

Islamic Banking in Malaysia: Framework, Performance, and Lessons

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The establishment of Bank Islam Malaysia Bhd. (BIMB) in 1983 marked the beginning of a new era in the Malaysian financial system. The introduction of Islamic banking in Malaysia has been viewed by many Muslims as an alternative to the already existing interest-based financial institutions and by non-Muslims as a healthy development that adds variety which renders commercial banking a highly competitive industry.

The Malaysian experience has shown that Islamic banking is a viable proposition. That the track record of BIMB is fairly impressive, however, does not necessarily mean that all is well with Islamic banking in the country. An attempt is made in this paper to review the performance of BIMB during the last six years and to draw lessons from it. It is hoped that the present analysis will provide a basis for charting out new directions.

BACKGROUND

Islamic banking in Malaysia is by no means the result of a historical accident but of conscious and concerted Islamization efforts fuelled by Islamic resurgence that began in the 1970s. The establishment of BIMB marked an important milestone in the Islamization process. To be sure, Islamic banking in the country was not without antecedents. In fact, the Pilgrims Management and Fund Board (PMFB), set up in August 1969, represents the pioneer interest-free financial institution in the country. The main function of PMFB is to promote and mobilize the savings of intending pilgrims and to coordinate the pilgrimage activities undertaken by members.

It now appears in retrospect that it was the PMFB's success that paved the way for Islamic banking in the country. Since 1980, the local Muslim community had exerted sustained pressure on the government to establish an Islamic bank. In July 1981, the government responded by instituting a national steering committee to study in detail the feasibility of Islamic banking in the country. On the recommendation of the committee, the Islamic Banking Act 1983 was promulgated, ushering in Islamic banking, subject of course to the supervision and regulation of Bank Negara Malaysia, the central bank.

BIMB was finally incorporated as a limited company under the Companies Act 1965 on 1 March 1983, with an authorized capital of M\$500 million and a paid-up capital of M\$80 million, 30 percent of which was provided by the Malaysian government. PMFB contributed 12.5 percent of the initial capital, with the balance held by the Muslim Welfare Organization of Malaysia and various religious councils and agencies. BIMB is steered by a board of directors and guided by a management committee. In addition, the bank is also advised by a religious supervisory council whose duty is to ensure that the bank's operations do not in any way infringe the basic principles of Islam.

It is quite obvious that BIMB could not have been set up without the strong support of the government. Evidently, the government has been sympathetic to the Islamic cause, which is not hard to explain. The United Malay National Organization (UMNO), the main component in the ruling Barisan Nasional coalition, has always been conscious of the need to implement Islamic values to stay in power. It was clearly in the interest of UMNO to take the winds off the sails of its rival, Parti Islam SeMalaysia (PAS), which advocates Islamization of the Malaysian economy and the establishment of an Islamic state in the country. Thus, the introduction of Islamic banking in the country was part of the government's strategy to steal the thunder of the Islamic opposition. In short, the political climate of the early 1980s was just right for the emergence of Islamic banking in Malaysia.

INSTRUMENTS

The most striking feature of Islamic banking is that, unlike conventional banking, it is totally interest-free. It is all too well known that payment and receipt of interest is prohibited in Islam, regardless of the rate of return or the purpose of financial transactions. It is therefore absolutely essential that no transaction entail any element of interest—directly or indirectly, explicitly or implicitly. Accordingly, BIMB has taken pains to ensure that all its transactions are cleansed of interest. BIMB, like Islamic banks elsewhere, is guided by Islamic jurisprudence, and it has replaced interest with instruments or devices that are consistent with Islamic codes.

Like conventional banks, BIMB operates current and savings accounts, but interest is replaced by invoking the principle of *al-wadiah* (safe-keeping under trusteeship) which allows the bank to use money deposited without having to share the profits with the depositors. In the case of current deposits, the bank provides all the usual current account services free of charge. In the case of savings deposits, the bank returns a portion of profits to the depositors at its absolute discretion.

In addition, the bank operates two types of investment accounts based on the *mudharabah* (profit-sharing) principle which permits the bank to use the deposits, with profits being shared with the depositors in predetermined proportions and any losses being borne entirely by the depositors. The general investment account enables deposit of funds for a specified period (from one month to a maximum of five years) to be invested in any way deemed fit by the bank. The special investment account is meant for government deposits and deposits from institutional and corporate clientele. The profit-sharing ratio in the case of the general investment account divides total profits, with 70 percent accruing to the depositors and 30 percent to the bank. Profit-sharing ratios for the special investment account are negotiable.

On the asset management side, too, investments are made strictly in accordance with Shari'ah. Under the *mudharabah* mode, the bank provides the capital and the borrower-entrepreneur provides the management expertise. Profits are shared according to an agreed proportion, while any losses are borne by the bank. The bank also resorts to the *musharakah* (equity-participating partnership) facility for project financing. Under the *musharakah* arrangement, the bank shares the cost of the project with the entrepreneur based on an agreed proportion, with both parties having the right (which may be waived) to participate in the management of the project. Profits are shared according to an agreed ratio, which may not correspond to the equity ratio. However, the sharing of any losses is based on the equity ratio.

The bank also resorts to other Shari'ah-based modes of financing. One of these is the purchase and resale of properties on a deferred payment basis. This is termed *bay' bi thaman ajil* (also referred to as *bay' muajjal* in the literature). Under this mode, the bank purchases the asset and subsequently sells it to the customer at an agreed price, adding a profit margin, which the

customer pays in instalments.

The bank also undertakes *ijarah*, first purchasing the asset required by the customer and then leasing it to the customer for a fixed period on a lease-rental basis. A variation of this mode is leasing that ends with ownership (*bay' al-takjiri*). This arrangement allows the customer eventually to buy the asset at an agreed price, with the rental paid previously constituting part of the price.

Shari'ah also permits the bank to practise *bay' salam*, pre-paid purchase of goods for financing production. In this case, the price is paid in advance at the time of the contract, but the delivery would take place at a future date.

The bank provides short-term facilities through the issue of letters of credit under the principle of *al-wakalah*. In this case, the customer may be required to deposit with the bank the full price of the goods to be bought or imported and to pay fees and commissions to the bank. The bank also issues letters of guarantee under the principle of *al-kafalah*. The bank charges service fees for this facility, and the customer is required to place a certain amount on deposit with the bank as collateral. Another trade financing instrument at the disposal of the bank is the mark-up device, or *murabahah*. In a *murabahah* transaction, the bank finances the purchase of a good or asset by buying it on behalf of the client and adding mark-up before selling it on a cost-plus basis.

In addition to all these, the bank also provides *qard al-hassan*, or benevolent loans. However, this facility is targeted mainly at the government. Under this mode, a borrower is obliged to return only the principal sum, but Shari'ah permits him to pay something over and above the principal amount at his own discretion without any demand on the part of the bank.

ACHIEVEMENTS

Although BIMB was incorporated on 1 March 1983, its operations did not begin until 1 July 1983. As of 31 December 1987, BIMB ranked ninth among the twenty-three locally incorporated commercial banks in terms of shareholders' funds and occupied the twelfth position in terms of both assets and deposits (table 1). Its market share, in terms of deposits, has increased from 0.57 percent in 1984 to 2.11 percent in 1988.

Until mid-1984, investment account deposits were accepted by the bank for periods ranging from six months to five years and above. Thereafter, investment account deposits were accepted also for shorter periods of one to three months.

Current account and savings account deposits have figured significantly right from the beginning. Current account deposits increased from M\$47.1 million to M\$158.8 million between December 1983 and December 1988. During the same period saving account deposits rose from M\$9.6 million to M\$166.9 million. The increase was particularly dramatic in the case of Investment Account deposits, which rose sharply from M\$34.4 million in December 1983 to M\$954.4 million in December 1988. It is relevant to note that the bulk of the total investment account deposits are for a period of two years and below. Total deposits stood by the end of 1988 at M\$1.285 billion, which compares very favorably with M\$91.1 million at the end of 1983. The total number of depositors also increased nearly tenfold, from 22,499 in December 1983 to 220,400 in December 1988 (table 2). It is also noteworthy that about 98 percent of the depositors are Muslims.

Some significant changes have taken place in the structure of deposits (table 3). The share of current account deposits in the total has fallen from 51.7 percent in December 1983 to 12.4 percent in December 1988. Savings account deposits accounted for 13 percent in December 1988, compared with 10.6 percent in December 1983 and 15.2 percent in December 1986. The

TABLE 1
Locally incorporated commercial banks

Institution	Assets		Deposits		Shareholders' funds		Profits	
	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank
Malayan Banking Bhd. ^a	29,141,879	1	19,833,459	1	1,919,060	1	96,171	1
Bank Bumiputra Malaysia Bhd. ^b	28,866,232	2	18,297,502	2	949,361	2	3,023	14
United Malayan Banking Corp. Bhd.	10,004,780	3	6,156,637	3	323,635	4	15,423	5
Public Bank Bhd.	7,373,383	4	6,108,198	4	329,380	3	54,126	2
Development and Commercial Bank Bhd.	4,552,660	5	3,300,821	5	237,780	5	6,616	7
United Asian Bank Bhd.	2,752,117	6	1,654,613	7	48,227	13	4,148	12
Malayan United Bank Bhd.	2,113,556	7	1,808,183	6	38,321	14	(81,779)	21
Southern Bank Bhd.	1,748,808	9	1,209,702	10	156,733	6	22,630	3
Perwira Habib Bank Malaysia Bhd.	1,699,845	10	1,571,619	9	(262,232)	21	6,581	8
Bank of Commerce Bhd. ^c	1,617,727	11	1,037,664	13	67,259	10	14,599	6
Hock Hua Bank Bhd.	1,521,826	12	1,156,197	11	97,835	8	21,294	4
Malaysian French Bank Bhd.	1,295,788	13	679,060	17	36,457	15	(12,632)	20
Bank Islam Malaysia Bhd. ^a	1,263,451	14	1,042,008	12	85,750	9	6,187	9
Bank Utama (Malaysia) Bhd.	1,198,087	15	972,610	14	35,459	16	(12,140)	18
Ban Hin Lee Bank Bhd.	1,096,284	16	821,760	15	50,976	12	246	17
Pacific Bank Bhd.	1,066,000	17	738,000	16	55,000	11	4,220	11
Sabah Bank Bhd.	688,953	18	590,122	18	23,052	19	(12,530)	19
Bank Buruh (Malaysia) Bhd. ^a	513,592	19	405,422	19	33,352	18	2,566	15
Hock Hua Bank (Sabah) Bhd.	301,874	20	224,426	21	33,896	17	4,643	10
Wah Tat Bank Bhd.	278,602	21	225,219	20	16,650	20	1,636	16
Kong Ming Bank Bhd.	—	—	—	—	—	—	—	—
Oriental Bank	—	—	—	—	—	—	—	—

Source: Arab Malaysian Merchant Bank Bhd., Kuala Lumpur Banker's Directory (1989).

Notes: All data are as of 31 December 1987 unless specified to the contrary. All amounts are in thousands of Malaysian ringgit.

^aAs of 30 June 1988. ^bAs of 31 March 1988. ^cAs of 31 August 1987.

TABLE 2
Bank Islam Malaysia Bhd, customer deposits

Account type	Period ending											
	Dec 83	June 84	Dec 84	June 85	Dec 85	June 86	Dec 86	June 87	Dec 87	June 88	Dec 88	
Current												
Depositors Amount	2,345	4,392	5,625	7,488	7,862	9,320	1,053	12,072	13,620	15,041	16,170	
	47.10	40.70	42.00	46.10	61.60	56.60	96.90	123.00	128.20	142.30	158.80	
Savings												
Depositors Amount	17,515	32,012	43,441	55,507	72,309	89,700	109,735	129,164	147,142	165,772	181,992	
	9.60	26.10	34.80	46.50	61.10	78.20	96.20	113.80	132.20	152.80	166.90	
Investment												
Depositors Amount	2,636	4,658	6,976	8,832	10,520	12,607	14,208	14,586	17,582	19,953	22,125	
	34.40	101.20	188.10	173.20	346.40	441.00	437.00	588.90	707.00	747.40	954.40	
Other												
Depositors Amount	3	24	39	72	58	70	63	85	98	110	113	
	—	3.60	4.80	5.30	3.90	5.40	3.10	8.00	4.70	3.90	4.90	
Total												
Depositors Amount	22,499	41,086	56,081	71,899	90,749	111,697	125,059	155,907	178,442	200,876	220,400	
	91.10	171.60	269.60	371.10	473.00	581.20	633.20	833.70	972.10	1046.40	1285.00	

Note: All amounts are in millions of Malaysian ringgit.

TABLE 3
Composition of Bank Islam Malaysia Bhd. deposits (percentage)

Account type	Year ending					
	Dec 83	Dec 84	Dec 85	Dec 86	Dec 87	Dec 88
Current	51.74	15.18	13.03	15.31	13.19	12.36
Savings	10.56	12.90	12.91	15.19	13.60	12.99
Investment	37.79	69.75	73.23	69.01	72.73	74.27
Other	0.01	1.77	0.83	0.49	0.48	0.38
Total	100.00	100.00	100.00	100.00	100.00	100.00

Note: Computed from table 2.

relative importance of investment account deposits has increased sharply, from 37.8 percent in December 1983 to 74.3 percent in December 1988.

BIMB keeps 30 percent of its profits and distributes 70 percent among its depositors. The rate of return to depositors in savings accounts increased from 4.96 percent per annum in June 1984 to 5.46 percent per annum in June 1985, but declined gradually to 3.25 percent in June 1988. A slight increase in the rate of return (to 3.31 percent) was posted in December 1988. A similar trend was also found in the returns on investment deposits, particularly in the categories of nine months and over. However, the rates of return on investment account deposits of one to six months peaked in June 1985, with a slight decline in December 1985 followed by a marginal increase in June 1986 and a subsequent fall until June 1988 (table 4).

The movements in the rates of return seem to reflect the macroeconomic changes in the country in recent years. However, the rates of return provided by BIMB pale somewhat in comparison with the rates offered by conventional banks (table 5).

As shown in table 6, BIMB's financing and investment extended to its customers amounted to M\$620.5 million in June 1988, nearly four times the level reached in June 1984 (M\$165 million). The customer investment portfolio changed significantly between 1983 and 1988. *Murabahah* financing grew year after year in absolute terms, but its relative share in the total outlay declined from 37.2 percent in June 1984 to 18.9 percent in June 1988. *Musharakah* investments grew absolutely, but their share in the total fell to 1.8 percent in June 1988 from 2.2 percent in June 1986, which nevertheless compared favorably with their 1.2 percent share in June 1984. The relative importance of *ijarah* declined consistently from 9.3 percent in June 1984 to

TABLE 4
Rate of profit paid to Bank Islam Malaysia Bhd. depositors (percentage per annum)

Account type	Period ending									
	June 84	Dec 84	June 85	Dec 85	June 86	Dec 86	June 87	Dec 87	June 88	Dec 88
Savings	4.96	5.14	5.46	5.18	4.71	4.68	4.20	3.49	3.25	3.31
Investment										
1 month	5.56	5.76	6.11	5.80	5.28	5.24	4.70	3.91	3.64	3.71
3 months	5.91	6.12	6.49	6.17	5.61	5.57	4.99	4.16	3.87	3.94
6 months	6.25	6.48	6.88	6.53	5.94	5.89	5.29	4.40	4.09	4.18
9 months	6.60	6.84	7.26	6.89	6.27	6.22	5.58	4.64	4.32	4.41
12 months	6.95	7.20	7.64	7.25	6.60	6.55	5.88	4.89	4.54	4.64
15 months	7.29	7.56	8.02	7.62	6.92	6.87	6.17	5.13	4.77	4.87
18 months	7.64	7.92	8.40	7.98	7.25	7.20	6.46	5.38	5.00	5.10
24 months	7.99	8.28	8.79	8.34	7.58	7.53	6.76	5.62	5.23	5.34
36 months	8.34	8.64	9.17	8.70	7.91	7.86	7.05	5.87	5.45	5.57
48 months	8.68	9.00	9.55	9.07	8.24	8.18	7.34	6.11	5.68	5.80
60 months+	9.03	9.36	9.93	9.43	8.57	8.51	7.64	6.36	5.91	6.03

TABLE 5
Interest rates of commercial banks (percentage per annum)

Account type	Year ending																		
	Dec 82		Dec 83		Dec 84		Dec 85		Dec 86		Dec 87		Dec 88						
	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High					
Savings	5.00	8.50	6.50	5.00	8.00	6.00	6.00	5.50	8.00	8.00	8.00	5.50	8.00	3.00	5.00	3.00	4.50	3.50	
Fixed deposit																			
1 month	8.57	10.50	9.00	6.25	10.00	8.25	9.00	6.50	8.00	7.25	5.00	7.00	6.00	1.75	3.25	2.00	2.75	4.50	3.00
3 months	7.50	9.50	9.00	6.75	9.75	8.50	9.25	6.75	8.25	7.25	6.00	7.50	6.25	2.00	3.75	2.25	3.00	4.50	3.25
6 months	8.00	9.50	9.25	7.00	9.75	8.50	9.25	6.75	8.50	7.50	6.25	7.75	6.75	2.50	4.25	3.00	3.25	4.50	3.75
9 months	8.00	10.00	9.50	7.00	9.75	8.75	9.50	7.00	8.50	7.50	6.50	6.50	7.00	2.75	4.75	3.50	3.50	4.75	4.00
12 months	9.25	10.50	10.00	7.50	9.50	9.00	9.50	7.00	8.50	7.50	8.50	8.50	7.00	3.00	5.00	4.25	3.75	5.00	4.25

Source: Bank Negara Malaysia, Monthly Statistical Bulletin (February 1989).

TABLE 6
Bank Islam Malaysia Bhd. customer financing and investment

Mode of financing	Year ending											
	June 84		June 85		June 86		June 87		June 88			
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage		
<i>Bay' bi thaman ajil</i>	80.96	49.10	232.84	68.40	325.88	77.00	372.92	78.70	471.50	76.00		
<i>Ijarah</i>	15.28	9.30	20.12	5.90	20.54	4.90	16.36	3.40	17.77	2.90		
<i>Mudharabah</i>	5.11	3.10	2.95	0.90	1.38	0.30	1.32	0.30	0.48	0.10		
<i>Murabahah</i>	61.39	37.20	77.51	22.80	65.72	15.50	71.03	15.00	117.17	18.90		
<i>Musharakah</i>	2.07	1.20	6.96	2.00	9.23	2.20	10.09	2.10	11.23	1.80		
<i>Qard al-hassan^a</i>	0.14	0.10	0.13	0.00	0.21	0.10	2.34	0.50	2.36	0.40		
Total	164.95	100.00	340.51	100.00	422.96	100.00	474.06	100.00	620.51	100.00		

Source: Bank Islam Malaysia Bhd.

Note: All amounts are in millions of Malaysian ringgit.

^aIndicates advance payments made on outstation cheques prior to central bank clearance.

2.9 percent in June 1988.

The most striking feature is that *bay' bi thaman ajil* (or *bay' muajjal*) accounts for the bulk of the total and that its relative importance has grown over time. The share of *bay' bi thaman ajil* in the total increased from 49.1 percent in June 1984 to 78.7 percent in June 1987, before declining marginally to 76 percent in June 1988. Another striking observation is that *mudharabah* investments have been falling both absolutely and relatively. The share of *qard al-hassan* (representing advance payments made on outstation cheques prior to central bank clearance) has understandably remained quite small.

It appears that about 90 percent of the bank's financing and investment is accounted for by Muslims. The number of financing accounts totalled 3,215 as of 30 June 1988. It is also worth noting that a large number of BIMB financing involved relatively small amounts, with 81 percent amounting to M\$100,000 or less. Evidently, the sectorial allocation of funds disbursed by BIMB exhibits considerable diversity, covering nearly all the major sectors (table 7). However, real estate, manufacturing and wholesale and retail trade jointly account for 56.9 percent of the total.

TABLE 7
Distribution of Bank Islam Malaysia Bhd. customer financing

Sector	Percentage
Agriculture	5.20
Mining and quarrying	2.10
Manufacturing	19.60
Construction	1.50
Wholesale and retail trade	11.90
Transport and storage	5.50
Business services	3.80
Real estate	25.40
Misc. (incl. housing)	25.00

Source: Bank Islam Malaysia Bhd., Annual Report (1988), 33.

Note: All data as of 30 June 1988.

Like all commercial banks, BIMB maintains statutory reserves with the central bank. As of 30 June 1988, these stood at M\$35.8 million, 3.35 percent of the bank's total liabilities. In addition, the bank is also required to maintain a liquidity ratio of 5 percent of its investment account liabilities and 10 percent of other liabilities.

The bank's short-term investments in government investment certificates amounted to M\$421.6 million as of 30 June 1988. These non-interest bearing certificates, issued under the Investment Act 1982, enable BIMB to meet its liquidity requirement in terms of its liquid asset holdings and represent an important avenue for BIMB to temporarily park its surplus funds. It is important to note that these certificates are not restricted to BIMB only, as they are readily available to other financial institutions as well. The purchase of these certificates is regarded as a benevolent loan (*qard al-hassan*) to the government. This means that BIMB cannot expect any returns on its capital and that the payment of dividends is completely at the discretion of the government.

Total liquid assets of BIMB, including its cash and balance with other banks and agents (M\$14.8 million), and statutory deposits with the central bank (M\$35.8 million), stood at M\$472.00 million, or 46.2 percent of total deposits received, as of 30 June 1988. This ratio is higher than what is legally required and exceeds that maintained by conventional banks (around 25 percent).

In addition, the bank also had short-term investments in stocks of commodities amounting to M\$4.5 million and an investment of M\$11 million in quoted and unquoted shares in Malaysia. Some of these took the form of joint ventures (*musharakah*) with other parties.

BIMB has established three subsidiaries to play auxiliary roles. One of these is the wholly-owned Syarikat Al-Ijarah, established in 1983 with a paid-up capital of M\$1 million to facilitate the acquisition of movable and immovable fixed assets for BIMB. Another wholly-owned subsidiary, known as Al-Wakalah Nominees, was set up in 1984 with a paid-up capital of M\$25,000 and acts as the nominee for BIMB and its clients on the sale and purchase of shares and the sale of collaterals. In addition, the bank holds 51 percent equity (valued at M\$5.1 million) in an Islamic insurance scheme under the name of Syarikat Takaful Malaysia, formed in 1985.

BIMB has been expanding its branch network. The total number of branches stood at twenty-one as of 30 June 1988, three times as many as had been established by the end of 1985. In financial year 1987–88 alone, three new branches were opened. Nearly all Malaysia's state capitals are served by BIMB branches. The bank plans to open three to four new branches per year between 1989 and 1993.

In its first financial year (1983–84), the bank incurred a loss of M\$1.3 million (after paying returns to depositors but before paying *zakah*). Subsequently, BIMB has reported profits. Pre-tax/*zakah* profits have grown from M\$4.4 million in 1984–85 to M\$6.2 million in 1987–88, after falling to M\$3.7 million in 1985–86. From the shareholders' point of view, the rate of return on investment is somewhat small, ranging from a low of 4.58 percent in 1985–86 to a high of 7.73 percent in 1987–88. Out of the annual profits, the bank has been transferring resources to its reserve fund. Until 1986–87, the bank retained all its profits without declaring any dividends to shareholders. The bank declared a modest 2.0 percent dividend for the first time, in June 1988. (See table 8.)

TABLE 8
Bank Islam Malaysia Bhd. annual profits and losses

	Year ending				
	June 84	June 85	June 86	June 87	June 88
Profit before <i>zakah</i> and taxation	(1,287)	4,375	3,662	4,524	6,187
<i>Zakah</i>	(484)	(415)	(377)	(381)	(358)
Taxation	0	(1,400)	(1,100)	(3,200)	(2,858)
Profit after <i>zakah</i> and taxation	(1,770)	2,560	22,185	943	2,971
Transfer to reserves	0	(641)	(800)	(450)	(1,490)
Proposed dividend	0	0	0	0	(1,039)
Retained profit	(1,770)	1,919	1,385	493	442
Retained profit brought forward	0	(1,770)	149	1,534	2,027
Total	(1,770)	149	1,534	2,027	2,469

Note: All data are in thousands of Malaysian ringgit.

ISSUES

Several important features of Islamic banking in Malaysia have surfaced in the preceding analysis. First, although investment deposits account for a larger proportion of the total, the bulk of these are short-term in nature, being made for a period of less than two years. Second, the equity-financing modes of *musharakah* and *mudharabah* represent a very small proportion of the investment portfolio, while *bay' muajjal* and *ijarah* are the most commonly used modes of financing. Third, excess liquidity is a serious problem in the absence of suitable non-interest-based financial instruments for money and capital market transactions. Fourth, the average rate of return on deposits has not been very competitive with that offered by the conventional banking sector. Finally, the rate of return on investment to the shareholders has been only modest.

BIMB may be criticized on a number of grounds. One criticism is that there have been no major changes in either deposit structure or investment portfolio in its six years of existence. Moreover, the bank has been acting in a risk-averting manner by de-emphasizing the *musharakah* and *mudharabah* modes and concentrating on *bay' muajjal* and *ijarah* transactions. Yet another line of criticism is that the bank has not contributed much to the socioeconomic development of the Muslim community in the country. While these criticisms seem legitimate, in the sense that they reflect the aspirations of the *ummah*, and valid, in the sense that they are apparently based on facts and figures, a relevant question to ask would be: Are we not expecting too much too soon?

One should not lose sight of the fact that BIMB belongs to the world of *tijari* (the commercial or private sector). Its primary objective is to generate reasonable profits for its depositors and shareholders. All other considerations, although important, should take a back seat. However, this observation should not be misinterpreted to mean that Islamic banks have no wider social obligations. It only draws attention to the need for an Islamic bank to get its priorities right. It would be incorrect to assign to an institution in the *tijari* sector the kind of responsibilities that are meant for organizations in the *siasi* (public) and *ijtimai* (welfare) sectors.

From this perspective, it would appear that BIMB has been acting prudently and responsibly to ensure a reasonable rate of return, especially to its depositors. Whether it could have performed even better on this score had it adopted different strategies is a moot point. It may be argued that *musharakah* and *mudharabah* modes could have yielded higher returns if the bank had paid adequate attention to them. In any case, it appears that the bank's performance has fallen short of popular expectations because its modes of operation are largely confined to such second-line techniques as *bay' muajjal* and *ijarah*. To be sure, there is nothing wrong with these modes, for the Shari'ah does not classify them as second-line techniques and equity financing as the first-line.

All this notwithstanding, economists are probably right in calling attention to the importance of equity financing (hence its labelling as the first-line technique) in Islamic banking. No one questions the Islamicity of such instruments as *murabahah*, *bay' muajjal*, *bay' salam*, or *ijarah*, as they are all cleansed of interest, and no one conversant with *fiqh* and economics would accuse the bank of admitting interest in any disguised form. Thus, there is no doubt that the various modes of financing provided by BIMB are *halal*.

However, there is much more to Islamic banking than the elimination of interest. One may argue that BIMB could have made a stronger impact had it resorted seriously to equity-financing techniques such as *musharakah* and *mudharabah*, which could have stimulated a lot more private sector initiatives with considerable multiplier effects. Theoretically, one of the main selling points of Islamic banking, unlike conventional banking, is its concern for the viability of the project and the profitability of the operation rather than the size of the collateral. Good projects that might be turned down by conventional banks for lack of collateral could be financed by Islamic banks on a profit-sharing basis. Thus BIMB is expected, not unreasonably, to be more enterprising than its conventional counterparts and to play a more catalytic role in stimulating private-sector activities in the country than it has so far.

In fairness, however, one must only evaluate the performance of BIMB in the context within which it operates. It is a new institution in a hostile environment, where not all who patronize it really subscribe to the principles behind it or are absolutely convinced about its commercial viability. In other words, the bank must be extremely cautious about every move it takes to ensure its survival. A wrong move could prove to be disastrous not only for the bank but also for the entire Islamization process in the country. It is in this sense that BIMB has a dual responsibility, to its shareholders and the *ummah* at large, and it therefore has to be doubly careful in its operations.

As was noted earlier, the bulk of the deposits in BIMB are short-term in nature. The deposit structure thus does not favor equity-financing, which is of a long-term nature. It is therefore imperative that the deposit composition be adjusted before the investment portfolio is restructured.

Past experience has shown that many patrons of BIMB have no qualms about shifting their funds between BIMB and interest-based conventional banks, depending on which bank pays more. Even marginal changes in rate of return seem to have resulted in substantial movements of funds. The implication is that not all depositors of BIMB are Islamically motivated. In a situation where funds are highly sensitive to even small changes in rates of return and mobile in response to small differentials in rates of return, it would be hazardous for the bank to commit deposit funds in long-term portfolios such as *musharakah* and *mudharabah*.

On the demand side, entrepreneurs seem to resent the idea of sharing their profits with banks on a *musharakah* or *mudharabah* basis, especially since such modes of financing imply sharing of equity and control as well. Many established firms with good potential seem to prefer borrowing funds at fixed costs from conventional banks to equity-financing through BIMB. On the other hand, BIMB is understandably reluctant to enter into *mudharabah* transactions with entrepreneurs with no track record, since all losses will have to be borne by the bank. BIMB also cannot afford to overlook the problem of borrower delinquency. In fact, the bank faces the need to make sizeable provisions for bad debts.

To put it differently, the market for *musharakah* seems somewhat limited, while that for *mudharabah* is beset with pitfalls. BIMB lacks management skills needed for project evaluation, supervision, and control of *mudharabah* deals. That equity financing forms a small proportion and that *bay' muajjal* and *ijarah* account for the bulk of total investments may be seen at least partly in terms of BIMB's response to market demand.

In evaluating the performance of BIMB, one should take into account the special circumstances in which the bank has been operating. The banking industry in Malaysia underwent a particularly bad period from 1985 to 1987 under the impact of a severe recession. It was a painful experience for almost all banks in the country. Some of them would have gone bust had they not been rescued by the central bank. Several banks were taken over by the central bank, and some finance companies came under receivership, as the incidence of bad loans increased sharply. That BIMB did not fall into this category is a major accomplishment in itself. In hindsight, it would probably have been a disaster had BIMB gone in big way into *mudharabah* financing in the mid-1980s.

CONCLUSION

While the preceding discussion might help vindicate BIMB's position, it does not constitute an argument in favor of the status-quo. That BIMB is totally and absolutely interest-free is not in dispute. Nonetheless, it is worth reiterating that there is much more to Islamic banking than the elimination of interest. To be sure, BIMB belongs to the world of *tijari*, but it cannot run away from its moral obligations to serve the *ummah*. It would strive to find out what the banking needs of the community are and devise means of meeting those needs within the framework of Shari'ah. For this purpose the bank should set up a research and development unit.

That *mudharabah* deals account for a tiny proportion of total financing is not in itself a major cause for concern. BIMB is probably justified in having down-played this mode, given the circumstances in which it has been operating since its inception. There is nothing sacrosanct about the institution of *mudharabah*, as it was a custom of the pre-Islamic Arabs.¹ This is not to deny the Islamicity of the institution, as the Prophet (s.a.w.) had raised no objections to it. Although *mudharabah* is approved by Shari'ah, the legitimacy of two-tier *mudharabah* is du-

bious, since not all schools of thought agree on the permissibility of a bank (which acts as a *mudharib* vis-à-vis its depositors) entering into a second round of *mudharabah* transaction with its customers.

Mudharabah is not an easy mode to operate, especially for an infant Islamic bank. The main deterrent is the high risk element, especially since all capital losses are borne by the bank. Of course, risks can be minimized through careful assortment and diversification of investments under normal circumstances. But, the problem with this mode is that it seems particularly vulnerable to cyclical downturns when the business failure rate is very high.

The *mudharabah* instrument would appeal in a society where the *mudharibs* are competent, honest, trustworthy, and God-fearing. No bank can afford to conduct its business under this assumption. Nor can a bank undertake character analysis of numerous customers, as it is a time consuming and costly exercise.

The *musharakah* mode, on the other hand, appears to be more practical and less risky, given that losses are shared by both the bank and the customer. But, the problem with this instrument is that most customers resent the idea of sharing ownership and control with a bank. In a society where Islamic banks co-exist with conventional banks, there is a tendency for the clientele, unless they are Islamically motivated, to borrow funds from the latter at fixed interest. More often than not, it is the "unbankable" customers who turn to the Islamic banks, after being turned down by conventional banks.

It appears that the *mudharabah* and *musharakah*, modes of financing are more appropriate for merchant banking than commercial banking. Maybe there is a case for an Islamic merchant bank. By the same token, one may even think of specialized Islamic financial institutions like a *mudharabah* bank or a *musharakah* bank.

There has been so much emphasis in the literature on these two modes, giving the impression that Islamic banking would be meaningless without them. There is an urgent need to devise new instruments that are compatible with Shari'ah principles. Hence the importance of research and development activities, which have hitherto been neglected by Islamic banks all over the world. In societies in which only a single Islamic bank operates, there may be a tendency for the bank to behave like a monopolist, resulting in complacency and inefficiency. Some competition would probably do wonders.

In Malaysia, BIMB enjoys such a monopoly status. The chances of another Islamic bank being established in Malaysia in the near future are remote, not because of any barriers to new entry but because private sector initiatives in this direction are unlikely to be forthcoming. BIMB has to prove its commercial viability and profitability before it can attract new entrants. However, competition to BIMB can be provided if Malaysia permits foreign Islamic banks to operate in the country. If Muslim countries are prepared to open their doors to foreign Islamic banks in a bilateral, if not multilateral, fashion the cause of Islam would be better served. Islamic banks can be the focal point of economic cooperation among Muslim countries, not only by being an arena of cooperation but also by acting as a vehicle for bringing about greater economic cooperation.

NOTES

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1. S. N. H. Naqvi, *Ethics and Economics: An Islamic Synthesis* (Leicester: The Islamic Foundation, 1981).