Chapter 7
The Conduct of Monetary Policy Under Dual Banking System:
The Case Of Malaysia

7.1 Background

As we have mentioned earlier, the first Islamic bank to be set-up was the Dubai Islamic Bank in 1975. In the 26 years, since the establishment of the Dubai Islamic Bank, over 150 Islamic financial institutions have opened their doors for business around the world (Akauntan Nasional, 2000). Their clientele have spread to Europe, the United States and the Far East. There is no doubt that these Islamic banks and financial institutions have been successful in breaking new grounds by developing a series of financing techniques, that comply with the Shariah and, at the same time, are efficient (Bank Negara Malaysia, 1989).

The initial reaction of the West towards Islamic banking was to consider it as a joke or as a financial gimmick or to treat it as a "fundamentalist phenomenon" (Hussein, 1987). Today, with about US $170 billion (Hamdi, 2001) worldwide under their management, Islamic banks have certainly survived the initial credibility crisis. The world now sees Islamic banks as not only practical but scientific as well (Bank Negara Malaysia, 1989).

The attitude of international financial community towards the system has since improved. Islamic banking continues to grow because of its value-oriented ethos that enables it to draw finances from both Muslims and non-Muslims alike. Islamic bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are not only profitable but also ethically motivated.

However, despite the fervour and enthusiasm created with the setting up of the first Islamic bank in Dubai in 1975, only two countries, namely Pakistan and Iran,
A significant milestone in the future development of Islamic banking was the launching of the Financial Sector Master Plan in March 2001, which incorporated the 10 year master plan for Islamic banking and takaful. The overall objective of the plan is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic needs of the nation (Bank Negara Malaysia, 2001). The specific recommendations are formulated with a view of building the capabilities of IBIs and takaful operators to compete effectively and to increase the significance of their market share in the financial system. In addition, the underpinning financial infrastructure needs to be strengthened to support the expansion of Islamic banking and takaful operations envisaged.

It is envisioned that the Islamic banking and takaful industry landscape in 2010 would evolve in parallel with conventional banking and insurance to achieve the following:

(a) Constitute 20 percent of the banking and insurance market share with an effective contribution to the financial sector of the Malaysian economy;

(b) Represented by a number of strong and highly capitalized. IBIs and takaful operators offering a comprehensive and complete range of Islamic financial products and services;

(c) Underpinned by a comprehensive and conducive Shariah and regulatory framework;

(d) Supported by a dedicated institution (Shariah commercial court) in the judiciary system that addresses legal issues related to Islamic banking and takaful;
a need for continuous research and experimentation. In our view, we cannot afford to close our minds to present-day developments and maintain that everything useful about Islamic banking and economics has already been said by Muslim philosophers, such as Farabi, Tusi and Ibn Khaldun. We cannot afford to merely sit back and insist that all that is required now is the political will on the part of the authorities to implement an Islamic economic and banking system. Such attitude will, undoubtedly, limit our progress and frustrate intellectual advancement in this area of knowledge.

Relentless research, seminars and conferences are, therefore, in the right direction, as they provide the opportunity for exploring new avenues and adding depth to our knowledge by way of dialogue and discussion. But this, in itself is not enough. There is also the need to be open-minded. It would do no good to the Muslim ummah, if we keep insisting for example that every Islamic financial instrument that is implemented should be strictly on the basis of PLS. Other forms, apart from PLS, should also be studied and experimented with, as long as such instruments do not involve riba and are in accordance with Shariah. This is especially so in areas where it would be difficult to apply the PLS principle. For example, an Islamic bank, instead of providing the entrepreneur with funds to acquire a given asset, may provide the asset itself. In the case of capital goods such as machinery, it may do this by way of hire-purchase or leasing (Al-Ijarah and Al-Takjiri). In the case of raw materials or trade machinery, a possible route is a fixed profit mark-up for the bank (Murabahah). The entrepreneur could even be allowed to defer payment. Such transactions should be admissible on the basis of Islamic principles, as they do not involve the pure lending of money but represent special way of conducting the financial side of the real transfer of goods (Hussein, 1987).

In addition to open-mindedness, we should also be practical. In this regard, we see the need to give new direction and purpose to the emerging force of Islamic resurgence by shifting the emphasis from the distant and abstract to the
immediate and concrete. We need to concentrate on specific aspects of the Islamic economic system, which could be implemented relatively quickly, rather than clamour, in general and emotional terms, for an Islamic economic system to be implemented in its totality overnight.

In addition to being open-minded and practical, there is also the need to be creative. In this regard, there is certainly a lesson for us from the early years of Islamic history. If we look back at the first generation of Muslims, we will realize that the important factor that contributed to their success was their ability to accept the cultures and systems around them. The early Muslims burst forth in such brilliance in so many fields, and created a period of temporal as well as spiritual achievements, an age of conquest and brilliance. The Persian Empire and much of the Roman Empire fell before the Muslims. Islam quickly established and took responsibility for a new order stretching from the Pyrenees to the Himalayas in the Indian sub-continent, an empire larger than the Roman at its height. In addition to the success and advancements in the field of politics and economics, both the arts and the sciences flourished. There was prosperity as well as social and cultural advancements. It armies won battles, its decrees were obeyed, its letters of credit were honoured, its architecture was magnificent, its poetry charming, its scholarship imposing, its mathematics bold and its technology effective.

The success of the early Muslims should be analysed in the spiritual context. The Muslims were not only victorious on the battlefield and effective in many diverse departments of living, but they succeeded also, in a relatively short period of time, in integrating the Islamic way of life into that wholeness that constitutes the Islamic civilization. A great new society arose under their endeavour and guidance, the product of their powerful spirit. Various elements and influences contributed to the emergence of the Islamic civilization: Arabic, Hellenism, from the Semitic cultures of the ancient Near East, from Iran and India.
The achievement of the early Muslims arose from their ability to mould these diverse elements and influences into a homogenous way of life and their ability to carry them forward into new developments. And it was Islam that provided the integration, while at the same time providing encouragement and the will and power to sustain it. It was an Islamic pattern too that gave the society cohesion as well as vitality. The early Muslims proved not only prosperous but also original and constructive.

The reason we have referred to our early history is not to suggest that we should be preoccupied with our glorious past. Our purpose is to show that, during the present period of Islamic resurgence, if we can inculcate in ourselves the commitment, the enthusiasm and, above all, the creativity of the early Muslims, we need to absorb from our surroundings what conforms to Islam's creative genius. No purpose will be served if the existing economic wisdom, which has been generated through the long process of active intellectual interaction, is ignored in the formulation of our views on Islamic economics.

Today, we are attempting to rebuild the Islamic civilization, after many centuries of decay and decline. The development of Islamic banking and takaful is part of that process. In attempting to recapture the past glory, we need to know why the first generations of Muslims were successful and why the later generations failed. The answer is clear. The early Muslims were able to accept what was good in the systems around them and then carry them forward into new developments. When Muslim society understood the underlying dynamics of Islam, we had progressive advance; when society's creativity and imagination gave way to rigid formalism and rituals, internal conflict and power struggle, we had progressive decline.

Four centuries separate Ibn Khaldun's "Muqaddimah" of 1374, which contains the first systematic and comprehensive exposition of the science of economics and Adam Smith's "Wealth of Nations", written in 1776, and widely (but wrongly)
acclaimed as the first treatise in economics (Chapra, 1992). It is sad that although Muslims had a lead-time of four centuries in the field of economics, we now lag behind the western world. We have to catch up fast and make up for the lost time. And it would be extremely silly on our part to reject completely the sophisticated banking system that already exists and resort to reinvent from scratch an Islamic system. Such an approach will put us even further back.

7.2 Operating Side-By-Side With Conventional System

As we have mentioned earlier in Chapter Three, the approach that the Malaysian authorities have taken in implementing Islamic principles in the Malaysian financial system is a step-by-step approach on a well planned and well thought out basis. In other words, the implementation will be in stages, based on prudential and practical considerations. According to Bank Negara Malaysia (1989), this is the right approach, particularly in the context of Malaysia, given the sensitivities of its multi-religious population.

We did not follow the method of Samson in the temple: he sought to pull down the pillars in the temple in one go, and there was no way he could escape in that destruction. This was the man who set out, quite deliberately, dismantles the system that created him, and he was crushed in the process. There is a lesson here for all of us who are committed to Islamic banking.

Malaysia, Indonesia and Brunei have since adopted a dual-banking system where traditional banks can also offer Islamic banking products and services if they have the right expertise and system. We feel it is necessary to have parallel banking systems where we can show that there is an alternative to the conventional system. And more importantly is that the alternative system works. Although not the pioneer in Islamic banking, today, Malaysia has developed one of the most advanced models of Islamic banking in the world (Akauntan Nasional, 2000), and its popularity has caught on even non-Muslims.
It has been the aspiration of the government to create a vibrant and comprehensive Islamic banking and takaful system operating side-by-side with the conventional system. Unfortunately, a single Islamic bank or institution or even a few Islamic banks and institutions, for that matter, do not fit the definition of a system. BNM in a report said there are three basic ground rules that have to be fulfilled to qualify as an Islamic banking system. The first is having a large number of players—different types of institutions taking part—to provide depth to the system. The second criterion is that availability of a wide range of Islamic financial products and innovative instruments to meet the current and growing needs of the financial institutions and customers. Finally, there must be an efficient and effective interbank money market to link the players and different instruments.

In addition to these requirements, Islamic banking is governed by a higher authority—the word of God. The system must reflect the socio-economic values of Islam. In other words, it must be Islamic in substance; not merely in form and certainly not in name only. Recognising this fact, the government, through BNM has taken a concrete and dynamic approach to achieving the goal of developing an Islamic banking system to complement conventional banking.

The first step towards realizing the vision was to disseminate Islamic banking on a nationwide basis with as many players as possible and within the shortest period possible. This was achieved through the introduction of Islamic Banking Scheme (IBS) in March 1993. IBS allows conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including staff and branches. The scheme was launched on 4 March 1993, on a pilot basis involving three banks. Following the successful implementation of the pilot run, BNM allowed other commercial banks, finance companies and merchant banks to operate the scheme in July 1993 subject to the specific guidelines issued by the central bank. On 1 October 1999, the second Islamic bank, namely, Bank Muamalat Malaysia Bhd, was established. The setting-up of
the second Islamic bank was expected to play a key role towards fostering an active and progressive Islamic banking system (Bank Negara Malaysia, 1999).

The Islamic banking and takaful industry has made steady progress since the establishment of the first Islamic bank in 1983 and the formation of the first Islamic insurance company (takaful) in 1984. As at end-2000, the Islamic banking system had 49 players, comprising two Islamic banks and 47 conventional banking institutions participating in the IBS (IBS banking institutions), an Islamic money market, two takaful companies and a broad range of Islamic financial products and services. The IBS banking institutions consisted of 17 domestic commercial banks, four foreign-owned banks, 14 finance companies, five merchant banks and seven discount houses. Upon completion of the merger exercise among the domestic banking institutions, the number of players will be 35, consisting of two Islamic banks and 33 IBS banking institutions (13 commercial banks, eight finance companies, five merchant banks and seven discount houses).

On Takaful, Malaysia spearheaded the commercial or Tijari-based approach of Islamic insurance by introducing the investment element. The practice adopted previously in the Middle East was on a non-profit making or co-operative basis that is without the investment element. Now more and more foreign takaful institutions have adopted Malaysia's approach. The two takaful institutions in Malaysia offer both general and life Islamic insurance. Together, they have more than 50 branches as at end of 2000.

Recognising the importance of an Islamic money market to enable the players' greater flexibility in the management of their portfolio, the Islamic money market was established in 1994. It is still the only such market operating in the world today. The market serves, as a platform for Islamic banking institutions to invest their short-term funds and to meet their short-term liquidity needs.
In 1997, the Malaysian takaful industry took another step forward with the formation of Asea Retakaful International Ltd. (ARIL) as an off-shore re-takaful company in Malaysia's international offshore financial center in Labuan. This is also the world's first Islamic re-insurance company of its kind. The establishment of ARIL was to create a vehicle for more dynamic re-takaful institutions operating in Malaysia, Brunei, Indonesia and Singapore, and to provide additional re-takaful capacity in the industry.

Another important step was the establishment of the National Shariah Advisory Council at Bank Negara Malaysia for Islamic Banking and Takaful in 1997. As a sole and highest Shariah authoritative body, it ensures the harmonization of Shariah interpretations in facilitating the steady growth of the Islamic financial system.

The significance of Islamic banking has been on a progressive upward trend, recording an average annual growth of 49 percent in terms of assets over the period 1995-1999. During the year 2000, the Islamic banking sector continued to register a strong asset growth of 30 percent to RM 47.1 billion, as compared to less than RM 5 billion eight years ago when this dual banking system was introduced, whilst deposits and financing increased to RM 35.9 billion and RM20.9 billion, respectively (Bank Negara Malaysia Annual Report, 2000). Accordingly, in terms of performance relative to the banking system, the growth of Islamic banking deposits represented an increase of 1,547.5 percent during the period of 1995-2000 as compared to the growth of deposits in the conventional banking of 65.8 percent. Similarly, the growth of financing by Islamic banking has increased for more than 1,269 percent during the same period as compared with the increase in total loans granted by conventional banking of 65.4 percent. The detailed of the total deposits and financing of Islamic Banking Scheme as compared to conventional banking are given in Tables 1 and 2 below:
### Table 1.1
Islamic Banking Scheme: Total Deposits and Financing (RM million)

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<tr>
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<tbody>
<tr>
<td>Total Deposits</td>
<td>2,180.4</td>
<td>3,932.5</td>
<td>6,521.1</td>
<td>11,234.9</td>
<td>24,804.0</td>
<td>35,923.0</td>
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<tr>
<td>Total Financing</td>
<td>1,525.5</td>
<td>3,596.0</td>
<td>7,127.2</td>
<td>7,317.5</td>
<td>13,724.0</td>
<td>20,891.0</td>
</tr>
</tbody>
</table>

### Table 1.2
Islamic Banking Scheme: Deposits By Type (RM million)

<table>
<thead>
<tr>
<th>As at End of</th>
<th>Demand Deposit</th>
<th>Investment Deposit</th>
<th>Saving Deposit</th>
<th>Total</th>
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<tr>
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<td>312.4</td>
<td>1,502.9</td>
<td>365.1</td>
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<td>1996</td>
<td>686.2</td>
<td>2,529.8</td>
<td>716.5</td>
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<td>1997</td>
<td>2,120.8</td>
<td>3,419.6</td>
<td>980.7</td>
<td>6,521.1</td>
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<tr>
<td>1998</td>
<td>2,015.0</td>
<td>8,027.8</td>
<td>1,192.1</td>
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<tr>
<td>1999</td>
<td>5,480.0</td>
<td>16,929.0</td>
<td>2,395.0</td>
<td>24,804.0</td>
</tr>
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<td>2000</td>
<td>6,564.0</td>
<td>26,032.6</td>
<td>3,326.4</td>
<td>35,923.0</td>
</tr>
</tbody>
</table>

### Table 1.3
Islamic Banking Scheme: Financing By Type (RM million)

<table>
<thead>
<tr>
<th>As at End of</th>
<th>Overdraft</th>
<th>Term-Financing</th>
<th>Bill Financing</th>
<th>Other Financing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>-</td>
<td>267.0</td>
<td>163.1</td>
<td>1,095.4</td>
<td>1,525.5</td>
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<tr>
<td>1996</td>
<td>79.9</td>
<td>2,178.9</td>
<td>493.5</td>
<td>843.7</td>
<td>3,596.0</td>
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<tr>
<td>1997</td>
<td>197.1</td>
<td>4,850.0</td>
<td>620.6</td>
<td>620.6</td>
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<td>1998</td>
<td>282.5</td>
<td>6,109.7</td>
<td>427.9</td>
<td>497.4</td>
<td>7,317.5</td>
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<tr>
<td>1999</td>
<td>211.6</td>
<td>12,191.9</td>
<td>816.1</td>
<td>504.4</td>
<td>13,724.0</td>
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<td>2000</td>
<td>321.9</td>
<td>17,142.2</td>
<td>1,427.5</td>
<td>1,999.4</td>
<td>20,891.0</td>
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Table 2.1  
Conventional Banking: Total Deposits and Loans (RM million)  
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<tbody>
<tr>
<td>Total</td>
<td>231,540.7</td>
<td>284,353.5</td>
<td>328,621.1</td>
<td>334,710.1</td>
<td>375,944.4</td>
<td>383,886.9</td>
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<tr>
<td>Deposits</td>
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</tr>
<tr>
<td>Loans</td>
<td>251,864.0</td>
<td>332,932.7</td>
<td>421,202.5</td>
<td>413,526.6</td>
<td>397,865.8</td>
<td>416,506.2</td>
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Table 2.2  
Conventional Banking: Deposits By Type (RM million)  
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<tr>
<th>As at End of</th>
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<th>Saving Deposit</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>36,490.5</td>
<td>166,668.9</td>
<td>23,381.3</td>
<td>231,540.7</td>
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<tr>
<td>1996</td>
<td>42,856.9</td>
<td>207,937.3</td>
<td>33,559.3</td>
<td>284,353.5</td>
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<tr>
<td>1997</td>
<td>43,846.4</td>
<td>255,327.1</td>
<td>29,447.6</td>
<td>328,621.1</td>
</tr>
<tr>
<td>1998</td>
<td>36,793.6</td>
<td>267,429.6</td>
<td>30,486.9</td>
<td>334,710.1</td>
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<tr>
<td>1999</td>
<td>48,324.0</td>
<td>289,676.2</td>
<td>37,944.2</td>
<td>375,944.4</td>
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<tr>
<td>2000</td>
<td>55,189.5</td>
<td>285,199.9</td>
<td>43,497.5</td>
<td>383,886.9</td>
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Table 2.3  
Conventional Banking: Loans By Type (RM million)  
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<thead>
<tr>
<th>As at End of</th>
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<th>Term-Financing</th>
<th>Bill Financing</th>
<th>Other Financing</th>
<th>Total</th>
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<tbody>
<tr>
<td>1995</td>
<td>44,512.0</td>
<td>137,959.0</td>
<td>25,584.4</td>
<td>43,808.6</td>
<td>251,864.0</td>
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<tr>
<td>1996</td>
<td>55,320.9</td>
<td>172,293.0</td>
<td>28,120.4</td>
<td>77,198.4</td>
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<tr>
<td>1997</td>
<td>70,548.2</td>
<td>228,193.6</td>
<td>32,187.2</td>
<td>90,273.5</td>
<td>421,202.5</td>
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<tr>
<td>1998</td>
<td>68,262.3</td>
<td>222,450.8</td>
<td>27,251.1</td>
<td>95,562.4</td>
<td>413,526.6</td>
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<td>1999</td>
<td>62,062.4</td>
<td>217,367.8</td>
<td>27,523.8</td>
<td>90,911.8</td>
<td>397,865.8</td>
</tr>
<tr>
<td>2000</td>
<td>60,468.6</td>
<td>208,613.2</td>
<td>30,728.0</td>
<td>116,696.4</td>
<td>416,506.2</td>
</tr>
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</table>
Our domestic Islamic money market has also shown encouraging performance since its inception in 1994. Over the last three years, daily transactions ranged from RM 3 billion to RM 4 billion (Aziz, 2001). The delivery channels have also improved significantly as there are more than 2,200 branches of Islamic banks and IBS banks offering Islamic banking products and services.

On takaful activities, the takaful fund assets of both family and general takaful have registered an annual growth of 68 percent for the period 1986-2000. Over the same period, total takaful contribution recorded an average annual growth of 47 percent. On the family takaful business, the total participation in force increased from RM 16.7 million in 1986 to RM 25.6 billion in 2000.

Today, Malaysia has succeeded in implementing a dual banking system and has emerged as the first nation to have a full-fledged Islamic system operating side-by-side with conventional banking system. The accomplishment of the Islamic financial system in Malaysia has created numerous spillover effects to other financial institutions. This has been some of the results emanating from the joint effort by BNM, government bodies and the financial sector.

Several development financial institutions which include Bank Pertanian, Bank Industri dan Teknologi, Bank Pembangunan dan Infrastruktur and Bank Simpanan Nasional have started to offer Islamic banking products. Bank Rakyat is also now offering full Islamic financial products and services. Cagamas Berhad, the national mortgage company, now promotes the secondary mortgage market for the Islamic home financing.

The Credit Guarantee Corporation Berhad has also started to assist small and medium-scale enterprises to obtain credit facilities from financial institutions by providing guarantee covers on such facilities based on Islamic principles. Funds established under the bank to help eligible applicants have also been designed
for those seeking Islamic financing. Finally, domestic rating agencies now also rate Islamic capital market instruments.

The success of Islamic banking in Malaysia has also had spill-over effects in other areas of finance and has led to other initiatives in other related areas such as Islamic insurance and Islamic capital market. Presently, the two Malaysian Islamic insurers that are takaful operators have expanded considerably, with one takaful operator having entered into strategic alliances with a number of foreign parties that have interest in establishing takaful companies in their respective countries. This is in line with Malaysia’s commitment in promoting takaful in the OIC member countries as entrusted by the D-8 member countries. In the Islamic bond market, debt securities issued under the Islamic principles have gained popularity and have now achieved a commendable market share in terms of absolute amount and size of the papers (Aziz, 2001).

Although the performance of the Islamic banking and takaful industry under this dual banking system has been encouraging, it is still relatively insignificant compared with conventional banking and insurance. The current market penetration level of Islamic banking of 6.9 percent in terms of assets implies a significant potential still remains untapped. On takaful business, the level of market penetration in terms of takaful certificates over the total population is only 2 percent compared with a market penetration of 28.4 percent for conventional insurance business. It is therefore timely to formulate specific strategies to develop further Islamic banking and takaful. Moving forward, these strategies will also contribute to strengthening Malaysia’s position to become an Islamic financial center in the Far East region.

The ability of the Islamic banking and takaful industry to capture a more significant market share in a rapidly evolving and challenging financial environment is dependent on the strategic positioning of the domestic industry players to maintain the competitive edge and become market leaders.
Specifically, the Islamic banking and takaful industry is expected to face the following challenges:

(a) Increased competition as a result of globalisation and financial liberalization. The emergence of global conventional players in Islamic banking business is clearly evident particularly in the area of structuring Shariah-compliant investment and financing deals;

(b) Increasing role of technology in shaping the microstructure of business and financial markets, contributing to enhanced efficiency and competitiveness; and

(c) New generation of well informed consumers demanding differentiated and sophisticated products.

Against this backdrop, in order for the Islamic banking institutions (comprising of Islamic banks and IBS banks) and takaful operators to become leaders in the industry, compete effectively and at the same time preserve their niche, there is a need to:

(a) Strengthen their institutional and operational capacities and build their resilience to operate successfully in a highly competitive globalised environment;

(b) Improve their efficiency and effectiveness to be at par with international best players; and

(c) Intensify research and development efforts in Islamic financial product innovation. This will involve IBIs and takaful operators to consider the possibility of forging strategic alliances to tap the research and development expertise developed outside the banking and insurance industry to create the range of Islamic financial products capable of meeting the customer requirements.
A significant milestone in the future development of Islamic banking was the launching of the Financial Sector Master Plan in March 2001, which incorporated the 10 year master plan for Islamic banking and takaful. The overall objective of the plan is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic needs of the nation (Bank Negara Malaysia, 2001). The specific recommendations are formulated with a view of building the capabilities of IBIs and takaful operators to compete effectively and to increase the significance of their market share in the financial system. In addition, the underpinning financial infrastructure needs to be strengthened to support the expansion of Islamic banking and takaful operations envisaged.

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(c) Underpinned by a comprehensive and conducive Shariah and regulatory framework;

(d) Supported by a dedicated institution (Shariah commercial court) in the judiciary system that addresses legal issues related to Islamic banking and takaful;
(e) Supported by a sufficient number of well-trained, high caliber individuals and management teams with the required expertise; and

(f) Epitomise Malaysia as a regional Islamic financial center.

7.3 Profitability and Quality of Asset

The Islamic banking sector recorded a pre-tax profit of RM 534.5 million for calendar year 2000 as compared to RM355.3 million in 1999. Improved profitability enabled the sector to continue generating a positive rate of return on assets of 1.1 percent (1.0 percent in 1999) and a return on equity of 21.2 percent (17.5 percent in 1999) for the year. In line with the strong growth in total financing, the Islamic banking sector recorded an increase in net financing income of RM550 million at the operating level. The non-financing income of the Islamic banking sector for the year 2000 increased by RM32 million or 18.7 percent from 1999.

The asset quality of Islamic financing continued to improve during the year 2000. The non-performing financing (NPF) ratio declined to 7.0 percent from 8.2 percent in 1999. The decline in the NPF ratio was attributed to the significant increase in the total financing during the year, which more than offset the increase in NPF absolute amount of RM534 million. With the increase in total financing and NPF, the total provision set aside in 2000 increased slightly to 47.8 percent of NPF, compared with 45.5 percent of NPF in 1999.

The broad property sector continued to account for the largest share of NPF, at 50.2 percent of the total NPF (49.0 percent in 1999). The high NPF in the broad property sector emanated mainly from residential and non-residential property financing, which accounted for 28.6 percent of the NPF in this sector (39.7 percent in 1999).
7.4 Summary

Islamic banking in Malaysia has evolved over the past 18 years into a comprehensive financial system covering banking services, corporate advisory, takaful and fully functioning money, capital and bond markets. The first Islamic bank in Malaysia was established in 1983 and the first takaful institution in 1984. There were also the first of such institutions established in East Asia.

By the mid-80s, Islamic banking in the OIC member countries could be divided into three categories. Many of them had no Islamic banking, few had Islamic banking on the fringe the financial system such as Saudi Arabia and Egypt and there were countries who were thinking of going into full-scale Islamic banking by doing away with conventional banking. These countries are Pakistan, Iran and Sudan. Malaysia is different from both groups in the sense that we have a dual system. Here we have a parallel system that would be equally sophisticated and comprehensive, and have equally good infrastructure to function side-by-side with the conventional system. Today, Malaysia is the only country with a dual system.

We believe a dual system is better than a pure Islamic system. In a conventional banking system, changes are made everyday and new products are developed as more research and development is done. Products get more sophisticated by the day. And if we don't have a conventional banking system, we don't know what is happening in the outside world. Because we have it in Malaysia, Islamic banks will have to learn and find products to keep Islamic banking system on its toes when compared with the conventional system.

The long-term objective of the government has always been to create an Islamic banking system to run parallel to the conventional banking system. However, a single Islamic bank does not fit the definition of a system. An Islamic and finance

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system requires a large number of dynamic and pro-active players, a wide range of products and innovative instruments, and a vibrant Islamic money market.

On 4 March 1993, Malaysia introduced the world's first dual banking system through the introduction of Islamic Banking Scheme (IBS) which allows conventional banking institutions to offer Islamic banking products and services within their existing infrastructure. Recognising that a successful Islamic banking and financial system required a large number of players, Malaysia sought to build critical mass and national reach within a short period.

From only three banks in March 1993, the number of conventional banking institutions participating in the IBS (IBS banking institutions) has increased to 47 comprising of 21 commercial banks, 14 finance companies, five merchant banks and seven discount houses. On 1 October 1999, the second Islamic bank, namely Bank Muamalat Malaysia Berhad, was established. As at end of December 2000, the Islamic banking system had 49 players, comprising two Islamic banks and 47 IBS banking institutions. Upon completion of the merger exercise among domestic banking institutions, the number of players will be 35 consisting of two Islamic banks and 33 IBS banking institutions. These institutions have more than 2,200 branches providing a comprehensive and comparable range of Islamic financial services. The retail and corporate products offered range from investment accounts and house financing to project financing and long-term bond investment.

Today, Malaysia has succeeded in implementing a dual banking system and has emerged as the first nation to have a full-fledged Islamic system operating side-by-side with conventional banking system. The aspiration to establish a comprehensive Islamic banking and finance system has create a spill-over effect to the non-bank Islamic financial intermediaries which started to offer Islamic financial products and services. Such institutions include the takaful companies, the savings institutions (i.e. Bank Simpanan Nasional and Bank Rakyat) and the
developmental financial institutions (i.e. Bank Pembangunan dan Infrastruktur, Bank Industri dan Teknologi and Bank Pertanian). Despite these developments, significant potential still remain untapped. Efforts therefore will be intensified to support the expansion of Islamic banking and takaful in Malaysia to operate effectively in parallel with conventional banking.

On 1 March 2001, BNM has launched the Financial Sector Master Plan which charts the financial sector landscape for the next 10 years. An integral part of the plan is the strategic plan for the development of Islamic banking and takaful in Malaysia. The Master Plan outlines the strategies to be implemented to develop the financial infrastructure for Islamic banking and takaful. More specifically, the Plan outlines strategies to strengthen the institutional and operational capabilities of the institutions in Islamic banking and takaful to operate in a more competitive environment. Research and development efforts in Islamic financial products and innovation will be intensified. Attention will also be focused on financial infrastructure development, in particular, to support the effectiveness of the Islamic financial markets.

To ensure the stable and sound development of Islamic banking and takaful, the legal, regulatory and Shariah framework will be strengthened. As a regulator, BNM will also continue efforts on product and market development to create more sophisticated instruments, specifically customised to meet the unique requirements needed to facilitate efficient management of the Islamic banking system. In these endeavours, the role of the government will continue to be important. The unrelenting support and unwavering commitment of the government has been an important force that has place Islamic banking and takaful in Malaysia where it is today.
References