

**OPTIMISING 'UQUD IN FINANCIAL SERVICES FOR THE SMEs¹:
A CASE STUDY OF THE SME BANK IN MALAYSIA**

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ABSTRACT

Islam has formulated very firm principles of the law of transaction in financial services as clearly stipulated in al-Quran and al-Sunnah. Various types of Uqud under the law of muamalat are actually contributing a lot to provide entrepreneurs regardless of SME or big conglomerate with very flexible modes of financing. However, there is an issue of how to optimize the uniqueness of these uqud for the betterment of ummah. Hence, this paper is intended to provide an overview of the concept of uqud under Islamic law. The scope of the discussion nevertheless confines only to the needs of the SMEs in Malaysia. As Malaysia has taken an initiative to support the SMEs through the establishment of the SME Bank in 2005, there will be an analysis on the trend of financing facilities offered and granted to its customers.

1.0 INTRODUCTION

Islam is neither simply a religion nor a mere ideological vision. It is a comprehensive religion and a practical system of life that covers every single aspect of human life. In Islam, the development of *ummah* is the priority in the economic system and therefore Islam strongly encourages people to involve in business or to be an entrepreneur. An entrepreneur will be dealing with a lot of commercial activities which falls under various types of contract or '*uqud*. '*Uqud* in Islam is the very essence of each human dealings and it covers a variety of transactions to meet the financial needs of the society either in equity or debt or any other modes of financing.

As for evolution of Islamic law of contract, it starts with *al-Quran* which already prescribes several types of nominate contract as well as certain general contractual maxims. Thereafter, the traditions or *al-Sunnah* supplement the Quranic groundwork as a support or additional explanation to its general provision. The Muslim jurists in all Islamic school of law later developed the principles of contract. In *al-Quran*, there are

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only over forty verses out of 6666 verses on a dozen types of commercial contract. Apart from one important verse on performing contract which enjoins believers to keep faith to contracts (Al-Quran: *Surah al-Maidah*, verse 1), three verses with a common theme of keeping promise (Al-Quran: *Surah al-Isra*, verse 34) and there are few verses which reveal a relatively advanced stage of commercial contracts, such as sale and hire, charges or personal guarantee as (security) and fiduciary contracts such as deposit.

The whole idea of having a contract is to satisfy the consent of both parties to a contract and it is the best available means to reflect the intention and accordingly the consent of the parties. As the effect, *al-Quran* has already prescribed on the believers ‘not to devour your assets among yourselves in vanity, except in trading by your consent’ (Al-Quran: *Surah al-Nisa*, verse 29). In addition, the Prophet is reported to have said that ‘The Property of a Muslim is not licit for others to enjoy unless by his consent.

In contract of financial services, the central idea of ‘*uqud*’ is to reflect the terms, conditions and intention of the parties. As regard to entrepreneurship, there are various types of ‘*uqud*’ under Islamic law which can be a basis for financing facility products in Islamic financial institution. Shariah principles offer a wide diversity and very flexible mode of financing in every field of entrepreneurship either for a small and medium enterprise or a non-small medium enterprise.

Various types of ‘*uqud*’ under Islamic law provide flexibility for entrepreneurs to choose the best mode of Islamic financing products that appropriate to the nature of their business. These types of contracts can be classified as unilateral and bilateral and primary and secondary modes. This chapter is intended to provide a general overview on ‘*uqud*’ in Islamic commercial transactions and its modern application as practiced by Islamic financial institution. It is hoped that the discussion in this chapter would be beneficial for students, the public as well as practitioners to understand basic concept of contracts under Islamic law in relation with the entrepreneurship.

2.0 'UQUD IN ISLAMIC COMMERCIAL TRANSACTION

Contract in Arabic term is called 'Aqd. Plural of Aqd is 'uqud. Literal meaning of Aqd is to bind or to strengthen. The word Aqd is also used in Arabic in the sense of confirming an oath. As such, any covenant, pact, agreement and treaty will also be referred to as Aqd since all of them demonstrate firm resolve for execution.

'Uqud or contract technically means as an expression of the matching between a positive proposal made by one of the contractors and the acceptance of the other contractor in a way which has an impact on the subject of the contract (Ala'Eddin Kharofa, 1997) . The Islamic Civil Law Codification which took place in the 19th century, namely the *Majallah al-Ahkam al-'Adliyyah* and *Murshid al- Hayran* (the 1891 Egyptian version of the Ottoman's Majallah), provides a precise definition to a contract. The Mejlle defined contract as little contracting parties obligating themselves with regards a given matter and binding themselves together with the same as a result of connecting an offer with an acceptance (Trans. by C.Y Tyser n.d. p. 16). A contract is the connection of an offer with an acceptance in a lawful manner which marks its effect on the subject of that connection.

From the above definition, it could be understood that a contract can be summarize to be an engagements and agreement between two persons in a legally accepted, impact, and binding manner whereby it has the connection of an offer with an acceptance in a lawful manner which marks its effect on the subject of that connection and there is an expression of the matching between a positive proposal made by one the parties and the acceptance of the other party in a way which has an impact on the subject matter of the contract.

A contract in Islamic approach implies beyond religious implications and totally different from conventional economist point of view. Islam emphasizes on the clarity, fairness of the transaction including the prohibition of interest, the elimination of uncertainty and the promotion of risk. In Islam all economic dealings or contract are meant to promote economically just, socially fair, and ethically correct dealings according to Islamic principles, foster the solidarity and cohesion of the Muslim *ummah* and bring about cooperation in all walks of life.

In modern time, the application of various contracts under Islamic law that has been currently practiced is slightly different from what has been practiced by previous generations as discussed by traditional *fuqaha*'. Modern Islamic financial instruments which provide financing facility for entrepreneur may fall under any category of '*uqud*' in project financing, trade financing and any other facility. Hence, it is important for us to know the current application of '*uqud*' in financial services and its relationship with the entrepreneurship in Islam.

3.0 ENTREPRENEURSHIP IN ISLAM

Entrepreneur can be defined as a person who starts or organizes a commercial enterprise or person who works under contract as an intermediary in the business. According to Graham Beaver (2002), the entrepreneurial characteristics has been identified include innovation, with the entrepreneur being recognize as the agent for change, the willingness to take risks and the ability to make confident and judgmental decisions. In short, the entrepreneur is a person who involve in business activity by setting up a company or enterprise in a certain commercial area such as manufacturing, services sector, food industries and construction sector.

In Islamic entrepreneurship, the entrepreneur must posses a different standard of qualities with other types of entrepreneur. Muslim entrepreneur must first to have faith in the oneness of Allah, that there is nothing worthy of worship except Allah, the Creator and Sustainer of the universe (See Muhamad Nejatullah Siddiqi 1989: 1-20). This tawheedic approach is the ultimate concept of entrepreneur in Islam.

Muslim entrepreneur must also believe that any asset from the business is a God's ultimate ownership (Wahbah al-Zuhaillyy, 1989). There is no disagreement among the Muslims scholars in the belief that ownership of property belongs to God as it is explicitly stated in *surah al-baqarah* verse 255 where Allah says: "*Unto Allah (belongeth) whatsoever is in heavens and whatsoever is in earth*".

The concept of entrepreneurship in Islam also bases on co-operation, generosity and benevolence. That is why Islam really encourages ‘*uqud al-tabarruat*’ or unilateral contract such as loan (*al-Qard*) in order to promote cooperation and inculcate sense of brotherhood amongst Muslims. At the same time Islam extremely prohibited monopoly, exploitation, fraud or usurious transactions. In other word, every entrepreneur should always preserve the good deeds and avoiding the evil such as being honest, fair, and accurate in every transaction.

All the above principles are expected not only to have significant impact on the business ethics of Muslim entrepreneur, but also to be a habit and customary practice of each person that involve in commercial activities. It is strongly urged that every Muslim entrepreneur to observe all the above principles in doing business in order to promote a good governance of Islamic entrepreneurship.

4.0 ‘UQUD IN FINANCIAL SERVICES FOR ENTERPRENEURSHIP

Many entrepreneurs need support infrastructures and financial facilities in commencing their business venture. In this modern time, it is undeniably to say that a lot of entrepreneurs adhere much on the existing financial instruments offered by Islamic financial institution. These financial instruments may fall under various categories of ‘*uqud*’ which is dependent on the nature of business of the respective entrepreneur.

Conceptually, contracts classified under the Islamic law of transaction can be divided into unilateral contract and bilateral contract. The former comprises of transactions which are gratuitous in nature such as *Isqatat* (waiver), *ibra’* (rebate), *muqasah* (off-set of the debt), *will (wasiyyat)*, *endowment (fund) and loan (al-Qard)*. The latter refers to a contract which require consent of both parties such as ‘*uqud Tamlikat*’ (contract of ownership) or ‘*uqud al-Mua’wadhat*’ (exchange), ‘*uqud Isytirak*’ (contract of partnership) either *mudharabah* (passive partnership) or *musyarakah* (active partnership), ‘*uqud Tawsiqat*’ (contract of security) either *Kafalah* (suretyship) or *Rahnu* (pledge), ‘*uqud Itlaqat*’ (contract pertaining to do a work) either *wakalah* (agency), or *hiwalah* (debt transfer),

'uqud Taqyiydat (contract of restriction) and *'uqud Hifz* (contract of safe custody) or *wadiah* (safekeeping) (Abdul Nasir Musa Abu AlBasl. 1999).

As regard to the *'uqud* in financial services for entrepreneurship, mostly it involves only a few types of *'uqud* namely *isytirak* and *al-muawadhat*. These modes of financing can be further categorized as the primary modes and the secondary modes (Chapra, M. Umer.1985). The primary modes refer to *mudharabah*, *musyarakah* and shares of joint stock companies (combination of *musharakah* and *mudharabah* term of financing. Secondly, it refers to the secondary modes such as *murabahah* (cost plus service charge), *ijarah* (leasing), *ijarah summa al-bay* or *ijarah wa iqtina* (hire purchase), *hiwalah* (debt transfer), *salam* (forward delivery contract), and *istithna'* (contractual production). Both of these modes are able to provide financial needs to the community especially to the entrepreneur.

The primary modes of *mudharabah*, *musyarakah* and shares of joint stock companies are classified under *'uqud Isytirak*. This is the most encourages mode of financing in Islam as it provides greater reliance on equity and profit loss sharing. Here, the profit or return is not being determined upfront and it depends much on the effort, business risk and viability and also to the ultimate outcome of the venture.

The secondary modes of financing refer to a contract of exchange or *al-Mua'wadhat* such as *murabahah*, *ijarah*, *ijarah wa iqtina*, *salam*, and *istithna'* and its supporting contract such as *hiwalah* and *wakalah*. *Hiwalah* and *wakalah* are considered as a supporting contract because they exist side by side with another contract. For example *hiwalah* is originated from contract of exchange whereby transfer of debt from one to another can not be done unless there is already a selling transaction which creates debt. The secondary modes are less preferable by some Islamic economist such as Nejatullah Siddiqi (Siddiqi. 1985) and M. Umer Chapra (Chapra. 1985. p. 165) due to its features which are keen to be similar with the existing conventional financing instruments that based on interest bearing. However, such argument on the Islamic banking model of profit and loss sharing is contended to be built upon independent perception of the

economic justice and in fact a few of Islamic economist have made references to the sources of Islamic law in support of their theory (Abd. Halim Ismail. 2002. p. 2).

Regardless of differences of opinion on the exact model of Islamic banking, the deferred contract of exchange is undeniably permissible by majority of Muslim jurists subject that they fulfilled all the conditions and pillars of *'uqud* as derived from *al-Quran* and *al-sunnah*. Majority of contemporary shariah scholars have recommended that it is perfectly legitimate and suitable for Islamic financial institutions to apply the deferred contracts of exchange in their operations for their uses of funds. These modes mostly concern on the trading or selling and buying transaction through different mode of payment either cash sale, lump sum, deferred payment, deferred delivery sale and etc.

5.0 THE SME BANK IN MALAYSIA

The SME Bank (hereinafter referred to as the SME Bank) a wholly owned subsidiary of Bank Pembangunan Malaysia Berhad started its new function on October 3, 2005 as a development financial institution to nurture and meet the needs of small and medium enterprises The SME Bank offers both conventional and Islamic banking products. The SME Bank has identified 500 small and medium scale enterprises out of 4,000 its existing customers that require assistance, a week after its SME Bank advisory centre started operations (www.smebank.com.my).

(a) Classification of the SME

To enable better performance monitoring of the SMEs, it has been classified into 3 distinctive groups.

Table 1:

Sector	Class	Annual or Projected Turnover
Manufacturing	Small	RM250000 - RM10 million or between 5-50 full-time employees.
	Medium	More than RM10 million - RM25 million or between 51-150 full-time employees.

	Micro	Less than RM250000 or less than 5 full-time employees.
Services	Small	RM200000 - RM1million or between 5-19 full-time employees.
	Medium	More than RM1million - RM5 million or between 20-50 full-time employees.
	Micro	Less than RM200000, or less than 5 full-time employees.

(b) The SMEs' Sector

There are schemes to promote entrepreneurship across priority and growth sectors. The programs include funds for university graduates to become entrepreneurs in specific sectors, scheme, funds for entrepreneurs for small businesses in the rural areas and funds for a program to develop entrepreneurship in the national batik and the handicraft industry. The sectors involve are as follows:-

(i) Vendor Entrepreneurial Programme.

Scheme to develop Malay and native entrepreneurs to become vendors in certain industries by matching them with an anchor company.

(ii) Special Scheme for Rural Economic Development.

Scheme in rural areas to encourage entrepreneurship in which the SME Bank collaborates with the Ministry of Rural Regional Development.

(iii) Batik and Craft Entrepreneurs Programme.

Financing programme in batik (Malay arts on cloth) and batik related industries as well as related handicraft industries.

(iv) Film Maker and Drama Financing Scheme.

Scheme for film with financing collaboration with the Ministry of Culture, Arts and Heritage.

v) Graduate Entrepreneurs Scheme.

Scheme with Ministry of Entrepreneurs and Cooperative Development to encourage graduates to be an entrepreneur and be involved in a business field as an alternative career

(vi) Factory Complex of the SME Bank.

This is an integrated entrepreneurship scheme that provides financing facilities, factory space rental, and entrepreneurship training as well as service advisory help and financial.

(c) The Distribution of Financing Facilities

Table 1: Income from Islamic Banking Business

Type of Financing	Group RM'000		Bank	
	2005	2004	2005	2004
<i>Al-Bai Bithaman Ajil</i>	4,415	4,297	2,853	726
<i>Al-Ijarah</i>	292	-	292	-
<i>Bai Al-Murabahah</i>	25	-	25	-
<i>Bai Al-Dayn</i>	87	-	87	-
<i>Bai Istithna</i>	106	-	106	-
<i>Ijarah Thumma Al-Bai</i>	1508	-	1508	-
<i>Murabahah Dayn</i>	427	-	427	-
<i>Mali</i>	705	-	705	-
<i>Maluk</i>	2	-	2	-
<i>Ijarah</i>	60	-	60	-
<i>Total</i>	7627	4297	6065	726

5.1 Optimising Uqud in Financial Services Offered By the SME Bank

Table 1 above shows the performance of the SME Bank in term of its income from Islamic financing. In 2004, income from the SME Bank amounted to RM726000 and from the group it achieved at RM4297000. The income increased to RM6065000 for the former and RM7627000 for the latter in 2005. Annual report of the SME Bank states that net profit for the year 2005 amounted to RM169214000. Income from Islamic financing only generates a small portion of profit to the SME Bank in comparison with other modes of financing.

Al-Bai Bithaman Ajil represents the highest per centum ie 57.8 per cent from group and 47 per cent from the SME Bank of the total income of financing in 2005. For Islamic financing based on the concept of *Ijarah Thumma Al-Bai* contributes 19.7 percent, *Mali* 9.2 per cent, *Murabahah Dayn* 5.6 per cent, *Ijarah* 3.8 per cent, *Bai Istithna* 1.3 per cent, *Bai Al-Dayn* 1.1 per cent, *Ijarah* 0.7 per cent, *Ijarah* 0.3 per cent and *Maluk* 0.02 per cent.

Based on the above statistic on income from Islamic financing, we may conclude that in 2004 and 2005, debt financing plays a dominant role in providing financing facilities to the SMEs constituting 100 percent. *Mudharabah* and *Musharakah* types of financing remain less popular whereby there are no financing facilities granted to any SMEs under these concepts². Presumably, the reason of less preferable of Islamic equity financing is due to the aspect of its risk management. Equity financing disposes the SME Bank with actual risk. In fact, if we refer to the SME Bank's Non Performing loans (NPL) or Non Performing Financing (NPF) level in 2006 it is about 30 per cent and considered as one of the highest amongst other banks in Malaysia. The SME Bank is now in the midst of reducing its NPL or NPF and the aim for 2007 is to achieve to 20 per cent by year end (New Straits Times: 19th December 2006).

By analyzing the distribution of financing facilities granted and offered of the SME Bank, it should change its trend and be prudent to offer more Islamic financing products based on the concept of *mudharabah* and *musyarakah*. This is the most encouraging mode of financing in Islam as it provides greater reliance on equity and profit loss sharing (Siddiqi. 1985). Even if we choose an adverse view of Siddiqi as advocated by Abdul Halim Ismail, it is submitted that there must be a balance on types of financing distribution of the SME Banks to the entrepreneurs. The SME Bank must not simply ignore the equity financing in granting any financial facilities.

² The Central Bank of Malaysia. (2004). *Annual Report*. Kuala Lumpur: BNM. *Mudharabah and musharakah* financing concepts only represent 0.5%, *Murabahah* 7%, *Istithna* 1.2%, *Ijarah* 24%, *Bai al-Bithamin Ajil* 49.9% and other Islamic concepts 17.4%.

Amongst the advantage of the equity financing is that the profit or return is not being determined upfront as in the case of debt financing and it depends much on the effort, business risk and viability and also to the ultimate outcome of the venture. In addition, these modes are treated as fiduciary contracts (*'uqud al-amanah*) whereby all partners in the business must act bona fide for the benefit of the partnership (See *Al-Quran*, 5:1 and 8:27). Any element of cheating and unfair treatment of sharing of profit is extremely prohibited. In these modes also all forms of business organization will be shared and it depends on their financial resources, entrepreneurship, skills and goodwill.

In promoting these types of financing to the optimum, the SME Bank must give greater emphasis on risk management and corporate governance. Any equity financing products must be capable of meeting the SMEs' needs and requirements and also comply with the spirit of Islamic principles ie promoting risk and prohibiting uncertainty and interest. It is strongly believed that potential of generating huge profit in equity financing is extremely high for the SME Bank.

6.0 CONCLUSION

Islam has formulated very firm principles of the law of contract in financial services. Islam is actually offering a very flexible mode of financing in every field of entrepreneurship either for SME or to big conglomerate. In relation to the contract in financial services and entrepreneurship, Islamic law emphasizes on the clarity, fairness of the transaction including the prohibition of interest, the elimination of uncertainty and the promotion of risk.

Malaysia has taken an initiative to support the SMEs through the establishment of the SME Bank, a wholly owned subsidiary of Bank Pembangunan Malaysia Berhad in 2005. The SME Bank aspires to provide financial sources to any SMEs to nurture and meet their needs and capital assistance. In 2005, the SME Bank generates profit at the amount of RM169214000.

In entrepreneurship, most of the Islamic mode of financing available refers to the primary modes and the secondary modes of financing. The annual report of the SME Bank shows that in term of its income from Islamic banking business, debt financing represents 100 per cent and equity financing contributes nothing. It is suggested that the SME Bank should balance its trend from granting to the SMEs types of debt financing facilities which are based on the deferred contracts of exchange to the equity financing products which are based on the concept of *mudharabah* and *musyarakah*. It is strongly believed that these modes may also generate high profit to the SME Bank. In fact, these modes promote the spirit of Islamic economy whereby they provide greater reliance the determination of profit which is depending on the effort, risk, and expertise and business viability. In developing the ummah, the SMEs sector will be very much important to the Muslims economy. Therefore, the SME Bank as a corporate body, Muslim entrepreneurs in Malaysia as well as Muslims of other countries shall develop a cooperative framework to promote Islamic entrepreneurship, through utilizing the existing Islamic mode of financing under various '*uqud* especially the equity modes of financing.

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