INTRODUCTION

South-East Asia consists of ten political countries namely Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam, nine of which are presently the member of the Association of South-East Asian Nations (ASEAN) whereas Cambodia has gained in-principle approval as the 10th member but a consensus on the timing of its admission is yet to materialize. It was formed in 8th August 1967 by a five founding members – Indonesia, Malaysia, the Philippines, Singapore and Thailand with the principal objectives to strengthen the economic cooperation and social stability of the region and to ensure peaceful and progressive national development, stability and security from external interference in any form or manifestation.¹

South-East Asia is, after all, not only home to all the major religions of the world – Islam, Buddhism, Christianity and Hinduism – but the geographical spread of these is such that the bonds that bind their adherents at one and the same time defy and accentuate political and territorial divides and boundaries. The case of Islam is especially striking in this respect, as its followers are presenting in significant numbers in almost every South-East Asian country, and in several of these across constraining political borders.

Spread of Islam in South-East Asia

When Islam was ‘historically’ born² during the 7th century A.D., little did the inhabitants of South-East Asia know that Islamic influences would one day
exert a major role in their part of the world. South-East Asia was then still a fragmented world, with some petty kingdoms and coastal areas as the foci of activities. Amidst the fragmentation, a unifying force, in the guise of the Hindu-Buddhist element, was beginning to penetrate the area, offering to the South-East Asia the first taste of a higher civilization, with its courtly life, bureaucratic process, new world view, political legitimacy for the local rulers, etc. The Hindu-Buddhist states of Srivijaya, Champa, Mataram, Aagkor were to become the cultural centers of South-East Asia. The process of Indianization was to take deep root in the mainland areas of South-East Asia (i.e., the present status of Burma (Myanmar), Siam (Thailand), Cambodia, Laos and Vietnam, while the island world (the present states of Malaysia, Singapore, Indonesia, and Southern Philippines), although influenced by Hindu-Buddhist traditions through the Srivijaya and Madjapahit Empires, were to turn Muslims permanently, beginning in the 13th century.  

Interaction between Arabs and Indian traders and the people of the archipelagic region preceded Islam. By the 5th century A.D., however, the Malay Archipelago had already become an important platform for traders en route to China and vice versa. With the emergence of the Srivijaya Empire in the 7th century its ability to guarantee safety of passage in the Straits of Malaca, the importance of the region in respect of international trade and shipping was enhanced further. By the end of the 9th century, the participation of Muslim traders in the commerce of the region had become evident. By the 11th century, there was already evidence of the existence of Muslim settlements in the archipelago.  

It was, however, not until after the rise to power of the Empire of Malaca that the Islamization of the archipelago was given a new impetus. Malaca began to assume the leadership of states, which had converted to Islam like Aru, Padir, and Lambri. Form Malaca the Islamization was further undertaken in Sumatra (Indonesia), Malay Peninsula (Malaysia and Southern Thailand), Borneo (Brunei, Eastern Malaysia and a part of Indonesia) and the island of
Mindanao (Southern Philippines). And in the 15\textsuperscript{th} century Islam was fully established in the archipelago, except Bali that the tradition of Hindu-Buddhist kingdom had survived.\textsuperscript{5}

The Islamization process in the region was greatly hastened by the acceptance of Islam by people in power and the pre-eminent position, which Muslim traders commanded in the archipelago. The conversion to Islam by the local ruler was a coup for the Muslims. Thereafter, the proselytization of the local people to Islam in the region followed very closely the trade routes.

**Muslims and the Colonial Period**

Like in the case of Muslim countries in the Gulf and Middle East, the spread and the full impact of Western colonial penetration was faced in South-East Asia in 19\textsuperscript{th} century. Apparently the economic and political order of the region appeared to be only peripherally affected by the European presence. In reality, a whole new order was beginning to evolve. By the time the implications of Western colonial presence were realized, all the traditional states of South-East Asia, with exception of Thailand, had lost their political independence. The impact of colonial powers in the region reflects mainly two phenomena.\textsuperscript{6} Firstly, the artificial boundaries over the region which had been delineated by the European Powers did not coincide by any means with the traditional, ethnic, linguistic, cultural, religious and, indeed, political boundaries. Secondly, following massive immigration, particularly of Chinese and Indian, which was encouraged, the new economic and educational opportunities that were introduced by the colonial powers largely benefited the immigrant communities. The bulk of the local population was virtually insulated form the developments that were taking place. Very few of common Muslim people were given access to higher and modern education. Economically, the majority of them almost, by design, remained in agriculture and fishing. Their entrepreneurial class had been suddenly displaced. Only the more cosmopolitan Muslims survived in trade and commerce. A pattern of unequal development between the local
Muslim inhabitants and immigrants emerged and often became the factor of ethnic conflict in the region.

These two phenomena together weekend politico-economic and cultural aspects of the Muslims in the Malay Peninsula and archipelago. All means of modernization introduced in the region imposed serious indirect impact on what is called 'malayu culture' of the region. This was exacerbated when the economy came under the control of Chinese immigrants. This phenomenon existed after independence and has continued until now. Nevertheless, the attempt of local Muslims to maintain their malayu identities has caused them to be exposed extensively to religious socialization. The traditional Islamic educational system has, for example, continued to survive. The mosque, surao, madrasah and pondok have emerged as important centers of religious instruction. Further education in the field of religion is sought in the Middle East.

South-East Asia and Economic Crisis

Recently, the region has experienced a widespread recession caused by Asian financial crisis that had been root-started in July 2, 1997, when Thailand has floated her currency and that the no-confidence contagion first emerged. The sense of loss is most bewildering to Thailand because the boom that began in 1985 has been one unbroken swing skyward, while both Indonesia and Malaysia have gone through layoffs that decade and the Philippines has started to grow only three years before the crisis took place.

The crisis has led to an abrupt and sharp reversal of high growth, low to moderate inflation, growing employment, stable currencies and rising asset values. Thus Indonesia's economy, ASEAN's largest, shank by 14 percent in 1998, Malaysia 8 percent, Thailand 11 percent and the Philippines by 1 percent (see table 1 below):
Table 1: GDP Growth%

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>7.8</td>
<td>4.7</td>
<td>-13.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>10.0</td>
<td>7.5</td>
<td>-7.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Philippines</td>
<td>5.8</td>
<td>5.2</td>
<td>-0.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>7.5</td>
<td>8.0</td>
<td>1.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>5.9</td>
<td>-1.8</td>
<td>-10.4</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: Asian Development Bank; International Monetary Fund; Asiaweek Research, published in Asiaweek September 1, 2000.

The poverty and unemployment levels have soared. Newer members (Vietnam, Laos, Myanmar and Cambodia) of ASEAN, which were expecting to benefit from the rapid growth of other ASEAN members have also been affected.

The crisis took the world by surprise because when it occurred, the economic fundamentals of most countries in the region were extraordinary sound. Between 1990 and 1996, Indonesia's GDP grew at more than 7.1 percent, Malaysia's 8.6 percent, and Thailand's at over 8 percent. After 1995 there were signs of overheating, but these did not get reflected in the economic statistics, for all the three countries continued to run current account budget surpluses. On the external account, Indonesia had a large trade surplus and Malaysia a negligible trade deficit in the 1990s. Only Thailand had a large balance of payments deficit at the time of the crisis, because of declining exports. But Thailand's foreign exchange reserves of about US$ 40 billion were healthy, and most of the deterioration had taken place in a single year - 1996. At the end of 1996 when the baht first came under pressure, the trend was not sufficiently well established or understood to provoke undue alarm.10

Attention was quickly focused on Thailand, which was being buffeted by a series of external and internal events causing the root contagion of Asian financial crisis. The pre-crisis decline of Thai export was mainly due to devaluation of Chinese and Japanese currencies allowing them to underprice
low good and high value-products respectively in relation to Thai commodities. As Thai export diminished, the flood of foreign investment continued. On the surface, Thailand still looked good, with its open markets and a fiscal surplus, but underneath, the balance sheet was rotting. Foreign reserves remained steady at about US$ 38 billion, but the amount of money Thailand owed to foreigners skyrocketed to US$ 106 billion. By 1996, cash outflow exceeded inflow by 8 percent of the nation's gross domestic product, and the net foreign assets owned by Thai government and commercial banks shriveled as the nation covered the outflow with borrowing. While earlier years most of these loans had gone to build industrial capacity, now the money poured into real estate speculation, the stock market and financial companies supporting an unproductive boom as consumer bought Mercedes sedans, cellular telephones and other luxurious goods. The Thai economy had become one big bulging bubble and late 1996 the currency speculators took notice.11

Thais are finally asking some hard questions like how could a country with an average income under US$ 6,000 become the world's second-largest market for Mercedes? Is this because of the implication of interest rate mechanism that cultivates and fosters luxurious consumers' habit and ambition? The truth is that Thailand, like its South-East Asia neighbours, was living the high life on borrowed money. A dizzying record of growth deluded millions of new middle-class achievers into feeling fabulously rich. They were late but fast bloomers among the Asian Tigers, determined to catch up in the shopping race.12

Were the characteristics of weak financial system, excessive foreign borrowing and lack of transparency of the Thai economy enough reasons to be punished by the American currency speculators like George Soros and Julian Robertson? Wasn't there any time-lag coincidence between the attack and the obligation of Article VIII of the American-led IMF in 1990 that required the Baht to become fully convertible on the current account and, then in 1993, established a Bangkok International Banking Facility (BIBF), which opened up
the country's capital market to foreigners which in turn exposed the Asian currency markets to foreign speculators and precipitated the crash?\textsuperscript{13} Thailand was once believed to be the key country to check the spread of communism from the North to the South, but the era of cold war period was over under the collapse of Soviet Union. Was not the attack a policy to check newly industrialized tigers such as Malaysia and Indonesia from getting out of line? However, the flaw of the conventional financial system such as forward currency market and interest rate mechanism, which supports excessive borrowing, unproductive loans and speculation, is now proved to be the built-in mechanism to unhealthy economic growth and development.

Muslim-Majority and Muslim-Minority Countries

Islam is a major social and political force to be reckoned within South-East Asia. Although there are no Islamic states, Islam is the state religion in Negara Brunei Darussalam, the official religion of the Federation of Malaysia and the religion professed by about 90 per cent of the population in the Republic of Indonesia, the world fifth most populous nation. Moreover Islam in the faith of the largest minorities in the Philippines, the Kingdom of Thailand, and the Republic of Singapore, with also some scattered amount in Socialist Republic of the Union of Burma (Myanmar) and Cambodia. In term of the number of adherents, there are more than 200 million people all over the South-East Asia who are Muslims. By virtue of this, South-East Asia can claim the distinction of being the only geographical area in the world, outside the traditional Islamic belt stretching from Northwest Africa to South Asia, with the largest concentration of Muslims.

Although, South-East Asian Muslims can be said to be living at the periphery of the heart land of Islam in the Middle East, in terms of their geographical distribution, their psychological and spiritual attachment to Islam is deep and dynamic and distinguishes their devout very little from the most devout of Muslim elsewhere. Intellectually, the South-East Asian Muslims have
always been open and receptive to the ongoing process of Islamization that has characterized their societies for centuries.

As well as in the field of Islamic economic, banking and financial development, their contributions therein continue to pre-occupy the minds of a great number of South-East Asian Muslims. The development of Islamic banking and finance in South-East Asia can be broadly discussed in three groups. Due to its important, this chapter will exclusively deal with the Malaysian experience of Islamic banking and finance. The development of Islamic banking and finance in other two Muslim-majority countries, i.e., Indonesia and Brunei, will be discussed in the next chapter. This will follow a discussion of such development in selected Muslim-minority countries.

MALAYSIAN SYSTEM OF ISLAMIC BANKING

Malaysia is one of the most dynamic and vibrant economies that is actively contributing towards economic development of South-East Asia. In fact, Malaysia is no more regarded as a developing country as it is now included in the category of newly industrialized countries. Further, South-East Asia is not a monolith. Instead, it has an amazing maze of ethnic diversity. This complexity of ethnicity is also reflected in the Malaysian society, whose total population is estimated in the year 2000 to be at 23.3 million people, with 54 percent Malay Muslims, 35 percent Chinese and 10 percent Tamil Indians.

Malaysia provides a best telling example of dual-banking system whereby Islamic banking co-exists with conventional one. Since it was in a capitalistic environment that the Bank Islam Malaysia Berhad was established, Malaysia sets for a dual-banking and financial system in the next decade. The development of an Islamic banking and financial system to function side-by-side with the conventional counterpart is firmly taking place. Latest developments include the supply of interest-free banking services by conventional bank, the establishment of an Islamic inter-bank money market as well as Islamic capital market. A wide range of Islamic financial instruments
adds further depth to the system. To some extent, all three premises for a viable and comprehensive Islamic financial system namely a large number of players, a variety of instruments and an Islamic inter-bank system have been met. The Malaysia Islamic financial system has also been recognized the most clearly structured in the world and as the model of the future. The Bank Islam Malaysia Barhad’s model served as the 'blueprint' for the Bank Muamalat Indonesia (1991), the Islamic Bank of Brunei (1993), and Amanah Bank of the Philippines (new version). Many other countries such as Saudi Arabia and Sri Lanka have shown keen interest to implement a similar system in their respective countries.\textsuperscript{16}

**The History of Islamic Banking in Malaysia**

The origin of Islamic financial system in Malaysia traces its root back to 1963, with establishment of the Pilgrims Management and Fund Board (Tabung Haji), which enabled intending pilgrims to save (and earn) gradually for the hajj without involving any interest. Because of its importance we shall devote a full chapter to its discussion and deal with it in detail in chapter 6. The success of Tabung Haji provided the main impetus for establishing a full-fledged Islamic bank, which in turn led to later development of Islamic financial system in the country. Following the implementation of the Tabung Haji, there was a continuous pressure on the government to help establishing an Islamic bank. Starting with the independent efforts of various organizations including Tabung Haji, Muslim Welfare Organization of Malaysia, and the Development Bank of Malaysia Berhad to form a body to undertake a study on various aspects of Islamic banking and its implementation in Malaysia. The government lastly agreed to form a National Steering Committee of Islamic Bank on 30\textsuperscript{th} July 1980. The Committee submitted its Report on 5\textsuperscript{th} July 1981, which was accepted by the government. Following this acceptance, the Parliament and the Senate had legislated the Islamic Banking Act towards the end of 1982. The Act had been gazetted in 1993. In March 1993, the first full-fledged Islamic Bank was incorporated as a limited company under the Companies Act 1965 under the
name of Bank Islam Malaysia Berhad with its registered office situated in Kuala Lumpur, Malaysia.\(^{17}\)

Bank Islam Malaysia Berhad

Bank Islam Malaysia Berhad (BIMB) began operation as Malaysian first Islamic bank on 1\(^{st}\) July 1983. Its Memorandum of Association prefaced that "all business of the company will be transacted in accordance with Islamic principles, rules and practices"\(^{18}\). It lists among the company's first objective as "to carry on the Islamic banking business in all its branches and department and to transact and do all matters and things incidental thereto, or which may at any time hereafter at any place where the company shall carry on business as usual in connection with the Islamic banking business", with the proviso "that nothing in this Memorandum contained also shall empower the company to carry on any business or do anything involving any element which is not approved by the religion of Islam".\(^{19}\) Obviously the objectives are meant primarily to cater for the financial needs of Muslims in the country and to further extend its services to the whole population at large.\(^{20}\) The Bank's Memorandum of Association has determined that its authorized capital would be RM 500 million divided in 499,999,999 ordinary shares of RM 1 each and one Special Rights Redeemable Preference Share of RM 1. The initial paid-up capital of the Bank was RM 80 million, with the Minister of Finance (Incorporated) Malaysia contributed RM 30 million, Tabung Haji RM 10 million, Muslim Welfare Organization of Malaysia RM 5 million, State Religious Council RM 20 million, State Religious Agencies RM 3 million, and Federal Agencies RM 12 million. The Bank's paid-up capital was increased to RM 133.4 million in 1991 to accommodate the growth of its asset and to better position itself in meeting future expansion and growth, in which Tabung Haji and Al-Baraka Investment and Development Company hold the larger portion of Bank's share of 26.76 percent and 9.88 per cent respectively, whereas the Minister of Finance holds one Special Rights Redeemable Preference Share of RM 1.00. The Bank was
listed on the Main Board of the Kuala Lumpur Stock Exchange (KLSE) on 17th January 1992.21

Under the Islamic Banking Act 1983 (IBA), BIMB was allowed for a smooth operation of Islamic banking to co-exist side-by-side with conventional banking of the country. The Act made it mandatory for the BIMB to set up a Religious Supervisory Council to supervise its operations with respect to their compliance with Islamic Shari’ah. Also the powers of supervision and regulation over the BIMB are vested in the Central Bank, Bank Negara Malaysia (BNM), as in the case of other licensed banks. Moreover, the Government Investment Act 1983 (GIA) was also enacted to allow the Government to issue Government Investment Issues (GII) or government non-interest bearing certificates based on Islamic principles. The introduction of GII enables Islamic bank to meet its liquidity requirement as well as acting as an instrument to absorb idle funds in the short-run. Certainly, both IBA and GIA provide specific legal framework and financial instrument that are prerequisites to the Malaysia’s Islamic financial system.22

Operation of BIMB

As provided by the IBA, BIMB carries out banking business similar to other conventional banks, but along the principle of Shari’ah. The Bank provides deposit-taking products such as current deposits and savings deposits23 under the concept of wadiah (guaranteed custody) and investment deposits under the concept of mudarabah (profit-sharing). The Bank grants financing facilities such as project financing under mudarabah and musharakah (profit-sharing and partnership) asset acquisition under bai’ bithaman ajil (deferred payment), leasing under ijarah (leasing), benevolent loan for the needy under qard Hasan (benevolent loan), syndication services under ajir (fee) and securitization and debt trading under bai’ dayn (debt trading). And in relation to trade financing, the Bank provides facilities such as letters of credit under the principle of wakalah (agency), musharakah (partnership) and
murabahah (cost-plus); letter of guarantee under kafalah (guarantee); working capital financing under murabahah (cost-plus); securitization of Islamic accepted bill and securitization of Islamic export credit refinancing scheme under bai' al-dayn (debt-trading).^{24}

On the prudential side, BIMB has to observe similar regulatory rules as applied to conventional banks. For instance, the Bank has to observe a minimum risk-weighted capital ratio of 8 per cent. The Bank is also required to maintain a statutory reserve account with BNM, and the prescribed statutory reserve ratio as at the end of June 1999 was 4 per cent of its total eligible liabilities.^{25}

Performance of BIMB

Table 2 illustrates the growth of deposits, assets and profits of BIMB during the period of 1984 to 1999. There was a rapid growth in deposits as well as assets of the Bank over the 1984 to 1987 period, as the concept of Islamic banking attracted Muslim depositors as a new alternative method, usually from those who already had acquired the banking habit. Deposit growth slow down the next few years until 1990, and the following year's deposits actually fell. Did this deposit performance, once the Islamic bank was regarded as a 'mature' and established institution, reflect developments in the Malaysian economy or its financial system, or customer perception of the institution itself?

Between 1987 and 1991, Malaysia gross domestic product growth actually accelerated from 5.4 per cent to 9.5 per cent. The years of economic stagnation had been in the mid-1980s with GDP falling by 1.1 per cent in 1985 and recovery by a mere 1.2 per cent in 1986.^{26} Yet these were the years when Islamic bank's deposits grew rapidly. It seems there is no correlation between macro economic performance and that of the Islamic bank.^{27} From the period over the 1992 to 1997, deposits of BIMB grew substantially at a consistent rate, with a slowing down in 1998 when the country experienced financial and economic crisis especially in the conventional banking and financial sectors.
And in the year of 1999, deposits with BIMB grew substantially and suddenly by 52 percent. This implies that the crisis had negative impact on customers' confidence towards conventional banking and financial system as they regarded that the crisis was a failure of such system. At the end of June 1999, BIMB's deposits increased to RM 5,620 million from RM 3,720 million in 1998, with the total assets, excluding contra items, grew by 37.84 percent to RM 6.76 billion from RM 4.9 billion in 1998, and that total number of depositors increased by 5.88 per cent to 647,507 from 611,532 in 1998.26

Table 2: Bank Islam Malaysia Berhad: Deposits, Assets and Profits, 1984-1999

<table>
<thead>
<tr>
<th>Year</th>
<th>Deposit (RM million)</th>
<th>Assets (RM million)</th>
<th>Profits before taxation and zakat (RM million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>241.4</td>
<td>326.0</td>
<td>-1.3</td>
</tr>
<tr>
<td>1985</td>
<td>410.2</td>
<td>514.0</td>
<td>4.4</td>
</tr>
<tr>
<td>1986</td>
<td>566.9</td>
<td>683.0</td>
<td>3.7</td>
</tr>
<tr>
<td>1987</td>
<td>809.1</td>
<td>932.0</td>
<td>4.5</td>
</tr>
<tr>
<td>1988</td>
<td>1,022.0</td>
<td>1,153.0</td>
<td>6.2</td>
</tr>
<tr>
<td>1989</td>
<td>1,229.0</td>
<td>1,368.0</td>
<td>10.0</td>
</tr>
<tr>
<td>1990</td>
<td>1,220.0</td>
<td>1,396.0</td>
<td>13.4</td>
</tr>
<tr>
<td>1991</td>
<td>1,175.0</td>
<td>1,357.0</td>
<td>14.1</td>
</tr>
<tr>
<td>1992</td>
<td>1,320.5</td>
<td>1,676.2</td>
<td>19.8</td>
</tr>
<tr>
<td>1993</td>
<td>1,611.7</td>
<td>2,009.0</td>
<td>35.7</td>
</tr>
<tr>
<td>1994</td>
<td>2,547.8</td>
<td>3,046.3</td>
<td>41.5</td>
</tr>
<tr>
<td>1995</td>
<td>2,865.9</td>
<td>3,248.3</td>
<td>42.5</td>
</tr>
<tr>
<td>1996</td>
<td>3,196.3</td>
<td>3,609.5</td>
<td>37.7</td>
</tr>
<tr>
<td>1997</td>
<td>3,716.5</td>
<td>4,440.2</td>
<td>47.7</td>
</tr>
<tr>
<td>1998</td>
<td>3,720.0</td>
<td>4,900.0</td>
<td>11.53</td>
</tr>
<tr>
<td>1999</td>
<td>5,620.0</td>
<td>6,760.0</td>
<td>47.95</td>
</tr>
</tbody>
</table>

Source: Bank Islam Malaysia Berhad, Annual Reports.

Regarding the BIMB's profits before zakat and taxation, it was negative in the first year of its operation, reflecting the cost in getting start and the lag in
obtaining return. After that it was profitable. Although the growth in profit was substantially negative in 1998 reflecting high rate of bad and doubtful debt or non-performing loan during the year of crisis. This impact might be the general atmosphere of the crisis and, however, proved short-life on Islamic banking system as in the following year, the profits of BIMB increased spontaneously by 316.05 percent from RM 11.53 million in 1998 to RM 47.95 million in 1999. The substantial improvement is attributed to efficient utilization of funds, increase in deposits and reduction in financing losses.²⁹

*Financing policy of BIMB*

Tables 3 and 4 show method and sector-wise distribution of financing policy of BIMB respectively

<table>
<thead>
<tr>
<th>Table 3: Method of financing by BIMB</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Methods</strong></td>
</tr>
<tr>
<td>BBA, <em>(bai' bithaman ajil</em> or deferred payment)</td>
</tr>
<tr>
<td><em>Murabahah</em> (sale at fixed margin)</td>
</tr>
<tr>
<td><em>Ijarah</em> (leasing)</td>
</tr>
<tr>
<td><em>Mudarabah</em> (profit-sharing)</td>
</tr>
<tr>
<td><em>Musharakah</em> (equity participation/ partnership)</td>
</tr>
<tr>
<td><em>Qard Hasan</em> (benevolent loan)</td>
</tr>
<tr>
<td>Staff Credits</td>
</tr>
</tbody>
</table>

*Source: BIMB holdings Berhad, Annual Report 1999.*

In table 3, *(bai’ bithaman ajil* or deferred payment constitutes about two-third of method of financing of BIMB. *Murabahah* or cost plus or sale at fixed margin which is popular among Islamic bank in the Middle East and elsewhere constitutes around one-third. These two methods of financing constitute major portion of finance of BIMB due to their short-term and less risk nature. The reverse is for other methods of financing.
Table 4: Distribution of BIMB Finance

<table>
<thead>
<tr>
<th>Sector</th>
<th>1998 (%)</th>
<th>1999 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, Mining and Quarrying</td>
<td>4.80</td>
<td>5.25</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>18.82</td>
<td>14.76</td>
</tr>
<tr>
<td>Real Estate &amp; Construction</td>
<td>15.12</td>
<td>12.48</td>
</tr>
<tr>
<td>Housing</td>
<td>35.55</td>
<td>37.41</td>
</tr>
<tr>
<td>General Commerce</td>
<td>10.39</td>
<td>8.41</td>
</tr>
<tr>
<td>Finance, Insurance and Business Services</td>
<td>1.07</td>
<td>2.36</td>
</tr>
<tr>
<td>Consumption Credit</td>
<td>4.02</td>
<td>5.37</td>
</tr>
<tr>
<td>Others</td>
<td>14.29</td>
<td>9.90</td>
</tr>
</tbody>
</table>

Source: BIMB Holdings Berhad, Annual Report, 1999

In table 4, the distribution of BIMB funding among the major economic sectors are illustrated. More than one-third of financing is for housing purchase, indicating the extent to which it functions like a US savings and loan association or a UK building society rather than a commercial bank.30 1999’s investment in manufacturing is relatively smaller than that in the year of 1998 reflecting less investment during the current year of economic crisis. The same pattern is in case of real estate and construction, commerce and others, which got relatively lower funding in recent years, whereas housing sector, agriculture, services and consumption credit received more finance. The possible reason for the larger finance for housing sector may be because of the cheaper price of the immense available of houses reflecting from less demand during the crisis. In addition people are not likely to invest their money during the downward economy. Rather they would prefer to save or hoard either in the form of cash or valuable asset such as house and car. The availability of housing project in excess supply during economic turmoil may have also been taken up by the government to promote its sale to reduce the rate of non-performing loans, which had been stuck in real estate construction and housing projects like in
the case of Thailand. Total amount of 1999's financing stood at RM 3.40 billion (net of provision for bad and doubtful financing) from RM 2.95 billion in 1998, reflecting a growth of 15.5 percent. Investment of BIMB in securities increased from RM 911.9 million in 1998 to RM 1.23 billion in 1999, consisting mainly in money market instrument and some portion in stock and shares.31

Return to BIMB’s Depositors

Table 5: Return to depositors, 1995 to 1999

<table>
<thead>
<tr>
<th>Account Type</th>
<th>Rate of Profit (% p.a)</th>
<th>1995</th>
<th>1996</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings account</td>
<td></td>
<td>3.42</td>
<td>3.64</td>
<td>3.36</td>
<td>-</td>
<td>2.51</td>
</tr>
<tr>
<td>Current Account – Tier 1</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>2.00</td>
</tr>
<tr>
<td>Current Account – Tier 2</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.25</td>
</tr>
<tr>
<td>Investment Account</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 month</td>
<td></td>
<td>4.13</td>
<td>4.66</td>
<td>4.57</td>
<td>-</td>
<td>3.53</td>
</tr>
<tr>
<td>3 months</td>
<td></td>
<td>4.39</td>
<td>4.95</td>
<td>4.86</td>
<td>-</td>
<td>3.75</td>
</tr>
<tr>
<td>6 months</td>
<td></td>
<td>4.65</td>
<td>5.24</td>
<td>5.14</td>
<td>-</td>
<td>3.97</td>
</tr>
<tr>
<td>9 months</td>
<td></td>
<td>4.90</td>
<td>5.33</td>
<td>5.43</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>12 months</td>
<td></td>
<td>5.16</td>
<td>5.83</td>
<td>5.72</td>
<td>-</td>
<td>4.19</td>
</tr>
<tr>
<td>15 months</td>
<td></td>
<td>5.42</td>
<td>6.12</td>
<td>6.00</td>
<td>-</td>
<td>4.41</td>
</tr>
<tr>
<td>18 months</td>
<td></td>
<td>5.68</td>
<td>6.41</td>
<td>6.29</td>
<td>-</td>
<td>4.63</td>
</tr>
<tr>
<td>24 months</td>
<td></td>
<td>5.93</td>
<td>6.70</td>
<td>6.57</td>
<td>-</td>
<td>4.83</td>
</tr>
<tr>
<td>36 months</td>
<td></td>
<td>6.19</td>
<td>6.99</td>
<td>6.86</td>
<td>-</td>
<td>5.07</td>
</tr>
<tr>
<td>48 months</td>
<td></td>
<td>6.45</td>
<td>7.28</td>
<td>7.14</td>
<td>-</td>
<td>5.29</td>
</tr>
<tr>
<td>60 months</td>
<td></td>
<td>6.71</td>
<td>7.57</td>
<td>7.43</td>
<td>-</td>
<td>5.51</td>
</tr>
<tr>
<td>Negotiable Islamic Debt Certificate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 days</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.30</td>
</tr>
<tr>
<td>63 days</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.40</td>
</tr>
<tr>
<td>92 days</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.50</td>
</tr>
<tr>
<td>122 days</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.50</td>
</tr>
<tr>
<td>153 days</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.60</td>
</tr>
<tr>
<td>183 days</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.70</td>
</tr>
</tbody>
</table>

BIMB has registered in 1999 a total of RM 166.5 million as profits attributable to depositors compared to RM 190.6 million in 1998. These figures may be reflected from higher provision kept in the form of reserve to meet statutory requirement of the BNM and uncertainties.

The monthly rates of return to depositors for June 1999 as well as of the previous years are given in Table 5, reflecting financial position in relation to general economic condition in respective years of the country. The longer the period the higher the rate of return to depositors.

Financial Products and Services Development of BIMB

The development of various Islamic banking and financial products and services is critical to ensure that the Islamic financial system can stay competitive. With an aim to be equally viable, modern, sophisticated and dynamic, the range of products should reflect these goals. During the period of financial crisis, BIMB has continued to introduce new products and services in its effort to stimulate business growth. In order to live up with its goal to meet various specific banking needs, BIMB introduced and managed the products and services such as Sakinah Investment Account, Pewani Saving Accounts, Al-Rahn Financing Scheme (Collateralised Borrowing Financing Scheme), New Vehicle Financing Scheme, Education Financing Scheme, and Official Zakat Payment Receipt. With their introduction, BIMB now has a range of 44 Islamic banking products and services.

BIMB's Subsidiaries and Branch Networks

BIMB has in recent period 4 subsidiaries including Al-Wakalah Nominees (Tempatan) Sdn. Bhd. dealing mainly in providing nominee services; BIMB Unit Trust Management Bhd. acting as a manager of Amanah Saham Bank Islam; Bank Islam (L) Ltd., an offshore Islamic banking business; and BIMB International Islamic Trust (Labuan) Sdn. Bhd., providing trust and related services. In 1999, Al-Wakalah Nominees (Tempation) Sdn. Bhd., a wholly-owned subsidiary, recorded a profit before zakat and taxation of RM 189, 260
against RM 101,702 in 1998. BIMB Unit Trust Management Bhd., a wholly-owned subsidiary, recorded over the same period a decline in profit to RM 1.75 million against RM 3.71 million in 1998. The decline was attributed to the decrease in the sale of units. Bank Islam (L) Ltd., a wholly-owned subsidiary, recorded a profit of RM 4.44 million compared to RM 3.5 million loss recorded in 1998. And BIMB International Islamic Trust (Labuan) Sdn. Bhd., a wholly-owned subsidiary, recorded a profit before zakat and taxation of RM 76,550, an increase from RM 20,394 in 1998. In the with its expansion plans, in March, 2000, BIMB introduced another subsidiary, BIMB Foreign Currency Clearing Agency (BIFCA). BIFCA operates mainly as a foreign currency clearing house/agent, foreign currency import-export center, and assist regulatory bodies in regulating import-export of foreign currency. BIMB has, in the end of June 1999, 61 full-fledged branches and 19 mini-branches, with 1,670 staff manning the Bank.35

Restructuring of BIMB

In 1997, BIMB implemented a restructuring arrangement to increase its paid-up capital to RM 500 million and shareholders' funds to RM 970 million. The restructuring entails the incorporation of a new holding company – BIMB Holdings Berhad (BIMB Holdings) in place of Bank Islam. Subsequently, BIMB Holdings was listed on the Main Board of the KLSE on September 16, 1997 in place of Bank Islam. The Group's activities can now be divided into specific division, namely banking (Bank Islam and its subsidiaries), takaful (Syarikat Takaful), capital market (BIMB Securities), property (Syarikat Al-Ijarah) and others (BIMB Institute of Research and Training, and Pembiayaan Perumahan National).36 At the end of June 1999 at the Group level, profit before zakat and taxation surged 333.13 per cent to RM 102.41 million from RM 23.64 million in 1998. Correspondingly, operating income increased by 13.22 per cent to RM 286.15 million from RM 252.75 million in 1998. The Group's earning per share increased to 15.6 sen from 2.2 sen attained in 1998. Total asset of the Group increased to RM 7,787.7 million on 1999 from RM 5,688.5 million in 1998. BIMB, the core subsidiary of the company is the largest contributor to
Group profits accounting for 46.8 per cent of total profits, followed by Syarikat Takaful Malaysia Berhad 23.7 percent. BIMB has proved that Islamic banking is viable and had demonstrated its ability and capability to operate in parallel with conventional banks within the banking system.

Development Strategy

The government and regulatory authorities have outlined a long-term plan to develop Islamic banking and finance in the country, which includes the parallel running of both Islamic and conventional system. Towards this end, there is a need to develop a wider ranging Islamic financial system.

Although Malaysia has already established an Islamic bank since 1983, the bank was not able to serve the entire needs of the population, especially since the operations of the Islamic bank were constrained by the limited number of branches and resources. Furthermore, 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 innovative instruments, and a vibrant Islamic money market. In addition to the above requirements, an Islamic banking system must also reflect the socio-economic values of Islam. In other words, it must be Islamic both in form and substance. The strategies of development of Islamic financial system in Malaysia can be studied under the following heads.

*Interest-free Banking Scheme / Islamic Banking Scheme*

In order to realize the above objective, BNM gradually implemented measures to provide the necessary infrastructure by optimizing available resources. The first step was to disseminate Islamic banking on a nation-wide basis. This was achieved through the introduction of Skim Perbankan Tanpa Faedah (SPTF) (Interest-free Banking Scheme) in March 1993. The scheme allows conventional banking institution to offer Islamic banking products and services using their existing infrastructure, including staff and branches. The
scheme was launched on 4th March 1993 on a pilot basis involving three banks namely United Malayan Banking Corporation, Bank Bumipatera Malaysia Berhad and Malayan Banking Berhad. Following the successful implementation of the pilot-run, BNM opened the scheme to the commercial banks, finance companies and merchant banks in July 1993 subject to specific guidelines issued by BNM. Although the participation of banking institutions are voluntary, they have to observe the requirements of the scheme, such as to establish an Islamic Banking Unit (IBU) to be headed by a senior Muslim banker, to create an Islamic Banking Fund (IBF) with minimum allocation of RM 1 million, to open separate current/clearing accounts for Islamic banking operation with BNM, to register as Indirect Members under the wholesale payment system, SPEEDS (now RENTAS), and observe a separate cheque clearing system for Islamic banking. The bank is also required to maintain separate general ledger for its Islamic banking operations. These requirements will obviously ensure that the banks do not co-mingle the fund freely without proper internal controls. The banks are also encouraged to appoint at least a Shari’ah consultant to advise on the day-to-day operations of its Islamic banking division. In these ways, Islamic banking customers are having confident to deal with the Islamic banking unit of conventional banks. From only three banks in March 1993, the number of participating banking institutions increased significantly to 54 as at end-June 1999, comprising 24 commercial banks, 18 finance companies, 5 merchant banks and 7 discount houses.

In 1998, as part of the overall review on Islamic banking, the usage of the term SPTF was revised and it was found that the term did not portray the right appearance with respect to the Islamic banking operations undertaken by the banks. Thus, BNM replaced the SPTF with Skim Perbankan Islam (SPI) (Islamic Banking Scheme) beginning since 1st December 1998. BNM also observed that the Islamic banking operations of the SPI was regarded as low hierarchy business, being manned by middle-level management, while the IBU was given limited functions to perform its duties and responsibilities effectively. As part of the on-going efforts to promote Islamic banking further, the existing
organization structure, scope and responsibilities of the IBU was reviewed and enhanced further by introducing a new / framework to replace the existing IBU. Some of the salient features of the new framework are as follows:

- Effective 2\textsuperscript{nd} January 1999, IBU was up-graded to an Islamic Banking Division (IBD). The IBD will be the one-stop center responsible on all aspects of Islamic banking operations such as retail banking, commercial banking, corporate banking, trade / international banking, treasury operations, corporate planning and branch operations. This includes product development, marketing, processing, approving limits, branches supervision and credit control.

- The IBD is also required to prepare strategic plan to chart out the future direction of Islamic banking in the banking on a medium-term basis.

- The IBD is expected to have a constructive working relationship with other departments/divisions and should be provided with the necessary support from the departments/divisions in ensuring smooth implementation of Islamic banking operations, particularly in areas where the same infrastructure is being shared.

- The IBD should be proficient in applying accounting standards (including Islamic banking accounting standards), legal and regulatory requirements, directives and guidelines used by BNM and other authorities, including rules and regulation issued by the relevant banking associations.

- As a division which operates like a ‘bank within a bank’, the level of resources should be justified to commensurate with the expected cost and profitability of the IBD, with a minimum staff requirement of at least nine officers.
• The IBD shall be headed by a Muslim senior management officer of the bank, at least the level of the Assistant General Manager (AGM). The position of the AGM should be equivalent to the status of other key functional heads to enable him to deal effectively with his peers and superiors when discharging his duties and responsibilities. Importantly, the AGM should be functionally responsible to the Chief Executive Officer (CEO). Initially, the AGM is allowed to carry out banking duties and responsibilities other than Islamic banking during an interim period of two years (1999-2000). Beginning 1st January 2001, the AGM shall perform his duties and responsibilities with regard to Islamic banking on a full-time basis.

In tandem with the enhancement of the IBU, the IBF of the SPI commercial banks and finance companies were increased from RM 1 million to RM 5 million, and RM 3 million for the merchant banks effective 2nd January 1999. By 1st January 2001, the IBF for the commercial banks and the finance companies was to be further increased to RM 20 million and RM 10 million respectively and RM 6 million for the merchant banks.

Target of 5 Percent

As part of the measure to gauge the commitment and performance of Islamic banking operators, in December 1995, BNM set a target to be achieved by the Islamic banking industry during a period of 5 years. Under this measure, BNM established a policy that by the end of year 2000, the Islamic banking operation, in terms of deposits and financing, must constitute at least 5 per cent of the total banking system. The target was reviewed in 1998 by replacing the target from an industry-wide target to individual banks’ target. With these changes, by the end of year 2000, the Islamic banking operations of each SPI banks was expected to constitute at least 5 per cent of the total banking operations of the bank.
Guidelines on the Specimen Financial Statement for the Banking Industry (GP 8)

Since the inception of the SPI in 1993, BNM has made it mandatory for the Islamic banking operations of the SPI to be segregated from the conventional banking operations. These segregation procedures, coupled with the internal separation of the accounting books of each SPI Islamic banking operations have made it possible for the SPI banks to disclose a true and fair value of Islamic banking operations during its financial year. Given the depositors in the Islamic banking also assume the role as investor as far as mudarabah depositors are concerned, it makes sense that they should be informed on the performance of Islamic banking operations undertaken by the SPI banks. In October 1996, BNM issued the Specimen Financial Statements known as GP8 to prescribe the minimum standards on the disclosure of SPI banking operation. Under the GP8, the disclosure of Islamic banking operation would constitute a special section in the Notes to the Accounts of the principal financial statements. The Note to the Accounts would have a dedicated section showing the balance sheet and the profit and loss of Islamic banking operations of the SPI operations.43

Second Islamic Bank

An important event in Islamic banking during 1999 was the setting-up of the second Islamic bank in Malaysia, namely Bank Muamalat Malaysia Berhad (BMMB) which commenced operation on 1st October 1999. The establishment of BMMB was the result of the merger of Bank Bumiputera Malaysia Berhad (BBMB) and Bank of Commerce (M) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to BMMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to BOCB. BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia with a staff work force of 1,000. The paid-up
capital of BMMB at establishment date was RM 300 million. The establishment
of the second Islamic bank was part of the strategy to promote greater
competition and innovation among the players in the Islamic banking system.
The Government decided that greater competition is necessary and essential to
provide the drive towards greater innovation, productivity and improvement in
the quality and efficiency of services. The setting-up of BMMB is expected to
play a key role towards fostering an active and progressive Islamic banking
system.\textsuperscript{44}

\textit{Institutional Development}

Malaysia has succeeded in implementing a dual banking system, and is
among countries with a free market economic system. Malaysia has emerged
as the first nation to have a full-fledged Islamic banking system operating side-
by-side with the conventional banking system. This has helped Malaysia to
create a comprehensive Islamic financial landscape in Malaysia, encompassing
the Islamic banking system, the non-bank Islamic financial intermediaries and
the Islamic financial markets.\textsuperscript{45} The Islamic banking system in Malaysia now
comprises two Islamic banks regulated and supervised under the Islamic
Banking Act 1983 (IBA); and 24 commercial banks, 18 finance companies, 5
merchant banks and 7 discount houses participating in SPI regulated and
supervised under the Banking and Financial Institutions Act 1989
(BAFIA), Islamic banking facilities are now available in 120 branches of the
Islamic banks, 1,663 branches of the SPI commercial banks, including six full-
fledged Islamic banking branches, 820 finance companies’ branches, including
two full-fledged Islamic banking branches, and nine merchant banks’ branches.
Total assets of the Islamic banking system as at end-June 1999 stood at RM
34.1 billion while deposits and financing amounted to RM 26.1 billion and RM
11.7 billion respectively.\textsuperscript{46}

The aspiration of BNM to develop a comprehensive Islamic banking
system has encouraged the non-bank Islamic financial intermediaries to
improve their participation in the Islamic banking sector. These ancillary institutions have created their own niche market in Islamic banking and may be broadly divided into four groups of institutions as follows:

i. the *takaful* or insurance companies;

ii. the savings institutions;

iii. the development financial institutions; and

iv. other financial intermediaries which offer Islamic banking services such as the housing credit institution.

_Takaful_ operations are regulated and supervised by BNM since 1988 with the appointment of the BNM Governor as the Director-General of Takaful. There are presently two takaful operators, namely Syarikat Takaful Malaysia Berhad (STMB) and Takaful National Sdn. Berhad (TNSB) operating a total of 113 _takaful_ offices throughout the country. For the financial year ending on 1999, total assets of the family _takaful_ funds and the general _takaful_ funds amounted to RM 607 million and RM 227 million respectively.

The most prominent Islamic savings institution is the Pilgrims Management and Fund Board or popularly known as Tabung Haji discussed below in a separate chapter.

Bank Rakyat is the leading co-operative credit institution in the country and has established itself as a co-operative bank operating based on Islamic principles. The principal activities of the bank are those of a co-operative bank, accepting deposits and providing personal, leasing and other financing facilities to its members. The bank introduced Islamic banking in 1993 and has been actively promoting and providing Islamic banking products and services through its 76 branches nationwide. All new branches of Bank Rakyat now offer solely Islamic banking products and services while the existing branches are gradually being converted into Islamic banking branches. Bank Rakyat also pioneered
the provision of Islamic pawn-broking services, popularly known as *al-rahn*, which is a joint-venture programme with Yayasan Pembangunan Ekonomi Islam Malaysia (YPEIM). As at end-June 1999, the total assets of the Islamic banking operations of Bank Rakyat amounted to RM 6.2 billion or 88 per cent of its total assets. The National savings Bank (NSB) offers Islamic banking services on a small scale via the Islamic window. The total Islamic banking assets of NSB as at end-June 1999 amounted to RM 138 million or 2 per cent of its total assets.\(^{48}\)

The development finance institutions (DFIs) which offer Islamic banking services are Bank Industri (BI), Bank Pembangunan dan Infrastruktur Malaysia (BPIM) and the Agriculture Bank of Malaysia, all of which provide the facilities on a window basis. The BPIM provides Islamic banking facilities in the provision of medium-and long-term funds to promote industrial, investment and growth while the Agriculture Bank developed a similar scheme to that of BPIM. In addition, BI and BPIM are also the national recipients of the Islamic Development Bank (IDB) financing facilities in Malaysia, which extends credit lines to both banks for Islamic direct financing and trade financing facilities. As at end-June 1999, the combined Islamic financing extended by the three institutions amounted to RM 164 million.\(^{49}\)

The Treasury Housing Loan Division (THLD) provides Islamic house financing facilities to civil servants since May 1996, in line with its policy to provide all new house financing to civil servants on an Islamic basis. As at end-June 1999, the total approved Islamic house financing extended to civil servants amounted to RM 2.8 billion or 17.3 per cent of total financing outstanding.\(^{50}\)

*Association of Islamic Banking Institutions Malaysia*

The Association of Islamic Banking Institutions Malaysia (AIBIM) was established in June 1995 with the objective to promote the establishment of sound Islamic banking system with best practices in co-operation and
consultation with BNM and other regulatory bodies. AIBIM comprise the Islamic banks, SPI banks as its ordinary member and non-banking financial intermediaries and related organizations involved in Islamic banking and finance as associate members.

National Syariah Advisory Council

One of the requirements that Islamic banks under the Islamic Banking Act 1983 has to comply with was the establishment of a Shari'ah advisory body. For the SPI banks, they are required to appoint at least a Shari'ah consultant to assist the banks on any Shari'ah operational issues, as stipulated in the Guidelines on SPI. BNM has also allowed institutions in the same banking group (commercial banks, finance companies, merchant banks, and discount houses) to maintain only a single Shari'ah consultant(s) to minimize duplication of resources. Although the inclusion of Shari'ah scholars in Islamic banking operations had its advantages, BNM also noted that there exists more differences in opinion among Shari'ah consultants on similar issues, which may impede the creation of a sound and healthy Islamic banking system. To resolve this issue, BNM established the National Syariah Advisory Council for Islamic Banking and Takaful (NSAC) in May 1997 as the highest Shari'ah authority on Islamic banking and takaful. Among the primary objectives of the NSAC are to act as the sole authoritative body to advise BNM on Islamic banking, to coordinate Shari'ah issues on Islamic banking and finance, and to analyze and evaluate Shari'ah aspects of new products / schemes submitted by the banking institutions. The NSAC has a maximum of 11 members and is appointed by the BNM Board of Directors to serve for a period of two years.

Statutory, Liquidity, and Capital Adequacy Requirements

Being a regulatory rather than a development strategy, an Islamic banking institution is required to observe the following requirements:
1. Statutory Reserve Requirement (SRR)

Under Section 37(1)(d) of the Central Bank Act 1958, an Islamic bank is required to maintain a prescribed percentage of its reserves with BNM, presently at 4 per cent of its total eligible liabilities. Similar to the conventional banking institutions, such reserves do not earn income to the bank (the funds placed at BNM is interest-free). For the SPI, the total eligible liabilities of Islamic banking are consolidated with the total eligible liabilities of the bank as they were not required to maintain a separate SRR for Islamic banking.

2. Liquidity Reserve Requirement (LRR)

Under section 16 of the IBA, an Islamic bank is required to preserve a minimum liquidity ratio (MLR) at all times to meet deposit withdrawals and other maturing liabilities. The MLR is expressed as a percentage of the eligible liabilities base of the Islamic bank. The eligible liabilities comprise all deposits, net investments from other financial institutions, namely commercial banks, finance companies and merchant banks and net Islamic forward purchase agreements (or Islamic repurchase agreements) while liquid assets include cash, balances with BNM (excluding statutory reserves), Cagamas Mudarabah Bonds, Islamic accepted bills discounted or purchased, and Government investment issues (GII). The Islamic bank adopts a two-tier structure comprising the primary and secondary liquidity ratios. Under the two-tier structure, an Islamic bank is required to observe:

- A ratio of total liquid assets to total eligible liabilities, excluding investment account liabilities of 10 per cent; and

- A ratio of total liquid assets to investment account liabilities of 5 per cent.

In tandem with the issuance of the new liquidity framework by BNM in January 1998, Islamic banks will also adopt the new framework to harmonize and streamline its management of liquidity. Similar to SRR, the SPI operators are not required to maintain a separate LRR for Islamic banking.
3. Capital Adequacy Requirement

An Islamic bank is also required to observe a minimum risk-weighted capital ratio of 8 per cent formulated along the line of the Basle Concordat.\textsuperscript{55}

Islamic Money Market

Another major development in Islamic banking was the establishment of the Islamic money market on 3rd January 1994. An Islamic money market is integral to the smooth functioning of the Islamic banking system. It plays an important role, firstly, in providing Islamic financial institutions with facilities for adjusting portfolios over the short-term, and secondly, in serving as a channel for the transmission of monetary policy. Hence as the Islamic banking sector gains greater significance in mobilizing resources for financing economic activities, the need to develop an Islamic money market would naturally gain importance. BNM did not have the benefit of an existing model Islamic money market in any part of the world to emulate and therefore had to pioneer its own ideas to realize this quest.\textsuperscript{56}

After careful consideration, BNM decided to implement the Islamic money market based on the concept of mudarabah or profit-sharing. Specific guidelines were issued preceding the establishment of the Islamic money market in December 1993 to ensure smooth implementation and running of the market. The Islamic money market comprises three aspects, i.e., trading of Islamic financial instruments, Mudarabah inter-bank investments (MII) and the Islamic cheque clearing system (ICCS). The Islamic bank and SPI banks are allowed to trade in Islamic financial instruments such as Islamic acceptable bills, green bankers acceptances Islamic bonds and commercial paper as well as Cagamas Mudarabah bonds among themselves. The MII refers to a mechanism whereby a surplus Islamic bank/SPI bank can invest in a deficit Islamic/SPI bank based on mudarabah. The tenor of MII is from overnight to 12 months while the minimum amount of investment is RM 50,000. The profit-sharing ratio is negotiated among the transacted parties but the rate of return
shall be based on the gross profit before distribution for investment of 1 year of the 'investee (receiving)' bank.

After monitoring the process of the Islamic money market during the period 1994-1995, it was realized that adequate incentives have not been put in place to promote efficiency, specifically in terms of rewarding the provider of funds. Although the provider of funds dictated the profit-sharing ratios, the onus was on the investee bank to declare the return on maturity. Such situation had led to exploitation by inefficient banks, thereby hampering the overall integrity of the market. As such, BNM introduced the minimum benchmark of the MII in February 1995 using the prevailing rate of the GII plus spread 0.5 percentage points. Accordingly, the players were required to observe the minimum benchmark as a reference rate. This has resulted in the banks entering the market when they are really short and in the position to use the funds efficiently.

BNM also recognized the need for a separate cheque clearing system for Islamic banking in order to distinguish it from the conventional cheque clearing system. In January 1994, BNM devised a mechanism to segregate Islamic banking cheque from the conventional banking cheques from the moment the cheques were issued. This was made possible as the SPI commercial banks and the Islamic banks were required to maintain *wadiah* current account with BNM to facilitate the clearing arrangement, apart from the existing conventional bank's account. The banks were also required to empower BNM under the concept of *wakalah* to square their funding position between the surplus banks and the deficit banks during the automatic cheque clearing system at 12.00 midnight. Should the deficit persist, it would be funded by BNM on the same concept of *mudarabah*, subject to maximum of three times in a week, following which a penalty shall be imposed.

The Islamic money market serves as an important tool to manage and regulate liquidity, particularly the *mudarabah* inter-bank investments (MII). The MII injects or absorbs liquidity to and from the market. In 1996, following new
measures were introduced by BNM to enhance further the Islamic money market. The daily volume invested or accepted in MII by BNM ranged between RM 50 million to RM 100 million. For the first two and a half year until the middle of 1998, BNM had been investing in Islamic money market at an average amount of RM 250 million to RM 500 million daily. However, towards the end of 1998, BNM had reversed its role to become the net acceptor of fund from the market due to the large surplus funds in the Islamic money market.

In managing liquidity in the Islamic Money Market, BNM employs two financial tools, namely the mudarabah money market tender and the bai' al-einah contract. In August 1999, BNM introduced the mudarabah money market tender (MMT) to further enhance the operations of the MII. The MMT is conducted through the acceptance tender and the investment tender. The former would be used if BNM intends to absorb liquidity from the Islamic money market during times of excess liquidity, and the latter if there is a need to inject liquidity into the Islamic money market when the overall market is in a deficit. The bai' al-einah contract (BAEC) refers to issuance of Islamic papers by BNM to inject funds to banking institutions that faced difficulties in meeting their daily cash flow requirements, particularly those which could not meet the minimum benchmark rate in the MII. The BAEC paper however, can only be traded between BNM and the participating banking institutions. The availability of these instruments has assisted BNM in mopping and injecting liquidity in the Islamic money market in an efficient manner as well as enabling BNM to use the appropriate instrument under different circumstances.

All these measures have improved the performance of the MII significantly. From a meager sum of RM 2.1 billion transacted in 1994, the Islamic money market surpassed the RM 100 billion mark by recording total transaction of RM 138 billion and RM 118 billion in 1997 and 1998 respectively. The cumulative volume for the first six months of 1999 amounted to RM 238 billion.
Product Incentives and Development

To increase the attractiveness of Islamic banking, in April 1995, BNM allowed SPI commercial banks to offer *ijarah* (Islamic leasing) facilities under the SPI subject to minimum size per transaction of RM 200,000. In December 1998, BNM liberalized the acceptance of Islamic repo from non-inter-bank customers to include all SPI operators, a privilege niche previously accorded only to principal dealers. In April 1999, BNM allowed the Islamic bank and the commercial banks participating in the SPI to offer return */hibah* for all their current account customers, so long the return does not exceed the return of one-month investment deposits.

In terms of product development, BNM issued two guidelines for two Islamic banking products, namely the guidelines on Islamic Accepted Bills (March 1993) and Guidelines an Islamic Negotiable Instruments (December 1998). The Islamic accepted bills (IAB) are the Islamic version of banker's acceptance and were designed to enhance and deepen further the trading activities in the Islamic money market. The Islamic negotiable instruments comprised two new Islamic deposit-taking products, namely the Negotiable Islamic Debt Certificate (NIDC) based on the concept of *bai' bithaman ajil* and Islamic Negotiable Instrument of Deposits (INID) based on the concept of *mudarabah*. The products were created to provide an additional avenue for the Islamic bank and banking institutions participating in SPI to mobilize domestic savings from the public, and at the same time, deepen the Islamic money market with marketable and liquid instruments. BNM also issued three guidelines to facilitate the provision of Islamic financing under the export credit refinancing (ECR), Special Scheme for Low and Medium Cost House (SLMH) and Fund for Small and Medium Industries (SMI).59

Islamic Capital Market

Malaysia has been hailed as a model for developing a domestic capital market in South-East Asia. Stock market in Malaysia is substantial in terms of
its capitalization which is estimated around US$ 245 billion. The presence of such capital market is a necessary condition for the participation of private sector in infrastructural development and in overall development process. A domestic capital market reduces foreign exchange risk of international investors, if well regulated, and provides a way for the mobilization of untapped resources of retail investors. Furthermore, a closer and deeper involvement of domestic players in the financial matters makes the capital market more stable. All these features also applied for the Islamic capital market.

The Islamic capital market comprises the primary, in which new issues of Government Islamic securities and the Islamic corporate securities are offered to the public and institutions; and the secondary market, in which existing Islamic Government papers and Islamic corporate securities are traded.

In the Government securities market, the current instruments available in the market are the Government Investment Issues (GII) and the Malaysian Savings Bonds-Islamic principle. The GII are issued under the Government Investment Act 1983, whereby under the Act, the Government is allowed to issue non-interest bearing government papers to the public based on Islamic principles. The GII is based on the concept of qard hasan (benevolent loan) whereby the purchase of GII by the public is considered a loan to the Government for its development expenditure. Since the GII are defined as liquid assets, the Islamic banks and SPI banks purchase the GII to meet their liquidity requirements as well as to park their temporary idle funds. As at end-June 1999, the total out-standing issues of GII amounted to RM 2 billion. In November 1999, BNM issued the second series of the Malaysian Savings Bonds to retirees totaling RM 2 billion, of which RM 1 billion was issued based on the concept of bai' al-einah (buy-back arrangement). The purpose of the bonds was to provide reasonable returns on investments to retirees during this phase of economic recovery where the returns on deposits with the banking system were relatively low. Under the Islamic bonds, BNM sells its identified
assets to the public through the designated Malaysian banks and repurchases the assets at a mark-up, which give rise to a debt, evidenced by a registered certificate, which are non-tradable and non-negotiable.

The two major components of the Islamic corporate securities market are Islamic debts securities market and the Islamic equity market. The Islamic debt securities (IDS) made its debut in 1990 when a multinational company issued a RM 125 million *bai' bithaman ajil* facility for a distillation plant. Since then, IDS has become increasingly popular with various Islamic concepts such as *musharakah* and *ijarah* being applied. Islamic debt securities comprise the medium-term Islamic bonds and the short-term Islamic commercial papers (Islamic CPs). As at end-June 1999, the outstanding IDS amounted to RM17.1 billion, comprising Islamic bonds (RM 14.3 billion) and Islamic CPs (RM 2.8 billion). Khazanah bonds constituted 40.1 per cent of the total outstanding IDS amounting to RM 6.85 billion. The rapid growth of IDS is reflected by its outstanding market share of 20.4 per cent of total IDS outstanding as at end-June 1999.63

The first Sanadat (bonds) Mudarabah Cagamas (SMC) was issued in May 1993 totally RM 30 million. The amount represented Islamic house financing purchased from the SPI financial institutions. As at end-June 1999, the total outstanding Islamic mortgage financing purchased by Cagamas stood at RM 123 million, while SMC issued amounted to RM 184 million.64

The Islamic equity market is reflected by the presence of Islamic stock-broking operations; Islamic indices; Islamic unit trusts, and a list of permissible counters in the KLSE issued by the Securities Commission (SC). At present, there is one Islamic stock-broking firm, three conventional stock-broking firm offering Islamic stock-broking services through Islamic windows, and four licensed fund managers. There are currently two Islamic indices: - the RHB Islamic Index introduced in 1994 followed by the KLSE Islamic index in April 1999. The KLSE Islamic index tracks Shari'ah-compliant stocks in the KLSE,
constructed from the list of Shari'ah-approved counters issued by the SC based on the deliberation of the Syariah Advisory Council (SAC) of the SC. The SC now issues the list of permissible counters in KLSE three times a year since 1997 and as at end-May 1999, 541 or 73 per cent of the total counters in the KLSE have been approved as permissible counters.  

In classifying these securities as approved securities, the SAC of the SC has applied standard criteria, that is, focusing on the core activities of the companies listed on the KLSE and Malaysia Exchange of Securities Dealing & Automated Quotation (MESDAQ). Hence, companies whose activities were not contrary to Shari'ah principles were classified as approved securities whereas securities that were excluded from the list based on the following criteria:

- Operations based on ribā (interest) such as activities of financial institutions like commercial and merchant banks and finance companies.
- Operations involving gambling.
- Activities involving the manufacture and / or sale of haram (forbidden) products such as liquor, pork and meat not slaughtered according to Islamic requirements; and
- Operations containing the element of gharar (uncertainty) such as conventional insurance business.

As for companies whose activities comprised both permissible and non-permissible elements, the SAC applied several additional criteria:

- The core activities of the company were not against the Shari'ah as outlined in the four criteria above. Furthermore, the haram element must be very small compared to the core activities
- Public perception or the image of the company must be good; and
• The core activities of the company have importance or maslahah (benefit in general) to the Muslim ummah (nation) and the country, and the haram element is very small and involves matters such as umum balwa (common plight), urf (custom) and the right of the non-Muslim community, which are accepted by Islam.

Approved securities include ordinary shares, warrants and transferable subscription rights. On the other hand, loans stocks and bonds are non-approved securities unless their issuance is based on Islamic principle. In classifying these securities, the SAC received input and support from the SC, which has been gathered from various sources such as company’s annual financial report, survey, and through inquiries. The SC, through the SAC, will continue to monitor the activities of all companies listed on the KLSE and MESDAQ from time to time to determine their status. As on 28th April 2000, the SAC of the SC has approved an updated list of securities to be 566 which included forty six companies which has been newly classified as approved securities and twenty five companies have been excluded from the previous list.67 In addition, the SC also carries out research on areas, such as non-cumulative preference shares and leasing instrument, and organizes various seminars in terms of education vis-à-vis the Islamic capital market to explore on the methodology employed in the analysis of listed companies and to expose the general public to the Islamic capital market.68

Another component of Islamic equity market is the presence of Islamic unit trusts. The unit trusts are a group of specialized financial intermediaries in the capital market, which offer small investors the opportunity to pool their resources in a diversified portfolio of securities, which are managed and selected by professional portfolio managers. The inception of Islamic unit trust began in 1993 when Tabung Ittikal was introduced by Arab-Malaysian Unit Trust. The success of the fund paved the way for the introduction of more Islamic unit trusts as at end-June 1999, there were 13 Islamic unit trusts in the country with total approved fund size of RM 3.55 billion. Not withstanding that,
the net asset value of the Islamic unit trusts is still small, totaling RM 1.2 billion as at end-June 1999.  

*Labuan and The International Islamic Money Market*

The Federal Territory of Labuan was inaugurated as an International Offshore Financial Centre (IOFC) in October 1990, making another milestone in the development of the Malaysian financial system, as it was part of the Government’s long-term plan to further enhance the attractiveness of Malaysia as a financial centre. Labuan has been developed as an IOFC to cater mainly for investment requirements in Asia. There are many offshore centers in the world today, but most of them are located in Europe and the Caribbean. The Labuan IOFC, on the other hand, is an integrated offshore centre which provides a wide range of offshore products available to customers worldwide (particularly those in Asia) including banking, insurance and insurance-related activities, trust business, fund management, investment holding, company management services and capital market activities, and Islamic financing. The scope of offshore services and activities in Labuan has increased steadily over the years and is set to gain momentum for further growth in the future. In line with the progress recorded in the area of conventional offshore financing, the Labuan IOFC is now broadening its activity to also develop offshore Islamic financing.

More than 2,100 offshore and supporting companies including banking and financial companies have been established as at the end of August 1999. While the total number is still relatively small, it is important to note that the number of offshore companies has been increasing very rapidly in recent years. This was due to many factors such as the increasing awareness of the Labuan IOFC among investors worldwide, political stability of the country, easy access by air and lower tax regime and operating costs compared with other financial centers in the world. These features have been indicated by the ability of Labuan to attract 63 offshore banks in 8 years which is commendable.
compared with other offshore centres that have been around much longer. Out of 10 largest banks in the world, 8 are present in Labuan, and out of top 20 banks, 17 are in Labuan.\textsuperscript{71}

The Labuan IOFC is, thus, moving ahead in the road to become a premier offshore financial center in the world. It will, however, continue and endeavour to promote more activities and services to become a truly integrated service provider center. Hence, new activities and innovative products are continuously being developed in Labuan, which will benefit investors and other offshore players, as well as provide them with avenues to take advantage of the wide spread investment opportunities in the region and use Labuan for such purposes. For instance, in particular, the purposed establishments of the Labuan International Financial Exchange (LIFE) and the International Islamic Money Market (IIMM) are expected to deepen the offshore capital market. LIFE, which was expected to commence operation in 2000, would provide facilities for listing and trading facilities for equity and debt instruments, including Islamic financial products. IIMM on the other hand is an alternative money market to the conventional money market. It is being developed to fulfill the needs of the global market participants, especially those involved in Islamic financing. Its establishment is expected to be a catalyst and give a thrust for the development of Islamic money markets worldwide and provide a platform for the flow of funds between Islamic financial markets. Both these markets would certainly be attractive to investors and financiers as more financing options would be available.\textsuperscript{72}

The Islamic International Money Market can be an impetus to generate greater activities, and more confidence, in the Islamic financial and banking systems. But for a great prospect of the IIMM in Labuan, not only the Labuan Offshore Financial Services Authority (LOFSA) will have to play a leading role, it has to seek support and collaboration form the IDB to help establishing an Islamic International Money Market on the island. This in turn implies that for a successful development of IIMM, the member countries of IDB will have to
equally take part in the market. Thus "Islamic banking in Malaysia needs to move faster and grow bigger to withstand the challenges of globalization and liberalization. The Islamic International Money Market will certainly provide this push for Malaysia, but for it to create waves internationally, the member countries of IDB will need to be equally committed".\textsuperscript{73}

**Factors Responsible For Rapid Development Of Islamic Banking In Malaysia**

Islamic banking and financial system in Malaysia has flourished and developed at a rapid pace due to many critical factors. The first and foremost must be the result of a genuine need of Muslims for banking and financial system free of *ribā* which has been felt long before the establishment of *ribā*–based banking and financial institution. It is not altogether correct to affirm, as did Philip Moore in his book "Islamic Finance"\textsuperscript{74} that such need had been felt ever since Muslim has established relations with modern interest-based banking system. Nor the Islamic system has rapidly developed due to the availability of well-developed and established interest-based system. As a matter of fact, Muslims have long before established financial relation with each other's free of *ribā* stipulated by the holy Qur'ān and the tradition of the last Prophet of Islam, but such relations did not become fully specialized and institutionalized. Similarly, like conventional banking development, the development of Islamic banking and financial system has resulted from expansion of trade and economic activities as well as wealth that has been accumulated by Muslim and that such wealth has to be reinvested with the existence of zakat system in Islam.

The development of Islamic banking in Malaysia was also supported by professionals and Islamic scholars, which facilitated such development through their proper management and judgment to gain remunerative return and confidence from depositors and investors for Islamic financial venture. They also help to developing and innovating new concept, product, instrument and
so on along the line of Shari’ah to suit the needs of Muslim customers and investors. The support of shareholders is also part of the success, for without their contributions in the initial stage and follow-up expansion of capital base to cater future growth and expansion, Islamic banking business could not make much effort to run such a highly capitalized venture.

The last but not the least, the critical factor that showers biggest effort to the successful development of Islamic financial system in Malaysia is that of the commitment of the government. This support is reflected through the creation of legal framework and strategies for such development and various efforts to strengthen and consolidate Islamic banking system to operate smoothly side-by-side with the developed conventional system.

Philip Moore admits “Islamic baking in Malaysia has flourished as a result of a genuine ideological belief that as a country in which they are in the majority, practicing Muslim have a moral right to access a banking system free of ribā‘”.

Again he misunderstood. The simple ideological fact is that for practicing Muslims whatsoever they are in majority or in minority in any country, they have a moral right to access to a banking system free of ribā‘. Further, he views “the development of the Islamic banking industry in Malaysia is part and parcel of an overall commitment at a government level to lessen the inappropriate influence in the business sector of the local Chinese population”.

This is obviously not reasonable and against the historical facts and objective of the establishment of Islamic bank in Malaysia. Even though, Islamic banking made its inroads in Malaysia with the setting up of Bank Islam Malaysia Berhad (BIMB) in 1983, the need for Islamic financial institutions in Malaysia was discussed as early as before World War II. The problem faced was basically religion not because of ethnical conflict. It follows that Muslims especially in the rural area, who were concerned with the illegitimacy of bank interest were saving huge sums for the pilgrimage by traditional or primitive methods which after resulted in dire economic consequence before and after the hajj. Ultimately efforts in the voluntary sector led to the establishment of
Pilgrims Management and Fund Board or Tabung Haji and which played a significant role in paving the way for other Islamic financial institution in Malaysia. The development of Islamic financial sector in Malaysia is, thus, not initiated by the commitment of the government but rather by the genuine need of people for such system. In fact Muslims in Malaysia had to wait for more than twenty years for the government to make any serious efforts towards implementing the idea of Islamic banking in the country. This was partly due to the fact that the idea of Islamic banking was not readily acceptable to conventional banks and the Central Bank. It was only after 1980 in the face of continuous popular pressure from local Muslims as well as from certain political parties who had been more assertive in their demand for the creation of an Islamic state, and in the wake of a world-wide Islamic resurgence, that the government responded positively by establishing the National Steering Committee of Islamic Bank that led to the promulgation of the Islamic Banking Act 1983, which paved the way for Islamic banking development in Malaysia. Furthermore, not only the Malay Muslims that gain advantage from the establishment of Islamic banking in Malaysia, but also the Chinese, who realize that the benefit from such system is commendable when they compare fixed interest in conventional system with the variable return from Islamic banking system and certainly with their transactions with Islamic bank, they can remain in business with the Malays.

The full support of the government for the development of Islamic banking industry in Malaysia is also in accordance to government's plan to attract and absorb international Islamic capital that would become the key issue to make the Federal Territory of Labuan a real alternative of an Intentional Offshore Financial Center of the world.

**Issues & Challenges**

The development of Islamic banking system to operate side-by-side with the conventional system has become the main feature of Malaysian experiment
of Islamic financial system. With a strong support from the government, shareholders, customers, Islamic scholars and professionals reflecting towards proper management and development, Islamic banking institutions do not face problems in conducting their businesses. They have also been through the economic crisis and now drawing next plan for future growth and competition. The existence of large number of players in the industry imposed certain challenge rather than problem to the oldest established Islamic bank, BIMB. Consolidation in the banking industry via merger programme, which is a part of the process to develop a core of strong and high-capitalized domestic banks, and the emergence of a second Islamic bank brought about new challenges to the bank. Larger and better-capitalized entities will emerge from the exercise, thus in a better position to reach wider customer base and offer better services. For the BIMB, the Bank views the scenario as a challenge, if it wants to position itself as a core player in the business. As such, the Bank has to consider possible means to equip itself for competition.81

On the industry level, the merge exercise and the establishment of the second Islamic bank was part of the government strategy to promote greater competition and innovation among the players in the Islamic banking system. The Government decided that greater competition is necessary and essential to provide the drive towards greater innovation, productivity, and improvement in the quality and efficiency of services.82

For an enlarged structure of the SPI from merger exercise, the need to develop a structured pricing mechanism for Islamic banking will be necessary in order to develop a comprehensive Islamic banking system. The absence of a proper framework to guide Islamic banking players in pricing their products have led to the banks resorting to the conventional base lending rate as a barometer to price their products. There is, therefore, a need to move away from over-reliance on conventional indicators and to use pricing mechanisms that are based on Islamic principles. Towards this end, BNM is in the process of
developing a reference rate for the Islamic banking industry to be the primary or based pricing mechanism.  

Market penetration remained a continuing concern for Islamic banking. Although the target of 5 per cent in terms of deposits and financing could be achieved for each banking institution by the end of 2000, the main thrust is to garner a respectable share in the banking system. Therefore, the challenge over the next 5 to 10 years would be to position Islamic banking as a significant player in the banking system and such significance could only be attained if the market penetration is more than 30 per cent of the banking system. The attainment of this target would make the existence of Islamic banking more meaningful.

All the measures introduced so far by BNM will go a long way in preparing Islamic banking for the challenge in the new millennium. Undoubtedly, the new millennium will be an exciting period with new opportunities, new markets, and new environment for Islamic banking to develop and expend. Islamic banking, thus, will need to continually adjust to the new environment and integrate its operations into a sophisticated system to meet the challenges of the changing environment. More importantly a robust and strong Islamic banking system can also contribute more meaningfully to the future economic growth of the nation.

NOTES & REFERENCES

1. The ASEAN Declaration, Bangkok, August 8, 1967, Preamble (with little modification).

2. The term is used to denote the belief of the Muslims that Islam as the only religion of God started with the creation of the world but came down historically during the age of the Prophet Muhammad as the last Prophet of the world.


7. Malayu means when the Malayness is wedded to Islam. It refers to an arrangement of attachment of Malay culture over Islamic culture. For example, those who embrace Islam or 'Masuk Islam' are not automatically and easily understood as 'Masuk Malayu', or it happens that the people of archipelago or Malay would consider the language of Malay or 'Bahasa Malayu' as the language of Islam.

8. 'Surau' means Mosque; 'madrasah' means Islamic educational schools, usually taught in Arabic and Malay mediums; whereas 'pondok' system of religious education, students of all ages (both males and females) come to seek knowledge from a religious teacher (guru or ustad) and reside in huts built around the teacher's residence. In this system, like
madrasah, of education one may take many years before one ‘graduates’.


15. For a good review of ethnic composition of South-East Asia and its implications for introduction of Islamic banking and finance in the region see, Farouk, Omar, op.cit., pp. 5-33.


19. Ibid.


21. Ibid.

22. Ibid, p. 3.

23. All the profits generated by the Bank from the use of savings funds belong to the Bank. However, in contrast with current accounts, the Bank may at its absolute discretion reward the customers by returning a portion of the profits generated from the use of savings depositor's funds from time to time. In case when the Bank decided to reward the savings account holders, the amount of profit distributed is calculated based on the following formula:

\[
\text{MP} = \frac{\text{CDB for the month}}{\text{Number of days in the month}} \times R \times \frac{1}{12}
\]

where,

- \(\text{MP}\) = Profit for the month
- \(\text{CDB}\) = Cumulative daily balance in the savings account
- \(R\) = Rate of profit given at the end of month,

with the assumption that profit is distributed on monthly basis. However, no mention is made on how the rate of profit is determined. [Haron, Sudin & Shanmugam, Bala, *Islamic Banking System - Concepts and


29. Ibid, p. 16.

30. Wilson, Rodney, op.it., p. 129.

31. BIMB Holdings Berhad, op.cit., p. 18.

32. *Al-Rahn* means pledge or pawn. It is a contract of pledging a security and becomes binding when possession of the pledge has taken place. In this principle the ownership of the security is not transferred to the pledgee. The transfer occurs only under certain conditions. [Haron, Sudin and Shanmugam, Bala, op.cit., p. 80]. At another place, *al-rahn* refers to an arrangement whereby a valuable asset is placed as collateral for a debt [or financing]. The collateral may be disposed off in

33. **BIMB Holdings Berhad, Annual Report 1999, p. 20.**

34. As at the end of June 1997, before BIMB’s restructuring to be part of the Group i.e., BIMB Holdings Berhad, BIMB’s subsidiaries include Syarikat Takaful Malaysia Berhad in which the Bank holds 70.12 per cent equity, providing general and family insurance (*takaful*) businesses; Syarikat Al-Ijarah Sdn. Bhd., a wholly-owned in-housing leasing company; a wholly-owned Al-Wakalah Nominees (Tempatan) Sdn. Bhd.; a wholly-owned BIMB Unit Trust Management; a wholly-owned BIMB securities (Holdings) Sdn. Bhd., the first stock-broking company operating on the Islamic principle of Shari'ah; and BIMB Institute of Research and Training Sdn. Bhd., providing training and consultancy services particularly those related to Islamic banking and insurance [BIMB, *Annual Report 1997*].


36. **ORGANIZATIONAL STRUCTURE: BIMB HOLDINGS BERHAD.**

- **BANKING**
  - BIMB
  - BIMB Unit Trust Management Bhd.
  - Bank Islam(L) Ltd.
  - BIMB Foreign Currency Clearing Agency.
• TAKAFUL (INSURANCE)
  - Syarikat Takaful Malaysia Bhd.
  - Asean Retakaful International Labuan Ltd.

• CAPITAL MARKET
  - BIMB Nominees (Tempatan) Sdn. Bhd.

• PROPERTY
  - Syarikat Al-Ijarah Sdn. Bhd.

• OTHERS
  - BIMB Institute of Research & Training Sdn. Bhd.
  - Pembiayaan Perumahan Nasional Sdn. Bhd.


41. Ibid, pp. 245-247.

42. Originally the attainment of a minimum target of 5 per cent market share in terms of deposits and financing granted by the SPI banks was deadlined by end-1999. Nevertheless, taking cognizance of the financial crisis and the merger exercise currently being carried out by the domestic banking institutions, BNM has decided to defer the compliance deadline to end-2000. Notwithstanding the deferment, 10 SPI banks, all of which are domestic banks, managed to surpass the 5 per cent target in terms of deposits and financing at end-1999. In terms of financing, three commercial banks, five finance companies and two merchant banks met the target, while seven commercial banks, two finance companies and one merchant bank reached the 5 per cent minimum market share for deposits. It is expected that once the merger exercise has been completed, the SPI banks will channel more resources and efforts towards meeting the 5 per cent target [Bank Negara Malaysia, Annual Report 1999, p. 158].


45. ISLAMIC FINANCIAL LANDSCAPE IN MALAYSIA

- ISLAMIC BANKING SYSTEM
  - Islamic Banks
  - Commercial Banks
  - Merchant Banks
  - Finance Companies
  - Discount Houses
- Association of Interest-free Banking Institutions (AIBIM)

- NON-BANK INTERMEDIARIES
  - Takaful Companies
  - Saving Institutions
  - Development Financial Institutions
  - Housing Credit Institutions
  - National Mortgage Corporation

- ISLAMIC FINANCIAL MARKETS
  - Islamic Money Market
  - Islamic Capital Market

- ISLAMIC INSURANCE (TAKAFUL)
  - Islamic Takaful Operators
  - Asean Takaful Group Retakaful

- OTHER ISLAMIC INSTITUTIONS
  - Pilgrims Management and Fund Board (Tabung Haji)
  - Islamic Cooperatives
  - Islamic Pawnning
  - Islamic Trustees
  - Bait al-Mal


The *Cagamas Mudaraba* Bonds (CGMB) was firstly launched on 1 March 1994 and is claimed to be the first mortgage bonds in the world to be issued on the basis of Islamic principles. The CGMB combines two basic concepts: *bai' al dayn* (debt trading) and *mudarabah* (profit-sharing). The bonds are issued on the basis of mudarabah in which the bond-holders (as provider of fund or *rabb al mal*) and the Cagamas (the issuing company acting as agent) share profits in a predetermined ratio. The proceeds of the bonds are utilized by the Cagamas to purchase what has been described as “Islamic housing debts” on the basis of *bai' al dayn*. Reflow funds are reinvested. The profit is payable in the form of semi annual coupons at a yield to be announced at the coupon payment date. All financial institutions participating in the interest-free banking scheme are now authorized to purchase CGMB. The issue of *Cagamas Mudaraba* Bonds, as Malaysian monetary authorities claim, may be a bold step in the development of Islamic securities, but its Islamic nature, at best, remains doubtful. In connection to this point please see more details in Ahmad, Ausaf, *Towards an Islamic Financial Market: A Study of Islamic Banking and Finance in Malaysia*, Jeddah, IRTIDB, First edition, 1997, pp. 69-72.


58. Ibid, pp. 248-249.


63. Ibid, p. 255.

64. Ibid.

65. Ibid.


70. Ibid, p. 545.

71. Ibid, p. 546.


75. Ibid, p. 184.

76. Ibid.


78. From political perspective, the Islamic banking project served as a vehicle for United Malay National Organisation (UMNO)-led government to stay in power. The UMNO-led government viewed the rise of 'da'wah' (Islamic preaching) phenomenon in the 1970s with some degree of apprehension and found it necessary to deal with this new wave of Islamic 'fundamentalism'. The growing popularity of the Muslim Youth Movement of Malaysia (ABIM) amongst young, educated Muslims within the Malay middle-class and its central message of Islam as a way of life posed a new threat to UMNO's approach of political compromise between the major ethnic groups. Moreover, Islamic resurgence was more in line with the principles of the Islamic opposition party, Parti Islam SeMalaysia (PAS) that was fast gaining support from the Muslim
masses in some states. Open intentions of PAS to form an Islamic state and its criticism of the New Economic Policy (1970-1990) were important issues, which UMNO could not ignore. In response, UMNO concentrated on efforts to protect an Islamic image yet emphasizing its moderate approach to Islam in view of the multi-ethnic and multi-religious society. Its effort to appease its voters within the Malay middle-class included a series of reforms under the Islamisation Programme launched in 1982. The establishment of BIMB was part of these reforms. Skeptics however saw it purely as a political strategy to gain Malay support in the 1982 general elections. Since PAS had move out of the coalition in 1978, the establishment of an Islamic bank, like the setting up of International Islamic University, was meant to take the thunder away from PAS. [Ariff, M. “Islamic Banking: A Southeast Asian Perspective” in Ariff, M. (ed.) *Islamic Banking in Southeast Asia*, op.cit., p. 200; and in Kader, R.A. and Ariff, M., op.cit., p. 264].


83. Ibid, p. 460.

84. Ibid.

85. Ibid. For more detail about Islamic banking system and economic growth and development of Malaysia, see chapter 7 of this thesis.

***