INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

PROSPECTS AND PROBLEMS OF ISLAMIC BANKING: A STUDY ON BANK MUAMALAT MALAYSIA BERHAD

BY

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Submitted to the

MANAGEMENT CENTER

INTERNATIONAL ISLAMIC UNIVERSITY

MALAYSIA

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

JUNE 2002

ABSTRACT

About sixty percent Malaysians are Muslims who strongly believe in prohibition of bank interest, whereas bank interest plays the pivotal role in conventional banking that had been prevalent exclusively in the country until 1983. Then realizing the issue of contradiction in faith and practice, Malaysian government established two full-fledged Islamic banks, Bank Islam in 1983 and Bank Muamalat in 1999, and encouraged conventional banks to open Islamic banking windows to make up deficiency of interest-free products and services. Accordingly, a number of local and international banks currently operate Islamic banking windows.

In this highly competitive environment, Bank Muamalat has to prove its worth. Being aware of this challenge, bank management has been dynamically reviewing its strategic plans and projects. This study is an endeavour in the same direction. In a service industry, since there could be various types of gaps due to which a service provided with the best of effort may not be up to the expectations of customers, therefore a survey of bank customers has been conducted to know their assessment of service quality of the Bank and their views about its marketing strategies. More than two hundred respondents with different backgrounds were chosen to fill out survey questionnaires. The objective of this survey was to investigate whether responses of various customer groups are significantly different from one another or not so that Bank management can better mend its strategic plan accordingly.

An interesting finding is that although Bank Muamalat is an Islamic bank, yet non-Muslim respondents have given higher rating to the Bank on most of the survey questions. A matter that needs attention of Bank management is that big-business customers are somewhat unsatisfied with the service quality. Yet another matter of concern is that Bank customers having big businesses feel that the pricing of term-financing products of the Bank is not very competitive. They also view fixed-return modes of financing significantly different from PLS modes. Furthermore, customers with longer period of relationship with the Bank suggest that the Bank should increase *hibah* payments to current account holder in order to attract more customers. In their view, the Bank can create a niche by converting itself to a financial supermarket.

APPROVAL PAGE

TITLE OF THESIS:

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Declaration

I declare that this graduation project paper is submitted in fulfillment of the requirements of the degree of Master in Business Administration at the International Islamic University Malaysia.

I declare that this project paper has not been accepted in whole or in part for any degree and that it is not being currently submitted to any candidature for any degree.

I also declare that this project paper is the result of my own investigation and my indebtedness is dedicated in bibliography and elsewhere in the text.

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ACKNOWLEDGEMENT

I owe a special debt of gratitude to my lecturer, Dr. Muhammad Mazhar Iqbal for his dedication, perseverance and unfailing encouragement. His suggestions and comments were invaluable and his vast knowledge has made such significant contribution to the outcome of this graduation project paper.

I would also like to say a special thanks to my family members, especially to my wife, Rahmah, my son Nashruddin and my daughters Nurliyana, Nur Raihan, Nur Amalina and Nurin Jazlina for their undying support and encouragement. My appreciation is also extended to Brother Darwis Abdul Razak and Sister Suhaiza for their kind assistance and advice.

Further appreciation is also extended to the senior managers, branch managers and officers of Bank Muamalat for their contributions and cooperation that enabled me to compile the data. A very special appreciation is extended to the bank's business customers for responding to the survey that made the findings possible.

Also, I would like to extend my sincere appreciation to the staff of Management Center, International Islamic University of Malaysia, Jalan Gornbak, Kuala Lumpur for their fullest cooperation throughout the course.

A special mention to EON Finance Berhad for providing me interest-free loan to partly finance my course at HUM.

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

According to the latest census conducted in the year 2000, almost three out of every five people in Malaysia are Muslims in the total population of 23 million. Yet, economic activity in the country is largely controlled by non-Muslims. Recently Muslim businesses have, however, shown some growth in number and value. The larger involvement of Malays, all of whom are Muslims, in economic and commercial activities began after the implementation of New Economic Policy (NEP) in 1970. Under this policy, Bumiputera community, who are mainly Malays, are encouraged to involve themselves in small and medium scale commercial activities and to own equity stakes in larger corporations. For this purpose, they need, of course, full cooperation from banking industry. It was however realized that Muslims, who have complete faith in prohibition of interest, were somewhat reluctant to make use of banking facilities, which were provided on the basis of interest only. That is why economic progress of Muslims in the whole of 1970's and early 1980's had been quite slow. The achievement target set in NEP was not fully met after a decade-long implementation of this policy partly because there was no Islamic bank at that **time.**

1.2 Establishment of Islamic Banks in Malaysia

Realizing the issue of contradiction in faith and practice, Government of Malaysia established Bank Islam Malaysia Berhad, the first Islamic bank, in 1983. However, in order to strengthen its footing, the bank was allowed to operate Islamic banking without having any competition from other Islamic banks at least for first ten years of its existence. Nevertheless Bank Islam had to face intense competition from a myriad of conventional banks and other financial institutions. After popularity of Islamic products of services, the government encouraged conventional banks to open Islamic banking windows from early 1990's. Conventional banks offer *Skim Perbankan Tanpa Faedah* (SPTF) or Interest-free Banking Scheme which operates under the Bank and Financial Institutions Act 1987 (BAFIA).

Subsequently, after sixteen years of exclusive operation of Islamic banking by Bank Islam, the second full-fledged Islamic bank, Bank Muamalat Malaysia Berhad, was established in 1999. Bank Muamalat was created by merging three financial institutions namely, Bank Bumiputra Malaysia Berhad, Bank of Commerce Berhad and BBMB Kewangan Berhad. Recent financial liberalisation and globalization of the world economy put more pressure on these two Islamic banks. These banks have to establish their competence if they want to grow in future. Furthermore, under the Financial Sector Master Plan (FSMP), these Islamic banks will face even more competition and challenges starting from 2004 when the government will start issuing licences to more Islamic banks. Competition will be further intensified starting from 2007 when government will allow free entry of foreign banks in the local market. Apparently, the two Islamic banks are running out of time to firmly establish themselves in the market. They have no other choice but to formulate and implement effective business strategies to ensure their survival in the forthcoming arena of global banking at the soil of Malaysia starting from the year 2007.

1.3 The Challenges Ahead

In a service industry such as banking, marketing strategies should be different from those for tangible products. This is because services have four unique characteristics that distinguish them from tangible goods: intangibility, inseparability, heterogeneity and perishability. Because of these characteristics, service quality is more difficult to define and measure. Customers evaluate service quality by five components namely reliability, responsiveness, assurance, empathy and tangibles. According to Lamb, Hair and McDaniel (2002), under the gap model of service quality, there are five types of gaps, due to any or all of which a service provided with the best of efforts may be different from the service expected by customers. These gaps may emerge even if management tries its best to match the expectation of customers. Therefore, it is extremely important to understand all possible reasons due to which services provided with the best effort may not be up to the mark.

No doubt, bank management is aware of the challenge of competition from Islamic as well as conventional banks. The bank has to move forward quickly and effectively so that its existence as the second Islamic bank is duly justified. Accordingly, the bank management has already embarked on business strategies that would enable the bank to excel in the marketplace. However, to ensure long term success, bank management has to close or. at least minimise all those gaps that exist due to any discrepancy between bank management's perception of customers' needs and customers' expectations from the bank.

1.4 Research Objective

The objective of this study is to investigate if different groups of customers have significantly different view about existing products and services of the bank or not. The groups have been formed with respect to religion, Muslims and Non-Muslims, with respect to size of business and with respect to length of banking relationship. Their opinion has been sought on various marketing strategies and desirability of Profit-Loss Sharing (PLS) mode of financing. The objective is to test the hypothesis whether average rating of one group is statistically different from the other or not. T-test analysis has been used for this purpose. More than one hundred business customers of the Bank have been interviewed. The survey questionnaire has covered some crucial issues of Islamic banking and marketing strategies of the bank including products and services, distribution, promotion, price and people (personnel). All these are covered in Section A of the questionnaire. A question on the subject of profit and loss sharing principle is also covered in this section. Section B consists of questions to explore customers' views on problems and prospects of profit loss sharing principle and the preferred modes of bank promotional activities as an effective communication tool. The survey data collected from business customers (hereinafter referred to as "customers") has been thoroughly analysed with a view to incorporate its findings into policy recommendation and planning of future business strategies of the bank.

Chapter Two reviews the relevant literature on the topic under the headings of participatory financing, universal banking, and marketing strategies and customers' behaviour. Chapter Three explores the scope of Islamic banking in Malaysia, history of Islamic as well as conventional banking that is followed by theoretical comparison between conventional and Islamic banking. Then it gives general information on Bank Muamalat and overall performance of Islamic banking in Malaysia. Relative performance of Bank Muamalat, Bank Islam and Malayan Banking has also been compared in this chapter. Chapter Four touches upon problems and prospects of Islamic banking in Malaysia in general and Bank Muamalat's strategic business focus and its present capabilities, strengths and weaknesses in particular. Chapter Five presents the survey methodology whilst Chapter Six analyses the results of the survey. This paper ends with Chapter Seven that includes conclusion and policy recommendations. Appendices containing questionnaire and other relevant data are also attached at the end.

CHAPTER TWO

LITERATURE REVIEW

2.1 Profit and Loss Sharing Concepts

During the initial stages, Islamic banks managed to attract large amount of deposits that resulted in surplus liquidity. The first challenge faced by these banks include the failure to devise an interest-free mechanism to place their funds on short-term basis. Besides that, the risk involved in profit and loss sharing seems to be extremely high. As a result, most of the banks resorted to financing techniques that generate a fixed and assured return which has been continuously opposed by many scholars. They could not expand despite having excess liquidity. Thus, the objective of abolishing interest has been partially achieved and the future of Islamic banks hinges on their ability to seek viable alternative other than currently followed fixed return mode of financing. Some questions have been included in the survey questionnaire to know customers' view about fixed-return and PLS modes of financing

According to Errico and Frahbaksh (1998), Islamic banks are characterized by the following:

* **Prohibition of interest:** Interest is defined as a fixed or pre-determined rate of return to be paid by a borrower. Interest is to be replaced by profit and loss sharing (PLS) arrangement under which the rate of return on financial assets is not known prior to completion of underlying project or business though ratio of profit/loss sharing must be known at the outset. The rate of return can only be determined ex-post, on the basis

of actual profit accrued from real sector activities that are made possible through the productive use of financial assets.

- **Investment Deposits.** The liability products of Islamic bank are Savings, Current and General and Special Investment Accounts. Such deposits are not guaranteed in capital value and do not yield any fixed or guaranteed rate of return. In the event banks record losses as a result of bad investment decision, depositors may lose part or all of their investment deposits. The only contractual agreement between depositors and banks is the proportion (ratio) according to which profits or losses are to be distributed.

- Islamic **modes of financing.** The asset products of Islamic banks include *Bai Bithaman* Ajil asset financing, *Murabahah* working capital financing, *Istisna'* project financing and *Ijarah* leasing as well as *Mudharabah* and *Musharakah* participatory financing. These modes affect both the assets and liabilities sides of the bank's balance sheet and can be divided into two groups: the ones that are based on the PLS principle (core modes) and the ones that are not (marginal modes)

Siddiqi (1983) emphasized the necessity for Islamic banking and finance to be based on the profit sharing concepts. According to him, in order to attain real success in Islamic banking, the players are to be involved more aggressively in profit sharing concept of *mudharabah* to replace entirely the institution of interest which is totally forbidden as according to him bank interest is equal to usury or *riba'.* He totally believed that Islamic banks cannot be successful if concentration of the banking business is sale and leasing based transactions. According to him, the interest-based banking and lending has resulted in injustice and inefficiency and hence, it is necessary for Islamic banking to change its operations based on to profit-sharing concept to ensure justice and improved efficiency. Siddiqi nevertheless did not elaborate on how banking should be organized on PLS basis in present day situation where misreporting is very likely while monitoring cost is significant.

In addition to the above, Siddiqi (1985) commented that, in view of the prohibition of interest in Islam, modem writers on Islamic economics were unanimous that any reorganization of banking will have to be done on the basis of *musharakah* (partnership) or *shirkah* and *mudharabah* (profit-sharing). The Prophet of Islam taught men the best rules of conduct and established a society based upon justice and fair dealing. Partnership and profit-sharing were in practice and the prophet expressed approval of these methods of business. Based on the four well-known schools of Islamic jurisprudence i.e. the Hanafi, the Maliki, the Shafi'i and the Hanbali, Siddiqi has come up with the definition of *musharakah* and *mudharabah. Musharakah* means participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profit and loss in specified proportions. On the other hand, *mudharabah* means that one party provides capital and the other utilizes it for business purposes under the agreement that profit from the business will be shared according to a specified proportion. Also, a party that provides the merchandise and the party that engages in business may each comprise many persons i.e. the capital may be provided by several persons and the business can be carried out by several other persons.

Nienhaus (1986) nevertheless stressed that not all Islamic banks adhere to PLS system. He argued that models presenting Islamic economics based wholly on PLS principles are misleading, in view of the true business activities of Islamic banks. In reality, the use of profit and loss partnerships is restricted to a small percentage of the total financing portfolio of Islamic bank. In fact, according to him, some banks have even suspended the use of *mudharabah* and *musharakah.* As an evidence of Nienhaus's view, annual reports of Bank Islam showed that the share of *mudharabah* and *musharakah* financing in the financing portfolio from 1984 to 1994 has shown a decline from 4.3% to just 0.04. Nienhaus further believed this situation had arisen because the banks operated in mixed economies and needed to compete with the established interest-financed banks. There are two major problems faced by banks applying the PLS techniques. Firstly, unlike interest financing where the bank knows its earning in advance, PLS techniques provide the bank with a rough guide of its probable realizable income. Claims from shareholders and depositors for dividends, and the need to compete with conventional banks, caused Islamic banks to strive for earnings not less than those of conventional banks. Secondly, the operation of a PLS system in a mixed economy could lead to a concentration of bad risks with Islamic banks.

According to Rosly (2000), the late 1990 financial crisis in East Asia could be due to the following main causal factors:

- Heavy borrowing and imprudent lending
- Over investment in property and infrastructure
- Fragile financial system that could not cope with globalisation
- Heavy import-dependent manufacturing sector

He quoted the reason for preference *for* debt rather than equity was the desire to control and own assets or refusal to share assets with others. The corporations would have thought that there is no reason to depend on shares to raise capital that will dilute ownership, Raising money through borrowing would be a better choice since it is cheaper. Rosly was also of the opinion that trade as permitted by Allah as quoted in Surah Al-Baqarah: 275 should refer to risk taking in line with the *Qawaid Fighiah or* Islamic legal maxim which says "Loss is burdened on those who have acquired profit" *(al-ghunmi bil ghurmi).* He further stressed that there should not be any confusion between risk-free profit from pre-determined profit quoting *Sarah* or leasing as pre-determined but not risk-free and hence is legitimate. He also questioned the present modes of financing such as *bay' bithaman ajil* and *murabahah* as practised in Malaysia at present. According to him though they are valid contracts but are not worthy of comparison with the al-bay' which the Quran recommends as an alternative to *riba* (usury or interest) because although both products involved the sale of goods at a pre-determined profit there is no risk-sharing between the bank and the customer.

According to Rosly (1999), Islamic banks should venture into direct production. Although risky, the profit margins could be higher. These high profits would eventually be passed on to depositors in the form of higher *hibah* and dividends. His view was based on empirical evidence that shows Bank Islam Malaysia's profit margin being reduced during the period of rising interest rates. This was explained by the bank's inability to increase profit rates on *Bai Bithaman Ajil* financing due to its fixed rate nature, resulting in lower profit margin attributed by rising interest rates that drove up its cost of funds.

This scenario occurred in dual banking such as in Malaysia where conventional and Islamic banks compete freely with each other for banking business.

Hasan (2001) while studying the determination of ratio for profit-sharing and operational issues pertaining to *mudharabah* financing concluded that the major difficulty arising from this mode of financing is the uncertainty of ex-post rate of profit as well as the return of money advanced to the business firm. This uncertainty is aggravated by asymmetric information that gives rise to agency problem. Besides this, he also quoted the attitude problems of the Muslim business people who, according to him, are generally risk averse. He suggested in his paper for the establishment of separate investment banks to provide long term financing to industry, leaving the business of meeting short term financing of trade and commerce to the conventional sort of Islamic banks. Further reform suggested by him is the launching of special programmes to develop entrepreneurship among the seekers and providers of credit for business on Islamic lines. The issue of asymmetric information in profit and loss sharing contracts was also raised by Abalkhail and Presley (2002). According to them, without effective information transfer, market performs poorly and inefficiently. This conclusion was based on their empirical investigation in Saudi Arabia.

According to Bacha (1995), *mudharabah* financing offered by Islamic bank is a hybrid of equity and debt financing in the conventional system. To *a mudharib* (a party that uses funds and manages the business), the financing is like conventional equity because there is no fixed annual payment that are due (unlike interest), payments made to Islamic banks come from profit like dividend, bank cannot proceed with legal action or foreclose if there is no profits to be shared and there is no increase in financial leverage like debt financing. On the other hand, *mudharabah* financing can appear as conventional debt to the *mudharib* because it represents a "fixed' claim by the Islamic bank on the company, being the initial amount plus whatever accrued profits (or losses) due to the bank and it is terminal which means the arrangement can be ended either by prior mutual arrangement or by either party. As a result, *mudharabah* financing has more agency problem that leads to higher cost compared to conventional debt or equity financing. Bacha felt that unless a workable solution is found, *mudharabah* financing will likely remain as a minor financing technique and with this Islamic banks remained as peripheral players.

According to Iqbal and Mirakhor (1999), whereas theoretical development has demonstrated the viability and practicality of an Islamic financial system, its implementation faces several challenges. One of the major challenges identified by them is the challenge to make operation of the system more efficient, stable, and well integrated with international markets. To overcome this, they insisted on governments' increased roles, among others in the following areas:

- The financial sector be liberalized to allow returns to this sector thus to reflect return to the real economy
- Equity market be developed to allow financing of investment projects outside banking institutions; and
- The structure of the banking system be such as to allow strong banking supervision and prudential regulation to commensurate with the risks involved in various transactions especially that of *mudharabah* and *musharakah.*

On the contrary, Naqvi (2000) criticized the majority view that Islamic banking should principally be based on profit sharing. According to him, empirical studies in Islamic countries which have implemented Islamic banking on profit-sharing basis showed that it was not very successful especially towards achieving economic objectives such as equity and efficiency. Moreover, he felt that in order for Islamic banking based on profit sharing blossom, Islamic banks should be allowed to continue with the debt-based instruments which are closer to reality of banking now although it is the `second best' choice. To him, it is not necessary for Islamic bank to operate on profit sharing basis alone as long as the present practice allows the banks to compete with their conventional counterparts. There is no point in rushing into the recommended banking mode based on profit-loss sharing if the present infrastructure is not ready to support their operations.

Naqvi also emphasized that besides *riba',* the Islamic economic system should eliminate all forms of transaction that are blatantly exploitative. Such example is the exploitative money lending in the rural areas such as in southern Punjab and Sindh in Pakistan. He further stressed that eliminating *riba from* the financial system is not the only solution to eradicate imbalance or inequality in. a society.

2.2 Financial Supermarket/Universal Banking

Many countries in the west such as the United States and United Kingdom practice banking system that separate commercial bank, investment bank and other finance related activities such as insurance. This is also known as dual banking system that is considered as financial fragmentation. The major exception is Germany. Germany is the largest European country in terms of population and economic output. The key differences between the Anglo-Saxon model and the German system according to Weber (1995) are:

- Universal banking is prevalent. There is no difference between commercial and investment banking as was enforced by the 1933 Glass-Steagal Act in the USA
- Large parts of the banking sector are publicly owned or controlled, or are cooperatives. These banks are not explicitly profit maximizers and they have other roles in developing local communities
- Many banks are subject to strong political influence, especially those in the public and cooperative sectors
- Large banks often have very important stakes in major companies and play a major role in their boards

So to take the feedback of customers on the issue, a survey questionnaire has been included to know whether Bank customers prefer universal banking or dual banking.

According to Weber, Germany is a classic universal banking country. Universal banks engage in all types of deposits, lending and securities business plus acquisition of holdings in non-bank under one roof. Its universal-type commercial banks predominate over its specialist bank. However, the term `universal bank' does not mean that every institution conducts every type of business with every type of customers. The banking system is basically categorized into two i.e. universal banks and specialist banks., Universal banks are made up of private commercial banks, co-operative banks and public sector banks. The commercial banks include the "big three" namely Deutsche Bank, Dresdner Bank and Commerzbank. Private commercial banks also include branches of foreign banks. The most number of banks under this category is the co-operative banks, the urban co-operative banks or Volksbanken and the rural co-operative banks or Raiffeisen-banken. The specialist banks on the other hand comprise the private bank that include private mortgage banks and banks with special functions, and the public banks (mortgage and special functions).

Historically, the important reason for the development of a universal banking system was the high capital investment created by industrialization that could not be accommodated by the private banks. The system started way back in the 1800's. The system has been expanding. *Allfinanz* strategies turn classical universal banks into conglomerates offering a comprehensive range of financial services. The `big three' have a high number of branch network throughout the country but their combined market share is less than 10%. The universal banking concept is not much different from Islamic banking equity system since the banks can own share in non-bank firm. Further, the banks can opt to have representatives in such companies and some even chair these non-bank companies' board of directors.

Benston (1990) made a study on the advantages and disadvantages of universal compared to specialized banking. The eight possible advantages/disadvantages covered in the study were as follows:

1. Financial stability, financial crises and risk taking
2. Allocation of resources
3. Efficiency- Economies of scale and scope