

CHAPTER 1

INTRODUCTION

1.1 INTRODUCTION

Banking is an important financial intermediary and vital institution in the economic structure of any country. It mobilizes savings and idle funds in an economy and makes them available to those who can make better and fuller use of them. In this way, banking affects a re-allocation of the capital funds. Besides this main function, the banking system makes possible a most convenient method of making payments through chequing facilities, renders many other subsidiary services.

Malaysia has emerged as one of the countries that gives more emphasis on the banking industry. For many years, Malaysia has practiced a conventional banking system in its financial system. Conventional means general, usually unspoken, agreement about how people should act or behave in certain circumstances¹. As for banks, conventional banks mean ordinary banks that have come into existence in a community of a country. Conventional banks in the West have become examples of any bank established in other countries. The roles of conventional banks may change from time to time in accordance with current circumstances. In general, all operations in conventional banks have been exposed to a motive of making profits through interest rate. This phenomenon has continued for a long time until the idea of Islamic banking system has come into picture by the creation of Bank Islam Malaysia Berhad (BIMB) in 1983.

1.1.1 Islamic Banking System in Malaysia

In Malaysia, the Islamic financial system can be broadly categorized into three i.e. the Islamic banking system, the non-bank Islamic financial intermediaries and

Islamic financial markets. In the context of the project paper, the writer will discuss about the Islamic banking system.

The Islamic banking system comprises Bank Negara Malaysia (BNM) as the central bank vested with powers under the Islamic Banking Act 1983 and the Banking and Financial Institutions Act 1989 (BAFIA) to regulate and supervise Islamic banking operations in Malaysia; the Islamic bank; and the commercial banks, finance companies, merchant banks and discount house participating in an Islamic Banking Scheme (Skim Perbankan Islam – SPI)^{1,2}. The Islamic Banking Act 1983 came into effect on April 7, 1983. It provides the legal framework for the introduction of banking products along Islamic principles and the establishment of Islamic banks in Malaysia. The Act is modeled on the Banking Act 1973 with necessary modifications and revisions in line with the Islamic banking principles and practices.

1.2 Islamic Bank

Bank Islam Malaysia Berhad (BIMB) was the first Islamic bank operating under the Islamic Banking Act 1983. The bank was incorporated in March 1983 and commenced banking operations a few months later with the operation of the first branch in Kuala Lumpur. In the year 1999, BIMB operated a total of 80 branches with staff strength of 1,600 people. The shares of the bank were listed on the Kuala Lumpur Stock Exchange (Main Board) in January 1992.

The bank accepts deposits under demand and savings deposits, term deposits in the form of general investment deposits and special investment deposits. In the case of demand deposits, which do not generate any profits, depositors are not entitled to any share and nominal service charges may be levied. As for savings account deposits, generally the bank may reward the savers to a share of profits generated. The general investment and special investment account holders are so entitled to a share of the investment profits as arranged with the bank.

The bank provides various other services and facilities such as Letter of Credit, Collection of Bills, Remittances and Foreign Exchange transactions. On the financing side, the bank provides facilities for project financing, term financing, trade financing and corporate finance under the relevant Islamic banking principles.

Since March 1993, the other financial institutions i.e. commercial banks, merchant banks and finance companies, have also begun to offer Islamic banking services and facilities under a scheme known as the Islamic Banking Scheme (Skim Perbankan Islam – SPI). With this encouraging development and progress, Malaysia has since further developed its Islamic banking infrastructure to include an Islamic Inter-bank market, which cover:

1. Inter-bank trading in Islamic financial instrument,
2. Islamic inter-bank investments, and
3. Islamic inter-bank cheque clearing system.

Thus, Malaysia has a sophisticated Islamic banking system running on a parallel basis with the conventional banking system, thus being the first country to implement a dual banking system.

1.2 OBJECTIVES OF THE STUDY

Islamic banking has become an alternative to conventional banking in Malaysia. The reason behind the emergence of Islamic banking during the 1980's in Malaysia was due to the realization of the country's leader about the importance of having a banking system that follows the *Shari'ah*¹. As it is commonly known

¹ The word *Shari'ah* is originally meant the path leading to the water and in religious usage it means the way which direct a person's life along the right path. The *Shari'ah* governs all aspects of human life. Its principles include not only faith or spiritual aspects of human life but also personal behavior, legal and social transactions. The Islamic banking system is linked with the

that conventional banking bases its operation mainly on interest. Interest as will be described in detail later, is *riba*. And in the *Shari'ah*, *riba* is forbidden (*haram*).

With regards to the emerging needs for Islamic banking, the writer is trying to observe and analyze the scenario in Malaysia and unveil any significant findings in it, especially in the context of loan repayments. Some people have said that the loan repayments under Islamic banking are higher than under conventional banking for similar types of loan. The writer will try to seek answers for the statement by making comparison between the two systems. The title has been chosen by the writer with the objectives as shown below:

1. To clarify the concept of interest rate or *riba*, the differences between *riba* and trading as well as profit. The existence of *riba* in conventional banking and the concept of profit sharing in Islamic banking will be explained. The benefits of the concept of profit sharing under the *Shari'ah* will also be highlighted;
2. To understand the concepts and principles of financing/loan under *Shari'ah*;
3. To know the implementation of financing facilities/loans being offered by Bank Islam Malaysia Berhad (BIMB) in accordance with the *Shari'ah* principles, and the setting up of profit sharing in loans repayments;
4. To apprehend the loan concepts and principles behind conventional banking especially in Bumiputra-Commerce Bank Berhad (BCB) and the operations of the bank as a whole, types of loans, the calculations of loans and their payments based on interest rates;

Shari'ah through one of the aspects of *Shari'ah* called *muamalat* or the man-to-man relationship. Haron, Sudin (1997), *Islamic Banking: Rules and Regulations*, Pelanduk Publications, p. 68

5. To compare similarities and differences between conventional banking and Islamic banking pertaining to loan repayments; and
6. Lastly the comparison between the two systems will be evaluated and recommendations will be given as to solve any discrepancies.

1.3 SCOPE OF THE STUDY

The scope of the research will be the analysis of *Al-Bai' Bithaman Ajil*, *Al-Murabahah*, *Al-Ijarah*, and *Al-Qardh Al-Hassan* concepts in relation to loans and financing facilities in Bank Islam Malaysia Berhad (BIMB) and conventional loans schemes in Bumiputra-Commerce Bank Berhad (BCB).

The above four Islamic concepts will be elaborated in general as well as touching also their implementation in Islamic banking. After knowing them then the writer will evaluate the concepts and narrowing them in the context of the BIMB.

The writer will proceed to explain the loan concepts being used under conventional banking apart from its procedure in the scheme. It includes several products that can be compared directly with the Islamic financing/loan products.

The comparative study will reveal similarities and differences in the two different banking systems practicing different concepts in loan repayments.

1.4 LIMITATIONS OF THE STUDY

Since this study is limited to the two (2) banks only, the results of this study cannot be used as a generalization of the loan repayments of other financial institutions such as finance companies, merchant banks etc.

Another limitation of the study is that some elements of the research require in-depth interviews, which are sensitive to the banks. Then the bank officers are not willing to respond in details so as not to reveal any confidential information to third parties.

1.5 ORGANIZATION OF THE STUDY

The study comprises of five (5) chapters with an abstract attached at the beginning of the study and followed by appendices at the end of the study.

Chapter 1 is the introduction of the study explaining about the banking environment, and the two types of banking systems, which exist in Malaysia.

Chapter 2 is the literature review, which highlights some past studies, opinions and descriptions of *riba*/interest, interest-free and its differences with profit. Secondly, it elaborates the concepts and principles of the Islamic banking system in relation to financing facilities and loan scheme. Lastly, it discusses about the concepts and principles of the conventional banking system pertaining to loan schemes.

Chapter 3 discusses about the hypotheses of the study, the research methodology and bank management principles. This chapter describes a sample selection, data collection techniques, data analysis techniques in the study.

Chapter 4 is the interpretation of the findings and the comparative analysis of financing facilities under the Islamic banking system and loan schemes under the conventional banking system. The last part of Chapter 4 illustrates real examples of housing loans under the above two systems and shows differences between the two systems.

Chapter 5 concludes the study and proposes some recommendations based on the findings. The findings and recommendations might be useful for future research, especially for studies in the similar area.