Chapter 3
The Implementation of Islamic Principles in the Malaysian
Financial System

3.1 Background

Before the re-emergence of the Islamic financial system, Muslims throughout the
world had only conventional financial systems to fulfill their financial needs. The
Islamic resurgence in the late 1960s and 1970s has initiated the call for a
financial system that allows Muslim to transact in a system that is in line with their
religious beliefs (Khan, 1985).

As a need to have an Islamic financial system was vital and immediate, Muslim
scholars had taken the effort to embark on the development of an Islamic
financial system. This led to the establishment of Islamic Development Bank in
1974 followed by the Islamic Bank of Dubai, the first Islamic commercial bank in
1975.

In the following years, a number of Islamic banks were estabiished, concentrated
mainly in the Middle East, such as the Islamic Bank of Faisal in Egypt (1977), the
Islamic Bank of Faisal in Jordan (1978), Bank of Islamic Finance and Investment
in Jordan (1978), Islamic Investment Co. Ltd. in UAE (1979) and others.

3.2 Stages in the Implementation Process

In Malaysia, the approach that the authorities have taken in implementing Islamic
principles in the Malaysian financial system is a step-by step approach. In other
words, the implementation will be in stages, based on prudential and practical
considerations. This, we feel is the right approach, particularly in the context of
Malaysia, given the sensitivities of its multi-religious population (Bank Negara
Malaysia, 1989).
Islamic principles were first introduced in the Malaysian financial system some 32 years back, with the setting up of the Pilgrims Management and Fund Board in 1969 (now called Pilgrims Fund Board). The purpose of the Board was to promote and co-ordinate all aspects of activities connected with Muslims going on pilgrimage. The Board manages a fund, derived from the accumulation of savings of intended pilgrims. The fund is managed on the basis of the principles of Shariah, aimed at yielding returns uncontaminated by riba (Hussein, 1987). Since its inception, the Board has grown rapidly in size with its total resources rising from RM 12.9 million in 1969 to RM 10.2 billion at the end of 2000. The expansion in resources arose from the increase in deposits placed by an increased number of depositors from 47,970 at the end of 1969 to 2.5 million at end-1998 to more than 4.3 million depositors, at the end of 2000 (Bank Negara Malaysia Annual Report, 2000).

The second major financial institution established in Malaysia was an Islamic bank. As a country whose population is dominated by Muslims, Malaysia was also affected by the resurgence that had taken place in the Middle East. A National Steering Committee was set up by the government in July 1981 to co-ordinate the efforts towards the establishment of an Islamic bank in Malaysia. Based on the recommendations of the committee, the Islamic Banking Act, 1983 was passed by the Malaysian Parliament to allow Islamic banks to operate banking business in the country, in accordance with Islamic principles, rules and practices, as contained in the Islamic Commercial Law. Bank Negara Malaysia, the Central Bank, was vested with powers of regulation and supervision over these banks (Man, 1988).

The first Islamic bank in Malaysia, Bank Islam Malaysia Berhad (BIMB) began its operations in July 1983, with an initial paid-up capital of RM80 million. Its shareholders include the government and a number of religious bodies. The corporate objective of the bank is to provide banking facilities and services to
Malaysians in general, and Malaysian Muslims in particulars, in accordance with Islamic Commercial Law (Bank Negara Malaysia, 1994).

In addition to its Board of Directors and Committee of Management, the bank also has Religious Supervisory Council consisting of eminent religious scholars in the country. The setting up of the Religious Supervisory Council is mandatory under the Islamic Banking Act, 1983. The Act further specifies that it is the duty of the Religious Supervisory Council to advise the bank on the operations of its banking business, in order to ensure that the operations do not involve any element which is not permissible in Islam. It must be emphasized that Islamic bank in Malaysia are not merely a bank whose operations are not based on interest, but rather a bank, which is guided in its operations by the economic and social principles of Islam.

The bank has grown tremendously since its inception. It was listed on the Kuala Lumpur Stock Exchange (KLSE) main board on 17 January 1992. BIMB’s total assets rose from RM325.5 million in 1984 to RM10.12 billion in 2000. Presently, the bank operates 82 branches nationwide with more than 1200 employees (Bank Negara Malaysia, 2000).

On 1 October 1999, a second Islamic bank in the country, namely, Bank Muamalat Malaysia Berhad (BMMB), commenced operation. The establishment of BMMB was the effect of spin-off following the merger between Bank Bumiputra Malaysia Berhad and Bank of Commerce Malaysia Berhad. The setting up of the second Islamic bank is expected to play an important role towards fostering an active and progressive Islamic banking system in the country (Bank Negara Malaysia, 1999).

When the first Islamic bank began its operations in 1983, the bank cannot among other things, purchase or trade in Malaysian Government Securities, Treasury Bills or other interest-bearing instruments. The government introduced an Islamic
financial instrument namely the Government Investment Certificate (now replaced with Government Investment Issues- GII). The GII were issued to enable BIMB to meet its statutory requirements in terms of its holdings of liquid assets, as well as to provide an investment avenue of BIMB to "park" its temporary excess funds. The GII were, however, not limited only to BIMB, but were also made available to others in the financial system. These GII represent borrowing by the government for its development expenditure. However, unlike the borrowings by way of the issue of Malaysian Government Securities or Treasury bills, the GII does not have a predetermined rate of interest. We are proud to say that Malaysia was one of the first countries to issue Government Securities on the basis of Islamic principles.

In deciding on the basis for determining the rate of return to the institutions and individuals who purchase the GII, the government realised that it would not be possible to apply the principle of profit-and-loss sharing directly, since it would not be possible to identify the revenues resulting from the investment of proceeds from the issue of the certificates. The government considered the possibility of applying an indirect form of profit-and-loss sharing, by anchoring the rate of return on the certificates the growth rate of Gross Domestic Product (GDP). However, the GDP growth rate is not a good proxy for the return on capital invested by the government, given that many other factors, apart from government capital expenditure, influence the rate of growth of GDP. The government, therefore, felt that the principle of profit-and-loss sharing would not be appropriate, at this stage, in determining the return on the GII.

The government decided, on the basis of practical considerations, to use the Islamic principle of Al-Qardhul Hasan (benevolent loan). On the basis of this principle, the purchase of the GII by any institution or individual will be considered as a benevolent loan to the government to enable the government to undertake developmental projects for the benefit of the nation. The providers of the funds would not expect any return on their loans but would expect the
principal amount to be returned at maturity. The rate of return, if any, would be at the absolute discretion of the borrower, that is, the government.

A committee comprising representatives from the Economic Planning Unit and the Religious Affairs Section, both of the Prime Minister's Department, the Ministry of Finance and Bank Negara Malaysia was formed to advise the government on the rate of return to be declared each year for the GII. The rate of return is declared only at maturity of the GII, where the GIIIs are of one-year maturity, and annually, at the end of one year after issue, where the GIIIs are of longer maturity. Although the government can, on the basis of the principle of Al-Qardhul Hasan, declare a zero rate of return, the government has, over the years, declared a satisfactory rate up return for these GII.

The concept of Al-Qardhul Hasan does not satisfy the GII as tradable instruments in the secondary market. To address this shortfall, Bank Negara Malaysia opens a window to facilitate the players to sell and purchase the papers with the central bank. The price sold or purchased by the players is determined by Bank Negara Malaysia which maintain a system to record any movement in the GII. As at end of 1999, the outstanding amount of the GII is RM 2 billion.

The third type of Islamic financial institution introduced in Malaysia was an Islamic insurance company, namely Syarikat Takaful Malaysia Sendirian Berhad (STMSB) which commenced operations in August 1985. In the same manner as the establishment of Islamic bank, a special body, "Task Force on the Study of Establishing Islamic Insurance Company in Malaysia", was formed in 1982 to study the possibility of establishing Islamic insurance to complement the services of Islamic banking. Following the recommendation of the task force, the Takaful Act, 1984 was passed by the Malaysian Parliament to enable the setting up of Islamic insurance companies. STMSB was incorporated with a paid-up capital of RM10 million, 51 percent of which is held by Bank Islam Malaysia Bhd. The
other shareholders comprise mainly the various state Islamic Religious Council and Baitulmals of certain states in Malaysia.

The launching of STMSB marked the culmination of the efforts by the Government and the Muslims in Malaysia to establish an Islamic insurance company, whose operations would be in conformity with Shariah. The provision of insurance cover, as a form of business structured on the foundation of Shariah, is based on the Islamic principles of Al-Takaful, Al-Mudharabah and Tabarru'. Al-Takaful refers to the act of a group of people called participants reciprocally guaranteeing each other against loss or damage that may befall any one of them. Al-Mudharabah is the commercial profit-sharing contract between the providers of funds (participants) for a business venture and the entrepreneur who conducts the business, while Tabarru' (donation) is the agreement by a participant to relinquish as tabarru', a certain proportion of the Takaful contribution that he agrees or undertakes to pay, thus, enabling him to fulfil his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss.

Thus, the operation of Takaful may be envisaged as a profit sharing business venture between the Takaful operator and the individual members of a group of participants who wish to reciprocally guarantee each other against certain loss or damage endured by any one of them.

The operation of Takaful is confined within the “Tijari” (commercial) sector or popularly known as the private sector. The traditional aspects of the commercials activity of Takaful must be subject to Islamic contractual laws to ensure its compliance with Shariah. Within this fundamental framework contract of “tijari”, Takaful is therefore based on the Islamic principle of Mudharabah.

The “tabarru'” concept is incorporated in Takaful contract to eliminate the uncertainty element. A participant shall agree to relinquish as tabarru', certain
proportion of his Takaful contributions that he agrees or undertakes to pay. Consequently, this enables him to fulfil his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss. The sharing of profit or surplus that may emerge from the operations of Takaful, is made only after the obligation of the assisting the fellow participants is fulfilled.

Another major step in the implementation of Islamic principles in the Malaysian financial system was taken in 1993, when Malaysia introduced the first dual banking system in the world in which the Islamic banking system and conventional banking system operated side by side. Recognising that an Islamic banking and financial system requires a large number of players and to enable the country to build a critical mass and national reach within a short period, the conventional financial institutions were allowed to offer Islamic banking products and services within their existing infrastructure including staff and branches (Bank Negara Malaysia, 1999).

Another important step which was taken by the government was the establishment of the National Shariah Advisory Council at Bank Negara Malaysia for Islamic banks and Takaful in 1997. As the sole and highest Shariah authoritative body, it ensures the harmonisation of Shariah interpretations in facilitating the steady growth of the Islamic financial system. Today, the Islamic financial system has become a reality with two Islamic bank 47 Islamic banking institutions and two takaful institutions.

The accomplishment of the Islamic financial system in Malaysia has created numerous spillover effects to other financial sectors. This includes mobilizing the funds for better returns using the Islamic investing instruments in the capital market. The Islamic capital market is an essential platform for the efficient mobilization of Islamic funds, and there is a need to develop capital market instruments to attract funds from such institutions as Lembaga Tabung Haji,
Islamic banks and Islamic unit trusts as well as the increasing number of individuals looking for Shariah-compliant investments.

The effort to develop an Islamic capital market in Malaysia started as soon as the Securities Commission was established in 1993. In fact, the Securities Commission had earmarked the development of the Islamic capital market as an important agenda within the overall activities of the country's capital market. Toward this, the Securities Commission has set up a unit called the Islamic Capital Market Unit, to carry out research and planning for the development of the Islamic capital market in Malaysia. The staffs for this unit are well versed in the fields of Muamalat (Islamic financial system and conventional capital market practices).

Subsequently, a working committee called the Islamic Instruments Study Group was formed. This was succeeded by an advisory board named Shariah Advisory Council that was established in 1996 to advise the Securities Commission in matters concerning Shariah financial instruments. The setting up of the Council and the Unit that combined Islamic thinking with modern financial market practitioners have enabled the Securities Commission to carry out sound and systematic development activities of the Islamic capital market.

In this regard, the Council of the Securities Commission has approved about 541 counters representing around 70 percent of the total counters in the KLSE as counters approved according to Shariah guidelines as at end of 2000. The approved shares include ordinary shares, warrants and transferable subscription rights. The Council is the authority that decides whether a share on the KLSE is approved or not in Shariah where the list of companies is updated periodically, presently three times a year. Usually, when an updated list is announced, there may be a few shares on the previous list which are de-listed, a few other new ones are included, and newly-listed shares which are included for the first time.
3.3 Summary

It is said that the journey of a thousand mile begins with a first step. In Malaysia, the first step in the implementation of Islamic principles in the Malaysian financial system began with the setting up of the Pilgrims Management and Fund Board (now called Pilgrims Fund Board) some 32 years back. The government has covered a reasonable distance since then. We realised, of course, that we have many more miles to go to reach our destination. Be assured, that the authorities have every intention of continuing the journey. In so doing, however, the government will ensure that every step is taken after testing the grounds for firmness, so that we do not have to turn back half way.

The Pilgrims Fund Board was set up to manage a fund, derived from the accumulation of savings of intended pilgrims, based on the principles of Shariah. The total resources of the Pilgrims Fund Board have grown tremendously since its inception. At the end of 2000, total resources mobilised by the Board amounted to RM 10.2 billion, representing an increase of RM 1.6 billion or 19 percent from 1999. The expansion in resources arose from the increase in deposits placed by an increase number of depositors.

The second major financial institution established in Malaysia was an Islamic bank. The first Islamic bank established in the country was Bank Islam Malaysia Berhad (BIMB) which commence operations on 1 July 1983. In line with its objectives, the banking activities of the bank are based on Shariah principles. After nearly two decades in operations, BIMB has proved to be a viable banking institution with its activity expanding rapidly throughout the country with a network of 82 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992. On 1 October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhad (BMMB) commenced operations. The establishment of BMMB was the effect of the spin-
off following the merger between Bank Bumiputra Malaysia Berhad and Bank of Commerce (Malaysia) Berhad.

At the time when Bank Islam Malaysia Berhad commenced operations in 1983, the government also introduced non-interest bearing certificates known as Government Investment Certificates (now replaced with Government Investment Issues) in July 1983 to enable Islamic bank to hold such liquid papers to meet the statutory liquidity requirements as well as to park its idle funds.

The third type of Islamic financial institution introduced in Malaysia was an Islamic insurance company namely Syarikat Takaful Malaysia Sendirian Berhad, which commenced operations in August 1985. The foundation for the development of Takaful or Islamic insurance was set by the wish of Muslims to realign more to Islamic practices in the economic activities coupled with the strong support from the government for Islamic financial services. In 1994, MNI Takaful Sdn. Bhd (which changed its name to Takaful Nasional Sdn. Bhd. on 19 November 1998) was established, to become the second Islamic insurance company in Malaysia. The company is a subsidiary of a conventional insurer licensed in the country.

An issue that often arises in discussion on the implementation of Islamic financial system is whether a step-by-step approach is desirable or a one-go approach is better. The Islamic financial system in Malaysia has been developed with a step-by-step approach is desirable or a one-go approach is better. The Islamic financial system in Malaysia has been developed with a step-by-step approach on a well planned and well thought out basis.

References