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Are Islamic banks in Malaysia really ‘Islamic’?

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Abstract

Understanding the underlying wisdom of the origin of *Muamalat* could clear some misconceptions towards Islamic banks in Malaysia. These misconceptions arise when we talk about transformation from conventional bank to Islamic bank. The development process of Islamic banking and the services offered by Islamic banks may be similar to those of conventional banks with some exception that include general banking principles. Therefore this term paper combine both practitioners and academicians thoughts and ideas regarding the Islamic banking and finance operating mechanisms and its possible impacts to clear some common misgivings.

1.0 The emergence of Islamic banks

Islamic banking pre-supposes an Islamic society and an Islamic polity. A society bereft of faith in Allah and in Islamic values can hardly be able to establish an Islamic banking order. And that is why the Holy Quran has emphasized faith as the first pre-requisite in setting up an Islamic economic order. Muslims should come forward to help their brothers in society to do their business, to do their trade, to carry on their industrialization, to carry on their cultivation, to carry on all that is required to get the wheels of the society and continuing to move more easily.

In ensuring the smooth functioning of the society, the role of money is of paramount importance. And having recognized this importance, the pioneers of Islamic history had come forward to invent the banking system at a time when the present 'Western World' was drawn into the interest based system. Allah Almighty has mentioned clearly in the Holy Quran, Surah Ali Imran: 130-131, "O you who believe, devour not usury, doubling its rate many times, but fear the Almighty God that you may really prosper. Fear the fire which is prepared for unbelievers."

Since its very inception, banking has never remained static. In keeping up with the needs and aspiration of different people and times, it has undergone continuous changes. Thus, a variety of banking models has been developed all over the world. Whatever is the nature and scope of the models, all of them function on the basis of the Interest. The most remarkable and revolutionary development in the field of banking is the emergence of Islamic banks.

By now, according to Azizul Hoque (2007), "About 15 Islamic banks have emerged and two countries are replacing their entire banking system with an Islamic one," (p.107). While in Malaysia, the establishment of the Islamic bank started in 13 May 1983, known as Bank Islam Malaysia Berhad (Nik Mahani, 2008). The Central Bank of Malaysia also introduced an Act of Parliament which is the Islamic Banking Act 1983. Thus, according to the Islamic Banking Act 1983 (Act 276), Islamic banking business in Malaysia can be transacted only by a licensed Islamic bank.

Despite in this era of development and growth in Islamic finance and banking, we should not ignore other relevant issues in order to ensure that the industry has a strong foundation and avoid any misconceptions. While some may disagree, I firmly believed that Islamic banks in Malaysia are fully *Shariah* compliant because it provides an interest-free banking system; sets justifiable prices, and produces *Shariah* compliant products.

2.0 Islamic Banks merely a change in name

The most common argument against contemporary Islamic banking in Malaysia is that there is “no difference at all”. Some people claim that Islamic banking in Malaysia merely involves change in name and documents. They argue that interest rate that being the practice in conventional banking is change of to “profit rate” in Islamic banking. Therefore, this imitation of so called ‘Islamic’ banking in Malaysia also involves an interest element that is clearly prohibited in Islam indirectly. This is because by changing names and documents, it is not enough to validate the contracts. Any excess over principle is *riba*, its include usury and interest. Thus no matter the interest rate is low or high, it is still considered as *riba* (Muhammad Musleh Uddin, 2007). Nor can there be any distinction between the interest for the productive and consumptive purposes.

The eagerness of Islamic banks in Malaysia to participate in the banking industry leads them to imitate the conventional products in order to attract the clients and compete with the conventional banks. Consequently, to compete with the conventional banks that have been established earlier than Islamic banks in Malaysia, the Islamic banks use the interest rate practices by the conventional banks as a benchmark in the products offered. Thus, while providing financing by way of any of the *halal* transactions, they determine their profit rate on the basis of the current interest-rate benchmarks prevailing in the conventional money market. Scholars believe that by applying these benchmarks, the Islamic banking industry makes their transactions “similar” to interest-based transactions and as a consequence, these transactions become doubtful from a *Shariah* point of view (Mustafa Ansari and Faizan Ahmed Memon, 2008).

3.0 The substance of transaction

Whilst this position has its supporters, their arguments are untenable because functions and operating modes of manmade principles are dissimilar from one that is based on the principles of Islamic Shariah. The argument that Islamic banks changing interest rate to profit rate is not relevant, this is because according to Tajul Islam (2007):

An Islamic bank is a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Shariah and forbids the receipt and payment of interest on any of its transactions. All other Islamic banks, the Islamic Development Bank (IDB) and also the General Secretariat for the Organization of Islamic Conference (OIC) has accepted this definition of Islamic banking (p. 127).

Thus, no transaction can be undertaken which involves interest in any form such as simple or compound, low or high, institutional or individual. In Malaysia, separate Islamic legislation and banking regulations existed side-by-side with those for the conventional banking system. The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) which came into effect on 7 April 1983. The IBA provides the Central Bank of Malaysia with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The different and separated legislation proves that the *modus operandi* of Islamic banks itself is different from that of conventional banks.

In addition, the investor in a conventional bank is assured of a predetermined rate of interest while in Islamic banks which promote risk sharing between provider of capital (investor) and the user of funds (customer). Rate of interest applied by conventional banks is known as Base Lending Rate (BLR) which fluctuates according to the interest rate. In contrast, Islamic banks determine the price upfront, the clients who are then free from interest rates risk. A case in point, if a purchase house financed by the conventional banking which may seem attractive with lower rate for the first few years, but the clients cannot predict the next rate that will be imposed on them because it is according to the fluctuation of Base Lending Rate (BLR).

As a result, Zaharuddin (2008) holds the view that during the inflation period, the clients may face Base Lending Rate (BLR) as high as 10 %. This is what happened in Malaysia during 1995 until 1998, Base Lending Rate (BLR) during these time was higher than 8 % and the clients had to pay at a higher rate. If the clients failed to pay according to the time period given, the clients will be subject to a higher penalty by the conventional banks and the total loan payable will be increased significantly. Nevertheless, the prices that are agreed upfront by both Islamic banks and their clients are much safer for the clients from any uncertainty in payments. Faizan Ahmed Memon and Omar Mustafa Ansari (2008) explain the similarities that lead to many misconceptions towards Islamic banks when they write:

The basic reason behind this similarity is to ensure three objectives. The first one, which can be considered the most important, is to provide a level playing field to ensure the survival of Islamic Financial Institutions in the financial landscape. The second is to ensure shareholders and depositors of Islamic Financial Institutions are not deprived of returns, preferably equivalent to that in conventional banks. And the third is to avoid arbitrage among Islamic and conventional financial systems which may be exploited by a few big guns to take advantage of the pricing difference between the two parallel financial systems. For such reason, time value of money concept is used for performance measurement and pricing of financial products (p. 25).

The above views have it merits because the objectives explain the purpose of establishing Islamic financial institutions in Malaysia which is Islamic bank. It means if a transaction can be engineered in such a way that it becomes Shariah compliant, we should not conclude that the same is haram only because of its similarity to interest-based financing. For example, only by uttering the name of Allah Almighty upon an animal at the time of slaughter makes it halal and permissible while not doing makes it haram.

That's the reason why Faizan Ahmed Memon and Omar Mustafa Ansari(2008) highlighted among the objectives of the Islamic banks is to provide Shariah compliant and prudent banking opportunities; hence providing an opportunity to Muslims to do their banking transactions in a halal manner. In other words, this is just an effort to avoid riba and other prohibited elements present in commercial and banking transactions, in order to ensure that we

do nothing that is haram. It can be concluded that it is the substance of a transaction that makes it halal or haram as the differences in rules and regulations implemented by the Islamic banks compared to conventional banks in its operations. By establishing the Shariah Advisory Council in every Islamic banks helps the Islamic banks to evaluate their product to make sure it is in line with the Shariah. Cooperation between the committee members of Shariah Advisory Council and the practitioners plays an important role to make sure the Islamic banks achieving their objectives.

4.0 Islamic banks charge higher price

In addition, there those who argue that Islamic banks are not Islamic because of it cause higher cost. Therefore, Islamic banks in Malaysia could not contribute anything positive towards the socio-economic changes that Islam desires. As an Islamic financial institution, Islamic banks should help in reducing the poverty rate in Malaysia and those people argue that the Islamic banks should help the poor people by financing the poor people. But what happens nowadays is by charging higher prices, Islamic banks only deals with clients that deserve doing transaction with them while poor people are neglected.

If microfinance organization like Grameen bank could help the poor people in Bangladesh, the Islamic banks in Malaysia could also do the same. By helping the poor people with small sums of money, they are able to purchase the inventory, supplies and tools needed to start or expand micro businesses. The Grameen bank also helps the rural poor to start technology micro businesses, such as selling cell phone time to other villagers, which also provides valuable means of communications and access to vital information. As a result, the entire community benefit from the microfinance, therefore the Islamic banks also could imitate the Grameen bank and focus helping the poor.

On the other hand, higher charges by the Islamic banks seem more oppressive compared to the conventional banks. Therefore, the clients are complaining and feel regret. Due to this higher price, the clients may turn to conventional banks since they offer lower price. The clients

also maybe confused when Islamic banks in Malaysia use some Arabic terms in their product but then charge the clients a higher price than the conventional.

The establishments of the Islamic banks are supposed to help the Muslims, not burden them further by charging higher price. As an Islamic finance institutional in Malaysia, Islamic banks should help the Muslims citizens in Malaysia in the same spirit that a Muslim person helps his own family and the ummah. By scaring the clients that riba is prohibited but at the same time charging people with higher price is deemed as unethical act done by the Islamic banks to attract people to come and use their products, because this is against the objective of Shariah which is the end does not justify the means.

5.0 Halal transaction is priceless

According to all the arguments above, there are many points in answering the claims, which could be explained through a real understanding of the purpose and the progress of the Islamic banks. The objectives of Shariah also state that the origin of Muamalat matters is by understanding its underlying wisdom. Datuk Abdul Halim, the pioneer of Bank Islam Malaysia Berhad in Malaysia, used 'sale' as the basic methodology in Islamic banking. According to him the Quranic verse in Surah Al-Baqarah verse 282 which means: "O you who have attained to faith! Whenever you give or take credit for a stated term, set it down in writing. And let a scribe write it down equitably between you; and no scribe shall refuse to write as God has taught him..." gives the solution to the banks problems from 'loans' to 'defrayal in sale' (Nik Mahani Mohamed, 2008).

From the basic methodology stated we could clearly see the difference in substance and fundamental action between Islamic and conventional banks. It is important to note that an Islamic bank and conventional bank are worlds apart and cannot be compared. A bank that uses its functions and operating modes based on Shariah principle is obviously different than manmade principles used by conventional finance. In a similar way, an Islamic bank's sole function as a finance institution is to help Muslims avoid riba and other prohibited elements

present in commercial and banking transactions, its main purpose is not to help poor people, this is because in Islam, zakah system is establish to help the needy.

Therefore it is not the aim of Islamic banks to help the poor since the zakah system has already provide the solution, the time of Caliph Umar Abdul Aziz proved that with good administration of the zakah system, the poverty could be eradicate. Zafar Sareshwala (2008) believed that Zakah is universal in its scope can be seen in the manner in which it is collected and distributed. After providing for the needs of eligible kin, the zakah fund is designed to cover the needs of those who live in the community where zakah is collected and then to those eligible recipients living in the county, state, country, and finally the world at large.

Besides that, comparing Islamic banks with microfinance institution like the Grameen bank is incomparable. An institution that based it based on Shariah principle is incomparable with one that charging interest rate in its loans. Fernando (2006) and Hasina (2007) hold the same view that similar to all microfinance institutes, the interest charged by Grameen bank is higher compared to that of traditional banks, as Grameen's interest (reducing balance basis) on its main credit product is about 20%. The Grameen bank's web site claims that the interest rates can range from 18 to 60 percent, depending on the conditions in each microfinance institutes service area. Thus Sudhirendar Sharma (2002), a development analyst, believed that the Grameen Bank has "landed poor communities in a perpetual debt-trap".

In contrast, how Islamic banks could help the poor is by paying zakah annually, all Islamic banks in Malaysia are subjected to zakah payment and the portion which comes from the total revenue is huge in number. Zaharuddin (2008) proves the amount of zakah payment by looking at the financial reports of Islamic banks in 2005 to give an example "RHB Islamic bank: RM920 thousand, HSBC Amanah: RM49 thousand, Maybank Islamic windows: RM 1.172 million, Public Bank Islamic windows: RM55 thousand, Hong Leong Islamic: RM45 thousand" (p. 137).

Therefore, Islamic banks are helping the poor people indirectly. The ultimate reason why Islamic banks have to charge their clients a higher price than what is on offer by the conventional

banks because of the costs they have to bear, such as commodity risk, asset destruction, holding risk and price risk, as well as their relevant overhead expenses costs. Moreover, the Islamic banks products had gone through the approval of the Shariah Advisory Board in respective Islamic banks while the conventional banks did not. Nevertheless, according to Faizan Ahmed Memon and Omar Mustafa Ansari(2008), the financial experts have generally felt that even if these factors are considered, the pricing by these banks is on the higher side. On the other hand, in a profit and loss-based model, it is agreeable that they assign weight to different types of deposits in a manner that the total return on investment and financing pools is allocated among various depositors and the bank (working as a partner).

Even then, it is generally noted that Islamic banks are paying less than the market rate to their depositors. This is different with conventional banks that act as a lender, lending money and getting it back with compounding interest as its fundamental function. Another simple analogy in explaining the high price charged by the Islamic banks, if there is a place operating with a market monopoly selling non-halal chickens, a shop that sells halal chickens may consider to set up selling at a higher price to satisfy the demand in halal chickens. This basic economic theory shows that when demand is high while supply is limited in number, the price will increase. The value of a halal transaction compared to haram ones is clear to a Muslim where a halal transaction is priceless.

6.0 Future role of Islamic banks

In conclusion, one may say that we are required by our religion to implement a complete Islamic way of living in our individual and collective lives and the society and in our government as well. The Islamic banking and financial system is part of such a system and is not construed to be applicable in isolation while other laws and customs repugnant to the Shariah requirements are still in force. Therefore, I do believe that Islamic banks in Malaysia are fully Shariah compliant because it provides us interest-free banking system, give reasonable prices and constructs Shariah products for the benefits of Malaysia citizens.

However, for our own benefit, in order to avoid interest by ourselves with a view to providing interest-free opportunities to our brothers and sisters in Islam, we should promote and support Islamic banking and finance in the country to the best of our ability. This is because Allah mentioned clearly in the Holy Quran, Surah Al-Baqarah: 275, “God has permitted trade and forbidden usury.” Therefore we are in need of halal transaction to obey the command of Allah.

Islamic banks is expected to face a rapid growth in Malaysia, this is because since the experiment in 1983 has shown that it is a commercially viable proposition (Mohamed Ariff ,2007). Islamic banking in Malaysia can provide us with a reprieve from interest-based transactions and might support us in augmenting a truly Islamic financial system. Ahmed Memon and Omar Mustafa Ansari (2008) believe that “we should not try to pull the legs of an infant who is just trying to take his first step towards a long journey just because of some misconceptions. However, we should try to ensure that he commences his journey the right way, on a strong footing.”(p.27). More appropriately, it will serve us well when we are in a position to implement the complete Islamic way of living.

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