

**A STUDY ON ISLAMIC BANKING INSTITUTIONS
IN MALAYSIA: FOCUS ON THE GROWTH,
PERFORMANCE AND FINANCING PRODUCT**

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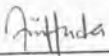
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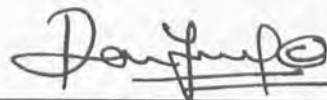
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The materials in this dissertation are original except for quotations, excerpts, summaries and references, which have been duly acknowledged.

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ABSTRACT

A STUDY ON ISLAMIC BANKING INSTITUTIONS IN MALAYSIA: FOCUS ON THE GROWTH, PERFORMANCE AND FINANCING PRODUCT.

This study was to determine the growth of Islamic Banking institution in Malaysia from earlier establishment, the performance of it and its product offered to customer which was in this study the researcher has more focused about financing (Bai-Bithaman Ajil financing). The study has looked at the experience of Islamic banking institution in Malaysia from 1983 to 2006 which was showed the growth of total asset, deposit and financing of this institution. Then to measure its performance, the researcher has looked for the changes in the profitability ratio over time from 2001 until 2005 that means cover five-year period of experience whether going parallel with conventional banks. This will answer to the target place by BNM as the long-term objective of BNM is to create an Islamic banking system operating on a parallel basis with the conventional banking system and examined the performance enable us to draw a conclusions about Islamic banking institution's financial health and its variation over time. Then issue about Islamic financing also been discussed to make people more understand about its mode of financing, which was in this study, the researcher has evaluated about BBA (Bai-Bithaman Ajil financing).



ABSTRAK

Kajian ini mengkaji mengenai pertumbuhan institusi-institusi perbankan islam di Malaysia sejak dari awal penubuhannya, prestasinya, serta produk yang ditawarkan kepada pelanggan iaitu dalam kajian ini pengkaji lebih memberi tumpuan kepada pembiayaan (pembiayaan Al-Bai' Bithaman Ajil). Kajian ini akan melihat pengalaman institusi-institusi perbankan islam di Malaysia sejak tahun 1983 hingga 2006 di mana telah menunjukkan pertumbuhan dari segi aset, simpanan dan pembiayaan di institusi-institusi ini. Untuk mengukur prestasi institusi-institusi perbankan islam ini, pengkaji telah melihat kepada perubahan nisbah keuntungan dari tahun ke tahun iaitu dari tahun 2001 hingga 2005, meliputi 5 tahun samada seiring dengan prestasi institusi-institusi perbankan konvensional. Ini akan menjawab kepada ketetapan yang dibuat oleh BNM sebagai objektif jangka panjang untuk mencipta operasi institusi-institusi perbankan islam seiring dengan institusi-institusi perbankan konvensional. Dan dengan memeriksa tahap prestasinya, kita boleh membuat kesimpulan mengenai tahap kedudukan kewangannya serta perubahan dari semasa ke semasa. Isu mengenai pembiayaan islam juga telah dibincangkan untuk meningkatkan lagi tahap kefahaman mengenainya, terutamanya pengkaji lebih memfokuskan kepada pembiayaan secara Bai' Bithaman Ajil.



ABBREVIATIONS

| | |
|---------------|---------------------------------------|
| AITAB | Al-Ijarah Thumma Al-Bai |
| AU | Asset Utilization |
| BAFIA | Banking and Financial Institution Act |
| BBA | Bai' Bithaman Ajil |
| BBMB | Bank Bumiputra Malaysia Berhad |
| BBMBK | BBMB Kewangan Berhad |
| BIMB | Bank Islam Malaysia Berhad |
| BMMB | Bank Muamalat Malaysia Berhad |
| BNM | Bank Negara Malaysia |
| GII | Government Investment Issues |
| IBA | Islamic Banking Act |
| IBDs | Islamic Banking Divisions |
| IBS | Islamic Banking Scheme |
| IIMM | Interbank Money Market |
| IM | Interest/Investment Margin |
| NOM | Net Operating Income |
| OER | Operating Efficiency Ratio |
| PBT | Profit before Tax |
| PM | Profit Margin |
| QH | Qardhu Hassan |
| RENTAS | Real Time Gross Settlement System |
| ROA | Return On Asset |
| ROE | Return On Equity |

ROD

Retun On Deposit

TH

Tabung Haji

SPI

Skim Perbankan Islam



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CHAPTER 1

INTRODUCTION

1.1 Overview

In Malaysia's dual banking environment, the Islamic financial system operates in parallel with the conventional financial system. The Islamic financial system encompasses the Islamic banking system, Islamic money market, Islamic insurance or takaful, Islamic capital market and the specialized financial institutions which provide alternative sources of financing. The Islamic banking system which forms the backbone of the Islamic financial system plays a vital role in mobilizing deposits and providing financing to facilitate growth. According to (BNM Annual Report, 2003), the Islamic banking system in year 2003 is represented by 33 Islamic banking institutions, comprising 2 Islamic banks (BIMB and Bank Muamalat) and 31 conventional banking institutions (9 commercial banks, 4 foreign banks, 7 finance companies, 4 merchant banks and 7 discount houses) offering Islamic banking products and services under the Islamic Banking Scheme (IBS).

The Islamic banks regulated and supervised by Bank Negara Malaysia under the Islamic Banking Act 1983 (IBA), while the conventional banks participating in Islamic Banking Scheme are regulated under the Banking and Financial Institution Act 1989(BAFIA). IBS banks are categorized into three groups, namely the commercial banks, finance companies and merchant banks. An IBS bank can be defined as a mainstream bank that participates in Islamic banking operations. Then for mainstream

bank it can be defined as the larger component of bank that offers interest-bearing facilities.

The Islamic banking institutions operate under a robust regulatory and supervisory framework based on international standards and best practices, at par with conventional banking institutions. For the IBS banks, the robustness of the regulatory and supervisory framework includes the establishment of effective firewalls to ensure that there is complete separation between Islamic banking and conventional banking portfolios in line with the dictates of the *Shariah*. This is to protect the integrity and confidence in the Islamic banking system.

The common trend in Islamic banking operations in Malaysia has been the application of credit sale in financing (*al-murabahah* and *ijara wa iqtina*). Presently, it constitutes more than 90 percent of Islamic banking assets. In credit sale finance, an Islamic bank will purchase goods on a cash basis and sell them on credit terms. In this manner, no loan is given away since what the customer wants is met by way of a sale and purchase agreement. The bank assumes the role of a seller while the customer stands as a buyer. Unfortunately, this has been widely practiced in most Islamic banks in Muslim countries. The important of risk-taking and value-addition seem lost, which is a crucial social imperative and hence islamicity. Finally ethics takes a back seat making way for legal rules to dominate Islamic banking juristic opinions. As ethics (*akhlak*) and law (*fiqh*) do not seem to mix, the Qur'anic spirit of justice and mutual aid is compromised to pave way for financing techniques that may look Islamic on the outside only. Since taking *riba* is prohibited in Islamic teaching, all the transaction must be in a good manner and that is unlawful to take the *riba*. *Riba* mean when somebody lend his/her money to other people, at the time to payback, his/her get double payment of

his/her money. Then whatever earnings or income that get from deceit, fraud is also unlawful because take other people ownership without permission. So this study also able to give clear perception about Islamic financing which practice profit/loss-sharing and will show what happen to this activity in term of return/income when economic downturn. By this, it means both the supplier for the capital and borrower share the risk; both prosper when returns are favorable and suffer together when returns are poor.

An issue arising in IBS banks was the overuse of credit and hire purchase transactions (*al-murabahah* and *AITAB*) which may not be able to show that IBS banks really matters, since it replicates a parent banks model. This is because Islamic credit finance retains mainstream attributes such as end-financing, banks' legal charge on asset purchase and taking contractual profits by virtue of time value. The same applies to Islamic hire purchase which applies financial leasing instead of true leasing. Among Muslim jurist (fuqaha), these contracts remain controversial since both allow profit taking by virtue of time value. According to (Saiful and Mohd Afandi, 2003), since this resembles mainstream banking practices, there is no strong reason to expect IBS banks to display a better performance. If any, it may be caused by non-religious factors such as government policy and operational issues. Saad and Mohammad (1998), agreed when these contracts not be able to show better performance as the results reported in their study showed that Islamic bank customers are not quite satisfied with the "financing facilities" as indicated by the low mean satisfaction score. Then, they find out that the cost and flexibility of these financing schemes are some concerns that actually indicated by customer.

Although various issue arise in credit sale in term of mark-up and financing payback, it has been said "*harus*" according to *shariah* principal and demand for this

term of financing (*BBA* and *Murabahah*) was highest among others financing type (Norhashimah Mohd. Yasin, 1996:261). Bank Islam Malaysia has been criticized for its heavy reliance on the less risky mode of financing, that is, *Murabahah*, *Bai Bithaman Ajil* and *Ijarah*. To some scholars, these modes of financing which entail fixed profit margins represent "backdoor *riba*". Secondly, its operations are geared towards profit maximization rather than focusing on socio-economic goals such as eradication of poverty.

Then issued arise in IBS especially on the management of assets and efficient use of resources were being said not show commendable performance compared with its parent banks, according to (Saiful and Mohd Afandi, 2003), their contention that Islamic banking scheme (IBS) in Malaysia will not show good performance since Islamic banking financial products resemble their mainstream counterparts, it is unlikely that they will perform in a superior way. Since both systems operate under one monetary regime, the fractional banking and money multiplier implications do not differentiate Islamic from mainstream banking. Unless, as they said in their study on performance of Islamic and mainstream banks in Malaysia , an Islamic banking scheme (IBS) bank uses the partnership framework (*musyarakah*) or embraces transactions yielding an equivalent counter-value(*mudharabah*), their risk-exposure will be similar to the mainstream system. As a result, return on Islamic deposits may not be able to exceed interest on conventional deposits.

This study involve measuring the profitability or return performance of Islamic banking institution by using some indicators namely financial ratio based on theory by (Shamugam *et al.*, 1990; Reilley and Brown, 1997:388; Rose and Hudgins, 2005:160). It attempts to show the performance of this institution which look from year by year and

its performance against conventional banking institution in term of the way they utilized resource and managed assets. The study also looked at the experience of Islamic banking institution in Malaysia from 1983 to 2006 which was showed the growth of total asset, deposit and financing of this institution as been said that those three items were some aspect which helped to the growth of Islamic banking institutions (Jamil Osman, 2003). Then issue about Islamic financing also has been discussed to make people more understand about its mode of financing, which was in this study, the researcher wasl evaluated about BBA (Bai-Bithaman Ajil financing).

1.2 Problem statement

The problem of the study was to determine the performance of Islamic Banking institutions; the growth of it from earlier establishment and its product offer to customer which was in this study the researcher was more focus about financing (Bai-Bithaman Ajil financing). According to (S. Al-Harran, 1995: 85), experiences have shown that Islamic banking system can coexist with conventional banking system and continue to grow and prosper. Therefore a continued evaluation of Islamic banking institutions performance is necessary. To measure its performance, the researcher has looked for the changes in the ratio over time from 2001 until 2005 that means cover five-year period of experience whether going parallel with conventional banks. This will answer to the target place by BNM as the long-term objective of BNM is to create an Islamic banking system operating on a parallel basis with the conventional banking system and examine the performance enable us to draw a conclusions about Islamic banking institution's financial health and its variation over time.

Then by studied and looked for the growth in term of its asset, deposit and financing of this institution from earlier establishment until now, it would able showed this institution may reach the target put by BNM as to achieve 20% market share by 2010. Another issue that the researcher analyzed was the issue about the Islamic financing in term of payback amount and profit rate policy as an example purchase and resale of properties on a deferred payment basis, which is termed bai' muajjal (bai bithaman ajil) is being said more expensive rather than conventional bank. Various issue come out about financing operation that apply by Islamic banking (Fadzila, 2003: 63), and was agreed by (Zakariya Man, 1988:95). To discuss more about this issue, this research paper firstly present the sensitivity of income from financing to the changes in the total debt of financing and customer financing. Then the financing performance has been shown after that to make people more understand about this activity. According to (S. Al-Harran, 1995:94), to examine the overall business performance of BIMB, on of the ratio can be used was profits to financing. So the BIMB was selected to be test for this interaction by taking 18 years data from 1988 until 2005 and has been analyzed used SPSS software. Since most empirical studies on Malaysia Islamic banking are limited to Bank Islam Malaysia Berhad (BIMB), Samad, A (1999) evaluates BIMB's productivity and managerial efficiency in the sources and the uses of the bank's funds. He found that managerial efficiency of mainstream banks was higher than BIMB. Productive efficiency or the average fund utilization rate and profit earned by BIMB were also found to be lower than those for mainstream banks. All profitability indexes indicate that profits earned by BIMB are lower than those for the mainstream bank.

Then, according to (Nik Hassan, 2001:131), he said that the Islamic banking services provide by mainstream banks not to much be squeeze out where its

establishment itself are only as optional product and not as an alternative product. So how about the overall performance of Islamic banking institution in Malaysia? Is it not impossible for Islamic banking institution to be parallel superior with the conventional banks and achieve its target about 20% market shares by 2010? So analyzed its performance over time allowed us to assess how well this Islamic banking system was working in terms of financial performance by measuring the profitability ratio.

The issue in Islamic banking personally attract researcher to study because according to (Saiful and Mohd Afandi, 2003), the interest-like Islamic banking operations are not expected to show a superior performance as should be. Instead, their study has shown that mainstream banking performed better than IBS banks. This is explained by the larger market size, long-term experience and financial deepening factor, which IBS banks have yet to develop. But the researcher believe that the IBS banks soon can be better performance than its parent banks because according to (Hegazy, 1995) where has investigated bank selection criteria for both Islamic banks and commercial banks, he concluded that the selection attributes for Islamic banks are different from those for commercial banks. He continued said that for the selection of Islamic banks, it was found that the most important factor was the advice and recommendations made by relatives and friends. Then convenience of location, friendliness of personnel, and the bank's vision of serving the community regardless of the expected profitability, timeliness and efficiency were also found to play important roles in the selection of Islamic banks. So the researcher believe that by identifying the main selection attributes will allow Islamic banks itself to develop appropriate marketing strategies. Since Islamic banks operate according to profit-loss sharing principle (prohibition of interest), they expected to develop this competitive advantage around the crucial selection attributes

emerging from comprehensive customer survey. Since based on study by (Saiful and Mohd Afandi, 2003) when they mentioned using ROA and other profit ratio performances such as ROD, PM, NOM and OER will be inaccurate for IBS banks. But, they continued said that there are still a reliable measure of performance for BIMB and Bank Muamalat. So due to this reason, the researcher has measured the performance not only on IBS banks, but include the overall performance of Islamic banking institution which consists of Islamic banks, IBS in mainstream banks and discount houses in Malaysia.

The main aim of this study was to examine the growth and performance of the Islamic banking system of Malaysia beside in the same time look the interaction between income from financing with total debt of financing and total customer financing where after that its profitability performance has been calculated used ratios for banks over several years, and note how they change over time. This study was helpful in that it has provided a better understanding of the Islamic banking system and its mode of financing (as example BBA) and has determined the performance of Islamic banking system of Malaysia from year it begin until now in used its asset and resources by evaluate on its profitability performance.

1.3 Objective of study

The objective of this research was to measure and analyze the performance of Islamic banking institution in Malaysia which including Islamic banks, Islamic banking scheme (IBS) in mainstream banks and discount houses by look for changes in the ratios over time (trend analysis) and observe the movement of ratio with its rival (conventional banking institution) for a better understanding of this institution. Therefore, calculate the financial ratio and analyzed base on trend analysis and competitive analysis have shown

the performance of these Islamic banking institutions in term of how this institution managed assets and utilized resource over a time which was from year 2001 to 2005.

According to (Saiful and Mohd Afandi, 2003), as BIMB was the only focus in Malaysia Islamic Banking studies, any conclusions made cannot imply the overall impact of the Islamic banking business. They continued mentioned that the performance of IBS in mainstream banks has not yet been studied. So by using some indicators in financial ratio, namely profitability ratio, this study has attempted to evaluate the overall performance of Islamic banking institution over a time whether on parallel basis to that of conventional banks. This study also has presented some aspects of the growth (asset; deposit and financing) which have helped in the process of increasing the growth of the Islamic banking institution by year it's begin until now. Another objective of this study was to make people more understand about the Islamic mode of financing (as example BBA) that offered by Islamic banking scheme in this case the researcher choose BIMB as a selected bank to see the sensitivity from income from financing to the changes in the total debt financing and total customer financing beside calculate ratio to measure its performance over a time.

1.4 Scope of study

This study was focusing on Islamic banking institution in Malaysia including Islamic banks, Islamic banking scheme (IBS) in mainstream banks and discount houses. See **Figure 1.1** below to see the list of Islamic banking institutions offering Islamic Banking services (as at 19 October 2006). Then to see the performance of Islamic banking institution, financial ratios have been used to measure and analyze Islamic banking institution as it is an indicator of measuring banking performance. This research involved

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