Chapter 2

Overview of Islamic Banking in Malaysia

2.1 Introduction

This chapter looks into the more recent development of Islamic banking in Malaysia. While the earlier historical facts have not been neglected, the thrust is on the growth and development of the sector in the last ten years, or so. As for the period before that, many researchers have elaborated on it in detail, such as Man (1988), Kader (1993) and Yakcop (1996).

This study, and in particular this chapter, will focus instead on the growth and expansion of the Islamic banking system in Malaysia during the late 1990s and beyond, as well as how the new rulings by BNM during the period have affected the system. It is interesting to note that during this period BNM introduced a number of new measures to boost and improve the status of Islamic banking.

Among the new policies is the introduction of Skim Perbankan Islam (SPI) or Islamic Banking Scheme (IBS) to replace the Skim Perbankan Tanpa Faedah (SPTF) or Interest Free Banking Scheme (IFBS). This change brings many implications, particularly to the non-Islamic Banks[12] participating in the scheme. One of them is that the banks are now required to upgrade its Islamic Banking Unit to a broader and more significant Islamic Banking Division. The Division, in turn, must be led by a senior officer at the same level of the Assistant General Manager[13], instead of a mere Head of Unit as before.

During this period, BNM also launched several campaigns aiming at creating and enhancing public awareness of Islamic banking. The most recent was the Islamic

12 Refers to the financial institutions other than Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad.
13 This Manager/Head of IBD reports directly to the CEO of the bank.

Banking & Takaful Week, which took place in October/November 2001. In the same spirit, BNM has also set a new target for SPI participants concerning Islamic banking operations. In December 1995, BNM set a target to be achieved by the Islamic banking industry during a period of five years. Under this measure, the Islamic banking operations must constitute at least 5% of the total banking system by the end of 2000. Hence, by the end of 2000, the Islamic banking operations of each SPI banks is expected to constitute at least 5% of the total banking operations of the bank.[14]

In the Financial Sector Master Plan 2001, BNM has set a 20% target to be achieved by 2010, in terms of the market share of Islamic banking assets relative to the total banking system[15]. This targeting is important since Islamic banking currently constitutes 6.9% and 7.4% of overall banking operations in the country, in terms of assets and deposits respectively. As for financing, the share of Islamic banking is still very modest at 5.3%.[16] This target is neither impossible nor unreasonable, although only a handful of SPI banks managed to achieve the target in 2000, including OCBC[17]. With the new public awareness and the introduction of new and more sophisticated products, Islamic banking is poised to grow.

It is also during the 1990s that the banking sector in Asia, and Malaysia in particular, suffered a meltdown. Ong (1999) quoted as saying that the non-performing loans (NPLs) of the banking sector exceeded RM25 billion, or 4.1% of total loans at the end of 1997. In addition, "between 2 July and 31 December 1997 the exchange rate of the ringgit depreciated by over 35 percent against the U.S. dollar and there were serious indication of capital flight...more than RM25 billion went over to Singapore where foreign banks reportedly offered deposit rates of 20-40 percent per

[14] BNM (2000), *The Central Bank and the Financial System in Malaysia.* Pg. 249.
[15] BNM (2002). *Annual Report 2001*
[16] BNM (2001). *Annual Report 2000.*
[17] Interview.

annum".[18] These are the situations that the Islamic banking has to face, and we will find later how did it fare amidst these calamities and uncertainties.

2.2 Expansion of the Islamic banking

Since its inception, Islamic banking in Malaysia has been growing steadily over the years. The number of banks[19] offering Islamic banking products and services has increased from a mere 3 in 1993 to almost 25 at the end 2000. This does not include the Islamic banks, finance companies and discount houses that add up the figure to about 45 institutions. However, with the restructuring process of the banking sector underway and the minimization of banks to only 10 (anchor) banks, this figure might change a little. However, the number of banks offering Islamic banking would not matter much, whether it is 10 or more, since it is basically the same in terms size of assets. What more, the restructuring process is part of long-term macro strategy to make banking industry more resilient and sustainable in the wake of global competition. However, other indicators of banking expansion would remain strong and robust, among which, is total assets.

In terms of total assets, Islamic banking has grown from a modest RM0.37 billion in 1983 to a whopping RM46.87 billion in 2000, or increased by more than 12,000%, or growing about 39% annually. During the 1990s itself, that is from 1991 to 2000, total assets grew even faster at about 47% per annum. In fact, when SPTF was introduced in 1993, total assets grew at a phenomenal 143% during 1993-94.[20]

---

[18] See Ong Hong Cheong (1999). *Evolution of the Malaysian Financial System beyond the Financial Crisis*".

[19] In this study, banks generally refer to Commercial Banks. Likewise, Islamic Banks refer to Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad. Finance Companies, Merchant Banks and Discount Houses are not included in the analysis.

[20] Based on BNM Annual Reports, and website.

What is interesting, however, is the participation of some foreign banks in Malaysia. To date, only four of them are actively involved in the IBS or SPI[21]. They are Citibank, HSBC, OCBC and SCBMB. These banks, pioneered by SCBMB, started Islamic banking in a very modest way, in fact it seemed that they were not really interested to open Islamic windows. This is evident from the deposits collected and number of products offered[22]. But after more than a decade of handsome growth, the hesitation has transformed into enthusiasm.

2.3 Introduction of new policies by BNM

During the 1990s, BNM introduced a number of measures in its attempt to improve and to invigorate Islamic banking in the country. The most important is the upgrading of Islamic banking operations at the conventional banks, including foreign banks. This promotion gave more authority as well as depth in Islamic banking operations, where the Islamic Banking Unit is now being replaced by a broader and higher-profile Islamic Banking Division.

In line with this change, the famous SPTF has been replaced by the bolder SPI, a change that reflects the more significant contribution of Islamic Banking to the financial sector in general.

The details of some significant measures taken by BNM can be observed below[23]:

i. Effective 1 December 1998, the term "Interest-free Banking" was replaced by "Islamic Banking" and banking institutions were required to

[21] Although it is more proper to continue using IBS throughout, but sometimes it is more convenient to use SPI - as it is more widely used. Thus, both IBS and SPI will be used interchangeably.
[22] This will be further elaborated and demonstrated later.
[23] BNM Annual Reports: 1998, 1999 and 2000.

use this term in all their Islamic banking operations, transactions and correspondence;

ii. From 2 January 1999, all banking institutions participating in the Islamic Banking Scheme are required to upgrade their Islamic Banking Unit to Islamic Banking Division, which are required to offer all aspects of Islamic banking, including banking services and administration;

iii. Effective from 2 January 1999, the minimum funds of Islamic banking was raised from RM1 million to:

   a) RM5 million for commercial banks, which will gradually be increased to RM20 million by 31 December 2000;

   b) RM5 million for finance companies, which will gradually be increased to RM10 million by 31 December 2000;

   c) RM3 million for merchant banks, which will gradually be increased to RM6 million by 31 December 2000.

iv. From 4 January 1999, discount houses are permitted to participate in the Islamic Banking Scheme;

v. From 12 November 1998, IBS participants were allowed to accept funds of less than one-month maturity from non-interbank customers. However, the funds received through the repos were to be utilised solely for Islamic banking purposes. Previously, only principal dealers were granted this privilege.

vi. On 8 December 1998, BNM issued guidelines on Islamic Negotiable Instruments for two new deposit-taking products based on Islamic principles, namely Negotiable Islamic Debt Certificate based on BBA and Islamic Negotiable Instruments of Deposits based on al-Mudharabah.

vii. Islamic banking institutions were allowed to offer Islamic floating-rate financing products subject to approval by BNM. This is to enable the Islamic banking institutions to mitigate risks arising from asset and liability mismatches more effectively as well as to stimulate product innovation in the industry;

viii. Amendments were made to the Guidelines on Islamic Negotiable Instruments (INI) in terms of pricing, issuance specification, maturity structure and standardization of market practices. These amendments would accord flexibility to Islamic banking institutions to structure the INI to meet their funding requirements as well as to fulfil diverse customer needs more effectively. It will also increase the supply of longer maturity Islamic financial instruments in the Islamic interbank money market (IIMM) and instil confidence among the players by promoting standard market practices; and

ix. IBS commercial banks were allowed to offer Islamic leasing facility under the concept of Al-Ijarah Thumma Al-Bai, subject to the condition that the leasing facility is for financing industrial and heavy machinery equipment costing more than RM200,000.

x. A target set by BNM for each IBS banking institutions was the attainment of at least 5% of Islamic banking business in terms of assets, deposits and financing relative to total banking business of each IBS banking institutions by the end of year 2000. As at end-December 2000, five commercial banks, six finance companies and two merchant banks achieved the target for all the three specified components.

Above all, the most remarkable initiative taken by BNM is the launching of Financial Sector Master Plan in March 2001. This master plan includes various strategies by BNM to ensure "that Islamic Banking will not only play a more important role in the development on the Malaysian financial system, but also that its development addresses the consumer needs in Malaysia and the region"[24] The plan incorporated the 10-year master plan for Islamic Banking and Takaful. The overall objective is "to create an efficient, progressive and comprehensive Islamic financial system and to promote Malaysia as a regional financial centre for Islamic banking and finance."[25]

The plan also laid out a target for Islamic banking to capture at least 20% of the banking market share by 2010. This target is implemented, in a way, by calling SPI participants to gradually increase the portion of Islamic banking in their overall banking operations, i.e. 5% for 2000 and 8% for 2001. Many SPI institutions are now aiming hard to reach the target. As for foreign banks, only OCBC had so far reached the target in deposit takings since 2000. The other two are close behind, though, and based on their records, they may be able to catch up soon.[26]

2.4 Islamic banking during Asian Crisis 1997-98

Many studies have provided detailed and comprehensive accounts on the Asian Crisis in the late 1990s. This research focuses on some key factors that severely affected the financial system of the crisis countries, particularly Malaysia. In relation to this, the thrust will also put on the impact of the crisis onto the Islamic banking system.

Delhaise (1998) suggested, "the main reason why the (conventional) banking systems are so weak lies in the quality of financial management. Most commercial banks of Asia are run like pawnshops. Proper credit culture, meaning lending upon

---

24 BNM, *Annual Report 2000.* Pg.34
25 *Ibid.*
26 Details on this will be elaborated in Chapter 4.

the basis of reasoned credit and cash flow analysis, is minimal. Rather collateral is king, and the primary factor in the lending decision. The other reason is the relationship between bank and customer. At best, the focus on relationship results in "name lending", or making credit decision primarily on the basis of the bank officer's assumed knowledge of the customer in question. At its worst, name lending deteriorates into related party lending and crony capitalism. Under such circumstances, depositors and minority shareholders tend to get short shrift. Bank owners milk deposits, friends of friends of the well connected get loans and creative accounting become an art form".[27]

Delhaise further contended that the (conventional) banking systems of the crisis countries[28] "would have met their fate at one point in time, regardless of the crisis that, by contagion, hit them at the same time in 1997". This is due to the fact that majority of Asia's banking system operate with "abysmally low real capital ratios, so much so that a large proportion of the banks are theoretically bankrupt".[29]

On the other hand, Islamic banking was not severely affected by the crisis. In fact, it was doing relatively well during this period. It was reported in the BNM Annual Report 1998, that the Islamic Banking Scheme received a large migration of customers' deposits from conventional banks to the Islamic banking system. This was partly due to a better investment deposit rates offered by the Islamic banking.

However, BNM also reported that there were some setbacks in the Islamic banking sector during this period. Firstly, in 1998, profit before taxation and zakat of the Islamic banking were down by 3.3% to RM148 million. Secondly, the expansion in total financing was also small in 1998, due mainly to a decline of 1.4% in the first semester. Nevertheless, lending to property sector remained high, at 41.7% of total

---

[27] Delhaise (1998). *Asia in Crisis: The Implosion of the Banking and finance Systems* .Pg. 2.
[28] Namely Korea, Thailand, Indonesia, Malaysia and Philippines.
[29] Delhaise (1998). *Ibid.* Pg. 8.

financing. This buoyant demand for property financing was partly attributed to the fixed-rate nature of Islamic financing, mainly BBA.

Further, "the contraction in economic activity in 1998 was also reflected in lower financing activities of the Islamic banking sector. The financing-deposit ratio declined from 104.1% as at the end of 1997 to 64.9% as at end-1998. The excess deposits were mainly invested in the Islamic money market."[30]

2.5 Conclusion

Islamic banking in Malaysia has been growing steadily over the years, since its inception in 1983. From just one institution, Islamic banking is now a full-fledged financial system at par with that of conventional system. Not only its growth is phenomenal, the performance of Islamic banking is thus far also impressive. During the Asian crisis, Islamic banking stood solid and unscarred by the attack of the much-talked financial sector failures.

This is one of the reason why there are so many financial institutions joining the ride of Islamic banking worldwide, especially those institutions hitherto foreign to Islamic finance. These institutions are not only big players, but also global institutions with networking or branches in all parts of the world. In short, these are mainstream institutions. To name a few, Citibank, HSBC, Standard Chartered and ANZ, are among the most active converts to Islamic finance.

In the Malaysian case, the role of BNM cannot be underestimated. It is partly because of BNM's market friendly policies that attract many conventional banks and other financial institutions, foreign and local, to embrace Islamic finance.

[30] BNM, *Annual Report 1998*. Pg. 162-3.