

## CHAPTER TWO

### AN OVERVIEW OF ISLAMIC BANKING IN MALAYSIA

#### 2.1 Introduction

The principles, operations, and activities of the Islamic banking system are all patterned on the Shari'a law. Islamic banks have spread in many Muslim and non-Muslim countries, which has attracted several researchers and scholars from all aspects, including religious, social, and political fields. Islamic banks have become increasingly popular as more Muslims believe in the prohibition of interest, and represent the financial market and the banking sector from the supply side, with their huge financial surpluses, or from the demand side, as consumers of financial and banking services.

The Islamic banking industry has introduced the idea of directing savings into various channels of Islamic investment packages, such as Murabahah, Musharaka and Mudharabah, to the possibility of conducting banking operations via new methods that are far from the loan process. Islamic banks are important in the comprehensive development process by attracting funds for various financial activities.

Islamic countries are concerned by certain provisions in Islamic law that discredits the benefits of banking. To overcome such provisions, Islamic banks are established as practical alternatives to prevent the majority of Muslims from addressing interest-oriented conventional banks.

Islamic banks have gained universal acceptance as they are now looked upon as viable alternative banking systems. More than 300 Islamic financial institutions can be found in more than 75 countries worldwide, with Bahrain and Malaysia as their central hubs (Noor and Ahmad, 2012).

## 2.2 Why Islamic Banking?

The dealing in *riba* is the basis upon which the conventional banks operate and avoiding *riba* in financial dealings is the most important justification for the Islamic banks to function, and further attract the Muslim masses. Islamic banking is the banking activity that is consistent with the principles of Shari'a law and its practical application. Shari'a prohibits the acceptance of interest (*riba* or usury) for money-lending. Islam prohibits interest but allows profit. Muslim scholars agree that in Islam the prohibition of *riba* is total and absolute. The verdict makes no distinction between usury and interest, between its simple and compound forms, between productive and unproductive loans, or for that matter between money and commodity borrowings (Hasan, 2008). The prohibition of *riba* is revealed in the Quran and has appeared in several revelations <sup>1</sup>.

The first revelation is in *Surah ar-Ruum*, whereby Allah Subhanahu wa ta'ala dictates:

وَمَا آتَيْتُمْ مِّن رَّبًّا لِّيَرْبُو فِي أَمْوَالِ النَّاسِ فَلَا يَرْبُو عِنْدَ اللَّهِ وَمَا آتَيْتُم مِّن زَكَاةٍ تُرِيدُونَ وَجْهَ اللَّهِ فَأُولَٰئِكَ هُمُ  
الْمُضْعِفُونَ

(Al- Quran. Ar-Ruum 30: 39)

The Meaning of this verse: *That which you lay out for increase through the property of (other) people, will have no increase with Allah; but that which ye lay out for charity, seeking the Countenance of Allah, (will increase): it is these who will get a recompense multiplied.*

The second revelation is in *Surah an-Nisaa*, when Allah Subhanahu wa ta'ala dictates:

فَبُظِّلِم مِّنَ الَّذِينَ هَادُوا حَرَمْنَا عَلَيْهِمْ طَيِّبَاتٍ أُحِلَّت لَهُمْ وَبِصَدِّهِمْ عَنِ سَبِيلِ اللَّهِ كَثِيرًا. وَأَخَذِهِمُ الرِّبَا وَقَدْ نُهُوا عَنْهُ  
وَأَكْلِهِمْ أَمْوَالِ النَّاسِ بِالْبَاطِلِ وَأَعْتَدْنَا لِلْكَافِرِينَ مِنْهُمْ عَذَابًا أَلِيمًا

(Al- Quran. An-Nisaa 4: 160-161)

The Meaning of this verse: *For the iniquity of the Jews We made unlawful for them certain (foods) good and wholesome which had been lawful for them- in that they*

<sup>1</sup> All Quranic translations in this writing are based on Abdullah Yusuf Ali. 2009. The Holy Qur'an, Text and translation.

*hindered many from Allah's Way- That they took usury, though they were forbidden; and that they devoured men's substance wrongfully- we have prepared for those among them who reject faith a grievous punishment.*

The third revelation is in *Surah Ali Imran*, Allah Subhanahu wa ta'ala says:

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُضَاعَفَةً وَاتَّقُوا اللَّهَ لَعَلَّكُمْ تُفْلِحُونَ

(Al- Quran Ali. Imran 3: 130)

The Meaning of this verse: *O you who believe! Devour not usury, doubled and multiplied; but fear Allah that you may (really) prosper.*

The fourth revelation is in *Surah al-Baqarah*, Allah Subhanahu wa ta'ala says:

الَّذِينَ يَأْكُلُونَ الرِّبَا لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ الَّذِي يَتَخَبَّطُهُ الشَّيْطَانُ مِنَ الْمَسِّ ذَلِكَ بِأَنَّهُمْ قَالُوا إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا فَمَنْ جَاءَهُ مَوْعِظَةٌ مِّن رَّبِّهِ فَانْتَهَى فَلَهُ مَا سَلَفَ وَأَمْرُهُ إِلَى اللَّهِ وَمَنْ عَادَ فَأُولَئِكَ أَصْحَابُ النَّارِ هُمْ فِيهَا خَالِدُونَ. يَمْحَقُ اللَّهُ الرِّبَا وَيُرِي الصَّدَقَاتِ وَاللَّهُ لَا يُحِبُّ كُلَّ كَفَّارٍ أَثِيمٍ. إِنَّ الَّذِينَ آمَنُوا وَعَمِلُوا الصَّالِحَاتِ وَأَقَامُوا الصَّلَاةَ وَآتَوُا الزَّكَاةَ لَهُمْ أَجْرُهُمْ رَبِّهِمْ وَلَا خَوْفٌ عَلَيْهِمْ وَلَا هُمْ يَحْزَنُونَ. يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا غَدًا إِن كُنْتُمْ مُؤْمِنِينَ. فَإِن لَّمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِّنَ اللَّهِ وَرَسُولِهِ وَإِن تُبْتِغُوا فَلَئِمَّ رُؤُوسُ أَمْوَالِكُمْ لَآ تَطْلُمُونَ وَلَا تَظْلُمُونَ. وَإِن كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ وَأَن تَصَدَّقُوا خَيْرٌ لَّكُمْ إِن كُنْتُمْ تَعْلَمُونَ

(Al- Quran. Al-Baqarah 2: 275-280)

The Meaning of this verse: *Those who devour usury will not stand except as stand one whom the Evil one by his touch hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever). Allah will deprive usury of all blessings, but will give increase for deeds of charity: For He loveth not creatures ungrateful and wicked. Those who believe, and do deeds of righteousness, and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve. O you who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If you do it not, take*

*notice of war from Allah and His Messenger. But if ye turn back, ye shall have your capital sums: Deal not unjustly, and ye shall not be dealt with unjustly. If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew.*

The above verses strongly prohibit banks or Muslims from taking *riba* (interest). The principle is that any profit that banks seek to gain from taking an interest is prohibited. Thus, Islamic financial products and services are offered by Islamic banks based on various Islamic concepts such as Mudarabah, Musharaka, Murabahah, Bai Bithamam Ajil to be a range of alternatives for loans and interest-oriented financial packages.

### **2.3 Definition of Islamic Banking**

Islamic bank is a deposit-based banking institution which scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liability side, it mobilizes funds based on *Mudharabah* and other Islamic operations. It can also accept demand deposits which are treated as interest-free loans from the clients of the bank, and which are guaranteed. On the asset side, it advances funds on a profit and loss sharing or financing basis, in accordance with the Shari'a (Islamic law). It plays the role of an investment manager for the owners of the time deposits, usually called investment deposits, as well as commodity and asset trading that constitute an integral part of Islamic banking operations (Al-Jarhi and Iqbal, 2001). Al Manaseer (2007) defines Islamic bank as a company which main business is to mobilize funds from savers and supply these funds to businesspersons (entrepreneurs). It is organized as a joint stock company with the shareholders supplying the initial capital. It is managed by the shareholders through their representatives on the board of directors.

The Islamic bank operates in accordance with Shari'a law and is guided by Islamic economic principles. In particular, the Islamic law prohibits the collection and payment of interests (usury) on the loans and deposits of the bank (Fatai, 2012).

## 2.4 History and Development of Islamic Banking in Malaysia

Malaysia has emerged as the first country to implement a dual banking system where the Islamic banking system operates side-by-side with the conventional banking system (Yusoff, 2004). The dual financial system has proven to be viable as more competitive and sophisticated Islamic financial products have been introduced into the Islamic banking industry, and have gained popularity and even preferred by the customers (Muda & Jalil 2007). The Malaysian model has been recognized by many Islamic countries as the model of the future and many countries have shown interest in adopting this system (Mokhtar *et al.*, 2006). In 2010, there were a total of seventeen Islamic banking institutions (see Table 2.1). These Islamic banks are part of the Malaysian Islamic financial system which has grown very rapidly and those subsequently names Malaysia the center for Islamic banking.

The establishment of Islamic banking in Malaysia can be traced back to 1963 when *Tabung Haji* (the Pilgrims Management and Fund Board) was established by the government. The institution was established to invest the savings of the local Muslims in interest-free places, want to save up to perform Hajj. *Tabung Haji* utilizes Mudharabah (profit and loss sharing), Musharaka (joint venture) and Ijara (leasing) modes of financing for investment under the guidance of the National Fatwa Committee of Malaysia. Based on the experiences of *Tabung Haji*, the government of Malaysia then introduced a well-coordinated and systematic process of implementing the Islamic financial system (Mokhtar *et al.*, 2006). Furthermore, to this end, the first call for a separate Islamic bank was made in 1980, in a seminar held at the National University of Malaysia. The participants passed a resolution requesting the government to pass a special law for the setting up of an Islamic bank in the country. Responding to the request, the government had found a National Steering Committee in 1981 to study legal, religious and operational aspects of the setting up of an Islamic bank.

In order to pave the way for this financial turning point, (the Islamic Banking Act 1983) was gazetted and had been brought into effect on 7 April 1983. This Act outlines the rules which must conform to Islamic banks that wish to operate in Malaysia, as well as entrusting the powers of the Central Bank of Malaysia in

supervising and regulating Islamic banks in Malaysia. At the same time, the government also passed the Government Investment Act 1983 to empower the Government to issue Government Investment certificates based on Shari'a principles (Haron and Azami, 2009).

The first Islamic bank to operate in Malaysia was Bank Islam Malaysia Berhad (BIMB), which was incorporated under the companies Act 1965 on March 1983 and which had commenced operations on 1st July of the same year. The important underlying force that led to the establishment of this Islamic bank in Malaysia was the elimination of interest-oriented *riba* (Abdul Hamid and Azmi, 2011). BIMB offers the products and services that have been available at conventional banks which are consistent with the Shari'a principles. BIMB also has subsidiaries which operations are based on the Shari'a principles. BIMB was listed on the Main Board of Kuala Lumpur Stock Exchange on 17th January 1992 (Haron and Azami, 2009).

The long-term objective of the Central Bank of Malaysia was to create Islamic banking system operations which are parallel to those of the conventional banking system. A single Islamic bank (BIMB) does not represent the whole financial system. It requires a large number of pro-active players, a wide range of products and innovative instruments, and a vibrant Islamic money market. Realizing the situation, the Central Bank introduced the Interest Free Banking Scheme (now replaced with the Islamic Banking Scheme (IBS) in March (1993). The scheme allowed conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including their staff and branches.

In March 1993, Bank Negara Malaysia (BNM) launched a scheme known as "Interest-free Banking Scheme". Through this scheme, financial institutions are allowed to offer Islamic banking products and services. The pilot phase of this scheme involved the three largest commercial banks in Malaysia and the second phase involved ten more financial institutions to join the scheme.

In October 1996, the BNM issued a model of financial statement for the IBS banks requiring them to disclose their Islamic banking operations (balance sheet and profit and loss account) as an additional item under the notes to the accounts. In order to

further strengthen the development of the Islamic banking system in Malaysia; the BNM established the National Shari'a Advisory Council (NSAC) on Islamic Banking and Takaful on 1 May 1997. The council is regarded as the highest Shari'a authority on Islamic banking and Takaful businesses in the country.

On 1<sup>st</sup> October 1999 the BNM issued a license for the second Malaysian Islamic bank namely Bank Muamalat Malaysia Berhad. This second full-fledged Islamic bank was established as a result of the merging between Bank Bumiputra Malaysia Berhad and Bank of Commerce (M) Berhad.

In line with the aim to expand and liberate the Islamic banking industry in Malaysia, in 2004 the BNM approved the applications of three new full-fledged foreign Islamic banks that were given the licenses to operate in Malaysia, namely Kuwait Finance House, Al-Rajhi Banking & Investment Corporation and the consortium led by Qatar Islamic Bank (Mokhtar *et al.*, 2006).

Concurrent with the progressive liberalization of the Islamic banking industry and the recommendations made under the Financial Sector Master Plan (FSMP) to further strengthen the institutional structure of the banking institutions participating in the Islamic banking system, the BNM had approved the Islamic subsidiary structure to replace the Islamic windows scheme (IBS). Hence, the seven domestic banking groups were allowed to transform their current Islamic window into an Islamic subsidiary within their respective banking groups. However, this transformation was not made mandatory (Haron and Azmi, 2009).

Currently, the Islamic banks in Malaysia comprise of domestic full-fledged Islamic banks, foreign full-fledged Islamic banks and the Islamic banking subsidiary. There are currently two full-fledged domestic Islamic banks operating in Malaysia, Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad. There are also six foreign Islamic banks and nine Islamic subsidiary banks (BNM, 2010).

**Table 2.1 List of Islamic Banks in Malaysia**

Number	Banks
<b>1</b>	<b>Domestic Full-fledged Islamic banks:</b>
1-1	Bank Islam Malaysia Berhad
1-2	Bank Muamalat Malaysia Berhad
<b>2</b>	<b>Domestic subsidiary Islamic banks:</b>
2-1	RHB Islamic Bank Berhad
2-2	Hong Leong Islamic Banking Berhad
2-3	CIMB Islamic Bank Berhad
2-4	AmIslamic Bank Berhad
2-5	Affin Islamic Bank Berhad
2-6	EONCAP Islamic Bank Berhad
2-7	Alliance Islamic Bank Berhad
2-8	Maybank Islamic Berhad
2-9	Public Islamic Bank Berhad
<b>3</b>	<b>Foreign Full-fledged Islamic banks:</b>
3-1	Kuwait Finance House (Malaysia) Berhad
3-2	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad
<b>4</b>	<b>Foreign subsidiary Islamic banks:</b>
4-1	Asian Finance Bank Berhad
4-2	HSBC Amanah Malaysia Berhad
4-3	Standard Chartered Saadiq Berhad
4-4	OCBC Al-Amin Bank Berhad

(Bank Negara Malaysia, 2012)

In August 2006, the Malaysia International Islamic Financial Centre (MIFC) initiative was launched. The main objective of the MIFC is to promote Malaysia as the major hub for international Islamic finance through several incentives designed to create a conducive environment for conducting Islamic finance business in the country (Haron and Azmi, 2009). To further advance Malaysia as an international Islamic financial center, the MIFC promotion activities have focused on increasing foreign participation in the Malaysian Islamic financial system including from the established financial centers in Europe, Asia and the Middle East.

Malaysia's Islamic finance continues to grow rapidly, supported by a conducive environment that is renowned for continuous product innovation, a diversity of financial institutions from across the world, a broad range of innovative Islamic investment instruments, a comprehensive financial infrastructure and adopting global regulatory and legal best practices. Malaysia has also placed a strong emphasis on human capital development, alongside the development of the Islamic financial

industry to ensure the availability of Islamic finance talent. All of these value propositions have transformed Malaysia into one of the most developed Islamic banking markets in the world (Khiyar, 2012).

Despite the challenging economic environment, the continued expansion of Islamic finance has demonstrated its viability and resilience. The Malaysian Islamic banking industry grew at a compound annual growth rate (CAGR) of 20.2% in the period of 2005-2009 to reach RM 233.7 billion or 16.4% of total assets of the banking sector. During the same period, the total Islamic banking deposits reached RM188.8 billion to constitute 17.8% of total deposits in the banking system. On the financing segment, total Islamic financing amounted to RM135.0 billion to represent 17.2% of the banking system's total loans and financing (Kuwait Finance House, 2010, PP.1). In year 2011, the total assets of the Malaysian Islamic banking increased by 24.1% to RM 436.1 billion. Representing 23.7% of the total assets of the banking system in the country (Muhibat *et al.*, 2013).

In 2009, Bank Negara Malaysia continued its efforts to promote a clear understanding and consistent interpretation of Shari'a contracts in Islamic finance. The initiative to develop a comprehensive codification of Shari'a contracts known as Shari'a Parameters achieved a major milestone, with the first Shari'a Parameter on the Murabahah Contract issued in 2009. The Shari'a Parameter on Murabahah would serve as a main source of reference for the Islamic financial institutions in developing Murabahah products and services. As of December 2009, 49.4% of Islamic contracts were structured in the form of Murabahah, including Murabahah Purchase Ordered and Al-Bai Bithamin Ajil. The bank is currently working on and aiming to finalise the Shari'a Parameters for the remaining contracts on Ijarah, Mudharabah, Musharakah, istisna' and Wadiah (BNM, Financial Stability and Payment Systems Report, 2009, PP. 61).

## **2.5 Islamic Banking Financing Modes in Malaysia**

Malaysia has a full-fledged Islamic financial system that operates parallel to the conventional financial system. With respect to products and services, there are more

than forty different Islamic financial products and services that may be offered by the banks based on various Islamic concepts such as Mudharabah, Musharaka, Murabahah, Bai Bithamam Ajil, Ijarah, Istisna and Ijarah Thumma Al-Bai. Chong and Liu (2009) define the instruments which the Malaysian Islamic banks are focusing on their investments as follows:

*Musharaka (joint venture)*

Musharaka contracts are similar to joint venture agreements, in which a bank and an entrepreneur jointly contribute on the capital and manage a business project. Any profit and loss from the project are shared in a predetermined manner. The joint venture is an independent legal entity, and the bank may terminate the joint venture gradually after a certain period, or upon the fulfillment of a certain condition.

*Mudharabah (profit-sharing)*

Mudharabah contracts are profit-sharing agreements, in which a bank provides the entire capital needed to finance a project, and the customer provides the expertise, management and labour. The profits from the project are shared by both parties on a pre-agreed (fixed ratio) basis, but in the cases of losses, the total loss is borne by the bank. Both Mudharabah and Musharaka have elements of equity financing. The Islamic bank, as a supplier of funds, undertakes joint ventures with individual customers. Such a relationship is prohibited in the conventional banking system (Abdus Samad *et al.*, 2005).

*Murabahah (cost plus)*

Murabahah financing is based on a mark-up (or cost plus) principle, in which a bank is authorized to buy goods for a customer and the goods are resold to the customer at a predetermined price that includes the original cost plus a negotiated profit margin. This contract is typically used in working capital and trade financing.

*Ijarah (leasing)*

Ijarah financing is similar to leasing. A bank buys an asset for a customer and then leases it to the customer for a certain period at a fixed rental charge. Shari'a (Islamic law) permits rental charges on property services, on the precondition that the lessor (bank) retains the risk of asset ownership.

*Bai' Bithaman Ajil (deferred payment sale)*

Bai' muajjal financing, which is a variant of murabahah (cost plus) financing, is structured on the basis of a deferred payment sale, whereby the delivery of goods is immediate, and the repayment of the price is deferred on an installment or lump-sum basis. The price of the product is agreed upon at the time of the sale and cannot include any charge for deferring payments. This contract has been used for house and property financing.

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

The Al-Ijarah (leasing/renting) contract is followed by Al-Bai (purchase) contract. Under the first contract, the hirer leases the goods from the owner at an agreed rental over a specified period. Upon the expiry of the leasing period, the hirer enters into a second contract to purchase the goods from the owner at an agreed price.

*Istisna (contract manufacturing)*

Istisna contracts are based on the concept of commissioned or contract manufacturing, whereby a party undertakes to produce a specific good for future delivery at a pre-determined price. It can be used in the financing of manufactured goods, construction and infrastructure projects.

Through the use of various Islamic finance concepts such as ijarah (leasing), Mudharabah (profit sharing), Musharaka (partnership), financial institutions have a great deal of flexibility, creativity and choice in the creation of Islamic finance products. Furthermore, by emphasizing the need for transactions to be supported by genuine trade or business-related activities, Islamic banking sets a higher standard for investments and promotes greater accountability and risk mitigation (BNM, 25 December 2012. [http://www.bnm.gov.my/index.php?ch=fs\\_mfs&pg=fs\\_mfs](http://www.bnm.gov.my/index.php?ch=fs_mfs&pg=fs_mfs)).

The following table provides the types of Islamic financing in Malaysia:

**Table 2.2 Malaysian Islamic banking financing (2007-2010)**

RM Million

<b>Financing System</b>	<b>2007</b>	<b>(%)</b>	<b>2008</b>	<b>(%)</b>	<b>2009</b>	<b>(%)</b>	<b>2010</b>	<b>(%)</b>
Mudharabah	109	0.24%	314	0.3%	375	0.3%	292	0.2%
Musharaka	314	0.68%	804	0.77%	1875	1.4%	3010	2%
Bai Bithaman Ajil	18478	40.06%	34308	32.97%	42732	32.2%	49140	32.8%
Ijarah	1059	2.30%	2741	2.64%	4017	3%	4183	2.8%
Ijarah Thumma Al-Bai	11553	25.05%	31847	30.61%	38953	29.3%	41240	27.54%
Murabaha	8060	17.47%	15847	15.23%	23016	17.3%	23330	15.58%
Istisna	804	1.74%	1384	1.33%	1486	1.1%	1463	0.98%
Others	5747	12.46%	16797	16.15%	20349	15.3%	27091	18.10%
<b>Total financing</b>	<b>46126</b>	<b>100%</b>	<b>104044</b>	<b>100%</b>	<b>132807</b>	<b>100%</b>	<b>149752</b>	<b>100%</b>

Source: Bank Negara Malaysia, 2007, 2008, 2009, 2010

The Islamic banks have made significant inroads in Malaysia that total financing in the Islamic banking sector amounts to RM46.126 billion as of the end of 2007, and RM149.752 billion as of the end of 2010. The data included above have shown that, Bai Bithaman Ajil constituted the largest share (32.8%) at the end of 2010, followed by Ijarah Thumma Al-Bai (27.54%) at the end of 2010, and Murabahah (15.58%) at the end of 2010.

## 2.6 Conclusion

since the giving and receiving of riba is forbidden in islam, which is is the most important justification for establishment the Islamic banking in malaysia. today Malaysian' islamic banking system is one of the most advanced in the Islamic world. Thus, this chapter highlights the development of islamic banking in Malaysia and how the liberalization has greatly changed the structure of the Islamic banking industry. The chapter also concerned in evaluating the instruments of Islamic banking financing in Malaysia and find that the Malaysian Islamic banks use fixed rate of financing, because, they are overly dependent on Bai Bithamin Ajil financing, Ijarah Thumma Al-Bai and Murabahah.