

# Islamic Banking and Financial Institutions in Malaysia: Current Developments

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## *Abstract*

*This paper presents current developments in Islamic banking and financial institutions in Malaysia. It begins by discussing the paradigm of Islamic banking and finance through the concept of Islam and economics, the emergence of Islamic financial institutions in Malaysia, the concept of Al-Bai' Bithaman Ajil (BBA) and also the future direction of Islamic banking. The writer argues that Islamic banking is still within the framework of the conventional system except on the element of riba in its transaction. The growing number of products, systems, infrastructures and supporting institutions of Islamic banking in recent years may sustain the development of the Islamic banking industry. With the current issues in BBA, the industry needs to better understand the basic tools in Islamic banking and any weaknesses in today's system should be rectified so as to help develop Islamic banks become truly innovative, competitive and integrated part of the contemporary global finance.*

## **Introduction**

Malaysia has emerged as the first country to implement a dual banking system where Islamic banking system operates side-by-side with the conventional banking system (Mokhtar, Abdullah & Alhabshi, 2008). According to Mohamed Ariff (1988), Bank Islam Malaysia Berhad (BIMB) like other Islamic financial institutions, operates under the principle of *Mudarabah*. Through this concept, current and savings accounts operate under the principle of *al-Wadiah* (safe-keeping under trusteeship) which allows the bank to use the deposited money without having to share its profits with the depositors.

According to Annual Banking Statistic 2007 released by Bank Negara Malaysia (BNM), the Malaysian Islamic banking industry, especially in terms of assets, total financing and total deposits has grown very rapidly. BNM has reported an increase in total assets of Islamic Banks from RM17.3 million in the year 2001 to RM94.9 million in 2007. Total financing has also increased from RM7.6 million to RM49.1 million, and total deposits from RM14.4 million to RM75.1 million for the period mentioned.

During this period, the number of Islamic Banks also increased from two in 2001 to eleven in 2007 and this figure does not include other banks participating in Islamic

Banking Scheme such as commercial banks, merchant banks, finance companies and discount houses.

### Islam and Economics

According to Muhammad Akram Khan, in his article, *Methodology of Islamic Economics*, cited in Ghazali and Omar (1989), a number of the verses in the Quran lay down general principles and predictions relating to economic phenomena.

*"God takes away (gain) from usury but adds (profit) to charity"* (Al Baqarah: 276)

*"I shall give you more if you are grateful, but if you disbelieve then surely My Punishment is very great"* (Ibrahim: 7)

Monzer Kahf, in his article, *Islamic Economics and Its Methodology*, cited in Ghazali and Omar (1989), wrote that from the beginning of Islam in Mecca, the verses of the Quran had presented the Islamic position on the relationship between religion and belief in Allah and the Day of Judgment on one hand and the economic behavior and the economic system on the other.

*"That which you lay out for increase through the property of (other) people will have no increase with Allah; but that which you layout for charity, seeking the Countenance of Allah, (will increase); it is these who will get a recompense multiplied."* (Al Ruum: 39)

Islam possesses its own paradigm of economic relations within the context of an entire Islamic system based on injunctions and norms, derived from the Quran and Sunnah (the actions and sayings of the Prophet Muhammad), called the *Syariah* (Iqbal & Mirakhor, 1987). Engku Rabiah Adawiah Engku Ali (2002), in the article on, *Islamic Banking and Finance Tools: The Shari 'ah Principles*, stresses the relevant juristic opinions or *ijtihad* are also included in the meaning of *Syariah* principles since they explain and expound the meaning of the *Syariah* texts in the most reliable manner. The *Syariah* specifies rules that relate to the allocation of resources, property rights, production and consumption, the workings of markets, and the distribution of income and wealth. Similarly, as argued by Iqbal and Mirakhor (1987), rules and requirements have been specified that define the framework within which the monetary and banking system can operate. The core of this framework is that the rate of interest or *riba* is replaced with the rate of return on real activities.

Monzer Kahf, in the article on, *Islamic Economics System- A Review*, as cited in Ghazali and Omar (1989), summarized the philosophical background of Islamic economic system as follows:

- This world is owned by God: all property, wealth, resources are God's ownership and He disposes them of the way it pleases Him. The concept of ownership in Islam is based on the doctrine that God is the sole creator of everything and every life in universe.
- The balance or non-partisanship. The behavior of Muslims such as the moderation, avoiding extravagance and parsimony.
- The concept of justice. Justice is applied in all stages of the economic activity.
- *Zakah*; a special financial duty on net-worth to provide for special purposes as determined in the Quran.
- *Riba*; any material favor or benefit stipulated to loan
- *Qirad*; introduces the owner of the monetary assets as partner rather than lender.

The prohibition of *riba*, participates with the *zakah* and the lawfulness of the *Qirad* in shaping the consumer behavior in the Islamic economy. In the Quran, the charging of interest is considered an unjust.

".. *Allah has permitted trade and forbidden riba ...* " (Al Baqarah: 275)

According to Iqbal and Mirakhor (1987), prohibition of interest and the fact that the banks have to rely primarily on profit sharing leads to a major difference between the two systems. Islamic banks have to offer their asset portfolios of primary securities in the form of risky open-ended "mutual fund" type packages for sale to investor-depositors, while in a conventional system, the banks will keep the title to the asset portfolios they originate.

Dr Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, in her speech on Islamic Banking: on the "Similarities and Differences with Conventional Banking", presented at a special discussion of the G-7 Finance Ministers and Central Bank Governors Meeting, in Washington D.C., United States of America on April 19, 2002 said that:

*"In conventional banking, the banker-customer relationship is a debtor-creditor relationship where the bank earns a profit by making a spread between the interest charged on the borrower of funds and interest paid to the depositors. In Islamic banking, the banker-customer relationship is not a debtor-creditor relationship but is based on a different contract that is entered into by the Islamic financial institutions and the customer."*

In another speech on the Accounting Standards for Islamic Financial Institutions, on May 29, 2002 in Kuala Lumpur, she said that:

*"Islam strongly advocates all forms of positive governance. These values and ethical conduct are already in-built and inherent in the principle of governance. Islamic corporate governance serves through its underlying principles of economic well-being of the ummah, universal brotherhood, justice and equitable distribution of income."*

Muhammad Akram Khan, in his article, *Methodology of Islamic Economics*, cited in Ghazali and Omar (1989), said that Islamic economic needs to have a name of Islamic economics and would be open to examination by Muslims and non-Muslims alike. He further argued that, in this era of economic problems such as unemployment, inflation, unequal distribution of income, poverty, debt overburden and international exploitation, which is in particular affect Muslim *ummah*, and that is the reason whereby the Muslim economists, could then probably use Islamic economics as solutions to these problems. He further emphasized that the main occupation of Muslim economists should be to present an analysis of the application of the *Syariah* to the present day society.

Therefore it is clear that the concept of contract in Islamic banking is different from the conventional banking. And at the same time, the relationship between the bank and the customer is also special and these are due to the *Syariah* principles derived from the Quran and Sunnah.

### **Emergence of Islamic Financial Institutions in Malaysia**

The conceptual developments of Islamic banking took cognizance in late 1940s (Khan & Bhatti, 2008) and practically, the first Islamic bank was started in Egypt in the early sixties when the Mit Ghamr Savings Bank was established under the leadership of Dr. Ahmad el-Naggar in 1963. The bank soon established over nine branches and successfully attracted about a million customers. It was only after this that many reputable Islamic banks emerged in 1970s. This included the Nasser Social Bank Cairo (1972), Islamic Development Bank (1975), Dubai Islamic Bank (1975), Kuwait Finance House (1977), Faisal Islamic Bank of Sudan (1977) and Dar Al-Maal Al-Islami (1980).

The history of Islamic banking in Malaysia started when Lembaga Urusan dan Tabung Haji (LUTH) was established by the government way back in 1963. According to Mohammed (2002) as cited in Mokhtar et al. (2008), the LUTH is a specialized financial institution that provides a systematic mobilization of funds to assist Malaysian Muslims to perform pilgrimage in Mecca as well as to encourage them to participate in investment opportunities and economic activities. Due to its uniqueness, LUTH is considered to be the first of its kind in the world that offers such activities.

Based on the experience of LUTH, the Malaysian Government then introduced a well coordinated and systematic process of implementing the Islamic financial system (Mokhtar et al., 2008). The process can be divided into three phases.

The first phase started in 1983 to 1992, was in the establishment of the first Islamic bank. This was the period when BIMB was established and the Islamic banking operations were started in accordance with *Syariah* principles, and also the period where Islamic Banking Act (IBA) was officially enacted. On March 11, 1983 IBA was taken into effect in order to provide for the establishment of Islamic banks in Malaysia (BNM, 1989). According to the Bank Negara Malaysia (1989), although the Act is modeled on the existing Banking Act, 1973, but with some modifications the Islamic banks to be established can conform to the Islamic banking principles.

On March 1, 1983 BIMB was the first Islamic bank established in Malaysia and was incorporated under the Companies Act, 1965. BIMB commenced its operations on July 1, 1983 with a branch in Kuala Lumpur. During this first phase period, BIMB was the sole provider of banking services based on Islamic principles, and this right was given to BIMB to allow them to develop as many Islamic products as possible. This is also to protect BIMB from having to compete with other experienced conventional banks.

In line with its objectives, of establishing banks based on Islamic principles to meet the banking and credit needs of the Muslim population in Malaysia, the activities of BIMB are based on the Islamic principles of banking and credit conforming to the *Syariah* which prohibits interest or *riba*.

The principles according to Bank Negara Malaysia (1989), and Bank Islam Malaysia Berhad (1982), are listed as below:

#### **AI-Muharabah**

An agreement between lender and entrepreneur, whereby the lender agrees to finance the entrepreneur's project on a profit-sharing basis according to the pre-determined ratio agreed upon in the earlier negotiation between them. In the event of loss, the lender bears the loss.

#### **AI-Musyarakah**

A partnership for a specific business activity with the aim of making profit, whereby the lender not only provides the capital but may also participate in the management of the project. In the event of loss, both parties bear the loss in the proportion to their shares.

**AI-Murabahah**

The sale of goods at a price which covers the purchase price plus the profit margin agreed upon by both parties. AI-Murabahah transformed traditional lending activity into a sale and purchase agreement, under which the lender buys the goods wanted by the borrower for resale to the borrower at a higher price agreed upon by them.

**AI-Bai' Bithaman Ajil (BBA)**

A variant concept of AI-Murabahah, whereby the borrower is allowed to defer settlement of the payment for the goods purchased within the period and in the manner determined and agreed upon by both parties.

**AI-Ijarah**

Concept of leasing finance, whereby the bank purchases the asset required by customer, and then leases the asset to the customer for a given period, the lease rental and other terms and conditions being agreed to by both parties.

**AI-Takriji**

A variant of the concept of AI-Ijarah, but provides for the acquisition of the leased asset by the lessee.

**Qard Hasan**

A "benevolent loan" which obliges a borrower to repay the principal sum borrowed to the lender. However, it is left to the borrower to reward the lender by paying any sum over and above the principal amount.

**AI-Wakalah**

An agreement between customer and bank, and in which the customer appoints the bank as his agent in undertaking a certain transaction on his behalf.

**AI-Kafalah**

An agreement between customer and bank, and the bank guarantees the fulfillment of the obligation of the customer to a third party.

### **Wadiah**

An agreement to deposit an asset in the custody of another party who is not the owner or any such asset deposited with a non-owner for custody.

The second phase started in 1993 to 2003, was in the development of Islamic banking facilities that was aimed at creating a more conducive environment for competition among the banks. In this phase, the Malaysian government set up a viable and sound Islamic banking system serving all Malaysians, both Muslim and non-Muslims alike. It is aimed to create an Islamic banking system which does not involve interest or *riba* that can operate side by side with conventional banking system. The second phase also helped to create the second full-fledged Islamic bank, the Bank Muamalat Malaysia Berhad (BMMB). The establishment of BMMB was the result of the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce Malaysia Berhad (BOCB). With the merger, BMMB lost its monopoly status and the creation of BMMB ensured healthy competition for BMMB.

The third phase and started from 2004 onwards, was more towards financial liberalization of Islamic banks. What came out from this liberalization was the instant emergence of three new full-fledged Islamic banks in the Malaysian banking market and all of them from the Middle-east. The full-fledged of foreign Islamic bank issued with license to operate in Malaysia are the Kuwait Finance House, Al Rajhi Banking and Investment Corporation and a consortium led by Qatar Islamic Bank (BNM, 2004).

The banks grant credit facilities such as project financing under the principles of *Al-Mudharabah* and *Al-Musyarakah*, lease financing under the principles of *Al-Ijarah* and *Al-Takriji*, hire-purchase financing under the principles of BBA, trade financing under such principles as *Al-Mudharabah*, *Al-Musyarakah* and *Al-Wakalah*, guarantees under the principle of *Al-Kafalah*, benevolent loans under the principle of *Qard Hasan* and overdrafts under any appropriate principle earlier mentioned above (BNM, 1989).

### **The Concept of BBA**

Siddiqui (2008), Obaidullah (2005), Bank Negara Malaysia (1989), Bank Islam Malaysia Berhad (1982) have defined BBA or also known as *Bay' al Muajjal* as basically a trade deal in which a seller allows the buyer to pay a price on a commodity deferred to a future date in a lump sum or installment.

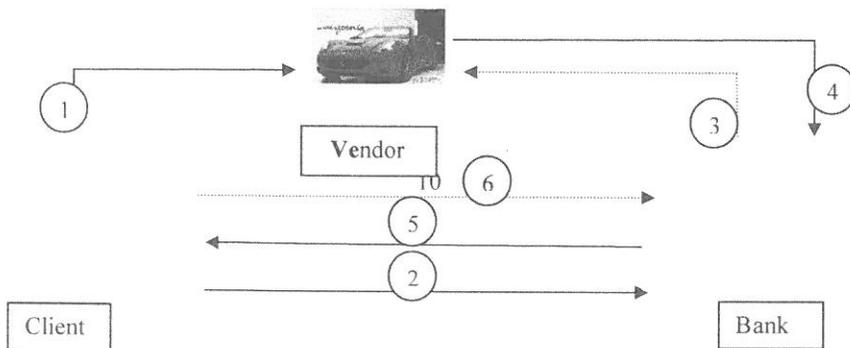
Its essential element which distinguishes it from a normal sale is the deferred payment. Obaidullah (2005) further argues that BBA simply implies deferment of payment of price irrespective of whether the cost and mark-up are known to parties or not. It is different from transaction in *Al-Murabahah*, whereby both parties to the transaction must know the cost and the profit or mark-up.

Special features for *AI-Murabahah* and BBA:

<i>AI- Murabahah</i>	<b>BBA</b>
It is a sale and purchase contract based on trust ( <i>Bay' al Amanah</i> )	Sale where payment of price is deferred
Full disclosure and transparency between the parties	Final price should be contractually agreed and known to both parties
Cost and amount of mark-up are disclosed	Time and mode of payment should be ascertained
Payment of price can be spot or deferred, depending on the agreement between the parties (if deferred - also BBA)	No need to state the cost price and amount of mark-up (if disclosed - also <i>AI-Murabahah</i> )

Source: Presentation slide on Applied Shari'ah in Financial Transactions by Engku Rabiah Adawiah Engku Ali, International Islamic University Malaysia.

The mechanism or the structure of BBA is shown below:





Dotted line indicates flow of funds

Activity:

1. Clients identifies and approaches Vendor / supplier of the commodity she needs
2. Clients approaches Bank for *BBA-Al Murabahah* finance and promise to buy the commodity from Bank upon resale at the mark-up price
3. Bank makes payment of base price to Vendor
4. Vendor transfer ownership of commodity to Bank
5. Bank sells the commodity, transfers ownership to Client at marked-up price
6. Clients pays marked-up price in full or installments over future (known) time period.

Sources: Islamic Financial Services. Obaidullah (2005)

Siddiqui (2008) then argues that the cost plus profit contract is hardly ever executed on spot through immediate payments by the client. A spot payment means that the bank loan is immediately paid off. The financial intermediary role is not different, or may appear similar to the conventional bank financing (Siddiqui, 2008; Obaidullah, 2005).

According to them, it is merely a substitution of profit rate or mark-up for the rate of interest. Obaidullah (2005) further explained that *Syariah* therefore, imposes several constraints and prescribes certain norms in order that *Al-Murabaha* facility is free from *riba*, namely:

### **Risk and Return**

In line with *Syariah* maxim of "*al-kharaj bi-al-daman*" or "revenue goes with liability the Bank must bear

certain amount of risk. The conventional banks also exposed to risk, however in order to ensure that the Bank's gains are above all suspicious *riba*, the sequence of activities highlighted in the above structures must be maintained.

### **Legal Nature of Promise**

In *Al-Murabaha*, when the Bank and/or its client make a promise, the same is a moral obligation. Even though there is difference of opinion among scholars on whether the promise is also legal obligation, the promise is still considered a moral obligation. If the promise is not enforceable in a court of law, this may create difficult situation.

### **Subject of BBA**

For a valid BBA, the subject of sale must exist in the ownership, physical or constructive of the Bank at time of sale to its client. *Al-Murabaha* must not involve sale of forbidden commodities such as liquor, pork and the like.

### **Specification of Price**

A requirement of a valid sale is knowledge and specification of price and payment terms. This is to avoid any *gharar* or uncertainty as a source of potential conflict between the parties.

### **Profit Rates and Benchmarks**

In *Al-Murabaha*, price includes a known profit or mark-up. BBA used fixed-rate, which is different from the volatile or floating interest rate charged by the conventional banks.

Ali (2002) wrote that, *Bay' al Muajjal* (refers to a sale against deferred payment) has been subjected to some controversies with regard to its permissibility. She further argued that there are differences among Muslim scholars whether the price charged by the Bank can be higher than the spot price. Even the scholars, who are of the view that charging higher price than the spot price is permissible under the *Syariah*, do not favor its used of BBA by the Islamic banks.

The main arguments for those who are against BBA are that it opens the back-door towards interest-based transactions. According to Ali (2002), the acceptance of the difference between spot and future prices is also identical to difference between the spot and future prices of a commodity called money. Second, they argue that based on the interpretation of the Hadith which reads:

*"The Prophet s.a.w. prohibited two sales in one single sale".* As cited in Ali (2002).

Some might interpret the Hadith as the sale of a commodity with two different prices that is the spot price and the other with two different prices (spot and future prices) in one transaction is prohibited.

Ali (2002) further argued that, in view of the controversy regarding the validity of BBA, it is wiser that *Bay' al Muajjal* be used with caution. The danger that *Bay' al Muajjal* may deteriorate into purely financing arrangements with the agreed profit margin being no more than a camouflage for interest, will still remain. She concluded that, it would not be advisable to use it widely or indiscriminately.

### **Issues Relating to BBA**

*Al-Bai' Bithaman Ajil* (BBA), a widely practiced Islamic property financing contract, faced a fallout from the recent High Court ruling that it is contrary to the Islamic Banking Act 1983. As written by Habhajan Singh (2008) in *Islamic Finance Asia*, the High Court Judge, Datuk Abdul Wahab Patail ruled that the sale element in the BBA is "*not a bona fide sale*" or in layman's term, not a genuine purchase and the Judge also brought into question the profit portion of the facility. In the written judgment, the Judge ruled that since some of the BBA contracts were structurally faulty, defaulters need not pay more than the original financing amount that they received. This deprived the banks the profit they would have otherwise received from the transactions. The banks feared that this judgment could mean that the current BBA financing clients would only have to pay the facility amount and would escape paying the profit portions.

Datuk Abdul Wahab's judgment, dated July 18, 2008 encompassed 11 separate cases involving Bank Islam Malaysia Berhad (BIMB) and Arab-Malaysian Finance Berhad as the plaintiffs. It is understood that the banks are appealing to the Court of Appeal to overturn the judgment through their lawyers.

In the mean time, the BBA concept is still being widely used in various Islamic financing instruments, including for bridging finance, contract financing, project financing and letter of credit, etc. (Siddiqui, 2008; Obaidulah, 2005; Rosly, 2005; Ali, 2002; BNM, 1989; BIMB, 1982). According to Bank Negara Malaysia (2004), as cited in Rosly (2005), in 2004, close to 50 per cent of total Islamic bank financing in Malaysia has been granted under the BBA concept which essentially is a deferred payment sale. That is the sale of goods on a deferred payment basis, at an agreed selling price, which includes a profit margin agreed on by the customer and the bank (Obaidullah, 2005; Rosly, 2005; BNM, 1989; BIMB, 1982).

Among the big local banks in Malaysia are CIMB Bank Berhad (CIMB), Malayan Banking Berhad (Maybank), BIMB and Public Bank Berhad, all of which have home

financing facilities based on BBA concept. Some of the banks, like CIMB and Maybank now have full-fledged Islamic subsidiaries that handle such financing.

### **Future Direction of Islamic Financial Institutions**

The condition of Islamic banking in the world today can still be considered at the stage of adding up more facilities and products to the customers. Islamic financial institutions are still in the process of changing its old products into the new and more competitive product to be in line with or at par with conventional banking thus at the same time must fulfill the rules and guidelines of the *Syariah* as well as satisfy what the clients wants.

In my opinion, Islamic banking is still within the framework of conventional systems and if we look at the external side per se, it is as if there are no differences except on certain terminologies, namely:

- a) Buyer and seller.
- b) Islamic banking use home financing facilities instead of housing loan.
- c) The major difference being in the use of *Syariah* concepts and guidelines in its operations and in all the banking transactions. The use of these concepts is a must in order to make sure all the transactions are in line with the *Syariah*, especially those transactions that involve contracts or agreements. These contracts differentiate the *Syariah* systems from the conventional systems and at the same time reject the elements of *riba* in the transactions.

Even though from the operational and technical side Islamic banking is in line with *Syariah*, but still it is within the framework of conventional system.

It is my view that the Islamic financial institutions need change. Islamic banking need to change into full Islamic economic system not only from the *Syariah* perspective, but must also include those basic principles of Islam as well. The way forward or the future direction of Islamic banking should be as follows;

1. *Through satisfying the needs of customers and the needs of the Bank*

The Bank should provide products that can fulfill the needs of their customers, especially providing them with halal product, higher return on investment, low financing price from the Bank, and at the same time the Bank will get higher profits.

2. *Through creating value added proposition that will differentiate between conventional banking and Islamic economic system.*

There must be the concept of justice between the Bank and the customers. Equal distribution of wealth is more advisable, thus the profit cannot go into one hand only.

As Monzer Kahf wrote in his article, *Islamic Economics System- A Review*, the philosophical background of Islamic economic system will hopefully add value to the system of Islamic financing institutions. He said that, this world is owned by God: all property, wealth, resources are God's ownership and He disposes them in the way it pleases Him.

The concept of ownership in Islam is based on the doctrine that God is the sole creator of everything and every life in universe. Followed by the concept of balance or non-partisanship of which includes the behavior of Muslims such as the moderation, avoiding extravagance and parsimony. Application of justice in all stages of economic activity and the prohibition of *riba*, participates with the *zakah* and the lawfulness of the Qirad in shaping the consumer behavior in the Islamic economy.

This is considered a new framework that Islamic banking need to foresee, need to focus and consider it as a new direction toward implementing the business through profit sharing (*Al-Musharakah*) and also the investment (*AlMudarabah*).

## **Conclusion**

Local Islamic bankers must try to get their act together in order to respond to the recent High Court ruling that application of popular home financing, BBA is contrary to the Islamic Banking Act 1983. The danger regarding the controversy of using *Bay' al Muajjal* had been highlighted by Ali (2002) in her discussion on the *Syariah* principles, whereby, the Banks need to better understand and reexamine the basic tools in Islamic banking in the light of the *Syariah* texts and views of the jurists. It is hoped that a better understanding of the operation of the said banking tools according to the *Syariah* can be achieved.

What happens if the customers refuse to pay their home finance if the ruling is not changed by the Appeal Court? Probably the Central Banks need to look into new policy, or introduce a new set of rules to clear the air with regards to the application of the BBA ruling. After sometime, Islamic financial institutions should come up with professionals who are skillful enough to operate and work in the context of Islamic economics to avoid such problems in the future.

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Presentation slide on Applied Shari'ah in Financial Transactions by Engku Rabiah Adawiah Engku Ali, International Islamic University Malaysia.