

# ISLAMIC ECONOMICS: THE CASE OF MALAYSIA

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## 1. INTRODUCTION

Financial systems are very important for allocation of resources in a modern economics. Their landscape is determined by the nature of financial intermediation, i.e. how the function of intermediation is performed and who intermediates between suppliers and users of funds. The acquiring and processing of information about economic entities and the financial contracting are common elements in the activities that differentiate financial intermediation from other economic activities<sup>1</sup>.

Islamic Financial and non financial institutions play a vital role as financial intermediation to allocate resources in Islamic economics activities. Financial intermediation based on the principles of Islam has an established historical record and has made significant contributions to economics overtime. Islamic financial system is based on a set of contracts and instruments which form the backbone and building blocks for more

complexes and elaborate frameworks<sup>2</sup>. It consists of two basic contracts i.e. asset based securities (examples: bay' bithaman ajil, bai as salam, istisna') and equity based contract (musyarakah and mudharabah).

The last four decades have witnessed the emergence and indeed a remarkable growth of Islamic financial institutions in many Muslim countries. This provides an alternative system to the Muslims for dealing with the muamalat matters, involving savings, investments and financing according to Islamic principles. The Islamic Bank established in Egypt in 1963 was the first experiment to test the operation of the Islamic banking on modern lines and also the response and trust of the Muslim communities to this type of institution. The institution which was initiated by Ahmad El-Najjar was a savings bank based on profit-sharing. This bank was involved in trade and industry directly or in partnership with

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<sup>1</sup> Drapper and Hoag (1978)

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<sup>2</sup> Several instruments find their roots in the pre-Islamic period but were further developed and widely practiced after confirming their compatibility with the principles of Shariah, i.e. elimination of riba and gharar. Further explanation of Islamic instruments in part 6.2

others, and shared its profit with their depositors<sup>3</sup>. It does not give or receive interest as practiced by the conventional banks. The bank worked basically in the form of a saving-investment institution and not as a commercial bank. Unfortunately, this first experiment managed to survive for a period of only four years. Later in 1971, another bank was initiated by the Government of Egypt called the Nasir Social Bank operating on interest-free basis.

During the same period (1963), another Islamic financial institution was launched in Malaysia. This institution was called 'The Muslim Pilgrims Saving Corporation' (now called the Lembaga Tabung Haji or the Pilgrimage Fund Board). The objective of this institution was to assist the prospective pilgrims to save and invest their money as preparation to travel to the holy city of Mecca to perform their Hajj. The contributors were given the assurance that their money deposited in this institution would be free from *riba*<sup>4</sup>. Also, their savings were to be invested in halal businesses only and the profits would be given to them in the form of dividends. As a result of the establishment of the Pilgrimage Fund Board, other Islamic financial institutions came about in Malaysia, such as the Islamic Bank of Malaysia (1983), Takaful Malaysia (1984),

Takaful Nasional (1993), Bank Muamalat (1999), Islamic Banking Scheme (1993) and the Islamic money market (1994), Islamic Capital Market (1993). Lately Malaysia is hosting the secretariat for the newly set up Islamic Financial Services Board. Today, Malaysia is recognized in the world as the leading country in the development and implementation of Islamic financial system. This success has led other Muslim countries to come and learn from the Malaysian experience. There are countries, indeed, who seek to emulate the model of Islamic financial system as developed in Malaysia.

By the early seventies, the development of Islamic financial institutions had become an important agenda as discussed at the international forum of the Muslim countries led by the late Prime Minister of Malaysia, Tunku Abdul Rahman Putra, the first Secretary General of Organisation of Islamic Countries (OIC). In 1974, OIC took the initiative to establish the first Islamic Development Bank (IDB), with its headquarters in Jeddah, Saudi Arabia. The IDB was established with the aim of providing loan facilities to member countries for development projects. Earlier the Muslim countries had no choice but to borrow money for their development project from the conventional banks which were based on interest (*riba*) system.

<sup>3</sup> Siddiqi, 1988.

<sup>4</sup> Interest charged by the institution is termed as '*riba*'.

The real surge in the expansion of Islamic financial institutions started during the seventies. Many Muslim countries started the setting up of Islamic banking to replace the existing conventional banks based on 'riba'. As an example, Dubai Islamic Bank (1975), Faisal Islamic-Bank of Sudan (1977), Faisal Islamic Bank of Egypt (1977), Bahrain Islamic Bank (1979), to mention a few.

Today, we have seen that Islamic banking and non-banking institutions operating in over sixty Muslim and non-Muslim countries worldwide. There are about 177 Islamic financial Institutions, managing assets estimated at US\$90 billion. Three countries, namely Iran, Sudan and Pakistan have fully transformed their banking systems into Islamic Banking system<sup>5</sup>, while Malaysia operates Islamic banking institutions parallel with the conventional system.

Presently, the Muslims have the option either to subscribe to the Islamic or conventional financial system. The response received from the Muslim communities towards this system seems to be very encouraging. In Malaysia for example, the growth of this institution in the last ten years was very rapid. There is a great potential that these institutions will grow and

develop in parallel with the conventional system, and hope it will become an important agent for uplifting the spiritual and socio-economic development of the Muslim ummah.

## **2.0 OBJECTIVES**

The objective of this paper is to study the development and growth of Islamic financial and other institutions in Malaysia and the potential role played by these institutions toward the development of the socio-economy of the Muslim ummah here. The financial institutions in Malaysia cover the banking and non banking institutions, and other financial institutions working in the savings, cooperative, and social areas; examples are Bank Rakyat, Pilgrimage Fund Board (Tabung Haji), Agriculture Bank, Development Bank, Industrial Bank etc. which come directly under the Central Bank of Malaysia(BNM). or under relevant ministries.

## **3.0 CONCEPT OF AN ISLAMIC ECONOMIC SYSTEM.**

Before discussing the concept of Islamic financial system, it would be appropriate for us to explain briefly a broader concept i.e. of an Islamic Economic System. The system has its own principles, philosophy and

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<sup>5</sup> The Central Bank and the financial system in Malaysia (1989-1999).

objectives. The philosophy of Islamic economics is based on the concept of *tauhid*, i.e. there is no God except Allah s.w.t. The concept of *tauhid* has two objectives: firstly to acknowledge Allah s.w.t. as the owner of this universe, and secondly, to accept man and woman as the creations of Allah s.w.t. Who has given human values to all of the same status. The concept of *tauhid* requires man and woman to observe righteousness in whatever they do<sup>6</sup> in accordance with the teachings of al-Quran and al-Sunnah. These primary sources for human guide all our relations with God, or with fellow human-beings. The concept of *tauhid* covers two aspects of worldly life. First is the relationship between man and man. Second is the relationship between man and the Creator. This is different from what inspires other systems: the capitalist economy is based on the concept 'laissez faire' and the socialist economy is based on the concept of competition between classes. Both systems are not based on religion and do not envisage any relationship between man and the Creator. The objective of the Islamic economic system should be directed towards developing Islamic economic order i.e. a society that thrives in prosperity, is free from all sorts of exploitation, and where everyone

enjoys the fruits of economic development.<sup>7</sup>

The structure on Islamic economy can be divided into three sectors, namely the public, the private and the social welfare sector. The public sector is the sector led by the government. Its function is to plan and implement the national economic policies such as the fiscal policy, the government financial policy and the national development policy as a whole. The private sector is the sector that runs business activities without dependence on the government. This sector is free to run their business activities according to the law and procedures set by the government authorities. It does not depend on financial assistance from the government. In addition, there is a public welfare or social sector in an Islamic economy set up by individuals, private companies or the government itself to assist the needy members of the community. This sector functions not for profit making. Should it make any profit, it is not for the benefit of the individual or the group of individuals. If this social body has excess of funds, the money can be invested or put into business to finance social welfare work.

#### 4.0 CONCEPT OF ISLAMIC FINANCIAL SYSTEM.

<sup>6</sup> Nur Muhammed, Sistem kewangan Islam di Malaysia, p2.

<sup>7</sup> Nor Muhammad, Sistem Kewangan Islam di Malaysia.

The Islamic financial system is part of an overall Islamic economics system which covers all activities related to finance in three economic sectors-public, private and social sector. However, when we discuss the Islamic financial system, it is often linked with the private financial institutions - only. These private institutions encompass banking institutions, short-term money market, foreign exchange market and non bank financial intermediaries.

The Islamic financial system is build on the basis that all activities should be free from the element of 'riba' and investment activities have to be in accordance with the principles and procedures which have been laid down in the muamalah contract, such as the "bay" contract, ijarah, rahn, wakalah, ju'alah, wadi'ah, hiwalah and others. The system should comprise two important elements<sup>8</sup>:

1. It should have the Islamic essence as a whole, not limited to labels alone. It should reflect the philosophy, values, ethics and the basis of syariah.

2. It should have the characteristics of a comprehensive and up-to-date system which is viable and

comparable with the conventional system.

For this to be realized, any financial system should fulfill at least three pre-conditions i.e. must have multiplicity of instruments, numerous and appropriate institutions, and a mechanism that links the institutions with the instruments.

## 5.0 STRUCTURE OF FINANCIAL SYSTEM IN MALAYSIA.

The financial system in Malaysia, as in other countries, is divided into three parts, i.e. the banking system, the non-bank financial intermediaries, and the financial markets.

The banking system consists of monetary institutions and non-monetary institutions. The monetary institutions consist of the Bank Negara Malaysia (BNM) as the Central Bank, and commercial banks (including Islamic banks). BNM has sole authority to issue currency. The commercial banks are the only institutions allowed to manage current accounts. Non-monetary institutions consist of the finance companies, the merchant banks and the discount houses, which are under the supervision of BNM. In addition to

<sup>8</sup> Nor Muhammad, Sistem Kewangan Islam di Malaysia pp 32-33.

local institutions, there are foreign banks' representative offices and the international offshore banks and financial center in Laguna are a part of the banking system in Malaysia.

The non-bank financial intermediaries are divided into five categories of institutions, viz the development finance institutions, the savings institutions, the provident and pension funds, the insurance companies including offshore insurance companies, and a group of financial intermediaries, comprising the building societies, the unit and property trusts, leasing companies, factoring companies, credit token companies, venture capital companies, special investment agencies and several special financial institutions such as the national Mortgage Corporation (Cagamas) and Credit Guarantee Corporation. All the institutions we have mentioned are under the supervision of the various government departments and agencies, except the insurance industry, over which the Central Bank (BNM) is given the sole supervisory authority effective from 1<sup>st</sup> May, 1988.

The financial markets comprise the money and foreign exchange markets, the capital market, the commodity futures market and the financial futures and options markets. The capital market comprises of a primary securities market, in which new issues of Government and corporate securities are offered to the

public as well as institutions, and a secondary market, in which existing government and corporate securities are transacted.

In the process of planning for the future development of the financial sector, the BNM has drafted the "Financial Sector Master Plan" (FSMP), which listed 119 suggestions for a 10 year plan for the financial system in Malaysia. The financial system will be developed as an effective, competitive, resilient and dynamic system, which will contribute positively towards the economic growth of the country. This is in line with the increase in the usage of modern technology in financial institutions. This planning has also taken into consideration the challenges that the financial system will face in the liberalization, globalization and information technology era and will make the financial sector as an effective and responsive sector<sup>9</sup>.

In the implementation process of the FSMP, this plan is divided into three phases:

1. The first phase emphasizes capacity-building. This includes the implementation of measures to enhance the capability of financial institutions to compete and become more efficient and effective as well as the measures to promote stability.

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<sup>9</sup> FSMP, Bank Negara Malaysia.

2. The second phase involves the gradual deregulation of the domestic financial market, with the objective of bringing about greater competition among the financial institutions.

3. The third phase envisages further liberalization measures, including the possibility of introducing new foreign competition.

In the process of diversifying the financial sector, the banking sector will continue to be the most important source of financing to facilitate and support domestic economy for growth and transformation process. In the insurance sector, FSMP suggests that this sector becomes more efficient, effective and stable, and continues to assist the needs of the real economy and the socio-economic objectives of the country. This includes making the insurance industry as an effective mobilizer of long term savings to support economic growth.

In view of the progress made by the Islamic banking and takaful which is quite encouraging, FSMP suggests to strategically position the industry to enter its next stage of development and enhance its significance in the financial landscape of Malaysia. As a country which is unique in pioneering Islamic banking and takaful institutions and the setting up of the financial infrastructure to support Islamic financial operation,

Malaysia is strategically positioned to establish a niche in Islamic banking and takaful at domestic, regional as well as international markets.

The objective of Islamic banking and takaful is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic requirements of the economy.

It is envisioned that the Islamic banking and takaful industry landscape in 2010 would evolve in parallel with the conventional banking and insurance to achieve at least 20% market share within the banking system and insurance industry and to make Malaysia as the regional Islamic financial center.

## **6.0 DEVELOPMENT OF THE ISLAMIC FINANCIAL SYSTEM IN MALAYSIA**

### **6.1 Islamic financial Institutions**

Malaysia is one of the Muslim countries which are highly committed to developing a complete and systematic Islamic financial system. Since the inception of the first Islamic financial institution, Tabung Haji, forty years ago, after the setting up of the first Islamic Bank, and Takaful Malaysia, twenty years earlier, the

Islamic Financial institutions in Malaysia have progressed in all aspects and received recognition from the society (both Muslims and non-Muslims) and government as constituting an overall financial system. Like the conventional financial institutions, both Islamic Banks and Takaful companies have been placed under the supervision of the Central Bank of Malaysia (BNM). Now all matters pertaining to syariah of the banking and takaful are to be referred to the Central Syariah Advisory Council or the syariah unit at the BNM. The effort of the government of Malaysia has received the recognition of other Muslim countries one of the most advanced in establishing the Islamic financial services, especially the banking and takaful institutions.

The Islamic financial system in Malaysia showed significant progress in an increasingly liberalised and competitive environment in line with the increased integration of the Malaysian Islamic financial system into the global Islamic financial landscape. The liberalization of the Islamic banking market saw the opening in August 2005, of the first foreign Islamic bank licensed under the Islamic Banking Act 1983 (IBA).

In tandem with the progressive liberalization of the Islamic banking industry, strategic initiatives were undertaken to further strengthen the institutional capacity and financial resilience of the domestic Islamic

banking institutions. In this regard, Bank Negara Malaysia has approved to date, the transformation of the "Islamic window" institutional structure of seven domestic banking groups into Islamic subsidiaries (IS) licensed under the IBA within their respective banking groups to carry out Islamic banking business. Three IS commenced operations in 2005 while four others commenced operations in 2006. The IS structure allows the domestic banking groups to maximize the full potential accorded by the universal nature of Islamic banking licence under the IBA which provides wider strategic focus for Islamic banking institutions to strengthen their competitiveness through diverse and innovative product offerings. These range from retail banking products to the higher end corporate finance and investment banking products that include private wealth and fund management as well as private equity and real estate investments.

The foundation for the development of takaful or Islamic insurance in Malaysia was set by the wish of Muslims to realign more to Islamic practices in their economic activities. This was supported by the strong commitment from the Malaysian Government in developing a financial structure based on Islamic principles in parallel with the more developed conventional financial system. In the same manner as conventional banking requires the



services of insurance, Islamic banking also needs the services of insurance. It is befitting therefore that the insurance services for Islamic banking must be based on a system acceptable to Islam. STMB is the first Islamic insurance company set up in Malaysia. It was established in 1984, after the Parliament approved the Takaful Act the same year. As the first takaful operator showed remarkable and stable growth over the first eight years of its business, supported by the favorable demand from the public for Islamic insurance, a second takaful operator (Takaful Nasional Sdn Bhd) entered the industry in 1993. The formation of the second operator was intended to create competition and open a vista for the exchange of business through retakaful. Its formation was also to accommodate the increased demand for Islamic insurance coverage arising from services provided under the interest-free banking system introduced in 1993.

Now Malaysia has successfully developed 10 Islamic banks, seven takaful companies, 23 conventional financial institutions (11 commercial banks, 1 finance company, 4 merchant banks and 7 discount houses) offer Islamic banking services under the Islamic Banking Scheme (IBS). In addition, the Bank Rakyat, the National Savings Bank, the Agriculture Bank, the Industrial Bank and the Development and

Infrastructure Bank are also offering Islamic banking services.

Apart from these, there are also other financial institutions which are not under the supervision of the Central Bank, namely, Tabung Haji, YPIEM, Islamic cooperatives, Islamic pawning companies, etc. which are answerable directly to their ministries or departments. These financial institutions also have the potential to grow and contribute towards mobilizing the saving of the ummah and promote investment in accordance to syariah. For example, the assets of Tabung Haji are quite large and comparable with the asset of an Islamic Bank.

#### **6.1.1. Tabung Hajji (TH)**

The TH which was incorporated in August 1962 and launched in September 1963, is the first Islamic financial institution established in Malaysia and is among the pioneers of the system in the world. In 1969, the corporation was merged with Pilgrims Affairs Office, operating since 1951, giving birth to the pilgrims Management and Fund Board or Lumbago Urusan dan Tabung Haji (LUTH) under the laws of Malaysia Act.8, The Pilgrims Management and Funds Board 1969 (and Act A 168, The Pilgrim Management and Fund Board (Amend.) 1973). The Pilgrims

Management and Fund Board Act 1969 (Revised 1973) was again amended and revised in 1995 in order to modernize and instill professionalism in the management and staff. The institution is now named as Lembaga Tabung Haji or Tabung Haji (TH).

The TH has been categorized as non-bank financial intermediary and plays a role in mobilizing the savings of pilgrims and other depositors and in investing according to the Islamic syariah.

The TH that started with only 1,281 depositors and a total deposit of RM46,600 (USD12,000) through three branches, in 1963, now has expanded widely as a corporate body with about 4 million depositors with RM 10.560 billion in deposits and RM 11.0 billion in total accumulated asset.. TH now has more than 100 branches around Malaysia and plans to increase its number of depositors to at least 6.5 million or 50% of the number of Muslims in Malaysia within a period of less than 10 years.

The TH is engaged in numerous economic operations such as activities in the capital market including commercial, industrial, housing development, plantation and other businesses which do not contradict the syariah. It pays bonus to the depositors based on profit sharing where the rate of the bonus paid is between 4 - 9.5 %, not inclusive 2.5%

zakat paid by the institution on behalf of the depositors. Based on the encouraging performance and the quality of service and operations, TH achieved much recognition at the national and international levels. Among these is the IDB award for Islamic Banking in 1990, Asia Pacific Quality Award (APQA) in 1999 and Malaysian Quality Award (IQM) in 2000. This award is recognition of the success in achieving efficiency and profitability in mobilizing deposit funds in Islamic investments.

The performance of TH remained favorable in 2005, as deposit mobilization and investment activities continued to expand further. Total deposits mobilized by TH rose by 10.2% or RM1.2 billion to RM13.3 billion as at end 2005 (end 2004: RM12.1 billion). Total investments increased by 9.8% or RM994 million to RM11.1 billion as at end 2005 (end 2004: RM10.2 billion). The increase was due mainly to the sustained growth of 25.2% in share investment, which amounted to RM6.8 billion as at end 2005.

## **6.1.2 Islamic Banks**

### **6.1.2.1 Bank Islam Malaysia Berhad (BIMB).**

Bank Islam Malaysia the first commercial Islamic bank in Malaysia and in the Southeast Asia and was established on 1<sup>st</sup> July 1983 with a

paid capital of RM80 million. It was set up under the Islamic Bank Act of 1983 (ABI) which monitors the establishment, licensing and operations of Islamic Banks in Malaysia and gives the authority to the Central Bank of Malaysia (BNM) to monitor the Islamic banks operations as with other conventional banks. Among the contents of the Act is the allocation that the aim and operation of the banking trade carried out by the Islamic bank should not consist of any elements that contradict with the Islamic syariah. Now the Islamic Bank of Malaysia has more than 100 branches around Malaysia, with a total asset of RM15 billion at the end 2005.

#### **6.1.2.2 Bank Muamalat Malaysia Berhad (BMMB)**

BMMB is the second Islamic bank established in Malaysia. This bank was set up following the merger of the Bank Bumiputra Malaysia Berhad (BBM) and the Bank of Commerce (M) Bhd. (BOCB) whereby all the assets of the Islamic banking of BOCB and BBMB Finance were transferred to BMMB, while all the assets of the conventional banking of BBM were transferred to BOCB. Accordingly, the BBMB was renamed as Bank Muamalat Malaysia Berhad (BMMB). BMMB started its operations on 1<sup>st</sup> October 1999 with an

asset value of RM3.24 billion having 40 branches in the country. At the end of 2005, Bank Muamalat has about RM10.3 billion worth of assets, 42 branches and total deposits amounting to RM9.47 billion.

#### **6.1.2.3 Other Islamic Banks**

AmIslamic Bank Berhad:  
AmIslamic Banking has a long and distinguished history in Islamic banking, serving banking needs of industries and individuals via the AmBank Group Islamic Banking. In 2001, the Islamic Banking operation of AmBank and AmFinance was consolidated and has established the AmIslamic Bank Berhad.

RHB Islamic Bank Berhad  
which was officially launched on March 1, 2005, is a wholly-owned subsidiary of RHB Bank Berhad. It is also the first full-fledged Islamic Bank of a commercial banking group in Malaysia.

CIMB Islamic Bank Berhad:  
CIMB Islamic was established as the Islamic financial boutique of CIMB during its inception but after the merger with Commerce Tijari on 6 June 2005, it is today an Islamic universal bank providing both Islamic commercial and investment banking services through its 233 branches nationwide.

Hong Leong Islamic Bank Berhad (HLIB) which is a member of

the Hong Leong Group Malaysia, is a wholly owned subsidiary of Hong Leong Bank Berhad. With its beginning as the Islamic Banking arm of HLB, the division was incorporated as a separate entity on 28<sup>th</sup> March 2005 with an authorized and paid up capital of RM1 billion and RM500 million respectively.

Affin Islamic Bank Berhad: Affin Bank's Islamic banking subsidiary, commenced operations on 1<sup>st</sup> April 2006. A full-fledged Islamic Bank, it offers a complete range of Islamic banking products and services encompassing the areas of enterprise and consumer banking.

Kuwait Finance House (Malaysia) Berhad: The first foreign Islamic Bank in Malaysia with an official opening on 17 February 2006

Al Rajhi Banking & Investment Corporation (Malaysia) Berhad: This is a foreign bank, based in Riyadh, Saudi Arabia, commenced operation in Malaysia into retail banking market on June 2006.

### 6.1.3 Takaful Operators

#### 6.1.3.1 Syarikat Takaful Malaysia Bhd. (STMB)

STMB is the first Islamic insurance company set up in Malaysia. It was established in 1984, after the Parliament approved the Takaful Act the same year. Initially, the company was established with a paid up capital

of RM10 million. At the end of 2005, it had net assets worth RM2.4 billion with a profit of RM27.6 million in 2005. STMB has now 119 branch offices in the country.

#### 6.1.3.2 Takaful Nasional Sdn. Bhd.

The establishment of this company was based on the encouraging demands from the Islamic community and to allow for competition among the Islamic insurance companies. Presently, the assets of this company are worth RM1.2 billion with 14 branches all over the country.

#### 6.1.3.3 Other Takaful Operators

Takaful Ikhlas Sdn. Bhd. (2002), Mayban Takaful Berhad (2003), Commerce Takaful Berhad (2006), HSBC Amanah Takaful (Malaysia) Sdn Bhd (2006), and Prudential BSN Takaful Berhad (2006).

### 6.1.4 The Islamic Banking Scheme (IBS)

The Islamic Banking Scheme or formerly known as the Non-interest Banking Scheme was launched in 1993. It is part of the process in speeding up the development of Islamic financial system in Malaysia. Following the scheme, the IBS can be developed with a reasonable amount of

participants at a lower cost in a shorter period of time. However, to ensure that the IBS banks really adhere to the syariah requirements, the Central Bank (BNM) had issued specific guidelines, requiring the banks *inter alia* to set up under the IBS a division of Islamic banking to be headed by at least an assistant general manager. The BNM allocated RM 20 million for commercial banks, RM10 million for finance companies, RM6 million for merchant banks and RM1 million for discount houses to serve as working capital opening with it a current account in accordance with the Islamic principles for settling cheques and becoming separate members in the RENTAS system (Real Time Gross Settlement System). Also, they were required to submit separate statistical report to the BNM under the scheme. This scheme has allowed conventional banks to offer products and services in Islamic banking at their premises and branches.

The expansion of the IBS is highly encouraging. At the end of June 2005, the number of banking institutions participating in the IBS consisted of 23 (commercial banks, foreign banks, finance companies, merchant banks and discount houses). The total Islamic banking assets also increased from RM2.4 billion in 1993 to RM111.8 billion at the end of 2005. Deposit and financing increased from RM2.2 billion and RM1.1 billion in

1993 to RM83.8 billion and RM67.4 billion at the end of 2005. IBS has the largest asset in the banking system. It comprises 45.4% of the total asset, while the Islamic bank has 29.4% and the rest only 16.5%<sup>10</sup>.

#### **6.1.5 Bank Kerjasama Rakyat Malaysia (Bank Rakyat)**

Bank Rakyat is another successful Islamic financial institution in the country. It is not categorized together with the other Islamic banks as the purpose of its establishment in 1954 was to act always as a cooperative credit institution. It channels fund from the government to farmers and encourages thrift and saving among the rural dwellers. The main function of the bank is to receive deposits and provide facilities such as personal loans, agricultural, business, rental, etc. to its members. As a cooperative bank set up under the cooperative act of 1993, and Bank Rakyat Act of 1978, it was previously not under the supervision of the central bank of Malaysia, but reports direct to the Minister of Land and Cooperative Development. However, as from 15<sup>th</sup> February 2002, the bank was placed under the supervision of BNM through

<sup>10</sup> Ekonomi Islam dan Perlaksanaannya, by Nik Musrafa Nik Hassan (pp 320-321)

the Development and Financial Institution Act. (DFIA).

Bank Rakyat started to build its name as an Islamic financial institution in 1993, when it launched a syariah banking system opened to all races and religions. Now it offers Islamic banking products and services at more than 95 branches all over the country. All new branches offer full Islamic banking products and services while the existing branches were changed in phases to be fully Islamic banks. At the end of December 2001, the total Islamic banking assets were RM10,955 million or 97.4% of the total asset of the bank. This percentage is targeted to increase to 100% by the end of 2003. The total financing based on syariah amounts to RM6,253 million or 95.7% from the total financing. Bank Rakyat is now offers full-fledged Islamic banking services.

Bank Rakyat has proven itself as one of the Islamic financial institutions pioneering in providing the Islamic pawn-broking services or arrant, which was officially launched by the Minister of Finance on 21<sup>st</sup> October 1993, the starting capital coming from the YPIEM (The Malaysian Islamic Economic Development Foundation). The conventional pawn broking service was not based on Islamic injunctions and it had been on the rise for many years. It was monopolized by non-Muslims who charge a high rate of interest (riba) from its borrowers. The

pawn broking system in Bank Rakyat offers services to Muslims and non Muslims. At the end of 2001, the Bank Rakyat ar-rahu shops gave out loans of more than RM10 million to 9,837 borrowers account. However, till now, the Bank Rakyat Islamic pawn broking system and other Islamic pawn brokers have only been able to penetrate only about 10% of the conventional pawn broking monopoly.

#### **6.1.6 Bank Simpanan Nasional / National Savings Bank (NSB)**

The National Savings Bank is the biggest savings institution in Malaysia at present. It offers Islamic banking services through the Islamic window, it has an asset value of RM572 million for Islamic banking or 5% of the total asset of the bank at the end of 2001. The NSB's total number of depositors was 11.17 million with total deposits of RM 823 million. Currently, the bank has 390 branches all over Malaysia.

#### **6.1.7 Development Finance Institutions**

There are three development finance institutions which offer Islamic banking services, i.e. the Industrial Bank of Malaysia, the Development and Infrastructure Bank of Malaysia,

and the Agricultural Bank of Malaysia. These three institutions offer Islamic banking services through the Islamic window for medium and long term industrial and investment financing. The Industrial Bank also offers the same services.

#### 6.1.8 Other Institutions.

Other Institutions are as follows:

i) Permodalan Nasional Berhad (PNB): PNB was incorporated on March 17 1978, was conceived a pivotal instrument of the Government's New Economic Policy to promote share ownership in the corporate sector among the Bumiputra and develop opportunities for suitable Bumiputra professionals to participate in the creation and management of wealth. With a total fund managed of more than RM49 billion, the PNB Group is the country's leading investment institution with a diversified portfolio of interests that include unit trusts, institution property trust, property management and asset management. Although it's not a full-pledged Islamic institution due to its investment activities, there are financial institutions like BIMB

Holdings Berhad (Bank Islam Malaysia Berhad) and BIMB securities Sdn Bhd are under PNB group.

ii) Zakat Institution: In Malaysia, though Islam is the official religion, The Federal Government does not have the fullest authority in religious affairs. Zakat is the responsibility of the Islamic Council of each state in the country. There are 14 Islamic Councils, one for each of the 13 states and one for the Federal Territory of Wilayah Persekutuan. Pusat Pungutan Zakat (Zakat Collection Center) was officially opened by the Honorable Prime Minister of Malaysia, Tun Dr. Mahathir Mohamad on 8<sup>th</sup> March 1991 by being the first zakat office to operate in a new corporate style. At the end of 2005, the amount of RM473.3 million zakat was collected compared to 2001 and 2004 were RM320.3 million and RM473.3 respectively.

iii) Malaysian Islamic Economic Development Foundation (Yayasan Pembangunan Ekonomi Islam Malaysia (YPIEM): It was established by the Federal Government of Malaysia on 13<sup>th</sup> October 1976 and incorporated under the

Trustees Act 1952. YPEIM was restructured and relaunched on 20<sup>th</sup> July 1984 to develop and uplift the Muslim Community through the culture of amal jariah (Beneficence).

iv) The Treasury Housing Loan Division started to offer Islamic housing loan services to government employees since May 1996.

v) Islamic Pawn companies, Islamic cooperatives or the normal cooperatives which use the Islamic system as a method of investment and providing loans to its members. *Baitulmal* and *waqaf* institutions. However, We do not propose to discuss all of these institutions in this paper.

In fact, on the inception of the new Malaysian Cabinet on the 27<sup>th</sup> March 2004, the honorable Prime Minister announced the formation of a department of Zakat, Waqf and Hajj under the Prime Minister Department with the aim of making their administration systematic and effective throughout the country. This shows a full commitment by the government to strengthen the Islamic financial system in Malaysia.

### 6.1.9 Islamic Financial Market

In the process of evolving a complete Islamic financial system for

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Malaysia, an Islamic financial market was also set up. It comprises of the Islamic money market and the Islamic capital market. The Islamic money market, introduced in 1994 may be regarded among the most structured Islamic money markets in the world. It comprises transactions in the trading of Islamic papers, the Mudharabah inter-bank investment, and the Islamic clearing and settlement system. Some of the instruments developed under the Islamic money market are the government Investment Issues, Islamic Acceptance Bills, green Bankers Acceptances, Islamic debt securities (bonds and commercial papers) and Islamic Negotiable Instruments. The Islamic Capital market comprises a primary securities market, in which new issues of Islamic Government papers and Islamic corporate securities are offered to the public as well as institutions; a secondary market, in which existing Islamic Government papers and Islamic corporate securities are transacted; the equity market and unit trusts.<sup>11</sup>

Further development in the Islamic financial institutions in Malaysia are the establishment of the Islamic Equity Market, Islamic debt securities, the National Syariah Advisory Council for banking and takaful, Association of Islamic Banking Institutions Malaysia

<sup>11</sup> The Islamic Financial Landscape in Malaysia, by Awang Adek Husin.



(AIBIM) and, Islamic Banking and Finance Institute of Malaysia (IBFIM). Labuan Offshore Financial Services Authority (LOFSA) is introducing an international Islamic banking money market, ASEAN Takaful Group to enhance cooperation and exchange of ideas among ASEAN countries. Malaysia is also hosting the secretariat for the Islamic Financial Services Board (IFSB) to coordinate and standardize the supervising system of the Islamic financial institutions apart from producing standards for Islamic financial institutions around the world.

#### **6.1.10 Institutions of Islamic Finance Education**

The International Centre for Education in Islamic Finance (INCEIF) was established recently in the second quarter of 2006 to offer professional certification and postgraduate programmes as part of the efforts to build the necessary talents and skills in Islamic finance. These developments are among important building blocks in the effort to position Malaysia as a premier international Islamic financial centre. INCEIF is to be a leading international centre for educational excellence in Islamic finance with the objectives of:

- i. facilitating the coordination, planning and implementation of human capital initiatives for the global Islamic financial industry;

- ii. developing superior talents for the global Islamic financial system;
- iii. offering internationally recognised professional certification and postgraduate programmes; and
- iv. supplying talented researchers and educators in Islamic finance.

The International Islamic University Malaysia (IIUM) also plays a vital role in developing Islamic economics and Islamic finance education and academics of PhD, Masters and Bachelors programmes through the Kulliyyah of Economics and Management Sciences since 1983 and the establishment of IIUM Institute Islamic Banking and Finance (IiBF) in 2004 to provide education and research in Islamic Banking and Finance. However, there are some universities also support the development of Islamic banking and finance by providing academic programmes in Islamic Banking and finance.

Besides developing the types of institution and its number, Malaysia is also diversifying the Islamic financial instruments and upgrading the services and infrastructure to enable it to be at par or competitive with other financial institutions.

## 6.2 Islamic Financial Instruments

One of the conditions for the Islamic financial institutions to be strong, sophisticated and viable, and competitive with the conventional financial system is through developing numerous financial instruments which can give more options to the customers. No financial system can be set up with only one or two instruments that have to compete with the conventional counterpart that provides a lot of choices to its customers.

In developing a financial instrument, we may have to consider two types, i.e. equity financing and debt financing instrument. In the conventional system, the equity financing may give profit in the form of dividends, while debt financing is done through loans based on interest. In the Islamic financial system, equity financing and debt financing is handled by its own norms and regulations. For equity financing, Islam allows profit sharing contracts, through *al-mudharabah* and *al-musyarakah* concepts. For debt financing, Islam allows contracts of exchange which involve deferred payments. There are many contract forms in this category, including *bai' bithaman ajil* or delayed price sale. Under this contract, the proprietor of any project may buy what he needs and pay for the cost of the item by

instalment. Second is the *ijarah* or rental. Through this contract, the proprietor may rent the items needed for its project. The third is *al-murabahah* or sale with marked up price. Under this contract, *al-murabahah* is usually used for trade finance, proprietor of the project may purchase the raw material and payment is made after the delayed period, e.g. after 90 days. The three contracts may provide a profit to the proprietor through fixed sale price and rental. Indirectly, the contracts can avoid *riba* or usury as found in the conventional financial system.

The evolution of the Islamic financial instruments has been rather rapid since the establishment of the first Islamic Bank in Malaysia in 1983. Within 10 years of the establishment of the bank, the Central Bank managed to introduce 21 kinds of Islamic banking products to fulfill the needs of the financial institutions and its customers. The approach used by the Central Bank was not to entirely abolish the conventional instrument. The instruments which do not conflict with *syariah* were absorbed into the Islamic financial system, whereas those that do not adhere to the Islamic *syariah* will be modified to fulfill the needs of *syariah* by rejecting elements that violate the *syariah*<sup>12</sup>.

<sup>12</sup> Nor Muhammad, *Sistem Kewangan Islam di Malaysia*, p. 53.

With the formation of a diversified and sophisticated instrument kit, the Islamic financial system fulfills the needs of the customers and will be able to compete effectively with the conventional system, and the number of customers and depositors of the bank will increase in course of time. In view of a successful evolution and growth of the Islamic system of finance, the Central Bank of Malaysia has organized a strategy to channel the its products to conventional financial institutions through the Islamic windows known earlier as the Non-Interest Banking Scheme but now termed as Islamic Banking Scheme (IBS). As such, the Islamic financial system is likely to spread and grow more effectively and at a faster pace.

Even after almost 20 years of Islamic financial system being in operation, more new products continue to be introduced. Among them, the Central Bank of Malaysia has introduced current account and savings account using the Islamic principles of Al-Wadiah Yad Dhamanah (Safekeeping with guarantee), general investment account and special investment account using the principles of Al-Mudharabah (profit sharing), investment in government certificate, overdraft facilities and welfare loans using the principles of Al-Qardhul Hasan (benevolent loan or

an interest-free loan given mainly for welfare purposes), investment in shares/shares financing using the principles of Al-Wakalah (agency) or Al-Mudharabah or Bai' Bithaman Ajil (deferred payment), house financing and financing for the acquisition of assets using the principles of Bai' Bithaman Ajil, Vehicle financing using the principles of Bai' Bithaman Ajil or Al-Ujarah Thumma al-Bai' (hiring following by sale and purchase) and many more.

### **6.3 Islamic Money Market (IMM)**

Effective January 3, 1994, an Islamic Money Market was set-up in the Malaysian financial system, which covers (i) inter-bank trading in Islamic financial instruments, (ii) Islamic inter-bank investments and (iii) Islamic inter-bank cheque clearing system. Through the inter-bank trading in Islamic financial instruments, the Islamic Bank and all Islamic banking schemes (IBS) are allowed to have transactions among them through the Islamic financial instruments such as mudharabah bond, Islamic acceptance bill, Islamic teller receipt and Islamic loan security. In course of time, new instruments will be introduced for this purpose.

Islamic inter-bank cheque clearing system is one of the latest introduction by the Central Bank for

Islamic Bank Malaysia Bhd. and Islamic banking scheme banks (IBS), where all cheques from any of these banks will be separated from the cheques of the conventional banks for clearing purposes. This system uses the principles of *al-mudharabah*.

Another achievement in the development of the Islamic financial system in Malaysia is the setting up of the Islamic equity market. This market is able to assist Islamic financial institutions to involve themselves in the equity market based on Islamic principles. In October 2006, there were 1029 stocks or counters having transactions at Bursa Malaysia on each board i.e. Main Board, Second Board and Mesdaq. Among them were 886 counters categorized as "halal" (Syariah compliance securities) by shariah scholars. This covers 523 stocks which are being traded at the main board, 237 stocks at the second board and 126 more at MESDAQ market. Counters which are not in the "halal" list are manufacturing companies which produce "haram" products, companies selling "haram" products, financial institutions operating based on *riba*, hotels selling liquor, gambling houses and conventional insurance companies.

Islamic brokerage service was established to assist in the operation of the Islamic equity market. The public interested in investing in the KLSE in an Islamic way can use this service of the Islamic brokerage. Among the

Islamic brokerage companies approved are the BIMB securities and several conventional brokerage firms approved to offer Islamic brokerage service, such as Rashid Hussien securities, Arab Malaysian securities, etc.

Another main component in the Islamic capital market in Malaysia is the Islamic Private Loan Security Market (IPLSM). It is also known as the Islamic corporate bond. The first IPLSM established in Malaysia was in 1990 for a multi-national company, Shell MDS Bhd. Securitization was made through delayed sales facility under the concept of *Bay bithaman 'ajil* involving an amount of RM125 million which was managed through a syndicate between the sponsoring companies and Shell MDS. Another IPLSM for Shell Sarawak was of a value of RM560 million issued according to the *al-musharakah* mechanism i.e. profit-loss sharing between the sponsors and the above named company. Another contract issued according to *qard-al-hassan* involved RM300 million for PETRONAS Dagangan berhad (PDB). However, the biggest corporate bond issued so far in Malaysia was by KL International Airport Bhd. (KLIA) with an amount of RM2.2 billion. The issuance of the bond was approved by the securities commission for the purpose of construction of the new airport in Sepang, based on *al-bay' bithaman 'ajil*.

Another important development in the securitization of assets in the Islamic way in Malaysia is the launching of the non-interest private loan security which is also known as bond *mudharabah* cagamas by Cagamas bhd. in Mac 1994. The launching of this bond was to fund the purchase of Islamic housing loans from institutions funding the project to the customers and its employees.

The issuance of Cagamas Bond involves two elements. The first element is the purchase of Islamic housing loans by Cagamas from institutions providing funding. This purchase is done according to the Bay al-dayn concept. The second element is the issuance of bond through *mudharabah* by Cagamas to finance the said purchase. Issuance of *mudharabah* Cagamas bond is implemented according to the *al-mudharah* concept.

Another success for Malaysia in the process of the development of Islamic financial system was when it became the first country in the world to issue government bond according to the shariah. This bond was called the government investment certificate Malaysia (GIC) which was issued in 1983, as soon as the Islamic bank of Malaysia started its operations. On 31<sup>st</sup> December 1994, the total GIC in the market was RM4.8 billion. More than 60% of this total was owned by BIMB. The GIC was based on the

concept of *al-Qardhul hasan*. This means that there were no fix returns on the GIC. The government as the debtor is only required to return the main loan. However, on the integrity on the debtor, it may give *hibah* (gift) to the creditor. This is called the concept *al-Qardhul Hasan*.

Bank Negara Malaysia also has introduced a new Islamic monetary instrument, namely, Bank Negara Malaysia Sukuk Ijarah. The Bank Negara Malaysia Sukuk Ijarah was issued in February 2006 through a special purpose vehicle, BNM Sukuk Berhad with an issue size of RM400 million. The proceeds were used to purchase Bank Negara Malaysia's assets which were then leased back to the Bank for rental payment consideration and to be distributed to investors as returns on a semi-annual basis. Upon the maturity of the sukuk, which would coincide with the end of the lease tenure, BNM Sukuk Berhad will resell the assets to Bank Negara Malaysia at a pre-determined price. The Bank Negara Malaysia Sukuk Ijarah will be issued on a regular basis with subsequent issues ranging from RM100 million to RM200 million. The Bank Negara Malaysia Sukuk Ijarah will add to the diversity of liquidity instruments used by Bank Negara Malaysia in managing liquidity in the Islamic money market as well as to serve as a benchmark for other short to medium-term Islamic bonds.

## 7.0 ISLAMIC FINANCIAL SYSTEM IN MALAYSIA: SOME ASPECTS OF GROWTH

During the last 20 years, we have seen the rapid growth occurring in the Islamic financial system in Malaysia. This is evident from the growth in the number of the institutions and branches throughout the country, the number of instruments and products set up, total assets, total deposits and depositors, total amount of financing, total investments, as well as other services which have helped in the process of increasing the growth of the said institutions. Before this, we have discussed about the growth and development of the institutions, instruments as well as the services which are the important determinants in the development of a financial system. In this section, we will present the growth of asset, deposit, and financing for all the Islamic financial institutions in Malaysia.

Even though Malaysia is among the pioneer countries who established an Islamic financial institution in the world ie with the establishment of Tabung Haji in 1963<sup>13</sup>, the institution has, however, limited services and functions. As such, we have selected the year of the establishment of Bank Islam Malaysia

(1983) to be the beginning of the growth of Islamic financial institutions in Malaysia.

### 7.1 Assets.

In the year 1983, when BIMB was established with an asset of RM171 million, TH already had an accumulated asset of up to RM 412 million and accumulated savings of RM1,034 million from 610,000 depositors. TH had accumulated assets in the form of land and building valued at more than RM1,200 million and investments in the form of shares valued at RM31.1 million.

The emergence of Syarikat Takaful Malaysia (STMB) and YPIEM in 1984 brought about further increase in the total asset of Islamic financial institutions. At the end of 1984, Syarikat Takaful had assets of RM10 million. YPIEM, which was established as a social financial institution had assets from the contributions of individual and institutions amounting to RM 4.8 million. The total accumulated assets of all these institutions reached RM 800 million at the end of 1984.

At the end of 1987, BIMB succeeded to increase its total assets to RM1,093 million with 21 branches which were set up. The annual rate of growth of the BIMB assets over a 5-year period was almost 50%. TH managed to increase its assets to RM 779 million with a growth rate of

<sup>13</sup> The establishment of Tabung Haji (TH) in 1963.

9.4%. In the same period of time, Syarikat Takaful Malaysia and YPIEM accumulated their assets totaling RM 13.7 million and RM 9.6 million respectively. The total accumulated asset of the four institutions reached almost RM1.9 billion. The overall asset grew at the annual rate of 11.6% during this five year period.

The second five year period (1988 - 1992), did not show much development in the establishment of new institutions. This is because the government would like the existing institutions to strengthen their positions through establishing more branches and developing new instruments rather than allowing new institutions to come in. In 1988, the accumulated asset of BIMB, TH, STMSB and YPIEM were RM1,429 million, RM 936 million, RM 18.7 million and RM 13.6 million respectively. The amount grew to RM 1661 million, RM 1662 million, RM 77.1 million and RM 45 million respectively by the end of 1992. This showed an increase of the total accumulated asset between RM 2,397 million to RM 3,445 million with an annual rate of growth of 8.7%.

The third five year period (1993-1997), marked a new phase of the development of the Islamic financial institutions in Malaysia. Two important events that took place during this period were the launching of Islamic Banking Scheme (IBS) and the

establishment of a second takaful company called Takaful Nasional. These had boost up the total asset and thus speed up the growth of Islamic financial system. In 1993, with 22 financial institutions offering Islamic financial services (including BIMB and Bank Rakyat); the total accumulated asset from 22 institutions reached RM2,559 million. This include the contribution from Bank Rakyat RM 166 million. The amount increased to RM 20,458.41 million by the end of 1997. In addition, TH accumulated assets grew from RM2,084 million in 1993 to RM6,145 million in 1997. Meanwhile, the assets of two Takaful companies and YPIEM rose from RM 100.9 million and RM 50 million to RM441 million and RM405 million respectively. This made the total accumulated assets for all the financial institutions offering Islamic financial services rise from RM 4,794 million to RM27,449 million, with the annual rate of growth of more than 90%..

During the following four year period, (1998-2001), another Islamic bank existed, namely Bank Muamalat (1999) i.e. the second Islamic bank established in Malaysia. From the period of 1988 to 2001, the total asset of Islamic banking (including Bank Rakyat) increased from RM 25,253 million to RM 69,884 million. Within the same period, the asset of TH and Takaful increased from RM 7306

million and RM554 million to RM11,398 million and RM2189 million respectively, while the asset of YPIEM decreased from RM 455 million to RM 401 million. The overall total accumulated asset of the financial system increased from RM33,570 million to RM 83,477 million (1998-2001) at an annual growth rate of 37 %. In 2001, the number of financial institutions offering the Islamic financial services decreased due to the decision of the Malaysian government to merge several commercial banks and finance companies as Malaysia was facing an era of financial crisis starting from 1998. The total number of institutions was reduced from 50 in the year 2000 to 39 at the end of year 2001. However the total assets and depositors continue to rise.

The following four year period (2002-2005), the number of financial institutions offering the Islamic financial services reduced from 37 (2002) to 29 (2005) in which 6 Islamic Banks, 11 commercial bank, 1 finance companies, 4 merchant banks and 7 discount houses. During the year, the total assets of the Islamic banking sector increased significantly by RM16.8 billion or 17.7% to RM111.8 billion with more than half of the increase attributable to a 16.5% (RM9.5 billion) growth in total financing. As at end-2005, total outstanding financing amounted to RM67.4 billion (2004: RM57.8 billion) or 60.2% of the total Islamic

banking assets. Investment in securities increased by 28.4% (RM4.6 billion) during the year to account for RM20.8 billion or 18.6% of the total assets. At the same time, deposits placed with other institutions also rose by 26.9% (RM4.3 billion), to account for another RM20.4 billion or 18.2% of the total Islamic banking assets. In terms of market share, the largest portion of Islamic banking assets remained with the commercial banks in the Islamic Banking Scheme (IBS) with a share of 53.4%, followed by the Islamic banks (38.8%) and the IBS discount houses (5.3%). In terms of the growth in assets, Islamic banks recorded the highest growth of 74.7% arising from the transformation of three "Islamic windows" into Islamic banks, followed by IBS commercial banks (10.7%) and IBS discount houses (0.5%).

## **7.2 \* Deposits.**

The total deposit for Islamic Banking rose from RM 241 million in 1994 to RM 809 million in 1997. Within this period, there was only one Islamic bank in Malaysia. The annual rate of growth in terms of total deposits was about 59%, while during the same period, the total deposit for TH increased from RM 1,034 million in 1983 to RM2,078 million in 1987 with a growth rate of 20%. Overall, the accumulated deposit for the two financial institutions increased from



RM 1,275 million to RM 2,887 million. The average annual growth rate for a five year period, between 1983 to 1987 was estimated at 25%.

In the second five-year period (1988-1992), there was not much changes in the growth of the total deposit in Islamic Institutions. The total deposits in Islamic Banks increased from RM 1,280 million to RM1,331 million at an annual growth rate of less than 1 %. However, the third five-year period (1993-1997) is regarded as the most important years in the history of Islamic financial institutions in Malaysia. The sudden growth occurred when the BNM allowed the conventional banks to offer Islamic financial products through Islamic windows. Within this five-year period, the total deposits for Islamic banking (including Bank Rakyat) increased from RM2,240 million to RM6,672, at the annual rate of 40%. Compared to the total deposits in the conventional banking system increased from RM229,225 to RM484,338, at the rate of 22%. Total deposits in Tabung Haji grew from RM1,885 million to RM5,701 million at the annual rate of 40%. The overall deposits for the financial institutions( inclusive of Bank Rakyat and Tabung Haji) increased from RM 1425 million to RM 12,373 million at the annual rate of 40%

Within the following four-year period, (1998-2001), the total financial

institutions offering Islamic banking services continued to increase. The total deposits of Islamic Banking (IBS) increased from RM 10,574 to RM33,575 million at the rate of 54% per year. Total deposits in Tabung Haji grew from RM 6,753 million to RM 10,565 million at the annual rate of 14%. The overall total deposits in the financial institutions increased from RM17,327 million to RM 44,140 million at the annual rate of 38.7%. Compared to the total deposits in the conventional system which increased from RM506,633 to RM545,494 million at the annual rate of 1.9%.

The following four year period (2002-2005), the total deposits of Islamic Banking System increased from RM53, 162 million to RM83, 874 million. Total deposits mobilized by TH rose by 10.2% or RM1.2 billion to RM13.3 billion as at end 2005 (end 2004: RM12.1 billion). The overall percentage of deposit for IBS at the end of 2005 was 11.7% as compared to conventional banking system was 88.3%. It is belief that the percentage will be increased as Bank Negara Malaysia has approved to date, the transformation of the "Islamic window" institutional structure of seven domestic banking groups into Islamic subsidiaries (IS) licensed under the IBA within their respective banking groups to carry out Islamic banking business.

### 7.3 Financing.

The total financing extended by Islamic Banking institutions<sup>14</sup> in 1983 was only RM 161 million. This amount increased to RM429 million in 1987 and RM1,046 million in 1992, with an average growth rate of 8.5 percent per annum. Within the first ten-year period (1983-1992), only the Islamic bank (BIMB) was providing the Islamic financing services.

By the year 1993, the Islamic financing services started to grow, with Islamic banking services offered through the conventional financial institutions. The total financing increased from RM1,098<sup>15</sup> million in the year 1993 to RM8,558 million in the year 1997<sup>16</sup> at the annual rate of 136%. Islamic Banking Scheme (IBS) of the conventional banks, Islamic Banks (BIMB), Bank Rakyat, Finance Companies, Merchant Banks and Discount Houses were among the institutions which offered this services.

From 1998 to 2001, the total financing extended by the above said Institutions increased from RM7, 739 to RM22, 449 million. The annual growth rate was more than 240%

during this eight year period. This high growth rate was the effect of increased in the Islamic funds for financing purposes and increased in the demand to finance economic activities.

During the year 2005, there was a higher number and amount of financing applications received by the Islamic banking institutions. In tandem with the increase in financing approvals of 55.1%, financing disbursements increased by 19.4%. Financing repayments also recorded an increase of 25.3% as the overall economic condition improves. Arising from the active financing activities, total financing expanded by 16.5% or RM9.5 billion in 2005, (19% or RM9.2 billion in 2004). In terms of financing concept, financing based on the *bai' bithaman ajil* concept remained dominant, constituting 40.7% of the total financing, albeit at a lower percentage compared with last year (49.9%). In contrast, financing based on *ijarah* increased to 31.6% of the total financing (2004:24%) following the increase of RM5.8 billion in passenger car financing.

### 7.4 Ratio.

Since 1983, the market share of Islamic Banking assets and deposits in the overall banking system continue to rise from year to year. The industry even sustained its expansion when Malaysia was hit by the economic crisis in 1998, whereas the overall

<sup>14</sup> Financing extended by Islamic Bank (BIMB) only.

<sup>15</sup> 99 percent of the financing given by the BIMB in 1993.

<sup>16</sup> In 1997 BIMB contributed only 25 percent of the total financing while the conventional Banks contributed 56 percent of the total Islamic financing and the rest by other institutions.

banking industry was facing a negative growth. The first ten years of the development, the share Islamic Banking assets were not exceeding 1.5%. After 10 years, the industry began to take off for the second phase of the development. The asset ratio of Islamic Banking to overall Banking System further increased to 2.54 percent in 1997. For the year 2001, the ratio reached 8.2 percent. This ratio in fact surpass the 8 percent target set by BNM for that year. The percentage could even be higher should BNM include the Islamic Financial asset of Bank Rakyat amounting RM10,955 million and Bank Simpanan Nasional (BSN) RM 194.45 million. This make a share of about 9.5 percent.

The Islamic Banking deposit share in the banking system increased from 7.4 percent in 2000 to 9.5 percent in 2001. However, taking into consideration of Bank Rakyat the figure reached almost 11.1 percent in the year 2001. Besides commercial banks, finance companies, merchants banks and discount houses, Muslims also deposit their money in Tabung Haji (TH). For example in the year 2001, more than RM10.5 billion were deposited in this institution.

Total ratio of financing extended by the Islamic banking institutions to the overall banking system is always on the rise. This is because the increase in amount of deposit in the institutions, the creation

of new financial instruments, and high demand from the Muslim on non-interest financing.

In 2001, the percentage of Islamic financing over total financing increased to about 5.6 percent (4.4 percent in 2000) or 6.5 percent with the inclusion of Bank Rakyat (5.2 percent in 2000).

### **7.5 Overall Financial Performance of Islamic Banking Industry at the end of 2005**

In terms of financial performance, the Islamic banking industry as a whole showed commendable results in 2005, with profitability and assets surpassing for the first time the RM1 billion and RM100 billion thresholds respectively. Assets increased to RM111.8 billion, registering a strong growth of 17.7% and accounting for 11.3% of the total assets of the entire banking system. The market shares of Islamic deposits and outstanding financing also increased to 11.7% and 12.1% of the industry's total respectively. Total outstanding financing grew by 16.5%, attributed by the growth in new financing approved and disbursed of 55.1% and 19.4% respectively, while net non-performing financing ratio declined further to 4.8% at the end of the year.

### **7.6 Point to Note**

Based on the past performance, the target to achieve 20 percent share by 2010 is not impossible.

### **8.0 PROSPECTS OF ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA.**

The prospects for the Islamic financial system to compete with the conventional system in terms of institutions, products and services are quite bright. It is expected that by the year 2010, the share of asset of the Islamic financial institution in the overall system will reach at least 20 percent.

This was based on the statistics that showed an increasing trend from year to year. This development occurred due to several factors. First, the involvement and strong support from the government and the Central Bank (BNM) who wanted to see this system succeed. Second, the conventional financial institutions contributed significantly to making this system a success. Third, the support for and confidence of the public in the Islamic financial system were the important factor in ensuring the success of this system to grow in Malaysia. Fourth, the commitment of the Islamic financial institutions themselves in proving that they are competitive in terms of quality of service, product innovation and

increasing the number of institutions and branches which offered the Islamic banking services compared to conventional banks. Fifth, the transformation of the "Islamic window" institutional structure of seven domestic banking groups into Islamic subsidiaries (IS) licensed under the IBA within their respective banking groups to carry out Islamic banking business. Sixth, the BNM policy of allowing conventional financial institutions to set up an Islamic window was very helpful and suitable, Malaysia being a multi-religious country. It helped attract more non-Muslim customers to have their business activities conducted through the Islamic system. The Muslims and non-Muslims now have both the options -- Islamic and the conventional -- open to them. This was proven when the Islamic Banking Scheme (IBS) in Malaysia received a good response not only from Muslim customers, but also from those non-Muslim customers.

The percentage of assets of the Islamic financial institutions compared to the overall asset of the banking institution increased from 0.3% in the year 1984 to 11.3% in the year 2005. To achieve 20% share of the market by 2010 is an achievable target. If we include other institutions, such as Tabung Haji, Development Financial Institutions etc. into reckoning, the percentage of the overall Islamic financial asset would be higher. If

efforts to speed up the performance of the Islamic financial system in Malaysia continue, the aspirations and targets of the government of Malaysia to make Islamic Financial Institutions as the most important institutions in the country can possibly be achieved. Malaysia can then be the best model or center of Islamic financial institutions among the Islamic nations in the world. It would be in line with Malaysia being the most developed among the developing countries in terms of economy, social and infrastructure development, let alone the stable political climate compared to other Islamic countries.

## 9.0 CONCLUSION.

The development of a financial system that is complete and efficient in Malaysia within a period of less than two decades has proven that this system has been successful in competing with other conventional system which has been operating in this country for more than half a century. The success of Malaysia in establishing an Islamic financial system apparently has contributed to the success in a direct or indirect way towards the socio-economic development of the Islamic ummah in this country. This system has not only succeeded in mobilizing the financial assets of Muslim ummah through

saving and investment in accordance with shariah, free from the element of riba, gharar, etc., but part of this accumulated asset will be returned to the needy Muslims through payment of zakat which is issued direct to the eligible recipients. Indirectly, the development of Islamic financial system has helped towards the eradication of poverty among the Muslims. As an example, Tabung Haji alone has paid out zakat in 2002 and 2003 totaling RM14.98 million and RM14.48 respectively. Bank Rakyat has paid out RM20 million in 2005 where the amount was the highest ever by the bank, because their profit has been rising every year for the last seven years.

The stable and competitive Islamic financial system has given the confidence to the Muslim and non Muslim. As an example, when Malaysia was hit by the financial crisis in 1998, many conventional financial institutions based on riba were affected in terms of their total deposits. However, the Islamic financial institutions continued to record a positive growth. This was due to the trust of the public towards the Islamic financial system.

The development of the Islamic financial system also relates to the spiritual development of the Muslim ummah in Malaysia. The Islamic society in Malaysia is not only free to perform their ibadah, but they are also

able to enhance their ibadah through Islamic business transaction (muamalat) which is free from elements of riba that is clearly forbidden in Islam, such as investment, savings and loans through Islamic banking system or Islamic financing and investment companies.

The socio-economic success of the government of Malaysia through the development of Islamic financial system has projected a good image of her in the Muslim world. Malaysia in uplifting the image of Islam and has proves that the country is serious in establishing a comprehensive Islamic economic system. This includes the efforts of the government in setting up other institutions which can assist in the spread of Islamic financial system as a whole.

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