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A Conceptual Model to Establish an Islamic Finance Unit at a Malaysian Public University

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Abstract

This paper seeks to propose a new conceptual model to establish an Islamic Finance Unit (IFU) at a public university in Malaysia in order to extend benevolent interest-free financing as an act of charity. The problem with conventional student financing is the extent of non-performance due to the interest component. This paper identifies the need, justification and implementation of establishing the IFU, and measures success through equity and justice, not from charging interest, but returns generated from fees derived from increased student enrolment. The model could equally apply to any private or public university, and involves a blue ocean strategy in support of the development of new academic programmes by providing financing to improve the welfare of students and the local community.

Keywords: charity, justice, welfare, Islamic finance

1. Introduction

This paper proposes a conceptual model to establish an Islamic Finance Unit (IFU) at a Malaysian public university, Universiti Sultan Zainal Abidin (UniSZA). The IFU is an enabling mechanism to enhance the branding of the university as an applied Islamic university and associated academic programmes. UniSZA has recently emerged from a local-centric state college and been transformed in to an international public university, but at 7,600 students of which most are undergraduate and only 230 postgraduate, the student population remains relatively small and ultimately UniSZA, as with any tertiary academic institution, must introduce more high quality degree, post-graduate and executive educational programmes, in order to enhance community development and improve student enrolment. Branding is a function of marketing, but increasingly students are facing an affordability issue. This is more pronounced with higher fees being charged by private universities, or when public universities also wish to introduce new programmes and charge higher fees through affiliated subsidiaries, they will increasingly face the same *ability to pay* from potential students. Other than a minority of new sponsored students, one of the first questions that every other potential student asks is how can the university assist them financially. Many wish to register but are unable to do so due to a lack of purchasing power.

Financing a student is thus a marketing tool, which in turn affects a university's brand. This paper therefore proposes a blue ocean strategy, involving the establishment of an Islamic Finance Unit (IFU), which seeks to address this financing gap, assess the competition and determine what would be achieved from such an undertaking. The project would leverage UniSZA's academic programmes, provide financing to students and potentially develop a future financing platform for graduates as well as for the wider local community. In so doing, it would thereby satisfy an important strategic intent in the university's mission of being an applied Islamic university, and establishing an IFU would certainly be putting academic theory into practice. This paper is organised into fives sections. The first provides a background by identifying the need for such a project; the second and third sections address the justification of the model by identifying the gap and the competition; the fourth section discusses how UniSZA can fill the gap in terms of implementation; and the fifth summarizes the proposal and highlights the expected outcome and impact.

2. Identifying the Need

There is clearly an identifiable need for quality and yet affordable tertiary academic programmes, especially for students and candidates from Africa, Asia (Aceh, Southern Thailand, Southern Philippines, Pakistan, India, Bangladesh, North-West and Southern China), Middle East (Palestine, Yemen, Syria) and also from Malaysia, especially Terengganu and the East Coast. Academic development in Terengganu is in accordance with the state's education policy ('one house one graduate'). According to the 2010 federal census, out of a total population of 27.6 million the population of Terengganu was slightly over 1.0 million (other east coast states: Kelantan 1.5 million and Pahang 1.4 million), and the male:female ratio is 103 (103 males to 100 females, or 51%). In terms of geography and demographics, according to 2011 state government data approximately 51% (597,716) of the population live in urban areas and 49% (413,647) in rural areas, and although density is at its highest in Kuala Terengganu (table 1), much of the population is located along the coastline.

Table 1. Estimated population by district

District	2010	Area/sqm	Pop.Dens./sqm
Besut	136,563	1,234	111
Dungun	149,851	2,735	55
Hulu Terengganu	70,800	3,875	18
Kemaman	166,750	2,536	66
Kuala Terengganu	337,553	605	558
Marang	95,283	666	143
Setiu	54,563	1,304	42
Total	**1,011,363**	**12,955**	**78**

Terengganu State Economic Planning Unit (2011)

Malays make up 95.3% of the population, Chinese 2.6%, Indians and other ethnic groups including foreigners 2.1%. (table 2). Whilst Muslims are derived from all ethnic backgrounds, Malays are predominantly Muslim, and so we may reasonably assume that about 95% of the population is Muslim.

Table 2. Population by ethnicity

Ethnicity	2010	Percentage
Malay	963,510	95.3%
Chinese	25,857	2.6%
Indian	2,344	0.2%
Others	1,350	0.1%
Non-Citizens	18,302	1.8%
Total	**1,011,363**	**100.0%**

Terengganu State Economic Planning Unit (2011)

The oil and gas industry is Terengganu's largest industry, although other significant industries include agriculture, tourism and fishing. Furthermore, reflecting their support for Islamic banking products, even by 1994, Kuala Terengganu represented the highest market share of Islamic (*al-wadiah*) deposits by amount with 18.4% (Choudhry *et al.*, 1997). Be that as it may when we consider various economic variables, real GDP per capita, real GDP in Terengganu as a percentage share of Malaysian real GDP, and comparing average household income (Note 1) data, it reveals that the purchasing power of Terengganu is far below the national average (table 3). Quality tertiary education will not only improve incomes and thus domestic purchasing power, but will also provide for additional entrepreneurial ability as an important factor of production. GDP is the value of production and output is a function of labour and productivity: the ability of a university to contribute to growing real economic wealth for the local community, is dependent upon the relevant knowledge and skills-sets it imparts from its academic programmes.

Table 3. Real GDP, real GDP/Capita, average household income for Terengganu and Malaysia (2011)

Economic Variables	Terengganu	Malaysia	% share
GDP (millions, constant 2000 prices)	15,473	588,300	2.6%
GDP/capita (constant 2000 prices)	15,082	19,907	
Average Household Income	3,348	4,025	

Malaysian Department of Statistics and Economic Planning Unit

3. Identifying the Gap

The gap involves providing student financing for academic programmes that cater for the need and preferences of students as customers. Therefore, starting with the premise that obtaining an exemplary education is the best investment for a community, there is not only a need but also a real demand for quality tertiary education. Of course potential candidates by default will choose those universities that offer quality academic services (in terms of lecturers and programmes) and university facilities. This does not necessarily mean at the cheapest price, but ultimately they are looking for academic programmes that cater for their needs and preferences in conjunction with price: this is a basic economic function of *willingness and ability to pay*. Typical fees (excluding hostel fees) for a three-year degree programme at public universities are about RM15,000. Typical fees for private universities are about RM50,000, or three times the amount. The gap is the lack of affordability of public fees let alone private fees given the prevailing low household income and wealth. The concept and policy recommendations that this paper proposes, is not only relevant for a public university but even more relevant for a private institution or a private subsidiary of a public institution: the higher the fees, the wider the gap. Not only is there a gap in student enrolment, but there is also a larger gap in extending financing to the wider community: if programme objectives are designed to produce quality industry-ready professional graduates, how many of them falter in their entrepreneurial ambitions due to lack of suitable micro-finance funding post-graduation?

There are three alternatives to consider: (1) to provide an Islamic finance unit (IFU) that extends student loans and financing to UniSZA students; (2) establish an e-commerce platform for the local community, and begin by extending financing to high performing graduates; (3) manage investments, source funds and extend financing for the local community in the form of an Islamic wealth management platform. Legally, student loans are technically permitted to deserving students under its constitution by an IPTA but not necessarily by an IPTS (Note 2). If an IPTA or an IPTS wishes to develop a wider financing model it would be better to ring-fence liability and invest in such a venture as a separate legal entity under a holding company, especially if the scope of financing activities are subsequently extended to include equity investee projects to graduates and/or the local community. In this case, UniSZA would require a simple money-lending license for money lending to its students from the Ministry of Housing and Local Government and not Bank Negara Malaysia (BNM). It would not require any license for private investments and financing transactions (involving graduates or local entrepreneurs) where the source of funds is internal (from UniSZA Holding). Even the e-commerce platform would not require a license, for this would be to establish an on-line market place where the source and application of private funds are exchanged between third parties. A wealth manager is distinct from a financial advisor, where the former does not, but the latter does require licensing from BNM. If UniSZA Holding established a fund-managing unit, it would require a fund manager's license from the Securities Commission. Also any sourcing funds (from the money market or deposits) and extending debt financing would either require a finance company or a banking license from BNM.

4. Identifying the Competition

Who would be the competitors of an IFU? Other public universities (albeit limited), Yayasan Terengganu, PTPTN, the SPP1M top-up facility and other education loans from retail banks, are all interest based, except the Kuok Foundation, which is interest-free (annual disbursements are RM16 million). Where options are limited, students are forced to consider conventional interest-bearing loans. In reality, the nature of the competition is reduced to the ability of the IFU to provide Islamic finance in the form of an interest free loan (*qardul hasan*) over a tenor that ensures the monthly repayment is less than what a student would otherwise have accepted if choosing a public university with similar fees, but less attractive financing terms involving a reduced tenor and an interest rate. The terms involve 100% financing to the value of all tuition fees, one-time fees and hostel expenses, and assume repayments that commence post-graduation. Tables 4 compares financing terms for a soft loan against an interest free loan, involving a masters degree (Note 3) over two years that includes the cost of tuition fees and accommodation (Note 4). The IFU offers a *Shari'ah* compliant monthly repayment, which is clearly lower than even a PTPTN (Note 5) soft loan. In reality, the IFU could also control the tenor of the financing, which could be extended to 15 years, thereby dropping the monthly payments to RM111 per month or RM1,333 per year and improving the ability of the student to repay even further. Many postgraduate and executives are already in employment, which again reinforces ability to repay.

Table 4. Comparison of financing terms for a Masters programme including accommodation

Soft Loan	Masters Fees/Accommodation:		20,000.00	
		$	Financing Ratio	
Student:	-		0%	
Bank Financing:	20,000		100%	
Insurance:	- (Note 6)		0.0%	
Sum assured:	**20,000**			
Interest Rate:		3.00%	p.a.	
Tenure:		10	years	
Num. of paym.:		12	(monthly)	
Tttl no. of paym.:		120		p.a.
Vpm:		$193.12	payment p.m.	2,317.46
Vpm incl. insurance:		$193.12		
Qardul Hasan	Masters Fees/Accommodation:		20,000.00	
		$	Financing Ratio	
Student:	-		0%	
Bank Financing:	20,000		100%	
Takaful:	- (Note 7)		0.0%	
Sum assured:	**20,000**			
Profit Rate:		0.00%	p.a.	
Tenure:		10	years	
Num. of paym.:		12	(monthly)	
Tttl no. of paym.:		120		p.a.
Vpm:		$166.67	payment p.m.	2,000.00
Vpm incl. takaful:		$166.67		

5. Filling the Gap

When considering financing students, we should begin with *Shari'ah* compliance, which is not only critical in terms of application but also source of funds. For example, RHB Islamic Bank was apparently capitalised by conventional funds from RHB Berhad and yet an Islamic legal maxim states that, "if something is void then all that flows from it is also void" (Majallah, no.52). Clearly, UniSZA's sources of income are student fees and additional government funds (dependent on student numbers). Furthermore, the key to student financing is the avoidance of interest, which is precisely the element that Islamic finance prohibits. In the case of U.S. college students, one in three are either delinquent or are in forbearance (CNBC, 2011) – in other words, 1 in 3 are technically in default, due to compound interest and non-performing students loans (NPLs) have increased substantially due to the presence of interest (*riba'*) as per figure 1.

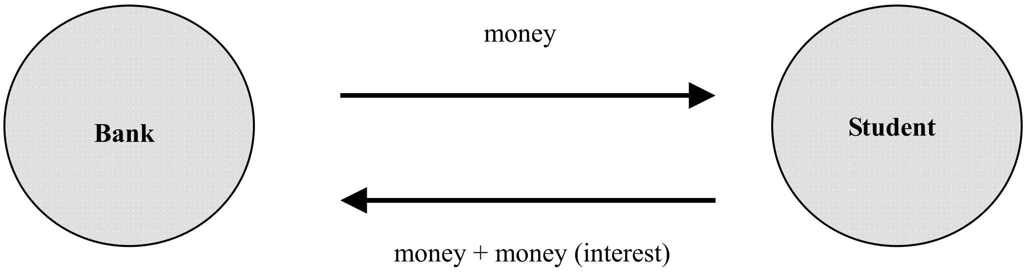

Figure 1. Conventional student loan: NPLs increase due to the cost of interest

In essence, the mechanics and flow of funds involved with the IFU proposal (figure 2) only require a competent finance officer whom can manage the financing applications (credit analysis, collateral management) and debt recovery (credit management). Concerns over credit analysis, credit and collateral management are eased, given that the ability to pay is significantly enhanced with an interest-free loan (*qardul hasan*), and the loan itself involves a guarantor (*kafalah*) with requisite life insurance (life *takaful*). The IFU would be capitalised by funds from UniSZA Holding Sdn Bhd, and would be a separate legal entity from the university in terms of the University Act 1971 for an IPTA (or for an IPTS, the Private Higher Educations Institutions Act 1996). The holding company is entitled to capitalise and operate investee projects under terms that it deems acceptable. Individual transactions are entered into between the student and the IFU on one hand, with fee payments made by the IFU to UniSZA. The attractiveness of this proposal from UniSZA's perspective is that the transactions involve book-keeping entries only and involve no cash disbursements, only collections of cash instalment repayments. For UniSZA the economic substance involves the marginal rate of transformation, or the opportunity cost, of re-deploying capital earning a relatively low time-deposit interest rate and instead investing in the IFU, thereby generating a much higher return on fees from students, albeit repaid over time – this being actually better than a scholarship where funds are disbursed and not returned.

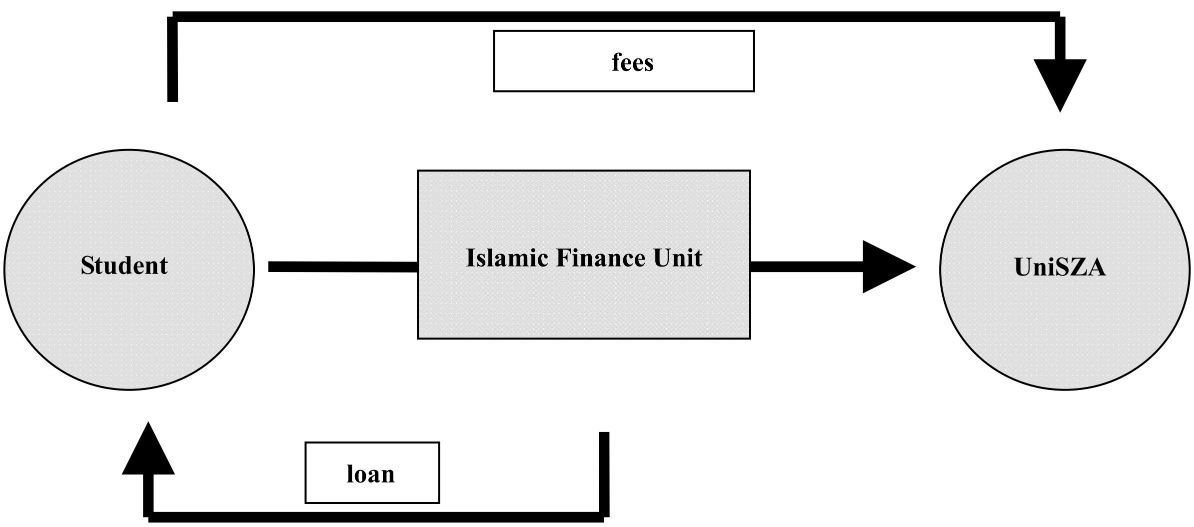

Figure 2. Islamic finance unit, flow of funds

For the IFU, the student financing application can be completed manually but may also be conducted on-line via the UniSZA website, so that the registration process (Note 8) inherently includes a student's successful application for funds from the IFU. The key points relating to the IFU operations (figure 3) can be summarised as follows:

- An Islamic loan (*qard al-hasan*) is an act of charity and is interest free.

- Involves non-cash disbursements within the University, but actual cash receipts from students.
- UniSZA Holding company staff to set up and manage the IFU including internet platform (Note 9).
- Applicants for *qard al-hasan* to be means tested and could be credit evaluated.
- Means testing: based on EPU data on current average household income for Terengganu (RM3,348 for 2011) or equivalent for students from elsewhere.
- Credit Evaluation: based on 5 Cs (Character 30%, Capacity 30%, Capital 20%, Conditions 10%, Collateral 10%) (Note 10).
- Collateral: Letter of Guarantee from one guardian or institution as guarantor (*kafalah*) with an absolute assignment of life insurance (family *takaful*) by way of deed of assignment, signed by the borrower as assignor and the IFU as assignee and all associated stamping, legal costs borne by guarantor/borrower (Note 11).

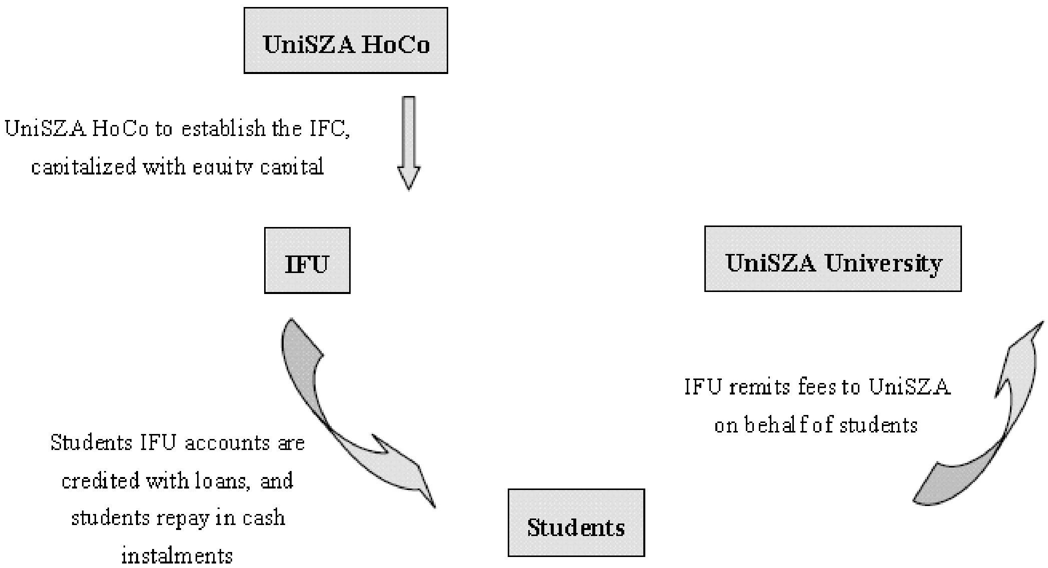

Figure 3. Islamic finance unit, operations

6. Summary and Expected Outcome

Therefore, the IFU is an educational enabler designed to help develop the community. It can finance students for under-graduate diplomas and degrees, post-graduate degrees and entrepreneurship academic short-courses. It can provide financing to qualified (means tested) students, not just to those from Asia, Africa, and the Middle East, but of course to Malaysians, especially to Terengganu and East Coast students. This concept involves a blue ocean strategy to re-position UniSZA including its Graduate School and Holding company from delivering programmes to largely domestic candidates, to delivering under-graduate, post-graduate and executive programmes to national and inter-national students. The IFU is a University led project, transforming academic theory into commercial practice - the very essence of an applied Islamic university. The establishment of the IFC is an enabling mechanism by which to achieve the strategic re-positioning by, financing national and inter-national candidates for educational programmes.

In essence, UniSZA can expect a very positive reaction from students and the local community. The associated public relations would also auger well for UniSZA, which would not only bring quality academic programmes within financial reach of students, but show-case how the theory and practice of Islamic finance can provide financing to students, and potentially local entrepreneurs, to impart justice and grow real economic wealth within the community. The impact of establishing the IFU involves,

1) A new concept to help those national and inter-national students with a poor background.

2) Students obtaining a first class education at UniSZA, with interest-free financing (a *qard al-hasan* is an act of charity to one who needs it).

3) The first university in Malaysia to establish an IFU and putting theory into practice as an applied Islamic university.

4) The university generates a profit from fees derived from increased enrolment.

5) The university is seen to be developing the community in line with State and Federal policies.

6) Student financing (phase 1), could be augmented by community financing (phase 2), in order to develop Islamic equity finance projects in partnership with Terengganu entrepreneurs to help local industry, on the basis of *mudharabah* or *musharakah*, from which a ROI would be generated to UniSZA Holding.

How much could UniSZA commit to the IFU for phase 1 (student financing)? Funding depends on whether the financing includes tuition fees as well as accommodation expenses: essentially, each tranche of RM0.5 Mn finances roughly 50 under/post-graduate students on the basis of tuition fees alone. However, phase 2 financing of graduates and the wider local community would require further detailed discussion and commitment of resources and funds from UniSZA Holding. Ultimately, implementation requires further due diligence on legal, tax, licensing and any other feasibility issues.

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Notes

Note 1. Malaysian GDP/capita is for 2010 and Malaysian average household income from 2009.

Note 2. IPTA is a public university and IPTS is a private university.

Note 3. Interest rates can be reduced by PTPTN depending on performance to 1% for a first-class honours degree. However, a candidate does not know whether this will be achieved, and rather than accept the normal 3% rate, is likely to choose the Islamic interest-free option.

Note 4. Assuming RM2000 per semester fees [total RM8000] and RM500 per month rental for 2 yrs [total RM12000] = total fees + rental RM20,000. Rental accommodation assumes renting a single storey terrace house for one family assuming an international candidate with family. Single and/or hostel accommodation would be less expensive, but these assumptions would not alter the favourable outcome of adopting interest-free financing.

Note 5. PTPTN is the National Higher Education Fund Corporation under the Ministry of Higher Education and is responsible for extending study loans to students pursuing tertiary education.

Note 6. The loan insurance premium is ignored for the purposes of simplicity of calculation.

Note 7. The *takaful* premium is also ignored for calculation purposes.

Note 8. A typical process involves application, offer letter, funding, registration.

Note 9. Management of the IFU should not emulate SME Banking, which extends *qard al-hasan* loans but charges an administration fee that is arguably equivalent to simple interest.

Note 10. In terms of capacity to pay, this could involve two main conventional debt-to-income ratios (DTI) of 28/36. Front-end DTI is the ratio of housing expenses (rental or mortgage/insurance/taxes payments) to net monthly income. Back-end DTI is the ratio of all recurring debt payments (housing, credit card, student loan payments as well as child support payments, alimony payments and legal judgments) to net monthly income. Conventional practice typically involves a 28% front-end DTI for housing expenses and a 36% back-end DTI for housing expenses and recurring debt.

Note 11. If the local student defaults the guardian must settle, if the international student defaults the institution must settle (bank guarantee), and if the student passes away the insurance operator must settle the balance.