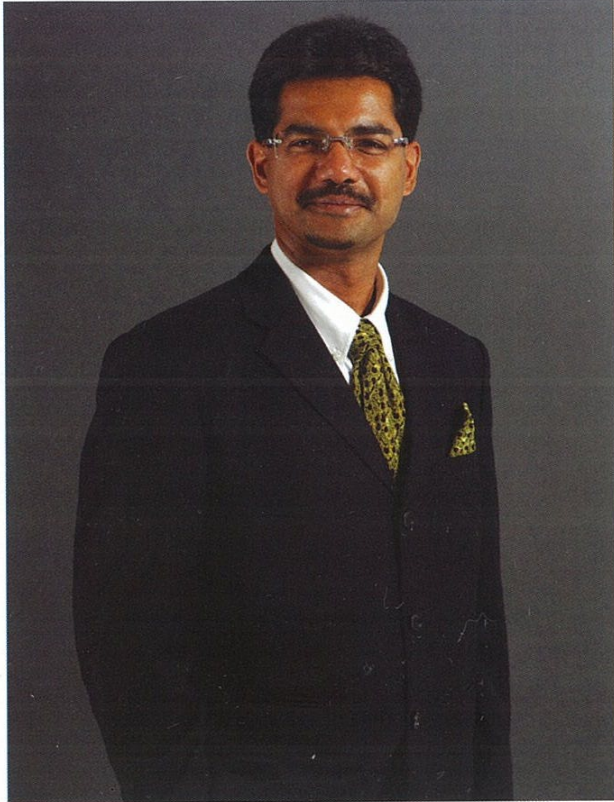


Development of Islamic Banking in Malaysia

by Encik Mohamed Ridza Abdullah



"Great strides are being made in the development of Islamic banking and finance in the country. Amongst others is the promotion of the settlement of disputes based on Islamic principles. The Kuala Lumpur Regional Centre for Arbitration (KLRCA) has introduced the Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services) which allows any disputes arising from Islamic banking and finance to be referred to KLRCA for resolution. KLRCA has invited Muslim arbitrators with background in Islamic banking to offer their services in the settlement of such disputes."

Malaysia has come a long way since the formation of the Lembaga Urusan Tabung Haji (LUTH) in 1969. Although not a financial institution per se, LUTH was the first institution to use Shariah principles in its fund management operations for Muslims going on pilgrimage. Instead of paying interest to its subscribers, LUTH pays a dividend earned out of its investments in equities and other securities. Before distributing its dividend to its members, LUTH pays a tithe i.e. business zakat based on both the profits earned during the zakat year and the amount of working capital at the end of the zakat financial year. However, LUTH is mainly a savings institution and thus lack any financial innovation and incentives in its schemes. It came as no surprise that the first Islamic bank, Bank Islam Malaysia Berhad (BIMB) was established in 1983 and was licensed and regulated by Bank Negara Malaysia (BNM) under the Islamic Banking Act. This marks as a milestone for the development of Islamic financial system in Malaysia. This was followed suit by the establishment of Bank Muamalat Malaysia Berhad in 1999. Islamic banks carry out banking business similar to conventional banks, but along the principles of Shariah. The three major principles that govern the operations of Islamic banks are the prohibition of riba (interest) and the sharing of profit and losses, the management of Islamic banks based on Islamic acts and practices and the avoidance of activities contrary to the Muslims' interests.

In 1993, the Islamic window concept was introduced when BNM introduced the Interest Free Banking Scheme (later known as Islamic Banking Scheme (IBS) which allowed existing commercial banks, merchant banks, finance companies and discount houses to offer Islamic banking products and services using their existing infrastructure and branches. With it, Malaysia has emerged as the first country to implement a dual banking system, whereby Islamic and conventional systems co-exist and run concurrently in the financial system. However, these institutions were required to separate their funds and activities for Islamic banking transactions from that of the conventional banking business to ensure that there would not be any co-mingling of funds. Banks such as HSBC Bank Malaysia Berhad, OCBC Bank Malaysia Berhad and Standard Chartered Bank Malaysia Berhad jumped on the wagon and participated in IBS. In 1999, Bank Negara introduced the concept of Islamic banking subsidiary which allowed financial institutions with Islamic window operations to convert and set up as full-fledged Islamic banks. The Islamic banking system in Malaysia started to flourish and became more competitive that it paved the way for foreign banks such as Al Rajhi Banking & Investment Corporation, Asian Finance Bank and Kuwait Finance House to begin their operations in Malaysia.

The Malaysian Islamic Capital Market (ICM) is another landmark development in Islamic finance in Malaysia and it has also witnessed encouraging development in recent years, with market participants showing greater interest to adopt ICM products and services in meeting their investment and financing needs. It has played a complementary role to the conventional capital market by providing value-added services that meet the needs of the market for a broad range of instruments. Since the first Islamic private debt securities was issued, ICM has developed and produced a wide range of equity products, debt securities and managed funds in line with the principles of Shariah. The rapid development in the ICM has encouraged major market players to issue sukuk (Islamic bonds). Malaysia pioneered the global sukuk market with the issuance of the Global Sukuk and Guthrie Sukuk in 2002. Malaysia has since established itself as one of the largest issuers of sukuk in the world, employing the concepts of ijarah, musharakah and mudharabah. The issuance of sukuk is regulated by the Securities Commission (SC) through based on the Guidelines on the Offering of Islamic Securities.

In Malaysia, the regulators of the Islamic finance system are BNM and the SC which govern the banking industry and the securities market respectively. Presently, there are two separate Shariah Advisory Councils (SAC) advising BNM and SC respectively. The SAC of BNM is responsible for advising on matters pertaining to Islamic banking and Takaful whereas the SAC of SC is responsible for advising on matters pertaining to the ICM.

Great strides are being made in the development of Islamic banking and finance in the country. Amongst others is the promotion of the settlement of disputes based on Islamic principles. The Kuala Lumpur Regional Centre for Arbitration (KLRCA) has introduced the Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services) which allows any disputes arising from Islamic banking and finance to be referred to KLRCA for resolution. KLRCA has invited Muslim arbitrators with background in Islamic banking to offer their services in the settlement of such disputes.

The expansion of the Islamic banking system in Malaysia has also provided a pathway for it to be extended to Labuan. The new Labuan Islamic Financial Services and Securities Act 2010 provides for the licensing and regulation of Islamic financial services and securities in Labuan. It also provides for the establishment of Islamic banking and Takaful business in Labuan. The Malaysian Government has actively promoted and encouraged interest-free banking, takaful, fund management and private debt securities in Labuan. The promotion of the SAC by Labuan Financial Services Authority is another strategic move towards developing the Islamic niche in Labuan International Business & Financial Centre (IBFC). The SAC's main role is to advise the authority on matters regarding Shariah and the development of Islamic banking and finance in Labuan. It would also review proposals for new transactions or products submitted by both the government and private sectors to determine whether they conform to Shariah. Labuan IBFC plays a central role in the promotion and development of Islamic banking and finance globally aims to be an active centre for Islamic banking and finance regionally as well as worldwide and aspires to be the home of innovative Islamic financial solutions.

When Islamic banking first made its debut in the country, it was to offer an alternative form of banking which is Shariah compliant. Its emergence is the starting point of many breakthroughs in the Islamic banking arena. It has undeniably put Malaysia on the map and caught the eye of Muslims and non Muslims alike. Islamic principles and values are universal and are applicable to all aspects of life. Although it has not reached its full potential yet, it is here to stay. Islamic banking and finance in the Malaysia has come a long way and it still has a long way to go.

Encik Mohamed Ridza Abdullah, is the managing partner of Mohamed Ridza & Co. He graduated with a Bachelor of Laws (First Class Honors) degree from the International Islamic University Malaysia. He is also a graduate of the Institute of Chartered Secretaries and Administrators (London). He is currently a Fellow of the Institute of Chartered Secretaries and Administrators (FCIS) and an Associate Member of the Chartered Institute of Arbitrators (ACI Arb.) He was called to the Malaysian Bar in 1993. His current practice includes oil and gas, corporate and commercial law, construction law and banking and finance with specialisation in Islamic banking and finance.

Being trained in Shariah as well as common law, he has advised clients locally and internationally on Islamic banking documentation utilising various Shariah concepts ranging from Islamic trade finance, Islamic corporate and retail banking and takaful. In addition, he also advises clients on Islamic offshore financing, Islamic securities and Islamic asset backed securities. He was also instrumental in developing Islamic banking documents for several financial institutions. He has spoken extensively in seminars locally and internationally involving corporate matters and Islamic banking and finance.

Encik Mohamed Ridza has written a chapter on Independent Directors in collaboration with the Securities Commission and has co-authored a book titled the "Law & Practice of Islamic Banking & Finance" and "Sukuk Islamic Capital Market Series" published by Sweet & Maxwell Asia. He currently sits as an independent director on the board of several public companies and also their respective audit committees. He is also a trainer with Securities Industry Development Corporation (the training arm of Securities Commission) and Financial Sector Talent Enrichment Programme (FSTEP) (the training arm of Institut Bank-Bank Malaysia). He was named as one of the world's leading Islamic finance lawyers as voted by his peers in the industry (Asialaw Leading Lawyers) in the area of Banking, Capital Markets, Corporate Finance and Islamic Finance and nominated as one of the outstanding practitioners in the World's Leading Islamic Finance Practitioners by Legal Media Group's Guide.