

ISLAMIC BANKING: MALAYSIA'S PERSPECTIVE

Abstract

This paper discuss on the development of Islamic banking in Malaysia since the establishment of first Islamic bank in 1983. From there onwards, the government with Bank Negara Malaysia (BNM) and Suruhanjaya Sekuriti Malaysia or Securities Commission (SC) has implemented various policies to expedite the growth of Islamic banking and finance in Malaysia. The absent of international manual or guideline in estimating Islamic banking and finance pose a bigger challenge to the countries. The Department of Statistics Malaysia (DOSM) has compiled value added of Islamic banking and Takaful from 2000 onwards but the challenges remained in Islamic capital market compilation.

1. Introduction

The Malaysia economy structure transforms from agriculture based to the manufacturing and services activities back in 1990. The services and manufacturing sectors were main catalyst for the economic performance. The services sector was the major contributor with a share of 54.6 per cent in 2012 at constant 2005 prices. The financial sector was one of important sub-sector in services sector with a share of 17.2 per cent in 2012 at constant 2005 prices. The main composition in financial sub-sector was financial intermediation and Insurance.

The financial intermediation grew at the rate of 8.9 per cent annually from 2005 to 2012 at constant 2005 prices which was higher than overall GDP growth at 4.7 per cent in the same period. The share of financial intermediation contributes almost to 68 per cent to overall financial and insurance sub-sector. Meanwhile, Insurance activity sector grew at 6.5 per cent annually for the period of 2005 to 2012 and contributed about 25 per cent to financial and insurance sub-sector.

2. The development of Islamic banking in Malaysia

The Islamic banking activities in Malaysia started back in 1983 with the establishment of Bank Islam Malaysia Berhad (BIMB). Prior to the establishment of BIMB, government has set up the Pilgrims Management Fund and Board of Malaysia (renamed to Lembaga Tabung Haji) in 1963 with the objective to facilitate Malaysian muslims to perform Haj by pooling and investing their savings. This is the first Syariah based deposit taking institution in Malaysia.

In early stage, Islamic banking in Malaysia provided basic banking services and products such as taking deposits and giving loans with free from riba' element which is forbidden in Islam. As the industry grows the products offered varies to meet the demand from both individuals and companies users. Currently, Malaysia's Islamic banking has widen the services and products by venturing into Islamic insurance (Takaful), Islamic pawn broking and taking underwrite activity for Sukuk. In broader term, Islamic financial market has become more dynamic in offering services and products such as Islamic securities, Islamic unit trust funds, stock broking and financial derivatives which comply with the Islamic guidelines.

The Islamic banking development in Malaysia was initiated by the commitment of the Malaysian government with the introduction of the Islamic Banking Act 1983 and the Government Investment Act 1983. Hence, the first Islamic bank establishment was the Bank Islam Malaysia Berhad (BIMB). BIMB posted an impressive growth with total assets grew by six fold from RM325.5 million in 1984 to RM1,890.6 million in 1993, meanwhile deposits increased from RM241.4 million to RM1,611.7 million and loans from RM161.1 million to RM996.4 million. However, the participation of Islamic

banking to overall banking system remained relatively low and the level of penetration to mass population remained limited.

The introduction of Interest-free banking Scheme or *Skim Perbankan Tanpa Faedah* (SPTF) for conventional banking by Ministry of Finance in 1993 was the turning point for Islamic banking system in Malaysia. This legislation allowed conventional banks to offer Islamic banking services or “Islamic window” using their existing facilities but the account strictly must be segregated between Islamic banking and conventional banking. The idea is to make Islamic banking services and products reach mass population with lowest cost and in within shortest time. The organic growth of Islamic banking seems to be more expensive and time consuming, with this Islamic banking Scheme set to be more effective and efficient mode of increasing the number of institutions offering Islamic banking services. Furthermore, SPTF will create competitive and dynamic environment to spur Islamic banking growth. The assets of Islamic banking increased by 44 per cent to RM2,392 million in 1993 as compared to previous year, while, deposit grew by 69.8 per cent to RM2,260 million and total financing expanded by 3.7 per cent to RM1,098 million (BNM annual report,1993). Malaysia is the first country practices this method (dual license), while some countries convert the entire banking system to Islamic banking and others practice "Conventional plus" system, where the system is basically a conventional system with a few Islamic banking institutions operating on the fringe of the banking system.

In January 1994, Bank Negara Malaysia (BNM) introduced Islamic Interbank Money Market (IIMM) and the objective of BNM is to create a full-fledged Islamic banking system to function parallel with the conventional banking system. The Islamic

interbank money market grew by 175.6 per cent in 1999 to RM435.7 billion from RM158.1 billion in 1998 (BNM Annual Report, 1999).

In effort to strengthen the Islamic banking system, BNM introduced few guidelines in 1996, firstly New Financial Disclosure (GP8) to give greater transparency and disclosure of Islamic banking operations. Prior to this, income recognition for SPTF participant banks was recorded in cash basis and its parent banking (conventional banking) using accrual basis. In order to promote consistency, SPTF operation allowed to record used accrual basis. Meanwhile, the full-fledged Islamic bank was allowed to report their income recognition with its existing cash accounting basis. Secondly, full-fledged Islamic banking branches for eligible SPTF banking institutions. SPTF banks were allowed to set up full-fledged Islamic branches which will focus more on development of Islamic banking. Thirdly, the establishment of Syariah Advisory Council (SAC) as the sole authority body to advice BNM on Islamic banking and Takaful operations. Furthermore, the SAC will coordinate Syariah issues related to Islamic banking and finance. The SAC is responsible to analyses and evaluate Syariah aspects on new products proposed by Islamic banking and Takaful companies.

The Bank Muamalat Malaysia Berhad (BMMB) was established in 1999 as a second Islamic bank in Malaysia. The establishment of BMMB rose from the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (M) Berhad (BOCB). The Islamic banking in Malaysia achieved a new milestone in 2004 with the issuance of three new Islamic bank licenses under the Islamic Banking Act 1983 (IBA) to Islamic financial institutions from the Middle East, namely Kuwait

Finance House, Al-Rajhi Banking & Investment Corporation and a consortium of Islamic financial institutions represented by Qatar Islamic Bank, RUSD Investment Bank Inc. and Global Investment House. The presence of full-fledged foreign Islamic banks in Malaysia would increase the potential to tap new growth opportunities as well as raise the performance and development of the overall Islamic financial system.

As Islamic financial system grew rapidly leading to a higher demand for personnel conversant and competent in Islamic finance, this scenario led BNM to establish the International Centre for Education in Islamic Finance (INCEIF) in 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 were among the important building blocks in the effort to position Malaysia as a premier international Islamic financial centre. Beside INCEIF, there are numbers of public and private higher learning institutions in Malaysia offering Islamic banking and finance courses from diploma up to PhD level.

The Malaysian Government launched the initiative known as the Malaysia International Islamic Financial Centre (MIFC) in 2006. The envisioned landscape is that MIFC will be a centre for the offering of Islamic financial products and services in international currencies with a large pool of highly skilled Islamic finance expertise. In an effort to achieve MIFC initiative, BNM issued International Islamic Banking (IIB) licenses to allow the banks to provide Islamic commercial and investment services denominated in foreign currencies in 2008. Currently five banks hold IIB license namely Al Rajhi Banking & Investment Corporation, Alkhair International Islamic

Bank Berhad, Deutsche Bank Aktiengesellschaft, Elaf Bank B.S.C. (c) and PT. Bank Syariah Muamalat Indonesia, Tbk.

Moving forward, Islamic financial sector is one of the segments emphasised through Financial Services with one of 12 economic sectors selected in National Key Economic Areas (NKEAs). NKEAs comprise of selected sectors of economic opportunity for the private sector which will drive Malaysia towards attaining high-income status and global competitiveness. Islamic financial sector through Entry Point Project 10 (EPP 10), the Government targets to increase Islamic financing's share to total financing in Malaysia from 29 per cent in 2010 to 40 per cent in 2020, reflecting the country's position as a global leader in the industry. The Government also targets for at least one local Islamic financial institution to be among the top 10 Islamic financial institutions in the world in terms of assets by 2020. Furthermore, Financial Sector Blueprint for period 2011-2020 was announced in 2011 will focus in nine areas and one of it is Internationalisation of Islamic finance. This Blueprint is a strategic plan that charts the future direction of the financial system as Malaysia moves towards becoming high-income economy by 2020.

3. The Compilation of Islamic Finance Value Added

The Department of Statistics Malaysia (DOSM) is an official statistics provider. DOSM produce a wide range of social and economy statistics that includes estimating GDP in quarterly and annual basis. The DOSM has compiled value added of Islamic finance since 2000 onwards. Prior to this the Islamic finance value added was compiled together with conventional finance activity. The composition of

activities in Islamic finance are Islamic banking, Takaful and Capital market that's includes Islamic stock broking activities, Islamic unit trust and other financial activities. These papers will emphasis on compilation of Islamic banking and Takaful value added.

The nature of Islamic finance activities is unique among countries. As at now, compilation of the value added of the Islamic finance and especially Islamic banking sector is a challenge as there is no international manual as a guideline. The System of National Accounts 2008 (2008 SNA), where used by most of the countries as manual in compilation of Gross Domestic Products and sequence of accounts emphasis on estimate output for financial intermediation for explicit services through financial intermediation services indirectly measured (FISIM).The proposal of using FISIM in estimating output of financial intermediation first mooted in SNA 1993. Furthermore, SNA 2008 elaborates further on reference rate and proposed FISIM to be allocated to the institutional units or economic sectors. The SNA 2008 stated (page 115):

One traditional way in which financial services are provided is by means of financial intermediation. This is understood to refer to the process whereby a financial institution such as a bank accepts deposits from units wishing to receive interest on funds for which the unit has no immediate use and lends them to other units whose funds are insufficient to meet their needs. The bank thus provides a mechanism to allow the first unit to lend to the second. Each of the two parties pays a fee to the bank for the service provided, the unit lending funds by accepting a rate of interest lower than that paid by the borrower, the difference being the combined fees implicitly charged by the bank to the depositor and to the borrower. From this basic idea the concept emerges of a "reference" rate of interest. The difference between the rate paid to banks by borrowers and the reference rate plus the difference between the reference rate and the rate actually paid to depositors represent charges for financial intermediation services indirectly measured (FISIM).

Generally the Islamic banking activities were differ from conventional banking and therefore using FISIM to estimate the output of Islamic banking may or may not be applicable. Due to this, estimations of Islamic banking value added may not comparable among the countries and different practices of Islamic banking also contribute to this cause.

The value added Islamic banking in Malaysia grew by 39 per cent per annum (2005-2012) at constant prices 2005 compared to Commercial and Investment banks which posted per annum growth of seven per cent and eight per cent respectively. The rapid growth in Islamic banking showed an acceptance of Islamic banking products and services by public not only Muslim community but also Non-Muslim. The Global financial crisis back in 2008 also gives new impetus for Islamic banks as alternative financial services. The share of Islamic banking to overall finance intermediation value added rose to 17 per cent in 2012 compared with three per cent back in 2005 as number of banks participated in full-fledged Islamic bank increased from six banks in 2005 to 16 banks in 2012 including local and foreign Islamic banks.

The Takaful industry in Malaysia started in 1985 with establishment of Syarikat Takaful Malaysia as sole Takaful operator and currently 12 Takaful Operators provided wide range of Takaful products for individuals and companies. The compilation value added for Takaful activity in Malaysia can be divided into two components that are Family Takaful and General Takaful. The value added of Takaful activity experienced a robust per annum of 20 per cent from 2005-2012 as compared to conventional insurance which posted two per cent growth. The Family

Takaful was the main impetus for this growth. In terms of share, Takaful activity share to Insurance subsector raised steadily from 15 per cent in 2005 to 34 per cent in 2012 due to liberalisation of Takaful industry in 2009. The Family Takaful contributed more than three quarter of total Takaful value added in 2012.

In 2010, MIFC together with BNM, SC, Bursa Malaysia, Labuan Financial Services Authority (Labuan FSA) and DOSM took initiative in compiling value added Islamic Capital market. Prior to this, DOSM compiled the capital market value added which include conventional and Islamic capital market at aggregate level. The challenges in compiling value added Islamic capital market were due to nature of business in these industries where the parent companies involved in both Islamic and conventional capital market and it is hard to breakdown the revenue and cost between Islamic and conventional Capital market activities. DOSM worked together with BNM, SC, Bursa Malaysia and Labuan FSA to conduct a special survey on capital market players, where the questionnaire was designed to allow the respondents to give a breakdown for revenue and cost involved in both Islamic and conventional capital market activities (see attachment 1). The discussion with few establishments to understand better the structure of capital market activities was conducted by DOSM. The project was the first step in estimating the value added for Islamic capital market.

Beside the value added data, there is other Islamic banking and finance indicators compiled by the regulators especially BNM, SC, Bursa Malaysia and Labuan FSA such as assets, deposit and financing of Islamic banking. Furthermore the employment data, number of branches, risk weighted capital ratio, value of Sukuk issuance, unit trust and statistics related to Takaful are also available.

4. Conclusion

The Islamic banking and finance in Malaysia started with single Islamic bank in 1983 to become one of the most progressive and innovative in providing Islamic banking services and products. The development of human capital is seen an essential for Malaysia Islamic financial system to remain competitive and producing more innovative Islamic financial products. DOSM from time to time will evaluate the methodology use in compiling the value added in Islamic banking and Islamic capital market. The DOSM will continue working together with the financial system regulators such as BNM, SC, Bursa Malaysia and Labuan FSA to refine the value added compilation of Islamic banking and Islamic Capital market activities. Moving forward, a universal guideline is needed to make the estimate of Islamic finance more comparable among countries.

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REFERENCE YEAR : _____

INCOME AND EXPENDITURE

	Description	STOCK BROKING COMPANY		FUND MANAGEMENT COMPANY		INVESTMENT ADVISORY SERVICES		FINANCIAL CONSULTANCY SERVICES		UNIT TRUST MANAGEMENT COMPANIES	
		Islamic	Conventional	Islamic	Conventional	Islamic	Conventional	Islamic	Conventional	Islamic	Conventional
1.00	Total Income										
1.01	Gross brokerage										
1.02	Advisory fees										
1.03	Management fees										
1.04	Underwriting fees										
1.05	Gain from foreign exchange/financial asset										
1.06	Margin interest and rollover fees										
1.07	Interest on amount due to holding or related company										
1.08	Proprietary gain										
1.09	Bad debts recovered										
1.10	Provision for bad & doubtful debts written back										
1.11	Other Income										
	Example :										
	Initial Fees										
	Processing Fees										
	Syndication Fees										
	Commitment Fees										
	Guarantee Fees										
	Acceptance Commisions										
	Charges & Fees for Money Transmission Services										
	Rental Income from building/machinery/equipment										
	Interest income										
	Dividen income										
	Gain on disposal of property, plant & equipment										

	Description	STOCK BROKING COMPANY		FUND MANAGEMENT COMPANY		INVESTMENT ADVISORY SERVICES		FINANCIAL CONSULTANCY SERVICES		UNIT TRUST MANAGEMENT COMPANIES	
		Islamic	Conventional	Islamic	Conventional	Islamic	Conventional	Islamic	Conventional	Islamic	Conventional
2.00	Total Expenses										
2.01	Commission to dealer's representatives										
2.02	Management fees and CDS charge										
2.03	Water consumed										
2.04	Electricity purchased										
2.05	Fuel, lubricants and gas										
2.06	Travelling expenses (including both local and										
2.07	Entertainment expenses										
2.08	Professional fees										
2.09	Payment for data processing and other services										
2.10	Telecommunication fees (e.g. telephone, telefax,										
2.11	Bank charges										
2.12	Interest charges										
2.13	Insurance premiums except workers' compensation										
2.14	Payment for security services										
2.15	Rent on land										
2.16	Rental payments (excluding rent for use of land)										
2.17	Current depreciation on assets										
2.18	Royalties paid:										
2.18.1	Government										
2.18.2	Private										
2.19	Indirect taxes										
2.20	Loss on foreign exchange/financial assets										
2.21	Bad debts written off										
2.22	Employment costs										
2.22.1	Salaries and wages paid										
2.22.2	Payment of gratuity, retirement/retranchment benefits to employees										
2.22.3	Employer's contribution to provident funds, social security schemes, pensions and welfare schemes.										
2.22.4	Fees paid to non-working directors for their attendance at Board of Directors' meetings										
2.22.5	Staff training cost										
2.22.6	Others										

	Description	STOCK BROKING COMPANY		FUND MANAGEMENT COMPANY		INVESTMENT ADVISORY SERVICES		FINANCIAL CONSULTANCY SERVICES		UNIT TRUST MANAGEMENT COMPANIES	
		Islamic	Conventional	Islamic	Conventional	Islamic	Conventional	Islamic	Conventional	Islamic	Conventional
2.23	Direct taxes										
2.24	Other Expenses										
	Example :										
	Repairs & Maintenance										
	Advertisement & Publicity Expenses										
	Cost of printing										
	Stationery & subscriptions										
	News & Subscription										
	Telephone Fax & Postages										
	Postage and courier service charges										
	Auditors' Remuneration										
	License Fees & Stamp Duties										
	Unrealised loss from investment account										
3.00	Investment										
3.01	Assets										
3.01.1	Land										
3.01.2	Buildings and other constructions										
3.01.3	Vehicles/Transport Equipment										
3.01.4	Machineries/Equipment/Fittings (e.g. computers,										
3.01.5	Other assets (e.g. goodwill, patent, R&D etc)										
3.02	Paid up capital										
4.00	Number of Employees										
4.01	Local										
4.01.1	Managerial and professionals										
4.01.2	Non-Managerial and non-professionals										
4.02	Foreign										
4.02.1	Managerial and professionals										
4.02.2	Non-Managerial and non-professionals										

For item that cannot be given directly, please provide the best estimate

