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Do the Treasury Activities Function Well in Shari'ah-Compliant Financial Market?

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Abstract

This applied study was aimed at offering an insight into the understanding of the treasury activities of shari'ah compliant financial institutions in Islamic financial market. Archival studies on characteristics of the treasury instruments, observations and analysis on the mechanism of the instruments used in the markets were carried out in investigating any existence of shortcomings both in term of products as well as the dealing of transactions. Based on the findings of this study, contribution in term of suggestion for improvement as innovation was recommended. It was hoped to improve the current practices in handling the instruments and the mechanism in the market

Qualitative methods of research and exploratory approach were used in this study. Observation to research method and interviews were also employed in this study. They were applicable in looking into the research issues understudied. Additionally, descriptive study approach was also applied in this study. Capitalizing on the explored and examined shortcomings became the basis in suggesting action to be taken to improve the policies and procedures by the relevant institutions.

Keywords: Shari'ah-compliant, Mechanism, Islamic inter-bank money market, Excess funds and debt trading.

1. Introduction

Treasury activities are crucial roles of financial and banking businesses in any financial market, which primarily responsible in managing the bank's funds. Financial market is composed of money market and capital market. Money market is a dealer market for short term debt securities whilst, capital market is for long-term debt and equity shares [Ross, Westerfield, Jaffe and Jordan, 2008]. Basically, the treasury's function of an Islamic financial institution is to essentially managing two types of funds namely the depositors' funds and the shareholders funds. The eligible liabilities of an Islamic banking institution are represented by the customers' deposits which composed of current account deposit, saving account deposit, general or unrestricted investment deposit and special or restricted investment deposit. The shareholders funds are comprised of paid-up capital, share premium, general reserve and retained earning [Mohd Nasir bin Mohd Yatim & Amirul Hafiz bin Mohd Nasir, 2008].

These sources of funds are utilized in various investments and financing activities. The excess from such utilization will be commingled, pooled and managed by the treasury division of an Islamic financial institution in compliance with the principle of fairness to mankind and in conformance with the requirements of shari'ah dictates [Mohd Nasir bin Mohd Yatim & Amirul Hafiz bin Mohd Nasir, 2008]. In brief, one can conclude that the functions of treasury department of an Islamic banking institution can be enumerated as maintenance of statutory reserve and liquidity requirement, management of clearing account with central bank and management of institution's excess funds.

2. Archival study

All financial institutions, including merchant banks and finance companies are required to maintain a small percentage of their eligible liabilities with a central bank in the form of statutory reserve and liquidity requirement based on stipulated rates which are subject to review from time to time depending on economic condition of the nation. The eligible liabilities are comprised of customers' funds in current accounts, saving accounts, investment accounts, amount due to the bank and amount due from other banks, merchant banks and finance companies. As such, in line with the bank's conceptual approach in profitability accounting, the account department of a branch bank is therefore be required to maintain a certain percentage of the branch's eligible liabilities equivalent to the amount required by the central bank as its statutory reserve . In addition the central bank requires such institution to maintain on daily basis, minimum liquid assets to meet the customers' demand. The central bank may from time to time notify the banks the percentage of liquid

assets that need to be maintained. The liquidity assets of a shari'ah-compliant financial institution comprise of notes and coins which are legal tender, balance with central bank excluding balance in statutory reserve account, Government Investment Certificate (GIC), Islamic Accepted Bills (IAB), banker's acceptance (BA) and other approved assets. In dealing with the Islamic treasury functions and the transactions involve within a shari'ah-compliant financial market, the primary shari'ah concept namely al-bai' al-dayn was often used. Al-bai al-dayn concept refers to debt trading or an exchange of debt with cash as its consideration, computed at a discounting basis [Mohd Nasir bin Mohd Yatim and Amirul Hafiz bin Mohd Nasir, 2008].

3. Methodology

This study emphasized on qualitative research method and exploratory research approach. Both are considered appropriate for this study. In addition analytical and comparative discussions were also applied where appropriate. Archives in the form of documentation were scrutinized in detail. This was done to ensure coverage on the focus of the issue under-studied. These were therefore being the justification on the holistic nature of the issue being focused and thus achieving the objective of this study. Observation of field study was also under-taken in validating the findings of this study. In achieving the objective of offering an insight in this study, treasury instruments features were scrutinized in ensuring their conformance with the tenets of the principles rendered in the creation of the related instruments as well as their dealing transactions in the shari'ah-compliant financial markets.

4. Discussion

The management of Islamic banking clearing account falls under the Islamic Inter-bank Money Market (IIMM) which was introduced by the central bank. The market is comprised of mudharabah inter-bank investment and Islamic inter-bank settlement cheque clearing system. The participants of this market are licensed Islamic banking institutions. The basic instrument in use is mudharabah inter-bank investment (MII). MII refers to a system whereby an Islamic bank could obtain investment from another Islamic bank under the principle of mudharabah. Its features include, the tenure of investment is from overnight to twelve months with stipulated minimum investment amount. The rate of return is computed based on the gross profit rate before distribution for one year investments of a receiving bank. The effective rate of return shall be the rate of gross profit declared on the maturity date of each investment. Further, the profit sharing ratio on all period of investment is negotiable.

MII is considered as special investment deposit known as Mudharabah Investment Deposit (MID) to a receiving bank. It forms part of the eligible liabilities of that bank and thus be subject to statutory reserve and liquidity requirements. On the other hand, to the provider of fund, MII is considered as amount due from other bank and thus be deducted from eligible liabilities for the purpose of computation of statutory reserve and liquidity requirements. The computation of the gross profit rate before distribution of one year investment of the receiving institution shall include MII. Therefore, MID is included in the profit distribution system together with listing of other deposits.

Another available mechanism is known as Islamic inter-bank cheques clearing settlement system (IICCS). It is a system whereby a central bank shall allocate and square the position of surplus and deficit balance of the related financial institutions at the mid-night clearing settlement. The features of IICCS are firstly, an Islamic bank is required to maintain a clearing account with a central bank under the principle of al-wadi'ah yad dhamanah (trustee custodian with guarantee). Any surplus fund of an Islamic bank at midnight clearing shall be automatically invested with the deficit bank using MII for an overnight or a day as investment. The surplus fund shall be distributed to the deficit banks proportionately. The amount of investment for the largest surplus bank shall be first invested with the bank with the largest deficit and any remaining balance to the next largest deficit bank and so on. Where the total surplus is less than the total deficit, the entire surplus of each bank shall be invested on the principle that the bank with the largest surplus shall first be invested with the bank with the largest deficit. The shortfall shall than be covered by the central bank.

The profit sharing ratio is fixed at a certain ratio such as 80:20 for which 80% is for the provider of fund. The investment by the bank and the profit earned shall be automatically repaid on the next working day through a debit against the clearing account with the central bank. An Islamic bank is to inform the central bank in writing on the effective rate of gross profit before distribution for investment of one year. In managing the bank's excess fund, treasury department of an Islamic bank shall be responsible in managing a pool of commingled excess funds comprises of excess customers' deposits, investment funds and shareholders' funds after being utilized for statutory reserve and liquidity requirements and various financing activities undertaken by such bank. Such excess fund is normally being invested in various short term investment avenues which include Government Investment Certificate (GIC).

The investment in GIC constitutes a benevolent loan to the government under the principle of al-Qard al-Hassan which is free from any element of usury. Nevertheless, the banker for government, Central Bank, at its own discretion, could provide hibah as gift for the good deed of offering funding to government. Such hibah is paid on the anniversary date of the GIC and it is computed based on average cost method. Since the GIC was created based on Qardhul Hassan principle, it cannot be traded in the secondary market as it is a good loan based underlying instrument. An investment in

GIC is also considered as a form of liquid asset. As such, it was concluded that GIC is a form of accommodative instrument in order to realize the operational practice of an Islamic banking at its initial stage and for that reason such instrument has been phased out from the Islamic financial market. In world-wide practices, investment of excess fund of an Islamic financial institution with another Islamic bank usually is arranged on the basis of Mudharabah Inter-bank Investment (MII). The return on MII is determined by the period of investment and the receiving bank's gross rate of profit of one-year investment.

In addition an Islamic bank may venture into a short term financing under the principle of murabahah (cost-plus marked up). By rendering this principle, a bank can provide fund for purchasing of certain tangible permissible commodity. In this regard, the purchaser is appointed as the bank's agent and thus is known as the purchase orderer for purchasing of the intended commodity. Upon settlement of the commodity, the bank subsequently sells the commodity to the purchase orderer at a marked-up value and allows him to defer the payment. In this way, a debt is created and thus enabling it to be traded based on the principle of al-bai' al-dayn in shari'ah-compliant financial market. In ensuring its shari'ah-compliant such debt must be originated from shari'ah permissible trade transaction such as arising from above-discussed cost-plus-marked-up sale and deferred payment sale. Currently, there are several debts instruments available in Islamic capital market which includes Islamic accepted bill (IAB), Permissible Bankers' Acceptances (Green BA) and Mudharabah Bond (MB). IAB is a bill of exchange drawn by an Islamic bank and accepted by the importer or purchaser of an underlying permissible trade transaction. For instance, an IAB originated from import or domestic purchase transaction. The pricing of an exchange in debt is computed on a discounting basis. Green BA are those issued by conventional banks that complied with the requirement of related tenets of the principles in use such as permissible export or sale transaction or drawn to finance permissible goods or commodities.

Mudharabah bonds are bonds issued under the principle of mudharabah. The bonds are originated from Islamic house financing under the principle of al-bai' bithaman ajil. This instrument allows the bondholders and the issuer to share on specified ratio of profits generated from the issuer's operation in purchasing the Islamic house financing assets and other Islamic investment. Based on the concept of mudharabah, the bondholders shall however, entirely bear any loss of diminution, if any, in the principal amount of the bonds. Investment in foreign currencies includes dealing in bullion transactions and foreign exchange transactions. Dealing in bullion transaction operation entails spot purchase of commodity of gold or silver for forward sale / delivery. By such dealing, income can be earned in two forms namely the appreciating value of commodity and resulted from swap exchange. The exchange of one currency against another through a price of a prevailing rate is allowed by shari'ah under the principle of al-sarf and be exchanged between the two difference currencies on a concurrent basis.

5. Conclusion

The proper and orderly operation of treasury's function of an Islamic financial institution within a shari'ah-compliant financial market is to essentially managing two types of funds namely the depositors' funds and the shareholders funds. . In achieving the objective of offering an insight in this study, treasury instruments features were scrutinized in ensuring their conformance with the tenets of the principles rendered in the creation of the related instruments as well as their dealing transactions in the shari'ah-compliant financial markets. The management of Islamic banking clearing account falls under the IIMM which was introduced by the central bank. The market is comprised of MII and IICCS. An IICCS is a system whereby a central bank shall allocate and square the position of surplus and deficit balance of the related financial institutions on an over nightly basis.

A debt is probable to be traded in Islamic financial market. The basis of its dealing is using the principle of al-bai' al-dayn. However, in ensuring its shari'ah-compliant such debt shall be originated from shari'ah permissible trade transaction such as arising from cost-plus-marked-up sale and deferred payment sale. There are several debts instruments available in Islamic financial market. Such available instruments include IAB, Green BA, and Mudharabah Bonds. The exchange of one currency against another at a prevailing price or rate is probable under the principle of al-sarf provided the exchange between the two difference currencies is made on concurrent basis. Therefore, in concluding on the wellness of the shari'ah-compliant financial markets, the writer viewed that the available instruments and the mechanism of their operations are competitive, efficient and effective in their nature.

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