ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

# TOWARDS AN ISLAMIC FINANCIAL MARKET

*Research paper*
*No. 45*

# ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

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ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

# TOWARDS AN ISLAMIC FINANCIAL MARKET

## A STUDY OF ISLAMIC BANKING AND FINANCE IN MALAYSIA

**AUSAF AHMAD**
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**FOREWORD**

The Islamic Research and Training Institute (IRTI) of the Islamic Development Bank has been established " to undertake research for enabling the economic financial and banking activities in Muslim countries to conform to *Shari'ah".* This is in implementation of the Article (2) of the Articles of the Agreement establishing the Bank, which has been ratified by 51 Islamic countries. In order to discharge the responsibilities assigned to it, IRTI pays special attention to basic and applied research in the areas of Islamic economics, banking and finance.

During the last two decades, Islamic banking has emerged as a viable and feasible alternative to traditional commercial banking which is mostly based on the concept of *Riba* , the rate of interest, which is strictly forbidden in Islam. Important developments have taken place both in the theory and practice of Islamic banking during this period. More than one hundred financial institutions are working around the globe, putting the principles of Islamic banking and finance into practice. The size of Islamic banking market is estimated to have reached U. S. $ 100.00 billion and the industry is poised for further growth and expansion. Islamic banking is no more regarded as wishful thinking of Muslim economists. It is no more a utopia. It is a dynamic reality of our time which has immense potential of transforming the contemporary Muslim societies into dynamic and vibrant economies.

Impressed by the success of various Islamic financial institutions and feasibility of Islamic banking, many Muslim countries have now embarked upon introducing Islamic banking into their economies at the macro level. Early attempts to do so in Pakistan, Sudan and Iran are now well known. Malaysia is the latest addition into this list, where only one Islamic bank was in existence during the eighties. However, important steps of far reaching implications have been taken during the early nineties to introduce Islamic banking on an economy- wide scale. Among the Islamic countries, Malaysia is one of the few countries that already have a well developed financial structure. Introduction of Islamic banking in such a well developed financial market provides both a challenge and an opportunity to Islamic banking. Hence, the Malaysian experiment deserves attention and analysis.

Present monograph on "Towards an Islamic Financial Market: A study of Islamic Banking and Finance in Malaysia" is a modest effort in that direction. It studies the efforts to introduce the concepts Islamic banking and finance in Malaysia with in overall framework of an Islamic financial market. It is hoped that publication of this monograph will lead to many similar research efforts so that future developments in the area of Islamic banking and finance become a good blend of theory and practice.

**MABID ALI AL JARHI**
**Director, IRTI**

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**AUSAF AHMAD**

**NOTE**

In this study expressions Malaysian dollar (M$) and Malaysian Ringgit (RM.) have been used interchangeably for the Malaysian currency, as both are used in Malaysia.

# I. INTRODUCTION

After successful development of Islamic banking and working of Islamic banks for about two decades in various parts of the world, the attention of theoreticians as well as practitioners of Islamic banking and finance is now focused on the issues of establishment of an Islamic financial market[1]. In terms of historical evolution, particularly on the theoretical side, the attention was motivated by a desire to develop Islamic financial instruments and a secondary market for these instruments. Malaysia is one of the few countries where some of these ideas have been put into practice and a systematic effort has been made to evolve an

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A sizable amount of literature, both on the theoretical and applied aspects of Islamic banking has been accumulated during the last twenty years. For theoretical models of Islamic banking see, M. N. Siddiqi, *Banking Without Interest*, Leicester: The Islamic Foundation, 1983 and *Issues in Islamic Banking,* Leicester: The Islamic Foundation, 1983, M. Uzair, *Interest Free Banking.* Karachi: Royal Book Company, 1978; M.U. Chapra, " Money and Banking in an Islamic Economy" in M. Ariff (ed.) *Monetary and Fiscal Economics of Islam*, Jeddah: King Abdul Aziz University, 1982, Mohsin S. Khan, Islamic Interest Free Banking: A Theoretical Analysis" in *Encyclopedia of Islamic Banking and Insurance,* London: Institute of Islamic Banking and Insurance, 1995. Several studies dealing with the experiences of Islamic banking in different countries are now available. A good account of Islamic banking in Pakistan and Iran particularly in the early period is available in Zubair Iqbal and Abbas Mirakhor, *Islamic Banking*, IMF occasional paper No. 49, Washington D.C.: International Monetary Fund, 1987. There are some studies dealing specifically with Pakistan, for instance, *Elimination of Riba from the Economy,* Islamabad: Institute of Policy Studies, 1994 and Nawazish Ali Zaidi, *Eliminating Interest from Banks in Pakistan*, Karachi: The Royal Book Company, 1988. Not many studies are available in English language on experience of Islamic banking in Sudan. However, one may be referred to T. E. Ahmad, *Islamic Banking Mechanism and Implications for Financing and Financial Control: The Case of Islamization in Sudan,* University of Gazera, Sudan, 1988 and Osman Babikir Ahmad, *The Contribution Islamic Banking to Economic Development: The Case of Sudan*, Unpublished Ph.D. dissertation, University of Durham, 1990. On experience of individual Islamic banks see, Ausaf Ahmad, *Development and Problems of Islamic Banks*, Jeddah: Islamic Research and Training Institute, 1987.

integrated approach to Islamic banking and finance[2]. Whether these *efforts* could be regarded as Islamization of financial and capital markets or not is a moot point as the term Islamization itself may mean different thing to different people. Hence, let it be clear at the very outset that, in this study, wherever the expression Islamization has occurred, it has been used in a rather narrow and specific sense i.e. introduction of Islamic modes, techniques and concepts in the banking and financial sectors of the economy. In the sense used in this study, the term does not contain any political connotation. Thus, the purpose of this study is two fold: First, to examine the issues that might be involved in introducing Islamic modes into financial sectors and in evolving an Islamic financial and capital market and secondly to study the efforts that have been made in this direction in Malaysia.

The paper has been divided into five sections. The remainder of this section takes a bird's eye view of nature of financial markets. Section II surveys various issues involved in the evolution of Islamic financial and capital markets and some of the suggestions that have been advanced from time to time to make contemporary financial markets to conform to Islamic injunctions. This section also presents a discussion of various Islamic financial instruments, which have been proposed by Islamic economists and Islamic bankers in order to evolve an Islamic financial market. The focus of last two sections is Malaysia, which has been the scene of one of the boldest experiment of Islamic banking and finance. Hence, Section III traces the development of Islamic banking in Malaysia. It has been included here because Malaysia is probably the first country in the world where efforts have been undertaken to establish an inter bank Islamic money market. Since money market is an integral part of the over all financial system, it would be useful to see how Islamic money market fits in the emerging financial system. Finally, Section IV is devoted to the study of evolution of Islamic financial and capital market in Malaysia. The

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2 For a review of early efforts of Islamic banking in Malaysia see, Zakariya Man, "Islamic Banking: The Malaysian Experience" in Mohammad Ariff (ed.) *Islamic Banking in Southeast Asia,* Singapore: Institute of Southeast Asian Studies, 1988.

last section evaluates this experience and presents the conclusion of the study.

## 1.1 COMPONENTS OF A FINANCIAL MARKET

Financial markets through out the world have been undergoing significant changes in the post war period. The capital markets have become deeper and broader. The significance of banking finance has been declining over time. The long-term trend of this change appears to be even more dramatic. The relative share of commercial banks in the financial market of the United States in the year 1900 was 55.2 percent, which declined to 26.8 percent in 1990. In contrast to this, the share of non banking financial institutions, such as thrift institutions, insurance companies, pension and trust funds, investment companies, mutual funds, and finance companies, has grown from 45 percent in 1900 to 73.2 percent in 1990. The pace of change seems to have been accelerated during the post War period. Even in 1960, the US commercial banks held more than one third of total assets of financial intermediaries but in 1990 this figure was no more than one fourth of total assets.[3] This shows the tremendous growth of financial markets in the contemporary American economy. Similar changes could be noticed elsewhere.

Since growth and development of Islamic banking and Islamic financial markets can not take place in detachment of global developments, let us take a close look at the nature of modern financial markets before we could go into issue how Islamic financial markets could be evolved.

The terms financial market and capital market are very often used interchangeably although it is useful to make a distinction between them. In fact, financial market is a much wider term, which covers both money market and capital market. While the former deals with the demand and

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[3] *Changing Capital Markets: Implications for Monetary Policy :* Proceedings of a Symposium sponsored by the Federal Reserve Bank of the Kansas City, Kansas City: Federal Reserve Bank, 1993 p.8.

supply of money in the short run, the latter is concerned with the demand and supply of funds of longer maturity. However, notwithstanding this, in day to day life as well as in technical usage, more often than not, both terms are used as synonyms.

## 1.2 DEFINITION OF A CAPITAL MARKET

Customarily a capital market is defined as a market in which governments, banks, international organizations and business companies borrow and invest large amounts of money from medium to long periods. This may be argued as a restrictive definition as it makes borrowing an essential attribute of a capital market. Borrowing is a particular form of raising financial resources. Other forms of resource mobilization are also possible. Making borrowing an essential attribute of capital markets is losing some of its generality. Hence, a capital market may be defined as a market in which savers and investors deal in medium and long term funds. On what terms they deal with each other is not and should not be a part of the definition.

## 1.3 FEATURES OF A CAPITAL MARKET

Distinguishing features of a modern capital market may be described as follows:

### 1.3.1 **Negotiability of Instruments**

The capital markets function with the help of some instruments through which financial resources are mobilized and invested. Technically these are referred to as financial instruments. These instruments must be negotiable. The negotiability means that these instruments can be bought and sold and ownership of instruments can be transferred from one person to another through the act of buying and selling.[4] In certain cases, the transfer of rights may also take place through endorsement.

[4] On the nature of negotiable instruments and commercial papers see: Richard Felix, *Commercial paper* (1987), Jerome Lacey, *Financial Instruments Markets (* 1986), Fred H. Miller and Alvin C. Harrel, *Law of Modern Payment Systems and Notes (1985).*

The examples of negotiable instruments are checks, bank drafts, and traveler's checks, money orders, certificates of deposits, promissory notes etc. that contain an order or a promise to pay a certain amount of money. This may be payable either on demand or on a definite future date. It may be payable to the order of a named person or payee or to the bearer. The negotiable instruments include promissory notes such as bonds and mortgage notes. Municipal bonds, corporate bonds, government bonds, etc. are other examples of negotiable instruments.

### 1.3.2 Dealings in Financial Instruments

The capital markets deal in financial instruments. Not all negotiable instruments are not financial instruments, although all financial instruments are necessarily negotiable. Financial instruments, which are in vogue in the contemporary world, may be divided into three categories: debt based instruments, equity and hybrid instruments. The debt-based instruments have a definite life. The amount stated on the instrument is a debt from the investor to the issuer for a specified period. These instruments yield a definite and fixed income i.e. interests. Bonds are the best example of debt based instruments. Since interest is forbidden in Islam and debt is not considered a legally valid form of investment which may yield return, the debt based financial instrument shall have no application in the area of Islamic finance unless interest free financial instruments are evolved.

Equity is an instrument of ownership. It represents a share in the ownership of the enterprise or the company as evidenced by a share certificate. The share certificate can be either in the registered or bearer form. While bonds have a definite maturity, equity is perpetual, as there is no maturity date. There is no fixed claim on the earnings of the company as it does not yield a fixed income but gets a share of profit called dividend. The equity holders ( with the exception of non voting share holders) also have a right to participate in running the company through nomination in the board of directors but bondholders have no such right.

The hybrid instruments combine different features of debt based and equity-based instruments. Common bonds have two main types: fixed rate and variable rate bonds. In case of fixed rate bonds, rate of interest is fixed at the start of life of the instrument and is paid at specified intervals unto maturity when the principal along with any unpaid amount of interest is returned. In variable rate bonds, interest rate is re-fixed during the life of the bond either at a specified date or at regular intervals in accordance with a pre agreed formula. Convertible bonds and bonds with equity warrants are hybrid between the bonds and equities. In case of convertible bonds, the bond holders can exchange the fixed rate bonds for shares of the issuing company at a specific price, called conversion price, in accordance with the terms of the bonds. The conversion premium is usually above the market price of the ordinary share at the time of the issue and naturally varies from market to market. Bonds with equity warrants, as the name suggests, have a warrant attached to them. A warrant is an option that allows its holder to buy a set number of shares at a predetermined price for a definite period of time. In most of hybrid instruments, the issuer pays a comparatively low interest rate to lender in order to give him the option to own shares.

During the past twenty to thirty years the capital markets, particularly in the advanced industrial countries, have been completely transformed. Firstly, the globalization of international economy and emergence of Eurodollars has integrated the capital markets that were once separate from each other. Secondly, the communication revolution and application of computer technology has produced new range of financial products that could attract financial resources as new investment from far away places. The advent of international networking of computers through satellites such as Internet has further accelerated this process. Thirdly, the computer technology and fast communication have reduced per unit cost of transaction to a very low level. This has facilitated the movement of large sums of money with an unprecedented speed. Fourthly, entirely new financial products have appeared on the scene. While stocks, corporate bonds, municipal bonds, treasury bills, bank certificates of deposits, commodities, currencies and real estates were traditional candidates for inviting investment, a number of new derivatives have now appeared on the market. Some of these derivatives are: Interest rate swaps, Interest rate options, currency futures and options, stock-index futures and options, collateralized mortgage obligations, commodity futures and options, forward commodity contracts, equity-link bank deposits, synthetic securities and Eurodollar futures etc.,

### 1.3.3 Non Bank Funding

Another feature of modern capital markets is that capital is raised by the companies by issuing the instruments that are sold directly to the investors. Thus, any function of financial inter-mediation is not involved. The main players on the capital market are issuers of financial instruments and institutional investors. In both the categories, non-banking institutions dominate the scene. Amongst the investors, in most of advanced countries, non banking financial institutions such as thrift associations, pension funds, mutual funds, investment companies, insurance companies etc. have far surpassed the commercial banks in their investment in the capital markets. In fact, their investments have increased so much that traditional distinctions between commercial banks and non-banking financial institutions have become blurred.

### 1.3.4 Long Term Maturities

Maturity means the period after which the amount raised in the market will be returned to the investor. The capital markets are distinguished from the money markets mainly on the basis that former deal with the funds which have long term maturity. Usually the term of funds raised in the capital markets is of duration more than two year. In contrast to capital markets, the money markets deal with the claims that have shorter maturity.

## 1.4 INGREDIENTS OF A CAPITAL MARKET

A capital market has essentially three constituent elements: the . issuer, intermediaries and investors. All three participate in the market process of a capital market. The issuer issues a financial instrument through which it wishes to raise financial resources. Multinational corporations, central governments, governmental agencies, business companies and banks issue these days financial instruments. Before an issuer can issue a financial instrument, it has to take a number of decisions, for example, for what purpose the funds are being raised? For how long the funds will be needed? In which currency the funds are required? In which market the required funds are available? What will be the cost of raising the funds? What are tax and regulatory implications etc. A financial instrument, to be issued by the issuer, shall be tailor made depending upon the answers to these questions.

The other constituents of the capital markets are intermediaries such as stockbrokers, security houses, international banks, merchant banks and investment banks. The functions of intermediaries in the capital markets are to match funds needs of the issuer with the investment needs of the investors through launching of new issues in the market taking a fee for the service provided, and to provide dealing and distribution services along with the investment advice in already established issues.

The last component of a capital market is the investor who can be either individual or institutional. Among the institutional investors central banks, commercial banks, pension funds, life insurance companies, unit trusts, mutual funds, and investment companies are of prime importance. The investor wants to minimize the risk and maximize the return. In the US, treasury bills are considered least risky and liquid investment. However, even these investments involve country risk for the international investors and interest rate risk for the domestic investors. In fact, all interest bearing financial instruments involve interest rate risk, which may change abruptly, either because of changes in the market situation or at the discretion of the monetary authority. The theory of portfolio management suggests two golden principles for investors: If two securities are of equal risk, the investor will chose the security that offers greater return and if two securities provide equal return, the investor will chose the security with the minimum risk. Thus, investors and portfolio managers (who manage the portfolio on behalf of the investor) look for the source of risk and attempt to minimize it along with an effort to balance return with the risk.

## II. ISLAMIC PERSPECTIVE ON FINANCIAL MARKET

Islamization of financial and capital markets in the Muslim countries is called for on various grounds. Firstly, most of the financial instruments used in contemporary financial markets are based on interest, which is clearly prohibited in Islam. Hence, development of financial instruments whose provisions, terms and conditions do not violate Islamic *Shari 'ah*, is the first and foremost requirement towards the evolution of Islamic capital markets. Secondly, most of the practices of stock markets and capital markets, in handling financial instruments may also be repugnant to both Islamic law as well as Islamic norms of morality. There is a need to review the present practices prevailing in the financial market to identify which of these practices needed to be reformed from an Islamic point of view and which of them may be acceptable. Thirdly, institutions, which may be conducive to functioning of Islamic financial markets, need to be established.

It may be pointed out that Islam is not averse to the idea of financial inter-mediation. It is a fact, that whatever be the form of economic organization, a society, may have surplus and deficit households in terms of possession of financial resources. Hence, efficient use of financial resources of the society would necessitate some form of cooperation between the surplus and deficit units. The Islamic contract of *Mudaraba* offers avenues of such cooperation in an Islamic society.' The
owner of resources (Rabb *al Mal)* is the unit with the surplus finance and the working partner *(Amil* or *Mudarib)* is the deficit unit. Under the contract of *Mudaraba,* the resources owned by the surplus unit are given to the deficit unit on the condition that profits generated from the specified

5 *Mudaraba* had offered a mechanism of financial inter-mediation in early Islamic and Arab societies. It is reported from authentic sources that *Mudaraba* (or *Muqaradah)* was prevalent in Medina at the time of the Prophet Mohammad (peace is upon him) and he did not disapprove of it. There are reports that *Mudaraba* was widely practiced in Makkah also and on some occasions, the Prophet himself obtained funds on basis of *Mudaraba* to conduct his trade activity. Mohammad Ali El Gari, " Towards an Islamic Stock Market" *Islamic Economic Studies, vol., No.,* Dec. 1993 p.1.

activity shall be shared between the contracting partners in pre agreed proportion. Investment accounts in Islamic banks are opened and operated using this principle. It is possible to devise other financial contracts by making innovative application of the same general principle[6].

It has already been mentioned that financial instruments used in the capital markets are negotiable. A financial instrument represents a share in a financial asset or a set of assets claim. As such, it is a title of ownership of an asset and reflects merely a claim and by itself does not constitute tangible wealth or asset. Hence, the question arises whether negotiability of such instruments is permitted by the Islamic *Shari 'ah?* The experts of Islamic jurisprudence are of the opinion that Islamic *Shari 'ah* does not disapprove of the disposition of financial claims. Hence, Islamic financial instruments could be negotiated in the financial market subject to certain conditions.[7]

With respect to trading in the stock market, this should be clear that no investment is to be made in the shares of those companies whose production, distribution and consumption has been prohibited by Islam[8].

Secondly, the trading and consequent contracts have to be in accordance

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6 There are other Islamic contract which are also amenable for application in the financial sectors such as *Musharaka* (Profit and loss sharing), *Murabaha* (Mark up sale), *Ijarah* (leasing) and *Istisna* (manufacturing contract) etc. Present day Islamic banks are making use of all these contracts in their financial operations. For a review of practices adopted by Islamic banks in this regard, see Ausaf Ahmad, *Contemporary Practices of Islamic Financing Techniques,* Jeddah: Islamic Research and Training Institute, 1993. Many experts of Islamic banking and finance have suggested that financial instruments could be devised on the basis of these contracts.

7 For details on Islamic view of negotiability of financial instruments see, Hussein Hamed Hassan, "Financial Inter-mediation in the Framework of *Shari 'ah"* Islamic Economic Studies, Vol. 1 No. 1 December 1993 pp. 21 -36.

8 For instance a leading holding company of Islamic banks, Al Barakah declares in its prospectus that the company abstains from dealing with gambling, alcohol, and pork. See Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law,* London: Graham & Trotman, 1995.

with the requirements of a valid Islamic contract. In Islamic jurisprudence, a contract is valid and deserves legal protection if it fulfills five conditions. i.e. it must. have a seller, a buyer, and a specified commodity, a known price and pronouncement of contract. The contract must not involve conspicuous ambiguity *(Gharar)* with respect to nature of commodity, time and place of delivery and distribution of benefits among the buyers and sellers.[9]

It has been observed in many thriving stock markets all over the world that greater bulk of transactions in these markets do not serve any useful social or economic function but are merely a cover for a series of speculative activities that closely resemble to gambling. In view of Islamic prohibition of gambling, there are serious doubts amongst the Muslim masses about the permissibility of any activity on the stock markets. They suspect that speculative profits are not *Halal* income. Although, it is difficult to determine whether real intention of an individual investor is to make a genuine investment or he is motivated only by a desire to make speculative profits, it shall be necessary to protect the Islamic stock market from speculative and gambling tendencies. It has been suggested in a recent study that several steps may be stipulated to check speculative tendencies in the stock market. Some of these might include:

a) imposition of a higher tax rate on the capital gains realized in relatively short periods,
b) restrictions on non banking financial institutions such as investment funds, insurance companies and pension funds to keep their financial investment on the stock market within reasonable limits, and

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[9] Hussien Hamed Hassan, "The Jurisprudence of Financial Transactions" in Ausaf Ahmad and Kazim Raza Awan, *Lectures on Islamic Economics*, Jeddah : Islamic Research and Training Institute, 1992, pp. 105 - 114.

c) restrictions on price changes that may prevent violent fluctuations in prices.[10]

The emergence of Islamic financial markets hangs on the efforts that might take following forms:

- Efforts to develop Islamic financial instruments
- Efforts to introduce Islamic Reforms in the existing stock markets by changing the rules and laws governing the market
- Develop Islamic institutions in the financial markets.

In the preceding paragraphs, few indications have been made2.1 about the kind of changes that are required for making the practices of stock market conform to Islamic precepts. In the remaining part of this section, an attempt shall be made to see what developments have taken place in the Islamic countries that might be relevant in putting together different components of an Islamic financial market. In this context, special attention has been given to the evolution of Islamic financial instruments and Islamic financial institutions in different Islamic countries that are discussed below:

## 2.1 ISLAMIC FINANCIAL INSTRUMENTS

Naturally, the most distinguishing feature of Islamic financial instruments is that these instruments do not involve interest. Instead of a creditor and debtor relationship, the Islamic financial instruments envisage

[10] Mohammed Ali El Gari, "Towards an Islamic Stock Market" *Islamic Economic Studies, Vol.* 1 No 1, December 1993 p. 9 It may be observed here that these suggested means of controlling speculation may also be used with prudence and care. For example, the control of investment of non banking financial institutions. It has been noticed that non-banking financial institutions are a great source of financial investment in the primary as well as in the secondary market. Hence a restrictive with respect to non banking financial institution policy may control speculation but may also starve the industry of much needed financial investment. Hence, in any practical situation, different alternatives and their pros and cons need to be carefully evaluated.

establishing a participatory relationship between the suppliers and users of finance. Therefore yield on these instruments is neither fixed nor predetermined. An Islamic financial instrument, instead of representing a claim, stands for a share in some real and productive asset. The yield of Islamic financial instrument will depend, on the one side, upon the productivity of the asset whose share it represents, and on the other more important side, it will be influenced by the changing market conditions in the real sector. The exact nature of the relationship between yield of the instrument and productivity of the real asset shall depend, among other things, upon the nature of the contract on which the instrument has been based.

In view of significance of development of an Islamic financial market, the efforts of Islamic economists, bankers and financial experts have been focused on developing certain Islamic financial instruments.[11]
Many of these suggestions remain at the level of ideas and have yet to be tested on the market. Notwithstanding, with the fact that a full scale Islamic financial market has yet to emerge in any Islamic country, some countries have experimented with the introduction of some Islamic financial instrument. Some important suggested Islamic financial instruments are briefly described below:

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11 A random list of Islamic financial instruments suggested by Islamic economists and bankers from time to time might include: Participation term certificates, Profit and loss sharing certificates, Certificates of Investments, Term financing certificates, *Mudaraba* certificates, Specific *Mudarabahs,* Equity financing certificates, Commodity linked bonds and Zero coupon bonds etc. M. A. Mannan has suggested no less than 10 different financial instruments including loan certificates, indexed loan certificates, Islamic commercial papers, integrated investment bonds, profit sharing certificates, expected rate of dividend certificates, rent sharing certificates, firm commitment certificates, *Zakah* certificates, and Human capital certificates. For details see: Mannan, M.A. (1990) " An Appraisal of Existing Financial Instruments and Market Operations from an Islamic Perspective" in Ariff, Mohammad and Mannan, M.A.; (ed.) *Developing A System of Islamic Financial Instruments***,** Jeddah: Islamic Research and Training Institute, p.96 also see Mannan, M.A. (1993) *Understanding Islamic Finance: A Study of Securities Market in Islamic Framework*, Jeddah: Islamic Research and Training Institute, pp. 75 -83.

## 2.2 MUQARADAH BONDS

The idea of *Muqaradah*[12] bonds was floated by the Ministry of Awqaf in the Hashemite Kingdom of Jordan. The Council of Islamic Fiqh Academy established by the Organization of the Islamic Conference (OIC) in its" fourth session held in Jeddah in 1408 H (1988) considered the subject of *Muqaradah* bonds and investment certificates and enunciated certain principles which must govern the issuance of these and other similar instruments. According to the Council, in order to be Islamically valid, the certificates must exhibit the following characteristics:

1. The certificate must represent a joint share in the project, for whose establishment on financing it has been issued. Ownership remains valid through out the duration of the project.
2. The instrument must provide all necessary information regarding *Mudaraba* contract required by the *Shari 'ah* such as the nature of capital, the distribution of profits etc.
3. The certificate must be negotiable at the end of the period.
4. The one who receives funds collected from the subscribers to the certificate for investment in the proposed project is *Mudarib. His* ownership in the project is limited to the extent of his subscription. The *Mudarib 's* role in handling the subscribed funds and the project property is that of a trustee who may not be held responsible unless his liability is permitted under the rules of *Shari 'ah.*
5. It should not contain a guarantee from the manager of funds for the capital or a fixed profit or a profit based on a percentage of capital.[13]

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12 *Muqaradah* is another name for *Mudaraba.*

13 Resolution No. 5 concerning *Muqaradah* bonds and investment certificates approved by the council of Islamic *Fiqh* Academy during its fourth session held in Jeddah, Kingdom of Saudi Arabia during *8* - 12 *Jumad al Akhira 1408* H ( *6* - *11* February 1988).

It may be noted that the issuing authority is not allowed to guarantee these bonds. Guarantee, according to the rules of the *Shari 'ah,* is allowed only by a third party under certain conditions which *inter alia* might include that: The third party must be totally unrelated to contracting parties in terms of legal personality and financial status i.e. it should not be a partner as an *Amel.* . The third party may promise to donate a specific sum without counter benefit to meet the loss in a given project. However, such commitment is independent of the commitments made in the *Mudaraba* contract whose implementation is not contingent upon the fulfillment of this promise.

**2.2.1 PARTICIPATION TERM CERTIFICATES**

The Participation Term Certificates (Puts) were introduced in Pakistan about a decade ago. The main purpose of issuing this instrument was to replace interest based debentures in corporate financial structure. The PTCs were conceived to be transferable corporate instruments based on the principle of profit and loss sharing and were intended to satisfy the medium and long term financial requirements of the industry as a major instruments of project financing on the basis of profit sharing [14] Although, there were many provisions of the PTCs that were debatable, it was a bold experiment in the application of principle of profit and loss sharing to a financial instrument. The experiment was rather short lived as PTCs were soon replaced by the Term Finance Certificates (TFCs) which were

14 More detailed information on PTCs can be obtained from M. Fahim Khan (1992) " A Case Study of Application of Profit Sharing Contract in the Banking Sector of Pakistan" in Al Al Bait Foundation (1992) : *Investment Strategy in Islamic Banking,* Amman: Al Al Bait Foundation. pp. 250 - 286 ; Qureshi, D. M. (1990) "The Role of Shari 'ah based Instruments in a Muslim Country" in Mohammad Ariff and M. A. Mannan, (1990) *Developing a System of Islamic Financial Instruments,* Jeddah: Islamic Research and Training Institute pp. 49-67 and Ebrahim Sidat, " Legal Framework for an Islamic Financial System with reference to Company and Mercantile Laws" in Institute of Policy Studies (1994) *Elimination of Riba From the Economy,* Islamabad: Institute of Policy Studies, pp. 237 - 257.

essentially based on the principle of mark up instead of Profit and loss sharing."

**2.2.2 HOUSING CERTIFICATES**

Housing certificates are being used as an interest free financial instrument by the Mass Housing and Public Partnership Administration (hereafter referred to as the Administration) in the Republic of Turkey to mobilize resources of the development of housing sector. The certificates are issued by the Administration against any specific mass housing project. Each single certificate represents one square meter of flat ownership in a given housing project. The housing certificates are issued bearer and are negotiable in the secondary market. The certificates bear an initial value declared ' by the Administration. It is recalculated on the 10th day of every month and remains valid until the 10th of the next month. The declared value of the certificate reflects the demand and supply situation in the construction sector and not the demand and supply situation of the housing certificate itself Thus, initial value becomes a reference price" for transactions in the secondary market. The housing certificate could be enchashed by authorized banks immediately upon demand at the latest certificate price announced by the Administration.[16]

These are few examples where an attempt, albeit partially and rudimentarily, has been made to devise a financial instrument that reflects the Islamic principles and to put them into practice. These efforts could have been lacking on many grounds, however, the least one could say without much fear of contradiction that, these examples suggest that it is

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[15] Ebrahim Sidat (1994) p.242.

16. Buykdeniz, Adnan (1991) Housing Certificate as an Interest Free Financial Instrument: the Turkish Case" paper presented at the workshop on Islamic Banking Methods for Financing Housing Sector jointly organized by the Islamic Research and Training Institute and The Sudanese Estate Bank in Khartoum, Sudan during 27 -29 October 1991, reprinted in Mhamoud Ahmad Mandi, *Islamic Banking Modes for Housing Building Finance,* Jeddah: Islamic Research and Training Institute, 1995, pp. 203-207.

possible to devise interest free Islamic financial instruments using various Islamic contracts such *Mudaraba*, *Musharaka*, *Murabaha*, and *Ijarah*. *As* mentioned above, some of these instruments have been tested on the market and have met varying degree of success. However, this is not the place to undertake an in depth evaluation of this experience as it calls for a separate and detailed study.

Once, the Islamic financial instruments become available, next ingredients of Islamic capital market will be financial institution that is willing to trade and deal in these instruments. Hence, we next turn to Islamic Financial Institutions.

## 2.3 ISLAMIC FINANCIAL INSTITUTIONS

Financial institutions play a crucial role in the development of a capital market, which is composed of issuers, investors and intermediaries. Financial institutions include both banking and non-banking financial institutions. While some of these institutions may issue financial instruments from time to time and thus be included in the category of issuers, their substantial functions is financial intermediation. This category includes stockbrokers, security houses, international banks, investment banks, and merchant banks. Generally speaking, intermediaries perform two important functions:

- Matching funding needs of the issuer with the investment needs of the investors through the launching of new issues in the market, taking a fee for this service
- Providing dealing and distribution services along with investment advice in the established issues.

During the past twenty five years so, with globalization of international finance, communication revolutions, growth of institutional investors, dominance of multinational companies, the activities undertaken by intermediaries have also got transformed. The intermediaries perform following activities with respect to financial instruments:

#### ORIGINATION

Research and development of new financial concepts, presentation of these concepts and products to potential users, negotiation of terms and conditions, preparation of documentation, securing mandate for the new issue etc.

#### SYNDICATION

After securing, the mandate the lead manager puts through a group of financial institutions (or a syndicate) which underwrites the issue. In this way the lead manager spreads the under writing risks of the whole issue among a number of other intermediaries.

#### DISTRIBUTION

The lead manager distributes the issue through the network of its branches. It may also authorize some other associates to distribute the issue. This service may be performed against a fee.

#### TRADING IN SECONDARY MARKET

Secondary market trading takes place from the time the proceeds of the issue are received by the issuer in exchange of its issue of securities. The trading team of intermediate institutions then becomes responsible for making a continuous two way price in the paper so that existing holders and the new investors are assured of a liquid market in which they can buy and sell.

## 2.4 ISLAMIC VIEW OF INTERMEDIATION

It appears that financial intermediation will be permitted in Islamic economy. The surplus and deficit households in terms of ownership of financial resources have existed in past and shall continue to exist future. The need of financial intermediation may also be underscored due to a fact that in modern economies, income accrues to millions of earners in small amounts and their savings are low. On the other hand, there shall always be need for making some big investment projects. Hence, there is a need for mobilization of savings of a vast majority of population. If there is no financial intermediation, these savings may not be invested at all and society may be derived of this investment. Therefore, the canons of necessity *(Darurah)* and public interest *(Maslaha)* may be evoked to justify financial intermediation. The appointment of a lead manger for the issue may be done using the concept of *Wakalah* where an agent performs a function on behalf of the person making the *Wakalah.* The financial intermediaries perform most of the functions by charging a fee. Providing a service against a price is permitted in Islam. Hence Islamic banks and other financial institutions may perform the function of an agent *(Wakil)* against an agreed upon fee. The issuer institutions may appoint an Islamic bank a leader manager of the issue and the Islamic bank may carry out the management of the issue. It may also devise, design and develop various financial instruments according to preferences of different issuers. However, clearer verdict may be required in case of underwriting which is one of the important functions of modern banks working as a lead manager and to which we turn now.

### 2.4.1 INVESTMENT BANKING

Investment banking is the distribution of new issues of stocks and bonds to investing public. An investment banking firm functions as an intermediary between the company or the government agencies issuing the security and the investors, non-banking financial institutions and public who buy them. In effect, an investment bank is wholesale dealer of securities. It buys the securities from the issuer in large quantities and sells to investing public in smaller quantities.[17]

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[17] Martin V. Sears and Irving Katz (1970) *Investment Banking in America;* R RG.Eccles and D.B. Crane, Doing Deals ( 1988 ) *Investment Banks at Works.*

In order to perform this function, the banks have to resort to a practice, which is known as underwriting. Under this arrangement, the banks take the responsibility for selling the securities at an agreed upon price and establishing a permanent market for them. In case the banks are not able to sell the securities at offering price, they will suffer a loss.[18] If it were a straight forward deal where the investment bank would make an outright purchase of the securities, then there would be no *Shari 'ah* problem involved in it. However, underwriting deals are most often quite complex, hence, the need for a complete *Shari 'ah* review of these deals and for a clearer verdict is evident.

Although a full-fledged Islamic investment bank has yet to emerge, certain Islamic banks are active in this area. The Faisal Islamic Bank of Bahrain has gained much experience in syndication of *Murabaha* finance. The United Bank of Kuwait (UBK) has established an Islamic Investment Banking Unit though which it is offering Islamic investments to its clients. It has established a leasing fund that provides an acceptable" yield enhanced" diversified product for Islamic banks and financial institutions. The UBK is also active in the field of *Murabaha* investment and has accumulated considerable experience in it during the last 13 years. In the beginning, UBK was dealing mainly in the commodities market (particularly in the metal market) but these popular *Murabaha* markets are slowly being replaced by more sophisticated trade finance based on *Murabaha* and *Salam* contracts.[19]

Although *Murabaha* provides the Islamic banks with a method that could be held comparable with standard money markets in terms of liquidity, the returns of *Murabaha* investments have been less than:

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[18] This is how investment banking is practiced in the United States. However, in Britain and various European countries, dealing in securities is one of the functions of commercial banks. It is also known there as merchant banking. In the United States investment banking is kept distinct from commercial banking.

[19] For Contemporary applications of *Salam* contracts see: Abdul Halim Umar, *Shari 'ah, Economic and Accounting Framework of the Bay' Salam in the light of*

*Contemporary Applications,* Jeddah: Islamic Research and Training Institute, 1995.

satisfactory. Hence, there is a quest for some Islamic modes of investment which would prove to be comparatively more lucrative. Inspired by this quest, the Islamic investment banking unit of the UBK has developed several "new" financial products such as property investment contracts, ship leasing opportunities, spot currency programs, residential mortgages etc. The UBK maintains that these products have been developed after due consultation of *Shari 'ah* scholars[20]. This brings out the significance of R & D in the development of Islamic capital markets.

**2.4.2 MUTUAL FUNDS AND INVESTMENT FUNDS**

Since 1980s, a significant trend in the capital markets has appeared in the form of emergence of mutual funds and investment funds. These funds are operated by commercial banks as well as by independently established investment companies. A mutual fund is a company that invests most of its money in stocks and bonds issued by other business corporations. Like any other company, a mutual fund also raises its capital by issuing and selling shares (common stocks) to individuals and investors who eventually become the share holders of the company.

There are two types of mutual funds: no load mutual funds and load mutual funds. Investors in a no load mutual fund pay no sales charge (also called load or commission) when they purchase the shares of the funds. It is equal to net asset value of the fund per share on the day of purchase. The investors in a load mutual fund pay a purchase price that is equal to the net asset value plus a loading charge.

There are many advantages of mutual funds to individual investors. First, professional managers manage their money on a continuous basis. Secondly, the investment has a large spread as mutual funds diversify its portfolio over a number of corporations and industries. Thus, increasing the spread of risk, total risk of the portfolio is minimized. Thirdly, mutual

[20] Ausaf Ahmad, *Islamic Banking Activities undertaken by the Conventional Banks,* Jeddah: Islamic Research and Training Institute, 1995, (Unpublished paper).

funds also provide a number of services to their customers such as maintaining the records of securities transactions, collection and disbursement of income etc.

The mutual funds have different investment objective. Some funds give preference to high return and hence invest in high growth companies, while others are satisfied with an acceptable rate of return but greater degree of safety and hence they invest in safer and less risky instruments.

The emerging Islamic financial markets have also taken notice of Investment funds. In fact, operating an Islamic investment fund is much easier than starting a full-fledged Islamic bank. It is true that it offers only a limited service to its clients. However, it adds to its efficiency. Consequently, a number of Islamic banks and some conventional banks have established Islamic investment funds whose objective is to invest the money of their clients in such a way as would conform to Islamic *Shari 'ah* and earn *Halal* returns. A brief account of some Islamic investment funds is given below:

A fund called International investor has been established in London with the collaboration of the Government of Kuwait and few Islamic commercial banks in the Gulf [2'] The Islamic Investment Company of the Gulf, located in Bahrain, employs funds estimated to be more than US $ 1.78 billion serving more than 58,000 clients and acts as a manager *(Modareb)* of a diversified range of investment funds ***(Mudarabahs)*** **which** comply with Islamic law and principles.[22] The main objective of the company is to obtain best possible return for investors in accordance with Islamic *Shari 'ah.* The Al Barakah group has established Al Tawfeek Company for Investment Funds and al Amin Securities Company, both located in Bahrain. These Companies were established in 1987. Al Amin is a subsidiary of Al Barakah Investment and Development Company and Al Tawfiq is a subsidiary of Al Barakah Islamic Investment Bank of

Bahrain.

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[21] *The New Horizon,* October 1992, p.3.

[22] Encyclopedia of Islamic Banking and Insurance, London: Institute of Islamic Banking and Insurance, 1995, p.310.

Al Amin and Al Tawfiq are registered as independent entities in the State of Bahrain under the companies law. Both of these companies mobilize resources from the private sector and invest them in Islamic way to earn *Halal* return for their clients.

Similarly, many conventional banks have also established investment funds, which operate on Islamic basis. For instance, The Saudi British Bank operating in Saudi Arabia has established an investment fund called *"Al Tadamon"* that offers interest free investment opportunities to prospective investors. The money available in this fund is invested in precious metals as well as in commodities. The fund operates on the basis of *Murabaha,* buying metals and commodities on cash and selling them on a differed payment basis. The Saudi British Bank also operates an investment fund dealing specifically with the domestic trade.

The establishment of Islamic mutual funds and Islamic investment funds offers ample scope for the development of Islamic financial markets. At present, these funds are mostly investing in precious metals and commodity markets. However, when Islamic financial papers become available, these funds shall also invest in them and play their role in the establishment of an Islamic capital market.

## 2.5 ISLAMIC STOCK EXCHANGE

Sudan had taken lead in establishing the first Islamic stock exchange in 1995. It is known as Khartoum Stock Exchange (KSE) and all its operations are said to be based on Islamic *Shari 'ah.* The Khartoum Stock Exchange shall trade only in those shares, bonds, leasing contracts, and those commercial and financial papers whose return is Islamically acceptable i.e. is not based on interest. Another feature of KSE is that it can trade only on the spot basis and with full values paid. It shall not

23 Ausaf Ahmad, *Islamic Banking Activities Undertaken by the Conventional Banks* Jeddah: Islamic Research and Training Institute, ( unpublished paper).

venture into future trading and thus has been prevented from indulging to speculative activity.

The KSE has been given a special law under which it has to operate. All public limited companies, banks and insurance companies have been made the members of the stock exchange by law. Thus, listing on the KSE is not optional. This is because the number of public limited companies in Sudan is only 140. The KSE has organized an increase in the share capital of National Popular Development Bank in the primary market. In the secondary market, the exchange has listed 28 companies. The total assets of the listed companies amount 20.8 billion Sudanese pound. Total volume of shares on the exchange is 287 million. It is expected that market capitalization of stock shall reach to five billion Sudanese pounds and the asset value to 35 -50 billion Sudanese pounds with in the next two year.

Thus, it may be noticed that efforts have been under way to develop different components of capital market i.e. financial instruments, institutions of financial intermediation. However, these efforts remain isolated and disjointed. A market is an organism in which different components have functional inter-relationships with each other. Only then, the market can come into being and can perform effectively. There is no doubt that it will be some time before an International Islamic financial market appears. Even, the development of a full fledged domestic capital market, that functions along the Islamic lines, has yet to take a concrete shape in any country. However, the efforts surveyed above indicate that all components of an Islamic financial market are available albeit separately. The closest one has come to the creation of an Islamic financial market is in Malaysia where an attempt has been made to put all the pieces together. Hence, the next two sections examine the attempts that point toward the emergence of an Islamic financial market in a contemporary Muslim country.

# III. SLAMIC BANKING IN MALAYSIA

Malaysia is one of most dynamic and vibrant economies in the Southeast Asian region that is actively contributing toward economic development of Southeast 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, Southeast Asia is not a monolith. Instead, it has an amazing maze of ethnic diversity. This complexity of ethnic structure is reflected in the Malaysian society also, whose total population is estimated to be 17.4 million people composed of 54 percent Malay Muslims, 35 percent Chinese and 10 percent Tamil Indians. [24]

Lately, Malaysia has also emerged as an important center of Islamic banking. It has the privilege of having the first Islamic bank of the region. During the last three years, Malaysia has taken steps of far reaching implications by introducing Islamic banking and finance at a much larger scale. An interest free banking scheme has been launched which has been extended to whole banking system and first inter bank money market based on principle of Islamic banking has been established. In the remainder of this section, these efforts have been examined in detail.

## 3.1 PRECURSORS OF ISLAMIC BANKING

Although the first Islamic bank in Malaysia was established only in the early eighties, there were some important precursors of Islamic financial institutions.

### 3.1.1 TABUNG HAJI

In terms of historical evolution of Islamic banking, a mention must be made of a unique financial institution which is generally not referred to in the discussions of Islamic banking and financial institutions but whose

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24 For a good review of ethnic composition of Southeast Asia and its implications for Introduction of Islamic banking and finance in the region see, Omar Farouk, "The Muslims of Southeast Asia: An overview" in Mohammad *Ariff: Islamic Banking in Southeast Asia,* Singapore: Institute of Southeast Asian Studies, 1988.

significance, importance and uniqueness demands it. This financial institution is the pilgrims Management and Fund Board of Malaysia, popularly known as Tabung Haji.

Main reason for the establishment of this institution was the desire of Malaysian Muslims that "money spent of the pilgrimage must be clean and untainted of *Riba. "* Since this was not possible by putting the money with the ordinary commercial banks, this desire necessitated the establishment of a special financial institution. Consequently, a pilgrims' Saving Corporation was established in 1963 and was later incorporated into the Tabung Haji in 1969. Main goals of Tabung Haji are:

- To enable Muslims to save in order to provide their expenses for performing the pilgrimage (Hajj) or for other expenses beneficial to them;
- To enable Muslims through their savings to participate in investment, industry, commerce and plantations as well as in real estate, according to Islamic principles; and
- To provide for the protection, control and welfare of Muslims while on pilgrimage through various facilities and services of Tabung Haji.[25]

To achieve these goals the board is assigned to collect savings through its branch offices and other agencies such as post offices and to invest the depositors' savings "in accordance with the investment principles and tenets of Islam."

Tabung Haji made a modest start in 1963 with 1281 depositors and a total deposit of M$ 46,600. However, it made fast and steady progress. By the end of 1985, i.e. within a period less than 25 years, it had succeeded in developing a network of 65 branches all over the country, the

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25 *Proceedings of the Workshop on Organization and Management of the Pilgrims Management and Fund Board of Malaysia,* Jeddah: Islamic Research and Training Institute, 1987, p.3.

number of depositors exceeded 800,000 and total deposits crossed the mark of one billion Malaysian dollars. [26] By any standards, it could not be said to be a modest achievement. This rate of progress has not only been maintained but also accelerated, with the result that, at the end of 1990, the total resources of the fund were increased to M$ 1.48 billion and the number of depositors reached to two million amounting to 16 percent of total population. Other financial indicators of Tabung Haji also registered substantial increase during the early nineties. Total resources of the Board stood at M$ 2.6 billion at the end of 1994 registering an increase of 26.6 percent compared with an increase of 18 percent during 1993. Total deposits in 1994 were M$ 2.3 billion registering an increase of 20.3 percent in 1994 (28.5 percent in 1993).[27]

Financial activities of Tabung Haji are managed by a department of finance and investment which has six divisions, viz., finance, saving and withdrawals, securities, land and buildings, property management and computer. It has also established five subsidiary companies dealing with plantation, pilgrim transportation, construction and housing and property management.

As a financial institution, Tabung Haji works as a saving and investment institution. It operates on the principle of *al wakalah al Mutlaqah* (absolute power of attorney) through which the depositors give their consent to Tabung Haji to manage their deposits for purposes of investment. Tabung Haji employs several schemes to attract deposits e.g. direct deposits, deposits through branches and post offices, salary deduction schemes, children's saving scheme etc. Withdrawals are allowed up to 100 per cent of the cash balances of the fund. However, normally only one withdrawal is allowed within six months.

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[26] ibid. p.3.
[27] *Annual Report Bank Negara Malaysia,* 1994, *p.* 173.

For making investments in accordance with the Islamic principles, Tabung Haji uses *Mudaraba* and *Musharaka as* modes of investment. In order to ensure that it does not violate any of Islamic principles, it used to consult the National *Fatawab* Committee of Malaysia. However, after the establishment of Bank Islam Malaysia, the services of the *Shari 'ah* Board attached to this bank are used.[28]

The investment made by Tabung Haji has mainly taken four forms: investment in shares, in subsidiary companies, in land and buildings and short term investment.[29] In 1990, the investment made by Tabung Haji stood at M$ 116 millions. The percentage distribution of total investment over various forms was as follows: quoted shares 24.81 percent, unquoted shares 13.65 percent, subsidiary companies 9.52 companies, trading 1.04 percent, government investment and securities 19.95 percent, *Mudaraba* investment 7.75 percent, *Murabaha* investment 2.54 percent and investment in land and buildings 18.73 percent. [30]

The Tabung Haji is an enthusiastic investor in corporate securities.[31] Its total investment in corporate securities was t M$ 1.1 billion accounting for 44 percent of its total assets at the end of 1994 (M$ 884 million accounting for 43 percent of total assets in the previous year).[32]

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28 *Proceedings of the Workshop on. Organization and Management of the Pilgrims Management and Fund Board of Malaysia,* Jeddah: Islamic Research and Training Institute, 1987, p.54.

29 ibid, p.88.

30 Calculated on the basis of figures provided by the Tabung Haji document distributed at the IDB Prize award ceremony and quoted by Tariqullah Khan, *Country Study on Malaysia,* Jeddah: Islamic Research and Training Institute, (unpublished document).

31 Islamic reservations about investment in securities have already been mention in the section II. It is expected that Tabung Haji, being an Islamic institution must be observing the rules and norms that are to govern such type of investment. However, the available information do not indicate in what kinds of securities, Tabung Haji is investing.

32 *Annual Report Bank Negara Malaysia,* 1994, p.173.

Although Tabung Haji is not a bank in the traditional sense of the term, but it works very much the same way as a specialized Islamic bank would. It performs two important banking functions i.e. accepting the deposits and making investment. It can also play a significant role in the Islamic capital market, as 67 percent of its total investment is financial investment. At present, it is satisfied only by purchasing the shares of companies. However, if interest free financial instruments are available in the market, Tabung Haji can emerge as a significant investor in the Islamic financial market in Malaysia.

### 3.1.2 BANK PARTAINIAN MALAYSIA (BPM)

Like Tabung Haji, the Bank partainian Malaysia (BPM) may also be regarded as a precursor of Islamic banking in Malaysia. Although the BPM was established as a traditional agriculture bank, it devised some interest free credit schemes as early as 1969 to serve mainly Muslim Malay farmers. These schemes were Padi Credit Scheme and Petty Traders' credit schemes. In 1990, the. bank started a saving scheme known as Patriot Ummah Saving Scheme (PUSS) under which a person pays the bank ten Malaysian Ringgit to start a saving account. Instead of earning interest on his saving account, the saver gets a bonus, which is equal to inflation rate in the economy.[33] Thus, this scheme protects the real value of savings for the participants in the scheme.[34] However, it may be pointed out that protection of real value of savings may be justified on economic grounds, particularly in periods of inflation when the real value of saving is declining fast; but it is not justifiable on *Shari'ah* grounds which holds that amount borrowed and amount lent must always have equal face value irrespective of time.

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33 It may parenthetically be mentioned that many scholars of Islamic *Fiqh* would not approve a scheme, which is devised to protect the real value of deposits in any bank. Their argument is that when borrower is not protected against inflation, there is no justification why creditor should be provided a cushion against inflation. Hence, the bonus which is paid to the depositors in this scheme may smack of *Riba*.

34 *New Horizon,* London, July 1994, p.7.

## 3.2 ISLAMIC BANKING SCENE IN CONTEMPORARY MALAYSIA

Islamic banking started taking roots in Malaysia in early eighties. The establishment and successful functioning of Tabung Haji as a specialized Islamic financial institution had already prepared a favorable climate for Islamic banking. The Bank Islam Malaysia Berhad (BIMB) was the first Islamic bank to be established in Malaysia. The BIMB came into existence in 1983. Since then, Malaysia has slowly but steadily moved towards the establishment of a dynamic and vibrant Islamic financial system in the country side by side with the traditional system. Although article 3 (1) of the Islamic Banking Act, 1983 under which the BIMB was established, declares that, "Islamic banking business shall not be transacted in Malaysia except by a company which is in possession of a license in writing from the Minister authorizing it to do so" there has been a change in the policy. After experimenting for about a decade with the BIMB, the Malaysian monetary authorities appeared to have decided, that other commercial banks may also be permitted to use Islamic financing technique. Thus, an interest free banking scheme was launched that was to be implemented in phases. This policy shall be discussed in detail. It suffices to say here that a number of conventional Malaysian banks announced to launch "Islamic banking windows' to get a share in the Islamic banking market.[35] Bank Rakyat, which is the largest bank in the cooperative sector in Malaysia, has declared to convert all its operation to Islamic banking within a year.[36]

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[35] The Islamic banking market in Malaysia is worth several billion Ringgits. It is claimed that Islamic deposits in Malaysia amount to more than two billion Ringgit. These deposits are shared between the Bank Islam Malaysia Berhad (BIMB) and other banks participating in the interest free banking scheme (IFBS). The BIMB had deposits more than 1.8 billion Ringgits and 0.2 billion Ringgits are with other banks. These deposits are handled by 52 branches of the BIMB and 578 branches of other commercial banks, which offer interest free banking services. See *New Horizon,* London, July 1994, p.10.

[36] ibid, p.6.

### 3.2.1 INTEREST FREE BANKING SCHEME

A momentous event in the development of Islamic banking in Malaysia took place on March 4, 1993 when the interest free Banking Scheme *(Skim Perbankan Tanpa Faedah* or SPTF) was launched. Under this scheme, conventional banks were allowed to offer Islamic banking services. Malaysia had taken an approach towards Interest free banking in which it was to be introduced in the country in a phased manner. As has been mentioned before, an Islamic bank namely Bank Islam Malaysia was established in 1983. After its successful operation for nearly a decade, SPTF was launched which also adopted a phased approach. In the first phase of the SPTF, three of the country's largest banks, United Malayan Banking Corporation, Bank Bhumiputra Malaysia and Malayan Banking Berhad were authorized to conduct interest free banking activities. In the second phase, six more banks were added to the list. By the end of 1993, nine banks were participating in the SPTF.[37] At the end of 1994, 21 conventional commercial banks had been given approval to offer interest free banking scheme (SPTF). In the third phase of the scheme, all commercial banks in Malaysia were brought under the purview of interest free banking scheme. The number of banking and financial institutions offering Islamic banking products has now reached to thirty seven[38]. The total deposit covered under this scheme in 1994 amounted to two RM billion while total interest free financing extended was to the tune of RM 274 million.[39]

Now, Malaysia has the first Islamic inter bank monetary system along with the Islamic banks, Islamic insurance companies and Islamic stock-broking house. Some of the latest development in the Islamic banking industry in Malaysia shall be reviewed below. However, before

37 *~~Annual Report Bank Negara Malaysia, 1993,~~ p.136*

38 *Annual Report Bank Negara Malaysia, 1994, p.127*

39 *Annual Report Bank Negara Malaysia, 1994, P.136*

39 ***Annual Report Bank Negara Malaysia,*** ***1994,*** **p. 136.**

that, let us take **a** look at the Islamic financial institutions operating in Malaysia.

### 3.2.2 BANK ISLAM MALAYSIA BERHAD (BIMB)

The Bank Islam Malaysia Berhad (BIMB) was established in 1983 under the provisions of Islamic Banking Act of 1983 (Act 276) of the Malaysian Parliament.[40] The Islamic Banking Act defines an Islamic bank as a company which carries out Islamic banking business which in turn is defined as "banking business whose aims and operations do not involve any element which is not approved by the religion of Islam."[41]

The BIMB has an authorized capital of M$ 500 million, divided into 500 million ordinary shares of one Malaysian dollar each. In I983, the bank had started with a paid up capital of M$ 80 millions. At that time, it enjoyed monopoly position in the domestic market of Islamic banking. After a period of I0 years, in I993, the capital resources of the BIMB stood at US $ 53 million. The BIMB may be viewed as a semi public sector financial institution as the government of Malaysia has contributed 37.5 percent of its paid up capital. Other major share holders are: Pilgrims' Management and Fund Board (Tabung Haji), Muslim Welfare Organizations of Malaysia, State Religious Council, State religious agencies and other Federal Agencies.[42]

During this period I983-93, the bank has made impressive progress. By 1993, its assets had risen to US $ 756 million, and deposits to

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40 Banking activity in Malaysia is regulated by the Banking Act 1973 that regards interest rate as important mechanism for the conduct of banking operations and bars commercial banks from indulging into trading activity. Since Islamic precepts of banking conflict with this view, this necessitated that a special act be promulgated for conduct of Islamic banking.

41 Section 2 Part I, Islamic Banking Act,1983.

42 Zakariya Man, "Islamic Banking: The Malaysian Experience" in Mohammad Ariff (ed.) *Islamic Banking in Southeast Asia,* Singapore: Institute of Southeast Asian Studies, 1988, pp.67-102.

US $ 644 million. It was having 57 branches all over the country and has enjoyed a tremendous growth in its clientele.[43]

The bank operates four types of deposit accounts: current account, saving account, investment account and special investment account. The current accounts are operated on the basis of *al Wadiab* principle with no distribution of profits. Saving deposits are also accepted under the same principle with the distribution of profits at the discretion of the bank. The investment accounts are organized on the basis of *Mudaraba* in which the bank is the active agent (Mudarib). The bank shares the gross profit with the depositor in 70: 30 ratio i.e. 70 percent to the depositor and 30 percent to the bank. The ratio is subject to the revision. In the event of loss, in accordance with the principle of *Mudaraba,* the depositor are to bear the loss.[44] Project financing is provided by the BIMB on the basis of *Murabaha* (cost plus or mark up), *Bay Bithaman Ajil* (deferred sale), *Ijara* (leasing), and *Qard Hasan* (interest free loan). The bank also issues letters of credit and letters of guarantee on the basis of principles of *Wakalah, Musharaka* and *Murabaha* in addition to conducting other banking functions that are discharged against a fee.[45]

The BIMB has been criticized on several grounds: for putting excessive reliance on "second line techniques" like deferred sale, mark up and leasing instead of profit sharing techniques, for short term financing of trade, for excessive liquidity etc. However, these criticisms may be advanced for any Islamic banks and are not unique to BIMB.[46]

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43 *Directory of Islamic Banks,* Jeddah: International Association of Islamic Banks, 1994 (mimeo).

44 Zakariya Man, op.cit., p.75.

45 The working of these techniques has been described in detail by Zakariya Man (1988) op.cit.

46 Zakariya Man, op.cit. pp.90-93. For a critique of these views see, Ausaf Ahmad, Review Article on Islamic Banking in Southeast Asia, *Journal Institute of Muslim Minority Affairs,* 1991.

### 3.2.3 BANK BHUIMPUTRA MALAYSIA BERHAD

Bank Bhumiputra Malaysia Berhad (BBMB) is a traditional bank, which opened an interest free section in I993. It offers saving and investment accounts on the basis of profit and loss sharing. Demand for Islamic banking in Malaysian society may be gauged from the fact that within three months of opening its interest free section, the BBMB attracted 5000 new clients.[47] The BBMB is reported to have collected more deposits under the interest free banking system than any other financial institution in Malaysia. In I993, the bank has succeeded in attracting the deposits worth more than RM I00 million. The BBMB collected RM 68.2 million through *al Mudaraba* General Investment Account and RM 34.8 million through *al Wadiab* Saving Accounts.[48]

The BBMB has also taken initiative in introducing other interest free products such as: Interest free Accepted Bills, Interest-free Export Credit Refinancing Facility, Autopay, and ATM Juweara *Muamalah* Cards. [49] The **BBMB** operates current accounts on the basis of *al Wadia* principle in which the account holders authorize the bank to use the amounts held in current account for any investment activity approved by the Islamic law. The bank makes token payments to account holders if it makes any profits from these investments."

### 3.2.4 UNITED MALAYAN BANKING CORPORATION BERHAD

The United Malayan Banking Corporation Berhad (UMBC) is also a traditional bank that received license to practice interest free banking

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47 *Encyclopedia of Islamic Banking and Insurance,* London: Institute of Islamic Banking and Insurance, 1995, p. 338.

48 *New Horizon,* London, July 1994, p.11.

49 Unfortunately, detailed information on the working of this technique is not available. It should be particularly interesting to see what Islamic justifications have been adopted for various instruments. However, due to lack of precise and detailed information on the nature and working of these instruments, any judgment about the Islamic nature of these instruments may not be given unless such information become available.

50 *New Horizon,* London, July 1994, p.11.

activities in I993. The bank wishes to progressively increase the range of its Islamic banking activities.[51]

**3.2.5 BANK RAKYAT**

Bank Rakyat is the largest cooperative bank in Malaysia. It has 48 branches all over the country. Total membership of Bank Rakyat (individuals and societies) stands at 55, 529. It mainly operates in the agricultural sector. Till very recently, the bank Rakyat has been operating on the basis of interest. However, it has declared to convert all its operation on interest free basis.

**3.2.6 SYARIKAT TAKAFUL MALAYSIA BERHAD**

It is an Islamic insurance company that has been incorporated in I993 with an authorized capital of I00 million dollars and a paid up capital of I0 million dollars. It is a subsidiary company of Bank Islam Malaysia Berhad, which owns 87 percent its equity. The rest of the equity is owned by various Islamic religious councils in different states of Malaysia. The company aims at providing the service of Islamic insurance *(Takaful)* to Muslim and general population in the country[S2]. Two types of insurance cover are offered by the company: family insurance and general insurance. The family Takaful is the counter part of life insurance. However, it may be mentioned here that the permissibility and legality of life insurance is considered doubtful from the Islamic point of view.

The company was registered under Takaful Act I984 on July 1985. In 1993 its total assets stood at RM I00.9 millions registering a thirty

51 *Enclopedia of Islamic Banking and Insurance,* London: Institute of Islamic Banking and Insurance, 1995, p. 338.

52 For details on the concept of Islamic insurance ( *Takaful )* see Chaudluy Mohammad Sadiq,"Islamic Insurance: Concept and Practice" in *Encyclopedia of Islamic Banking and Insurance,* **London:** Institute **of** Islamic Banking and **Insurance,** 1995 **pp.** 197 -210.

percent increase from the previous year.[53] The bulk of Takaful finds are invested in the Government Investment Certificates[54] (about 69 percent) while I2 percent is given as loans.[55]

Islamic insurance (Takaful) still accounts for a very small share of a big insurance market. The annual premium income of general insurance companies in Malaysia is over three billion Malaysian dollars[56]. These companies are also enthusiastic players in the financial market, as large portions of their funds are not required by them immediately. Hence, they are in a position to place their funds in the assets of longer maturity. Similarly, Islamic Takaful companies, if they are to play any useful and substantial role in the evolution and development of Islamic financial market, will have to increase their number, enlarge their scale of operation and control a larger share of insurance market.

## 3.3 INTEREST FREE BANKING SCHEME (SPTF)

As observed before, the movement towards the establishment of a full fledged Islamic banking and financial system is a gradual process in Malaysia. Until 1993, the Bank Islam Malaysia Berhad (BIMB) had a virtual monopoly on Islamic banking activities. The successful functioning of the BIMB prepared the ground in which a large and more ambitious experiment for establishment of Islamic financial system could be undertaken. This may also be noted that approach adopted in Malaysia is not to replace the existing system by the Islamic system completely but the conventional and Islamic system have to exist side by side giving the

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[53] Bank Negara Malaysia, *Annual Report,* 1993, pp. 165-66.

[54] The legality of this investment shall naturally depend upon the legality of government Investment Certificates. Although it is claimed by official sources in Malaysia that government investment certificates are Islamic financial instrument that have been specially devised to solve the liquidity problem of Islamic banks, many experts of Islamic jurisprudence outside Malaysia have expressed doubts about the legality of this instruments. It is suspected the element of *Riba* from these instruments may not have been eliminated as is claimed.

[55] ibid. p.165.

[56] ibid. *P.165.*

opportunity to "customer" what kind of "banking products" he would like to chose. That is why it is said that Islamic banking in Malaysia is "a banking issue".[57]

It may also be argued that in the nascent stage of development of Islamic banking, probably it was necessary to give some kind of monopoly advantage to Bank Islam Malaysia. However, once the basic viability and feasibility of Islamic banking technique have been established, the monopoly position has to give way to competition. Now, the banking institutions offering Islamic banking products have to compete among not only themselves, but they also have to compete against the conventional system. That is why it was necessary that number of banking institutions offering Islamic banking products must be expanded and these institutions must be linked together to form a money market as the traditional banking institutions do..

The interest -free Banking Scheme (SPTF) was launched on March 4 I993. It was thought that expansion of interest free banking should be a phased process. In the first phase, three commercial banks, namely Malayan Banking Berhad, Bank Bhumiputra Malaysia Berhad and United Malayan Banking Corporation were authorized to offer Islamic banking products. The second phase of the SPTF was launched on August 2I, I993 in which I0 financial institutions were allowed to participate in the SPTF. Some of these ten institutions were: Development and Commercial Bank, Standard Chartered Bank), Perwira Habib Bank, Kwong Yik Bank, Arab Malaysian Merchant Bank, MBF Finance, Public Finance and BBMB Kewangan.[58] The Bank Negara in its Annual Report I993 claimed that
"With the implementation of the interest free banking scheme, Malaysia has emerged as the first country to implement a dual banking system, whereby an Islamic banking system functions on a parallel basis with the conventional system."[59]

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[57] "The Malay Way: Shifting Sands of Islamic Banking" *New Horizon,* London, No.29 July, 1994.
[58] *The Daily Arab News,* July 12, 1994
[59] *Annual Report of Bank Negara Malaysia,* 1993, p.51.

The Central Bank of Malaysia ( Bank Negara) evaluated various alternatives at the time of launching of interest free banking scheme. Basically, three alternatives were available:

- To start new Islamic banks on the pattern of the Bank Islam Malaysia that would offer Islamic banking service exclusively.
- To start Islamic branches of existing banks and financial institutions.
- To allow commercial banks and financial institutions to offer Islamic banking products through their existing branches and networks.

It may be observed that these three alternatives as a choice problem also exist in other Islamic countries that have introduced Islamic finance in one form or the other and some kind of choice has been made either officially or unofficially. In most of the countries in the Middle East and Arabian Gulf, first alternatives has. been preferred. In these countries, Islamic banks have been established as new companies. Second alternative may be noticed in Egypt where a number of banks including Bank Misr have opened Islamic branches of already existing conventional banks. In Saudi Arabia, the National Commercial Bank is also known to have opened several branches specializing in Islamic banking and finance. Many other conventional banks in Saudi Arabia including the Saudi British Bank, Bank Riyadh etc. are said to have emulated the example of the National Commercial Bank. The alternative adopted in Islamization of commercial banking in Pakistan looks similar to the third alternative but it is not. In Malaysia, the conventional banking has been retained as a conscious policy decision while in Pakistan, all existing commercial banks where asked to switch over to what the then government of Pakistan conceived as Islamic banking.

After careful evaluation of three alternatives, the Bank Negara chose the third alternative, which was said to be time saving also and cost effective. Starting new Islamic banks from the scratch was considered expensive in terms of resources as well as time. Similarly, opening new Islamic branches of existing commercial banks would involve expenditure of considerable resources, as estimated cost of opening a new branch of an established bank was RM 500,000. This would also require more time, administrative procedures and recruitment of new staff to run the branches. Hence, introduction of Islamic banking products through existing net work of commercial banks and financial institution was considered to be least cost solution in terms of resource and time requirements. [60]

The interest free banking scheme (SPTF) has also made steady progress. At the end of 1993, there were a total of 20 financial institutions including 9 Malaysian commercial banks, one foreign bank, 8 finance companies and two merchant banks offering Islamic banking services under the SPTF[61]. A list of these financial institutions is given in the Appendix I. The number of financial institutions participating in the interest-free banking scheme had risen in I994 to 2I commercial banks, I3 finance companies, and three merchant banks when third phase of the scheme was in operation. In principle, all commercial banks, merchant banks, and finance companies are eligible to participate in the SPTF. The deposits handled under SPTF and the finance extended under the scheme amounted to RM. 1.8 billion and RM. 482 million respectively.[62]

Under the SPTF a financial institution participating in the scheme is required to set up, an interest free Islamic Banking Unit (IBU) in its head office. The IBU has been assigned to conduct the following functions:

a) To attend all aspects concerning the operation of the SPTF including policy and procedures.
b) To liase with other departments in the financial institutions to ensure smooth operation of SPTF.

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[60] "The Development of Islamic Banking in Malaysia" *Money and Banking in Malaysia,* Kuala Lumpur: Bank Negara, 1994, p. 328.
[61] *Annual Report of Bank Negara Malaysia,* 1993, p.147.
[62] *Annual Report of Bank Negara Malaysia,* 1994, p.145.

c) To ensure that all funds pooled into the Interest free Banking Fund are channeled into financing and investment activities on the basis of Islamic principles.
d) To arrange for training of staff on Islamic banking so as to ensure the smooth and effective implementation of the SPTF;
e) To arrange for compilation and submission of such returns as may be required to be submitted to the Bank Negara from time to time.
f) To ensure that all directives and guidelines issued by Bank Negara pertaining to SPTF are strictly complied with; and
g) To undertake on-going research and development in Islamic banking for the further enhancement of Islamic financial system. [63]

Each financial institution participating the interest free banking scheme has also been required to establish and maintain a working fund namely Interest free Banking Fund (IBF). The Bank Negara will determine the minimum amount for this Fund from time to time. At present, the amount of this fund has been determined to be one million Malaysian Ringgit. This Fund is funded by an allocation made by the head office of the participating institution. It is placed under the IBU to conduct and fund the operation of the SPTF. The main purpose of the IBF is to cover the overhead expenses relating to the operation of SPTF. The profits and fees earned by the SPTF are credited to the IBF.[64]

The recent progress of Islamic banking in Malaysia has been summarized by the Annual Report of Central Bank of Malaysia (Bank Negara) in the following words:

> With the increasing number of financial institutions offering Islamic banking services, the operations of the Islamic banking system expanded rapidly in 1994. During the year, total assets

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63 "Development of Islamic Banking in Malaysia" in *Money and Banking in Malaysia"* Kuala Lumpur: Bank Negara, 1994, p.334.
64 ibid.

accumulated by the Islamic banking system (comprising BIMB and SPTF ) rose sharply by RM 2.8 billion or II7% to RM 5.2 billion, while total deposits mobilized by the Islamic banking system rose by RM 2.4 billion or 106% to RM I.7 billion, compared with a growth of 3.7 percent in I993. A significant portion (71.4 %) of deposits in the Islamic banking system was in the form of investment deposits which grew sharply by RM 2 billion (156%) to RM. 3.3 billion. . The increase in deposits of Islamic banking system emanated largely from placement by individuals... [65]

Further light on the dynamics of Islamic banking in Malaysia is shed by the Table 1, which gives comparable data about Islamic banking system and other commercial banks.

Table 1

**KEY INDICATORS OF ISLAMIC AND COMMERCIAL BANKING SYSTEMS**

(Figures in RM. Billions)

| **Indicators** | **Islamic Banking System** | **Commercial Banking system** |
|---|---|---|
| Total Assets | 5.2 | 22.8 |
| Total Deposits | 4.7 | 16.0 |
| Total Financing | 1.7 | 19.5 |
| Investment Deposits | 3.3 | - |
| Demand Deposits | 0.8 | - |
| Total Loans | - | 13.4- |
| Loans/Deposit Ratio | - | 83.7% |
| Financing/Deposit Ratio | 36.1% | - |
| Asset/Deposit Ratio | 110% | 98.2% |

Source Compiled from the data given in Annual Report Bank Negara Malaysia, 1994

[65] ibid

Islamic banking system includes the BIMB and all other commercial banks which have been given permission to practice Islamic banking techniques under the interest free banking scheme (SPTF) while commercial banking system includes all other banks. It may be seen that in terms of deposit mobilization, Islamic banking system now offers some competition to conventional banking as its deposits account for at least one fourth of deposits of conventional banks. In terms of asset creation also, Islamic banking system compares quite favorably with the conventional banking system. The conventional system had assets worth of RM 22.8 billion in I994 while Islamic banking had assets worth of 5.2 billion. Hence, in terms of assets and deposits, the Islamic banking system has succeeded in capturing about one fourth of Malaysia money market.

The conventional commercial banks made a total loan of RM I3.4 billion in I994 with a deposit base of RM I6.0 billion having a loan deposit ratio of 83.7 percent. This is an indicator how efficiently the commercial banks used the resources obtained by them. Although financing done by the Islamic banking system is not exactly comparable with the loan operations of conventional banking, financing ratio of Islamic banking (the ratio of total financing to total deposit) may indicate how efficiently Islamic banks were using their resources. It may be seen that financing ratio of Islamic banking system at 36.I percent is not very high. On the other hand, the asset deposit ratio of Islamic banking is rather too high. Partly, it may be due to safe financing policies of Islamic banks and partly due to rather blurred conceptual distinction between financing and investment. However, on the basis of figures what they are, it may be suggested that, probably, more deposit resources should be devoted to provide financing and asset deposit ratio should be retained in the safer limits.

A few remarks are in order before concluding this section. The data reported above have been obtained from the annual reports of the Central Bank of Malaysia. In a way, it represents the official view about Islamic banking in Malaysia. There have been certain doubts about these claims in the circles would like to see more enthusiastic action in favor of Islamic banking. More particularly the magnitude of certain reported variable is subject to scrutiny. It is suspected that proportion of deposits under Islamic banking is not all that high as it is made out to be and that Islamic banking deposits still constitute a very low proportion of the total. The basis for such a suspicion is provided by the Annual Reports of the Bank Negara Malaysia which no where specifically mentions that Islamic banking deposits handled by the bank participating in the interest free banking scheme and conventional deposits handled by the same banks have been separated. It is also not clear if any mechanism to have such a distinction exists.

It has been mentioned earlier that launching of interest free banking scheme (SPTF) in Malaysia has authorized conventional commercial banks participating in the scheme, to practice Islamic banking techniques. From available evidences, it is also not clear whether these banks have been instructed by the central bank (Bank Negara) which is supervising the implementation of interest free banking scheme, to maintain separate accounts for conventional and Islamic banking activities. The successive Annual reports of the Bank Negara are silent on the issue. However, in case separation of accounts is not being observed by the participating commercial banks, it may undermine the confidence of the people in Islamic banking. The people may think that the profits they earn by putting their money in the Islamic banking units of the conventional banks are " tainted by *Riba ".* Hence, separation of accounts appears to be necessary for the success of the scheme itself.

Secondly but more importantly, it would be recalled that Bank Islam Malaysia Berhad (BIMB) has *a Shari 'ah* Supervisory board from the very beginning. This is the standard practice in all Islamic banks all over the world that has been adopted to ensure that banking practices do not trespass the boundaries of *Halal* and enter into the realm of what has been prohibited *(Haram).* However, the available evidences do not suggest any mechanism of *Shari 'ah* supervision that might have hopefully been adopted in the operation of SPTF.

## 3.4 ISLAMIC MONEY MARKET

The Malaysian experiments in Islamic banking becomes more prominent than all such endeavors undertaken so far, because it has attempted to establish an Islamic money market, a feature which is totally absent, for one reason or the other, in all other Islamic banking models. The Islamic inter-bank money market was launched by the Bank Negara Malaysia on January 3, I994 and covered three aspects: Islamic inter-bank investment, inter-bank trading in Islamic financial instruments and Islamic inter-bank check clearing system.[66] All 37 banks taking part in the interest free banking schemes as well as the BIMB are empowered to participate in the Islamic inter-bank money market.

Inter-bank trading of Islamic financial instruments enables the BIMB and other commercial banks participating the SPTF to trade among themselves in Islamic financial instruments such as Islamic bankers acceptance.[67] The Bank Negara will introduce more instruments in due course for this purpose.[68]

Under the system adopted for clearance of checks, all checks and letters of credit issued by the BIMB and the Islamic banking units of conventional banks participating in SPTF are cleared separately under a computerized pool system. The pool system works in such a way that at midnight, the deficit Islamic bank or unit will borrow interest free funds from surplus Islamic banks or units. Any net shortage is covered by the Bank Negara on an interest free basis. The system has the provision to penalize those banks that are found persistent borrowers.[69]

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[66] ibid, p.127.

[67] It may be pointed out that Bankers' Acceptance bill is a debt sold on discount. Hence, it may not qualify to be called Islamic financial instrument. However, it is described as an Islamic financial instrument in the reports of the Bank Negara Malaysia (Malaysian Central Bank).

[68] *Annual Report of Bank Negara Malaysia, 1993,* p. 52.

[69] *International Trade Finance,* August 27, 1993,. p.7.

The system of inter-bank investment may be described as follows: a bank participating in the interest free banking scheme may invest its surplus funds in another bank in the scheme that has a deficit. These funds may be invested on the basis of *Mudaraba*. The period of investment may vary from overnight to 12 months with the profit sharing ratios 70:30 (70% for the provider of the capital) for period less than or equal to one month, 80:20 for the period of one to three months and 90:I0 for period exceeding three months. The minimum of amount of inter-bank Islamic investment has been determined to be RM 50,000 only. The rate of return to the provider of capital would be calculated on the basis of amount of investment, period of investment, gross profit before tax and the profit sharing ratio.[70] The formula for calculating the profit to be paid to the
provider of funds is as follows:

X = P r t (k) / 36500

where

| | |
|---|---|
| | Amount of profit (in Ringgit) to be paid to the provider of funds. |
| P = | Principal investment. |
| | Rate of gross profit (in % per annum ) before distribution or investment for one year of the receiving bank. |
| t = | Number of days invested. |
| k = | Profit sharing ratio. |

The Central Bank of Malaysia, the Bank Negara Malaysia has naturally played a significant role in the establishment of Islamic money market in Malaysia. Although, at theoretical level, a number of instruments have been proposed through which central banks could intervene in the money market, no central bank had been daring enough to experiment with these instruments." The Central Bank of Malaysia has evolved a number

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[70] ***Annual Report Bank Negara, 1993***, p.133.

[71] ***For a Summary of the proposed instruments that could be used the regulation of***

**For a summary of the proposed instruments that could be used for the regulation of**

of Islamic financial instruments which can help in building a viable and efficient Islamic money market. Some of these instruments are: Islamic Accepted Bills (IAB), Islamic Export Credit Refinancing Scheme (IECRS), and Government Investment Instruments (GII) etc.[72] Earlier the government had issued Malaysian Government Investment Certificate and Islamic Accepted Bills in order to satisfy the liquidity requirements of the BIMB. The. IAB were issued in 1983 specifically for the BIMB**.** The MGIC - very similar to treasury bills - were issued to enable to the BIMB to raise resources from the non interesting bearing securities[73]. However, that scenario has changed and now all commercial banks participating in the SPTF can invest in the Islamic financial instruments[74]. Inter-bank trading in Islamic financial instruments received a big boost when the Bank Negara issued two issues of GII amounting to RM I billion and RM 2 billion respectively. [75]

The Malaysia experiment is the first of its kind to establish an Islamic money market. So long Islamic banks have remained either isolated with the money market or their participation in the established money markets have been minimal. At present, mainly because of Islamic prohibition of interest and speculation, Islamic banks can not use the facilities that are offered by the banking system and availed by other commercial banks. For example, the Islamic banks can not avail the facilities of overnight deposits and transactions that give the conventional

Islamic money market as well as practices thus far adopted to regulate and control Islamic banking, of Islamic Banks, see: Ausaf Ahmad, *Instruments of Regulation and Control of Islamic Banks by the Central Banks,* Jeddah: Islamic Research and Training Institute, 1993.

72 Tariqullah Khan, *Country study on Malaysia,* Jeddah: Islamic Research and Training Institute, (unpublished), p. 28.

73 The issue regarding Islamic nature of these instruments and their conformity with the requirements of Islamic *Fiqh* remains unresolved. There are several difficulties. First of all, the technical details about correct nature of these instruments are difficult to come by. Then, the juristic positions adopted appear to bent highly in favor of a particular juristic school.

74 *New Horizon,* London, July 1994, p. 8.

75 *Annual Report Bank Negara Malaysia,* 1994, p.127.

commercial banking system a great deal of flexibility and maneuverability. In case Islamic banks do deposit their financial resources with other banks for short terms, they have to forego interest accrued. Some Islamic banks have made private arrangements with their western correspondent banks for such deposits and movement of funds. The terms and conditions of these private arrangements differ from case to case and no satisfactory arrangement exists. However, this is a fact that inter-bank transactions between the Islamic banks as well as those between the Islamic banks and conventional commercial banks have been hampered by the non availability of short term instruments in which Islamic banks could invest. This had itself adversely affected the growth of Islamic banking. With the establishment of Islamic money market in Malaysia, the interest free bank can resort to more instruments in their short term funding as they can resort to inter-bank borrowing, in a significant manner. It has been estimated by the Bank Negara Malaysia that total transactions in the Islamic inter-bank money market amounted to RM 2.3 billion during the first year of its operation.[76] Although size of this market is expected to grow in future, it is rather early to judge the performance of the market. With the passage of time and when more detailed data become available, then, it would be appropriate to evaluate the functioning of Islamic money market and compare its performance with the conventional interest based market.

[76] ibid.

# IV. ISLAMIC CAPITAL MARKET IN MALAYSIA

Among the newly industrializing countries of Southeast Asia, Malaysia can boast of a robust and flourishing financial system supported by a dynamic and growing economy. The rate of growth of the Gross Domestic Product (GDP) in Malaysia has been hovering around 8% per annum during the last several years. The strong GDP growth has resulted in burgeoning trade surplus, a shrinking national debt and increased manufacturing output. The sectors, which have been growing at a fast rate in Malaysia during the last five years or so include: wood products, textiles, electronics, construction and services. All this dynamism has given birth to a thriving financial sector to the extent that some times there was a fear that Malaysia is being turned into a "bubble economy"."

In addition to a thriving economy, Malaysia has also been hailed as a model" for developing a domestic capital market in Southeast Asia. The presence of such capital markets is a necessary condition for the participation of private sector in infrastructure development and in over all development process. A domestic capital market reduces foreign exchange risk of international investors 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 markets more stable.

A capital market is characterized by the existence of financial instruments, issuers, investors and intermediaries. The issuers issue different kinds of financial instruments to meet their medium and long term capital requirements. These instruments are traded by financial dealers that are called financial intermediaries. Various individual and institutional investors purchase the instruments and thus supply the required capital by investing their saving. A successful and functioning capital market requires all this as necessary ingredients. However, in addition to these, an institutional and legal framework is also required to control and regulate

[77] See, for instance, Saiful Azhar Rosly, "Islam and Investment in the Stock Market" Daily *Sun*, Kuala Lumpur, August 19, 1994, p. 19.

the financial activity. In the earlier part of this section, an attempt shall be made to bring out the contours of the Malaysian capital market. In the later part of the section, the attempts to evolve an Islamic capital market shall be reviewed.

## 4.1 REGULATORY AGENCIES

Following regulatory agencies are responsible for effective functioning of the Malaysian capital market.

### 4.1.1 Securities Commission

A securities commission has been set up to oversee and regulate the securities and financial futures market in Malaysia. It was established in March I992 as a result of promulgation of the Securities Commission Act, I992. The Securities Commission shall regulate and supervise the securities industry. The establishment of securities commission completes the regulatory framework of Malaysian financial system. The Central Bank (Bank Negara) will supervise the functioning of banking system and money market while the Securities Commission will regulate the functioning of capital market, in general, and in particular, supervise the development of securities industry, financial futures, option market, unit trusts and the take over and merger of companies. The operations of the Securities Commissions are financed by charging a levy of 0.03 per % on the value of each transactions of both purchaser and seller of securities on the stock exchange.[78]

### 4.1.2 Kuala Lumpur stock Exchange

Malaysia is one of those few IDB member countries that can boast of having a thriving stock exchange. The existence of a stock exchange is a necessary condition of creating a capital market. Among the Southeast Asian countries, Kuala Lumpur stock exchange is a dynamic and flourishing institution that has registered phenomenal increase in the

[78] *Annual Report Bank Negara 1993,* p.191.

number and value of transactions during the past few years. It is reported that on I5 April I993 the Kuala Lumpur Stock Exchange had a staggering turn over of I.039 billion shares that were worth RM 2.444 billion.[79] The upturn of the market continued up to early I994, when, on January 4, the market capitalization index reached to RM 637.7 billion. The Kuala Lumpur composite Index peaked at I,3I4 points on the January 5, I994 and the daily turn over rushed to a record RM 5.6 billion on the same day.[80] The unprecedented growth has led to some concerns regarding "speculative bubbles". However, since then, some corrective actions have been taken and the market is not that bullish.

## 4.2 PLAYERS ON THE MARKET

In addition to existence of regulatory agencies, who set the "rule of the game" and the instruments through which the "game" is played, a successful and functioning capital market requires a large number of players on the market. This includes both the issuers and investors. Presently, the Malaysia financial system is composed of following institutions:

1. Commercial Banks
2. Finance Companies
3. Merchant Banks
4. National Saving Bank
5. Provident Fund and Pension Funds
6. Insurance Companies
7. Industrial Finance Institutions
8. Housing Credit Institutions
9. Agricultural Credit Institutions
10. Urban Cooperative Societies
11. Leasing Companies.

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[79] "Too Clever by Far" *The Banker* July 1993, p.18.
[80] *Annual Report Bank Negara* 1994,p.178.

A brief introduction of these institutions is presented in the following:[81]

**1. Commercial Banks**

There are 37 commercial banks in Malaysia. All 37 banks are now participating in the interest free banking scheme. In I994, commercial banks had a total deposit of RM I60, 272 million and had advanced loans of RM I34,I5I million.

**2. Finance Companies**

The number of licensed finance companies is 40 of which I2 finance companies are owned by the commercial banks as subsidiaries. There are 860 branches of these finance companies. Nineteen finance companies participate in the inter-bank money market and I3 have been authorized to participate in the interest free banking facilities. In I994. these companies had held total assets of RM 73.5 billion.

**3. Merchant Banks**

The merchant banks had total assets of RM 20.I billion in I994. The activities of merchant banks in the interest free banking scheme (SPTF) expanded steadily. There are three merchant bank which participate in the SPTF. Total deposits under the *Mudaraba* schemes by the three merchant banks amounts to RM 53 million at the end of I994 compared to RM 25 million at the end of I993.

**4. National Savings Bank**

The National Savings Bank is also an important financial institution in Malaysia. At the end of I994, total deposits at the National Savings Bank equaled to RM 4, 309 million. It held federal government's securities

[81] This section is based on the information available in the *Annual Report Bank Negara, 1994*.

to the amount of RM 2, 141 million while its other investment were worth RM I,I08 million.

**5. Provident and Pension Funds**

Various Provident and Pension funds also occupy important place in financial sector in Malaysia. Among these are included: the Employees Provident Fund, the Pension Trust Funds, the Social Security Organization, the Armed Forces Fund, the Malaysia Estate Staff Provident Fund, the Teachers Provident Fund as well as six largest of other approved statutory and private provident and pension funds. At the end of I994, total assets under these funds were RM 97, 02I million and the Malaysian Government Securities held by them were worth RM 42,582 million.

In addition to these institutions, there are life insurance companies, general insurance companies, Industrial finance institutions, Housing finance institutions, Agricultural credit societies, Urban Cooperative Societies, and Leasing Companies. This briefly outlines the contours of the Malaysian financial system, which exhibits both depth and width. Of course, not all of these institutions work on interest free basis. Most of them still operate on the basis of interest. The institutions, which either have converted to interest free basis or have been permitted to practice interest free banking have already been taken note of. However, all these institutions take part in the Malaysian capital market.

Two important developments that have taken place in Islamization of Malaysian capital market are the establishment of an Islamic stock broking facility and the issue of Islamic bonds. Both of these developments are briefly reviewed here.

## 4.3 ISLAMIC INSTITUTIONS IN THE CAPITAL MARKET

It is well known that existence of primary and intermediary financial institutions is necessary for the development and functioning of an effective capital market. These institutions perform the functions of the effective capital market. These institutions perform the functions of the issuer and investors both. Thus, they help the capital market discharge its most essential economic function: bringing financial resources from the surplus households to deficit households and reconciling the preferences of savers and investors. Some of the important financial institutions participating in the Malaysian capital market have been discussed above. Since the evolution of Islamic capital market started in Malaysia, a few Islamic financial institutions dealing in capital market have also been established. Special mention may be made of the following institutions:

1. BIMB Securities.
2. Amanah Saham Bank Islam.

The BIMB Securities is an Islamic stock-broking firm while the Amanah Saham Bank Islam is an Islamic unit trust. A brief profile of both of these institutions is presented below:

#### 4.3.1 AMANAH SAHAM BANK ISLAM (ASBI)

Amanah Saham Bank Islam (ASBI) is an Islamic unit trust fund established by the Bank Islam Malaysia Berhad (BIMB). Its purpose is to provide a channel for the investors to pool their funds and invest in a manner approved by the Islamic *Shari 'ah.* The ASBI is managed by BIMB Unit Trust Management Berhad, which is a wholly owned subsidiary of the BIMB. Investors' resources are mobilized by the trust manager by selling the units, which represent the assets of ASBI. Thus, by purchasing the units, the investor is sharing in the ownership of the assets of ASBI. The manager will invest the resources of the ASBI in a portfolio of investment comprising of shares in the listed and unlisted companies as well as in other forms that are approved by the religious Supervisory Council of the BIMB. Some important features of the ASBI are discussed below: 82

[82] The information reported in this section has been based on the prospectus of Amanah Saham Bank Islam.

The investment objective of the ASBI is to earn reasonable return for its investors by investing the funds investible resources in approved stocks and in other interest free forms of investment that are acceptable from Islamic point of view.

**REGULATION**

The ASBI has declared its intention to conduct its business in strict adherence with the requirements of *Shari 'ah* which shall be controlled and supervised by the Religious Supervisory Council of the Bank Islam Malaysia. The ASBI is subject to regulation by the Securities Commission under its Guidelines to Unit Trust Funds.

**WORKING OF ASBI**

The ASBI will work with the help of a manager and trustee. The manager will issue the unit certificate which are to be bought by the prospective investors. The investors' money shall be deposited with the trustee. The manager shall invest the resources of the Fund in portfolio equities and other forms of investment approved under Islamic principles. The managers shall instruct the trustees to pay relevant stock brokers, financial institutions and government agencies. All securities purchased by the ASBI shall be registered in the name of the Trustee. The profits generated by the authorized investment shall be utilized either to distribute the dividends amongst the investors or to enhance the value of the unit.

**TYPE OF INVESTMENT**

The investible resources of the ASBI shall be utilized to make investment in stocks and shares of approved companies, Islamic money market instruments and Government Investment certificates.

**RESTRICTIONS ON INVESTMENT**

**RESTRICTIONS ON INVESTMENT**

The managers shall not be allowed to invest the proceeds of the ASBI in the securities of the companies dealing with conventional banking and finance, gambling, alcoholic beverages, non *Halal* food products and interest bearing money market instruments.

### 4.3.2 BIMB Securities

The Bank Islam Malaysia Berhad Securities is Malaysia's first full fledged Islamic stock-broking facility. It may also be the world's first such facility. The firm was launched on Aug. 19, 1994. The main purpose of the BIMB Securities is to provide facilities and services in the security industry, which are in compliance with the *Shari 'ah.* The counters offered by the BIMB Securities exclude the companies which exclusively deal with the interest based banking and finance, conventional insurance, gambling, alcoholic beverages and other non *Halal* products. Even with these restrictions, the BIMB Securities is able to offer about 230 counters.

It is expected that at least one third of Bank Islam Malaysia's stock portfolio shall be covered by the BIMB Securities which shall be able to manage to the portfolio rather efficiently in comparison to other stock-broking houses because preferences of the investor and portfolio manager match exactly.

In addition to the BIMB Securities, another stock-broking firm Rashid Husain Securities also claims to be operating on the Islamic principles.[83] However, it has been found that it has only established an "Islamic" subsidiary while the parent firm continues on the conventional basis. It may be noted that while the BIMB Securities started anew as an Islamic stock-broking institution, the Rashid Husain Securities was "in existence" . conventional stock-broking firm to have established an "Islamic" subsidiary in order to convert at least some of its operations on the Islamic basis. It is reported that several big institutional investors like

[83] *Daily Business Times,* Kuala Lumpur, January 16, 1995.

the Employees Provident Fund, the Armed Forces Beneficiary Fund, the Pilgrims Fund Management Board etc. are exploring the possibilities of channeling their investments through these Islamic stock-broking firms.

For functioning of Islamic stock-broking firms, some general guidelines have been worked out which ensure that activities of these firms will continue to remain within the boundaries set by the Islamic principles. Some of these guidelines are:

- The Islamic stock-broking firms shall continue to be governed by the general regulatory framework of the Kuala Lumpur Stock Exchange (KLSE). However, an Islamic Stock-broking firm shall comply with the precepts of Islamic *Shari 'ah.*

- These firms shall deal only in shares that are on the list of approved securities.

- The list of the approved securities is to be updated form time to lime as and when companies acquire or divest businesses that may be approved or disapproved from an Islamic point of view.

- The list of approved securities excludes the securities of those companies which have significant involvement in interest based banking and finance company services, conventional insurance, gambling, alcoholic beverages and other non *Hall* products and activities. It may be suspected that it leaves little room for the Islamic securities firm to operate. However, it is pointed out that even with these restrictions, Islamic stock-broking may recognize nearly 280 or 60% of 478 counters available on the KLSE. Hence, the Islamic stock-broking firms may be able to diversify their investment portfolios.

- The short term investment of Islamic stock-broking firms shall remain confined only to the instruments available in the Islamic money market.[84]

## 4.4 ISLAMIC FINANCIAL INSTRUMENTS

Financial instruments that can be traded on the market are a necessary ingredient of capital markets. In the first section of this paper a brief survey of those proposals has been undertaken that have been advanced from time to time by the Islamic economists and bankers for devising financial instruments conforming to Islamic law. In this section, some of those financial instruments have been examined that have been issued and used in Malaysia.

### '4.4.1 Government Investment Certificates

Malaysia was the first country to experiment with the issue of government bonds on Islamic basis. For this purpose, Government Investment Act was promulgated as early as 1983. The Act empowers the government to issue Government Investment Certificates (GIC). These certificates are regarded as liquid assets and Islamic banks could invest in these certificates to fulfill the central bank's requirements regarding liquidity as well as to place their excess idle funds.

In the beginning GICs were being issued only on an experimental basis and its main function was to help the Bank Islam Malaysia, the only Islamic bank of the country at that time, in meetings its prescribed liquidity requirement as the Bank, being an Islamic bank, could not keep its liquid assets in the form of interest bearing assets. However, since then, the GICs have acquired the character of a full scale Islamic financial instrument. In 1993, the Government of Malaysia floated three issues of non-interest bearing GICs with different Maturities amounting to RM 1.2 billion. This was the largest issue since 1983 when the GICs were first issued. Main reason for such a large issue was the increase in demand for interest free

[84] ibid.

financial papers which came as a result of increase in the number of financial institutions offering Islamic banking products. Hence, these institutions wanted more GICs for meeting statutory liquidity requirement as well as to place their excess liquid funds.[85]

**4.4.2 CAGAMAS MUDHARABA BONDS**

The Cagamas Mudaraba Bonds (CGMB ) were launched on March 1, 1994. This is claimed to be the first mortgage bonds in the world to be issued on the basis of Islamic principles. The working of the CGMB is explained below:

The CGMB combines two basic concepts: *Bai' al Dayn* (sale of debt or debt trading) and *Mudaraba* (profit sharing). The bonds are issued on the basis of *Mudaraba* in which the bondholders and the Cagamas 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 first CGMB issue was of RM 30 million. Its duration was three years with a profit sharing ratio of 90:10 (90% for the bondholder and 10% for the Cagamas). 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 authorized to purchase CGMB. The Annual Report of the Malaysian Central Bank claims the merit of GGB saying that, " the new scheme would enable financial institutions, *which* offer financing of house purchases on Islamic principles to obtain a continuous refinancing facility from Cagamas so that they would be able to provide house financing to a large group of people. The existence of refinancing facility would also

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55 For details see, ***Annual Report Bank*** *Negara 1993,* p. 201.

enable the financial institutions to grant Islamic house financing at reasonable rates.[86]

The Cagamas Berhad (the National Mortgage Corporation) a public limited company, which is incorporated under the Malaysian Companies Act 1965, issued RM 30 million unsecured bearer *Mudaraba* bond on 25 March 1994. The information memorandum of the bond issue specified, under principal terms of the issue, that bond holders and the issuing company shall share a specified ratio of profits generated from the company's operation in the purchase of Islamic housing debts and the income earned from the reinvestment of reflows of funds from the repayment of debts. In accordance with the stipulations of *Mudaraba,* the bondholders, in their capaci**ty** as provider of funds *(Rabb al Mal)* had to bear entirely any loss or diminution of capital.

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. The information memorandum of the bond issue testifies that the purpose of the issue is to "finance company purchase of a pool of Islamic housing debts". It is well known that purchase or transfer of a debt, in Islamic jurisprudence, is allowed only under certain specific conditions.[87] The first and foremost condition is that "the assigned debt should be defined, fixed, due and equal in quantity and quality to the debt which was the cause of the

86 *Annual Report Bank Negara 1993,* pp. *52-53.*

87 The transfer of debt is treated in the Islamic jurisprudence under the heading *Hawalat al Dayn.* According to famous compendium of Islamic law according to Hanafite School, *Majalla, "Hawalat al Dayn* is that it amounts to the transfer of a debt from one *dhimma* to another *dhimma."* See Nabil Saleh, *Unlawful gain and Legitimate Profit in Islamic law,* London: Graham & Tronton, 1992, *p. 102.* It could be seen that the case behind the issue of Cagmas bonds comes within this definition of *Hawalat al Dayn* as bonds transfer the ownership of the debt from one agency to another.

assignment."[88] It means that debt can not be sold or bought like the sale and purchase of other commodities.

On the transfer of ownership of a debt from a debtor to another person, there is more than one opinion in the Islamic jurisprudence. According to one opinion, transfer of debt from a debtor to another is allowed with or without consideration. The second opinion does not allow it. According to this opinion, the transfer of a debt may take place either through *Hiba, Bay'* or *Ijar.* In all the three cases, it may not be allowed as the person transferring the debt does not have the *Mal* in his possession, and is not capable of delivering it. Further, there may be *Gharar* (excessive lack of certainty or mis-specification) in the contract. Hence, it is not permissible. According to a third opinion, transfer of debt is not allowed in general but may be allowed only through *Wakalah* (agency) *or Wassiyab* (Will).[89]

It appears that the *Shari'ah* position behind the Cagmas bonds is has been heavily influenced by just one opinion and other viewpoints have not been paid enough attention. The dominant view amongst the Islamic scholars is that an out right sale of a debt is not permissible. There are other aspects of the deal that also need to be carefully considered and cleared from the *Shari 'ah* point of view. There are at least four parties that are apparently involved in the deal implied in the sale of CGMB: financial institutions, individuals that obtain housing loans from these institutions, Cagamas corporation and bondholders. There is a deal between the financial institutions and individuals on the basis of which the financial intuitions grant housing loans to individuals. There is another deal between the Cagamas and bondholders. The Cagamas issues the bonds, collects the proceeds and purchases the housing debts from the financial institutions. Then, debtors pay back their debts to the Cagamas. The issuers and

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[88] Nabil Saleh, ibid, p.103.

[89] *Al Mawsu 'ah al Fiqhiya* (Encyclopedia of Islamic jurisprudence ), Ministry of *Awqaf and* Islamic Affairs, Kuwait, Vol. 21 Chapter on Dayn, pp.127- 132.

promoters of the Cagamas bonds maintain that there is a transfer of debt *(Hawalat al Dayn).* However, this is not a case of transfer of debt as much it is a case of a sale of debt *(Bay' al Dayn) in* which a claim is being sold for a price that is different from the original amount of debt. Further, it is said in the memorandum of the Cagamas bond that "the profits from the Islamic housing debts and other Islamic financial assets accumulated during a Coupon Payment period would form the basis for computing the amount of coupon for that period. The profits would be distributed according to the specified profit sharing ratio to the bondholders and the Cagamas...." [9°] It is not at all clear how these profits are generated. In case housing debts are purchased for the same nominal amount, then, the scheme of profit generation should be spelled out and in case, there is any discounting of the purchased debt, then, it may involve *Riba,* that is prohibited. Hence, the whole transaction merits close examination from the point of *Shari 'ah.*

[90] See section iii on yield of bonds in the information memorandum of Cagamas Mudaraba bonds.

# V. CONCLUSION

Probably it could be said without much fear of contradiction that Islamic banking has become an established reality of our times. However, it is an evolving and dynamic reality. If one makes a survey of present scene of Islamic banking, three distinct patterns of Islamic banking may be noticed. These patterns may be described as the macro model, the individual bank model, and the dual system model.

The Macro Model of Islamic banking is characterized by a version of Islamic banking which claimed to be implemented in Pakistan, Sudan and Iran. The efforts were undertaken in these countries, to introduce Islamic banking at an economy wide level by changing the entire existing structure of commercial banking. Although the experience of each of these countries in the area of Islamic banking may be considered unique and has met with varying degree of success, there is at least one thing common among them. In all of these countries, Islamic banking was attempted to be introduced from the top through an administrative fiat. The individual bank model of Islamic banking is common mostly in the Middle East and elsewhere. Under this model, the permission is granted by the government either to one or more Islamic bank to function under the existing laws or under a special charter. The individual Islamic banks have succeeded in providing a viable alternative to interest free banking activities in the countries where they function, at least to the customers who do not wish to transact business with conventional system of banking. To the extent of these bank users, these Islamic banks have succeeded in providing an alternative way of commercial banking. However, these banks are not in a position to implement the Islamic banking system per se. The essence of commercial banking is not the operation of an individual bank in isolation with other banking and financial institution. Commercial banking assumes unprecedented economic and financial might when all banks are taken together. The commercial banking system allocates the financial resources of the economy among competing uses. It is the efficiency of the whole system that affects and directs the economic activity. It is the working of the banking system in its totality that works as a lubricant to economic system. The individual Islamic bank can contribute to provide an interest free banking service as an alternative to interest based banking product but they can not contribute to attainment of macro economic objectives of Islamic economic system in any significant measure.

The third model of Islamic banking is to develop an Islamic banking system in its totality side by side with the existing system. It is the model, which has been chosen in Malaysia. Probably, the choice has been influenced,. in addition to the economic reasons given by the Bank Negara, Malaysia, by special ethnic composition of the country. Malaysia is a multi-lingual, multi-racial and multi-religious society. Although Islam is recognized as official religion of the country, local Malay Muslims, (sons of the soil or *Bhumiputra* as they are known in Malaysia) constitute only 55% of population. The Chinese and Indians are other important ethnic groups in the country. The classification based on the concept of *Bhumiputra is* not a classification based on religion as not all *Bhumiputra* are either Malay or Muslims. A substantial number of *Bhumiputra* are from Sarawak and Sabah who are neither Malay nor Muslims. The *Bhumiputra* classification also underscores the rural urban dichotomy as most of *non-Bhumiputra*, mostly Chinese, are of urban origin and most of *Bhumiputra*, mostly Malay, are of rural origin.[91] The distribution of income between the urban and rural as well as between the non-*Bhumiputra* and *Bhumiputra* was very uneven and highly skewed in the favor of the former in comparison to the latter. This was manifested in the ethnic and racial riots of 1960s after which a New Economic Policy was adopted to take corrective measures. The new policy was aimed at eliminating poverty irrespective of racial origin and restructuring of Malaysian society in which economic vocation and specialization instead of ethnic identity would be the distinctive feature.

It was only natural that, under these circumstances, a gradual approach to introduction of Islamic banking in the country be adopted. The era of Islamic banking in Malaysia started with the passage of Islamic Banking Act, 1983. The Bank Islam Malaysia Berhad was established under the provisions of this Act. For about a decade the Bank Islam Malaysia remained the only Islamic banks not only in Malaysia but also

[91] Omar Farouk, "The Muslims of Southeast Asia" in Mohammad Ariff, *Islamic Banking in Southeast Asia,* Singapore: Institute of Southeast Asian Studies, 1983, p.20.

almost in the entire Southeast Asian region and enjoyed the monopoly on the Islamic banking products and services in Malaysia. Thus, Malaysia relied on the individual bank model for a long time before it embarked on building a dual system of banking comprising of conventional and Islamic banking systems. The advantage of this gradual approach was that the success of the Bank Islam Malaysia helped to remove any doubts about the feasibility and viability of Islamic banking. Further, it gave the Islamic bankers an opportunity to improve and perfect various Islamic banking products. Further, it created a favorable climate in which bolder experiments of introducing Islamic system of banking and financing at the economy wide level became possible. It was also a wise choice keeping the diverse and complex ethnic structure of the country. A system of banking and finance in which the Islamic and conventional banking systems exist side by side gives the non-Muslim population a choice for opting for conventional system reducing any possibility for social conflicts. Thus, it may be concluded that gradual approach of introducing Islamic banking system did pay rich dividend in Malaysia.

However, the role of state in the development of a parallel system of Islamic banking and finance may not be underestimated. In most of the Islamic countries, with the possible exception of those countries where macro model of Islamic banking has been experimented, the state has adopted only a permissive role with respect to Islamic banking. However, in Malaysia, the state has assumed the role of an enthusiastic supporter. However, it has not been the intention of the government to develop Islamic banking as a state enterprise. On the contrary, and very rightly so, in this era privatization, the state has confined itself only to provide necessary framework and left the rest on the private initiative. Thus, the government promulgated the Islamic Banking Act of 1983. The Bank Islam Malaysia Berhad (BIMB) was started with the initiative of the government of Malaysia. The Federal government of Malaysia and its related agencies contributed the bulk of subscribed capital, although the BIMB is not formally owned by the government.[92] Further, a financial

[92] The BIMB had an authorized capital of M$ 500 million, divided into 500 million shares of one Malaysian dollar each. The bank started its operations with a subscribed capital of M$ 80 million which was contributed by different agencies as

instrument, government Investment certificate was also created way back in 1983 that can be used for satisfying the liquidity requirements.

During early nineties the process of establishing a parallel Islamic financial market has been accelerated. The Interest free banking scheme was launched which in the beginning was confined only to three large banks but now has engulfed all 37 commercial banks as well as several merchant banks and finance companies. From a modest start, Islamic banking and finance in Malaysia has come to a position where it could be conceived of as a parallel system. It has a money market. It has intern bank transactions having a check clearing system of its own. It covers to financial sector having Islamic insurance companies, and Islamic security houses. All necessary ingredients of a financial markets, i.e. financial instruments, financial institutions, rules and regulations, etc. have been put in place although there is a need of *Shari'ah* review of some of the financial instruments. Thus, Malaysia has become the first country to experiment with establishment of Islamic financial market side by side with the conventional system. How Islamic system would fare in comparison to conventional system? It is too early to tell. However, it may be said that concepts of Islamic banking and finance have been put to their toughest test in Malaysia. If it can succeed in the face of a well-established, functioning and dynamic financial system in Malaysia, it may succeed elsewhere also.

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subscribed capital of M$ 80 million which was contributed by different agencies as follows:

| | **MS Million** |
|---|---|
| Government of Malaysia | 30 |
| Pilgrims' Management and Fund Board | 10 |
| Muslim Welfare Organization of Malaysia | 5 |
| State Religious Councils | 20 |
| State Religious Agencies | 3 |
| Federal Agencies | 12 |
| Total | 80 |

The data has been reported by Zakariya Man, (1988).

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# ISLAMIC DEVELOPMENT BANK (IDB)

**Establishment of the Bank**

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent by a Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Qa'da 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank formally opened on 15 Shawwal 1 395H (20 October 1975).

**Purpose**

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari'ah.*

**Functions**

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari'ah.*

**Membership**

The present membership of the Bank consists of 50 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

**Capital**

The authorized capital of the Bank is six billion Islamic Dinars. The value'of the Islamic Dinar, which is a unit of account in the Bank, is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund. The subscribed capital of the Bank is 3,654.78 million Islamic Dinars payable in freely convertible currency acceptable to the Bank.

**Head Office**

The Bank's headquarters is located in Jeddah, Saudi Arabia and it is authorized to establish agencies or branches elsewhere.

**Financial Year**

The Bank's financial year is the Lunar Hijra year.

**Language**

The official language of the Bank is Arabic, but English and French are additionally used as working languages.

## ABOUT THE AUTHOR

**Dr. Ausaf Ahmad** (born 1945) is associated with the Islamic Research and Training Institute of the Islamic Development Bank since 1983. He obtained in Master's degree in Economics with distinction from Lucknow University, India in 1969. He did M. Phil in Regional Development from Jawaharlal Nehru University, New Delhi in 1974. He was awarded Fulbright Hays Scholarship to study in the United States where he obtained Ph.D. in Economics from Northern Illinois University in 1977.

Before joining IDB, Dr. Ausaf Ahmad was associated with the Departments of Economics in many universities. He taught economics to graduate and undergraduate students at Aligarh Muslim University, Delhi University and Jamia Millia Islamia in different capacities. He was professor of Economic 'Development at the Academy of Third World Studies, New Delhi. He has carried out several research projects for the Indian Council of Social Science Research, New Delhi, International Labor Office, Geneva, and King Abdul Aziz University, Jeddah.

His research works, which include 25 research papers and 14 books, have been published in India and abroad. His many works have been translated into other languages including Urdu, Arabic, French and Italian. Economics of Development, Public Finance, Monetary Policy and Islamic Banking are main areas of his research. His main works include:

*Saving Behavior. in a Metropolitan Economy*
*Development Issues of the Third World*
*Development and Problems of Islamic Banks*
*Lectures on Islamic Economics*
*Contemporary Islamic Financing Techniques*
*Indian Muslims: Issues in Social and Economic Development*

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