ISLAMIC BANKING AND FINANCE IN SOUTH-EAST ASIA
– A CASE STUDY OF MALAYSIA

ABSTRACT

Scheme of the research

There is growing curiosity on the part of economists and policy makers to know closely precept and practices of Islamic banks and financial institutions. The main purpose of this research is to conduct an in-depth study of the fast growing movement of Islamic banking and finance in several countries of South-East Asia in general and Malaysia in particular, where it is playing a significant role in channelising idle savings into productive activities. Thus becoming an important source of financing various sectors of the economy and development programmes.

To begin with, the theoretical background and raison d'être of Islamic banking has been examined to clearly distinguish the Islamic system from the conventional Western system. Subsequently to acquaint us with this movement, its historical development worldwide as well as in the region of South-East Asia has been studied. Since Malaysia has been one of the pioneering countries in the field of Islamic banking and finance, the role of these institutions in Malaysian economy as well as their influence towards such movements in its neighbouring countries has also been explored.

Summary of the Research

The first chapter provides the theoretical background of Islamic banking and finance. The Islamic injunction of the prohibition of ribā or
interest implies Islamic banking principle, which does not rely on the rate of interest. Rather it is based on the concept of mudarabah (profit & loss sharing) that has been innovated by contemporary Islamic economists. This is because Islam stands for justice, equitable distribution of wealth and universal brotherhood, whereas interest mechanism perpetuates exploitation, concentration of wealth in few hands and causes various social and economic problems such as economic instability, public debt, etc.

*Mudarabah* is an agreement made between two parties; one of which is called *rabb al-mal* or provider of capital who merely provides capital and another the *mudarib* or agent-entrepreneur who utilizes such capital, both of which will share in the resulting profit in accordance with a predetermined percentage stipulated in the contract before hands. The, loss if incurred, will be borne by the capital owner whereas the working partner loses the fruits of his labour. *Mudarabah* banking principle implies that the risk factor is applicable to both capital and labour. An Islamic bank can be set up and operated employing a two-tier *mudarabah* principle. That is on its liability side, depositor enters into a contract with Islamic bank to share in profit accruing to the bank’s business on the basis of *mudarabah*. The bank, on its asset side using the same principle, enters into another contract with an agent-entrepreneur who is searching for investible funds and is agreeable to sharing the profit with the bank in accordance with a predetermined percentage stipulated in the contract.

Besides assuming risk and abolishing interest transaction, an Islamic bank must steer clear from illegitimate businesses. Like conventional
banking, Islamic bank divides deposits into three main categories, i.e., current, savings, and investment. Islamic bank pays no fixed return on deposits. Depositors in the investment account share a return with the bank on the basis of profit and loss sharing. On financing side, unlike conventional bank which charges fixed interest income on its lending, Islamic bank employs several Islamic modes of financing based substantially on profit, rent and service charge such as *mudarabah* (profit and loss sharing), *musharakah* (partnership), *murabahah* (mark-up deferred sale), *bai’ salam* (forward sale), *istikana’* (manufacturing contract), *ijarah* (leasing), loan with service charge, and fees from normal banking business.

Chapter 2 provides an account of historical development of Islamic banking and finance in modern period. Like conventional banking whose evolution has been synchronized with the emergence of industrial revolution – capitalism – in the 18th century, development of Islamic banking system has been a consequence of worldwide Islamic resurgence in various Muslim countries and communities to transform their economies and economic lives along the Islamic line. Since interest in conventional banking system is repugnant in Islam, an interest-fee banking system has been developed. *Mudarabah* – the core of Islamic banking was practised by the Prophet and his followers, and Muslims in later period had developed such practices to better suit their financial needs. Nevertheless, such practices and developments could not become institutionalized and specialized until the second half of the 20th century.
Development of Islamic banking in modern period has been both in
the forms of theory and practice. Up to the end of the 20th century, there
were over 1,500 academic works on Islamic economics, banking and
finance, and approximately over 200 Islamic banking and financial
institutions have been set up and run successfully spanning the globe from
Canada to Indonesia, with estimated total assets of over US$ 160 billion.
Islamic banking services rendered by worldwide multinational financial
institutions such as American Citibank, ANZ Grindlays and ABN AMRO not
only imply emphatic endorsement of the viability and popularity of the
system, their cooperation with the full-fledged Islamic banks and financial
institutions also helps in the area of Islamic product development. The
establishment of Islamic financial markets and the launches of Islamic
funds and Islamic market indices pave the way for worldwide commitment
in Islamic financial market and show that the interest in Islamic financial
and monetary scheme has taken on a global dimension.

The subsequent three chapters provide discussion on Islamic
banking and financial development in South-East Asia. For this purpose,
the region has been divided into two distinct groups, i.e., Muslim-majority
and Muslim-minority countries. A brief history of the region and socio-
religious background of the countries have been given in the beginning to
familiarize with people, their culture and the economy. Chapter 3 and 4 are
devoted for the Muslim-majority countries comprising Malaysia, Indonesia
and Brunei, whereas chapter 5 for selected Muslim-minority countries, i.e.,
the Philippines, Singapore, and Thailand. Since Malaysia is the main focus
of this research and has played a pioneering role in development of Islamic
banking and finance in the region, a full chapter has been devoted for its discussion.

With most advanced and highly organized Islamic banking and financial movement than any other countries in the region, Malaysia's Islamic banking and financial development deserves to be regarded as model for the future. Despite Bank Islam Malaysia Berhad (BIMB) has been established since 1983 and successfully operated with great performance along side with the conventional banking system, the bank was not able to serve the entire needs of the population with limited number of branches and resources. Moreover, a single Islamic bank does not constitute a banking system. An Islamic banking system requires a large number of dynamic and pro-active players, a wide range of products and innovated instruments and a vibrant Islamic money and capital markets. This has led the central bank of Malaysia, Bank Negara Malaysia (BNM), to introduce various measures to provide the necessary infrastructural and institutional framework of an Islamic banking system in the country. These measures include, for instance, the introduction of Skim Perbankan Tanpa Faedah or Interest-free Banking Scheme in March 1993. The scheme allows conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including staff and branches subject to certain guidelines issued by BNM. Another measure has been the introduction of Islamic money market since 3rd January 1994, for the smooth functioning of Islamic banking system. BNM has also encouraged non-bank financial intermediaries such as takaful (insurance) companies, savings institution like Tabung Haji, development finance institutions, etc., to improve their participations in the Islamic
banking sector. On 1st October 1999, the second Islamic bank or Bank Muamalat Malaysia Berhad commenced operation as part of the strategy to promote greater competition and innovation among the players in the Islamic banking system. Apart from Islamic money market, Islamic capital market provides another important Islamic resource mobilization for financing economic activities. All these hub of measures help Malaysia to create a comprehensive Islamic financial landscape in the country encompassing the Islamic banking system, the non-bank Islamic financial intermediaries, and the Islamic financial markets. Malaysian Islamic banking and financial system provides a blueprint of such a system for its neighbouring countries in the region, since BIMB has been associated in the conversion and setting-up of Islamic commercial banks in Brunei (Islamic Bank of Brunei), Indonesia (Bank Muamalat Indonesia) and the Philippines (Amanah Bank of the Philippines).

Chapter 4 is dedicated to discussion of the Islamic banking and financial development in Indonesia and Brunei. In fact, both the countries followed the steps taken by Malaysia in their implementation of Islamic banking system in the country. There is no need to go in such a detail. However, it may be noted that during the recent economic crisis of Indonesia, while other commercial banks have been badly affected by the crisis, Islamic bank or Bank Muamalat Indonesia remained almost intact.

Indonesia has more or less two established Islamic banking players namely, Bank Muamalat Indonesia established in 1991 and Bank Mandiri Syariah founded in 1999. In fact, Indonesia should have much earlier and more Islamic banking players like in the case of Malaysia as Indonesian
Muslims represent the largest number of Muslims in the world. But due to the fact that Indonesia is a secular state and adopted the ideology of *Pancasila* in which democracy and capitalism constitute significant elements, the movement of Islamic banking and finance could start very late.

In the tiny Sultanate of Brunei, Islamic Bank of Brunei Berhad started operation in 1993 as a royal-patronized financial institution paving the way for Islamic banking and financial movement in the country. With its aim to diversify its economy from oil-rich nation into a regional financial hub providing employment opportunities as well as attracting new skills and technology to compete with its neighbouring countries, i.e., Malaysia and Singapore, Brunei has decided to build (following the step of Labuan of Malaysia) an international offshore financial centre to capitalize on the niche market of Islamic banking.

In chapter 5, development of Islamic banking and financial system in Muslim-minority countries has been discussed. This group comprises of seven political nations whereas Islamic banking and finance is found in three countries only; namely the Philippines, Singapore and Thailand. The Philippines is the pioneer of this group to have institutionalized Islamic banking in a secular environment. Despite the Philippine Amanah Bank (PAB) was set up in 1973, its banking operations for several years entailed interest transaction, whereas Islamic banking component has been limited to the Pilgrims Special Savings Deposits (PSSD) working similar to that of the Tabung Haji located in Malaysia. Until January 1990, due to inefficient operation and poor performance, the PAB (with the assistance of BIMB)
was then replaced by another image of a full-fledged Islamic banking under the name of Al-Amanah Islamic Investment Bank of the Philippines.

In Singapore, although Islamic banking development seems to be less significant in proportion to the country’s financial and human resource development, Singaporean Muslims have achieved great success in mobilizing resources through Mosque Building Fund (MBF). MBF, whose significance is worth-mentioning despite its seemingly irrelevance to Islamic banking operation, represents a systematized and centralized collection of funds for the construction and maintenance of mosques. As for as Islamic banking is concerned, there is no restriction from the Singapore’s Government for the implementation of Islamic banking services by private units. But the establishment of Islamic banking has not seen the sun yet. For the country to become a truly Asia’s premier business and financial centre, its consideration to broaden its banking and financial industry to compose of Islamic alternative (like the case of Labuan of Malaysia) to diversify its financial structure need not to be emphasized.

In Thailand, the struggle towards government implementation of Islamic banking and finance is highly becoming politicized. Islamic banking practice in Thailand has been through several years of transitional stages from self-managed informal arrangement to government-regulated Islamic cooperative and Islamic window. Due to difference in stands towards the implementation of Islamic banking, a government policy to approve and implement Islamic banking in certain government-led party was not supported and accomplished by another succeeding government. This has created frustration among the Muslim community and led to the idea of
establishing an Islamic savings cooperative. Despite being small financial units, Islamic savings cooperatives have proved great advantage in creating proper public understanding and popularity of Islamic banking. It paves the way to future aspiration of having an Islamic bank established. Islamic windows (taking procedures from Malaysia) rendered by conventional banks draw up public debate. Many Muslims are doubtful while many others compromised with such arrangement due to lack of infrastructural and human resources to establish a full-fledged Islamic bank.

Chapter 6 discusses a unique financial institution in Malaysia, which is regarded as the pioneer to institutionalize Islamic financial system, paving the way for Islamic financial development in the country. The Pilgrims Management and Fund Board or popularly known as Tabung Haji (TH) is arguably the world's largest Islamic savings institution, having been set up to fulfill the desire of Malaysian Muslims that money spent on pilgrimage (hajj) must be clean and unmixed with ribā.

Tabung Haji, a semi-government body, was established in 1963 to serve two functions – as a financial institution and as a pilgrims management body. Although Tabung Haji is not a bank, it operates as a bank does. That is to say, it accepts deposits, carries withdrawal, and makes investment. It has a wide variety of investment activities and its implementation of various operational schemes enables Muslims to save for the purpose of hajj. Its impressive contribution to the development of Islamic banking and finance in Malaysia that has been replicated elsewhere, coupled with its significant successful operation and
performance in primarily fulfilling the long life desire of many individuals for the performance of hajj rituals enable it to win award of Islamic Development Bank (IDB)'s prize in Islamic banking in 1989. It is the model of the future financial institution, which transformed from a non-commercial Islamic voluntary organization to a highly organized and specialized Islamic financial institution that join the objective of fulfillment of Islamic religious ritual and commercial banking together.

Chapter 7 is dedicated to a discussion of the role of Islamic banking and financial institution in economic development of Malaysia. Islamic banking and financial institutions, like conventional ones, play crucial role in the process of capital formation needed for economic development. However, they serve special function that can never be served by conventional banking institution. In countries where there exists sizeable Muslim population, there are considerable number of practising Muslims, who, for religious reason, stay away from financial transaction with interest-based institutions. It is in this connection that Islamic banking and financial institutions, through permissible means of savings and investments, can convince and bring them into mainstream economic process of capital formation and development. Equity participation through musharakah and mudarabah, for instance, not only brings about greater justice and efficiency in the allocation of resources; but also reduce concentration of wealth, inequality in the distribution of income, and poverty; and ensure better human resource mobilization and greater employment generation.
Islamic banking and financial institutions have played a meaningful role in fostering social and economic progress of Malaysia. Overall, Islamic banking and finance constitute at least 5% in the process of capital formation in Malaysia by which the rate is on and on increasing. Islamic banking institution like BIMB has achieved its financing facilities for the implementation of various infrastructural and development project. It is also active in promoting priority and tourism sectors of the economy. Accumulated zakat provision of various individual Islamic banking and financial institutions as part of religious obligatory social welfare function helps improving social and economic status of the community especially the poor and needy. The setting up of various Islamic banking and financial educational, training and research institutes by various institutes and Islamic bank, no doubt, contribute to the development of knowledge, expertise, innovative ideas and instruments in Islamic banking and finance. This, in turn, leads to social and economic progress of the people of Malaysia.

In concluding chapter, in the light of our study, various problems, challenges and future prospect of Islamic banking and financial institution are discussed. Since the establishment of Islamic banking and financial institutions is a new development in the world contemporary financial system, such a novel working system must naturally be accompanied by a number of methodological and operational problems and criticisms. These problems and critiques are enumerated below:

1. High level of excess liquidity.
2. Concentration on secondary modes of financing short-term basis (such as *murabahah*) for well-established firms and individuals, i.e., low percentage of long-term PLS (profit and loss sharing) financing and financing for new entrepreneur.

3. Lack of government and monetary authority commitment as well as proper legal regulatory and institutional frameworks for the well-functioning of such system.

4. High level of competition with well-established conventional banks offering Islamic banking services.

5. Lack of uniformity in the accounting and auditing practices.

6. Lack of standardized products and centralized Shari'ah council of various Islamic banks and financial institutions.

7. Shortage of trained and qualified personnel.

8. Lack of well developed Islamic financial markets, etc.

As far as all these problems and critiques are concerned, Malaysia faces less or none of them due to its well-organized Islamic financial landscape supported by legal and regulatory framework. All those problematic factors, however, provide some kind of challenges for the industry to overcome in the 21st century. Islamic banks and financial institutions are thus determined to respond to such challenges and critiques. Some of them may be stated here as: -

1. Increasing the size of Islamic banks and financial institutions.
2. Moving away from the *murabahah* syndrome.

3. Greater focusing on human resources development.

4. Making a clear distinction between business and social objectives.

5. Greater cooperation with conventional banks for more sophisticated product and technological development.

6. Greater responsibility to management.

7. A full-blown embracing of information and banking technology.

8. Building up proper institutional framework such as Islamic financial market and Islamic equity institution, etc.

9. Establishing a centralized Shari'ah body to ensure standardization of Islamic financial products and remove inconsistency in the verdicts of Shari'ah bodies of various Islamic banks, and etc.

Despite the fact that Islamic banks and financial institutions confront with a number of problems and challenges, Islamic banking has grown in size and is no longer a negligible phenomenon. It is a fast growing industry and its future prospect is really promising. In the region of South-East Asia, in addition, two major growth the development projects namely Indonesia, Malaysia, Thailand - Growth Triangle Development Project (IMT-GT) and Brunei, Indonesia, Malaysia, the Philippines – East ASEAN Growth Area (BIMP-EAGA) will provide a tremendous opportunity for the prospect of
Islamic banking and finance in the region. Since most of the targeted people involved are Muslims, it is more likely that their demands will be for the Islamic financial products as their means of economic activities as part of their commitments.

In the case of Malaysia where Islamic financial industry is highly organized and developed, with the establishment of Labuan as an International Offshore Financial Centre (IOFC), the opportunity of Islamic financial system as a provision of a wide range of product to existing conventional one will only lead the country to fulfill its ambition of becoming a regional financial centre in competition with Singapore. Moreover, Brunei is another new competitor to draw up its ambition to turn itself from oil-rich nation into an international offshore financial centre. This competitive atmosphere will obviously lead to a glorious prospect of Islamic banking and finance in the region as a whole.

Finding of the Research

1. Islamic banks and financial system is a viable alternative to conventional system in the world financial industry. This is proved by outstanding performance and operation of various Islamic banks and financial institutions both in Muslim and non-Muslim countries. Islamic banks and financial services rendered by worldwide multinational banks only add up to such credibility.

2. Islamic banks and financial development is a fast growing phenomenon having a prosperous future due to many reasons such as: -
(2.1) The viability and profitability of the system.

(2.2) High demand for and popularity of the system both in Muslim and non-Muslim countries on grounds of religious and ethical issues.

(2.3) Inadequate supply of such product despite its high demand. In other words, there is a vast market for Islamic banks and financial products to be tapped.

(2.4) Islamic banks and financial system is looked upon as a viable alternative to conventional banking system whose strength has been tackled by prevailing economic and financial crisis.

(2.5) Great contribution of various Islamic economists in terms of literatures, research, training, courses, seminars, etc. to the well functioning of the system.

(2.6) Greater competition in the Islamic financial industry implying a high growth-potentiality.

(2.7) Problems and critiques of Islamic banking operation pose some kind of challenges and the ambition to overcome such challenges is also a growth-led phenomenon, etc.

3. Malaysian model of Islamic banking and financial system is regarded as a model of such development in the region of South-East Asia (and the world at large). It is a pioneer to apply and develop such system in its economy at a macro level and hence
assume the leading role. Since Malaysian Islamic bank (BIMB) and financial institutions, like Tabung Haji, serve as a blueprint assisting in the conversion and setting up of Islamic commercial banks and financial institutions of all of its neighbouring countries.

4. Islamic banking and financial system can better serve for social well-being and economic development of an economy. Since it perpetuates both material and spiritual aspects of development, it brings about growth with less social and economic consequences to the community.

5. For the well functioning of Islamic banks and financial system, combined efforts from all parties including government, monetary authority, religious supervisory body, the bank, and individuals dealing with the bank must be to foster for the implementation of the system. Supports from the government and monetary authority in terms of proper legal regulatory and institutional framework and development strategy for the well-functioning of the system are prerequisites. Proper religious supervisory decision and Shari'ah verdicts are needed for ensuring and creating public confidence, standard of Islamic financial product and compliance with Shari'ah. Proper decision-making and management, transparency of operation, cooperation, greater innovation and sophisticated technology employed, etc., help individual Islamic bank to stay and prosper in the business. Great spirit and morality of depositors as well as entrepreneur or clients
dealing with the bank also substantiate the well performance of Islamic banks and financial institutions.

6. Islamic banking and financial development in South-East Asia in general and in Malaysia in particular shows that the fast growing movement of Islamic banking is not a consequence of petrodollar boom in the Middle East. Rather, it is a consequence of combined efforts of individuals longing for such system, government muscle and monetary authority including the viability and profitability of the system.