

# The Changes of Product Structure in Islamic Banking: Case Study of Malaysia<sup>1</sup>

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## Abstract

Malaysia is aggressively developing its Islamic financial system to becoming an international Islamic financial hub. One of all Islamic financial system segments is Islamic banking sector. Beginning with Bank Islam Malaysia Berhad (BIMB) as the first Islamic bank in Malaysia which was set up in 1983, Malaysia is currently having a significant number of Islamic banking institutions including full-fledged Islamic banks, Islamic banking windows and Islamic banking subsidiaries. Rapid growth in the Islamic finance industry has encouraged foreign financial institutions to make Malaysia their choice destination to conduct Islamic banking business. This has created competition among industry players, indirectly affected the structures of Islamic banking products, services and activities. What is wrong with the increasing number of Islamic banks in Malaysia that has shown a positive result in enhancing the Islamic financial sector? Is there any new shariah principle applied to construct a new Islamic banking product? Is there any significant distinction in running its activities? What are the differences of principles between Islamic banks in Malaysia and Gulf Cooperation Council (GCC) Countries? How can Malaysia Islamic banks improve their products and services in order to be globally accepted?

Thus this paper attempts: 1) to examine the trend of Islamic banking system in Malaysia; 2) to identify the new products and services of Islamic banks and analyze their activities; 3) to criticize the applied principles between Islamic banks in Malaysia and Gulf Cooperation Council (GCC) Countries; and 4) to give suggestion on how Malaysian Islamic products and services can be accepted globally. The descriptive analysis using secondary data will be used to answer these questions. The expected findings is hoped to improve the Malaysian Islamic banking operational aspect that finally lead the products and services to be globally accepted.

## Introduction

The establishment of Islamic banking is very crucial in the Islamic world generally and Malaysia specifically. Islamic banking is one of the components in Islamic financial sector that plays very vital role to generate the growth of economic, beside Islamic capital market, takaful (Islamic insurance) and mutual fund. It could be as alternative fund sources to non-Muslim and as imperative to all Muslims who are engaged in the economic activities. The emergence of Islamic banking had eliminated the roles of *riba*, (usury or interest), *maisir* (gambling) and *gharar* (uncertainty) which were implemented by conventional banking system. On the other hand, Islamic banks can generate on *halal* activities, promoting profit lost sharing, quest for justice,

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ethical and sanctify contract (Mohd. Bakir Mansor, 2008). Hence the Islamic bank is expected to run according to shariah principles, mobilize and utilize the financial resources for the sack of Muslims, and to serve the ummat al-Islam (Sudin Haron, 1999).

As regards the above concern, Malaysia is aggressively developing its Islamic financial system to becoming as an international Islamic financial hub. One of all Islamic financial system segments is Islamic banking sector. Beginning with Bank Islam Malaysia Berhad (BIMB) as the first Islamic bank in Malaysia which was set up in 1983, Malaysia is currently having a significant number of Islamic banking institutions including full-fledged Islamic banks, Islamic banking windows and Islamic banking subsidiaries. Rapid growth in the Islamic finance industry has encouraged not only local but also foreign financial institutions to make Malaysia their destination of choice to conduct Islamic banking business. This has created competition among industry players, indirectly affected the structures of Islamic banking products, services and activities.

Thus this paper attempts: 1) to examine the trend of Islamic banking system in Malaysia; 2) to identify the new products and services of Islamic banks and analyze their activities; 3) to criticize the applied principles between Islamic banks in Malaysia and Gulf Cooperation Council (GCC)<sup>3</sup> Countries; and 4) to give suggestion on how Malaysian Islamic products and services can be accepted globally.

The structure of this paper is as follows. Section 2 discusses the trend of Islamic banking system in Malaysia. Section 3 describes the Malaysian Islamic banking products and services, activities. Section 4 examines the muamalat principles applied by both Malaysia and GCC Countries. The paper concludes with the Section 5 which summarizes this work along with some views on how Malaysian Islamic products and services can be accepted globally.

### **The trend of Islamic banking system in Malaysia**

Bank Islam Malaysia Berhad (BIMB) was the first Islamic bank in Malaysia and was established in 1983 under the Islamic banking Act. The concept of Islamic window started in March 1993 when the Bank Negara Malaysia introduced the "Interest-Free Banking Scheme". This scheme is to allow the existing of conventional banks together produced Islamic products and services<sup>4</sup>. Most of the foreign banks interested and offered the two window schemes, because they wanted to capture the market. The Islamic banking Scheme was established at 1999, which included the interest-free banking system and full-fledged Islamic banks involved in operating Islamic financial products and services. In 2000, there were 2 full-fledged Islamic banks, and 17 commercial banks offering Islamic window. In the July 2007, there were 11 full-fledged Islamic banks, 8 commercial banks offering Islamic window, 4 Islamic investment banks and 5 development institutions offering Islamic banking products and services. Rapid growth in the number of Malaysia Islamic banks participation was due to the liberalization policy by Malaysia's government. With these policies, three banks from Middle East opened their operations (Al-Rajhi Banking & Investment Corporation, Kuwait Finance House and Islamic Financial Consortium<sup>5</sup>) in Malaysia. All previous foreign banks such as; HSBC Bank Malaysia Berhad, OCBC Bank Malaysia Berhad and Standard Chartered Bank Malaysia Berhad were also participating in Islamic banking Scheme. To be more

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<sup>3</sup> GCC is a Gulf Countries Council. The countries involved are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirate.

<sup>4</sup> Malaysia's approach towards Islamic banking is unique whereby a dual banking system was introduced where Islamic and conventional banks operate side by side (Yap Pei Ling, 2009)

<sup>5</sup> It was established with the joint venture of Qatar Islamic Bank, RUSD Investment Inc., and Global Investment.

comprehensive, Bank Negara had also introduced the concept of Islamic banking subsidiary and issued licenses to RHB Islamic Bank, Commerce Tijari Bank Berhad and Hong Leong Islam Bank Berhad in 2005. These participations made Islamic banking system in Malaysia more competitive and flourished.

In terms of deposit and loan financing, Islamic banks show increasing trend and more resilient compared to conventional banks. For instance, BIMB's deposit increased to RM4.44 billion in 1997 from RM325 billion in 1984. BIMB's loan financing and services also increased to RM0.9 billion (Abdus Samad & M. Kabir Hassan, 1998). At the end of 2000, total deposit at Islamic banking system was RM31 billion while total deposit in conventional system was RM381 billion. In the case of loans financing, RM21 billion was extended by Islamic banking system, and RM416 billion was given by conventional system (Norafifah Ahmad & Sudin Haron, 2000). The amount of Islamic Bank's deposit increased up to RM154.86 in 2008, while total deposit in conventional banks was RM 619.43 billion. Loans financing also increased to RM86.7 billion compared to the conventional banks, that was RM773.4 billion (Bank Negara Malaysia Monthly Statistic Bulletin).

Annual growth of Islamic banks deposit was 22.6% compared to conventional banks deposit (7.16%) in the commercial banks from 2000 to 2004 (Sudin Haron & Wan Nursofiza Wan Azmi, 2005). In loans financing, Islamic banks contribution increased from 5% in 2000 to 11.2% in 2007. The explanations above reveal that the products and services offered by Islamic banking system had attracted the depositors, customers, investors and others. The increasing of new products gives banks' users alternative to choose services provided by Islamic banks. This could be affording done by Malaysia's government to increase the Islamic financial sector contribution in order to achieve 20% of banking market share by the year 2010.

### **The products and services of Islamic banks**

Generally, the Islamic banking product was formed by using the principle of muamalat such as murabahah, istis'na, al-salam, al-ijarah, mudharabah, musyarakat, al-wakalah, al-kafalah and etc. In the case of Islamic banks in Malaysia, there are currently more than 50 products and services. The products and services development in Malaysia can be divided into 4 phases: 1) first phase (1983), the earliest products were wadiah saving account, wadiah current account, mudharabah investment account and Bai Bathamin Ajil housing financing; 2) second phase (1993), additional products such as murabahah working capital finance, interbank Islamic Money Market, and securitization of assets; 3) third phase (1999), new products were introduced such as Islamic credit card, Islamic high-purchase (al-Ijarah Thumma al-Bai), and Ijarah fixed financing; and 4) fourth phase (current), musyarakah & musyarakah mutanaqisah financing, mudharabah financing, structured deposit and derivatives & hedging products are newly introduced products.

The details applied muamalat principles in the Islamic banks in Malaysia as mentioned by Saiful Azhar (2005) and Mohd. Bakir (2008) are as follows:

- a) Saving account applied wadiah yad dhamamah (WYD) and mudharabah;
- b) Current account applied WYD;
- c) Investment account applied mudharabah and wakalah;
- d) Asset and vehicle financing applied Bai Bithamin Ajil (BBA) and al-Ijarah Thumma al-Bai (AITAB)<sup>6</sup>;
- e) Islamic Credit Cards, Personal and education financing applied bai al-innah and tawaruq;
- f) Pawn Broking applied rahnu

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<sup>6</sup> Maybank has already applied *musyarakah mutanaqisah* in housing financing.

- g) Negotiable Islamic Certificate of Paper applied bai al-innah and bay al-dayn; and
- h) Islamic acceptance bill applied bai al-innah

The four phases of products development and details applied muamalat principles reveal that Malaysia Islamic banks have put their efforts to introduce various and profit lost sharing products and services. Despite that, they still maintain the debt-financing modes. Some products such as structured deposit, derivatives and hedging financing are more towards secondary market which attract the interest of investors and customers when facing liquidity problems. On the other hand, the percentages of debt financing are still high and even increasing even though various new products were introduced. This can be seen from Table 1. Generally the Islamic banking products and services can be divided into several categories based on the Bai-Bithamin Ajil (BBA), Ijarah, al-Ijarah Thumma al-Bai (AITAB), Murabahah, Mudharabah, Musyarakah, Istisna' and others. Overall, debt-financing, i.e. Bai-Bithamin Ajil, Murabahah, and Ijarah<sup>7</sup> gives major contribution to the growth of Islamic banking financing. These financing consist of average 80% of the total Islamic banking financing. The percentages keep on increasing from 78.2% in 2006 to 84.2% in 2009. This shows that there is no changes happened in the structures of Islamic banking products even though there are various new products had been introduced.

**Table 1: Type of Financing in Malaysia's Islamic banking System**

Year Financing	2006	2007	2008	2009
Bai Bithamin Ajil	29,845.0	31,630.3	34,533.0	35,738.1
Ijarah	762.9	1,153.5	2,774.1	2,973.1
Ijarah Thumma al-Bai	21,470.0	25,806.1	31,847.2	33,697.1
Murabahah	5,300.0	9,691.7	15,854.8	18,583.5
Mudharabah	156.8	374.4	1,137.1	1,333.2
Musyarakah	147.9	105.8	314.0	389.3
Istis'na	509.0	804.1	1,384.2	1,477.3
Other financing	15,958	15,818.0	16,802.4	13,836.7
<b>Total</b>	<b>73,368.1</b>	<b>85,957.8</b>	<b>104,647.6</b>	<b>108,030.3</b>

Sources: Bank Negara Malaysia Monthly Statistical Bulletin

Conversely, equity financing or profit lost sharing (PLS) principles seem no improvement even though the contract accepted globally. Humayon A. Dar & John. R. Presley (1999) assert that the lack of PLS exist because PLS contracts are inherently vulnerable to agency problems. It requires well-defined property right to the function efficiently, the restrictive role of shareholder in management, equity financing is not feasible for funding short-term projects (liquidity problem) and lack of secondary market for musyarakah and mudharabah. Both musyarakah and mudharabah are implemented with the bank managing the project management. To certain extent, their partner is just a sleeping partner. For example product like investment account, bank is sab al-mal, not as mudharib. Bank has to consider the high risks if bank happened to be mudharib. Therefore Islamic banks have to focus more on debt-financing and services such as fees, guarantees and commissions to maintain degree of liquidity and low risks.

<sup>7</sup> Ijarah plus Ijarah Thumma al-Bai.

### **The activities In Islamic banking operation**

Generally, bank activities can be grouped into two activities. First is banking traditional activities and the second is banking non-traditional activities. Banking traditional activities refer to activities which based on accepting deposits and offering loans (Moshirian, F. & Van der Lean, 1998), while banking non-traditional activities are activities that offering fee-producing activities (ranging from underwriting activities to cash management, custodial services<sup>8</sup> and trading income (Shahida, Abdul Ghafar Ismail & Sanep, 2005).

Both activities can generate income to Islamic banks as described above (Islamic products – muamalat principles). Bank's income can be generated from equity financing profit i.e., musyarakah and mudharabah instruments. Profit also can be generated from debt financing activities by using BBA, AITAB, and murabahah and from money/securities instrument. Non-financing income such as fees, commissions and guarantees and custodial services contribute to the bank's profit. Some muamalat principles such as al-wakalah, al-kafalah, ar-rhanu and al-wadiah are applied in services activities<sup>9</sup>.

The role of banking traditional activities is gradually declined. In the awake of competitiveness and liberalization, Islamic banks must be more innovative and entrepreneurship to maintain business and survival. Traditional activities have to compete with other fund providers such as Islamic capital market, venture capital and others. One way to be innovative, Islamic banks should create new services that can generate income. Studies by Shahida et. al (2005:12) shows that banks involved with higher level of non-traditional activities tend to have more net income margin, fewer core deposit, and exhibit less risks. When bank accessed less deposit to finance traditional activities, the banks should focus heavily on creating non-traditional activities.

### **The different Islamic banking principles between Malaysia and GCC Countries**

The discussion of the principles applied by Islamic banking in Malaysia and GCC countries can be accessed from studies done by Mohd. Bakir (2008), Sudin Haron (1999) and Saiful Azhar (2005). From these studies, the number of Islamic banking principles applied in GCC countries are less than their counterparts. Other interesting finding is the rejection of two popular principles by Malaysian Islamic banking i.e bay al-innah and bay al-dayn by GCC countries. Some of them but no all members GCC applied the principle of tawarruq in their Islamic banking operations.

As regards bay al-inah and bay al-dayn, there is continuously debating between scholars from local and Middle-Eastern. Only Syafiee accepts bay al-inah and bay al-dayn in implementation of the transaction in Islamic finance. The other mazhabs reject the usage of both principles in Islamic finance<sup>10</sup>. According to Asmadi Mohamed Naim (2006: 117-131), the way local scholars practicing the method of choosing any fatwa from any imam without considering the proofs of other scholars when deducting the rule and put themselves as ordinary people who are permitted by usuliyyin to practice any mazhab they like. Whereas GCC scholars are in favored to practice comparative study method of fiqh in order to identify the valid principle or nearest valid principle of Syariah for Islamic finance regardless of which mazhab they belong<sup>11</sup>

<sup>8</sup> For examples, pension funds, mutual funds, and wealth management.

<sup>9</sup> Sudin Haron (1999: 81 – 82), divides these activities of Islamic Banks into four groups which are based on muamalat principles. There are (1) profit and loss sharing principles, (2) fee and charged based principles, (3) free services charge principles; and (4) ancillary principles. Whereas, Muhd Nasir & Amirul Hafiz (2008) categorizes above activities into trading, participation, capital or fund mobilization and other support contracts.

<sup>10</sup> Most of Muslims in GCC were Miliki, Hanafi and Hanabali mazhab follower.

<sup>11</sup> They are more interested on deductive of hokum by using the method of fiqh muqarar and through group discussion, in which members of the group are made up by representative from different countries and

Niyah matter is debated by the scholars regarding the permissible of bay al-Inah. For Shafi's, he regards this as valid as the one has the right to sell goods at any prices he wants to (Saiful Azhar, 2005: 456). In other mazhab, they stress more on niyyah. Bay al-Dayn can be allowed, if the instrument is sold at par to issuer, but not at discount to the party and first party (Saiful Azhar, 2005:439). Therefore, less Islamic products are introduced in countries of GCC compared to their counterpart, Malaysia. It seems Malaysia Islamic banks have more products offered. In this case Mohd. Bakir (2008) asserts that Malaysia Islamic banks are more progressive to conventional bankers and more efficient but yet too liberal to GCC scholars. The questions is, do they in line with appropriate Islam teaching? Or local scholars stick to "the basic rule in al-Mumalat is permissible unless proven forbidden".

### **Suggestions**

From the explanations above, we can categorize common problems and challenges that facing Islamic banking system in Malaysia into i) muamalat contracts applied; ii) too much depending on debt financing; and iii) to achieve economic of scale. To overcome muamalat contracts dispute, Malaysia Islamic banks have to change bay al-inah principle to tawarruq principle in doing trading transaction as suggested by (Abdul Mumin Ab. Ghani & Ahmad Sufyan Che Abdullah, 2006). Tawarruq seems to be more effort to provide alternative loans to users/customers and avoiding the riba element. In making fatwa regarding muamalat principles which is acceptable or not, local scholars should use comparative methods to fiqh (fiqh muqaram) by comparing the evidences from various views<sup>12</sup>. After the view proposed, this view later can be proposed for international discussion in any related councils, such fiqh Academy. At last this al-Quran and sunnah.

There must be much effort to enlarge equity financing through musyarakah and mudharabah which its nature is not in fixed determined profit and lost. Even though few initiatives to introduce this contract had been done, but the reality is still far from targeted. Product contract musyarakah munataqisah has a great potential to expand, not only for investment but also for home financing. As asserted by Abdullah M Noman (2001:2-3), Islamic banks need more financial engineering and innovation which can tackled the problem of mobilizing the resources, placement of funds, create new products and risks management. Evidence showed with more bank products on non-traditional activities, they can deteriorate their risks and earn more net profit.

At the same time, BAFIA does not allow a bank to involve with non-banking activities, such as insurance, stock broking and others. However the bank can form subsidiaries if it wants to play actively in these non-banking activities. But this effort may increase the cost of operation rather than one bank carried out the operation in one roof. Like Japan and Germany, banks are allowed to involve in non-banking operation, but also provides insurance, stock-broking services and also underwrite securities (Saiful Azhar, 2005). To be competitive in banking industry, Islamic banking must try to achieve the status economy of scale. These steps will reduce costs of operation and the lower marked up charged to users of Islamic banking products and services.

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who are free from any pressure from their government in order to come out with independent and responsible views on Islamic financial products (Asmadi Mohamed Naim, 2006: 32)

<sup>12</sup> Asmadi Mohamad Naim, (2006: 33) quoted, "Thorough study to subject matter must be done with the goal to achieve the nearest view of the teaching of al-Quran and sunnah. In addition, any current issues should be highlighted among local Islamic scholar and be debated.

### **Concluding Remarks**

The discussion on the product structural in Malaysia Islamic banks reveals that the emphasis to equity financing in Islamic banking activities should be put more aggressively. The product structural remains the same which rely more on debt financing even after it has been in existence for the past 27 years in Malaysia. In addition, the difference of muamalat principle applied by both Malaysia and GCC countries has weakened some initiatives to promote Malaysian Islamic products and services to be accepted globally. Among other things to be solved is to harmonize the differences of views among scholars and also creating new innovative product with equity financing to meet the current demand. Last but not least, there is a requirement to have bank with economic of scale in order to lower the cost.

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