

THE DEVELOPMENT OF ISLAMIC BANKING IN
MALAYSIA

BY

ISLAM TORREK HASANI

INTERNATIONAL ISLAMIC UNIVERSITY
MALAYSIA

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ABSTRACT

This thesis is a Historical/Analytical research on the development of Islamic Banking in Malaysia. It starts by giving an overview of Islamic banking. The concepts underlying Islamic banks, their objectives and the principles on which they operate are among the topics discussed here. It also gives a short history of Islamic financial institutions. The second chapter focuses on the Islamic banking in Malaysia. It considers its political, legal and administrative aspects, as well as its history, and stages of its development. In the last chapter, the discussion focuses on the structure and operation of Islamic banking in Malaysia: it examines the sources of funds and the financing techniques that Islamic banks follow in Malaysia and it compares some aspects of the Malaysian system of Islamic banking with some Islamic banks in other countries. The study concludes by making some criticisms and offering some suggestions for the further development of the Islamic banking system as a whole.

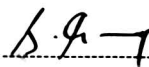
ملخص البحث

هذا البحث عبارة عن منهج تاريخي/تعليمي للنظام المصرفي الإسلامي. يلقي البحث أولاً نظرة عامة على النظام المصرفي الإسلامي حيث يناقش المفاهيم والمبادئ التي يجب أن تعمل المصارف الإسلامية على أساسها، ويتعرض لأهداف هذا النظام بصورة عامة. كما يعطي نبذة تاريخية قصيرة عن المؤسسات المالية الإسلامية منذ عصور الإسلام الأولى. بعد هذه المناقشة العامة يأتي القسم الثاني ليركز على النظام المصرفي الإسلامي في ماليزيا. يبدأ البحث هنا بمناقشة الجوانب السياسية والقانونية والإدارية وتاريخها في الفترة ، وكيف بدأت المبادرة التي دعت إلى تطبيق هذا النظام، ومراحل تطوره. وفي جزء الأخيرة من البحث تتركز المناقشة على بنية وتسيير عمليات النظام المصرفي الإسلامي في ماليزيا. تتم هنا مناقشة مصادر الأموال وكيفية التمويل التي تتبعها المصارف الإسلامية في ماليزيا. وتقوم الدراسة بمقارنة بسيطة في بعض أوجه هذا المجال بين النظام المصرفي في هذا البلد و بين الأنظمة المصرفية الموجودة في بلدان أخرى. و خلاصة البحث تعني بتقديم من نقد للتجربة و بعض المقترحات.

APPROVAL PAGE

(For Master)

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Arts (Islamic Civilization)



Sabri Orman
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Arts (Islamic Civilization)



Ugi Suharto
Examiner

This thesis was submitted to the Kulliyah of ISTAC and is accepted as partial fulfilment of the requirements for the degree of Master of Arts (Islamic Civilization)



Malik Badri
Dean, Kulliyah of ISTAC

DECLARATION

I hereby declare that this thesis is the result of my own investigation, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Name..... ISLAM EKREM HASAUI

Signature..... 

Date..... 24/2/2004

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To: my beloved parents,
wife and daughter.

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TABLE OF CONTENTS

ABSTRACT.....	ii
APPROVAL PAGE.....	iv
DECLARATION PAGE.....	v
COPYRIGHT PAGE.....	vi
DEDICATION PAGE.....	vii
ACKNOWLEDGMENTS.....	viii
CHAPTER 1: INTRODUCTION	1
CHAPTER 2: AN OVER VIEW OF ISLAMIC BANKING.....	4
I. Introduction	4
II. Concept of Islamic banking.....	5
A. Principles of Islamic banking.....	6
B. Objectives of Islamic banking.....	10
III. Characteristics of Islamic banking.....	13
IV. The need for Islamic banking	18
V. Classification of Islamic banks.....	20
A. specialized Islamic banks.....	21
B. Islamic commercial banks.....	22
VI. Social scope of Islamic banks	22

VII. The rise of Islamic banking	
A. Financial institutions in the early days of Islam.....	25
B. Islamic banking in modern times.....	29
VII. Concluding remarks.....	32
CHAPTER 3: HISTORY OF ISLAMIC BANKING IN MALAYSIA.....	34
I. Introduction.....	34
II. Initial Establishment of Interest-free Financial Institutions.....	35
A. Establishment of Tabung Haji 1969.....	37
B. Establishment of Bank Islam	38
C. Establishment of Bank Muamalat.....	41
III. Development and Maturation: 1991-2003.....	42
A. 1991-1996 period.....	43
B. 1997-2003 period.....	49
IV Political, Legal and Administrative aspects.....	51
A. Political Aspect.....	51
B. Legal Aspect.....	58
C. Administrative Aspect.....	60
V. Cooperation of Islamic Banks with other banks in Malaysia	62
VI. IDB Branch in Malaysia.....	65
VII. Concluding Remarks.....	67

CHAPTER 4: STRUCTURE AND OPERATION OF ISLAMIC BANKING IN MALAYSIA.....	69
I. Introduction.....	69
II. A General Look at the Malaysian Financial System	70
III. Structure: legal status, organization and composition.....	74
IV. Sources of funds used in Islamic banking in Malaysia.....	76
A. Current Accounts.....	77
B. Saving Accounts.....	78
C. General Investment Accounts.....	79
D. Special Investment Accounts.....	80
V. Financial techniques of Islamic banking in Malaysia.....	81
A. The Equity Financing.....	83
B. Term Financing.....	84
C. Trade Financing.....	86
D. Investment.....	89
VI. Types of Islamic banking in Malaysia.....	89
A. Islamic Banking System.....	90
B. Non-Bank Islamic Financial Intermediaries.....	94
C. Islamic Financial Markets.....	97
VII. Critical analyses of the instruments used in Islamic banking in Malaysia.....	98
VIII. Some suggestions for the further development of Islamic Banking.....	102
IX. Concluding Remarks.....	104

CONCLUSION.....	107
BIBLIOGRAPHY.....	110
APPENDIX.....	117

CHAPTER ONE

INTRODUCTION

This study is concerned with an important topic, namely, **The Development of Islamic Banking in Malaysia**. It is important because one of the challenges that the Muslim *Ummah* faces today is the need to establish interest-free financial institutions. An efficient and strong banking system is crucial for meeting the needs of modern and developing Muslim countries. At the same time, this banking system must be based on Islamic principles, and hence the keen desire among many to develop interest-free financial institutions. The Malaysian example is particularly important and worthy of attention. Not only does Malaysia have the oldest still functioning Islamic financial institution (Tabung Haji), but its Islamic financial system is widely regarded as the most successful one in operation.

There is a considerable amount of literature available both on Islamic banking in general and on Islamic banking in Malaysia. In general, the literature—in the form of monographs, journal articles, and conference papers—highlights the novelty of Islamic banking, and examines the particular challenges faced by Islamic banking such as the prohibition of interest and competition with conventional banks. The literature on Malaysia, which also includes materials published by Malaysian banks, discusses both the historical development of Islamic banking in Malaysia, and the modes of investment. While the general tone of the literature is one which praises

achievements, there are some critical writings too on issues that are discussed in this Thesis.

The Thesis examines the development of Islamic Banking in Malaysia from the period of its gestation, 1963, up to 2003. The author reviewed both primary and secondary sources, and interviewed relevant persons. The study focuses on the historical development and the operation of Islamic banking in Malaysia.

This work is divided into four chapters. Following this Introduction, the second chapter is entitled 'An overview of Islamic banking'. Matters discussed in this chapter are related to the Islamic banking in general. The discussion covers the key concepts and principles on which Islamic banks must operate. Questions addressed include: what are the characteristics of Islamic banks that distinguish them from the conventional ones; who oversees Islamic banks to make sure that the business they do is *halāl*; do they have in their program of operation a social element or are they only concerned to expand their business. After answering these questions there will be a brief history of Islamic financial institutions starting from the time of the Holy Prophet (S.A.W.S.) to the present time.

The third chapter is on the 'History of Islamic banking in Malaysia'. As the title indicates, the discussion here is focused on Islamic banking in Malaysia, its characteristics and stages of development. The period covered in the discussion is from 1962-3 when the first Islamic financial institution, Tabung Haji, was formed. Tabung Haji is also the oldest institution of this kind still functioning in the world,

up to 2003. This chapter includes some historical data to explain the context of the establishment of Interest-free financial institutions. The chapter then discusses the support and the help of the Malaysian government for Islamic institutions in general and for Islamic financial institutions in particular. Here, it is argued that there were certain domestic political considerations that probably influenced the government to support the development of Islamic financial institutions.

The fourth chapter, 'Structure and operation of Islamic banking in Malaysia', starts with a brief history of the economic and financial system of Malaysia since independence, and continues by addressing the following questions: How Islamic banks are structured and operate in Malaysia; what are the sources of funds; financial techniques; types of Islamic banking and some critical analyses for financing facilities used in Islamic banking in Malaysia. The chapter is concluded with some suggestions for future development of Islamic banking.

CHAPTER TWO

AN OVER VIEW OF ISLAMIC BANKING

I. Introduction

The Religion of Islam regulates all aspects of human life including the conduct of business and commerce. Many verses in the Holy Qur'an encourage trade and commerce, and the attitude of Islam is that there should be honest and legitimate trade and business. People earn their living and support their families in accordance with the requirements of their religion to be fair, honest and just towards others.

Every system should fit into the philosophy of life of the people in order to succeed. The Qur'an and *Sunnah* did not provide an economic model as we understand it in our present days, but these two main sources of the Islamic *Shari'ah* contain principles and rules that allow '*ulama'*' (Muslim scholars) *fuqahā'* (experts in Islamic jurisprudence) and the economists to deduce and devise such models.

Islam attaches great importance to the dignity of each individual human being. It stands for the establishment of a just socio-economic order in which the basic needs of all human beings are met. The Islamic banking system which is part of this order is very helpful instrument in achieving economic justice, and in bringing benefit to the social and environmental spheres.

This chapter is organized as follows. Section II provides information about the concept of Islamic banking by discussing its basic principles and objectives. Section III discusses some of the most important characteristics of Islamic banking. Section IV discusses the need for Islamic banking by answering the question whether we need to have an Islamic banking when conventional is available and highly sophisticated. Section V discusses the classification of Islamic banking. Section VI discusses the social scope of Islamic banking: how an Islamic system deals with social problems, and whether it is for making money at any cost or should it operate for the benefit of the community as a whole. Section VII discusses the rise of Islamic banking in different countries, both Muslim as well as non-Muslim ones. And finally some concluding remarks.

II. The concept of Islamic Banking

Islamic banking is part of the broader concept of Islamic Economics, the aim of which is to introduce the value system and the ethics of Islamic philosophy of life into the economic sphere. Islamic concepts revolve around the belief that the whole universe is controlled by One, and that the real owner of everything is Almighty Allah (S.W.T). Man is appointed by Allah as His *Khalifah* (vice-regent) on earth to fulfill certain objectives through obeying His commands. These commands are not restricted to some modes of worship or religious rituals only.¹ They cover all aspects of human life. Part of these commands is that he (man) should utilize resources given

¹ Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Kluwer Law International, The Hague: 2002, p. xiii.

to him as a gift in a just manner in order to fulfill Allah's will for establishing prosperity on earth for the good of all human beings.²

A. Principles of Islamic banking

Islamic banks have to operate under strict religious guidelines, which are different principles than those of conventional banks. The main principles of Islamic banking are as follows:

1. Prohibition of *Ribā* (interest) in all forms of transactions.
2. Undertaking business and trade activities on the basis of fair and legitimate (*halāl*) profits, with a special Shari'ah board to supervise and advise the bank on the property of transactions.
3. Payment of *Zakāt* from their operations.
4. Cooperation in the development of the society.³
5. Avoidance of *Gharar* (uncertainty) and *Maysir* (Gambling).⁴

1. Prohibition of *Ribā* (Interest)

The term *ribā* refers to the addition in the amount of the principal of a loan according to the time for which it is loaned. Earlier there was a debate as to whether

² Saad Abdul Sattar Al-Harran, *Islamic Finance: Partnership Financing*, Pelanduk Publications, Kuala Lumpur, 1993, p. 56.

³ Sudin Haron, *Islamic Banking: Rules & Regulations*, Pelanduk Publications, Kuala Lumpur, 1997, p. 7. Also see, Omar A. Ali, *Accounting Issues in Islamic Banking*, The Institute of Islamic Banking and Insurance, London, 1994, p. iii.

⁴ Mervyn K. Lewis and Latifa M. Algoud, *Islamic Banking*, Edward Elgar, Cheltenham, 2001, p. 34.

ribā refers to interest or usury. The original meaning of usury and the present meaning of interest are practically identical. The term usury comes from the Latin word *usura* meaning enjoyment, interest or money paid for the use of money, and this term was used to describe interest generally.⁵ In all major religions i.e. Judaism, Christianity, Buddhism or Hinduism and ethical systems, interest was originally prohibited but later they deviated. From this norm, for example Jewish people do not charge interest when they do business within themselves, but when they do business with others (non-Jews) they charge interest because it is permitted for them according to their laws.⁶ The prohibition of *ribā* is the most important principle of Islamic banking and also the most controversial issue between Islamic and conventional banking. The prohibition of *ribā* is mentioned in four different *Sūrah*s (chapters) of the Holy Qur'an⁷, and explained by the Prophet (S.A.W.S). Paying or receiving *ribā* as occurs in the conventional banking system is strictly prohibited in the Islamic system, but it has to be replaced by other means which are permitted in Islam. There is a complete unanimity among all schools of thought in Islam that the term *ribā* stands for interest in all types and forms.⁸ And "it matters not whether interest is small or large, 1% or 25%, it would still be considered *ribā* and would still be prohibited".⁹ Islam prohibits it because it is against the spirit of justice; the

⁵ Ibid, 2.

⁶ Sabir Tu'yamah, *Al-Asfar Al-Muqadasati Qabla Al-Islam*, First edition, Dār Ālam Al-Kutub, Beirut, 1985, p. 18

⁷ Qur'an: Ar-Rum 30:39, An-Nisaa 4:161, Ali-Imran 3:130, Al-Baqarah 2:275-281. the first of these, which is part of Surah Ar-Rum, was revealed in Makkah, and is not of prohibitive nature, it says that the *riba* does not increase with Allah, meaning it carries no reward in the here after. According to the famous *mufassir* of the Holy Qur'an Ibn Jarir Al-Tabari, the word *riba* in this verse mean gift offered by someone to a person with the intention that he later will receive a greater gift. For more details see: Justice Muhammad Taqi Usmani, *The Text of the Historic Judgment on Riba (Interest) Given by Supreme Court Of Pakistan 23rd December 1999*, The Other Press, Kuala Lumpur, 2001, pp. 6-7.

⁸ Lewis & Algoud, p. 37.

⁹ Imran N. Hosein, *The Prohibition of Riba in the Qur'an & Sunnah*, Ummavision, Kuala Lumpur, 1997, p. 32.

entrepreneur may earn a large amount of profit with the help of other people's money and he pays a small amount in return for its use. Or it is possible that he may experience a loss and he has to pay the principal as well as a fixed amount of interest.¹⁰

2. *Halāl* (permitted or legal) activities

Islamic banks must undertake business and trade activities only on the *halāl* basis. In order to ensure that the practices and activities of Islamic banks do not contradict the ethics of Islam, they are expected to establish a Religious Supervisory Board. Theoretically, this board consists of Muslim jurists who act as independent *Shari'ah* auditors and advisers to the banks. The main objective of this board is to ensure that, firstly, the banking products and services offered to customers are in accordance with *Shari'ah*; secondly, the investments of the projects in which the bank is engaged is permissible by *Shari'ah*; and finally the bank itself is managed in accordance with Islamic principles.¹¹ Furthermore, contracts issued by this supervisory body will have positive effect in assuring costumers who are dealing with such contracts that actual operations are efficient as well as in accordance with *Shari'ah* law.

3. Payment of *Zakāt*

¹⁰M. Ramzan Akhtar, "Modelling the Economic Growth of an Islamic Economy" *The American Journal of Islamic Social Sciences* Vol. 10, No. 4, 1993. pp. 500-501.

¹¹Haron, 1997, p. 103

Islamic banks have to pay *zakāt* from their operations, and they also have to establish a *zakāt* fund for collecting *zakāt* and also for distributing funds that have been collected. The Religion of Islam guides and regulates the relationship of mankind with God and with society, it also regulates and organizes mankind in both spiritual and material life. *Zakāt* is an instrument of equitable distribution that purifies wealth from selfish greed and brings about social harmony.¹² It is an important instrument in the redistribution of the wealth. It is compulsory and it constitutes the one of the five basics of Islam. The amount of *zakāt* is 2.5 per cent assessment on assets held for one full year, the purpose of which is to transfer wealth from wealthy to the needy.¹³

4. Cooperation in the Development.

Based on Islamic teachings, cooperation in development of the environment and the infrastructure which serves to the benefit of the society is very important. Development has a dynamic content which means it has to continue all the way so mankind will achieve more control over available resources. Development is also one of the principles of Islamic banking. However, cooperation in development has to be in accordance with the teachings of Islam.¹⁴

5. Avoidance of *Gharar* and *Maysir*.

¹² Masudul Alam Choudhury and M. Kabir Hassan, "The Role of Zakah in an Interactive Model of Non-Wage Labour Force Activity", *Review of Islamic Economics*, No. 10, 2001, p. 41.

¹³ Lewis & Algoud, p. 30.

¹⁴ Hatem El-Karanshawy, "Financing Economic Development from an Islamic Perspective", Seminar Proceedings Series *Financing Development in Islam*, ed. M.A. Mannan. (Jeddah: IDB, 1996), pp. 38-39

The term *gharar* literally means 'hazard' it refers to speculation or unreasonable uncertainty. In business terms, *gharar* means uncertainty, and the undertake adventure blindly without sufficient knowledge of one or both parties of the subject or attributes of the objects of sale, and also uncertainty regarding its availability and existence.¹⁵ The unanimous view of the jurists is that in any transaction that the essential pillars of the contract are not very clear or neglected to be defined relating to the consideration measure of the object, the parties undertake a risk which is not necessary for them. Speculative transactions with these characteristics are prohibited, although when there is some necessity minor uncertainties are allowed.¹⁶

The word *Maysir* is used in the Holy Qur'an for the games of hazard. The term is now applied generally to all gambling activities which are prohibited by the Holy Qur'an (5:90-91) in all its forms. Gambling is prohibited in Islam and along with it Islamic law prohibits any business activity which contains any element of gambling.¹⁷

B. The objectives of Islamic banking

Although Islamic banks differ from conventional banks on the principles in which they operate, the main objective of both is to provide a good return to the

¹⁵ Mohammad Hashim Kamali, *Islamic Commercial Law: An Analyses of Futures and Options*, Ilmiah Publishers, Kuala Lumpur, 2002, pp. 84-85.

¹⁶ *Ibid.* 31.

¹⁷ *Ibid.*