

Workings of an Islamic bank

Case study of Bank Islam Malaysia Berhad

by

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at

the Fourth International Conference on Islamic
Economics, Banking and Finance
Loughborough, United Kingdom

August 13 - 15, 2000



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This paper focuses the Islamic banking in Malaysia, with specific reference given to the experience of Bank Islam Malaysia Berhad (Bank Islam) - Malaysia's first full-fledged Islamic bank - in propagating this relatively new form of banking in a country where conventional banking system is dominant.

This paper will trace back the background, approach, policies, and growth of the Islamic banking sector in the country. Thereon, it will also look at the various financial resources of Bank Islam, its assets and liabilities, and the utilisation of these resources.

PART ONE

BACKGROUND: Islamic financial system in Malaysia

Introduction

Islamic banking as starting point

From its modest beginnings in 1963, with the establishment of the Malaysian Pilgrims Fund Board, followed by the setting up of the Muslim Welfare Organisation, and other private institutions, up to the setting up of the country's first Islamic bank, Bank Islam Malaysia Berhad (Bank Islam) in 1983, the Islamic financial system has witnessed a tremendous growth — in terms of demand, acceptance, and development.

Bank Islam became the core component of the country's new Islamic financial system. Its initial objective was confined to developing a viable and modern banking system to meet the needs of Malaysians. Today, the Malaysian model of Islamic banking has realised this primary objective, and has gone to become a part of a larger system termed the Malaysian Islamic financial system which encompasses takaful, capital market, and other Islamic financial related components.

Objective

Viable alternative

The ultimate objective of the Malaysian Islamic financial system model is to operate in parallel with the conventional financial system in the country. In order to achieve this goal, the Malaysian Islamic financial system should be able to present itself as a viable alternative to the more established conventional system.

Market forces as final determinant

Towards this aim, gaining support and undivided commitment from the government and other regulatory institutions for this initiative is crucial to ensure its success.

In addition, market forces play a major role as a final determinant in achieving the objectives set by the government and regulatory bodies for the Islamic financial system.

Approaches

Gradual implementation

Albeit the strong backing from the government, being a relatively new system, the general approach taken by the government in introducing and developing the Islamic financial system is a gradual one.

Step-by-step approach

The step-by-step approach was taken to ensure that the Islamic financial system would be able to develop totally, and in doing so optimising all available opportunities, and not overlooking financial considerations.

In addition, through the creation of various legal frameworks and financial infrastructures, opportunities for the Islamic financial system to further develop are enhanced.

Regulatory Authorities

Among the regulatory authorities governing the Islamic financial system are:

- i) Central Bank (Bank Ne'gara Malaysia [BNM])
- ii) Securities Commission
- iii) Other relevant authorities

Legal Framework

As crucial support for Islamic financial system

Specific legal frameworks and financial instruments are prerequisites to the Islamic financial system. At the initial stage, an Islamic Banking Act and Government Investment Act were introduced to cater for this system.

Supervision & regulation

As the Islamic financial system continues to develop and new components within the system are introduced, other legal acts such as the Takaful Act, and acts governing the Interest-free banking services and Islamic Inter-bank Money Market were introduced.

To supervise banking operations

Such acts seek to provide for the licensing, regulating and monitoring of business activities and investment activities, with conformity with Islamic financial practices in mind. They vest the central bank with powers of supervision and regulation over Islamic financial institutions as in the case with other conventional institutions.

Shariah Supervisory Council

With the establishment of Bank Islam in 1983, the Bank also set up a Shariah Supervisory Council to supervise its operations with respect to their compliance with Shariah. The role of the council was further expanded to include supervision of other conventional banks offering Islamic banking services beginning 1993.

Harmonising differences in opinions

In 1997, a National Shariah Advisory Council was set-up, taking over the role of the Bank's Shariah Supervisory Council. The council is the highest authority to decide Shariah issues pertaining to Islamic banking and takaful operations, and plays a key role in harmonising Shariah differences in the Islamic system.

Conceptual Framework of Banking and Finance

Islamic financial
landscape

Starting with the introduction of Islamic banking system, the Malaysian Islamic financial landscape has evolved into one of the more extensive backdrops in the Islamic world, and is still growing in tandem with the increasing needs of the nation. Currently, the Malaysian Islamic financial landscape comprise the following:

1. Islamic Banking System

- i) Islamic banks
- ii) Commercial banks
- iii) Merchant Banks
- iv) Finance Companies
- v) Discount Houses
- vi) Association of Interest-free Banking Institutions (AIBIM)

2. Non-Bank Intermediaries

- i) Takaful companies
- ii) Savings institutions
- iii) Development financial institutions
- iv) Housing credit institutions
- v) National Mortgage Corporation

3. Islamic Financial Markets

- i) Islamic Money Market
- ii) Islamic Capital Market

4. Islamic Insurance (Takaful)

- 5.
- i) Islamic takaful operators
- ii) Asean Takaful Group Retakaful

6. Other Islamic Institutions

- i) Fund Board
- ii) Islamic Cooperatives
- iii) Islamic Pawning
- iv) Islamic Trustees
- v) Bait al-Mal

Developmental Strategy

The government and regulatory authorities have outlined a long-term plan to develop Islamic banking and finance in the country, among which include the parallel running of both Islamic and conventional system. Towards this end, there is a need to develop a wider ranging Islamic financial system. Three major areas are identified as crucial for the development of the Islamic financial system. They are:

- 1) More players in the Islamic financial set-up
- 2) Development of new products and infrastructure
- 3) Islamic inter-bank market

1.1 Islamic Banking Scheme

More players in the Islamic financial set-up

In 1993, in a move to include more players in the Islamic banking scene, to increase productivity and in preparation for the development of an Islamic money market, BNM introduced the--Interest-free Banking Scheme, later termed Islamic Banking Scheme, operated by conventional banks through Islamic banking counters and branches. Today, while Bank Islam leads the way for Islamic banking, other financial institutions complement its objective with the introduction of the Islamic Banking Scheme.

Stimulate further growth

Besides Bank Islam, 52 other conventional financial institutions, comprising 22 commercial banks, 16 finance companies, five merchant banks, and seven discount houses, have joined the bandwagon, offering Islamic banking services as part of their operations. The sheer number of institutions offering Islamic banking currently speaks volumes of how far this form banking has progressed within a short period of time.

1.2 Second Islamic bank

More recently, in a move to stimulate growth in the Islamic banking sector, the government introduced a new full-fledged Islamic commercial bank, Bank Muamalat Malaysia Berhad, to complement Bank Islam's objectives and efforts to promote Islamic banking in Malaysia.

1.3 Growth Target

Other government measures to further strengthen the Islamic banking scheme, include upgrading the Islamic banking unit in conventional banks into Islamic banking divisions, effective January 2, 1999. The Islamic banking fund in conventional financial institutions was also revised, as follows:

- Commercial banks - RM 5 million (RM 20 million by 2000)
- Finance companies - RM 5 million (RM 10 million by 2000)
- Merchant banks - RM 3 million (RM 6 million by 2000)

20% market share by 2010

Currently, each Islamic Banking System (IBS) institution is required to achieve 5% Islamic deposits vis-à-vis total deposits and total loans by year-end 2000. Recently, BNM has set a target for IBS institutions to achieve 40% growth and capture 20% of the market share of the total banking industry by 2010.

2.1 Islamic financial products and instruments

Meeting various financial needs

The development of various Islamic banking products and services is critical to ensure that the Islamic financial system can stay competitive. With an aim to be equally viable, modern, sophisticated and dynamic, the range of products should reflect this goal. Islamic banking, for one, parades more than 40 various products, and services that are comparable to their conventional counterparts.

Bank Islam started out with about eight (8) financial products in the first year of its inception. Currently, Bank Islam has a range of more than 40 banking and finance products to meet the various financial needs of Muslims and non-Muslims of the country, en route to becoming a truly alternative means of banking to Malaysians. The following are among the financial products and services available:

Deposits

- a) *Current Account (Wadiah)*
- b) *Savings Account (Wadiah)*
- c) *Savings Account (Mudharabah)*
- d) *Ijraa Savings Account (Mudharabah)*
- e) *Wadi Savings Account (Mudharabah)*
- t) *Pewani Savings Account (Mudharabah)*
- g) *General Investment Account (Mudharabah)*
- h) *Special Investment Account (Mudharabah)*
- o) *Sakinah Investment Account (Mudharabah)*
- D) *Negotiable Islamic Debt Certificate (Bai Ad-Dayn & Al-Bai Bithaman Ajil)*

Financing

Financing:

- a) *Project financing (Al-Mudharabah / Trustee profit-sharing)*
- b) *Project financing (Al-Musyarakah / Joint-venture profit sharing)*
- c) *Asset acquisition (Al-Bai Bithaman Ajil / Deferred sale)*
- d) *Leasing / Use of services of assets (Al-Ijarah / Leasing)*
- e) *Benevolent loan for the needy (Al-Qardh Hasan / Benevolent loan) t)*
- Syndication services (Al-Ujr/ Fee)*
- g) *Securitisation and Debt Trading (Bai Ad-Dayn / Debt-trading)*

Trade Finance:

- a) *Letter of Credit (Al-Wakalah /Agency) •*
- b) *Letter of Credit (Al-Musyarakah /Joint-venture profit-sharing)*
- c) *Letter of Credit (Al-Murabahah / Cost-plus)*
- d) *Letter of Guarantee (Al-Kafalah / Guarantee)*
- e) *Working capital financing (Al-Murabahah / Cost-plus)*
- t) *Securitisation and Islamic Accepted Bill (Bai Ad-Dayn / Debt-trading) g)*
- Securitisation and Islamic Export Credit Refinancing Scheme (Bai Ad-Dayn / Debt-trading)*

Other Services

- a) *Zakat payment*
- b) *Remittances*
- c) *Purchase of Foreign Currency*
- d) *Purchase of Travellers' Cheques*
- e) *Sale of Islamic Economic Development Foundation of Malaysia (YPEIM) receipts*
- t) *Portfolio management*

The development of specific Islamic financial instruments is equally noteworthy. Debt instruments, equity instruments, Islamic discounting instrument and debt -trading instrument, are a few such instruments: Currently, the country's Islamic banking practitioners are in the midst of formalising a floating rate their financings and derivatives.

3.1 Islamic Inter-bank Money Market

With the introduction of more players in the market, the Malaysian Islamic Money Market introduced in 1993, along with the Islamic capital market, will further facilitate the development of a complete Islamic financial system.

PART TWO

Bank Islam Malaysia Berhad

Established in 1983

Bank Islam, a name synonymous with Islamic banking in Malaysia, continues to lead the way and assume the role of trend-setter for Islamic banking. Bank Islam began operations as Malaysia's first full-fledged Islamic bank on July 1, 1983. Its establishment was primarily to cater for the financial needs of Muslims in the country, and to further extend its services to the whole population at large.

Crucial component of an Islamic financial system

Ultimately, the role of Bank Islam is to realise Malaysia's dream of setting up and developing an Islamic financial system that is modern and competitive, as well as being a viable alternative to the more established conventional system. The introduction of Islamic banking, a crucial component of an Islamic financial system, is also the first step towards realising the nation's ambitions.

Various components

In Bank Islam, the Malaysian government entrusted the responsibility of spearheading the advancement of Islamic banking, and also a wide spectrum of other specific Islamic financial services in Malaysia. This was done through the incorporation of its subsidiaries. Among others, Bank Islam was directly involved in developing financial sectors dealing in banking, takaful, stock broking, leasing, research and training, and other related services. The synergy between Bank Islam and its subsidiaries dealing with these services has complemented the overall growth of the whole Islamic financial system in Malaysia.

Paid-up & authorised capital

Bank Islam was set up with an initial authorised capital of RM500 million and a paid-up capital of RM79.9 million. The bank's paid-up capital was increased to RM133.4 million in 1991 to accommodate the growth of its asset and to better position itself in meeting future expansion and growth. The Bank was listed on the Main Board of the Kuala Lumpur Stock Exchange (KLSE) on January 17, 1992.

Branches network & products

True to the vibrant and dynamic spirit of the bank, coupled with the continuous support from the government and public, Bank Islam has developed into one of the more respectable financial institutions in the country. To date, Bank Islam has a network of 80 branches throughout Malaysia, parading a comprehensive list of more than 40 innovative and sophisticated Islamic banking products and services, comparable to those of their conventional counterparts.

While Bank Islam continues to grow at a rapid pace, so too does the Islamic banking and finance sector. The bank's success in the local banking scene has propelled its conventional counterparts to emulate its accomplishment with the setting up of Islamic banking counters, windows, and branches within their conventional set-up beginning 1993.

Restructuring exercise Bank Islam undertook a restructuring exercise in 1997. The restructuring entails the incorporation of a new holding company - BIMB Holdings Berhad - (BIMB Holdings) - in place of Bank Islam. Subsequently, BIMB Holdings was listed on the Main Board of the KLSE on September 16, 1997, in place of Bank Islam.

The move to define the group's activities into specific divisions, namely banking (Bank Islam and its subsidiaries), takaful (Syarikat Takaful), capital market (BIMB Securities), property (Syarikat Al-Ijarah), and others (BIMB Institute of Research and Training, and Pembiayaan Perumahan Nasional), will rationalise its group structure, increase competitiveness, and accommodate future expansions.

Ensuing the restructuring exercise, Bank Islam's authorised capital was increased to RM 2 billion and its paid-up capital to RM 500 million - allowing it to further expand its services.

PART THREE

WORKINGS OF AN ISLAMIC BANK

Sources of Funds

Shariah dictates the financial resources available at the Bank and other Islamic financial institutions. These avenues and sources of funds will continue to expand as the Islamic banking system develops. Currently, the Bank has five major avenues in which it generates its sources of funds, namely:

- i) Shareholders' Fund
- ii) Customers' Deposits
- iii) Mudharabah Inter-bank
- iv) Other Liabilities
- v) Provision

Shareholders' Fund

The Islamic bank is essentially an *Inan* company, a separate legal entity based on the concept of *Al-Musyarakah*. The *Inan* company is made up of a minimum two shareholders with no limit to the maximum number. It is a business entity, formed by having a group of shareholders, electing representatives to manage the company (board of directors) on the basis of *Wakalah*. At the same time the shareholders retain their management control (voting rights) in the company in proportion to their shareholding.

There is no restriction imposed on shareholding in terms of religion, i.e. shareholders of the Islamic bank can be composed of both Muslims and non-Muslims. Different shareholders may have different shareholdings.

The shareholders supply capital for the company - which make up the shareholders' fund - for it to be able to carry out its business activities. The shareholders' fund comprises ordinary shares, preference shares, paid-up capital, share premiums, general reserve, and retained earnings.

Profits and dividend are distributed in proportion to their shareholdings, or in other ways agreed upon by the shareholders. Losses are also to be shared in proportion to their shareholdings. An Islamic bank, therefore, is based on the terms of issue of their shares, and the rights and responsibilities of their shareholders.

When established in 1983, Bank Islam raised its initial equity (or paid-up capital) in a straightforward way through the Islamic equity-financing contract of Al-Musyarakah among its initial shareholders. Only one class of shares – ordinary shares – were issued; and these were unquoted. In 1990, steps were taken to expand the Bank's equity and list its entire ordinary shares on the Main Board of the Kuala Lumpur Stock Exchange (KLSE).

All of Bank Islam's ordinary shares were listed and quoted on the Main Board of the KLSE on January 17, 1992. With the incorporation of BIMB Holdings Berhad, the new holding company took over listing status. Currently, the number of shareholders is approximately 4,000, and total shareholders' fund as at March 31, 2000, is RM 1,461,590,000.

Among Bank Islam's major shareholders include established, influential, and financially sound institutions such as Lembaga Tabung Haji (Pilgrims Fund Board) and Permodalan Nasional Berhad (National Funds Board), State Religious Councils, as well as individuals.

Customer Deposits

Two major types of deposits of the Bank are those operated under the concept of Al-Wadiah (safe custody) and Al-Mudharabah (profit sharing).

According to the concept the Al-Wadiah, the Bank pools together and utilises deposits put in by customers for its investment or financing projects. The Bank is responsible for the safe-keeping of the fund, and obliged to return the fund as and when requested by the customer.

The Bank is not allowed to mention or to promise any rewards or return. Any form of reward is at the Bank's discretion. At the same time, the customers or depositors are not allowed to demand any rewards or return on their savings. Deposit accounts that operate using the concept of AlWadiah are the Current Account and Savings Account.

Al-Mudharabah is a contract between two parties, i.e. the owner of capital and the entrepreneur. Depositors (the owner of capital) place a specified amount of money at the bank (the entrepreneur) for a stipulated period of time with an agreed pre-determined ratio of profit. The Bank is entrusted to utilise the deposits in its financing and investment projects without any intervention from the depositors.

Profit earned on the investment will be distributed between the two parties according to the profit distribution ratio determined at the point of akad or

contract. Loss, if any, will be borne totally by the depositors. Deposit accounts that operate using the concept of Al-Mudharabah are various Savings Account and Investment Accounts. In view of the returns and its attractive profit-sharing feature, the Bank adopts Al-Mudharabah concept on a majority of its deposit products.

Mudharabah Inter-bank Money Market

For ten years after its inception, Bank Islam was the sole Islamic banking institution in Malaysia. The Bank operated in a relatively restrictive circumstances and limitations in terms of the lack of basic infrastructure such as an Islamic money market and capital market.

An Islamic bank does not operate on the conventional inter-bank money market. Without an exclusive Islamic money market, all funding for its financing and investment and all other operations will have to depend on its internal funds from its own depositors and shareholders.

Beginning 1993, the government introduced an Interest-free banking scheme (later termed Islamic Banking Scheme) at conventional banks, complementing the Bank Islam's role in promoting Islamic banking.

With the increase in number of financial institutions offering Islamic banking, the government, in 1993, also introduced an Islamic Inter-bank cheque clearing and Islamic Money Market, facilitating Islamic Inter-bank investment and borrowing among the Islamic bankers. The Malaysian Islamic Money Market, then, was believed to be the world's first Islamic Money Market.

With the introduction of the Islamic Money Market, in the case of temporary shortage of funds, Islamic banks can now borrow from the Islamic Money Market (Inter-bank Mudharabah). Likewise, in the case of surplus of fund, Islamic banks can also channel its funds into the Islamic Money Market as a form of investment in other institutions offering Islamic banking.

The Bank is also responsible to manage a pool of excess fund. This pool of fund comprises of excess customers' deposits and shareholders funds after being utilised in various financing, statutory reserve and liquidity requirement undertaken by the bank. Excess fund is normally utilised in the following short-term investment avenues:

- Government Investment Certificate (GIC)
- Mudharabah Interbank Investment
- Murabahah Financing
- Purchase of Debt Instrument
- Investment in Foreign Currency

Other liabilities

Other liabilities arise from commitment to pay on expenses already incurred. Although the availability of fund in the account is temporary and short-term in nature, utilisations for short-term investments are usually applied to match the source. The minimum requirement of authority on the amount of general provision is currently at 1.5% of total financing.

Provision

As required by the regulatory authority, banking institutions (including Islamic banks) are required to set aside some portion of its profit as provision to cover loss in non-performing and bad financings. This amount of provision accumulate over time and will form quite a substantial part to the banks' reserve which will later be utilised when the loss on financing crystallise. While in the provision account, the amount constitute part of the source of fund which can be invested and generate financial return or income.

In line with the concept of Al-Mudharabah on deposits received from customers, loss on financing are to be borne wholly by the fund provider, i. e. Mudharabah depositors. However, the practice of Bank Islam is to apportion the amount of provision between the Wadiah and Mudharabah deposit fund in the proportion of the deposit balance. The portion attributed to the Wadiah deposit fund are borne by the shareholders.

Application of Funds

Following from the five sources of fund, the application of funds are also divided into five major sections, namely:

- i) Statutory Reserve
- ii) Liquidity Requirements
- iii) Financing
- iv) Islamic Stock Market
- v) Islamic Money market

Statutory Reserve

Section 37(1) of Central Bank of Malaysia Ordinance 1985 requires all banks, merchant banks, and finance companies to maintain a certain percentage of their eligible liabilities with Bank Negara Malaysia (BNM) in the form of a Statutory Reserve account.

These eligible liabilities consist of customer deposits, i.e. current account, savings account, investment account, and amount due to other banks, merchant banks, and finance companies. BNM determines the ratio of reserve to deposits to be maintained from time to time. Currently, BNM has set 4% as percentage due to the Statutory Reserve account. The probable contract is Al-Wadiah Yad Dhamanah.

The Statutory Reserve placed by a commercial bank with BNM does not give any return. This is so in view of the purpose of having such reserve being placed in BNM is to cover any incapability of a commercial bank to fulfil the needs of the depositors to withdraw their money, where BNM will be the lender of last resort. The Statutory Reserve, then, acts as a safety valve for the Bank's solvency in the event it faces a serious difficulty, and also as a monetary instrument for BNM to conduct the country's monetary policy.

Liquidity Requirements

It is also a statutory requirement that the Bank maintains certain ratios of defined liquid assets to its various types of deposits at all times. In meeting customers' demands, BNM requires all banks to maintain daily a minimum liquid assets. From time to time, BNM will notify banks the amount of liquid assets that need to be maintained based on a percentage of eligible liabilities. The forms of the liquid assets are also determined by BNM. Currently, among the items classified as liquid assets include:

- i) Assets
- ii) Near Cash
- iii) Marketable government bonds

Currently, liquid assets are determined as follows:

- i) 10% of the bank's total eligible liabilities excluding investment account liabilities
- ii) 5% of the bank's investment account liabilities

The bank's liquid assets comprise of the following:

- i) Notes and coins which are legal tender in Malaysia
- ii) Balance with BNM excluding balance in Statutory Reserve Account
- iii) Government Islamic Certificate (GIC)
- iv) Islamic Acceptance Bills (IAB)
- v) Banker's Acceptance (BA)
- vi) Other assets as may be approved by the Minister of Finance on the recommendation of BNM

Investments in liquefiable money market instruments currently provide marginal returns due to the low investment rate regime ruling the money market scenario.

Financing

Subsequent to assigning the stipulated percentage funds for statutory reserve and liquid assets, the Bank may utilise the remainder of customer deposits for various forms of financing and investment, including trade finance, in meeting the various different financial needs of its customers. These forms of financing and investment that are to be undertaken on the basis of Shariah principles, contribute a major portion of income to the bank. The following are the major types of financing and investments:

Financing:

- a) Project financing (*Al-Mudharabah / Trustee profit-sharing*)
- b) Project financing (*Al-Musarakah / Joint-venture profit sharing*)
- c) Asset acquisition (*Al-Bai Bithaman Ajil / Deferred sale*)
- d) Leasing / Use of services of assets (*Al-Ijarah / Leasing*)
- e) Benevolent loan for the needy (*Al-Qardh Hasan / Benevolent loan*)
- f) Syndication services (*Al-Ujr / Fee*)
- g) Securitisation and Debt Trading (*Bai Ad-Dayn / Debt-trading*)

Trade Finance:

- a) *Letter of Credit (Al-Wakalah /Agency)*
- b) *Letter of Credit (Al-Musyarakah / Joint-venture profit-sharing)*
- c) *Letter of Credit (Al-Murabahah / Cost-plus)*
- d) *Letter of Guarantee (Al-Kafalah / Guarantee)*
- e) *Working capital financing (Al-Murabahah / Cost-plus)*
- t) *Securitisation and Islamic Accepted Bill (Bai Ad-Dayn / Debt-trading) g)*
Securitisation-and Islamic Export Credit Refinancing Scheme (Bai Ad-Dayn / Debt-trading)

Investment

The Bank may also utilise the customers' deposits and shareholders' funds to undertake the following types of investment. In all cases where it involves other parties, the contractual form is Al-Musyarakah / Joint-venture profit-sharing.

- a) Setting-up wholly-owned subsidiaries
- b) Taking up equity as a shareholder in unquoted companies
- c) Purchase of shares in public companies quoted on the KLSE for longterm investment
- d) Portfolio investment in shares of public companies quoted on the KLSE

Involvement in Development and Infrastructure Programmes

As part of its corporate mission, Bank Islam aims to play a meaningful role in fostering economic development and social progress of Malaysia. Bank Islam achieves this objective through its various financing facilities for the implementation of various infrastructure and development projects. Among others, Bank Islam has successfully syndicated the following financing packages in various capacities:

1. Joint Lead Manager to the Al-Musyarakah Financing with Participating Certificates Issuance Facility of RM 600 million for Sarawak Shell Berhad.
2. Lead Manager to the Al-Bai Bithaman Ajil Financing with Notes Issuance Facility of RM 125 million for Sarawak MDS (Malaysia) Sdn Bhd.
3. Arranger to RM 2.2 billion Syndicated Al-Bai Bithaman Ajil with Notes Issuance Facility for K.L. International Airport Berhad (KLIA) for the 1996 financial requirement.
4. Joint Arranger to RM 2.2 billion Syndicated Al-Bai Bithaman Ajil with Notes Issuance Facility for K.L. International Airport Berhad (KLIA) for the 1997 requirement.
5. Lead Manager to the Issuance of Islamic Debt Securities of Petronas Gas Berhad amounting to RM 800 million.

Co-Manager to the Issuance of RM 300 million Islamic Debt Securities for Petronas Dagangan Berhad.
7. Co-Manager to Syndicated Al-Bai Bithaman Ajil RM 200 million for Lebuhraya Shapadu Sdn Bhd. (a highway concessionaire)

8. Co-Manager to Syndicated Al-Bai Bithaman Ajil of RM 160 million for Miri Port Authority.
9. Manager to RM 65 million Syndicated Al-Bai Bithaman Ajil Facility for Chase Perdana Berhad.
10. Arranger to RM 45 million Syndicated Al-Bai Bithaman Ajil for Shell MDS (Malaysia) Sdn. Bhd.
11. Co-Arranger and Shariah Advisor to RM 1- billion Istisna'/ Ijarah Project Financing Facilities for Projek Usahasama Transit Ringan Automatik Sdn. Bhd. (PUTRA).

Stock Market

A complete Islamic financial system is made up of various components in which Islamic banking is a part of. Others include takaful, property, and other relevant sectors. There exist a crucial interdependence between the various components, with each individual complementing one another. Another equally critical area is capital market.

The Malaysian Islamic Capital Market came into existence with the establishment of BIMB Securities (subsidiary of BIMB Holdings Berhad) in 1994 to achieve this objective. BIMB Securities sets out to initiate and develop a modern, innovative, and dynamic Islamic capital market in Malaysia. Functioning as a normal securities company, BIMB Securities is set apart from its conventional counterparts by virtue of its business dealings, which are in accordance with Islamic principles, rules, and practices.

A Shariah Supervisory Council of the Securities Commission issues a List of Approved Securities, which is updated from time to time, specifying the listed companies on the Main Board and the Second Board of the Kuala Lumpur Stock Exchange (KLSE) whose shares Muslims are allowed to own and deal with in line with Shariah principles. In general, the list excludes those companies whose major activities are involved with: interest-based banking and finance and conventional insurance, gaming, alcoholic beverages, and non-halal products.

Currently, more than 550 counters from a total of around 700 on the local exchanges are verified as Shariah-approved. This latest development facilitate the Bank in increasing its investment avenue, e.g. Shariah-approved securities such as Islamic unit trust funds, Islamic fund management companies, takaful companies, and so on.

Islamic Money Market

The development of an Islamic Money Market has helped expanded the Islamic banks' source of funds, through investment and borrowing activities. With the initial participation of five banking institutions when it was first introduced in 1993, currently 52 banking institutions participate in the Malaysian Islamic Money Market. The Islamic Money Market recorded a sharp increase in 1998 to RM18.3 billion from RM2.1 billion in 1994.

With the introduction of the Islamic Money Market, as stressed earlier, Islamic banking institutions will be able to request from participating banks in the Islamic Money Market the Islamic banking Mudharabah deposit

(Interbank Mudharabah), and in the case of surplus of fund, Islamic banks can also invest in the Islamic Money Market as Mudharabah Interbank investment. Those placement or investment are at a nominal return which is normally equivalent to the return in the conventional money market.

PART FOUR

Current Developments and Future Plans

In the near future, Bank Islam envisages the establishment of consumer banking units, an investment banking unit, and the introduction of more products and outlets throughout the country, in fulfilling its responsibility to develop Islamic banking and finance system.

Total Islamic Banking Solution

Receptive of the advanced needs and banking requirements of the public, Bank Islam has also developed the world's first Total Islamic Banking Solution, which will serve as the platform for Bank Islam's fully computerised banking service. Bank Islam has spent about RM100 million to carry out this computer upgrading exercise, which include putting together hardware, systems software, applications software, communications network facilities and support services, which will cater specifically for Islamic banking operations.

The upgrading of its information technology system is in line with the bank's corporate mission and objectives which entails, among others, a strong customer service orientation and will accommodate new and future advancements in electronic banking. The computerisation of Bank Islam will offer more efficient service, and facilitate decision-making efficiency, through sophisticated computer systems.

Bank Islam plans to export TIBS to local and international Islamic banking institutions as part as its service for the development of Islamic banking world-wide. Currently, Bank Islam's TIBS has already generated interests from a number of Islamic banks wanting to equip themselves with state-of-the-art Islamic banking computer system.

Developing Islamic banking through education:

Kolej Perbankan dan Kewangan Islam (College of Islamic Banking and Finance)

The advancement of the field of Islamic banking received a further boost with the establishment of Kolej Perbankan dan Kewangan Islam (College of Islamic Banking and Finance) [KPKIL a private institution of higher learning, established in 1998. KPKI is managed by BIRT. Through KPKI, Bank Islam hopes to contribute in a more meaningful manner the development of knowledge and expertise in Islamic banking and finance in Malaysia. Furthermore, the establishment of KPKI was to further enhance its objectives and support the Malaysian government's aspirations to turn the country into a tertiary education hub.

Development strategy: Pembiayaan
Perumahan Nasional

Another positive development for Islamic banking in Malaysia is the establishment of Pembiayaan Perumahan Nasional (PPN), a company of the BIMB Holdings Group incorporated to undertake the privatisation of the Government Housing Loans Division – which involves more than 800,000 government employees. This group is seen as an important market segment that will be able to influence the country's policy makers and in turn the whole section of the Islamic financial industry.

The incorporation of PPN, a giant step for the BIMB group, further proves the government's seriousness in promoting the Islamic financial system. The shares within PPN are divided between BIMB Holdings Berhad (51%), Trans-Cosmic Sdn Bhd (44%) and Syarikat Takaful Malaysia Berhad (5%).

Besides placing Bank Islam as one of the main players in the financial scene and boosting its business activity, the commencement of operations of PPN will also promote the introduction of new financial instruments.

Diversifying Group Activities:
BIMB Foreign Currency Clearing Agency (BIFCA)

In line with its expansion plans, in March 2000 Bank Islam introduced another subsidiary BIMB Foreign Currency Clearing Agency (BIFCA). Among others, BIFCA operates as a foreign currency clearing house / agent, foreign currency import-export centre, and assist regulatory bodies in regulating import-export of foreign currency.

Expansion of Bank Islam operations overseas

Bank Islam took the initial step towards expanding overseas with the incorporation of its offshore subsidiary, Bank Islam (L) Ltd (BILL), in the Federal Territory of Labuan, Malaysia. BILL was established on July 1, 1997. Labuan is Bank Islam's training ground in preparation for further expansion overseas.

Labuan was chosen in response to the Malaysian government's effort to promote and enhance the island's capability as an International Offshore Financial Centre (IOFC). The government, with the assistance of BILL have also planned to turn Labuan into an International Islamic Offshore Centre in the near future, complementing and capitalising on the growth of the Islamic financial system in the Asian region and the world at large.

The enormous potential in the establishment of an international Islamic money market, estimated at approximately USD 152 billion (in 1997) would also ensure that BILL will be playing a bigger role in the advancement of Islamic banking in the near future.

Currently, BILL has ventured to the United States of America, China and Sri Lanka and several countries in Europe, and are in the midst of negotiating deals in Sudan, Mauritius, Pakistan and Australia.

Bank Islam has also assisted in the conversion and setting-up of Islamic commercial banks in Brunei (Islamic Bank of Brunei), Indonesia (Bank

Muamalat Indonesia) and the Philippines (Amana Bank of the Philippines). The experiences gained from its direct involvement in the setting-up of Islamic banking in these countries will be valuable for its future development plans overseas.

Bank Islam undertook its first overseas venture when it acquired a small stake in Amana Investments Limited, Sri Lanka in October 1999. Bank Islam plans to use Sri Lanka as a springboard to expand operations to other the region, and to other Muslim countries in the near future.

Bank Islam-as an Islamic Corporate Citizen

Bank Islam's corporate objective, among others, states that the bank should " be always conscious of its responsibility and duties as an Islamic corporate citizen." Apart from its commercial activities, Bank Islam also assumes this role as part of its social responsibility.

This social-religious obligation is carried out through various financing facilities with social dimensions and other financial assistance to those from the lower social strata. Among the financing schemes of Bank Islam include the Benevolent Loan for the Rural and Urban Poor through the Malaysian Islamic Economic Foundation [YPEIM] (Al-Qardhul Hassan); Indirect Lending through Amanah Ikhtiar Malaysia [AIM]; Pawnbroking project financing; and zakat endowment.

Although operating in the private (Tijari) sector, Bank Islam assists other sectors, namely the social (Ijtima'i) sector, especially in the economic sector. This is in line with its corporate mission. One such example is the Ar-Rahnu scheme. The Ar-Rahnu scheme is jointly developed by YPEIM and BNM and operated by Bank Islam. YPEIM as a social organisation has targeted the scheme for the lower income group, especially in meeting their financial needs. The role of Bank Islam here complements that of YPEIM in meeting this social goal.

Other financing schemes with social dimensions include the Vendor Development Programme, the Exchange programme with the Entrepreneurial Development Corporation; Financing Schemes through the Credit Guarantee Corporation Guarantee; Financing Schemes through Bank Negara Malaysia, and others.

Apart from providing the financial means to those in the lower social strata to carry out business activities and other economic ventures, Bank Islam hopes that these forms of financings will help further stimulate the country's economy.

In addition, Bank Islam and other subsidiaries of BIMB Holdings have continuously given financial assistance through its zakat fund to the needy and others who are deemed qualified by the bank's Shariah council. In 1999, the BIMB Group of companies had contributed over RM 1 million from its zakat fund to those in need. Bank Islam hopes that, through these contributions, it will play a crucial part in developing a caring society in Malaysia.

CRITICAL SUCCESS FACTORS OF ISLAMIC BANKING Among the

critical success factors of Islamic banking in Malaysia are:

1. Government support

One of the key success factors of the Malaysian Islamic banking model is the government support behind the initiative. Initially, this support was reflected through the creation of various legal frameworks, the introduction of more Islamic banking practitioners and new products and instruments, and the formation of the Islamic Money Market.

More recently, the central bank announced the consolidation of conventional banks to form 10 major banking groups, thus reducing the number banks in the country. However, the same rule did not apply to Islamic banking. Rather, a second Islamic bank was introduced in October 1999. This reflected the consistent level of commitment and optimism that the government has towards Islamic banking.

During the recent economic recession, Islamic banking received a major boost when it was identified as being among the country's top potential growth sectors, and incorporated as part of a larger national economic development plan under the National Economic Consultative Council.

At the ASEAN regional level, the support for Islamic banking is equally noteworthy. Among the focus of the Northern ASEAN Growth Triangle (Thailand, North Sumatra-Indonesia, Malaysia) and Southern ASEAN Economic Growth Triangle (the Philippines, Brunei, Borneo-Indonesia) is the promotion of Islamic banking and finance growth in the region. This mutual goal among member countries will definitely benefit the growth of Islamic banking system in the region.

2. Support from professionals

Credit for the tremendous growth of Islamic banking in Malaysia is not only due to Islamic banking practitioners but also those professionals who are directly or indirectly involved in the Islamic banking sector.

Professionals such as those from other financial institutions, business corporations, government departments and statutory bodies, academicians, accountants and auditors, legal practitioners, consultants, and so on. These groups of people, specialist in their respective fields, facilitate the development of Islamic banking as a whole.

3. Support from shareholders and. depositors

Bank Islam in particular has the backing of strong and influential corporate bodies such as the government-owned Permodalan Nasional Berhad (National Trust Fund) and Lembaga Tabung Haji (Pilgrims Fund 'Board) which tops its list of major shareholders.

Apart from that, more than 30 per cent of its customer base can also be considered as 'loyal customers.' This figure is rapidly increasing, taking in also a fair percentage of non-Muslims in its fold.

4. Openness of Islamic scholars

Malaysia is blessed with a pool of Islamic scholars who contribute to the development of Islamic banking in the country – in terms of developing new concepts, products, instruments, and so on.

Their non pre-judgement approach towards any new Shariah issue, and willingness to study and discuss any new Shariah-related development in Islamic banking augurs well for the progress of Islamic banking. _____

5. Favourable economic climate

The favourable economic climate of the country, particularly prior to the economic recession of 1997 – 1999, and the gradual recovery provides the much-needed impetus for Islamic banking in the country.

CONCLUSION

The Islamic banking system in Malaysia is relatively still in its infancy. In Malaysia it started off with Islamic commercial banking, and progressed to include different components within a wider Islamic financial landscape such as takaful, capital market, and so on.

While it started out concentrating on debt instruments (as commercial banking tend to), Islamic banking in Malaysia has progressed to include equity instruments (e.g. Mudharabah and Musyarakah). With each instrument having its own inherent risk profile, it is imperative that Islamic bankers identify these risks and act accordingly.

Depending on how advanced a particular market is, all instruments can be capitalized, in no particular order. In Malaysia, debt instruments were developed first because of the market needs and available infrastructure. As the demands and needs of the nation became more sophisticated and advanced, the need to develop equity instruments increases.

Following from this development, it is anticipated that the Malaysian Islamic banking system will witness a convergence between debt and equity markets, as both components continue to develop at a rapid pace.

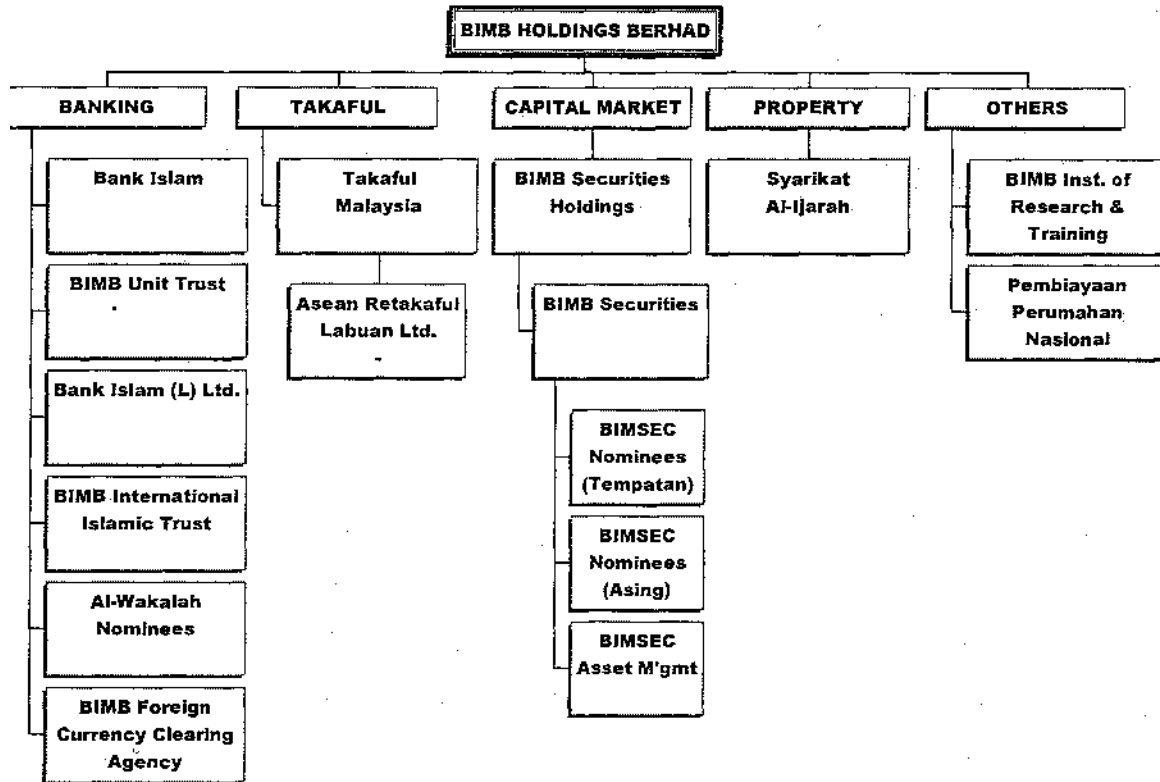
With its pledge to develop Islamic banking and finance still clearly intact, Bank Islam will continue to serve Muslims and non-Muslims with the same vigour, and commitment that saw it grow from a relatively modest banking institution into one of the country's more respectable banks.

The success story of this home-grown innovation is by and large a significant victory for Islamic banking as a whole. Its part in promoting and developing Islamic banking has put Bank Islam in the centre of attention in the banking sector, and is well on its way to turn Malaysia into the international capital of Islamic banking.

Bank Islam has, and will continue to promote Islamic banking locally and the world over. Its existence has not only triggered an Islamic financial market but also complemented the growth of other critical Islamic financial sectors. Bank Islam's success story in Malaysia is by and large a significant victory for Islamic financial system as a whole.

APPENDIX I

ORGANISATIONAL STRUCTURE



APPENDIX II

Current Development of Islamic banking in Malaysia

Number of financial institutions offering Islamic banking

| Institutions | Dec 1998 | ' Dec 1999 |
|---------------------|-----------------|-------------------|
| Commercial banks | 25 | 22 |
| Finance companies | 18 | 16 |
| Merchant banks | 5 | 5 |
| Discount houses | - | 7 |
| Islamic banks | 1 | 2 |
| Total | 49 | 52 |

Total Assets

| Institutions | Dec 1998 (RM mil) | Dec 1999 (RM mil) |
|---------------------|--------------------------|--------------------------|
| Commercial banks | 11,835 | 15,812 |
| Finance companies | 3,321 | 4,704 |
| Merchant banks | 778 | 1,407 |
| Discount houses | - | 2,578 |
| Islamic banks | 5,698 | 11,253 |
| Total | 21,632 | 35,754 |

Total Deposits

| Institutions | Dec 1998 (RM mil) | Dec 1999 (RM mil) |
|---------------------|--------------------------|--------------------------|
| Commercial banks | 9,108 | 10,366 |
| Finance companies | 2,677 | 2,642 |
| Merchant banks | 607 | 909 |
| Discount houses | - | 1,109 |
| Islamic banks | 4,040 | 9,713 |
| Total | 16,432 | 24,739 |

Total Financing

| Institutions | Dec 1998 (RM mil) | Dec 1999 (RM mil) |
|---------------------|--------------------------|--------------------------|
| Commercial banks | 4,764 | 5,203 |
| Finance companies | 2,108 | 2,996 |
| Merchant banks | 421 | 778 |
| Discount houses | - | - |
| Islamic banks | 3,650 | 5,030 |
| Total | 10,943 | 14,007 |

APPENDIX III

Terms And Conditions for the Kuala Lumpur International Airport Berhad
 Syndicated Al-Bai Bithaman Ajil With Islamic Notes Issuance Facility

Purchase Price

Disbursement

Subject to the Financiers' standard disbursement conditions, the Purchase Price shall first be credited to the Customer's Marginal Deposit Account with the Financiers and subsequent release shall be against acceptable documentary evidence and tentatively in January 1996.

Selling Price

Installment Period

Payment of
 Selling Price

- a) Payment of the Selling Price shall be by semi-annual installments as follows, the first to commence six (6) months after first of Purchase Price :
- b) The Selling Price shall be evidenced by the issuance of non-interest bearing Al-Bai Bithaman Ajil Notes which represents the Issuer's unconditional obligation to settle the Selling Price in the following manner:
 - i) Primary Notes shall be issued representing the cost portion of the Selling Price which shall all mature and be payable by the Issuer at the end of the tenor
 - ii) Each Primary Note shall be supported by secondary Notes of 6 (six) monthly maturities commencing 6 (six) months from release of Purchase Price, representing the profit portion of the Selling Price
 - iii) The details of the Primary and Secondary Notes are as follows :

| <u>Primary Notes</u> | | <u>Secondary Notes</u> | |
|--------------------------|---------------------|------------------------|---------------------|
| <u>Nominal Value(RM)</u> | <u>No. of Notes</u> | <u>Face Value(RM)</u> | <u>No. of Notes</u> |

Note : Each Primary Notes shall be supported by 40 Secondary Notes

Security

Guarantee by the Government of Malaysia

APPENDIX IV

Light Rail Transport Project, Kuala Lumpur: Features Of The Syndicated Project Financing Facility

| | |
|--------------------|---|
| Finanee | |
| Project | The design, construction, operation and maintenance of the Light Rail Transit System and the undertaking of Ancillary Activities along the Corridor of the Railway as defined in the Concession Agreement |
| Financing | <p>Islamic project financing facility comprising:</p> <ol style="list-style-type: none">1. Bai Al-Istisna'2. Al-Ijarah <p>(Note: 1 convertible to 2)</p> |
| Project Financiers | A syndicate of financial and non-financial institutions in Malaysia to be assembled by the Arrangers |
| Purpose | <p>To provide goods to the Finanee corresponding to those under the System Contract and in connection therewith to assume rights, liabilities and obligations in respect of the System Contract related to LRT project.</p> <p style="text-align: center;"><i>Bai Al-Istisna' Facility</i></p> <p>(a) The Financiers will provide Istisna facility to the Finanee during the System Contract competition period of 4 years (the "Istisna' Facility Selling Price")</p> <p>(b) Concurrently the Financiers will on parallel basis assume rights and obligations under the System Contract in respect of specific provisions and services (the "Istisna' Facility Purchase Price")</p> <p>2. <i>Al-Ijarah Facility</i></p> <p>Under this facility the Financier shall purchase the goods and equipment under the Istisna' Agreement (the "Ijarah Purchase Price") and subsequently the Financiers shall enter into an Agreement To Lease with the Finanee to lease the goods and equipment to the Finanee at a rental to be mutually agreed (the "Ijarah rentals"). At the end of the Ijarah Facility period of 11 years, such goods and equipment are available for purchase by the Finanee.</p> |
| Period | <p>Istisna' Facility - 4 years Ijarah Facility - 11 years Total - 15 years</p> |

Istisna' Facility
Selling Price

Ijarah Rental

Rental to be fixed every six (6) months, calculated based on 1.5% plus majority Financiers' Base Lending Rate ("BLR") or Cost Of Fund. There will effectively be 22 lease agreements through the 11 years Ijarah Facility period.

Payment of Istisna'
Facility Selling Price

By quarterly payments over a period of 4 years commencing from the date of first disbursement of the Istisna' Facility. (Novation Agreement)

Payment of Ijarah
Rentals

By 22 semi-annual rental payments over a period of 11 years

Note: (Rental has to be negotiated and contracted separately at each of the "renewal date")

Documentation

1. Istisna' Facility
 - (a) Istisna' Agreement
(between the Financiers and the Finanee).
 - (b) Novation Agreement
(between the Financiers and the Contractors)
 - (c) Collateral Agreement (Agency) between the Financiers and the Finanee as Agent of the Financiers for all purpose under the Parallel Istisna' System Contract, including to administer and supervise the execution of the Parallel Istisna' System Contract
2. Ijarah Facility
 - (a) Agreement To Lease
 - (b) Lease Agreement/side letters
3. Security

Debenture documents

 - (a) Assignment documents
 - (b) Project Account Agreement
 - (c) Shareholders' Undertaking

Security

Debenture by way of first fixed and floating charge over all the Present and future assets, undertaking and rights of the Finanee, including, but not limited to, the following:

1. All real property and assets
2. The Finanee's right under all property leases, licenses and permits
3. The Finanee's rights under the major contracts and all Project Agreements (other than System Contract)
4. All performance bonds and guarantee under the contracts
5. Finanee's right under the Concession Agreement, subject to the Government's approval
6. The Project Bank Account
7. All insurance policies

Background

Petronas Dagangan Berhad ("PD") is a wholly owned subsidiary of PETRONAS. PD on being on the Kuala Lumpur Stock Exchange ("KLSE") decided to restructure its inter company loan from PETRONAS. BIMB was appointed adviser and lead manager to arrange for the issue of and Islamic Bond on behalf of PD.

As the inter-company loan from Petronas was made on an interest-free basis it was deemed to have given on a Qardhul-Hasan ("Good Loan") basis.

The Qardhul-Hasan is to be repaid/ Securitised as follows:

- i) ,through the issue of new ordinary shares of RM1.00 each, at par to Petronas
- ii) to be securitised in the form of Islamic Debt Securities ("IDS") representing an IOU from PD to PETRONAS payable at the end of 5 years.
- iii) Attached will be 120 million Transferable Subscription Rights ("TSR"), given to PETRONAS as the Hibah (voluntary gift) for the Qardhul-Hasan

Details of the IDS and TRS's are as follow

Main Terms of the IDS Issue**Amount**

| | |
|------------------|--|
| Issuer | Petronas Dagangan Berhad |
| Initial Allottee | Petronas |
| Tenor | 5 years from Date of Issue, upon which the outstanding IDS will be redeemed at 100% nominal value |
| Status | The IDS shall be unsecured obligation of PD ranking pari passu with the Company's other unsecured obligations |
| Form | Issued in registrable form |
| Repurchase | PD may at any time during the tenor of the issue redeem the facility through the repurchase of part or whole of outstanding IDS in the open market |

| | |
|------------------------------------|--|
| Documentation | <p>The Facility shall be governed by the following principal documents :-</p> <ul style="list-style-type: none"> i) Loan ("Qardhu – Hasan") Facility Agreement or Acknowledge of advances by PD ii) Islamic Debt Securities Issue Agreement iii) Islamic Debt Securities with TSR and other - documents which shall reflect the terms and conditions, warranties, covenants, events of defaults, etc. currently normal for facilities of this nature <p style="padding-left: 40px;">Trust Deed</p> <ul style="list-style-type: none"> v) Deed Poll |
| Rating | Appropriate rating by Rating Agency Malaysia ("RAM") shall be procured by the Issuer prior to the issue of IDS |
| Listing | The KLSE |
| Governing Law | Malaysian Law |
| Offer for Sale | Upon issue of the IDS the primary holder, PETRONAS, shall tender out the entire issue of the nominal value IDS |
| <u>Main Terms of the TSR Issue</u> | |
| Number | |
| Maturity | 5 years from the Date of Issue, after which they shall become null and void |
| Convertibility | Each TSR entitles its holder to subscribe for 1 new ordinary share of RM1.00 each at the Exercise Price at any time during its maturity |
| Form | TSR's are issued in registrable form |
| Exercise ("Strike") Price | |
| Detachability | TSR's upon issue will automatically be detached from the IDS and can be freely traded or transferred on their own |
| Tenderability | Holder of TSR's exercising their right to subscribe shall pay the subscription consideration by cash |
| Documentation | The TSR's will be governed by a Deed Poll |
| Listing | The Kuala Lumpur Stock Exchange (KLSE) |