

Islamic Banking in Malaysia : Prospects and Challenges

Bank Islam was set up in 1983 to cater for the need of having a bank with operations based on Islamic principles. The author analyses its performance over the years and discusses its prospects and challenges in the years ahead.

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The evolution of the Malaysian financial system can be divided into four stages. It started with the commodity money stage, the birth of paper currency stage and the financial intermediation stage. The system is now in the maturity stage where a variety of specialised financial institutions have emerged to effectively meet the needs of both surplus and deficit units in the economy. These institutions include commercial banks, finance companies, merchant banks, discount houses and forex brokers. This banking system is closely supervised by Bank Negara Malaysia. The institutions which are supervised by the various government departments and agencies are classified as non-banking financial institutions. And they include building societies, pension and provident funds, cooperative societies, and savings companies.

To date, institutions within the banking system are the key players in developing the economy. Growth of the banking system in past decades has been quite remarkable. Its assets rose from \$1.1 billion in 1959 to about \$200 billion at the end of 1991. Within the banking system, commercial banks still maintain their supremacy with total assets of \$152 billion at the end of 1991 compared to \$1.1 billion in 1959. In 1991 there were 37 commercial banks with 1050 branches, 41 finance companies with 603 branches, 12 merchant banks with five branches,

seven discount houses and eight brokers doing business in Malaysia.

The operations of the Malaysian banking system are very much similar to the banking system practices in the United Kingdom due to the country's historical background. As a former British colony, the first few commercial banks operated in this country were naturally branches of British banks.

The emergence of banks based on Islamic principles in Islamic countries around the world created a growing awareness among Muslim scholars, associations and societies in Malaysia that this country should also have such a banking system. An Islamic banking system may be broadly defined as an organised institutional framework designed to spread the application of an interest-free banking concept by establishing banks and investment organisations carrying operations in accordance with Islamic economic doctrines.

The first Islamic bank was established in the late 1950s in a rural area of Pakistan which charged no interest on its lendings. However, problems such as demotivation among the staff and lack of supervision caused the bank to cease operations. The first Islamic bank in the Middle East, the Mitraghams Savings Bank, Egypt, was established in 1972. As in Pakistan, the bank run into difficulty despite its initial success.

The discouraging experience faced by the pioneer Islamic banks in Pakistan and Egypt did not deter other Muslim countries from establishing this new banking system. Some of the banks which have been established in other Muslim countries are Nasser Social Bank of Egypt (1972); Dubai Islamic Bank (1975); Kuwait Finance Bank of Egypt (1977); Jordan Islamic Bank for Finance and Investment (1978); Bahrain Islamic Bank (1980); Iran Islamic Bank (1979); Abu Dhabi Islamic Bank (1980); Qatar Islamic Bank (1981); Pakistan banks' Islamic Counters (1981); and Islamic Bank of Malaysia (1983). Since then Islamic banks have commenced operations in Indonesia (May 1992), and in Brunei (January 1993).

HISTORY AND DEVELOPMENT OF BANK ISLAM IN MALAYSIA

Like in most countries, the initial steps to establish an Islamic bank were taken under private initiative. The emergence of many Islamic banks especially in the Middle East during the 1970s created greater awareness among Muslim scholars in Malaysia. Although many people had voiced their support for setting up an Islamic bank, this issue was not taken seriously by the government. The first formal request to the government on this matter was made during the Bumiputera Economic Congress in 1980. Another request was made during the National Seminar on Islamic Development in 1981. As a result of these requests, the government appointed a steering committee to examine the possibilities of establishing an Islamic bank in this country. The committee completed its report and acknowledged that the country was in urgent need of having a bank with operations based on Islamic principles.

The establishment of the first Islamic bank in Malaysia on March 1, 1983 marked a new milestone in the Malaysian banking system. This bank,

known as Bank Islam Malaysia Berhad (BIMB) was incorporated as a company under the Companies Act 1965 and the major shareholders are the Government of Malaysia (30 per cent), the Pilgrims Fund (10 per cent), and the State Religious Councils (25 per cent). To govern this bank, a new law was passed by the government known as the Islamic Banking Act 1983. The Act is basically modelled after the existing laws for conventional banks, but with modifications, so that the Islamic bank can conform to Islamic banking principles. The Act provides Bank Negara with similar powers to supervise and regulate the Islamic bank like other commercial banks.

In line with Islamic banking objectives, the 'syariah' principles govern all banking operations. They are:

Mudharabah : basically an agreement between a lender and an entrepreneur, in which the lender agrees to finance the entrepreneur's project on a profit-sharing basis according to a pre-determined ratio agreed upon in the negotiation between the two parties. The lender will bear any loss incurred.

Musarakah : a partnership for a specific business activity with the aim of making profit, whereby the lender not only provides the capital but may also participate in the management. As in the case of *Mudharabah*, all parties agree through negotiation on the ratio of distribution of profits generated from the business activity which need not coincide with the ratio of participation in the financing of the activity. However, in the event of a loss, all parties bear the loss in proportion to their shares in the financing.

Murabahah : basically the sale of goods at a price covering the purchase price plus the profit margin agreed upon by both parties concerned, which transformed traditional lending activity into a sale and purchase agreement, under which the

lender buys the goods wanted by the borrower for resale to the borrower at a higher price agreed upon by both parties.

Al-Bal Bithaman Ajil : a variant of the concept of *Murabahah*, whereby the borrower is allowed to defer settlement of the payment for the goods purchased within the period and in the manner determined and agreed upon by both parties.

Al-Ijarah : the 'syariah's' concept of leasing finance, whereby the bank purchases the asset required by the customer, and then leases the asset to the customer for a given period, the lease rental and other terms and conditions being agreed to by both parties.

Al-Takjiri : a variant of the concept of *Al-Ijarah* which, however, provides for the acquisition of the leased asset by the lessee.

Qard Hasan : a "benevolent loan" which obliges a borrower to repay the lender the principal sum borrowed on maturity of the loan. However, the borrower has the discretion to reward the lender for his loan by paying any sum over and above the amount of the principal.

Al-Wakalah : an agreement between a customer and his bank in which the former appoints the latter as his agent in undertaking a certain transaction on his behalf.

Al-Kafalah : an agreement between a customer and the bank whereby the latter guaranteed the fulfillment of the obligation of the former to a third party.

Wadiah : an agreement to deposit an asset, excluding immovable fixed assets, in the custody of another party who is not the owner or any such asset deposited with a non-owner for custody.

At present BIMB offers services which are similar to those services

available at the conventional banks. The bank accepts savings and demand deposits under the principle of *Wadiah*. It also accepts time deposit which is known as investment deposit under the principle of *Mudharabah*. The bank grants credit facilities such as project financing under principles of *Mudharabah* and *Musyarakah*, lease financing under the principles of *Al-Ijarah* and *Al-Takjiri*, hire-purchase financing under the principles of *Al-Bai Bithaman Ajil*, trade financing under the principles as the *Mudharabah*, *Musyarakah* and *Wakalah*, and guarantee under the principles of *Al-Kafalah*.

Starting business with the opening of its first branch in Kuala Lumpur on July 1, 1983, BIMB now has 31 branches mostly located at the states of Muslim majority. As at December 31, 1983, the total deposits placed with BIMB was \$91 million compared to \$37.1 billion placed with ordinary commercial banks. The deposits at BIMB increased to \$1.178 billion in 1991 and for commercial banks, the total deposits increased to about \$96 billion. As for loans, total credit facilities extended at the end of 1983 amounted to \$40.7 million, whereas total loan extended by other commercial banks was \$36 billion. At the end of 1991 total credit extended by Bank Islam increased to \$828 million and \$97 billion for ordinary commercial banks.

PERFORMANCE OF BANK ISLAM COMPARED WITH CONVENTIONAL BANKS

The introduction of the first Islamic bank is to fill a gap in the existing banking system in terms of mobilising the savings and meeting the credit needs of the Muslim community, in accordance with the rules and principles of 'syariah'. At the same time, it would provide the general public and the corporate sector with an alternative form and avenue for investments

and credit, to be based on the principle of profit and loss participation and not on interest. The bank would share the profit earned from the utilisation of the deposit funds of its depositors, including a share in the profits gained from the bank's investments in the projects of the clients of the bank. The return to the depositors, the bank and the users of funds would depend on the volume of profit and on the pre-determined profit and loss sharing ratios agreed to by the parties concerned.

SOURCES OF FUNDS

When the bank first started operation in July 1983, it accepted three types of deposits, namely demand deposits, savings deposits and general investment deposits. Special investment deposits, which allow the customers to specify the manner in which their funds are to be invested were first introduced in January 1984. Of the total deposits outstanding at the end of its first year of operations, demand, saving, general and special investments accounted for \$40 million, \$26 million, \$101 million and \$71 million respectively. These deposits were placed mainly by statutory authorities, the general public and business enterprises. The bank's savings de-

posits were accepted entirely from the general public. Except for special investment deposits, deposit figures for other types of deposits increased every year. For financial year ended 1990, figures for demand deposits, savings deposits and general investment deposits were \$220 million, \$250 million, and \$609 million respectively. The deposits figures for various types of deposits is shown in Table 1 below:

Meanwhile, commercial banks have expanded their activities significantly during the past three decades. Total bank resources which amounted to a mere \$1.232 billion in 1960, or one third of the total resources of the entire financial system, increased to \$129 billion at the end of 1990, equivalent to about 40 per cent of the total resources of Malaysian financial system. The annual growth in total resources was 13.7 per cent during 1960s, and 18.3 per cent for 1970s. However, total resources of the commercial banks increased at a slower pace of 8.3 per cent in the period 1984 to 1990, following the marked deceleration in growth of deposits due to declining income earnings and stiff competition from other financial institutions. The deposits placed at commercial banks are mainly in the form of demand deposits, saving

Table 1 Bank Islam Malaysia Berhad: Breakdown of Deposits (\$ million)								
Type of deposits	1984	1985	1986	1987	1988	1989	1990	1991
Demand deposits	40	43	57	123	142	129	195	220
Savings deposits	26	47	78	114	153	181	213	250
General investment	101	276	404	572	724	918	688	609
Special investment	71	49	37	17	23	5	124	99
Total	238	415	576	826	1042	1233	1220	1178

Source: BIMB Annual Report, various issues

Table 2
Commercial Banks:
Breakdown of Deposits
(\$ million)

Type of deposits	1984	1985	1986	1987	1988	1989	1990
Demand deposits	7992	7654	7502	8277	9124	11182	13402
Savings deposits	5712	5816	6678	8860	11248	12386	13321
Fixed deposits	24672	32432	31317	33164	27609	30026	33503
Total	38376	45902	45497	50301	47980	53594	60226

Source: BNM Annual Report, various issues

Table 3
Growth of Deposits (%)
for BIMB and Commercial Banks

Type of deposits	1985	1986	1987	1988	1989	1990
<i>Current account:</i>						
Commercial banks	(4.2)	(2.0)	10.3	10.2	22.5	19.8
BIMB	8.0	31.0	117.3	15.6	1.1	40.4
<i>Savings account:</i>						
Commercial banks	1.8	14.8	32.8	26.9	10.1	7.5
BIMB	78.2	68.2	45.5	34.3	18.8	17.2
<i>Fixed deposits:</i>						
Commercial banks	19.6	(3.4)	5.9	(16.8)	8.8	11.8
BIMB	89.1	35.4	33.5	27.0	27.0	(10.6)
<i>Total deposits</i>						
Commercial banks	19.4	(0.9)	10.8	(4.6)	11.7	12.4
BIMB	74.3	38.8	43.4	26.3	21.9	(1.0)

Source: BIMB Annual Report, various issues

deposits and fixed or time deposits. The breakdown of deposit figures is shown in Table 2 below:

The smaller number in deposit figures does not mean that BIMB does not enjoy public confidence on its services. On the contrary, BIMB is performing much better than the

commercial banks. Growth in deposits as shown in Table 3 is evidence to this statement. With the exception of growth in current account in 1989 and growth in fixed deposit in 1990, BIMB has enjoyed double digit growth figures for all types of deposits from the first year of its operation.

USE OF FUNDS

Growth in the extension of credit by BIMB has become the most significant use of funds, increasing at an average of 35 per cent annually, from \$163 million in 1984 to \$871 million in 1990. In terms of growth in loans and advances, BIMB performed much better than the commercial banks. Total loans extended by commercial banks amounting to \$39.848 billion in 1984 increased to \$71.441 billion in 1990 with the average growth rate of 10.3 per cent per year. The annual growth rate and loan figures are shown in Table 4.

Like any other commercial bank, BIMB also extends credit facilities to various economic sectors i.e. agriculture, mining and quarrying, manufacturing, electricity, real-estate, transport and storage, and many others. During the early years of establishment, a bulk of miscellaneous credits (including housing loans, purchase of stock and shares and consumption credit), were extended to selected sectors such as transport and storage, mining and quarrying. Total credit to these sectors was \$128 million or 78 per cent of the total credit extended at the end of the first year's operation. However, over the period 1984 to 1990, there was a noticeable shift in the direction of credit extended to the customers. Since 1986, BIMB has started to diversify its portfolio by extending more credit facilities to the manufacturing, financial, insurance and service, and real estate sectors. The percentage of use of funds for various important sectors is shown in Table 5.

From 1960 to 1980, there had been a noticeable shift in the direction of bank lending. Prior to the 1960s, a significant proportion of the commercial banks' funds was used to finance international trade. This pattern, however, changed significantly by the late 1960s, when loans and advances to finance manufacturing activities increased substantially, reflecting

Table 4
Loan Figures (\$ million) and Growth (%)
for BIMB and Commercial Banks

	1984	1985	1986	1987	1988	1989	1990
<i>Commercial banks:</i>							
Loans & advances	39848	46324	50940	51235	54199	61124	71441
Growth (%)	-	16	10	1	6	13	17
<i>BIMB</i>							
Credit facilities	163	334	414	464	649	728	871
Growth (%)	-	105	24	12	40	12	20

Sources: BIMB & BNM Annual Report, various issues

Table 5
Use of Funds by Sectors (%) for BIMB

Sectors:	1984	1985	1986	1987	1988	1989	1990
Housing & consumption	43	34	34	25	25	25	27
Wholesale & retail trade	25	28	16	15	12	7	6
Real estates	1	3	6	11	25	18	14
Manufacturing	5	4	14	12	20	28	34
Agriculture	-	3	2	4	5	5	5
Others	26	28	28	33	13	17	14
Total	100	100	100	100	100	100	100

Source: BIMB Annual Report, various issues

Table 6
Uses of Funds by Sectors (%) for Commercial Banks in Malaysia

Sectors:	1984	1985	1986	1987	1988	1989	1990
Housing & consumption	12	13	13	14	14	12	12
Wholesale & retail trade	19	18	17	17	17	16	14
Real estates	21	22	22	22	21	20	18
Manufacturing	18	18	17	17	20	21	23
Agriculture	6	6	6	6	5	5	5
Others	24	23	25	24	23	26	28
Total	100	100	100	100	100	100	100

Source: Bank Negara Report, various issues

largely the rapid pace of industrialisation in the country. At the end of 1991, total loans to manufacturing was \$23.5 billion or 24 per cent of the total loans granted by the commercial banks. As shown in Table 6, there were no significant changes in the lending direction of the commercial banks for the last eight years. Except for the manufacturing and other sectors which are on the upward trend, lending to the housing, general commerce and real estate sectors are on a downward trend.

PROSPECTS AND CHALLENGES

The 1990s is the decade for rapid industrialisation. The banking industry must therefore brace itself for the challenges and opportunities which will emanate from this new dimension in the economy. The immediate challenge to the banking institution is to strengthen its balance sheet and be more dynamic, innovative and to continue reducing their costs and raise productivity in order to provide better and more competitively priced banking services to its customers.

The 1990s promise even more challenges to BIMB than to the conventional banks. Its successful years as indicated by the rapid growth in the number of branches, number of customers, amount of assets or money it handled would probably come to an end. This is supported by the findings of empirical research, trend analysis of its performance, changes in the market place and existing practices.

As stated earlier, the establishment of an Islamic bank in Malaysia is to meet the banking and credit needs of the Malaysian Muslim population according to the rules of 'syariah' which prohibits interest. This objective is also consistent with the belief of many people that religion is the reason for customers patronising an Islamic bank. However, evidence from an empirical study conducted in

Sudan shows that other reasons are more important than religious factors. This finding should not be taken lightly by those who are managing BIMB because it indicates the dangers that may be encountered by future operations of the bank. Therefore, it is necessary for BIMB to address this issue by developing or offering a total package of banking services equivalent to services and products available at commercial banks.

Another issue to be addressed by BIMB is the downward trend of its growth in sources of funds. The profitability of any banking institution greatly depends on its capabilities in tapping resources from the economy. Except for the current account which experienced fluctuating growth rates for the past seven years, growth for savings and fixed deposits of BIMB were on the decline every year. For example, growth for savings was 78 per cent in 1985, it then decreased to 17 per cent in 1990, while for fixed deposits, the rate decreased from 89 per cent in 1985 to 10.6 per cent in 1990. The introduction of Islamic counters

by other financial institutions would worsen the situation. To counter these problems, BIMB should enhance its promotional activities, and introduce attractive products and services. Besides its traditional customers, the bank should also expand its customer base by soliciting for more corporate customers.

However, marketing its services to corporate customers could generate additional problems to BIMB. First, these big corporations have been maintaining accounts with the conventional banks for many years. Through the years they have developed trust and loyalty to a particular bank. Second, big corporations normally require a bank with networks which are easily available around the globe. BIMB currently lacks this facility.

Besides having problems in getting funds, another challenge which probably will be faced by BIMB is the limitation in investment opportunities. At present the bulk of its funds are used for loans and advances, and

investments in government securities. The downsizing of government expenditure will further reduce the amount of bills issued by the government. Therefore, BIMB must search for other investment alternatives. One way to solve this problem is by giving more loans to customers. Rather than focusing business loans on *Mudharabah*, BIMB should also encourage loans to be given under the principle of *Musyarakah*.

CONCLUSION

Bank Islam Malaysia Berhad (BIMB) which currently represents Islamic banking practice in Malaysia, is still in its infant stage; therefore it is too early to predict its success. However, since Muslims make up 50 per cent of the estimated 18 million population in Malaysia, there is a strong possibility that BIMB will emerge as a major financial institution in the future. To ensure its future success, the management of BIMB must be customer oriented, innovative, creative and susceptible to any possible change in the market. □

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BANKER'S JOURNAL MALAYSIA ESSAY COMPETITION 1992

"What Does It Take To Be A Good Banker"

The Institute has decided not to award prizes for last year's essay competition as none of the entries matched the expectations of the organisers.

The Institute thanks those who submitted essays for the competition.