

# MALAYSIAN PRACTICE OF AR-RAHNU SCHEME: TRENDS AND DEVELOPMENT

By:

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## Introduction

The important of helping the needy especially the poor has long been emphasized in much of Islamic faith. Therefore, lending to the needy should be the main focus in Islamic finance. In this context, the Islamic pawnshop (*ar-rahnu scheme*) is the most appropriate mechanism as it provides a financial product for the lower-income group and small businesses which usually have limited capital or have been excluded from the mainstream financial system. Prior studies have shown the importance of Islamic pawnshop to the Muslim societies<sup>1</sup>.

Before the implementation of the Islamic pawnshop system, the conventional pawnshops had charged high interest rates on the loans given. The conventional pawnshops were more motivated on making profit from the needy individuals and this activity was only restricted by the laws in the Pawnbrokers Act 1972. The conventional pawnshops had indeed oppressed and put a burden on the lower-income group.

The purpose of the Pawnbrokers Act 1972 was to guarantee a healthy pawnshop industry, as well as safeguarding the interests of the consumers. However, it failed to control the problems of the oppression of the lower income group and the pawnbrokers' malpractices. In fact, it seemed to encourage the practice of usury, with high interest rates of 2 percent per month, or 24 percent per annum. The high interest rates make it difficult for the consumers to reclaim their goods or jewellery. As for those who need the loan as a business capital, they find that their capital is rapidly diminishing. The conventional pawnshop system is more likely to put a burden on the lower-income group and this is against the Shari'ah practices.

The concern over higher interest rates, usurious and exploitative activities imposed by the conventional pawnshop makes the customers choose to deal with the Islamic pawnshop. This paper reviews the historical background of conventional pawnshop, the modus operandi of conventional pawnshop and their weaknesses and followed by the history, modus operandi and the development of Islamic pawnshops in Malaysia.

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<sup>1</sup> Ismail, A. G. and Maamor, S. (2007). *Ar-rahnu*. Paper presented at the Workshop on Islamic Financial Institutions and Market on 27<sup>th</sup> – 28<sup>th</sup> February 2007, Bangi; and Amin, H., Chong, R., Dahlan, H. and Supinah, R. (2007). "An Ar-rahnu Shop Acceptance Model (ARSAM)". *Labuan e-Journal of Muamalat and Society*, 1, 88 – 101.

## Conventional Pawnshop in Malaysia

In Malaysia, the pawnbroking business began since the 15<sup>th</sup> century and was introduced by the Chinese merchants during the sultanate of Malacca. The business became more popular after the discovery of tin mining activity in Larut in the 19<sup>th</sup> century. In the initial stage of development, this business was not bounded to any laws. However, in the era of British administration, the licensing system of pawnshop was introduced and it is called as the Pawnbrokers Ordinance 1871.

At first, the ordinance only applicable to pawnshops operated in the Straits Settlements (Penang, Malacca and Singapore), followed by Federal Malay States (Selangor, Perak, Negeri Sembilan and Pahang) and finally the Unfederated Malay States (Johor, Kedah, Kelantan, Perlis and Terengganu). At that time, several states have introduced their own enactment such as Pawnbrokers Enactment 1917 for pawnshop operated in Johor (supposed to be the first of regulation in pawnshop). Finally, the Pawnbrokers Act 1972 was introduced in June 1973 in order to standardize the regulation of pawnbroking in Malaysia. Currently, there are 276 licensed conventional pawnshops regulated under Ministry of Housing and Local Government throughout Malaysia.

## Modus operandi of conventional pawnshop

### The lending process

The loan process of pawnbroking transaction<sup>2</sup> can be described according to this chronology. First of all, the customer must be 18 years of age and can show a valid identification card. Not like the banking system, the pawnbroker will not make any credit scoring and will not ask the purpose of the loan.

Secondly, when a customer walks in a pawnshop with their pawned item, they will be entertained by a clerk or an officer that is expert as a valuer. The task of the valuer is to assess the value of the pawn (used as a collateral) to make loan. Based on this, the valuer decides on the size of the loan. Commonly, in the case of conventional pawnshop in Malaysia, customers can negotiate the amount of loan with the pawnbrokers.

Detailed account of the pledge assets, the ratio of borrowed amount and maturity are provided in Table 1.

Table 1: Types of pledged assets, amount and maturity in pawnshop

<b>Types of pawnshop</b>	<b>Pledge Assets</b>	<b>Maximum borrowed amount (RM)</b>	<b>Maturity (Months)</b>
Conventional	Jewelry, watch, handphone and electronic instruments	50 percent of the value of pledged assets/negotiation	6

<sup>2</sup> Refer to the Pawnbrokers Act 1972.

Thirdly, the customer will receive the loan immediately in cash. The pawnbroker will give a receipt to the person as a proof of transaction and record the particulars transaction in the pawnbroker's book. The receipt states the customer's name and address, a description of the collateral, amount lent, maturity date and the amount that must be paid to redeem the assets. In conventional pawnshop, the customer must repay the loan with interest, usually 2-2.5 percent of the loan per month. The entire transaction seldom takes more than a couple of minutes.

### **The redeeming process**

In most transactions, pawnbrokers make loans with maturities up to six months. Every pawnbroker within this period from the pawning transaction date must deliver up the pledge to any person who present the pawn-ticket issued by him.

However, if a customer is not able to repay the loan with interest within a predetermined of period, the loan can be extended within which the pledge may be redeemed for a further period of not less than three months<sup>3</sup> by paying the interest that have built up over time. A note of every such extension shall be made in the pawnbroker's book and an endorsement made on the pawn-ticket.

If the pledge shall not be redeemed within the six months period or the extension period agreed by both parties, there will be two possible outcomes: (i) if pawned for a sum nor exceeding two hundred ringgit, the pawn item shall become the property of pawnbroker, and (ii) if pawned for a sum exceeding two hundred ringgit, the pawnbroker can dispose the pledge by auction<sup>4</sup>.

### **The auctioning process**

The auction of the unredeemed pledge must be conducted by a licensed auctioneer. The pawnbroker can bid for and purchase at a sale by auction and they shall be deemed the absolute owner of the pledge purchased. If the pawned item is sold with surplus in the auction, the customer is entitled to that surplus within the period of four months. On the other hand, if no claim for the surplus is made, the pawnbroker shall pay the surplus to the Accountant General within fourteen days after expiration of the period of four months. The Accountant General shall pay the amount paid to the Consolidated Trust Account.

### **The weakness of conventional pawnshop**

In his report, Adnan (2004)<sup>5</sup> has listed nine weaknesses faced by the conventional pawnshop. Firstly, the most number of complaints received from customers is related to the decreasing value of pawned goods. Many had reported that their gold jewellery had decreased in weight or length after the pawning period. According to the Federation of

<sup>3</sup> Refer Section 19, Pawnbrokers Act 1972.

<sup>4</sup> Refer Section 23(1) (a) dan (b), Pawnbrokers Act 1972.

<sup>5</sup> Adnan, M. H. (2004). *Pajak Gadai dari Sudut Pengguna*. Kompilasi Prosiding Konvensyen Ar-rahnu Serantau 2002/2004. Kuala Lumpur: YPEIM.

Consumers Association (FOMCA), this happened because under the Pawnbrokers Act 1972, it is not compulsory for the pawnbrokers to write down the weight, length or type of gold of the jewellery to be pawned. The customers who had complained suspected that the pawnbrokers had tampered with the jewellery. However, it could be difficult for the customer to prove this matter.

The second weakness is that pawnbrokers are likely to offer a higher interest rate compared to the rate stated in the Pawnbrokers Act 1972. This often happens to illiterate customers or impoverished people and villagers from rural areas.

Thirdly, pawnbrokers are likely to give a low collateral value during the valuation process. This usually happens because the Pawnbrokers Act 1972 does not state a certain value or criteria to determine the value of the collateral. Unscrupulous pawnbrokers will refuse to give out loans of more than RM200 for jewellery valued at RM400. As stated in the Pawnbrokers Act 1972, pawnbrokers are allowed to take possession of any collateral valued less than RM200 if the customer fails to redeem it in the specified period.

The fourth weakness is that unscrupulous pawnbrokers would often issue an illegible pawn ticket. This happens when the pawnbroker offers a much higher interest rate or does not complete the information needed as stated in Pawnbrokers Act 1972. The pawnbroker tries to cover his misconduct by using a large rubber stamp so that the receipt could not be read. The pawnbroker also uses a language or technical jargons not usually understood by the customers. The receipts were also made of poor quality paper and could be easily torn.

As for the fifth weakness, it has been reported that some unscrupulous pawnbrokers had asked for 50 cent for each replacement of pawn receipts and extension of the pawning period. According to Section 21, Pawnbrokers Act 1972, customers are allowed to get a free replacement for any torn, destroyed or lost pawn receipts. However, some pawnbrokers neglect to follow this guideline when customers ask for an extension for the pawning period.

The sixth weakness is that some immoral pawnbrokers will auction pawned goods worth more than RM200 without the customer's knowledge. Even worse, the pawnbroker does not auction the goods off and takes possession of the goods instead. This is against Section 23(1) (b) of the Pawnbrokers Act, in which any collateral worth more than RM200 should be auctioned off by a licensed auctioneer.

As for the seventh weakness, it has been reported that pawnbrokers do not return the surplus after the goods have been auctioned off. This irresponsible act will no doubt be a burden to the customers who need the money. As such, the customers should enquire to the pawnbroker the surplus that has been taken by the pawnbroker after the auction of the goods.

The eighth weakness of the conventional pawnshop system is that many customers do not know when their collateral will be auctioned off. The notices about the auction are only publicised in Chinese and English language papers. Usually, these notices will be overshadowed by other more interesting notices. This is a disadvantage to the pawnshop customers who are usually Malays from the villages or Indians from the

estates. Only a handful of them read the English or Chinese papers, and some of them are illiterate. This will cause them to lose the opportunity to reclaim their goods.

Lastly, some pawnbrokers will ask for advance payment from the pawnshop customers although this is against the Pawnbrokers Act 1972. This will add further burden to the customer's misfortune.

### **Islamic Pawnshop as a Shari'ah Compliant Solution to Conventional Pawnshop**

The first Islamic pawnbroking institution, Muassasah Gadaian Islam Terengganu (MGIT), was set up by the Terengganu State Islamic Affairs and Malay Customs in January 1992. Following in March 1992, Ar-Rahn, a subsidiary of Permodalan Kelantan Berhad commenced its operations as a stand alone Islamic pawnshop. On 21 August 1993, the Minister of Finance announced the introduction of a scheme, known as *ar-rahnu* scheme through the collaboration of three institutions namely Bank Negara Malaysia (supply the expertise in financing field), Islamic Economic Development Foundation Malaysia or YPEIM as the funder, and Bank Kerjasama Rakyat Malaysia Berhad which supply the infrastructures and managing the transaction. Later, on 27 October 1993 the first phase of *ar-rahnu* scheme was launched at six branches of Bank Kerjasama Rakyat Malaysia Berhad. Now, the *ar-rahnu* scheme is available at all Bank Kerjasama Rakyat Malaysia Berhad branches throughout Malaysia. YPEIM had also taken the initiative to launch 17 counters of *ar-rahnu* scheme through YPEIM co-operatives.

The next financial institution to enter the Islamic pawnbroking is Bank Islam, formerly commenced in 1997, followed by EON Bank (August 2002) and Bank Pertanian Malaysia in September 2002. In 2005, there are 209 outlets provide the *ar-rahnu* scheme throughout Malaysia with number of outlets under Bank Kerjasama Rakyat Malaysia Berhad (112), Bank Islam (24) and YPEIM's co-operatives (18).

### **Modus operandi of Islamic pawnshop**

Generally, the modus operandi for conventional and Islamic pawnshop transaction is quite similar. Despite the similarities, the contract (*aqad*) in the Islamic pawnshop is different from the conventional pawnshop. The loan granted is based on four concepts, *i.e.* *al-qardhul hassan* (loan without interest), *al-wadiah yad dhammanah* (keeping valuable goods by guarantee), *al-ujrah* (storage fees) and *ar-rahnu* (collateral). The storage fee is based on the value of gold and not on the amount of the loan, as shown in Table 2. This fee is charged differently by each Islamic pawnbroker.

In the Islamic-based pawnshop, gold is the only permitted item. Gold have several advantages as collateral over other items<sup>6</sup>. Firstly, gold is easily resold and so there is potentially auctioning the collateral should the borrower not redeem the pledge. Secondly, gold's purity can be easily determined and so the risk of mispricing the collateral can be minimized. Thirdly, gold chains and rings typically require only a small flat envelop for storage and so can be kept securely in the bank safe at little, if any, additional cost.

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<sup>6</sup> Skully, M. S. (2005). *Islamic Pawnbroking: The Malaysian Experience*. Paper presented at the 3<sup>rd</sup> International Islamic Banking and Finance Conference 2005.

Finally, women often receive gold chains and bracelets as wedding gifts and generally retain personal ownership of these items especially in Malaysia. This practice is common across income levels and so provides a rich base of potential customers.

Table 2: The safekeeping fees charge in Islamic pawnshops

Value of pledged asset	Bank Kerjasama Rakyat Malaysia Berhad (RM per month)	Permodalan Kelantan Berhad (RM per month)	MGIT (RM per month)
RM1-RM400		0.60	No charge
RM1-RM1,000	0.65	–	No charge
RM401-RM2,000		0.85	No charge
RM1,001-RM5,000	0.75	0.95*	No charge**
RM5,001-RM50,000	0.75	–	–

\* Range of financing is from RM2,001 to RM5,000.

\*\* Maximum financing is RM1,500.

The valuation is based also on the purity of the gold item. For example 85 carat gold carries a value of RM25 to RM26 per gm. The gold will be valued at the prevailing market price. The best method of assessing gold jewellery in Islamic pawnshop is by using acid test. The method is such as the piece of jewellery will be rubbed on a black stone. The quality of gold will depend on the friction; the rougher the feel of the gold, the better the quality. The action of rubbing will be done at corners of the jewellery as these parts are the easiest to determine if the gold is fake. In addition, a special density meter is used to value the gold. In order to make the valuation free from mispricing, the staffs in Islamic pawnshop will be sent to YPEIM institution for courses that relate to get training in such matters.

In terms of legislation, the Islamic pawnbroking system is subject to certain laws but no specific acts. For example, *ar-rahnu* scheme in Bank Kerjasama Rakyat Malaysia Berhad is subject to three different acts, which are the Bank Kerjasama Rakyat (M) Berhad Act 1978, the Co-operative Societies Act (1993) and the Development Finance Institutions Act 2002. In addition, Bank Kerjasama Rakyat Malaysia Berhad has introduced separately the *ar-rahnu* manual guidelines<sup>7</sup>. Other relevant acts are the Occupational Safety and Health Act for workers who are exposed to acid for the gold test and the Weight and Measurement Act, in which the gold weighing device has to be licensed every year.<sup>8</sup>

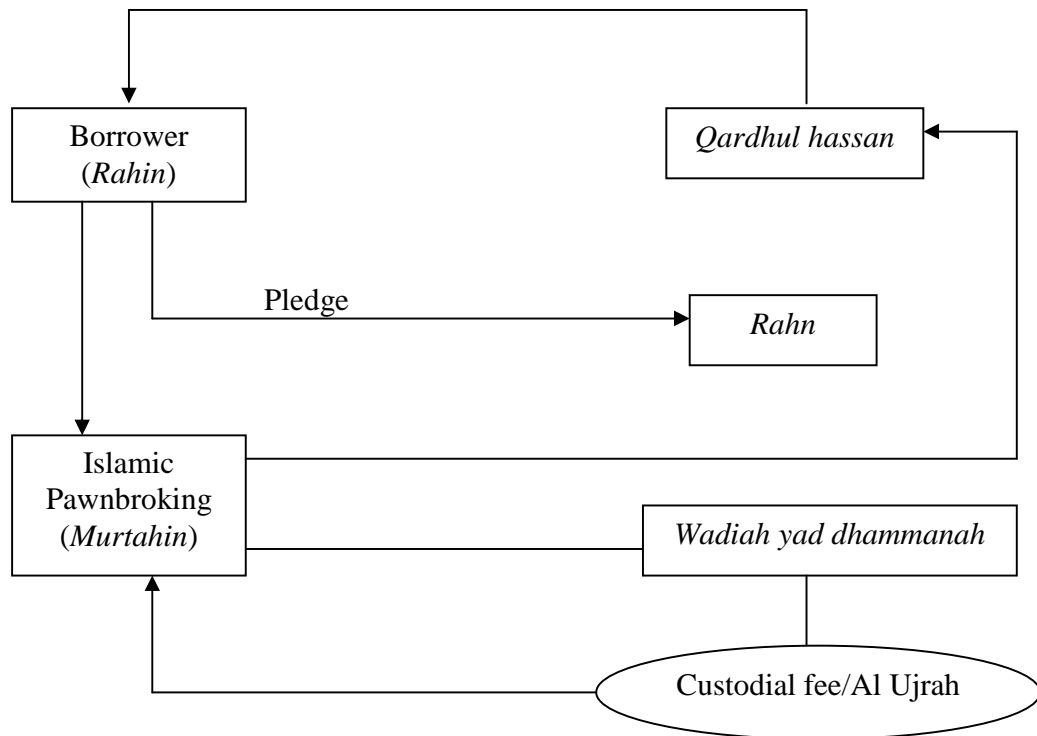
Principally, Islamic pawnbrokers would prefer the customer to redeem their collateral within six months. However, if there is no repayment, there is an extension period of three months after which the client is informed that the item will be sold by auction within a further of two months period. Based on the Manual of Islamic Pawnbroking of Bank Kerjasama Rakyat Malaysia Berhad, any surplus from the sale of

<sup>7</sup> Refer Bank Kerjasama Rakyat (M) Berhad (2000, 2002 dan 2003). Manual Pinjaman Pajagadai Islam. Not published.

<sup>8</sup> Sehan, M. A. (2004). *Isu-isu dalam Pelaksanaan Pajak Gadai Islam di Negara Serantau*. Paper presented at the “Konvensyen Ar-rahnu Serantau” on 12<sup>th</sup> – 13<sup>th</sup> October: Kuala Lumpur.

the gold over the amount owed to the pawnbroker, including accumulated deposit fee and any costs related to the sale, has to be returned to the customer. In case the customer cannot be located, the surplus will be forwarded to the *Baitulmal* from which the customer is entitled to make future claims. As a whole, the mechanism of Islamic pawnbroking can be illustrated as below.

Figure 3: *Ar-rah*n Pawnbroking Business



Source: Rosly, S. A. (2005). *Critical Issues on Islamic Banking and Financial Markets*. Indiana: Authorhouse.

## A Brief Description of Different Islamic Pawnbroking in Malaysia

### Muassasah Gadaian Islam Terengganu (MGIT)

Muassasah Gadaian Islam Terengganu (MGIT) is given an honour by Bank Negara Malaysia as the first Islamic pawnbroking operating in January 1992 under the rule of the State Council for Religion and Malay Customs. The sole objective is to fulfil the needs and welfare of the less fortunate.

The loans offered in the MGIT *ar-rahnu* scheme are free from interest (*qardhul-hassan*). However, customers are encouraged to contribute a small sum to the Muassasah treasury account. A Muslim who has borrowed from his friend is encouraged to repay a little extra as a symbol of gratitude. This is known in Islamic banking as '*hibah*' or gift.

The collateral for the loans may be in the form of gold or diamond jewellery. The loans given should not be more than 75 percent of the jewellery's value. Also, the

customer is only eligible for loans up to RM1,500 for each item. If the customer fails to pay in three months, they can apply for an extension for three months. If they fail to pay after the extension period, the collateral will be auctioned by MGIT to pay off the loan. If there is any surplus after the loan has been settled, it will be returned to the customer. This service is available for those 18 years old and above and it gives priority to the residents of Terengganu only. The customers need to show valid proof of ownership of the goods. Business of MGIT has been flourished since its first formation, as it started with 12,732 customers in 1992 which increased to 26,632 customers in 2005<sup>9</sup>. The value of pawned items has increased from RM9.85 million in 1992 to RM28.9 million in 2005<sup>10</sup>.

### **Permodalan Kelantan Berhad**

In March 1992, the Kelantan State Economic Development Corporation, through its subsidiary, Permodalan Kelantan Berhad had set up Ar-Rahn as the second Islamic pawnshop in Malaysia in order to fulfil the syariah needs. It is part of the Kelantan government's effort to help those in need by giving out interest-free loans. The *ar-rahnu* system in Kelantan collects a certain fee for safekeeping of pawned goods. Table 2 shows the safekeeping fee charged by Permodalan Kelantan Berhad. Currently, there are about 13 outlets of Ar-Rahn operates in Kelantan.

The collateral accepted is only in the form of gold jewellery. The loan given is 60 percent of the value of jewellery and not more than RM5,000. The pawning period is six months. Those who are unable to pay back may extend the pawning period, subject to approval of both parties and the customers need to pay the safekeeping fees of the previous six months. If customers are still unable to pay back after the extension period, the *ar-rahnu* pawnshop will send an auction notice before the auction is held by licensed auctioneers. The customers are eligible to get any balance of the auction price after subtracting costs and any debts.

### **Bank Kerjasama Rakyat Malaysia Berhad**

The Bank Kerjasama Rakyat Malaysia Berhad *ar-rahnu* scheme was introduced in 1993. It was first introduced in six branches but now there are 112 branches (including Kedai Ar-Rahnu) operating throughout Malaysia. Interestingly, the bank had also opened the first stand alone Kedai Ar-Rahnu in Kota Bharu, Kelantan in June 2000. These schemes are more of a social oriented to customers. It is not for profit and thus, the customers will benefit from it. A fee for safekeeping the goods is collected based on the value and the pawning period. Table 4 shows the rates of safekeeping fees charge by the *ar-rahnu* counters.

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<sup>9</sup> Johari, M. S. and Sanusi, N. A. (2007). *The Demand of Pawnbroking Services: Evidence from Malaysia*. Available at: <<http://ibacnet.org/bai2007/proceedings/Papers/2007bai7490.doc>> Access date: 6<sup>th</sup> March, 2008.

<sup>10</sup> *Ibid.*

Table 4: The fees for Ar-rahnu Scheme in Bank Kerjasama Rakyat Malaysia

Type of Scheme	Amount of Loan	Safekeeping fee for every RM100.00 of gold value per month
Ar-rahnu	RM1,000.00 and below	RM0.65
	RM1,001.00 - RM5,000.00	RM0.75
Az-zahab	RM5,001.00 - RM50,000.00	RM0.75

Source: Bank Kerjasama Rakyat Malaysia.

The scheme is open to Malaysian residents aged 18 and above and not more than 65 years old. Only gold jewellery is accepted as collateral. Loans for the pawned goods will not be more than 50 percent of the goods value. Maximum loan is RM5,000 for each time or a cumulative worth of RM25,000 for each customer. Pawning period is only six months, which may be extended for another three months. If the customer fails to claim the goods, the bank will send a notice to auction off the goods. The bank will subtract the loan amount, fees for safekeeping and other costs involved in the auction process from the auction profits. Then the balance will be given to the customer.

A week before the six month period, the bank will send the first reminder. After six months, a second reminder will be issued. After the third reminder, if the customer is unable to claim the goods, the pawnbroker will disposed the goods by auction to the licensed auctioneer. Suppose the value of the item pawned is worth RM1,666.00, and the bank will only release a maximum loan of RM1,000.00 with repayment period of six month. If the fee for safekeeping is 65 cent for every RM100, then the fees will be RM10.68 per month or RM64.08 for six months (Not surprisingly, with the same amount of loan, customer of conventional pawnshops will have to pay almost double which cost RM20). If the goods are auctioned at RM1,666.00, the bank will subtract RM1,000.00 for the loan, RM96.12 for safekeeping fees (9 months) and administration fees for the auction RM50, then the balance of RM519.88 will be returned to the customer.

To date, the Managing Director of Bank Rakyat, Datuk Kamaruzaman Che Mat points that through its fully owned subsidiary, Rakyat Management Services Sdn Bhd, is aiming to open 15 branches of the Islamic based pawn franchise outlets, which is called Ar-Rahnu X-Change, in the next three years<sup>11</sup>. The prototype branch of Ar-Rahnu X-Change in Sentul which has been in operations in 2007 has shown good performance with an average loan payout of RM900,000 a month. In future, Bank Rakyat planned to expand the Ar-Rahnu outlets to various locations such as Medan Tuanku, Kuala Lumpur (managed by Koperasi Pendidikan Islam Malaysia Bhd), Pokok Sena, Kedah (managed by Koperasi Kementerian Kesihatan Negeri Kedah Bhd), and Sri Gombak (managed by Koperasi Serbaguna Iman Malaysia Bhd).

<sup>11</sup> Bernama. (2008). *Bank Rakyat Aims to Open up 15 Ar-Rahnu Branches in 3 Years*. Kuala Lumpur. Available at: <http://www.bernama.com/finance/news.php?id=333396> Access date: 16<sup>th</sup> May, 2008.

### Ar-rahnu scheme in Bank Pertanian Malaysia

Bank Pertanian Malaysia has introduced the *ar-rahnu* scheme in 12 of its 132 branches nationwide. The bank introduced the scheme to meet short-term financial needs of the rural people who are mainly farmers and fishermen to improve their business and modernize their methods. This scheme is open to Malaysian residents of 18 years above. All types of gold, jewelry such as necklace, earring, ring, bangle, brooch and others are accepted. A loan of not more than 60 percent of the market value of pawned goods will be issued. Maximum loan is RM50,000 subject to RM5,000 daily limit, while the pawning period is six months, and can be extended to three months with the final extension of another two months<sup>12</sup>.

Table 5: Storage Fee Imposed by Bank Pertanian Malaysia

Margin of financing	Monthly Storage Fee per RM100 of jewelry value
50%	RM0.50
60%	RM0.60
70%	RM0.70

### Conclusion

The emergence of conventional pawnbroking operating side by side with the Islamic pawnbroking (dual system) provides an option to the customers to choose the best pawnbroking service based on the features offered. As for Muslims, this opportunity will enable them to reject monetary transactions which involved *riba* and *gharar*. Other than that, it is hoped that Islamic pawnbroking will be able to eliminate the informal lending activities such as 'loan shark' or 'along' which have clearly oppressed and victimised the lower-income group.

As for Malaysia, the government has always been committed in developing the Islamic financial product. In order to enhance the growth of this product, the participation of mainstream financial institutions in the *ar-rahnu* scheme will complement the existing range of Islamic banking products offered by the financial institutions. Based on the role of pawnshop, it cannot be denied that pawnshop institution has a big impact to the society development and hence contribute to economic growth. Finally, the Malaysian experience of Islamic pawnbroking seems to offer a very useful model which other countries might wish to consider.

<sup>12</sup> Bank Pertanian Malaysia. *Ar-rahnu Scheme*. Available at: <http://www.bpm.com.my/article.cfm?id=560>  
Access Date: 2<sup>nd</sup> February, 2008.