



**FINANCING AND ITS DETERMINANTS:
COMPARISON BETWEEN ISLAMIC BANKS AND
CONVENTIONAL BANKS IN MALAYSIA AND
INDONESIA**

BY

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ABSTRACT

Bank lending in Malaysia and Indonesia is thought to remain an important factor to generate the economy. In Malaysia, the ratio of bank lending to its GDP has increased steadily from about 80% in the 1980s, to about 100% the 1990s and about 125% in 2003 (Kassim, 2006). Similarly, in Indonesia, the banking sector continues to be the major source of domestic financing, reaching up to 80% of the region's investment (Goeltom, 2007). Furthermore, the important role of bank lending is also attributed to the relatively less developed capital market. Studies on the determinant of loan have been put in greater attention by many researchers. However, most of the study was done in the context of conventional banks such as by Ibrahim (2006), Calza, Gartner and Sousa (2003), Vaithilingam, Guru and Shanmugarm (2003) Kim and Moreno (1994) and etc. To our knowledge, there has been only one study on that issue in the case of Iran which adopt full Islamic banking system Makiyan (2001). Yet, no study has been done in the case of dual banking system. This paper aims to fill that gap. It investigates the factors determining the Islamic Bank Financing in the case of Malaysia and Indonesia. This paper will also look into the determinant of conventional bank lending for comparison. This paper employs the standard time series analysis such as unit root test, cointegration, Vector Error Correction Models, Variance Decomposition and Impulse Response Function. Variables used in this study consist of Islamic bank financing, Conventional bank lending, Financing rate, Interest rate, Industrial Production Index, Price, Stock Market, Exchange Rate, Islamic deposit and Conventional deposit. Among the results is that the output as well as Islamic deposit significantly influence Islamic financing. Meanwhile, the role of stock market is found insignificant to Islamic financing in both countries. In the conventional counterpart, this study shows that the roles of output and stock market are significant in influencing conventional lending in both countries. However, conventional lendings do not seem to rely heavily to their deposit as the main source of lending. This study will provide the guidelines for the Malaysian and Indonesian governments to further develop and enhance the performance of Islamic banking system. Furthermore, it provides some important information for other countries which are about to adopt a similar system.

ملخص البحث

إن قروض البنك في ماليزيا وإندونيسيا لا تزال تُعدُّ عاملاً مهمًّا لتوليد الطاقة الاقتصادية، وبخصوص ماليزيا، فإن نسبة القروض المصرفية إلى الناتج المحلي الإجمالي ازدادت بشكل مطرد من حوالي ٨٠% في الثمانينات، إلى حوالي ١٠٠% في التسعينات، وحوالي ١٢٥% في عام ٢٠٠٣ (قاسم Kassim، ٢٠٠٦). وكذلك في إندونيسيا، فإن القطاع المصرفي لا يزال المصدر الرئيسي للتمويل المحلي، بل وصل إلى ٨٠% من الاستثمارات في هذه الدولة (جولتم Goeltom، 2007). بالإضافة إلى ذلك، فإن أهمية دور الإقراض المصرفي تتعلق بسوق رأس المال الذي ينمو بشكل ضئيل نسبياً. وقد وُضعت دراساتٌ عن العوامل المحددة للقروض في مزيدٍ من الاهتمام من قِبَل العديد من الباحثين، ومع ذلك جرى معظم الدراسات في سياق البنوك التقليدية، مثل إبراهيم Ibrahim (٢٠٠٦)، و تجلزا Calza، وغرتنر وسوسا Gartner and Sousa (٢٠٠٣)، وفايتيلينجام Vaithilingam، وغورو وسنموغرم Guru and Shanmugarm (2003) وكيم ومورينو Kim and Moreno (١٩٩٤) وغيرها. علماً بأن هناك دراسةً واحدةً فقط عن هذا الموضوع في قضية إيران التي تتبى النظام المصرفي الإسلامي الكامل، ماكيان Makiyan (2001)، وعلى الرغم من ذلك، لم يتم عمل دراسة في حالة النظام المصرفي المزدوج. ولذلك فإن هذه الدراسة تهدف إلى سدّ تلك الفجوة، فالدراسة تحقّق في العوامل التي تحدّد تمويل البنك الإسلامي في القضايا التي تجري في كلّ من ماليزيا وإندونيسيا. وهذه الدراسة سوف تنظر أيضاً من أجل المقارنة في العوامل المحددة لإقراض البنوك التقليدية. وتستخدم هذه الدراسة منهج تحليل السلاسل الزمنية القياسية، مثل اختبار جذر الوحدة، والتكامل المشترك، ونماذج متجهات تصحيح الخطأ (Vector Error Correction Models)، وتحليل تباين الأخطاء (Variance Decomposition) ودفعه وظيفة الرد (Impulse Response Function). وأما مستويات المتغيرات المستخدمة في هذه الدراسة فتتكون من التمويل المصرفي الإسلامي والقروض المصرفية التقليدية، ومعدل التمويل، ومعدل الفائدة، ومؤشر الإنتاج الصناعي، والسعر، وسوق الأسهم، وسعر الصرف، وودائع وحسابات الودائع الإسلامية التقليدية. ومن نتائج الدراسة يظهر أن الإخراج وكذلك الودائع الإسلامية تؤثر تأثيراً كبيراً على التمويل الإسلامي. ومن ناحية أخرى، فإنه تم العثور على أن دور سوق الأوراق المالية ضعيفة للتمويل الإسلامي في كلا البلدين. وفي المماثلة التقليدية، فإن هذه الدراسة تبين أن لكل من الإنتاج وسوق الأوراق المالية دورٌ كبيرٌ في التأثير على الإقراض التقليدي في كلا البلدين. ومع ذلك، فإن القروض المضمونة التقليدية لا يبدو أنها تعتمد بشكل كبير على الودائع كمصدر رئيسي للإقراض. علماً بأن هذه الدراسة توفر المبادئ التوجيهية للحكومتين الماليزية والإندونيسية لمواصلة تطوير أداء النظام المصرفي الإسلامي وتحسينه. وفضلاً عن ذلك، فإنها توفر بعض المعلومات المهمة بالنسبة للبلدان الأخرى التي ستعتمد على النظام المشابه.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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To

My beloved parents, Muhammad Amin and Farida Hanim

My beloved sister Temy and Ika

My Wife, Ema, my love

My daughter, Nifa

My Son, Fakhri

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Among other countries in South East Asia, Malaysia is the home of well-developed Islamic financial institutions, not only banking but also non-bank financial institutions. The first institution established is, in fact, not an Islamic bank, but the Pilgrimage Management Fund Board (PMFB), as part of the government service for the people who intend to perform their hajj. PMFB offers a number of instruments based on the Shari'ah principles as its commitments to avoid the element of interest in its business activities or in the social services in general. The success of the PMFB paves the way to the establishment of Islamic banks in the country, which was firstly initiated by Bank Islam Malaysia Berhad (BIMB) on 1 March 1983, with the promulgation of the Islamic Banking Act 1983.

As an Islamic bank that operates differently from the existing conventional system, BIMB had been granted a privilege by the government having no competitor for ten years since its establishment. As of 30 June 1988, BIMB was able to compete with conventional banks in terms of profit, deposits and assets. A study by Ariff (1989) finds that whilst some of the conventional banks experienced losses, BIMB gained profits as much as RM 6,187,000, so as to rank BIMB ninth. In terms of asset and deposit, BIMB was able to reach up to RM 1,263,451,000 (the fourteenth rank) and RM 1,042,008,000 (the twelfth rank) respectively.

Those achievements lead the government to provide a room for conventional banks to offer Islamic products, by introducing a policy on establishing Islamic

windows, which has been implemented since 1992. According to Bank Negara Malaysia (BNM) in its official website, this policy is well received by conventional banks, indicated by mushrooming Islamic financial instruments offered by conventional financial institutions. In 1995, as many as twenty three commercial banks, nineteen finance companies and three merchant banks were established. Henceforth, Islamic Banking sector has grown very significantly. This is so since customers who wished to deal with the interest-free transactions are given another alternative to deposit their funds. Customers are provided better facilities by the Islamic windows such as a large number of branches throughout the country.

As a result, total Islamic banking asset¹ significantly increases, due to the additional huge amount of funds deposited in the Islamic banking system. A report by BNM states that in the consecutive years of 1993 and 1994, the assets increased from RM 2,009 million to RM 4,885 million. This substantial amount of deposits, in turn, provides Islamic banks with bigger loanable funds or financing² to be channelled into various sectors of the economy, reaching in total RM 1,737 million in 1994 and double in 1995, or about RM 3,492 million.

However, in 2005, Islamic banking assets compose only 11.3% to the total banking assets in Malaysia. For the sake of further developing Islamic Banking system, the BNM Annual report (2000) reveals the commitment of the Malaysian Government in targetting 20% of Islamic Banking market shares, to be reached in 2010.

As comparable to Malaysia for its development in the area of Islamic banking and finance, Indonesia is another leading country in this area. Indonesian Government

¹ The assest consist of those of full-fledged Islamic banks and Islamic windows.

² Throughout this study, loans, and lending are used interchangeably to represent credit in the conventional bank whereas financing is used in the case of Islamic bank.

allowed the first establishment of its kind in Indonesia namely Bank Muamalat Indonesia (BMI) in 1991, which obviously is an Islamic Bank. Although the regulation on Islamic Banking had not been enacted at that time, with the political support from the President, BMI came into existence (Harahap and Basri, 2003). Eight years later, the second Islamic bank was established as a result of the conversion of Bank Susila Bhakti to Bank Syariah Mandiri (BSM). The establishment of the two banks has initiated Bank Indonesia to give permission for conventional banks to set up Shari'ah-compliant or Islamic banking units. By May 2007, there were 3 full-fledged Islamic banks and 23 Islamic Banking Units (Indonesian Shari'ah Banking Statistics Monthly report, May 2007).

Harahap and Basri (2003) stated that the composition of Islamic banking assets, financing, and deposits of Indonesia in 1992 came out to be about US\$ 15.11 million, US\$ 4.07 million, and US\$ 2.6 million respectively³. Furthermore, the Government's introduction of Shari'ah-compliant units or Islamic banking units in 1999 had a tremendous effect on total assets causing them to increase significantly. Total banking assets in that year was about US\$ 86.66 million and increased six folds within three years to about US\$ 516.85 million. On the financing side, the increment came out to be about US\$ 42.84 million in 1999 and surprisingly, within three years, it multiplied ten times to about US\$ 433.65 million. Similar to that of Malaysia, Bank Indonesia (BI), as a central bank, also targets a market share of Islamic banking assets to be in the range of 8-15% out of total banking assets by the year 2015⁴.

The two figures above, help indicate that with the support of the Government and its people, Islamic banks have developed and performed very well and would be able to thrive in the future as well. The increment in assets, financing, and deposits

³ With the assumption that US\$ 1=Rp 8000

⁴ *Blue Print of the Development of Islamic Banking System*, Bank Indonesia (2006: 28)

which serves to be an indicator of satisfactory performance of Islamic banks, also tells us that the public, in particular, Muslims, have started to understand the importance in the role that they play in the economy. The main function of all banks, regardless of whether they are Islamic or conventional would be the same, although their primary purposes would be different. As such, similar to conventional banks, Islamic banks carry out their role by allocating resources in the most efficient manner. As financial intermediaries, banks will receive the excess money from the public and allocate to those who are in need for running their business. The difference lies on the types of contract used in those banks. Conventional banks use loan contract as the only contract whilst Islamic banks uses various types of contract such as profit sharing, sale, rent. Once the financing is approved by the Islamic banks, then the investment component will increase in the Keynesian model of gross domestic product (GDP) which will eventually be increased.

In theory, there are many factors which could be considered as determinants of supply and demand when relating to lending. Examples of such determinants include wealth, expected return, risks, interest rate and profitability. Take for instance a situation where there's an economic boom represented by an increase in wealth. In such a situation, banks tend to extend or increase their loans. On the same hand, assuming a better economy in the near future, firms will automatically demand more loans in order to expand their businesses. Further elaboration on the determinant variables of lending will be made in Chapter 3 under the theoretical framework.

The explanation above shows the important role of lending or financing in economy; and the evidence is made available in many studies that have been conducted to describe the behaviour of bank lending. However, those past studies mostly focused on conventional banks, such as by Ibrahim (2006), Kim and Moreno

(1994), Calza, Gartner and Sousa (2003), and Vaithilingam, Guru and Shanmugarm (2003) etc. Variables such as the stock market, GDP, exchange rates, and interest rates, are all utilized as determinants for lending. Kim and Moreno (1994) and Ibrahim (2006) from their researches done, concluded that there is a positive relationship between the stock market to lending in Japan and Malaysia, respectively. Similarly, income as represented by GDP was also found to be positively related to lending by various authors such as Ibrahim (2006), Vaithilingam et al., and Calza et al (2003).

Unfortunately, there are only limited amount of studies on the role of Islamic Banks with regards to financing. For that particular reason, it has limited this present research to examine into only one particular study which was done by Makiyan (2001). Makiyan looked into the issues of the determinants of loans in the Iranian context, where the country has made a complete replacement of the interest-banking system with the Islamic banking concepts. Since studies on the determinants on the financing of Islamic banks are limited, this paper attempts to fulfil the gap by investigating this scenario of two Asean countries, namely, Indonesia and Malaysia. Due to the fact that both countries run a dual banking system, examination of the determinants would also be made on the conventional banks as it would be necessary for comparison purposes.

1.2 RESEARCH PROBLEM

Loans made by banks are definitely considered to be an important factor in helping generate the economy. Such is the same for Malaysia and Indonesia as well. For the former, the ratio of bank loans to its GDP increased steadily from about 80% in the 1980s to about 100% in 1990s and about 125% in 2003 (Kassim, 2006). Furthermore, the important role of bank loans is also attributed to the relatively less developed

capital market. For example, In 2003, the share of private debt securities and bank loans to the Malaysian economy were 30% and 70%, respectively.

Similarly, in Indonesia, the banking sector continues to be the major source of domestic financing, reaching up to 80% of the region's investment (Goeltom, 2007). Capital market as an alternative to help boost the economy is still at a premature stage. Hence, this study attempts to investigate the determinants of lending in conventional banks and financing of Islamic banks in two countries: Malaysia and Indonesia. Furthermore, in order to get more comprehensive view of the relationship, this study also examines the role of financing and lending to other variables, hence a more comprehensive view of the relationship can be obtained.

1.3 OBJECTIVES OF THE STUDY

Many studies (Ibrahim 2006; Calza et al., 2003; Vaithilingam et al., 2003; Kim and Moreno 1994, etc) have generally been focused on conventional bank loans, which is very much in contrast with the amount of studies available on financing of Islamic banks. Most of those studies suggest the significant impact of macroeconomics variables on lending. Motivated by Makiyan's (2001) study (Iranian case), this paper aims to study the role of financing in Malaysia and Indonesia. Selection of the two countries is based on rapid development of Islamic banks as compared to other countries in the same region.

This study focuses on the role of financing/lending, deposit, exchange rate, price level, financing/lending rate, industrial production index, stock index on the Islamic bank financing. This study will also look at the determinants of conventional bank loans in the respective countries, in order to gain a comprehensive and complete

picture since both countries operates in a dual banking system. The objectives of this study are as follows:

- i. To describe in brief the economic performance of two Asean countries: Indonesia and Malaysia.
- ii. To describe the development of Islamic banks in both countries hence, including a short history, along with the progress and current performance will be briefly elaborated.
- iii. To identify which of the macroeconomic variables such as income, stock prices, price level, Islamic banking deposits, conventional banking deposits, lending rates, Islamic financing rates, exchange rates, have significant relationship with the financing of the islamic banks and conventional bank lending in both countries respectively.
- iv. To investigate the dynamic relationship between Islamic bank financing and those macroeconomic variables in both countries.
- v. To investigate the dynamic relationship between conventional bank lending and those macroeconomic variables in both countries.
- vi. To provide explanation for the result obtained.
- vii. To propose policy recommendation

1.4 SIGNIFICANCE OF THE STUDY

As far as the Islamic banking system is concerned, the operation of it is relatively new, as compared to the conventional one. No specific record is available but a few. The first Islamic bank, according to the available historical record is Mit Ghamr, established in the 1950's, though, its performance is, again, not well recorded. The major expansion in Islamic banking came into existence in the 1970s, with the

establishment of the Dubai Islamic Bank in 1975, the Faisal Islamic Banks in Egypt and Sudan in 1977, the Kuwait Finance House in the same year; the Jordan Islamic Bank in 1978 and the Bahrain Islamic Bank in 1979. This movement, as observed by Wilson (2000), has emerged partly from the oil revenue boom in the Gulf and the growing economic muscle of the more conservative Muslim states there.

Since then a lot of studies have been conducted, theoretical as well as empirical, on the role of Islamic banks. Even so, there are so many aspects in the area of Islamic banking and finance which remain unobserved. Issues relating to Shari'ah, regulations, internal management, Islamic financial instrument, and those relating to the roles and contributions of Islamic banks to the economy, are of concerns. This study attempts to portray on the small aspect, that is, determinants of financing in Islamic banks; and is expected to contribute the following significance:

- i. This study will add new empirical knowledge specifically in the modelling of financing and lending. So far no study has been done in comparing the determinant of financing and lending in dual banking system. Malaysia and Indonesia will be taken as the case study as both adopts that system. Hence, it will increase the number of studies in the area of Islamic banking and finance.
- ii. To identify the determinants of financing which will help provide the guidelines for the Malaysian and Indonesian governments to further develop and enhance the performance of the Islamic banking system.
- iii. To provide suggestions for Islamic bankers to optimize the financing schemes for their customers.
- iv. To provide ideas for other countries which are keen to implement a dual banking system.

1.5 ORGANIZATION OF THE STUDY

The following chapter, Chapter two would briefly discuss about the general performance of the economy along with the performance of the Islamic banks in Malaysia and Indonesia. The theoretical framework and findings of the previous studies will be elaborated in Chapter three. This is followed by the empirical methods used in this study, such as cointegration method, Vector Error Correction Model, and Variance Decomposition and Impulse Response Function in chapter four. Subsequently, Chapter five will look at the result obtained and its analysis. The study ends with a concluding chapter, a summary consisting that of the empirical study, recommendation, limitation of study as well as suggestions for further research.

1.6 CONCLUSION

This chapter is initiated with the background of the study which highlights the importance of financing by Islamic banks along with lending by conventional banks. The research problem will then be discussed. Given the fact that the banking sector is very dominant in the two countries, this study seeks to identify the determinants in financing as well as lending. Objective and significant of the study will be elaborated and this chapter will be followed and ended with the outline of the study and conclusion.