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Redefinition of the Role of Asia-Pacific Region in the Global Economy ISSN 1899-3192

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ISLAMIC BANKING – THE CASE OF MALAYSIA

Abstract: In the last few decades the increasing significance of Islamic finance has been observed. Among all the Islamic financial institutions, banks have been playing a dominant role in Islamic financial industry. A distinctive feature of Islamic banks is the obligation to conduct operations in accordance with principles of shariah, which is the religious law of Muslims. The purpose of this paper is to analyse the Islamic banking market in Malaysia. The reason why Malaysia has been chosen is the fact that it is one of the most developed Islamic banking markets in the world, and many other Muslim countries introduce the same regulations and banking practices, that has been functioning with success in this country. The methodology used in the paper is based on the analysis of the literature, as well as statistical data, provided mainly by Bank Negara Malaysia.

Keywords: Islamic banking, shariah, Malaysia.

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1. Introduction

In the last few decades the increasing significance of Islamic finance has been observed. Among all the Islamic financial institutions, banks have been playing a dominant role in Islamic financial industry. According to estimates of Kuwait Finance House Research Department, assets of Islamic financial institutions amounted to $1.8 trillion in 2013.[1] About 80% of those assets belong to Islamic banks. Islamic banks operate in over 75 countries, not only Muslim ones, but also those, where Muslim minority live, such as the UK, the USA or France. The reasons why such institutions were established across the world are connected with the neo-revivalist movements among Muslim societies on the one hand and the raising wealth of some Middle East countries on the other. One of the most influential movements was the Muslim Brotherhood, established in Al-Ismailijja (Egypt) in 1928 by Hasan

[1] The numbers are given according to a short scale system, used in most English and Arabic speaking countries.

al-Banna. The Muslim Brotherhood criticized interest-based financial system in Egypt and other parts of the Muslim world and argued that since Islam provides its followers with a comprehensive ideological framework for all aspects of life, economic affairs should be also included within that framework.[2] The opinions of Muslim Brotherhood and other Muslim movements found followers in academic world as well as among market practitioners. But if it were not the wealth of the Gulf states, which was the result of oil crisis and the enormous increases in the oil prices, the development of Islamic finance probably would have been much slower. Almost all the Islamic banks that were established in the 1970s were partly or even totally funded by oil-linked wealth.

In Malaysia the first full-fledged Islamic bank was founded in 1983, when the Islamic Banking Act came into force. Since the very beginning Islamic banking sector of the country was supported by the government and as a result Malaysia has become world's leading Islamic financial centre.

2. Operations of Islamic banks

A distinctive feature of Islamic banks is the obligation to conduct operations in accordance with principles of shariah which is the religious law of Muslims. The basic principle applied by Islamic financial institutions is the prohibition of usury (arab. *riba*). It also constitutes the main difference between Islamic banks and conventional financial institutions which base all their operations on interest rate. The prohibition of *riba* has its origins in the holy book of the Muslims – the Koran. The hadiths, which describe the life and actions of Muhammad, the Messenger of Allah, also state that *riba* is condemned. However, neither the Koran nor the hadiths define what *riba* is. According to most Islamic economists, usury is any sort of increase over the principal amount.[3] So it has a different meaning than in contemporary Western world, where usury is defined as the practice of charging excessive, unreasonably high interests on loans.

Apart from the prohibition of *riba*, Islamic financial institutions must operate in accordance with other principles. They must avoid contracts that involve excessive risk (*gharar*), that is transactions where a significant element of uncertainty exists. That is one of the reasons why Islamic banks should not trade in derivatives.

It should be also mentioned that all economic transactions of Muslims should support those practices or products which are not considered *haram*, or unlawful, to Islam. Thus investments in areas such as alcohol, casinos, cigarettes are prohibited.

[2] A. Saeed, *Islamic Banking and Interest. A Study of Prohibition of Riba and Its Contemporary Interpretation*, E.J. Brill, Leiden 1996.

[3] S.M. Hasanuz Zaman, Conceptual foundations of riba in Qur'an, Hadith and Fiqh, *Journal of Islamic Banking and Finance* 2001, vol. 18, no. 3-4, pp. 17–25.

Since *riba* is prohibited in Islamic finance, instruments typical for conventional banking are not allowed either. They must be replaced by other types of products. Financial tools of Islamic banks can be divided into two groups: profit and loss sharing (PLS) instruments and cost-plus instruments.

The basic principle of PLS instruments is that instead of lending money at interest, the bank forms a partnership with the borrower, sharing in a venture's profits and losses. Hence unlike an interest-based product, in the case of PLS modes of finance there is no guaranteed rate of return on the investment, since income depends on the profit earned by the partnership company and may possibly result in losses. *Mudaraba* and *musharaka* are the most common PLS contracts. In the *mudaraba* contract one party of the agreement, called *rabb-ul-maal* or *sahib-al-maal* provides capital finance for a specific venture indicated by the other party, called *mudarib*. *Mudarib's* contribution to the venture is professional and technical expertise. It is also responsible for the management of the business. If the venture brings profits, they are shared according to a pre-agreed ratio between *rabb-ul-maal* and *mudarib*. Losses however are entirely borne by the *rabb-ul-maal. Musharaka* on the other hand is a form of joint venture, where two or more parties combine their capital and labour together to share the profits, enjoying similar rights and liabilities. The profits resulted from such a venture are shared according to a pre-agreed ratio between the parties of *musharaka,* while losses are borne in proportion to contributed capital.[4]

The second group of instruments includes such modes of finance as *murabaha*, *salam*, *istisna* and *ijara*. *Murabaha* (a cost-plus, mark-up contract) is a trade contract stipulating that one party purchases a good for its own account and sells it to the other party with a mark-up.[5] The payment usually takes place sometime afterwards or in instalments. There are many controversies connected with this tool of finance. Some Islamic scholars even consider *murabaha* not shariah-compliant, since the mark-up is often based on the interest rate. However, since it is a very useful mode of finance, appreciated by both the banks and their clients, it is widely used. The practice of heavy usage of *murabaha* has even earned its own name – "*murabaha* syndrome".[6]

In a *salam* contract one party of the contract agrees to provide specific goods at a future date while the other party agrees to pay its price in full at the conclusion of the contract. Just like *salam*, an *istisna* contract is a purchase agreement for future delivery of an asset. Unlike the *salam* contract, however, in the *istisna* contract, the payment to the producer or contractor of the asset does not have to be in full in advance. Payment usually is done in instalments in line with the progress made on

[4] I. Sobol, Concept of profit and loss sharing in Islamic finance, [in:] S. Hittmar (ed.), *Regional Management. Theory, Practice and Development*, Faculty of Management Science and Informatics, University of Zilina, Zilina 2012.

[5] H. Vissner, *Islamic Finance: Principle and Practice*, Edward Elgar Publishing, Cheltenham 2013.

[6] T.M. Yousef, The murabaha syndrome in Islamic finance: Laws, institutions and politics, [in:] C. Henry, R. Wilson (eds.), *The Politics of Islamic Finance*, Edinburgh University Press, Edinburgh 2004.

the development of the asset. Therefore this tool of finance is especially suited to project finance and construction.[7]

An *ijara* contract is the Islamic equivalent of a leasing transaction. The difference between two instruments is that in *ijara* the proprietorship of the object of the lease stays with the lessor. The asset stays on its balance sheet until the end of the period of the lease. What is transferred is its usufruct.[8]

Naturally, Islamic banks, just like their conventional counterparts, offer their customers the possibility of depositing their money. Islamic deposits may be based on the profit and loss sharing principle. In that case the return the customer receives depends on the profits of venture in which the bank has invested the money of the depositor. Since in this case the depositor's profits are uncertain, Islamic banks often use other constructions for deposit accounts, where they present their customers with a gift, called *hibah*, which is an equivalent of interests, typical for conventional banking. The value of *hibah* cannot be stipulated in the contract and can be paid in any moment, agreed by the bank and its client.

3. Overview of Islamic banking in Malaysia

Malaysia is a multicultural country in Southeast Asia, inhabited by about 30 million people. The two largest ethnic groups of Malaysia are Malay (over 50% of population) and Chinese (over 22%). Over 60% of the population of the country are Muslims. Most of them are Sunni and represent Shafi'i school of shariah law.[9]

For generations Malaysian economy had been controlled by minority communities, mainly Chinese, but also in a lesser extent Indians. When Malaysia gained independence in 1957, it was agreed that Indians and Chinese would receive citizenship in exchange for the political power for Malays. As a result, Malay became the official language and Islam the state religion. It should be noted, however, that the system of government remained secular and all the religions have a guarantee of freedom of worship.

Although religion has been present in the political and economic life of the country, it should be emphasised that in Malaysia Islam was never an obstacle for modernisation, but quite opposite. It can be argued that it contributed to the growth of financial services, which made Kuala Lumpur a leading regional financial centre. The Malaysian brand of Islam is considered to be pragmatic and tolerant,[10] which probably influenced the popularity of Islamic finance in Malaysia, also among non-Muslims.

[7] N. Schoon, *Islamic Banking and Finance*, Spiramus Press, London 2010.

[8] A. Boumediene, Is credit risk really higher in Islamic banks?, *The Journal of Credit Risk* 2011, vol. 7, no. 3, pp. 97–129.

[9] There are four main Sunni schools of law: Hanafi school, Maliki school, Shafi'i school and Hanbali school.

[10] I. Warde, *Islamic Finance in the Global Economy*, Edinburgh University Press, Edinburgh 2000.

Islamic finance origins in Malaysia can be traced back to 1963, when Malaysia Muslim Pilgrims Savings Corporation was established, which was a saving fund for Muslims planning to perform the religious duty of pilgrimage (*hajj*). Within 20 years the fund (known as Tabung Hajj), received a wide recognition as a successful Islamic investment company in Malaysia. Its success encouraged the Malaysian government to establish in 1983 the first full-fledged Islamic commercial bank, the Bank Islam Malaysia Berhad (BIMB).[11] The creation of the bank was possible owing to the introduction of the Islamic Banking Act (IBA) of 1983, which provided Malaysian central bank with powers to regulate and supervise Islamic banks, in similar way to other banks, operating in Malaysia. The move was considered to be a part of the government's strategy to support Muslim Malays, who were perceived to be not competitive enough in comparison with more commercially minded Chinese.[12] In a very short time BIMB gained success, proving that Islamic banking services were needed in the country.

The 1993 was another important year for Islamic banking industry in Malaysia. In this year Ministry of Finance introduced legislation regulating an "Interest Free Banking Scheme", which was actually a step liberalising Islamic services in the country. As a result those services started to be offered by about 50 financial institutions, such as commercial banks, finance companies, merchant banks, cooperative banks and discount houses. Also in 1993 Malaysian central bank, Bank Negara Malaysia (BNM) undertook an initiative that further boosted growth of Islamic finance in the country. It was a creation of Islamic interbank money market, which was essential for managing liquidity of Islamic banks.[13]

Another important factor, contributing to the development of Islamic banking in Malaysia, was establishment of the National Shariah Advisory Council (NSAC) in 1997 as the highest *shariah* authority on Islamic banking and *takaful* (Islamic insurance) in Malaysia. The main objectives of the NSAC include: acting as the sole authoritative body to advise the central bank on Islamic banking and *takaful* operations, coordination of shariah issues with respect to Islamic banking and finance, analysing and evaluation of shariah aspects of new products and schemes submitted by the banking and *takaful* institutions.[14]

It should also be added that in recent years, Islamic banking in Malaysia has been promoted through special fiscal incentives, such as:[15]

[11] W.S. Hegazy, Contemporary Islamic finance: From socioeconomic idealism to pure legalism, *Chicago Journal of International Law* 2007, vol. 7, no. 2, pp. 581–601.

[12] A.M. Venardos, *Islamic Banking in South East-Asia: Its Development & Future*, World Scientific Publishing, Singapore 2005.

[13] S. Haron, N. Ahmad, The Islamic banking system in Malaysia, [in:] *Islamic Finance: The Task Ahead. Proceedings of the Fourth Harvard University Forum on Islamic Finance*, Center for Middle Eastern Studies, Harvard University, Cambridge, MA, 2000, pp. 155–163.

[14] A.M. Venardos, *op.cit*.

[15] http://www.mifc.com (retrieved: 10.06.2014).

– 10-year tax holidays on income earned from the Islamic banking operations conducted in foreign currencies by international banks from years of assessment 2007 until 2016,
– 10-year stamp duty exemption on instruments executed pertaining to Islamic banking operations in foreign currencies undertaken by international Islamic banks from years of assessment 2007 until 2016,
– tax exemption on any profits paid out by Islamic banks to non-residents for deposits placed at those banks,
– 20% stamp duty remission on Islamic finance instruments as approved by Bank Negara Malaysia from 2 September 2006 until 31 December 2015,
– tax exemption for five consecutive years given to Islamic banks from payment of income tax in relation to sources of income derived from its overseas branch or investee company.

The Malaysian regulations also guarantee some personal tax incentives. These are:
– tax exemption on any profits paid out by an Islamic bank to individual residents and non-resident depositors,
– withholding tax exemption on income received by non-resident experts in Islamic finance.

It should also be added that banks, operating in Malaysia, have full flexibility to employ expatriates with expertise to contribute to the development of Islamic financial system in the country.

Taking into account all the factors mentioned above, it is not surprising, that Islamic banking has been developing very well in Malaysia. Today, Malaysia is considered to have one of the leading Islamic financial systems in the world, which includes banking. As for 2014 the following Islamic banks operated in Malaysia: Affin Islamic Bank Berhad, Al Rajhi Banking & Investment Corporation (Malaysia) Berhad, Alliance Islamic Bank Berhad, AmIslamic Bank Berhad, Asian Finance Bank Berhad, Bank Islam Malaysia Berhad, Bank Muamalat Malaysia Berhad, CIMB Islamic Bank Berhad, HSBC Amanah Malaysia Berhad, Hong Leong Islamic Bank Berhad, Kuwait Finance House (Malaysia) Berhad, Maybank Islamic Berhad, OCBC Al-Amin Bank Berhad, Public Islamic Bank Berhad, RHB Islamic Bank Berhad, Standard Chartered Saadiq Berhad. Apart from those institutions, Islamic services are also offered by the branches of the following international banks: Al Rajhi Banking & Investment Corporation, Alkhair International Islamic Bank Bhd, Deutsche Bank Aktiengesellschaft, Elaf Bank B.S.C., PT. Bank Syariah Muamalat Indonesia, Tbk.[16]

Malaysian Islamic banks offer their clients products that satisfy the same needs as the products offered by conventional institutions. Additionally they give their clients the feeling of involvement in the operations which are ethical. Because, it should be

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[16] http://www.bnm.gov.my (retrieved: 5.06.2014).

stressed, there is more to Islamic banking than only elimination of *riba*. All Islamic financial products should be also free from any form of deceit or exploitation. This can be one of the reasons why not only Muslims are attracted to Islamic banking in Malaysia, but also people of other religions. The other reasons are the tax incentives mentioned above and the fact that some Chinese banks have been actively promoting Islamic products to their customers.

The popularity of Islamic banking in Malaysia is reflected in the numbers. In 2012, assets of Islamic banks operating in Malaysia, accounted for 13% of total global Islamic banking assets.[17] Only banks in Iran and Kingdom of Saudi Arabia had larger shares, 37 and 18%, respectively (Figure 1).

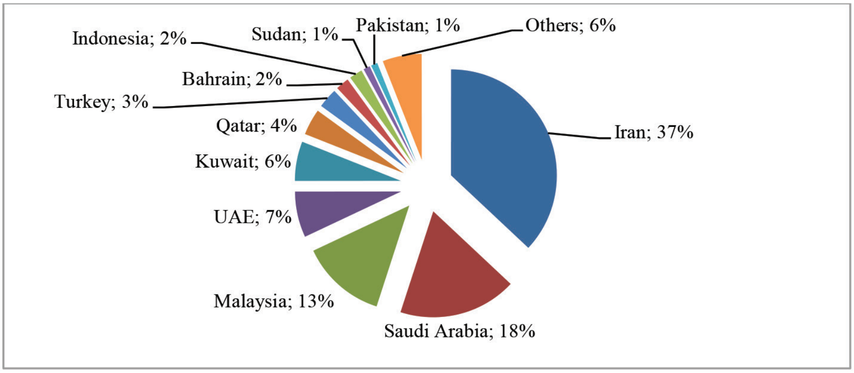

Figure 1. Domicile of Islamic banking assets

Source: http://www.mifc.com (retrieved: 10.06.2014).

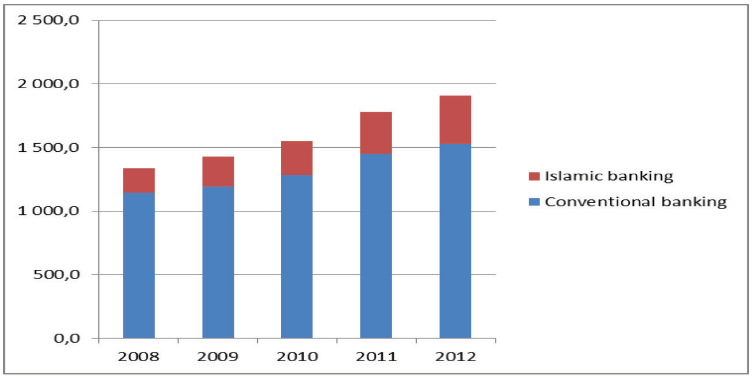

Figure 2. Islamic Banking Assets in Malaysia (in RM billion)

Source: http://www.bnm.gov.my (retrieved: 5.06.2014).

[17] http://www.mifc.com (retrieved: 10.06.2014).

The assets of Islamic banking in Malaysia amounted to 381.5 billion RM in 2012, which accounted for almost 20% of total assets in the banking system of the country. In 2008, that share was about 14%, so it increased over the last few years (Figure 2). Also the share of Islamic financing and Islamic deposits increased. In 2012 the share of Islamic financing was 21%, while in 2008 it was less than 15%. Similarly, in 2012, the Islamic deposits represented almost 22% of all the deposits in the Malaysian banking sector in comparison with 16% in 2008.[18]

It should be pointed out, however, that although Malaysia is considered to be the country, where Islamic finance, including banking, has gained a big success, the country's system meets also some criticism. Especially there are doubts with regard to lawfulness of some instruments and procedures with shariah. For instance, one of the most popular ways of managing liquidity by Malaysian Islamic banks is by means of commodity *murabaha*, which a deferred sale or instalment credit sale which uses commodity as an underlying asset for the transaction. Commodities chosen as underlying assets should be non-perishable, freely available and can be uniquely identified. Most of commodity *murabaha* transactions use metals, traded on London Stock Exchange (LME) as an asset since they meet all above mentioned criteria required from a commodity.[19] In Malaysia a special trading platform, the Burssa Suq Al-Sila', was established for commodity *murabaha* transactions. On this exchange crude oil palm (COP) is used as the underlying asset.[20] The intention of commodity *murabaha* is to replicate conventional interbank deposit transactions. Thus this instrument may serve as both: a deposit placement facility and instrument which helps to increase liquidity. It should be also added that commodity *murabaha* can be conducted between a bank and a central bank. Bank Negara Malaysia is the example of a central bank which is engaged in such transactions. In the case of commodity *murabaha*, the mark-up, the delivery date and repayment date are agreed up front. It should be added that the banks engaged in commodity *murabaha* usually do not possess the underlying commodity. The commodities are purchased and sold solely to manage liquidity in accordance with shariah principles.[21] This is one of the reasons why commodity *murabaha* provokes disputes among scholars about its permissibility.[22] According to shariah, uncertainty (*gharar)* should be avoided in financial contracts. And selling of the product which the seller does not own is considered *gharar*.

[18] http://www.bnm.gov.my (retrieved: 5.06.2014).

[19] N. Schoon, *op.cit*.

[20] A.W. Dusuki (ed.), *Islamic Financial System. Principles & Operations*, International Shari'ah Research, Academy of Islamic Finance, Kuala Lumpur 2001.

[21] N. Schoon, *op.cit*.

[22] A. Rais, A. Majid, *Development of Liquidity Management Instruments: Challenges and Opportunities*, International Conference on Islamic Banking: Risk Management, Regulation and Supervision, Jakarta 2003.

Malaysian Islamic banking system is also criticised for the limited usage of PLS modes of finance. Both *mudaraba* and *musharaka* are considered to be the ideal Islamic transactions. And according to Islamic scholars, especially conservative ones, all financial institutions should base their operations on them. But in practice, PLS transactions are not often conducted by Islamic banks. The reason for that lies in the fact that there are many problems associated with those modes of finance. Most of the problems result from the information asymmetry, which may lead to moral hazard behaviour of the borrowers.[23] As a consequence of problems associated with PLS transactions, other methods of finance, especially *murabaha*, are much more often used by Islamic banks. According to the data provided by Bank Negara Malaysia, in 2013 PLS instruments accounted for only 6% of all the modes of finance in Islamic banking sector. It should be noted, however, that this problem does not concern only Malaysia, but all the countries, where Islamic banks operate. Even in Sudan, where the whole financial system is Islamised, PLS modes of finance are not frequently used.

4. Conclusions

Islamic banking sector in Malaysia has always had a strong support from the government on legislative and regulatory aspects. Also good promotion, accompanied by the revival of the religion among the society, heavily influenced the quick development of Islamic banking in this country.

The future of this sector seems also to be bright. Malaysian policy makers and bankers even believe that Islamic banking will take over the conventional banking by 2020. There are a few factors that should contribute to this. Firstly, in the next few years still tax incentives favouring Islamic sector will be in force. Secondly, the further opportunities for Islamic lie also in the inclusion in the banking system of those members of the society who have not used any banking services so far, but who will be attracted to the system by the ethical values, represented by Islamic banks. It should also be added that Islamic banks in Malaysia are also engaged in microfinance schemes, in much greater scale than their conventional counterparts. And in the future their engagement is going to be even higher.

It should be stressed, however, that although the Islamic banking in Malaysia is considered to be very progressive, and as it has already been written, it is believed that it would develop in the next years, there are still problems that have to be solved.

First of all, Islamic banks still sometimes are perceived as imitators of conventional institutions. And the philosophy and goals of Islamic banks should be different from those of conventional banks. It is impossible to require from Islamic banks not to concentrate on achieving profits, but the profit motive must be accompanied by the motives of ethics and morality. It is also important for Islamic banks to concentrate on

[23] I. Sobol, Concept of profit…

offering the products that cannot be considered as conventional products in disguise, which is now a frequent case. The first step in this direction was made in 2013, when Islamic Financial Services Act was enacted in Malaysia. In this regulation it is stipulated that an Islamic institution shall at all times ensure that its aims, operations, business, are in compliance with shariah.

It should also be noted that Islamic banking is only one element of Islamic financial system. Islamic bonds (*sukuk*) or Islamic insurance (*takaful*) markets were not discussed in this paper, but they have also been developing very well in Malaysia.[24] When it comes to *sukuk* issuance, Malaysia is the absolute world leader. And it should be also noticed that development of Islamic banking is related to the development of other Islamic financial sectors. For instance, *sukuk* are used by Islamic banks in Malaysia for liquidity management purposes.[25]

Finally, it should also be added that the development of Islamic banking in Malaysia is impossible without the cooperation with foreign institutions. And this is possible only if there is uniformity between products and procedures used by Islamic banks in different countries. It means the necessity of the development of globally accepted shariah compliant products and practices. It is not an easy task taking into account different shariah schools, but it is a challenge that Islamic banks, also those from Malaysia, have to face.

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BANKOWOŚĆ ISLAMSKA – PRZYKŁAD MALEZJI

Streszczenie: W ciągu ostatnich kilku dekad wzrosło istotnie znaczenie finansów islamskich, w szczególności zaś bankowości islamskiej. Charakterystyczną cechą banków islamskich jest konieczność przeprowadzania operacji finansowych zgodnie z religijnym prawem muzułmanów – szariatem. Celem niniejszego artykułu jest analiza rynku bankowości islamskiej w Malezji, ze szczególnym naciskiem na czynniki, które przyczyniły się do rozwoju tego rynku.

Słowa kluczowe: bankowość islamska, szariat, Malezja.