

The Role of Islamic Financial Institutions in the Socio-economic Development in Malaysia

MUHAMMAD ANWAR

It is a truism to say that the financial sector plays a critical role in the socio-economic development of any country. Financial institutions provide for effective mobilisation and allocation of savings and this contributes effectively towards socio-economic development.

Malaysia, which is, as of now, perhaps the fastest growing country in the third world, is characterised by a well-developed financial system. What, however, is unique about Malaysia is that, as in some other Muslim countries, conventional and Islamic financial institutions exist side by side, interacting with one another. The development of Islamic financial institutions in Malaysia has the potential to play a leading role in serving the Muslim *Ummah* and contribute towards socio-economic development of the country in conformity with Islamic sensibilities. Yet their market share is rather insignificant in comparison with the conventional financial institutions.

As elsewhere, financial institutions in Malaysia provide four distinct types of intermediation in the process of exchanging funds and financial instruments among the surplus units and the deficit units – viz., denomination intermediation, maturity intermediation, risk diversification intermediation, and liquidity intermediation.

FINANCIAL STRUCTURE

The commercial financial institutions in Malaysia, as in any modern country, are supervised by a central monetary authority called *Bank Negara Malaysia*. It has nine offices. Additionally, there are 38 commercial banks, 47 finance companies, 12 merchant banks, 7 discount houses, 7 development institutions, several cooperatives and savings institutions, 5 provident and pension funds, 60 insurance

Muhammad Anwar is associated with the International Islamic University, Malaysia.

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companies, 4 housing credit institutions, 7 unit trust companies, 2 stock exchanges, and several other institutions. These institutions channel funds from the surplus units to the deficit units and account for the flexibility of denomination, maturity, risk, and liquidity.

ISLAMIC FINANCIAL INSTITUTIONS

Financial institutions primarily sell demand deposits, savings deposits, time deposits, insurance policies, pension funds, commercial papers, and bonds to the surplus units. They purchase business loans, consumer loans, mortgages, government securities, corporate bonds, corporate stocks, municipal bonds, and money market securities from the deficit units. By providing finances for both consumption and investment purposes, financial institutions contribute towards the prosperity of households and economic growth in the economy. Conventional financial institutions pay interest on funds procured and charge interest on funds loaned out. But Islamic scholars describe interest as *riba* which is prohibited in Islam. Hence, the participation of Muslims in interest-based contracts is considered illegal by the Islamic law.¹

Secondly, the Islamic perspective on development is also distinct from the conventional, Western perspective. The conventional development paradigm emphasises development of material factors such as industrialization, agricultural development, per capita growth, per capita calorie intake, literacy, poverty and health (e.g., mortality, life expectancy, sanitation), and so on.² Islamic scholars wish to supplement material development with spiritual development as well. Indeed, emphasis on spiritual factors dominates the emphasis on the material factors because, in Islam, mundane material progress at the neglect of its consequences in the hereafter does not represent development. Therefore, spiritual and material components of human endeavours should not be separated, but rather be developed concomitantly.

Consequently, the dominance of the interest-based financial system may not remain acceptable for long to the Malaysian Muslims. Hence the need to Islamize some of the conventional financial institutions, upgrade the existing Islamic financial institutions, and permit establishment of new Islamic financial institutions.

¹See M. Umer Chapra *Towards a Just Monetary System*. Leicester: Islamic Foundation. 1985, pp. 235-246.

²See Gerald M. Meier *Leading Issues in Economic Development*. New York: Oxford University Press. 1989. Fifth Edition, pp. 5-10.

ISLAMIC FINANCIAL STRUCTURE

The Islamic Financial structure in Malaysia consists of three profit-oriented institutions (commercial bank, savings institutions, insurance company); some social welfare institutions like *baital mal*, *waqf*, *YAPEIM* (Malaysian Islamic Economic Development Foundation); and a few Islamic cooperatives. Additionally, some of the operations of the Agricultural Bank of Malaysia, Development Bank of Malaysia, and Perwira Habib Bank are also based on interest-free principles.

Evaluation

The Malaysian population comprises of 53 percent Muslims and 47 percent non-Muslims, and Islamic finance is no more than a drop in the bucket.³ In order to determine the viability of the interest-free institutions within the interest-bearing environment, two major Islamic institutions, Bank Islam Malaysia Berhad and Pilgrims Management and Fund Board are evaluated below. These profit-oriented commercial institutions operate independently in the competitive financial market of Malaysia without financial support from public funds.

*Bank Islam Malaysia Berhad*⁴ The Islamic Banking Act, 1983, modelled after the Banking Act, 1973, provides for interest-free banking operations. The first Islamic bank, called the Bank Islam Malaysia Berhad (BIMB), founded in 1983, and operating within the existing Malaysian financial system, sought to cater to the banking and credit needs of the Muslim population according to the rules of the *shariah*. The bank comprising 27 branches and manned by a staff of 741 including 303 officers covers a large number of strategic locations throughout the country.

The major banking facilities and services presently provided by the bank include acceptance of deposits in the forms of current account under the principle of *al-Wadiah* (safe custodianship) without return, saving deposits under the same principle but obtaining returns at the absolute discretion of the bank, and investment deposits for periods ranging from 30 days to over five years under the principle of *mudarabah* (trust financing) with obligatory distribution of profits resulting from the employment of the investment deposits between depositors and the bank in the proportions determined at the time of making deposits.

³See *Information Malaysia, 1990-91 Yearbook*. Kuala Lumpur: Berita Publishing Company.

⁴Data and information used in this section is from *Annual Reports of Bank Islam Malaysia Berhad*. Various Issues, 1984-89 and from Bank Negara Malaysia.

The bank provides financing facilities under the Islamic principles of *mudarabah*, *musharakah* (joint venture), *bai bithamin ajil* (deferred payment sale) and *ijara*. Trade financing provided by the bank include letter of guarantee, letter of credit and bills of exchange under the principles of *wakalah* (agency), *murabaha* (mark-up), and *musharakah*. The bank purchases shares in existing companies and invests in equities in new companies. Other services provided by the bank include remittances and transfers, transactions in foreign currencies, sales of traveller cheques, and investment portfolio management.

The Islamic bank has grown rapidly. During 1985–90, the assets of the Islamic bank have increased three-fold from around M\$ 500 million to around M\$ 1.4 billion; its growth rate averaged 44 percent annually as against 10 percent per annum for the conventional banks. Nevertheless, the Islamic bank accounted only for about 1 percent of the total assets of the banking system in 1989. During 1985–89, deposits mobilised by the Islamic bank increased from M\$ 241 million to M\$ 1.2 billion at the average rate of 39 percent per annum. Household deposits (M\$ 339 million) accounted for 31 percent of the total deposits; and business deposits (M\$ 247 million) 19 percent. Other deposits comprised government deposits, deposits of the statutory or semi-government authorities and deposits of other financial institutions.

At the end of 1989, *mudarabah* deposits (M\$ 938 million) accounted for 74 percent of total deposits representing an increase from 42 percent of total deposits (M\$ 238 million) in 1985. Current accounts represent 12 percent and savings accounts 14 percent. Dividends paid on investment accounts varied according to both the profits of the bank and the terms regarding maturity of the deposits. The rates of return to depositors ranged from 3.7 percent to 4.6 percent per annum in 1989 compared with 5.8 percent to 7.3 percent in 1985. Generally, the rates of dividend paid by the Islamic bank to its account holders are 1.8 to 2.5 percentage points lower than the deposit rates of the banking system. At the end of 1989, Islamic bank deposits constituted barely 2 percent of the total deposits mobilised by the conventional banking system, but the former's growth rate for the past five years averaged 39 percent per annum as against 10 percent for the latter—this, *inter alia*, indicates growing public demand for the profit-sharing contracts.⁵

⁵These are simple annual average rates of growth calculated from statistics provided by Bank Negara Malaysia.

The Islamic bank also plays an important role in re-channelling the funds, especially for the well-being of the society and for enhancing the productive capacity of the economy. In the Islamic context, this would involve helping the needy and financing activities not considered *haram*. In conformity with the Islamic injunctions, the Islamic bank has adopted four main modes of financing: *bai bithamin ajil*, *mudarabah*, *ijara*, and *murabaha*. Of these, financing through *bai bithamin ajil*, has become the most popular. During 1984–89, it increased from 55 percent (of M\$ 148 million) to 76 percent of the total financing (of M\$ 741 million). *Murabaha* financing (M\$ 126 million) and *ijara* (M\$ 19 million) constituted 17 percent and 13 percent, respectively in 1989. All these financing modes are on the principle of profit and loss sharing. The Islamic bank has also granted a small amount of *qard al-hasan* (benevolent loans) to help the poor.

In terms of sectoral finance, about 28 percent (M\$ 209 million) of the total financing in 1989 was channelled to the manufacturing sector, 18 percent (M\$ 130 million) to real estate, and the rest were channelled to agriculture, construction and the services sector. There were a total of 4,036 financing accounts at the end of 1989.

*Pilgrims Management and Fund Board*⁶ Pilgrims Management and Fund Board, known as "Tabung Haji", provides interest-free financial services, besides assisting Muslims to perform their pilgrimage to Mecca. It was established by an Act of Parliament in 1962. The original Act was formalized into Pilgrims Management and Fund Board Act, 1969. It received the royal assent in April 1969 and was published in the official gazette in May 1969. Thus, it was the first formal Islamic financial institution to be established in Malaysia.

Tabung Haji is meant to provide Islamic means of mobilizing savings and preventing the fragmentation of wealth by assisting Muslims to perform the pilgrimage without impoverishing them or further imposing financial hardships after their pilgrimage. Its goal is to render the best services to Malaysian pilgrims throughout the performance of the Hajj and to give maximum returns on their deposits. The main objectives of the Tabung Haji are to enable Muslims to save gradually in order to provide for their expenses in performing the pilgrimage or for other expenses beneficial to them; to enable Muslims through their savings to participate in investments in industry, commerce, and plantations as well as in real estates, according to Islamic principles; and to provide for the protection, control and welfare of Muslims while on pilgrimage through various facilities and

⁶Data and information used in this section is from *Annual Reports Pilgrims Management and Fund Board*. Various Issues, 1963–1988 and from Bank Negara Malaysia.

services of Tabung Haji.

Unlike the Islamic bank, the Tabung Haji can only accept deposits but cannot advance money to the public although it invests deposits in accordance with the tenets of Islam, i.e., through ownership participation by buying shares and participating in joint venture project financing.

Since its establishment, Tabung Haji has recorded an impressive performance.⁷ As of November, 1990, it has 83 branches operated by 1022 employees. Its assets rose from M\$ 126,000 to M\$ 1,181,935,000 during 1963–1989. The number of depositors have risen to 1,519,000 and its deposits, mobilised entirely from Muslims, from M\$ 45,000 to M\$ 1,014,444,000 during the same period. Its capital and reserves stood at M\$ 78 million in December 1988. As Tabung Haji has no loan portfolio, all the funds it mobilises are invested in the forms of holding of fixed assets such as land and buildings, holding of shares (quoted and unquoted), setting up of subsidiaries involving plantation, manufacturing, construction and communication activities. In 1988, its investments included shares of mainly manufacturing companies (59 percent), palm oil companies (19 percent), and real estate companies (11 percent).

With its well-diversified investment portfolio, Tabung Haji has been able to pay reasonable dividends to its depositors. Its dividend rates, termed bonus rate, varied between 6.5 percent – 9 percent (excluding 2.5 percent payment for *zakat* paid by Tabung Haji on behalf of its depositors for business transacted) since 1981, depending on profits made for the year. In 1988, the dividend rate of 7 percent was paid to 1,512,090 depositors.

To Tabung Haji, mobilizing deposits is of a lesser priority than enhancing the ability of the Muslims to perform pilgrimage. Nevertheless, failure in mobilizing deposits would mean inability on the Muslims' part to perform pilgrimage and failure on the part of Tabung Haji in its mission. Measured in terms of this major criterion, Tabung Haji has indeed performed extremely well. During 1972–1988, the number of Muslims who have been able to perform pilgrimage has increased from 10,395 to 28,679 persons.⁸ Since 1981, Tabung Haji has also helped to manage pilgrims from Singapore, Indonesia, India, Brunei, Australia, Hong Kong and Fiji,⁹ thus making a valuable contribution to the world Muslim com-

⁷Tabung Haji has received the 1990 Islamic Development Bank Award for being the best managed Islamic organisation.

⁸Tabung Haji started reporting of number of pilgrims in the annual reports in 1972.

⁹The services provided to the foreign pilgrims are similar to those provided to the Malaysian pilgrims.

munity. It also looks after the welfare of the pilgrims from beginning to end and all the way.

Contribution Towards Socio-economic Development in Malaysia

The Islamic financial institutions contribute towards socio-economic development of Muslims by mundane and spiritual improvements in a number of ways: they provide a wider choice in the modes of financing and financial contracts; enhance the growth of GNP by advancing finances for businesses and other economic activities; motivate Muslims to increase savings and reduce hoarding, thereby increasing their participation in the development process; contribute to the process of savings mobilisation and capital accumulation; provide employment opportunities; improve the standard of living of their clients by extending finances for purchase of consumer durables such as cars, homes, etc.; lead towards greater socio-economic unity by providing finance to the poor sectors of the population in agriculture and small businesses; help the managers, employees and clients to improve their Islamicity as they can deal on the basis of Islamic financial contracts; provide ways to avoid interest-bearing contracts; and enable for more systematic collection and utilization of *zakat* for the purpose of eradication of poverty and socio-economic equality.

CONCLUSION

In the Malaysian network of financial institutions, some provision is made for Muslims to practice their faith by permitting Islamic operations through the establishment of Bank Islam, Tabung Haji, Islamic cooperatives and other more limited Islamic financial contracts. However, the financial needs of 53 percent of the Muslim population is not adequately catered according to Islamic dictates, because only a meagre share of the whole financial system constitutes Islamically organised institutions. An equitable provision of financial services would, however, require that a substantial portion of the financial services industry be organized on the basis of Islamically approved interest-free principles. The performance of the Bank Islam, Tabung Haji, and other institutions indicates that interest-free institutions have done rather well compared with their interest-based counterparts. Nevertheless, despite proven feasibility, superiority, and growing demand for interest-free finance, market share of the interest-free institutions in Malaysia remains negligible.

The co-existence of Islamic financial institutions and *riba*-based institutions would necessarily require a stable working relationship and cooperation among

both types of institutions to work together, in certain important aspects of financial operations e.g., in cheque clearing and in a fund transfer mechanism. Therefore, the staff of both types of institutions should be well versed with interest-free as well as interest-based modes of finance. It is, therefore, necessary that education and training be provided to the staff from both types of institutions while Islamizing selected institutions. This calls for an Islamic Banking Training Centre in order to ensure (1) training of interested staff of the existing conventional financial institutions, and (2) availability of qualified staff for the existing, but growing, Islamic financial institutions.

Tabung Haji presents an extremely successful experience for Muslims to save and perform pilgrimage. Perhaps, other Muslim countries and communities would do well to adapt its model in their pilgrims management.

Comments on
"The Role of Islamic Financial Institutions in the
Socio-economic Development in Malaysia"

The paper discusses a very important subject: the role of interest-free Islamic financial institutions in Malaysia in the context of an interest-based capitalist financial system. It is important because similar experiments have been made in some other Muslim countries. In Pakistan, from July 1985, under the government directive all banks ceased operating on interest charges and adopted the twelve Islamic modes of financing. Similar Islamic banks are also operating in Turkey, Egypt, Kuwait, Jordan, Sudan, Iran and Saudi Arabia. [Wilson (1990)].

The paper examines in detail the role of two major profit-oriented Islamic financial institutions in Malaysia: Bank Islam Malaysia Berhad and 'Tabung Haji'. They compete with interest-based conventional banks. In the first part of the paper the authors point out the necessity and importance of these Islamic banks arguing, first, that interest is *riba* and prohibited in Islam; secondly, they think that material acquisitions and improvements in income, housing, health, education, sanitation etc., must be supplemented with spiritual development of the Muslims of Malaysia.

In evaluating the performance of these Islamic banks, the authors contend that Bank Islam Malaysia Berhad accepts deposits on the principle of the distribution of profits on the Bank's own discretion: it invests them for the period from one month to five years and beyond under the principle of *mudarabah*. It provides financing facilities through *mudarabah*, *musharakat*, mark-up, leasing, etc. The bank has grown rapidly from the time when it was established in 1983. The assets of the Bank rose from M\$ 500 million in 1985 to M\$ 1.4 billion in 1989. The rates of dividend paid by the Islamic bank to its account-holders, say the authors, are 1.8–2.5 percent lower than paid by the conventional banking system; nevertheless, the authors claim that the demand for profit-sharing contracts has grown.

In terms of sectoral finance, say the authors, about 28 percent or \$ 209 million of the total financing outstanding at the end of 1989, was channelled to the manufacturing sector, another 30 million or 18 percent financed real estate activity while rest went to agriculture, construction and services-sector.

The "Tabung Haji", bank was established in 1962. It provides, in addition

to its main purpose of assisting the Muslims to perform Hajj, the financial services based on interest-free principles. It also provides *halal* or religiously permissible returns to depositors for their savings. It invests in sectors of manufacturing, agriculture and real estate. The dividend paid by "Tabung Haji" was 8.5 percent in 1984, and 7 percent in 1988. It was lower than the interest paid by the commercial banks. *Zakat* at the rate of $2\frac{1}{2}$ percent is also deducted at the source which further lowers the profit rate. Nevertheless, according to the authors the bank has made progress in attracting funds from the Muslims.

The second part of the paper assesses the contributions of these Islamic banks to the overall socio-economic development of Malaysia: they have inculcated habits of saving and investment among the Muslims, and have provided opportunities for employment, and have helped small businesses and the agricultural sector; they have enabled the Muslims for the systematic collection of *zakat* funds and their distribution to the poor and needy.

The authors conclude their discussion with their suggestion that, as the two Islamic banks have performed well, a substantial part of the financial sector in Malaysia must be organized on the basis of interest-free banking for the welfare of the Malaysian Muslims who form 53 percent of the entire population (17 million).

The paper reveals as I understand that the profit paid by these Malaysian Islamic banks is in general lower than the returns paid to their depositors by the interest-based conventional banks. There is a general tendency in many Muslim countries for the returns, paid by the Islamic banks to their depositors, to fall.¹ The banks, as a principle, invest their deposits in ventures where returns are higher, and the Islamic banks of Malaysia are oriented toward the private sector and market economy. Both the Islamic banks invested in the rapidly growing sectors of manufacturing, agriculture and real estate in 1988-89. The World Bank (1989) study on the Malaysian economy says that Malaysia made rapid recovery in 1987 and during 1988 the growth rate was estimated about 6-7 percent. Growth was led by manufacturing (13 percent) agriculture (7.5 percent), the largest contributions to growth rate was in the export-oriented sector of electronics, textiles,

¹According to [Zaidi (1987) p. 41] from June 1981 to December 1986 the nationalized commercial banks in Pakistan showed falling profit rates on the Profit-Loss Scheme savings deposits: they fell from 9.00 to 8.50 percent in 1981, and then eventually to 6.5 percent in December 1986.

According to [Moore (1990), p. 250]. In Egypt, "The Islamic branches of the conventional banks could do no better than their parents, whereas the investment companies were paying their depositors more than twice the prevailing interest rates on Egyptian pounds and enabling savers to keep up with inflation".

garments, timber and cocoa (p. xi).

The question then arises why did the Islamic banks pay to their depositors profits lower than those paid by the interest-based banks in a period of rapid growth of the economy? It would have been interesting if the authors could provide a comparison of various rates of return on the different categories of deposits of conventional commercial banks, investment companies and the Islamic banks during this period of rapid economic growth. It may be assumed that the Islamic banks are as profit-oriented as the conventional banks (except that the former wrap themselves up with the label of Islam). They obviously earn handsome profits in lucrative investments in the growing sectors of manufacturing, agriculture and real estate but they pay lower returns to their depositors.

The authors could have also elaborated on another relevant point: whether, it may be asked, the Islamic banks are creating distortions in allocating scarce money resources by branding interest as *riba* and declaring all other profits and rewards of other factors of production permissible. The Islamic banks operate as a part of the entire economic system based on capitalist profits and rewards. [Gieraths (1990), pp. 193-194] observes in a recent article on Pakistan's Islamic finance that in Pakistan, mark-up has replaced the interest charge but in actual practice it is working like interest. "The transaction of granting a loan under this method is in many cases only formally accompanied by a real sale transaction, thus following the letter of the Islamic injunctions but hardly its spirit".

The Islamic Banks operating within the context of a capitalist market economy cannot bring any social change but, instead, they will be forced by the logic of circumstances to follow a policy of *status quo*, of capitalist profits and self-interest of the economic agents.

Ziaul Haque

Pakistan Institute of
Development Economics,
Islamabad.

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