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وَتَشْرِيفَتِي إِسْلَامًا أَبْنَاءَ رَجَائِنَا مُلْكِيْنَا

A STUDY OF THE CUSTOMERS' SELECTION
CRITERIA AND THE FINANCIAL PERFORMANCE
OF THE ISLAMIC BANK OF THAILAND (ISBT)

BY

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A dissertation submitted in partial fulfilment of the
requirements for the degree of
Master of Science in Accounting

Kulliyyah of Economics and Management Sciences
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MARCH 2009

ABSTRACT

A study on the bank selection criteria has been done empirically by several studies in the Islamic and non-Islamic countries. The Islamic bank is relatively new in Thailand, a non-Muslim country. The Islamic banking in Thailand has started since 2002's and it is the first Islamic bank called the Islamic Bank of Thailand (ISBT). Since the Islamic bank in Thailand is newly established, no empirical study has been done on it. Moreover, five years have passed since the ISBT was established, and so far, there has been no study done on its financial performance evaluation. Therefore, this study attempts to capture the perceptions of the Thai (Muslim and non-Muslim) customers towards the objectives and characteristics of the Islamic bank and also to determine the bank selection criteria used by them. In addition, this study also evaluates the financial performance of the ISBT during the period of 2003-2007. The study surveys a sample of 462 respondents. The results show that the Thai customers know that the characteristics of the Islamic bank is interest prohibition and they desire the Islamic bank to achieve the social objectives more than the commercial objectives. In addition, the empirical findings of the bank selection criteria indicate that there are differences between the Thai Muslim and non-Muslim customers in the ranking of the various bank selection criteria. The Muslims highly consider the interest-free saving, while the non-Muslims are concerned more on its reputation and image, knowledgeable and competent personnel. Besides, the study evaluates the financial performance during the period of 2003-2007. In general, the performance evaluation of the ISBT during these periods indicated that the bank had no profits, less liquidity, high risky and less efficiency during 2003-2007.

ملخص البحث

يدرس البحث معايير اختيار البنوك في عدة بلدان مسلمة وغير مسلمة وخصوصا في تايلند حيث ما تزال تجربة البنوك الإسلامية حديثة العهد في هذا البلد غير المسلم. لقد بدأت البنوك الإسلامية في العمل بتايلند عام ٢٠٠٢ بإنشاء بنك تايلند الإسلامي، ونظرا لحداثة هذه التجربة فلا يوجد دراسات تجريبية في مجال البنوك الإسلامية بتايلند كما لا يوجد دراسات على أداء هذا البنك رغم مرور خمس سنوات على تأسيسه. تسعى هذه الدراسة إلى معرفة آراء التايلنديين، مسلمين وغير مسلمين، بأهداف ومزايا البنك الإسلامي ومعاييرهم عند اختيارهم للتعامل مع بنك ما. وتقيم هذه الدراسة أيضا الأداء المالي لبنك تايلند الإسلامي خلال الفترة ٢٠٠٣-٢٠٠٧. تقوم الدراسة على عينة من ٤٦٢ مشاركا أظهرت نتائجهم وجود وعي عام بتحريم الربا في البنوك الإسلامية ورغبتهم بتحقيق البنوك الإسلامية لأهداف اجتماعية مختلفة عن البنوك التقليدية. وأظهر البحث وجود اختلاف في معايير انتقاء البنوك بين التايلنديين المسلمين وغير المسلمين حيث يثمن المسلمون انعدام الربا في التعاملات البنكية بينما يركز غير المسلمين على السمعة وأداء الموظفين فحسب. وأظهر التقييم المالي للبنك في هذه الدراسة انعدام أرباح البنك وقلة سيولته النقدية وكفاءته العملية.

APPROVAL PAGE

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DECLARATION PAGE

I hereby declare that this dissertation is the result of my own investigative research work, 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 of higher learning.

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FINANCIAL PERFORMANCE OF THE ISLAMIC BANK OF THAILAND
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ACKNOWLEDGEMENTS

In the name of Allah S.W.T, the Most Gracious and the Most Merciful. All praises are due to Allah and peace and blessings be upon His Prophet Muhammad S.A.W. First and foremost, I would like to thank Allah for giving me His blessing, because without His mercifulness, I would never complete this thesis. To my parent, Mah Song Sani and Ali Lateh, for their unconditional love, encouragement and continuous support and sacrifices in completing this thesis and throughout my life.

My special thank to my supervisors, Dr. Noraini Mohd Ariffin and Dr. Suhaiza Ismail, for their constant support, supervision, advice, motivation, patience in guiding me through the thesis completion. Without their constant untiring support, I would not have been able to finish this thesis. I consider myself to be very fortunate to be under their supervisions. May Allah bless and repay their kind and valuable cooperation.

I would also like to present my warm gratitude to all of my lecturers, namely, Dr. Hafiz Majdi Abdul Rashid, Dr. Muslim Har Sani, Assoc. Prof. Dr. Shahul Hameed Mohamed Ibrahim, Assoc. Prof. Dr. Abdul Rahim Abdul Rahman, Assoc. Prof. Dr. Nik Nazli Nik Ahmad, Dr. Nazli Anum Mohd. Ghazali, and Dr. Fatma Abdul Hamid. May Allah give His blessings to all of them.

My sincere thanks to Assoc. Prof. Abdullah Abru, a Muslim Economics lecturer of the Prince of Songlanakharin University, Pattani, Thailand, who had given excellent invaluable advice and evaluation to the questionnaires. May Allah bless and reward his patience and very kind cooperation.

I would also like to take this opportunity to thank all of the ISBT' bank staff, from the five branches in Pattani, Yala and Narathiwat, who had given good cooperation in my work during the survey. I pray that Allah will reward their kind assistance and tolerance in helping me to conduct my research.

I would also like to express my thanks to all of my dearest friends, who have always been there to offer me moral support and academic advice, especially, during my hard times, and I will never forget the help and memories that we have shared together. I hope that our friendship will last forever. InshaAllah.

Last but not the least, thank you to all who have been involved directly or indirectly in the completion of this thesis.

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LIST OF ABBREVIATIONS

AHP	Analytic Hierarchy Process
AU	Asset Utilization
BAAC	Bank for Agriculture and Agricultural Cooperatives
CTA	Credits to Total Assets
CDR	Cash Deposits Ratio
DEA	data envelop analysis
e.g.	(exempligratia): for example
et al.	(et alia): and others
EM	Equity Multiplier
GSB	Government Savings Bank
i.e.	(id est): that is
IIAB	Islamic International Arab Bank
IBS	Islamic Banking Scheme
ISBT	Islamic bank of Thailand
JIBFI	Finance and Investment
KTB	Krung Thai Bank
LDR	Loan Deposits Ratio
n. d.	No date
NOM	Net Operating Margin
OE	Operating Efficiency
PCA	Prompt Corrective Action
PER	Profit to Total Expenses
PLS	profit-loss sharing
ROA	Return on asset
ROE	Return on equity
SET	Stock Exchange of Thailand
SFA	Stochastic Frontier Approach
THB	Thai Baht
UAE	United Arab Emirate
US	United State of America

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Since the establishment of the Islamic bank in the early 1960s, it has continued to play an important role as a financial intermediary until today. It has received wide acceptance not only in the Muslim countries but also in the non-Muslim countries as well (Iqbal and Molyneux, 2005; Abdelhamid, 2005). Generally, the Islamic banks perform the same functions as other conventional banks, except that the Islamic banks have to comply with the *Shari'ah* rules in all their financial activities, transactions and to uphold the crucial principles of the profit and loss sharing and the prohibition of the application of interest or *Riba* (Iqbal and Mirakhor, 2007). Additionally, the main objective of the Islamic bank is not only to achieve profit maximization, but also to provide fair, equitable and just financial instruments as well as a social welfare entity.

As one of the most important players in the banking service industry today, the Islamic bank is no longer regarded as a business entity striving only to fulfil the religious obligations of the Muslim community, but more significantly, as a business entity that is unavoidably in need of winning over new customers whilst retaining the regular ones as well (Wilson, 1995). This necessitates the Islamic banks to understand the perceptions of their customers towards the Islamic banks in terms of their characteristics, objectives and also towards the bank selection criteria (Haron et al., 1994; Garrard and Cunningham, 1997; Metawa and Almosawi, 1999; Dusuki, 2005). Furthermore, an understanding of the behaviour of different customer groups (Muslim and non-Muslim) may provide some useful information to the Islamic banks in terms

of market segmentation, so that different products and services can be provided for different groups of customers (Kader, 1995).

There is a significant amount of studies that have investigated the criteria for bank selection by customers for both the conventional and the Islamic banks. In the context of the Islamic bank, studies by Erol and El-Bdour (1989), Nasser et al. (1999), Metawa and Almosawi (1998), Otman and Owen (2001), Haron et al. (1994), Ahmad and Haron (2002) and Zainuddin et al. (2004) had focussed on the customer in Muslim countries, while Garrard and Cunningham (1997) had focussed on non-Muslim countries. These studies indicated that customers selected the Islamic banks not merely because of the religious factor, but also because of the bank's reputation, confidentiality, friends and family influences and provision of quality service factors. As a matter of fact, many studies (Erol and El-Bdour, 1989; Haron et al., 1994; Garrard and Cunningham, 1997; Nasser et al., 1999; Metawa and Almosawi, 1998) indicated that the profitability factor (high return on saving) is also considered as one of the important factors for the customers in selecting the Islamic banks.

However, in Thailand, a non-Muslim country, the Islamic bank is relatively new. The Islamic banking system in Thailand had started since 2002 with the first Islamic bank called the Islamic Bank of Thailand (ISBT). The establishment of the ISBT is to improve the quality of life of the Muslim community, by providing financial services according to the Islamic financial principles one of which is the prohibition of interest (*Riba*). Moreover, it is also expected to provide the *Shari'ah* compliance banking products and services not only to the Muslims but also to the non-Muslim customers as well (Haron and Yamirudeng, 2003). Since its establishment in 2002, the ISBT has expanded its business over the years. Its deposits have increased from THB 511.68 million to THB 12,962.73 million in 2007. In addition, its total

loans have also increased from THB 5.41 million to THB 650.31 million in 2007 with the number of branches increasing to 27 in 2007.

As it is newly established, it is important for the ISBT to evaluate its past performance in order to improve its activities and performance and analyze its shortcoming in a realistic, pragmatic and practical term. At the same time, it also provides certain signals to the depositors or the investors whether to invest or withdraw funds from the bank. Similarly, it also provides options and targets to bank managers whether to improve its deposit services or financing services or both. Moreover, financial regulators are also interested to know the bank's performance in terms of adherence to banking regulation (Samad and Hassan, 2000; Kader and Asarpota, 2005).

Since the Islamic bank in Thailand is relatively new, a study on the customers' perceptions towards the Islamic bank in terms of characteristics, objectives and the customers' selection, particularly in Thailand, is almost nonexistent. Furthermore, five years have passed since the ISBT was established, and there has been no study on its performance evaluation so far. Therefore, this study is an attempt to fill this gap in the literature.

1.2 MOTIVATION OF THE STUDY

Studies indicate that in order to increase the customers' base and to secure the customers' loyalty, it is important, particularly for the Islamic banks, to understand the customers' perception towards the different characteristics and objectives of the Islamic bank, and the customers' selection (Haron et al., 1994; Garrard and Cunningham, 1997; Metawa and Almosawi, 1999; Dusuki, 2005). Therefore, this study attempts to study the understanding of the characteristics and objectives of the

Islamic bank, and the customers' selection from their point of view of the Islamic bank in Thailand.

Further, studies on the Islamic bank selection criteria indicate that an understanding of the different groups of the bank customers, the Muslims and the non-Muslims, would help the bankers to develop more accurate marketing strategies and policies (Haron et al., 1994; Garrard and Cunningham, 1997). Thus, different products and services can be targeted for different groups of the bank customers (Kader, 1995). However, there are very few studies undertaken to compare the Muslim and the non-Muslim customers' perception in selecting the Islamic banks. Haron et al. (1994) and Garrard and Cunningham (1997) have compared the Muslim and the non-Muslim customers' perception in selecting the Islamic banks in Malaysia and Singapore, respectively. These studies show that the Muslims and the non-Muslims have different perceptions in selecting their Islamic banks. Therefore, this study was performed to find out the opinions and perceptions of the Thai Muslims and non-Muslims in their selection of the Islamic bank.

Moreover, to make the Islamic bank more competent in the banking sector, it is important to evaluate the growth of the Islamic bank. Therefore, this study also attempts to fill the gap in the existing literature by evaluating the ISBT's performance in liquidity, profitability, risk and solvency, and efficiency during the period of 2003-2007.

1.3 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS

Due to the aforementioned gap in the literature, this study aims to explore the Thai customers' perceptions on the Islamic banking characteristics, objectives and bank selection criteria. The main objectives of this study are as follows:

1. To elicit the perception of the ISBT's customers towards the characteristics of the Islamic bank.
2. To elicit the perception of the ISBT's customers towards the objectives of the Islamic bank.
3. To identify the bank selection criteria of the ISBT's Muslim and non-Muslim customers.
4. To evaluate the performance of the ISBT during the 2003 to 2007 period.

In order to achieve these objectives, the following questions guided the research:

1. What are the Islamic banking characteristics that customers need the Islamic bank to possess?
2. Do customers of the ISBT show equal degree of importance to the commercial and social objectives of the Islamic bank?
3. Are there any differences between the Muslim and the non-Muslim customers in the ranking of various bank selection criteria?
4. How does the Islamic bank of Thailand (ISBT) perform in profitability, liquidity, risk and solvency, and efficiency during the period of 2003-2007?

1.4 ORGANIZATION OF THE STUDY

The content of this study is organized into five chapters: Chapter one provides a brief discussion on the background of the study, motivation, and research objectives and research questions of the study.

Chapter two provides the literature review on the Islamic banking. It provides a brief discussion on the definitions of the Islamic banking and the philosophy of the

Islamic banks which, incidentally, consists of the characteristics and objectives of the Islamic banks. It also outlines the historical background of the Islamic banks in general and the Islamic bank in Thailand, in particular with the performance of the of the Islamic bank being discussed. Finally, this chapter provides a discussion on the bank selection criteria, the conventional and the Islamic banks.

Chapter three presents the hypothesis development and the research methodology. It discusses the hypothesis development and the research instruments used for this study. The pilot test, sample selection and data collection procedures are presented in detail. In addition, tools for the analysis are also presented in this chapter.

Chapter four presents the analysis and findings. First, the response rate is presented and followed by the descriptive analysis involving the profiles of the respondent, normality analysis and the Islamic banking characteristics. Subsequently, results obtained from paired sample t-test examined the perception of customers on the commercial and the social objectives of the Islamic bank and the bank selection criteria are presented. In addition, the chapter also presents the results of the factor analysis and performance evaluation of the Islamic bank.

Chapter five concludes the study by discussing the major findings and their implications. The limitations of the study and suggestions for future research are also discussed in this chapter.

CHAPTER 2

LITERATURE REVIEW

2.0 INTRODUCTION

This chapter reviews the literature related to the Islamic banking. The literature indicates that the Islamic banking sector has grown significantly since the last four decades and operating in Muslim and non-Muslim countries worldwide. It has attracted large funds through investment banks and other financial intermediaries with many business links with the Muslim world (Lum, 2006). The main focus of this chapter is to review the literature on how customers approach the Islamic banking. The existing literature suggests the reasons for selecting the Islamic bank are not solely based on religion, but a combination of religious and economic factors.

This chapter is organized as follows: Section 2.1 reviews the Islamic banking system. Section 2.2 reviews the philosophy of the Islamic banking system which includes its characteristics and objectives. The historical background of the Islamic banking system in general and in Thailand, in particular, is reviewed in section 2.3. Section 2.4 reviews the literature on the performance of the Islamic banking system. Section 2.5 reviews the literature on the bank selection criteria which includes the bank selection criteria of a conventional bank and of the Islamic bank. Finally, section 2.6 concludes the chapter.

2.1 ISLAMIC BANKING

The Islamic banking, like any other banking system, is not a religious institution; they are profit-seeking institutions (Iqbal and Molyneux, 2005). The Islamic banking refers to a system of banking which is consistent with the *Shar'iah* (Islamic law), guided by the Islamic economics. The *Shari'ah* does not allow the paying and receiving of interest (*Riba*) and promotes a greater level of fairness and equity in the conduct of the banking business (Al-Quran; 2:275). Thus, instead of using the rate of interest to mobilize savings, the Islamic banks mobilize funds on the basis of profit-sharing with the depositors. These funds are then passed on to corporations and other customers using sale-based or asset-based contracts. The contracts do not only fulfil the religious requirements of the Muslim customers, but also provide a wider set of products for all customers.

Theoretical research has established that the contracts based on the profit-sharing have several diverse economic advantages for the society. For instance, they improve the allocation of resources, ensure justice and fairness among the contracting parties, lead to a more stable financial system and have a favorable impact on the economic growth (Iqbal and Molyneux, 2005).

Among the contracts which are commonly applied by the Islamic banks are: *Mudarabah* is a contract of sharing profit and loss. It is a mode of financing through which the bank (the owner) provides capital finance for a specific venture indicated by the customer (the entrepreneur). This contract is responsible for the management of the business and provides professional, managerial and technical expertise for opening and operating the business enterprise or project. Profit is shared according to a pre-agreed ratio, while loss (if any) is borne by the capital provider (the bank).

Musharakah (Joint venture) is a form of a partnership where two or more people join together either through capital, labour or credit-worthiness with an aim to share the profit and the loss. In doing so, the parties enjoy similar rights and involve similar liabilities.

Murabahah (Cost-Plus Profit/Sale on Credit) is the sale of goods at a price covering the purchase price plus the profit margin agreed by both parties concerned, which transforms a traditional lending activity into a sale and purchase agreement, under which the bank buys the goods desired by the customer and resell it to the customer at a higher price agreed to by both parties.

Ijara (Leasing). The bank purchases the asset required by the customer and then leases the asset to the customer for a given period, the lease rental and other terms and conditions have been agreed to by both parties.

Wakalah (Agency) is a legal contract between one who appoints (*Muwakil*) with the appointed person (*Wakil*), where *Al-Muwakil* gives the right to *Wakil* to perform a duty on behalf of him or her, for a specified remuneration.

In order to understand the Islamic bank, it is important to know the philosophy of the Islamic banks which is discussed in the subsequent section.

2.2 PHILOSOPHY OF THE ISLAMIC BANKS

As a *Shari'ah*-oriented business entity, the Islamic bank is strongly expected to be guided by the Islamic business philosophy. The philosophy of the Islamic banking system can be fully understood in the context of the overall Islamic economic system. This section will review the philosophy of the Islamic banks, as well as the characteristics and the objectives of the Islamic banks.

2.2.1 Characteristics of the Islamic banks

The Islamic banking system operates under the *Shari'ah* that prescribes specific patterns of economic behaviour for individuals and society as a whole (Khan and Mirakhor, 1987). Hence, the Islamic banking system is not only about prohibiting interests and conforming to the *Shari'ah* requirements on offering the Islamic financial products, but it is also a system which aims at contributing to the fulfilment of the socio-economic objectives of the society (Ali, 1994; Siddiqi, 2001; Haron and Hisham, 2003). Many Islamic philosophers have stated that the Islamic banks perform mostly the same functions as the conventional banks, but the Islamic banks do this in distinctly different ways (Ali, 1994; Ahmad, 2000; Hason, 2005; Iqbal and Molyneux, 2005).

Firstly, the Islamic banking stands for a system of equity-sharing, risk-sharing and stake-sharing. Under these principles, the investor and the entrepreneur will be sharing the result of the project, be it profit or loss in an equitable way (Ahmad, 2000; Iqbal and Molyneux, 2005). For instance, in the case of profits, both of them would share this in pre-agreed proportions. On the other hand, in the case of losses, all financial loss is borne by the capital provider and the entrepreneur loses his labour (Iqbal and Molyneux, 2005). As a result, this provides a just distribution between the parties.

Secondly, the Islamic banking system is based on the Islamic law (*Shariah*) that is the Islamic banks have to work within the ethical and moral frameworks of the *Shari'ah*. Under this framework, the Islamic banks are prohibited from dealing with activities that are considered unlawful (*haram*) in Islam. For instance, the Islamic banks cannot finance a wine factory, a pig farm, a casino, a night club and other activities that are harmful to the society or considered *haram* (Ahmad, 2000; Iqbal and

Molyneux, 2005). The Islamic banks should be involved in lawful (*Halal*) activities that benefit the society. Further, the Islamic banks are supervised by a Shari'ah Supervisory Board that will confirm all the banking activities are under the *Shari'ah* framework (Ali, 1994) whereby the Islamic banks have to comply with the Islamic accounting standards since the conventional accounting standard is not suitable to them and not compliant with the spirit of the Shari'ah. All information is made transparent to the customers showing that the bank complies with the *Shari'ah* principle (Ali, 1994). Transparency is important, as it encourages the customer to come to the bank as stated by Zubair (2005) that;

“Greater transparency in transactions, encouragement for participatory financing, opening up for more specialized banks and customer services, increasing indulgence in the long run finance, and promotion of co-operative organizations are some of the suggestions to revamp, and reorganize Islamic finance. Things *are* moving in that direction even as the pace is slow” (p.17).

Thirdly, the Islamic banking system seeks a just and fair society. Thus, it prohibits interest, gambling and all activities that are harmful to the society. This is to protect the interests and benefits of all parties involved in the projects as well as to promote a social welfare (Iqbal and Molyneux, 2005).

There are some empirical studies that have observed the customers' perception of the characteristics of the Islamic banks (executive summary, 2004¹ and Ahmad and Haron, 2002). A study in Indonesia, focussed on 1,047 respondents to determine the perception of the community towards the financial features of the Islamic bank. Findings reported that half of the respondents viewed that the main feature of the Islamic bank is profit distribution. In addition, many of them viewed that the Islamic bank is operated according to the Islamic principles (executive summary, 2004).

¹ Collaboration between Islamic Banking Directorate - Bank Indonesia with Bogor Agricultural University, 2004.

In addition, Ahmad and Haron (2002) and Dusuki (2005) examined the perception of the corporate customers towards the Islamic banking system in Malaysia by focussing on a different sample size. Ahmad and Haron (2002) focussed on 45 corporate customers, while Dusuki (2005) based his study on a larger sample, that is, 1,500 respondents. Both studies reported that the majority of the respondents agreed that the Islamic banking system was introduced because the Muslims are prohibited from associating themselves with the element of interest practiced by the conventional banking system. In addition, many respondents agreed with the view that profit and loss sharing is the only principle representing a true spirit of the Islamic banking system. Both studies have found that most of the respondents disagreed that the Islamic banking products available in Malaysia are similar to the products of the conventional banks except that the banks use different names for those products. Further, Dusuki (2005) revealed that most of them agreed that entrepreneurs by associating themselves with the Islamic banks will become more ethical in conducting their business and the Islamic banking is not about competing in price, but rather in stressing the unique quality of products and services.

2.2.2 Objectives of the Islamic Banks

The system of the Islamic bank moves from a debt-based financial intermediary of the conventional system to an equity based and risk-sharing arrangement (primarily *Mudarabah* and *Musharakah* contracts, Dusuki, 2005). In other words, an ideal Islamic banking system model is based on the profit and loss sharing (PLS), where both the bank and the depositor share the risks and the rewards of financing a business venture (Scheele, 2002). Apart from that, there are two different emphasis (Siddiqi model and Chapra model) in outlining the overall functions and objectives of the

Islamic banking system. Siddiqi's model advocates that the purpose of interest-free loans is to meet basic needs and it is the duty of the community and the state to cater for those needs. In addition, Siddiqi asserts that the primary objective of the Islamic bank, like that of any other business unit, is profit maximization, but the role of the Islamic banks is not only to restrict but also to prohibit interest.

On the other hand, Chapra's model asserts that the nature of the Islamic banking system (outlook and operations) could be clearly differentiated from those of the conventional ones. Besides the prohibition of interest or *Riba*, the Islamic banking system should serve the public interest rather than the individual or group interests. The Islamic banking system should generate adequate savings and productive mobilizations and be properly equipped to be able to meet the genuine, non-inflationary needs of both the public and the private sectors. In other words, Chapra's model asserts that the Islamic banks hold socio-economic purposes that not only have a profit-maximizing role but also seek to promote the Islamic norms and values as well as protecting the needs of the society as a whole. He considered the Islamic bank as a cross-breed of the commercial and the merchant banks, the investment trusts and the investment-management institutions, that would offer a wider spectrum of services to their customers. Unlike the conventional banks which depend heavily on the "crutches of collateral and of non-participation in risk" (p. 155), the Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing.

Similarly, Ziauddin's model stresses that the Islamic banking system is more than just prohibiting the application of interest, but it also should help in achieving the socio-economic objectives of an Islamic society, such as alleviating poverty, ensuring