

- (3) to understand what the problems and Challenges the Islamic Banking System in Malaysia is facing;
- (4) to examine whether we can recommend Malaysian experience in Islamic banking operations to other societies.

3. Literature Review

The establishment of Bank Islam Malaysia Berhad (BIMB) is regarded as a healthy and positive sign towards the development of a dual banking system in Malaysia. The main aim of Islamic banking system is to provide an alternative to the conventional interest-based banking system. Whether BIMB has performed well in the banking industry has been widely debated among professionals and scholars in the country.

Man (1988) evaluated performance of BIMB from 1984 to 1985 in terms of growth of customers' deposits, total assets, liquidity requirements, investments and its management. He found that the progress of the Bank was encouraging and experience was somewhere similar to the Islamic banks in other countries.

Though BIMB may have achieved the conventional banking objectives of profitability and liquidity, it is also equally important for it to take into account its social responsibilities as an Islamic Bank.

In terms of assets and profits, the bank occupied the thirteenth position while in terms of deposits, it ranked tenth among the 23 locally incorporated banks as at December, 1992 in its 10th year of operation in the industry (Malaysian Business 1992).

A few studies on BIMB had been conducted before its debut on the Kuala Lumpur Stock Exchange (KLSE) on January 17, 1992. Most analysts were satisfied with the performance of BIMB as an Islamic bank.

Mahidin (1992) carefully evaluated BIMB's financial performance over period of five years (1986-1990) in terms of growth of assets, shareholders' funds, customers' deposits and financing. He concluded that the bank had lived up to its corporate mission of "provide banking and financial facilities, which are in compliance with Shariah and at the same time, attain viability and growth."

Anwar (1991) who evaluated the growth of BIMB's assets, deposits and financing during the 1985-1990 period claimed that its performance was somewhere to be encouraging. He indicated that the growth rates of

deposits implied growing public demand for profit-sharing contracts. He concluded that the financial needs of 53 per cent of the Muslim population in Malaysia were not adequately catered for according to the tenets of Islam, as there were only a small number of Islamic financial institutions locally.

Bank Islam Malaysia has been criticised for its heavy reliance on the less risky modes of financing, which are *Al-Baithman Ajil*, *Al-Murabahah* and *Al-Ijarah*. To some scholars, these modes of financing which entail fixed profit margins represent "backdoor *riba*". Secondly, its operations are geared towards profit maximisation rather than focusing on socio-economic goals such as eradication of poverty.

Abdul Halim (1987), the former Managing Director of BIMB argued that the concept of "backdoor *riba*" was alien to Shariah. He said, in Shariah, if a contract was permissible, it was permissible irrespective of the frequency and the extent of its application. Thus, he concluded that it could not be a pathway to *riba*.

He further illustrated that the operations of Bank Islam belonged to the *Tijari* (Commercial) sector. Therefore, BIMB should operate like a commercial institution. The fulfilment of socio-economic objectives should

lie with the institutions operating under the principle of *khairatul ljtimai* (social welfare) sector.

Hussein (1992), the former Governor of Bank Negara declared that a "full fledged Islamic financial system was very much desired." In particular, a proposal allowing the conventional banks to set up their own Islamic counters was under serious consideration.

Wong (1995) evaluated the performance of Bank Islam Malaysia for a period of 10 years from 1983 to 1993. He concentrated on a number of parameters in terms of the growth of the bank's deposits, total assets, profits and returns to its depositors and shareholders. He also analysed the mode of financing, usage of fund, and social responsibilities of being an Islamic bank. He commented that the bank had problems in the modes of financing. He indicated that BIMB failed to uphold fundamental spirit of an Islamic Bank since it was partial towards short-term financing, which implied that the risk had to be born by the borrowers. Here, the risk meant "interest", or "riba" in Islamic term, which is prohibited by Islam. However, he concluded that the bank could maintain growth in a capitalistic financial market and specially provided a possible alternative for conventional banking system. He concluded that a continued evaluation was needed, as the environment of the bank in the future would be dynamic.

Bank Islam Malaysia has also been criticised as conservative by scholars. But, Tajudin, the new Managing Director did not agree with this view and he argued that the bank was not aggressive as such (Malaysian Business 1994). However, with a firm foundation, it managed to make reasonable profits. He said that the bank must be extra-careful. "Any failure will reflect not just on the bank but on Islam."

Regarding on how the Islamic banks operate, Harran (1993) said that if normal banking practices did not clash with Islamic principles, Islamic banks would adopt the current banking tools and procedure. If any clash arose, the Islamic banks would have to devise their own tools and procedures. He further explained that Islamic banks received two types of deposits (a) deposits not committed for investment which took the form of current or saving account. (b) deposits committed for investment, which were called Investment Account. Current Account operated in Islamic bank would be same with conventional banking system. There were also two investment accounts correspondent to the above mentioned two deposit accounts for utilising customers' funds. (c) account with authorisation where the account holder authorised the bank to invest his fund to projects selected by the bank. (d) accounts without authorisation, where the account holder might choose any particular project for investment for his fund.

Harran's statements clearly tell us that people would be confused between the Islamic banking system and conventional banking system if there is no proper education to Muslim customers on how an Islamic Banking System operates and works. Even though, Bank Islam Malaysia has been operating for over 10 years in the industry, if you ask any customer randomly on what is difference between the two, they would tend to tell you that there is no difference between the two.

Raji (1995) confirmed this by saying that " Malaysia's success in this field is due to the fact that the interest-free banking industry was rapidly developed by adapting conventional banking services instead of creating new Islamic financial instruments from scratch." If this were the case, one would not be surprised to notice that the general public could not differentiate the two systems.

Sadeq (1995) stated that " Bank Islam Malaysia was established in 1983 to offer commercial banking facilities based on Shariah principles and fulfil socio-economic goals. Given its background, it has performed this development function quite successfully." However, he further indicated that the Bank was not efficiently allocating the funds and fully utilising the resources. In order to overcome the above shortcomings, he introduced the concept of "Equity Financing". He said in equity financing, an Islamic bank would earn better return when the financed projects would be more productive projects. Thus, its resource allocation would

be more efficient compared to interest-based financial institutions. He explained the reasons why. He also criticised that Bank Islam Malaysia was at the low satisfactory level of equity financing in resource allocation. However, in sectoral allocation of resource analysis, Sadeq reckoned that the Bank Islam Malaysia's role looked conducive for development.

In terms of the poor and needy in the society, Sadeq praised the bank as it paid RM484,000 in 1984 as Zakat (religious tax for help the poor and needy) and RM622,000 in 1994. As other banks did not provide for this contribution to the poor and needy, he said that this service was unique to Islamic banking.

By evaluating "Mudarabah financing" portion in the bank's total customer financing, Obiyathulla (1995) criticised the bank for heavily relying on short term financing which is interest based financing, instead of long term "Mudarabah Financing", which is considered as the core concept of Islamic financing and based on profit sharing. He argued that Shariah prohibited conventional debt financing which is based on the inherent inequity, such as lending, where the lender is not exposed to any of the project/business risk yet receives a fixed return regardless of outcome. He stated that Mudarabah financing is neither equity nor debt financing, it was rather a hybrid. Based on his Risk and Return Analysis

study on Mudarabah, Debt and Equity Financing, he concluded that Mudarabah Financing was much more risk than debt and equity financing.

Besides, high risk and low return in Mudarabah Financing, he also found that there were much more "agency problems" involved in Mudarabah Financing than in an ordinary debt or equity financing. The "agency problems" made the Mudarabah Financing much more complicated; as a result, it became the least attractive to financiers to finance Mudarabah based project/business comparing to debt or equity. Hence, he explained why Mudarabah financing was declining among Islamic banks, why its role as a financing technique had reduced significantly over the time, even though it was the core concept of Islamic financing and a rational banker would not be willing to provide Mudarabah Financing.

Despite the above problems, the experiences of Malaysian Islamic Banking System have shown us that Islamic Banking System can coexist with conventional banking system and continue to grow and prosper. There were 49 financial institutions (25 commercial banks, 21 finance companies and three merchant banks) offering interest-free services besides Bank Islam Malaysia in the country by end of the year of 1996. These 49 institutions (exclusive Bank Islam Malaysia) contributed roughly

half of the Islamic banking sectors total deposits and financing (Bank Negara Annual Report 1996).

However, any review of Malaysian Islamic Banking System is invariably along the lines of "good but a lot more can be done". For example, its total loan assets in 1995 at RM3.5 billion, accounted for only 1.3 per cent of total funds raised by the country's entire banking industry (Malaysian Business 1996).

Former Deputy Finance Minister, Datuk Abdul Ghani Othman, now Chief Minister of Johor State said that many people were aware of the availability of interest-free banking but do not understanding the workings and advantages of its facilities. The system, which is based on the existence of good relationships between the bank and its customers, was ideal for those who seek specific capital investments (Malaysian Business 1996).

Minister in the Prime Minister's department, Datuk Dr Abdul Hamid Othman also touched on the issue of Islamic banking system. He said "We have a collective responsibility to ensure that consumers do not have the perception that the Islamic financial system is almost the same as or acts only as complement to the conventional banking system. We also have to correct the perception that the system is a gimmick in the financial market."

Bank Governor, Datuk Ahmad Mohd Don called for stronger commitment from managers of all financial institutions to develop Islamic Banking System in his opening speech at Bank Negara's (Malaysia's Central Bank) 11th annual conference with financial institutions on September 9, 1996. He stressed that the quality of Islamic Banking System based on the foundation of Islamic ethics, high value-added products and service would be a critical factor in the success of system. Currently, Bank Negara has listed over 20 Islamic banking products that can be offered by participating institutions in the Islamic Banking System (Oh 1996).

Current Deputy Finance Minister, Datuk Dr Affiuddin Omar expanded this theme when he officially opened the World Islamic Banking Summit held in Kuala Lumpur on 23rd October 1996. He said that the Malaysian government realised that a few of Islamic banks or financial institutions did not constitute an Islamic Banking System. For Islamic banking to qualify as a banking system, there has to be a large number of players to provide depth and a broad variety of instruments to meet the needs of financial institutions and customers, and a stronger interbank market to link the players with the instruments. He said " We need the presence of Islamic socio-economic values, which must be Islamic in substance, and not merely in form and label. " He also added that " We should not rush through the implementation of Islamic banking, we must