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A STUDY OF LIQUIDITY AND PROFITABILITY IN MALAYSIA ISLAMIC BANKS

BY

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ABSTRACT

This thesis engages in a comparative analytical study of the liquidity and profitability management performance of Islamic banks in Malaysia. It seeks to explore the developments and growth of Islamic banks since the formation of Muslim Pilgrim Savings Corporation in 1963 which later metamorphosed into a full-fledge Islamic bank. The research begins with a short history of Islamic banks with special focus on the Malaysian examples. It then examines the profitability and liquidity management over a period of five years - 1999 -2003 of thirteen Islamic banks in Malaysia so as to locate the impact of its legacy on the prevailing economy of Malaysia. In doing so, it adopts the Ordinary Lease Square regression statistical methods to examine the management and performance of these Islamic banks. Different types of internal and external variables which consist of bank characteristics and financial structure variables including tax were employed in this study to examine performances and efficiency of these banks as far as liquidity and profitability are concern. It focuses on both full-fledged Islamic banks and banks with Islamic banking windows. Finally, the study reveals and discloses the impact of the Islamic banking activities on the Malaysian economy. All things been equal, our regression result revealed that Malaysian Islamic banks are liquid but not really in excess as could be found in the Mid-eastern banks. This shall be partly due to varieties of liquid assets created in this region to employ idle funds. Tax and overhead were found to have a positive relationship with Islamic banks' profitability. This confirms previous findings on this subject. It concludes on the need for a complete upgrading of Islamic banking activities which will meet Muslim aspirations.

ملخص ا لبحث

يهدف هذا البحث إلي إنجاز الدراسة المقارنة للظاهرة المالية في إدارة البنوك الإسلامية في ماليزيا .هذه الدراسة تعتمد علي توضيح مسيرة التقدم في البنوك الإسلامية منذ تأسيس إدارة الحج التي أصبحت فيما بعد البنك الإسلامي.استهل هذا البحث بقصة وجيزة عن البنوك الإسلامية عموما وعن حركاتها في ماليزيا خصوصا.ثم أردف البحث بتحليل الإنجازات وإدارة البنوك فيما بين خمسة سنواة في ثلاث عشرة من البنوك الإسلامية بحيث تركت أثرا إيجابيا في تنمية الاقتصاد الماليزي. وبالفعل قد استأنف هذا البحث مسيرته بالاستعانة بالمنهج الاحصاحي لتحليل عملية الإدارة و الانجازات في هذه البنوك. مع اختلاف نظام الإداري داخليا وخارجيا الذي يشمل طبيعة البنوك ونظامها المالي الذي يشمل ضريبة المال ،كل هذا قد درس في هذا البحث لتحليل الانجازات وقوة الفعلية لهذه البنوك من حيث ربحها أو خسارتها. وقد تركز البحث كذالك علي كلا البنوك الإسلامية و غيرها من البنوك التي ينهج منهجها. وأخيرا وقد تتبع هذا البحث أثر نشاطات البنك الإسلامي في اقتصاد الماليزيا. فالدراسة كشفت لنا بأن البنوك الماليزية في الواقع لم يربح كالبنوك الأخرى في شرق الأوسط إلا أنها لم يخسر.هذا ليوضح لنا مدي إمكانية كل منطقة علي كسب الربح.وللضريبة ورأس المال أثر إيجابي في كسب الربح في البنوك الإسلامية وهذا يصور لنا مدا النفقات التي أنفقت على مشروع البنوك الإسلامية.واختتم البحث ببيان ضرورية تطوير نشاطات البنوك الإسلامية بحيث يوفر حاجة المسلمين.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Science in Finance

MohcTAzmi Omar
Supervisor

This thesis was submitted to the Department of Business Administration and is accepted as partial fulfillment of the requirement for the degree of Master of Science in Finance.

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Mansor Hj. Ibrahim
Dean
Kulliyyah of Economics and
Management Science

Declaration

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Name: Adesina-Uthman Ganiyat A.

Signature.....G. Uthman.......... Date..2nd September, 2005

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DECLARATION OF COPYRIGHT AND AFFIRMATION OF FAIR USE OF UNPUBLISHED RESEARCH

A Study of Liquidity and profitability in Malaysian Islamic banks

Affirmed by Adesina-Uthman Ganiyat A.

Signature Date

This thesis is dedicated to my father, Alhaj Abdul Adesina who passed away a long time and my mother, Alhaja Adesina who toiled to bring me up alone both materially and spiritually and my husband who has stood by me especially throughout this study. May Allah enrich them on this earth and in the HereAfter, Amin.

Likewise, the dissertation is dedicated to children especially, the boys in Nigeria.

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CHAPTER ONE

INTRODUCTION

1.1: Introduction

This research is an attempt to investigate the viability of the liquids assets in Islamic banks with regard to their profitability by examining the performance of Malaysian Islamic banks. An attempt is been made in this study to examine how efficient Malaysian Islamic banks have been in the management of their liquid assets for the purpose of profitability. It is hoped that this study will contribute to the current Muslim scholarship in the field of finance and economics in general. This study seeks to be part of the banking and financial genre by studying how the Malaysian Islamic Banks have successfully ensured the viability of the Islamic Bank operational management of its liquid assets.

This study is as a matter of fact seeking to enquire into what can be termed the Malaysian long history and experience of the Islamic banking industry. The choice of studying these this country on Islamic Banking operational management of its liquid assets can only be intelligible within the context of a banking industry where the Islamic Banks have had to deal competitively with the conventional interest-based banking institutions. The charging and paying of interests by these conventional banking institutions contradict the Islamic teachings. Islamic banks and financial houses do not pay or charge interest - the core of the Western banking system - as it is considered usury. Money is made instead by using a system of profit sharing from returns on approved investments. Ever since the ugly incident of September 11, 2001, there has been a crackdown in the petrodollar investments in New York and London as well as other charities' funds which lead to a diversion of funds from these cities in the West into the Islamic world. Interestingly, most of such funds are going into the Islamic country with an Islamic money market which would later become the center of Islamic finance. According to Professor Mahmoud Amin El-Gamal, this is a big prize that Malaysia and Bahrain are contending for.[1]

Consequently, the goal here is therefore to provide a basis for exploring the main intricacies of running the Islamic banking system as central to banking practices in an industry where conventional interest based banking institutions are also operating. The Malaysian example appears as the best experience because the Islamic banks are operating in competition with conventional interest-based banks in South Asia East. Malaysia has always been at the forefront of innovation of Islamic finance - at least 10 years ahead of Bahrain, the United Arabs Emirates, and so on. This Malaysian leading position is boosted by an interbank money system for Islamic bonds certified by the powers that be, which Malaysia developed. The size of the Malaysian economy is also a huge attraction.

The attempts by these Islamic banks in Malaysia are highly encouraging today when the economies of most Muslim countries are fast disintegrating as a result of the fiat interest-based monetary system following the economic measures imposed by the IMF and World Bank on these Muslim countries which are among the poor and less-developed countries. These economic measures caused the International debt crisis

[1] "The Race to Rule Islamic Finance" Phone Interview with Mahmoud Amin El-Gamal - Professor of Economics and Statistics, Rice University Houston by *Businessweek online October 27th 2003.*
[2] Ibid.

some times called the Third World debt crisis due to the IMF and World Bank's lending to the sovereign governments of some of these less-developed countries (LDCS) more than they should have.[3]

Ironically the IMF Structural Adjustment programmes for these countries were even predicated on the economic notion that the people of these countries must experience pains and sufferings before they can enjoy economic buoyancy which is contrary to sound economic and banking principles. The IMF has also failed in is economic integration measures. It only forced the poor countries to open up their markets through the elimination of trade barriers but could not force rich countries to integrate their various national economies in such a manner that it can benefit the Third World and other less-developed countries.[4]

The impact of the 1997 East-Asian economic recession on the Asian including Malaysian economies is an example of how this oppressive monetary system can destroy both developing and underdeveloped economies. The crisis began in Thailand in the mid-1997 but soon spread over the whole continent, affecting the continent markets and other emerging markets in other regions. But for the swift and bold intervention of the Malaysian government in nailing down the problem of offshore currency speculation, the Malaysian economy would have totally collapsed.[5] It thus appears that if the crisis could almost cripple the economy of emerging giants like

[3] Cheon S. Eun and Bruce G. Resnick, *International Financial Management*, (New York: McGraw Hill Irwin, 2004), pp. 143 and 150.
[4] See Bose Mihir, Crash! A New Money Crash, (1989).
[3] See Prologue in Ahamed Kameel Mydin Meera, *The Theft of Nations, Returning to Gold*, Selangor, Malaysia: Pelanduk Publications, 2004.

Malaysia, then the success of the Islamic banking system will go a long way in helping Muslim countries in this age of globalization.

It will help them in a way that will ensure that their national wealth and sovereignty are not given away free of charge because of IMF had failure to remove all barriers to free trade between the rich and super developed economies and their counter developing and under-developed economies. An indication of the plundering away of the wealth of these weaker nations is the fact that the interest-based global monetary system has destroyed most of the national economies of Muslim and third world countries and made them subservient to the economies of America and Europe.[6]

1.2 Background of the study

Islamic financial institutions preceded Islamic banking in Malaysia. Tabung Hajj - The Pilgrim Management and Fund Board formerly known as Pilgrims Saving Corporation transformed into a full-fledge commercial bank known as Bank Islam Berhad in July 1983 when the Parliament passed the new Islamic Banking Act which was an amendment to 1973 banking Act. Bank Islam which was bom in this capitalistic environment has been proving its viability as banking institution. It has also been in the fore front of financial innovation albeit the competition it faces in its co-existence with conventional banks.[7]

[6] Ibid, pp. 3-61 and Ahamed Kameel Mydin Meera and A. K. M. Hasanudeen, D he Malaysian Financial Crisis of 1997: Is the Monetary Sector the Culprit?D Kuala Lumpur, IKIM Journal, (2002), Vol. 9.
[7] Zakaria man, Islamic Banking: The Malaysia experience, in Islamic banking In Southeast Asia edited by Mohammad Arrif, 1992,pg.68

The other Islamic banking institution (the bank Muamalat Berhad) was established in 1999. But prior to its establishment, Malaysia had taken a step further through the introduction of Islamic banking Scheme in 1993, a dual banking system which allows the conventional banks to have two windows - one for conventional banking operations and the other for Islamic banking operations. In 1994, Islamic Interbank Money Market was established to assist the smooth operations of the Islamic financial institutions, ease placement of surplus and idle funds or borrowing on short term basis to enhance liquidity in the market. As the Islamic financial center in its region, Malaysia had been in the fore front of constant financial innovations in term of Islamic financial instruments such that there exists today numerous Islamic product and services in the Malaysian economy.

Moreover, with the formation of Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI] in Bahrain, in conjunction with Islamic banks and other financial institutions worldwide, the services of Malaysian Islamic banking operations have improved tremendously. This has mainly assisted in the introduction of more transparency and accountability into the Islamic banks system and also to set international accounting standards in the area of Islamic financing.

Bahrain Monetary Agency [BMA] became the first Central bank to approve a set of guidelines on reporting and accounting practices that would bring about a measure of standardization for the Islamic banking industry as a whole[Q]. AAOIFI is not only providing regulatory framework for Islamic banks but also monitoring their returns on quarterly basis to detect any sign of deterioration in their performance. There are six

[s] *Bahrain: The financial Hub of the Middle* East online news

major areas covered by AAOIFI objectives namely assets quality, capital adequacy, corporate governance, earning quality, liquidity and lastly management of investment account. This is to enhance the confidence of the investors in particular and the participant in financial service industry in general in Islamic banking.

With the interpretation of some Islamic Scholars that the Mudarabah contract (equity sharing between the Islamic bank and its customers) is not binding in term of maturity which means that investors can withdraw their money anytime, BMA comes in. It is on this note that BMA pointed out that monitoring and controlling liquidity is of greater important in an Islamic bank which is one of the most critical responsibilities of bank management. The Middle East survey reports that the BMA stipulates as follows:

> That banks must monitor their equity mismatch position for both corporate books (carrying self-financed assets and those financed by unrestricted investment accounts) and restricted investment account holders. It has laid down criteria for reporting inflows and outflows from 0-6 months on a cash basis and from 6 months to 5 years on maturity basis. The agency has set mismatch limits for the unrestricted investment accounts of 15% for the 0-8 day time band and 25% for the 8 days to 1 month band. However, on a consolidated basis for both corporate books (carrying self-financed assets and those financed by unrestricted account holders) and restricted investment accounts, the BMA has set a ceiling of 15% for the 0-8 days time band and 25% for the 8-days-l month time band.[9]

"Bahrain Monetary Agency Issues New Islamic Banking Regulations" in *The Middle East Economic Survey,* VOL. XLV No 5, 4 February 2002

1.2.1 Roles of Islamic Banks Money Market in Malaysia and IIFM

Though the Islamic banking is still in its infant stage, it has recorded a remarkable growth and recognition globally. Interestingly, conventional banks in Muslim countries and in the West are rushing to explore the new fertile market. It is pertinent to note that most of the financial instruments that are in use for management of liquidity in the conventional banking system are not Shari'ah compatible because they are interest-based instruments. Meanwhile, money market is the first avenue to borrow funds on short-term basis to meet short term obligations as they fall due or to place excess or surplus funds for investment purposes. This explains the place of money market in liquidity management framework.

In order to enhance a cooperative framework among Islamic banks globally, the International Islamic financial market was established. In November 2001, an agreement was signed by the Governors of Central banks and Monetary agencies of Bahrain, Malaysia Indonesia, Sudan and the President of the Saudi-based Islamic Development Bank (IDB) to create the International Islamic Financial Market (IIFM). The main aim was to facilitate international secondary market for trading of Islamic financial instruments. The different interpretations of the Shari'ah on the instruments had been harmonized by the IIFM Shari'ah Supervisory Committee consisting of representatives of member states who are Scholars from different regions shari'ah school of thought.[10]

This has greatly enhanced cross-border acceptance of Islamic financial instruments and had been strengthening cooperation among Muslim countries. For instance, about 27 investors partook in the first global sukuk endorsed by the IIFM which was issued by Malaysia. This deal achieved many milestones with 51 % of the investors from the Middle East, followed by 30% to Asia investors with half of this placed to Labuan investors. 15% was taken by European investors and 4% by US investors." It is therefore in order to meet the varying demands of investors in a fast changing market environment, that IIFM is addressing the critical need for liquidity management among Islamic financial institutions which shall eventually enhance their profitability.

1.2.2 Liquid asset management in Malaysia Islamic banks

The role of Malaysian Islamic banks in the country's Money Market is not in doubt as Islamic financial institutions are part and parcel of Malaysian economic development and modernization's drive. Since the Islamic Banking Act of 1983 that created the Bank Islam Malaysia Berhad (BIMB) and the later 1992 establishment of the Interest-Free Baking Scheme (IFBS) which allowed all Malaysian banks to offer the dual conventional and Islamic banking services under the auspices of Bank Negara

[10] Abdul Rais Abdul Majid (CEO of IIFM)"Development of Liquidity management Instruments: Challenges and Opportunities" a paper presented at the international conference on Islamic Banking: Risk Management, Regulation and Supervision, 2003, 15.

Malaysia, Malaysian Islamic banks have been playing a central role in the country's Money Market. The Islamic banks have since issued Islamic corporate bonds, Islamic acceptance bills, Islamic exports credit facility and Islamic mortgage bonds. Malaysia can also boast of the Syarikat Takaful Malaysia which is a leading Islamic insurance company as well as an Islamic Inter-bank Money Market (IIMM), Islamic Unit Trusts (IUT) and Islamic Debt Securities (IDS).

1.2.3 Malaysian Islamic Interbank Money market

The Islamic Inter-bank Money Market [IIMM] offers a broad spectrum of Islamic financial products to assist the Islamic banking institutions to absorb or meet their liquidity and investment needs. These products range from Islamic funds such as Mudharabah [profit-sharing] Interbank investment [Mil] which allows the Islamic banking institutions to raise funds to meet their short term liquidity needs based on profit- sharing arrangement as against the interest payment in the conventional system. It includes: overnight Mudharabah, one week, one month and three months Mil to Islamic papers such as Government Investment Issues [Gil], Bank Negara Negotiable Notes [BNNN], Short-term Trade Bills and Negotiable Islamic Debt Certificates. Wadiah Interbank deposit is also one of the instruments use to absorb excess liquidity from Islamic banking institutions.

In addition, there are some Islamic financial instruments that are traded under the Bay'al Dayn in IIMM. These includes: Islamic private debt security, Green bankers acceptance, Islamic accepted bills, and Islamic mortgage bonds. The efficiency of the Islamic Money Market is enhanced by the Real-Time Gross Settlement System

(RENTAS) and the Fully Automated System for Tendering (FAST). RENTAS facilitates larger value Interbank funds transfers and scripless securities while FAST facilitates the tendering process for the Islamic securities including government securities, commercial papers and private debt securities.[12] Below is a table of liquid assets available in the Islamic money Market in Malaysia with their applications.

Table 1.1

Bank Negara negotiable notes-i	*Bai'al-lnah*
Cagamas papers	Bai Bithaman Ajil Mudaharabah
Commercial papers-i	*Murabahah*
Government investment issues-i	*Bai' al-lnah*
Malaysian islamic treasury bills	Bai' al-lnah
Negotiable debt certificate-i	*Bai' Bithaman Ajil*
Negotiable instument of deposit-i	*Mudaharabah*
Sell and buy back agreements (Repo-i)	Bai' al-lnah
Foreign exchange	Ujr

The 'i' denotes Islamic while the concept applied in each case are in the right column. The first one which is Bai' al-inah which means buy back sales is most controversial and unaccepted to the Middle Eastern Scholars.

Bank Negera Malaysia has series of operation that are always undertaken to maintain an appropriate level of liquidity in the Islamic banking system. Apart from the use of wadiah interbank deposit to absorb excess liquidity, these Islamic papers are commonly use through the Islamic Interbank Money Market: Bank Negara negotiable note (BNNN), Government Investment Issue (Gil), negotiable Islamic debt certificate

[12] Bank Negara Malaysia 2003 Annual reports,"7Yie *Islamic Financial System"* page 183, March 26, 2004

and Mudharabah interbank investment. In 2002, it was observed that there was an excess liquidity in the system. Figure 2.4 and 4.4 in the appendix confirmed this. High percentage of liquid assets to customer deposit and short-term funds and a low percentage of loans to customer deposit and short-term funds are indicators for surplus liquidity. This accounted for the issuance of RM2 billion worth of Gil and RM1 billion worth of BNNN in 2003 by Bank Negara to absorb excess liquidity. Gil rose from RM5.9 in 2002 to RM36.1 in 2003, BNNN rose from RM2.2 billion to RM 8.8 billion in 2003. Ditto for Mudharabah Interbank Investments (Mil) from RM247 to RM 283.8 billion and Negotiable Islamic debt certificate rose from RM0.8 billion to RM4.2 billion. There was a huge growth of 511.9% in Gil, 425% in Negotiable certificate of deposit, 300% increase in BNNN and the least was from Mil at 14%. The Islamic Money Market had continued to witness a tremendous growth each year with the worth of the market in 2002 at RM280.7 billion, it stood at RM367.7 billion in 2003 and increased currently to RM562.4. The market recorded a growth of 64.8% in 2004 compare to 31.0% in 2003.[13]

1.2.4 Profitability versus liquidity

Going by the definitions from *Hanson 's Dictionary of Banking and* Finance, the term liquidity is used to describe all assets that are held in cash or near cash. Liquidity is one of the significant components of a viable bank. In fact, liquid assets are the most salient features of the banking operations and all other financial businesses. As far as commercial banks are concerned, failure to manage their liquid assets effectively is

[b] Bank Negara Malaysia 2004 Annual reports,"*The Islamic Financial System"* page 171, March 23, 2005

[14] Derrick G. Hanson, *Dictionary of Banking and* Finance, (London: Pitman, 1985).

like "throwing good money after bad" to quote Olashore.

However, the above definition of Islamic financial instrument does not include the convertibility and negotiability of these instruments into money or other liquid assets in accordance with Shari'ah. For instance, an Islamic certificate is not negotiable for more than its face value until the mobilized funds changes form to become property or usufructs. No wonder, Islamic Banks all over the world, Malaysia inclusive are always extra careful to make adequate strategies on the management of their liquid assets especially money. Money itself represents the most liquid assets as it possess the highest degree of liquidity because of the ease, simplicity, promptness, readiness and mobility with which it serves as cash. Other assets do not have the same quality at least in the same degree with money.

These liquid assets form parts of the working capital of financial or banking institution. It is however the capability of the financial or banking institution to meet all its demands for money that is its liquidity. The more this capability by a financial institution to meet the anticipated demands made by its customers, the more it is said to be liquid. Meanwhile, Bank managers "feel pressure from the stockholders for greater profits, which may be earn by investing in longer-term securities and reducing the idle cash balances. On the other hand, managers are actively aware that these actions greatly reduce liquidity which may be needed to meet deposit withdrawals and credit demands of long-standing customers".

Thus, in resolving the conflict between liquidity and profitability which is regarded as

See Olashore Oladele, *Perspective in Finance, Banking and Economic Policy,* (n. p. 1990).
[16] See Douglas Greenwald and Associates, *The Concise McGraw- Hill Dictionary of Modern Economics* (New York: McGraw- Hill, 1983).
[17] E. W . Reed,(et al.) Commercial Banking, (Prentice Hall: New Jersey, 1984), Third Edition, p. 108.