

## INCEPTION AND MATTERS OF ISLAMIC BANKING SYSTEMS IN MALAYSIA

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**Abstract.** This conceptual paper describes the insight held of the Islamic banking theory and its issues which is discussed from the perspective of Islamic Banking. The Islamic banking sector had making a wave in the developing a products and services persuading into warship to Allah SWT and therefore more researchers workout towards any clash items in order to improve this sectors. Many believed that return generated from investments in Islamic banking would far ahead better off conventional ones. Some issues to ponder perhaps the shariah law and legal perspective, riba and different school of thought may be discuss in this paper and it then will reveals the specifically the thought and arguments of various scholars in regards to this matters. This paper will contribute a new knowledge on the design of Islamic financial institutions laterally in Malaysia.

### Introduction

Islam is a complete religion and comprehensive way of life whereby Muslim conduct and character is controlled and guided by Islamic principles. Islam encourages Muslims to acquire property in a lawful manner with the divine right to enjoy the acquired property in the best way. Islam encourages Muslims to engage in any lawful and profitable business and transaction in order to enhance and enrich their daily income whereby pertaining to the balance life. Islamic banking and finance categorized under contract where financial activities generate income and change of ownership. The prime objective of Islamic banking and finance is having the deposited capital by the customer and other related purpose. However, Islam prohibits all element of interest which known as riba in transactions and business.

Islamic banking is gradually taking path into the global financial system. The banking system is very significant in the development process of every economy. The practise of commercial banking is predicated on inter mediation and generation of net interest income through two core operations, the collections of deposits on which banks pay interest and issuing of loans for which banks receive interest income. In short, conventional banking system is interest based or credit based. The development of banking has opened new frontiers for commercial banks to expand beyond their traditional role and sources of income to activities that generate non-interest income such as fee based activities, licensing and insurance. The banking system has ever been changing with the changes in the society. Indeed, a variety of banking models has been developed all over the world, but mainly they function on the basic of interest. The most significant development in the field of banking is the emergence of Islamic Bank (Wan Hakimah Wan Ibrahim, 2017).

Islamic finance has achieved considerable growth and considered to be the fastest growing segment of the financial system. This development brings a challenge to the Islamic banking. Islamic banking and finance is widespread globally and requires critical discussion on current issues and practices in the industry. Bashir (2003) believed that the stability progress of Islamic banks has been the hallmark of the Muslim world financial landscape in the 1980s and 1990s since the first Islamic bank was established in 1963. Islamic banks have been accepted and gained trust by almost every majority Muslim country as well as non-Muslim countries. To be more specific, Islamic banks are now playing an increasingly significant role in their respective markets with a network that spans more than 60 countries and an asset base of more than \$200 billion. Malaysia is one of the countries that have implemented the concept of Islamic finance in the banking industry for over thirty years with the first Islamic bank that was established in July 1983 called Bank Islam Malaysia Berhad (BIMB). 30 years after that, the government gave the opportunity for foreign Islamic banks in Malaysia and surprisingly has made the growth of Islamic banking in Malaysia become more rapid. In 1994, some of the selected commercial banks were legally allowed to introduce facilities of Islamic deposit which makes the Islamic banking in Malaysia was accepted due to the increasing amount of total deposits and total financing based on Islamic principles that are placed by Muslim and non-Muslim customers.

Since the establishment of BIMB, banking sector has improved its performance with an upward trend of average annual

growth of 48.5% in terms of assets over the period of 2006 until 2009. The assets continued to grow with 12.8% as at November 2010. In terms of market share of Islamic bank, Bank Negara Malaysia (BNM) reported that it quadrupled in 2016 to 28% from 7.1% in 2010. Malaysia has long been appointed as a leading country in terms of Islamic finance since the first Islamic bank was introduced over 30 years ago. According to the World Bank and Islamic Development Bank Group's Global Report on Islamic Finance 2016, Islamic banking product and services are now offered in 50 Muslim and non-Muslim jurisdictions worldwide. So, it is proved that Islamic finance is being accepted by non-Muslim as well and considered to be a real competitor to conventional finance. Prohibition of *riba* (interest) is the main important factor for the establishment of the first Islamic bank in Malaysia. (Madun & Kamarulzaman, 2015) (Oloso & Koyejo, 2016).

The importance and potential of Islamic Banking prompted the International Monetary Fund (IMF) to facilitate the establishment of the Islamic Financials Services Board (IFSB) in 2002. The IFSB serves as the Islamic equivalent of IMF towards addressing the need for a suitable regulatory framework, new financial instruments and institutional arrangements for Islamic finance operations. Earlier in 1990, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established to set the accounting standard for the Islamic financial industry. In 2010, the International Islamic Liquidity Management Corporations (IILM) was established to enhance liquidity management in the Islamic financial system, among others, through the periodic issuance of short term shari'ah compliant financial instruments. However, there stills several issue of Islamic banking pertaining to the evolvement of such as risk of high cost of financing, interest charges issue, placed commercial risk, assess to finance, lacking of public awareness, sufficient of shariah law and legal framework in ensuring the Islamic banking product are practices according to the letter and the spirit of shariah need to be fonder (Desai, 2016)

### Issues Pertaining In Islamic Banking

**Shariah law and legal framework.** As the Islamic bank will have to engage itself in Islamic banking business, s. 30 of the Banking Act (which forbids a bank from engaging in trade) will not apply to it and is not included in the Islamic Banking Act. "Islamic banking business" is defined in the Islamic Banking Act as banking business whose aims and operations do not involve any element which is not approved by the religion of Islam. To ensure that the business of the Islamic Bank does not contravene the requirements of the Islamic religion and law, the Bank has a Shariah Advisory Body to advise it on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the religion of Islam. . In Malaysia in order to set up the Islamic bank, the Islamic Banking Act 1983 (Act 276) was enacted. In general, the provisions in the Islamic Banking Act follow those in the former Banking Act in regard to financial requirements, maintenance of reserve funds, statutory requirements and power of supervision and control by the Central Bank (Bank Negara) with slight modifications (BNM, (2013)).

Where the normal banking practices do not clash with the Islamic principles, the Islamic banks have adopted the current banking practices and procedures. Where any clash arises, the Islamic banks have devised their own practices and procedures to accomplish their banking activities. In some cases as in Malaysia a Shariah Advisory Committee is constituted to advise the bank on the operations of the banking business in order to ensure that they do not involve any element which is not approved by the religion of Islam. It is also provided that the Islamic bank should, in addition, to making provision for taxation under s. 22 of the Banking Act, also make provision for the payment of zakat. The facilities that are provided by the Islamic bank will in general be similar to those provided by other commercial banks. Its customers can maintain current accounts and deposit accounts, however no interest is payable. In addition, the customers can deposit their moneys in the investment accounts in which the profits and h will be shared with the bank. The Islamic bank can also provide services for the transmission and transfer of money, the purchase and sale of currency and the financing of trade documents, for all of which the Islamic bank can charge commissions. In addition, the Islamic banking business provided by the bank includes the methods of mudharabah, musyarakah, bai bi-thamin ajil, murabahah, wadiah and ijarah (Amuda, 2015).

There is a need of law and legal framework in managing bank especially Islamic bank. Law and legal framework is a form of regulation which subjects banks to certain requirements, restrictions and guidelines, designed to create market transparency between banking institutions and the individuals and corporations with whom they conduct business (BNM, 2013). The growth and development of Islamic banking industry are supported through goods governance and its comprehensive legal frameworks. As Malaysia is one of the common law countries, it is very essential to have standard law of practice, which harmonizes both shariah and civil law. The integration of these two traditions is really necessary in the context of Islamic banking in Malaysia. This law and legal framework of Islamic banking is important for regulatory agencies to maintain control over standardized practices, to reduce the level of risk to which bank creditors are exposed, to reduce the risk disruption resulting from adverse trading conditions for banks causing multiple or major bank failures, to reduce the risk of banks being used for criminal purposes, to protect banking confidentiality and to direct credit to favoured sectors. The Islamic banking regulator imposes requirements on banks in order to promote the objectives of the regulator. Often, the requirements are closely tied to the level of risk exposure for a certain sector of the bank and there are insufficient of harmonize in shariah law with existing legal framework.

## Riba

Riba is a concept in Islamic banking that refers to charged interest. It is forbidden under shariah and Islamic religious law because it is thought to be exploitive. Depending on the interpretation, riba may only refer to excessive interest. However, the whole concept of interest is riba and thus is unlawful (Desai, 2016). There are riba al-fadl and riba al-nasiah are strictly prohibited based on Quran and Sunnah evidence. Riba Al-Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase & sale as explained in the famous hadith: The Prophet said, “Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat- in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (Riba). Secondly, Riba An-Nasiyah refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. The prohibition of Riba An-Nasiyah is one of those issues which have been confirmed in the revealed laws of all Prophet Muhammad. According to the above definition of Riba An-Nasiyah, the giving and taking of any excess amount in exchange of a loan at an agreed rate is included in interest irrespective whether at a high or low rate.

Another controversy on riba is due to the Quran injunctions against riba whether it is ‘interest’, or ‘usury’. Meanwhile, Interest refers to the fee a lender charges when she allows your business to borrow money. Most lenders calculate interest based on a percentage of the amount you owe on the loan. While some lenders charge a flat interest rate for the duration of your contract, others may charge a variable rate. Usury refers to interest that is higher than the maximum rate that the state allows lenders to charge. “Interest” is a general term that can refer to any percentage fee charged by a lender for his services, regardless of whether it is usurious. Usury, on the other hand, is a specific type of interest that isn’t fair to the borrower. While the law permits lenders to charge interest, lenders can’t require borrowers to pay interest at usurious rates. In fact, there may be legal repercussions for lenders who commit usury.

There is a divergence in opinions on whether Islamic banking and finance has succeeded incompletely eliminating riba in all aspects. The interviewee’s agreed that it has been eliminated to an extent. However, it was also observed that riba can sometimes occur in the case of default payment, although it is usually distributed back to charity. In other cases, riba may occur when certain financing instruments are not applied properly, leading to money-with-money transaction. (Amuda, 2015). Riba (usury or interest) is forbidden, but doing good things and trading is permitted [al-Baqarah verse 275-279]. Instead of riba, Allah SWT encourages man to give ‘Qardul Hassanah’ which is benevolent loan to Allah SWT as a consolation for loss of value of money, Prophet Muhammad SAW used to voluntarily repay debts handsomely (Hadith 1104) (Abdul-Yakeen, 2016). Since interest is prohibited in Islam, the Islamic banking and finance alternative to finance houses avoids interest. Nevertheless, due to unavailability of a distinctive price benchmark, Islamic banking has also been using the interest rate benchmark in pricing the assets and computing rents. The financial structure of products from cash flow perspective does not differ much in Islamic banking from conventional banking. The practitioners argued that the difference lies in contract mechanics. They contend that as long as the prices are specified, the method used for pricing the product does not matter (Shaikh, 2016). Conventional risk management techniques and tools are based on interest, gambling and speculation, which are prohibited by Shari’ah. Islamic finance is sorely lacking on product breadth, depth and sophistication. There are still only few risk hedging instruments and techniques in Islamic finance despite its rapid growth. A number of risk management techniques are not available due to requirements for Shari’ah compliance. In particular, these are credit derivatives, swaps, derivatives for market risk management and money market instruments (Ali, 2016)

Scholars have raised concerns about the validity of certain products which are riba or interest based. The avoidance of interest in an Islamic economy is of paramount importance, although Islamic Banking and Finance entails more than simply being interest-free. It is in any case critical to ensure that all products and services rendered by Islamic banks and similar financial outfits are devoid of interest, regardless of what form it may take, whether Bai’al-Inah, tawwaruq or commodity murabahah, sales of debt derivatives and so forth, to ensure the uniformity and vitality of the industry. Beyond what is clearly lawful or clearly prohibited, there is a need to spotlight ambiguous or gray areas and to stay clear of doubt and unlawful indulgence; for whosoever falls into ambiguity strays towards the haram. (Oloso & Koyejo, 2016) (Rafay & Sadiq, 2015).

### School of Thought Islamic Banking

A particular problem in developing uniform framework is the existence of different schools of thought within Islam. Many Islamic jurists were capable of juristic reasoning like Al-Shaafi, Abu Hanifa, Malik, Ahmad bin Hanbal, Al-Awzai, Layth bin Saad, AlThawri and Ibn Jarir al-Tabari but the approaches of only five main jurists became established, as outlined in Table 1. All the Imams of these schools of thought are of the views that in case of any conflict between their Fatawa and Quran or Sunnah (Sahih Hadith), then follow the teachings of Quran & Sunnah only.

Table 1: Islamic Schools of Thought

School of thought	Headed by
HANAFI	Imam al-Nu’man ibn Thabit (Abu Hanifa) [80AH-180AH]
MAALKI	Imam Malik ibn Anas Al-Asbahi [93AH-179AH]
SHAAFI’I	Imam Muhammad ibn Idris al-Shafi’I [150AH-198AH]
HANBALI	Imam Ahmad ibn Hanbal [164AH-241AH]
JAAFARI	Imam Ja’far ibn Muhammad al-Sadiq [83AH-148AH]

In these countries followers of all school of thoughts live but no common framework has been developed for consensus and contention which are the integral part of these schools. In Malaysia, for example, Islamic banking and financial matters fall within the jurisdiction of the civil court though they are fiqh mua’alaat matters. 22 Scholars have offered solutions to this problem; however, it has not worked out as expected. For instance, Zakhiri (2010) advocates integration of al-fatwa, al-imaamah and al-qadaa. He stresses that there should not be conflict between them and therefore there is a need to work together, harmonise and codify these ordinances (Oloso & Koyejo, 2016). Unfortunately, as he has observed, Shariah has been used as an escape route by the debtor not to pay the creditor, when a certain product had been declared as invalid by the court even though the Shariah Board had already issued a resolution/fatwa and approved that the product is Shariah compliant, using the argument that Islamic banking businesses are not fully Islamic as they are dependent on their conventional counterparts. Zakhiri (2010) observed that fatawa, Shariah resolutions and civil law often tend to overlap and are not properly integrated; the proper integration or co-ordination of all regulations could ensure the healthy growth and proper functioning of the industry. Given the geographical spread of the industry, this is worth considering and would give a positive role to the higher objectives of Shariah, the maqasid al-Shariah. This would also facilitate a degree of uniformity in the global practice of Islamic Banking and Finance.

### Conclusion

The transition economics of the financial institutions can be divided into conventional banking and Islamic banking. This evolution of Islamic banking and finance has created some innovations on the institutions which is call dual systems. Precisely the improvements needed for some modification in Islamic banking so that no arguments of unlawfully Shariah compliance products and services. The role plays by the Islamic regulatory bodies in supervise and monitoring agenda referring to all aspects of Islamic Banking will laterally boost the demand for Islamic finance all over the world. (Mokhtar, Abdullah, & Alhabshi, 2008) (Nik Hassan & Musa, 2004)

The applications of Islamic banking products over the years will enhance the financial landscape with conditions of better systems covered. The demand and funds injected in Islamic banking not only from Muslims but the trends see a massive flow form non- Muslims. This is the evidence of better succession in the productivity and development of Islamic banking world widely.

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