

Growth and Prospect of Islamic Finance in Malaysia

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Abstract—Over the past three decades, the Islamic finance industry has emerged as one component of a competitive and comprehensive market, consistent with the conventional financial system in contributing to economic development. Although in early development the Islamic financial system is concentrated just in the country, but its growth internationally has seen a positive trend with the creation of growth in the number of Islamic financial institutions, with shareholders from various countries. This paper provides insights into the practice and prospect of Islamic finance in Malaysia. The application and mechanics of Islamic Finance are examined in the light of Islamic Finance Guidelines issued by Central Bank of Malaysia. As will be evident in this paper, this system has its own advantages and value added which would make it the system of choice in meeting specific investment interests and needs.

Keyword : Islamic finance, growth, prospect, Malaysia.

I. INTRODUCTION

Islamic Finance is governed by the Shariah (Islamic Law), sourced from the Quran and the Sunnah, which are followed by the consensus of the jurists and interpreters of Islamic law. According to Shariah, the Islamic mode of finance should emphasize profit and loss sharing and prohibit fixed-returns. In other words, any predetermined payment over and above the actual amount of the principal (i.e. interest) is prohibited. The Shariah also prohibits activities related to uncertainty, risk and speculation. Investment in businesses dealing in alcohol, drugs and gambling, which are considered unlawful or undesirable also included in this prohibition (Grail, 2007). Islamic financial system should be based on Islam fully, not just the name and label only. It must reflect the philosophy, values, ethics and objectives of Islamic Shariah.

The evolution of the Islamic finance in Malaysia has followed in the wake of innovations in the global financial services industry. A natural progression of the Islamic finance industry are competitive retail offerings,

sophisticated corporate banking products, innovative project finance solutions and commercial banking.

When Islamic finance started at 1970's, the initiative offered simple banking solutions that encourage savings and financing. The products were structured in a manner that is in line with Shariah principles and easily understood by the public at large. In 1980's, showed an increase of Islamic financial products, which is project finance and syndications. In the 1990's, Ijarah and equity are included and in the 2000's, sukuk, structured and alternative assets, liquidity and management tools also are implemented.

Today, Islamic finance in Malaysia is a dynamic industry that is widely regarded as a competitive alternative to conventional financing solutions. There are now diverse local and foreign players in the market, showcasing their dynamism with a wide array of innovative financial products and services on offer. Islamic banking now comprises 20% of the total banking sector, complemented by a vibrant Islamic capital market, where 55% of outstanding domestic private debt papers are sukuk, representing the largest volume of sukuk issuances globally.

II. PRINCIPLES AND PRODUCTS OF ISLAMIC FINANCE

Basic elements of Islamic finance include profit and risk sharing, transparency and full disclosure, good governance, value-based innovation and principles of justice. These collectively provide implicit checks and balances in the system. Currently, the guiding principles regarding Islamic finance include the following:

1. Any predetermined payment over and above the actual amount of principal is prohibited.
2. The lender must share in the profits or losses arising out of the enterprise for which money was lent.
3. Making money from money is not acceptable by Islamic law. Money is only a medium of exchange, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else.

4. *Gharar* (uncertainty, risk or speculation) is also prohibited.

5. Investments should only support practices or products that are not forbidden (or discouraged) by Islam.

The following is a brief description of Islamic financial products: (Imady and Seibel ,2006) (Grail, 2007)

i) Profit sharing financial products

- *Musharakah*- It is joint venture. Under *Musharakah*, all the partners contribute funds and have right to participate in the management of the business. Profits are shared in an agreed ratio but losses are shared in the ratio of capital invested. Contributions can be made either in cash or in kind.

- *Mudarabah*- It can be categorized into asset based, liability based and profit sharing. Under *Mudarabah*, one party provides 100% capital and the other party manages the investment project. Profits are shared in a pre-agreed ratio whereas losses accrued are borne by the provider of capital only. *Mudarabah* is often used for investment funds, where investor provides money to the Islamic bank, which the bank invests charging a management fee.

- *Qard Hasan*- charitable loans free of interest and profit-sharing margins, repayment by installments. Modest service charge is permissible.

- *Wakalah*- a bank is authorized to conduct business on customers' behalf.

- *Hawalah*- an agreement by the bank to undertake some of the liabilities of the customer in return for a service fee. The customer pays back the bank when the liabilities mat.

ii) Advance purchase financial products

- *Murabahah*- It can be categorized into asset based and cost plus financing. Bank purchases the commodity and resells it at a predetermined higher price to the capital user, disclosing the margin of profit included in the sales price. The client pays for the goods in deferred payments or over a stated installment period. In case of default the client is liable only for the contracted sale price

- *Istithna'*- It can be categorized into asset based and commissioned manufacturing. Under *Istithna'*, a party (bank) undertakes to produce a specific thing that is possible to be made according to agreed specifications at a determined price and fixed date of delivery. As banks do not normally carry out manufacturing, a parallel contract for manufacture is instituted. The bank charges the buyer the price it pays to the manufacturer plus a reasonable profit (monetary installment) and takes the risk of manufacture of the asset.

- *Mu'ajjal*- a sales contract that allows purchase with deferred delivery.

- *Ijarah*- It can be categorized into asset based and leasing.

The bank buys and leases out the asset for a rental fee, which includes the capital cost of the equipment plus a profit margin. The ownership of the equipment remains with the lessor bank and in case of a finance lease, is transferred on pre-determined terms. It was available under both operating lease and finance lease (*Ijara-wa-iktana*). Widely used in house and aircraft financing.

- *Tawarruq*- It can be categorized into asset based and monetization of commodity. *Tawarruq* is the mode adopted by banks to lend cash and the customer buys a commodity from the bank under *Murabahah* which is then sold to a third person on cash at a price less than the purchase price. The customer hence obtains cash without taking an interest-based loan. If the customer resells that commodity to the bank, it is called *Al'inah*.

iii) Deposit products

- *Wadi'ah*- deposits, including current accounts (*giro wadi'ah*).

- *Mudarabah*- deposit products based on revenue-sharing between depositor and bank, including savings products that can be withdrawn any time and time deposit products.

- *Qard al-Hasanah*- unremunerated deposit products, usually for charitable purposes.

iv) Insurance products

- *Takaful*- It was an Islamic insurance. *Takaful* is insurance based on mutual co-operation, responsibility, protection and assistance between groups of participants. It is a kind of a cooperative insurance wherein members contribute a specific sum of money to a common pool. Every policyholder pays his subscription to help those that need assistance. Losses are divided and liabilities spread according to the community pooling system.

iv) Sukuk

- *Sukuk*- Islamic bond. *Sukuks* are similar to conventional bonds with the difference that these are asset backed and represent proportionate beneficial ownership in the underlying asset. *Sukuk* holders are entitled to a share in the revenues generated and in the proceeds of the realization of the *Sukuk* assets. The overall *Sukuk* market size is estimated to be close to USD 50 billion globally as of the end of 2006. (Development Bank of Malaysia, 2006)

All Shariah-based products, including private equity, project financing, organization and *sukuk's* issue and fund management products, assets and property. This proved successful Islamic financial services emerged as one of the fastest growing services in the financial services industry.

III. ISLAMIC FINANCE IN MALAYSIA

The early history of Islamic finance in Malaysia has been affected by external and internal factors. External factors began with the establishment of the Mit Ghamr Local Savings Bank of Egypt in 1963 that sparked the development of modern Islamic banking system, followed by the establishment of the first Islamic Bank of Dubai UAE and the Islamic Development Bank (IDB) in Saudi Arabia in 1975. Internal factors played an important role in promoting Islamic banking system is the mission, the strengthening and consolidation of religious knowledge among the Muslims through the institutions of formal and informal education. In addition, awareness among the Muslims is also influenced by the success of the Tabung Haji as a respected financial institution.

The Islamic financial system in Malaysia comprises of banking institutions and companies offering discount schemes *takaful*, leasing companies, leasing, institutional development costs, savings institutions, cooperatives,

mortgage institutions, the Pilgrims Fund Board, the management of the institution of zakat, the national endowment institution, agency credit, rating agencies and fund management companies. The system also includes financial markets, accounting for offshore financial markets, money markets and foreign exchange, Islamic government securities, Islamic private debt securities, shares, unit trusts, insurance agencies and financial security.

Today Islamic finance has evolved into a complete and competitive form of financial intermediation that serves both Muslim and non-Muslim consumers and businesses. The Islamic finance industry is currently worth more than \$1 trillion and growing at a rate of 15-20 percent annually, with projected growth to reach \$2 trillion in the next 3 to 5 years, as more countries around the world seek to further develop Islamic finance within their jurisdictions. The appeal of Islamic finance has led a number of established conventional players to enter the industry, thus widening the diversity of Islamic financial institutions and its product range. The impressive growth however is not confined to the Muslim world, but spans across the West and the Asia Pacific region where the growth is driven by commercial and business considerations. (Zeti Akhtar Aziz, 2008)

Malaysia is the largest Islamic banking and financial market which valued RM113.5 billion (US\$30.9 billion) in Islamic banking assets, RM6.2 billion (US\$1.7 billion) in Takaful assets and the largest Islamic Private Debt Securities (IPDS) market attained RM125 billion or US\$34 billion (45.5%) of domestic corporate bonds. Active Islamic money market channelling about RM30 billion - RM40 billion monthly. (Central Bank of Malaysia, 2008)

The following is the summary of growth and development of Islamic financial in Malaysia.

A. Government Regulations and Incentives.

Based on the legal infrastructure of the existing Islamic finance, including Islamic Banking Act 1983, Act 1984 and Government Funding Act 1983, Malaysia has provided a legal framework for the further development of Islamic financial system in Malaysia. It aims to give due recognition to the Islamic financial system that operates in tandem with the conventional financial system and give the task to the bank and other government agencies to promote Malaysia as an international Islamic financial center.

10 Year Master Plan for the development of global Islamic financial industry been undertaken and it is a collaboration between the Islamic Development Bank (IDB) and the IFSB. Perhaps that the development of efficient measures will be taken. In addition, it is also the best guide for every cooperation to contribute to economic growth. This plan also emphasized the importance of the level of understanding and awareness of investors, who want to join Islamic financial system by providing information about the expected level of performance and shariah law is the cornerstone to any investment details. (Plan of The Financial System Malaysia, 2002).

On 9 February 2006, the Central Bank of Malaysia announced a new Islamic monetary instrument, called the Sukuk Ijarah. It seeks to manage liquidity in the market and

the first issue of these instruments amounted to RM 400 million.

Advances in ICT also have a significant impact on Islamic financial operations. On this awareness, the Central Bank of Malaysia has developed a website on the market, namely Islamic Interbank Money Market (IIMM) as an initiative to disseminate information more efficiently, to facilitate investment decisions and enhance public confidence in their investments.

Malaysia had also earlier launched the first global Islamic derivatives master agreement (IDMA) in 2007 to develop hedging tools for the Islamic financial markets to manage investment risks. This was followed by the Interbank Murabahah Master Agreement (IMMA), which was signed in August 2009 by Malaysian Islamic banks, designed to facilitate effective risk and liquidity management through Shariah-compliant deposit placements using the commodity murabahah concept.

B. Islamic Organization

Islamic Financial Services Board (IFSB) established on year 2002. It seeks to outline the standards of financial prudence of Islam. IFSB has also joined the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) that was established in 1990. These two organizations have collaborated in producing an international best practice in development of global Islamic finance. Significantly, this effort is to ensure the resilience of Islamic finance is more sustainable.

On 24 June 2006 at the Islamic Finance Summit, Governor Tan Sri Dato 'Dr. Zeti Akhtar Aziz spoke, there were four main challenges that must be addressed to sustain the development of Islamic finance in the global financial system. First, the development of a robust financial system at the national, international Islamic financial market development, efficient and effective manner, implementing standards and IFSB standards of adequate human capital development.(Zeti Akhtar Aziz,2006)

C. Education

On year 2005, the International Centre for Education in Islamic Finance (INCEIF) was established to develop human capital to meet the needs of the industry domestically and internationally. For starters, the Central Bank of Malaysia has established an endowment fund of RM500 million.

D. Cooperation Between Countries.

On 19-20 May 2010, cooperation between INCEIF and Islamic Finance Industry United Kingdom was held at Multipurpose Hall, INCEIF, proving that Islamic financial system in the world market value. (ISRA Report, 2010)

Malaysia, United Kingdom and Hong Kong has declared intention to become the Islamic Financial Base. The existence of this center to facilitate the transaction and would further strengthen relations between the countries. (ISRA Report, 2010)

E. Banking.

Islamic banking and financial system in Malaysia has shown a remarkable development and improvement. Before 1993, Malaysia has only one Islamic bank with 36 branches is limited. However, after the government introduced a scheme of Interest Free Banking in 1993, Islamic banking is now available in nearly 2,500 branches of Islamic banks, commercial banks, merchant banks and finance companies.

According to the Economic Report 2001/2002, at the end of July 2001, the Islamic banking system consisting of Holdings, Bank Malaysia Bhd and 35 other financial institutions (14 commercial banks, nine companies, five merchant banks and seven discount houses) that offer services Islamic Banking Scheme (IBS).

In the current international financial, Islamic finance in Malaysia is among the fastest growing areas and competitive. This development triggered the need for financial institutions to be more dynamic in the development of Islamic products, other than to strengthen their skills and diversify their products.

IV. CHALLENGES AND OPPORTUNITIES IN ISLAMIC FINANCE

A. Challenges in Islamic Finance

Shariah principles adopted are intended to ensure the validity of the entire operation. However, there are issues such as differences in interpretations of shariah among the countries involved. This has led to the existence of many ruling on an issue. There is a difficult situation when cooperation between the countries was held because many countries still do not have provisions on the shariah advisory services. Each country has different laws and some laws require amendments before the Islamic financial system to operate. In addition, there are various forms of tax to be accounted for. So, those involved need to formulate an appropriate law. The author believes that all countries involved should formed Global Shariah Advisory Council together. This collaboration may be difficult to interpret, but if successful, it will pave the way for Islamic financial system to move forward. Besides that, the challenges in the Islamic financial system is comprised of product innovation, efforts to penetrate the global market, bridging the gap of knowledge, transparency, and maintain the identity of the unique features of Islamic financial system.

Although the INCEIF, ISRA and other organizations actively disseminating information, but information dissemination through partnership forums, training and education center should be improved. Effectiveness of the efforts made should be a priority. However, the most important challenge is the global market. This is because every decision must be evaluated, whether it is driven by market forces, or in accordance with shariah law.

Muslim community itself must be wise to consider how to outline the level of harmonization of standards without interfering with the smoothness of a product that has the potential to be marketed. For those who are "familiar" with the practices of the conventional financial system, they will

tend to ask for the same product with the characteristics of conventional products. This make the unique features of Islamic finance become difficult in application and lost identity. Thus, the conversion of conventional products is very important and necessary in accordance with Islamic financial system.

B. Opportunities in Islamic Finance

There are existing markets and new markets in the global Islamic financial. The existing countries are Malaysia, UAE, Bahrain, Qatar, Brunei, Indonesia, Pakistan and Sudan. Potential new markets are United Kingdom, Hong Kong, Singapore, Thailand, Japan and USA. Currently, there are over 300 Islamic financial institutions in more than 75 countries though they are mainly concentrated in the Middle East and Southeast Asia, but are also gaining popularity in Europe and the United States. It is estimated that the industry will grow at a rate of 15 to 20 percent annually, from current assets of US\$300 billion (Al-Salem, 2008).

Furthermore, exploring new markets can be realized with more efficient when there is cooperation with various institutions that conduct research in Islamic finance such as:

- i) Islamic Research and Training Institute, IDB
- ii) Centre for Research in Islamic Economics, King Abdul Aziz University
- iii) Salih Kamil Centre for Islamic Economics
- iv) Durham University in U K
- v) OCIS (Oxford Centre for Islamic Studies)
- vi) IIFM (International Islamic Finance Market)

Prospects for the development of Islamic finance should contain a balanced development of the shariah and integrated market by the prospect of a unique Islamic finance. In addition, the products and services must also not limited to Muslim's market only. But, also emphasizes acceptance and applications globally. The creation of many innovations and initiatives have also contributed to the advancement of Islamic financial system. However, the challenges can be overcome by increased effort in every cooperation, increase understanding of the shariah concern, mutual respect and collaboration practices.

Islamic finance has a role in shaping the future of the global financial system and reinforcing ethical and moral values that are inherent in Islamic finance principles and fundamental towards promoting the stability of the global financial system. Ongoing efforts to further strengthen the resilience of Islamic financial industry would enhance the prospects for global growth and the potential of Islamic finance to contribute toward global financial stability. (Mushtak,2010)

V. CONCLUSION

Currently, Malaysia is considered to have a comprehensive Islamic financial landscape. However, to ensure the effectiveness and competitiveness of this system continues, the institutional infrastructure of Islamic finance should be further enhanced. Each of the dissemination of information should have access to it. This is important so that investor's awareness of the unique features of Islamic financial system will be increased.

Islamic financial industry should be prudent and it is time for it to keep its financial system from imitating the practices of conventional products. This is because identity is an important financial and compliance with Islamic Sharia as the basis for Islamic finance and sharia maqasid be considered.

Thus, Islamic finance is emerging as a rapidly growing part of the financial sector in the Islamic world. Islamic finance is not restricted to Islamic countries, but is spreading wherever there is a sizable Muslim community. Islamic Financial System shall be based on the philosophy of Islam as it is part of the teachings of Islam itself.

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