Chapter 4

Islamic Banking in Malaysia

4.1 Call for Establishment of Islamic Banking in Malaysia

It has been the desire of the Muslims in Malaysia to practice the rule of Shariah in the field of banking and credit operations. The establishment of an Islamic bank as a financial institution is a sacred duty which is mandatory for all Muslims who are capable of undertaking it. Following the establishment of a number of Islamic banks in other countries such as Dubai Islamic Bank (1975), Faisal Islamic Bank of Sudan (1977), Faisal Islamic Bank of Egypt (1978), Islamic Bank of Jordan (1978) and Islamic Bank of Bahrain (1979), among others, many parties had voiced their desire to establish such a bank in Malaysia.

The Bumiputra Economic Congress 1980 passed a resolution calling on the government to allow The Pilgrims Management and Fund Board (now called Pilgrims Fund Board) to establish an Islamic bank in Malaysia in order to mobilize and invest the funds of the Malays and the Muslims.

The issue of the establishment of Islamic banks was also tabled at the National Seminar on the Concept of Development in Islam, which was held at Universiti Kebangsaan Malaysia from 10-12 March 1981, and a resolution was passed requesting the government to take immediate action to have a legal Act to enable the setting up of banks and financial institutions whose operations would be based on Islamic principles. It was proposed that the Pilgrims Fund Board should provide banking services according to the principles of Islam. The desire to establish an Islamic bank was also voiced at the state level, where the governments of the States of Kelantan and Malacca issued statements indicating their desire to establish Islamic banks.
In line with the resolution of the Bumiputra Economic Congress 1980, the Pilgrims Fund Board undertook a study on the establishment of an Islamic bank in Malaysia. A number of important documents on Islamic banking were obtained, such as the Model Islamic Bank (MIB) prepared by the International Association of Islamic Banks, as well as materials on the operations of the Faisal Islamic Bank of Sudan and the Faisal Islamic Bank of Egypt. These documents formed part of the study materials for the establishment of an Islamic bank in Malaysia.

The issue of the establishment of an Islamic bank in Malaysia was also discussed at the meeting of the Financial Advisory Board of Pilgrims Fund Board. The Financial Advisory Board had a discussion on 10 July 1981 with the Study Group on Islamic Bank where the two parties agreed that a Steering Committee at the national level should be formed to study and make recommendations on the establishment of an Islamic bank in Malaysia. The government accepted the proposal by the Pilgrims Fund Board that the efforts towards the establishment of an Islamic bank should be coordinated at the national level, and a National Steering Committee on Islamic Bank was formed on 30 July 1981.

In carrying out its tasks, the committee used a number of reference materials, documents and models for the purpose of its detailed and in-depth study. The Committee used the MIB prepared by the International Association of Islamic Banks as a basic guide. The Committee also referred to the operations of the Faisal Islamic Bank of Sudan and the Faisal Islamic Bank of Egypt, and reference were also made to the report entitled "Memorandum on the Establishment of Islamic Bank for Malaysia" prepared by the Study Group on Islamic Bank and the report entitled " The Establishment of an Islamic Bank in Malaysia" prepared by Bank Negara Malaysia. The committee also referred to various books on the subjects of economics of Islamic banking and insurance. In addition to reviewing the religious, legal and banking operations aspects, the
National Steering Committee on Islamic Bank, in carrying out its tasks, also took into account the socio-economic conditions in Malaysia.

4.2 Concepts in Islamic Banking

The Islamic banking system shares similar functions as the conventional banking system. However, the former has to abide by the rules of the shariah. The shariah is an Islamic canon law, the rules and norms of which emanated from two primary sources – the Qur'an and the sunnah (the living tradition of Prophet Muhammad). Thus, the basic principles underlying Islamic transactions are the prohibition of riba and the sharing of profit and loss between a bank and its customers (Yakcop, 1996).

There are various concepts that can be applied in Islamic finance. However, the four main concepts are mudharabah, murabahah, musyarakah and wadiah (Bank Negara Malaysia, 1989).

4.2.1 Al-Mudharabah (profit-sharing)

This concept refers to an agreement made between a party, who provides the capital and another party (entrepreneur), to enable the entrepreneur to carry out business projects, which will be on a profit sharing basis, according to a pre-determined ratios agreed upon earlier. However, losses are borne solely by the provider of the funds.

4.2.2 Al-Murabahah (cost plus)

Al-Murabahah is the sale of goods at a price, which includes a profit margin as agreed to by both parties. Such sales contract is valid on the condition that the price, other costs and the profit margin of the seller are stated at the time of the agreement of sale.
4.2.3 Al-Musyarakah (joint venture)

Al-Musyarakah is a partnership or joint venture for a specific business with a profit motive, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, all parties involved will share the losses on the basis of their equity participation.

4.2.4 Al-Wadiah Yad Dhamanah (savings with guarantee)

Al-Wadiah is the deposit of goods or funds with another person, who is not the owner, for safekeeping. As wadiah is a trust, the depository becomes the guarantor, who guarantees the return of the whole amount of the deposits, or any part thereof, outstanding in the account of depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the depositors as a token of appreciation.

Other Islamic business concepts are:

4.2.5 Bai’ Bithaman Ajil (deferred payment sale)

The sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties.

4.2.6 Bai’ al-Dayn (debt trading)

The sale of debt to another party. Only documents evidencing real debts arising from bona fide commercial transactions can be traded.

4.2.7 Al-Ijarah Thumma al-Bai' (leasing and subsequently purchase)

Two contracts undertaken and subsequently purchased are as follows:

(a) Al-Ijarah contract (leasing/renting); and

(b) Al-Bai’ contract (purchase).

Under the ijarah contract, the hirer leases the goods from the owner at an agreed rental over a specified period. Upon expiry of the leasing period, the hirer enters
into a Bai’ contract to purchase the goods from the owner at an agreed upon price.

4.2.8 Al-Ijarah (leasing)

An arrangement under which the lessor leases equipment, building or other facility to a client at an agreed rental against a fixed charge, as agreed by both parties.

4.2.9 Al-Qardhul Hassan (benevolent loan)

A loan or debt extended which is absolutely free from interest. The borrower is only required to repay the principal amount borrowed, but he may pay an additional amount at his absolute discretion, as a token of appreciation.

4.2.10 Bai’ as-Salam (future delivery)

An agreement whereby payment is made immediately while the goods are delivered at an agreed later date. It is equivalent to an advance payment.

4.2.11 Bai’ Al-Istijrar (supply contract)

An agreement between the client and the supplier, where the supplier agrees to a supply a particular product on an on going basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment.

4.2.12 Al-Kafalah (guarantee)

A guarantee provided by a person to the owner of goods, who had placed or deposited his goods with a third party. The guarantor and the third party must meet any subsequent claim by the owner for his goods.

4.2.13 Ar-Rahnu (collateralised borrowing)

An arrangement where a valuable asset is placed as collateral for debt. The collateral may be disposed in the event of default.
4.2.14 Al-Wakalah (nominating another person to act)
A situation, where a person nominates or appoints another person to act on his behalf.

4.2.15 Al-Hiwalah (remittance)
Transfer of funds/debt from the depositor's/debtor's account to the receiver's/creditor's account where a commission may be charged for such service.

4.2.16 As-Sarf (foreign exchange)
As-Sarf refers to the buying and selling of foreign currencies.

4.2.17 Al-Ujr (fee)
The concept of Al-Ujr refers to commissions or fees charged for services.

4.2.18 Al-Hibah (gift)
Gifts awarded voluntarily in return for loan given.

4.2 Interest-free Banking Scheme/Islamic Banking Scheme

The long-term objective of BNM is to develop a comprehensive and vibrant Islamic banking system operating side-by-side with the conventional banking system. To achieve this objective, BNM has, over the last five years, introduced various measures to translate this objective into workable policies. Although Malaysia has already established an Islamic bank since 1983, the bank was not able to serve the entire needs of the population, especially since the operations of the Islamic bank were constrained by the limited number of branches and resources. Furthermore, a single Islamic bank does not constitute a banking system. An Islamic banking system requires a large number of dynamic and proactive players, a wide range of products and innovative instruments, and a vibrant Islamic money market. In addition to the above requirements, an Islamic
banking system must also reflect the socio-economic values of Islam. In other words, it must be Islamic both in form and substance.

In order to realise this objective, BNM had gradually implemented measures to provide the necessary infrastructure by optimizing available resources. The first step 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 Skim Perbankan Tanpa Faedah (SPTF) or Interest-free Banking Scheme in March 1993. The scheme 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 (Bank Negara Malaysia, 1999). Following the successful implementation of the pilot implementation of the pilot-run, BNM opened the scheme to the commercial banks, finance companies and merchant banks in July 1993 subject to specific guidelines issued by the central bank.

Although the participation of the banking institutions are voluntary, they have to observe the requirements of the scheme, such as to establish an Islamic Banking Unit (IBU) to be headed by a senior Muslim banker, to create an Islamic Banking Fund (IBF) with minimum allocation of RM1 million, to open separate current/clearing accounts for Islamic banking operations with BNM to register as Indirect Members under the wholesale payments system, SPEEDS (now RENTAS) and observe a separate cheque clearing system for Islamic Banking (Bank Negara Malaysia, 1999). The bank is also required to maintain separate general ledger for its Islamic banking operations. These requirements will ensure that the banks do not commingle the funds freely without proper internal controls. The banks are also encouraged to appoint at least a Shariah consultant to advise on the day-to-day operations of its Islamic banking division. From only three banks in March 1993, the number of participating banking institutions increased significantly to 49 as at end 2000, comprising 2 Islamic banks, 21 commercial
banks, 14 finance companies, 5 merchant banks and 7 discount houses (Bank Negara Malaysia Annual Report, 2000).

In 1988, as part of the overall review on Islamic banking, the usage of the term SPTF was revisited and it was found that the term did not portray the right appearance with respect to the Islamic banking operations undertaken by the banks. Thus, BNM replaced the SPTF with Skim Perbankan Islam or Islamic Banking Scheme (IBS) with effect from 1 December 1998. BNM also observed that the Islamic banking operations of the SPI was regarded as low hierarchy business, being manned by middle-level management, while the IBU was given limited functions to perform its duties and responsibilities effectively. As part of the on-going efforts to promote Islamic banking further, the existing organization structure, scope and responsibilities of the IBU was reviewed and enhanced further by introducing a new framework to replace the existing IBU. Among the salient features of the new framework are as follows (Bank Negara Malaysia, 1999): -

(a) Effective 2 January 1999, IBU was up-graded to an Islamic Banking Division (IBD) will be the one-stop centre responsible on all aspects of Islamic banking operations such as retail banking, commercial banking, corporate banking, trade/international banking, treasury operations, corporate planning and branch operations. This includes product development, marketing, processing, and approving limits, branches supervision and credit control;

(b) The IBD is also required to prepare a strategic plan to chart the future direction of Islamic banking in the banking institution on medium term basis;

(c) The IBD is expected to have a constructive working relationship with other departments/divisions and should be provided with the
necessary support from the departments/divisions in ensuring smooth implementation of Islamic banking operations, particularly in areas where the same infrastructure is being shared;

(d) The IBD should be proficient in applying accounting standards (including Islamic banking accounting standards), legal and regulatory requirements, directives and guidelines issued by BNM and other authorities, including rules and regulations issued by the relevant banking associations;

(e) As a division which operates like a "bank within a bank" the level of resources should be justified to commensurate with the expected cost and profitability of the IBD, with a minimum staff requirement of at least nine officers; and

(f) The IBD shall be headed by a Muslim senior management officer of the bank, at least the level of the Assistant General Manager (AGM). The position of the AGM should be equivalent to the status of other key functional heads to enable him to deal effectively with his peers and superiors when discharging his duties and responsibilities. Importantly, the AGM should be functionally responsible to the Chief Executive Officer (CEO). Initially, the AGM is allowed to carry out banking duties and responsibilities other than Islamic banking during an interim period of two years (1999-2000). With effect from 1 January 2001, the AGM shall perform his duties and responsibilities with regard to Islamic banking on a full-time basis.

In tandem with the enhancement of the IBU, the IBF of the commercial banks and finance companies were increased from RM1 million to RM5 million and RM3 million for the merchant banks effective 2 January 1999. By 1 January
2001, the IBF for the commercial bank and the finance companies will be further increased to RM20 million and RM 10 million respectively, and RM6 million for the merchant banks.

4.4 Performance Target

As part of the measure to gauge the commitment and performance of Islamic banking operators, in December 1995, BNM set a target to be achieved by the Islamic banking industry during a period of 5 years. Under this measure, BNM established a policy that by the end of year 2000, the Islamic banking operations, in terms of deposits and financing, must constitute at least 5% of the total banking system. The target was reviewed in 1998 by replacing the target from an industry-wide target to individual banks' target. With these changes, by the end of year 2000, the Islamic banking operations of each IBS banks have constituted 6.9% of the total banking operations of the bank.

4.5 Payment System

Before the establishment of Islamic Banking, Malaysia already has a reliable payment, clearing and settlement system that ensures the process of settling monetary transactions can be completed efficiently. However, the main issue is the segregation of Islamic funds from the conventional one. Participating banks must ensure that their Islamic funds must not be blend together with conventional funds that contain interest. Hence, the central bank has made a requirement for all participating banks to maintain a separate current and clearing accounts with the central bank. The purpose of this requirement is to prohibit participating banks from putting the Islamic and conventional funds into the same account and also preventing wrongful accounting entries by the banks. Hence, participating banks must have two separate accounts, i.e. the conventional account and the Islamic account. There is also a separate account to be maintained with the central bank for fund transfer and payments.
4.6 Financial Disclosure for Islamic Banking System

Since the inception of the IBS in 1993, BNM has made it mandatory for the Islamic banking operations of the IBS to be segregated from the conventional banking operations. These segregation procedures, coupled with the internal separation of the accounting books of each IBS Islamic banking operation have made it possible for the SPI banks to disclose a true and fair value of Islamic banking operations during its financial year. Given the depositors in Islamic banking also assume the role as investor as far as Mudharabah deposits are concerned (BIMB, 1994), it makes sense that they should be informed on the performance of Islamic banking operations undertaken by the SPI banks. In October 1996, BNM issued the Specimen Financial Statements known as Garispaduan 8 (GP8) to prescribe the minimum standards on the disclosure of IBS banking operations. Under the GP8, the disclosure of Islamic banking operations would constitute a special section in the Notes to the Accounts of the principal financial statements. The Notes to the Accounts would have a dedicated section showing the balance sheet and the profit and loss of Islamic banking operations of the IBS operations.

4.7 Association of Islamic Banking Institutions Malaysia

The Association of Islamic Banking Institutions Malaysia (AIBIM) was established in June 1995 with the objective to promote the establishment of sound Islamic banking system with best practices in co-operation and consultation with BNM and other regulatory bodies (BNM, 1999). AIBIM comprises the Islamic banks, IBS banks as its ordinary members and non-banking financial intermediaries and related organisations involved in Islamic banking and finance as associate members.
4.8 National Shariah Advisory Council

One of the requirements that Islamic banks under the Islamic Banking Act 1983 have to comply with was the establishment of a Shariah advisory body. For the SPI banks, they are required to appoint at least a Shariah consultant to assist the banks on any Shariah operational issues, as stipulated in the Guidelines on SPI. BNM has also allowed institutions in the same banking group (commercial banks, finance companies, merchant banks, discount houses) to maintain only a single Shariah consultant(s) to minimize duplication of resources. Although the inclusion of Shariah scholars in Islamic banking operations had its advantages, BNM also noted that there exist some differences in opinion among Shariah consultants on similar issues which may impede the creation of a sound and healthy Islamic banking system. To resolve this issue, the government established the National Shariah Advisory Council (NSAC) for Islamic Banking and Takaful in May 1997 at BNM as the highest Shariah authority on Islamic banking and takaful. Among the primary objectives of the NSAC are to act as the sole authoritative body to advise BNM on Islamic banking, to co-ordinate Shariah issues on Islamic banking and finance, and to analyse and evaluate Shariah aspects of new products/schemes submitted by the banking institutions. The NSAC has a maximum of 11 members and is appointed by the BNM Board of Directors to serve for a period of two years. The full list of the NSAC members is attached as Appendix 4.

4.9 Second Islamic Bank

An important event in Islamic banking during 1999 was the setting-up of the second Islamic bank in Malaysia, namely Bank Muamalat Malaysia Berhad (BMMB). The establishment of BMMB arose from the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (M) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were
transferred to BMMB, while the conventional operations of BBMB, BOCB AND BBMBK were transferred to BOCB. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia with a staff workforce of 1,000. The bank commenced operations on 1 October 1999. The setting-up of the second Islamic bank is expected to play a key role towards fostering an active and progressive Islamic banking system (Bank Negara Malaysia Annual Report, 1999).

4.10 Summary

Islamic banking is a very young concept. Yet it has already been implemented as the only system in two Muslim countries; there are Islamic banks in many Muslim countries, and a few in non-Muslim countries as well. Despite the successful acceptance there are problems. These problems are mainly in the area of financing.

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome, burdensome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. All the necessary ingredients are already there. The modified system will make use of only two forms of financing — loans with a service charge and Mudharabah participatory financing — both of which are fully accepted by all Muslim writers on the subject.

Such a system will offer an effective banking system where Islamic banking is obligatory and a powerful alternative to conventional banking where both co-exist. Additionally, such a system will have no problem in obtaining authorization to operate in non-Muslim countries.

Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects.
This is an additional service Islamic banks offer over and above the traditional services provided by conventional commercial banks.

Since the establishment of first Islamic Banking in 1983, various measures were carried out by BNM to further strengthen the operation of Islamic banking. There were more players in the Islamic financial system during this period and BNM need to regulate and also resolve any new or complicated issues by the participating financial institutions in relation to Islamic banking. BNM then felt that it needs to provide a conducive infrastructure for the development of Islamic banking in the country. Among various measures taken by BNM was the establishment of Interest-free Banking Scheme/Islamic Banking Scheme, performance target, payment system, financial disclosure for Islamic Banking system, Association of Islamic Banking Institutions Malaysia, National Shariah Advisory Council and second Islamic Bank.

References:


