-based facilities. In the floating rate system the customer can not determine the actual monthly repayment over and above the total cost of financing. Whereas in the VRF instrument the ceiling price have been mutually agreed by both parties and thus eliminate the element of *gharar*…p.180

In response to this concern, there are two views about the legality of VRF. The proponents' view is based on the fact that there is no clear prohibition from the *Quran* and the *Hadith*. This argument was based on the legal maxim implies that the jurists will approve any business transaction as long as no clear-cut and decisive ruling mentioning the invalidity of such transaction either from the *Quran* or the *Hadith*. In fact, the instrument is based on the concept of rebate, which is in line with the principle of Shariah, to encourage a practice of rebate among buyer-seller. In contrast, the opponents' side claimed otherwise. For them, VRF is a product duplicated from conventional banking system, although there some distinguishing features found. Their argument was based on VRF is adjusted according to the performance of interest rate in the market. In short, their argument was referred to the positive relationship between interest rate and the profitability of Islamic banks. Another concern is that VRF tends to create uncertainty issue in its practice. From Islamic point of view, to avoid *gharar* is by creating a mutual agreement between buyer-seller at the beginning of the contract. However, for VRF the price will be determined according to the interest rate movement. No certainty created by using this mechanism.

It is hard to judge either the contract is valid or not. However, BNM has its own precedence and target why VRF is introduced. The idea of introducing VRF is based on the fact to match the risk associated in the Islamic banks operation that is to fulfill the rate of return for depositors as well as to entertain the borrowers. Initially, VRF is planned to offer an alternative to Islamic banking system and it does not apply widely in the Malaysian Islamic banking system. It is used to finance home-financing, property and term-financing. Consequently, VRF offers value-added for Islamic banks to remain competitive in the Malaysian banking industry, where conventional banking is still lead the industry. In sum, the introduction of VRF by BNM is at the right time, where to minimize the pressure from competition by conventional banks.

It is obvious to claim that, the introduction of VRF is in line with the BNM's concern to enable IFIs can compete healthy to their counterpart by manipulating clearly the usage of financial innovation. This may provide a greater position for Islamic banks to satisfy their depositors and borrowers.

The concept of commercial banks is not only devoted for conventional banks but also to Islamic banks. Islamic banks perform the common role as practiced by conventional commercial banks, but *riba* and *gharar* are not present in Islamic banks. In this regard, the commercial banks were governed by the Banking Act 1973, but it did not last long when it replaced by the Bank and Financial Institutions Act 1989 (BAFIA). One will learn that the commercial banks are the largest group of financial institutions in the Malaysia financial system, making up the bulk of the total assets of the entire financial system. One of the institutions under commercial banks is an Islamic bank.

A question to ponder in commercial banks, why the commercial banks play a very major role in mobilizing the surplus on the economy, from the deficit unit in strengthening the existing economy? There are two main causes. First, the commercial banks provide the current account facility, which is absence in other institutions (i.e non-bank institutions). Second, the commercial banks deal with foreign exchange for international trade.

For lending rates, the commercial banks began to introduce their own BLR basing on the cost of funds. The BLR is to be quoted in multiples of 0.05% and is permitted to be adjusted only once in a month. However, with effect from 1st September 1998, the BLR framework was revised to allow a faster transmission of changes in monetary policy on interest rate levels. The calculation of the BLR is based on the BNM 3-month intervention rate instead of Kuala Lumpur Interbank Offer Rate (KLIBOR), while the administrative margins of financial institutions that are allowed in the BLR computation has been reduced 2.25% from 2.5%.

In this regard, with effect from 1st September 1998, the formula for computing the BLR would be revised as follows;

Commercial Banks;

$$\text{Computed BLR} = \frac{[(\text{Intervention Rate}) \times 0.8]}{(1\text{-SRR})} + 2.25\%$$

Finance Companies;

$$\text{Computed BLR} = \frac{[(\text{Intervention Rate})]}{(1\text{-SRR})} + 2.25\%$$

According to the above formula sets for commercial banks, it has denoted that the additional factor of 0.8% for the commercial banks is due to the fact that commercial banks offer current facility which is interest-free, whilst finance companies do not so.

IV. THE RELATIONSHIP BETWEEN BLR AND PROFIT RATE

One may argue that conventional banks apply BLR in their daily operation, which is in contrast with Islamic banks. Islamic banks devoted their operation according to the flat rate by the use of profit rate in home, car and other financing purpose. In this regard, an interest rate as imposed by conventional banks will vary according to the level of economy's healthy whilst a profit rate as imposed by Islamic banks will fix at the agreed monthly payment, period of payment as well as rebate. A rebate in Islamic banks is to be found absent in conventional banks.

One will learn that the value of money is changed according to the time. During the inflation, conventional banks welcome to receive an increment in their profit due to the increment in cost of borrowing. In contrast, during the inflation, Islamic banks still adopt the same rate regardless the market level. At this concern, there are two interesting questions to address in this paper as follows;

> "In the event of rising interest rate, an Islamic bank in a dual framework (Malaysia) will find it difficult to compete with conventional banks?"

In this regard, according to the above statement, Islamic banks will pull out from the banking market due to the advantage gained by conventional banks. Islamic banks rely on the fact that both parties have determined the monthly payment namely a seller and a buyer based on mutual concern. Any amendments in the agreement in order to reflect the market rate will not be compromised due to uncertainty entails vague justification of the contract, which is *gharar*.

Also, based on the above statement, it is obvious that the financing activities in conventional banks will be the lucrative segment. In addition, their fixed deposit will be attractive from the customers' point of view. By putting RM 1,000 at the 3.5% (for 3 months), a customer from Public Bank enables to earn RM1, 000 + RM 8.75 (interest), at the end of 3 month. In contrast, Islamic banks only offer *hiba* to *al-Wadiah Yad Damanah*, as well as Mudarabah Account based on profit sharing accounting. Therefore, the conventional banks gain popularity compared to Islamic banks.

Another question is interesting to address in this paper, which reads as follows;

> "In the event of rising interest rate, Islamic home financing is gained popularity among the married people?

Based on the fact of the question, it is noticed that the increment in interest rate has two face implications. On the positive side, the conventional banks earn profit since the existing borrower cannot be gone out from the system. On the customers' side, the increment of interest rate in conventional home financing is a signal to turn into Islamic home financing. The reason why this fact is concerned due to the flat rate as being practiced by Islamic banks, which is constant regardless the economy fluctuation. For instance, if the current BLR is 7%, the interest charged is 7.30% (BLR + 0.30%) whereas the profit rate imposed by BIMB for personal lending is 5.5% based on the flat rate. Then suddenly, the BLR is changed from 7% to 9%, thus the interest charged is 9.30%, whereas the profit rate imposed by BIMB is remained unchanged. Which is the best?

It is slightly interesting to mention about conventional home financing and Home Financing under BBA. In this case, the selling price has already been fixed and agreed upon in the contractual agreement by both parties. Meaning that, Islamic banks' profit rates do not have relationship to the BLR rate, either negative or positive. Hence, it will not increase. In fact, it may even reduce if the Islamic banks were to provide rebates for early settlement. This is occurring before the introduction of VRF.

As addressed above, there is no an alternative has provided by Islamic banks to increase its competitiveness in gaining profits and share the banking market. Basically due to the fierce competition in the banking industry, current variable rate financing introduced by Islamic banks (before the introduction of VRF by BNM) is not practical at two reasons. First, it considers as not practical based on the fact that it needed an extra agreement to reflect the alteration in financing rate. Second, it only proposed based on the usage of the bank only, not to apply to other banks.

Overall, when BLR is increased, the interest charged will also increase but the profit rate by Islamic banks is remained unchanged. On the other way, if BLR is decreased, the interest charged will also decrease, but the profit rate by Islamic banks is also remained unchanged. This means, the interest rate imposed by conventional banks reflect the market rate by the mean of BLR, however the profit rate by Islamic banks is not tailored to the market rate, it is a flat rate.

V. VARIABLE RATE FINANCING: TAILORED TO THE MARKET RATE?

The concern of lack of competitiveness among IFIs has pressure the BNM and the committees to be innovative in allowing IFIs apply VRF.

Table 1: Financing according to the type of financing (as end of 2003)

No	Type of financing	Contribution %
1	Fixed hire purchase	29.0
2.	Fixed home financing	26.2
3	Variable rate financing	12.2
4	Other mean of fixed financing	32.6

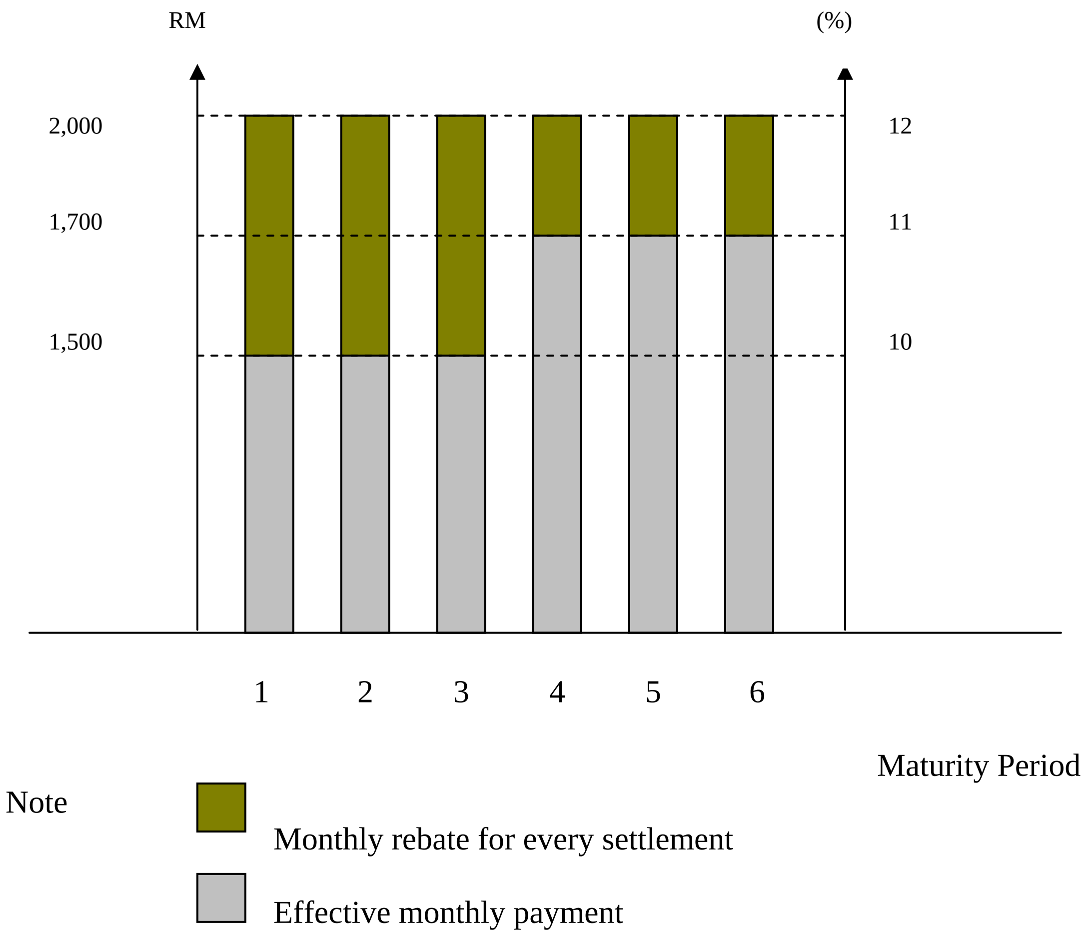
Source: BNM (annual report 2003)

As end of 2003, the fixed total financing equal to 87.8% of the overall financing. Of these, including home financing, property financing and long term lending, equal to 58.8% from the total financing. By referring to the above table, variable rate financing is not referred to the latest as introduced by government, said early. This method entails weaknesses. An additional agreement is required to fulfill the contract to reflect the market rate, which is, produced unpractical issue, from customer's point of view.

The fixed regime has produced unmatched in IFIs funding. This occurs due to the basis said that the long term financing is financed by short-term deposit. In fact, this deposit has fluctuated return rate. In this regard, the increment of market rate has caused problem for IFIs to reimburse their depositors at the satisfied return rate, due to the fact that the IFIs rate of return for depositor is less than the conventional banks. The profit flow from the fixed financing has fixed profit, which is in comparison low than conventional banks, if the floating conventional loan increased.

In VRF, asset-selling price has made based on deferred payment, which is accordingly determined up to the ceiling profit rate. The VRF BBA will have more profit created compared to the fixed BBA. This is reflected by imposing high selling price and also to the monthly payment. To reduce burden, this method will practice *ibra* to reduce the monthly payment to meet the current market rate. The following graph shows how the system is working;

Graph 1: Variable Rate Financing



Source: BNM (annual report 2003)

Based on the graph, to better illustrated the following transaction is taken place between three parties namely, the seller of the property (i.e. a house), the buyer of the property and BIMB. Since the buyer is very interested to buy that house, subsequently he will enter a contract with BIMB. In the first action, BIMB purchases the house from the seller on cash, this house will then resell to the buyer who interested to buy based on deferred payment or so-called BBA.

The transaction entered by the buyer will be effective from the beginning of the payment, he then needs to reimburse the monthly payment at the stipulated date to avoid any court action by BIMB. In the contract, the agreement between both parties entails buying cost of BIMB plus mark-up, which is a profit for BIMB. Based on the maximum profit rate 12%, selling price is higher than the fixed financing BBA. Both parties agreed for monthly payment at the RM2, 000 each month for the period of payment, mutual consent. If the BLR become as a benchmark for the above graph, so the amount to be paid by the buyer will be deducted from his monthly payment, namely rebate. Say, if the market rate is equal to 10%, the bank needs to deduct RM500 from the buyer account to reflect the market rate, this RM500 is a difference between ceiling rate at the 12% and the effective monthly rate 10% (RM2, 000 minus RM 1,500=RM500). If the market rate is increased, let say 11% for BLR, for instance Maybank will earn interest equal to 11.25% (BLR +0.25%, 11%+0.25%). This means the bank needs to deduct only RM300 from the buyer monthly payment to reflect the change between ceiling profit rate and effective monthly rate, RM2, 000-RM1, 700=RM300.

The reasons why IFIs need to tailor the rebate and the BLR can be read as follow;

(a) In case of market rate is higher, conventional banks will earn more from the existing deposits and loans, less profit earned by IFIs due to the fact that the gap between profit. At the same time, it is a common practice by IFIs to give rebate for the customers in order to reflect the *Shariah Islamiyyah*. Therefore, if the rebate constantly given at RM500, IFIs will find difficult to manage its daily operation mainly in fulfilling the depositors transaction which is altered from time to time. IFIs need to pay *hiba* for *al-Wadiah Yad Damanah* and profit gain for Mudarabah deposit, *Pewani* and so on. If the rebate is tailored to the market rate, it can gain more competitive rate. For instance, if the market rate is increased up to 11%, less rebate which means preserve the right of the depositors in IFIs and vice versa;

(b) The profit rate earned by IFIs relatively is low that the conventional ones. In a dual framework, such in Malaysia, the fierce competition will also influence the popularity of IFIs in terms of increasing profit in yearly operation. In 1983, IFI was given an opportunity to operate based on the monopoly basis, supported by the Malaysian government. Until 1993, the system become oligopoly due to the fact that, Islamic banking products and services are offered by conventional banks through Islamic window namely Maybank and other banks as well. Meaning that, in conventional banks they have two segments of market namely profit for Islamic banking segment and profit for conventional banking segment, altogether will reimburse a high volume of profit for conventional banks. Unlike, IFI, which is, relying to Islamic based transaction, no one of the banks is allowed to perform non-*halal* banking activities;

(c) Pricing for Islamic financing which is based on the flat rate system does not price financing equitably. The flat rate system is fixed all the time may affect in terms of the increasing public participation in Islamic banks. The riskiness of Islamic bank is not factored into the price as they offer for outsiders. There are three (3) methods of Islamic financing pricing. First, a determination of a price sufficient to keep the level of deposit funds at an adequate level. Second, pricing may tailor according to the volatility history of the Islamic financing group (i.e. home, equipment, property, and durable good financing). Third, pricing for Islamic financing can be done through use the market rate as a benchmark (i.e. as in this paper we have discussed variable rate financing); and

(d) It is the government idea to promote more reliable financing innovation in Islamic banking system. By doing so, it enables to IFIs to face liberalization for Islamic banks in Malaysia, which is started in early year of 2006 by the new comer from the Middle East institutions such as Kuwait Finance House (KFH). Therefore, product and services offering may differ from the new comer in terms of practice and procedures. The profit gained may also higher than the Malaysian. Hence, it is a right time for BNM to permit IFIs to apply VRF to fulfill the pressure.

In practice, the rebate as deducted from the buyer monthly payment (as noted earlier), is modified in order to ensure the effective profit rate can reflect the movement of market rate. IFIs can increase their financing rate when the market rate is increased via imposing low rebate deduction. This action will assist the depositors to earn a reasonable return for their money in IFIs. The discrepancy between the floating rates as introduced by the conventional banks and VRF can be addressed to the fact that VRF rate is controlled by the ceiling rate as depicted by the graph previously. This indicated that the profit rate will not move beyond 12%, which means it provides a boundary to overcome uncertainty in extreme market rate basically a protection for the bank's customer.

Also in order to facilitate this system, the maximum profit rate is accordance to the 4 points percentage on BLR, except in case of significant reason about the expectation ob the change and the fluctuation market rate, so it can be adjusted. 4 points percentage mean BLR + 0.040. To determine the effective profit rate, a bank needs to look after the maximum ceiling profit about 2.5 point percentage on BLR. 2.5 point percentage mean BLR + 0.025. As stressed by the BNM, the effective profit rate should be not beyond the maximum profit rate although in the event of current market rate beyond the maximum profit rate. To promote justice, any change of effective profit rate should be forwarded to the customer before any alteration can be made.

In Islamic banking system, one may claim that "merely offering *Shariah* compliant product may not sufficient, other attributes are needed to complement the product's function". Given this fact, IFIs give monthly rebate as well as the rebate for early settlement, redemption, or the cease of the contract. In fact, IFIs also can extent the financing period if they choose not to increase monthly effective rate, even there is an increment in effective profit rate. This is only can be done when the agreement between both sides reveal the clause of reschedule, the total payment should not be exceed the initial selling price.

The scope of this financing method is still limited to apply in home financing, property financing and term financing. It is expected to expand into other field of financing in the future. As one of the new innovations in IFIs, it is practical for hedging to absorb the risk association the market rate fluctuation that may affect the performance of IFIs.

VIII. A CASE OF THE APPLICATION OF VRF

In introducing a new innovation in Islamic banks, a continuous assessment particularly is crucial in evaluating a significant impact to the Islamic banks' operation. The BNM committee has reviewed VRF in November 2004 in promoting efficiency in the pricing of this mode of financing. Based on that effort, the maximum financing spread of 2.5 percentage points above BLR, which is used to determine the effective profit rate, has now been removed. In addition, the requirement to seek BNM's approval for the ceiling profit rate to be more than four percentage points above the benchmarked BLR has been lifted. Accordingly, IFIs are now allowed to determine a reasonable ceiling profit rate taken into account the institution's risk management capabilities, business strategies and market outlook. The IFIs are also required to include in their financing agreements, and in their letter of offer, the mechanism and benchmark used in deriving the effective profit rate.

The following case illustrates the application of VRF. Suppose that, A has entered an agreement with Bank B to purchase a piece of land located at Village C on behalf of A. The following shows the exact information of the transaction;

Cost of Financing or Purchase Price (CF)	=	RM 80, 000
Annual Profit Rate (r)	=	9.5% p.a.
Period (N)	=	15 years
Number of compounding per year	=	12 months
Monthly Installment	=	RM 835.38 per month

In this regard, Bank B proposed VRF to A in order to finance the property as illustrated above. In addition, both parties agreed for monthly payment at the RM 835.38 per month based on mutual agreement between A and Bank B. Please notice that 9.5% is a profit rate for the transaction. If the BLR becomes as a benchmark for the transaction, A will be given a rebate to release burden for monthly payment and to reflect the market condition mainly to tailor to the BLR. Assume that, if the market rate is increased let say 8.5%, only RM 35.38 will be deducted from the A monthly installment. If the market rate is decreased let say 7.5%, about RM 100 will be deducted from the A monthly installment.

A. What is meant by BLR?

BLR stands for base lending rate imposed by conventional banks based on the concept of market rate. BLR will be determined according to the market condition, for instance, if inflation BLR will be increased and if deflation BLR will be decreased and vice versa.

B. Explain the relationship of the following?

a. BLR and rebate

This financial innovation is very interesting to explore its nature since BLR and rebate have significant relationship. However the relationship is negative relationship. If BLR increases means rebate reduced, whereas if BLR decreases means rebate increased.

b. BLR and monthly installment

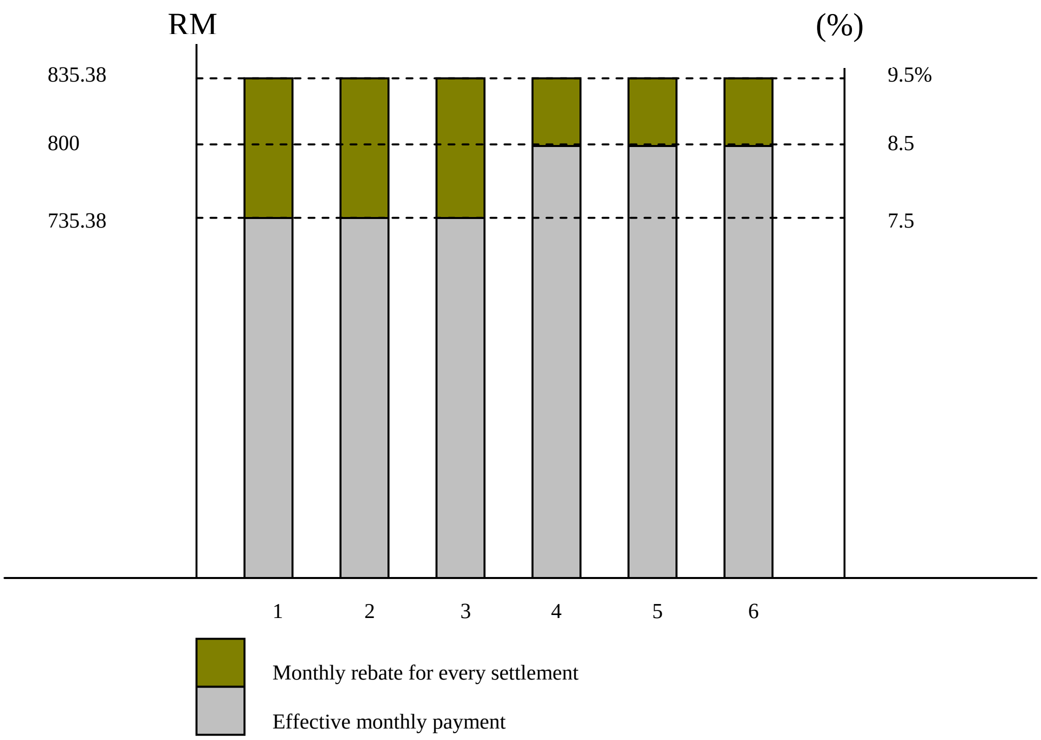
There is positive relationship between BLR and monthly installment as depicted in above case. Let's say if BLR increases means monthly installment increases whereas if BLR reduces means monthly installment reduces

C. How much A needs to pay for monthly payment if;

a. The BLR increased to 8.5% (pays RM 800)
b. The BLR decreased to 7.5% (pays RM 735.38)

D. The following diagram illustrate the transaction above, show the monthly rebate for every settlement and show the effective monthly payment. For this purpose, please illustrate only 6 months period instead of 12 months.

Graph 2: Variable Rate Financing



Source: BNM (annual report 2003)

IX. CONCLUDING REMARKS

This paper has provided an overview regarding the theoretical and practical aspects of VRF. The Islamic banking system in Malaysia is considered to be more progressive compared to the systems in other Muslim countries (Haron & Shanmugam, 2001). This is in accordance to the fact that the Malaysian Islamic banking system served as a model for Islamic banks in Indonesia, Brunei, Thailand, Philippines and Singapore. Given this fact, Malaysia wants to preserve the popularity of its Islamic banking system. Hence, VRF is one of the efforts to preserve the existing system.

In this aspect, the introduction of VRF has seen as a dynamic change and improvement to give more liquidity in IFIs daily operation. This practical approach gives advantages to the following parties;

(a) IFIs - VRF enables to increase the competitiveness power in profit gaining for Islamic banks;

(b) A buyer - can get a reasonable rate for monthly rebate according to the market rate changes; and

(c) A depositor - can receive a reasonable return rate in his saving in Islamic banks where it is evidence that Islamic banks must give a reasonable return for respected depositors. In the future, it may helpful to create a customer loyalty in becoming a lifetime customer for Islamic banks.

However, this creative techniques need to be observed continuously in terms of its performance, validity and market from time to time. In sum, VRF is one of the methods to ensure the performance of Islamic banks. VRF is devoted to eventually release the market pressure to Islamic banks. The objective of the paper is to explain and elaborate on the mechanism of variable rate Islamic financing as adopted by some banks in Malaysia. Further studies focusing on *Shariah* perspective are vital to ensure the acceptability of this financial innovation.

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