



الجامعة الإسلامية العالمية ماليزيا  
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA  
بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

INVESTMENT / LOAN ACTIVITIES OF  
COMMERCIAL BANKS.

by

MISLIAH BT. MD. YUSOF

Q30114

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International Islamic University, Petaling Jaya, Selangor.

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## CHAPTER 1

### INTRODUCTION

The commercial banks are the largest and the most important group of financial institutions in Malaysia. The number of commercial banks operating in the country had increased steadily from 26 in 1959 to 38 in 1985 and its activities have expanded significantly during the past two and a half decades.

Over the 1960s, total resources of the commercial banks increased at an average annual rate of 14.2 % and in the 1970s and early 1980s, growth in total resources accelerated to an average annual growth rate of 22 %. The rapid growth in resources was due mainly to the increase in deposits placed with the commercial banks, which accounted for 70.6 % of the total increase in their new resources. Growth in other sources of funds, including capital and reserves and foreign liabilities of the commercial banks, was relatively minor up to 1970, but subsequently, foreign liabilities, comprising mainly amounts, due to head offices of foreign-incorporated banks, assumed increasing importance.<sup>1</sup>

Since the end of 1950s, total investment of the commercial banks expanded at a rapid rate, increasing at an average annual rate of 19.9 % (8.8 % of total resources in 1960 to 12 % of total resources at the end of September 1983.) At present, the commercial banks, are the largest single group of holders of Malaysian Treasury bills and of the largest group of Federal Government Securities.

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<sup>1</sup>Bank Negara Report , Silver Anniversary, page 162.

Report for 1983:

The number of commercial banks operating in Malaysia remained 38 at the end of 1983, of which 22 were domestic-incorporated banks. The commercial banks enjoyed another year of rapid growth where their total resources increased by 22.9 % in 1982.<sup>2</sup>

On the lending side, there remains much room for the banks to improve the quantity of their lending to help raise the nation's productive capacity. An efficient allocation of increasingly scarce resources in the banking system has become critical to the long-term sustained growth of economy, with price stability and increasingly external equilibrium. Banks will need to play a catalytic role in promoting a more vigorous inflow of new technology and investment that effectively enhances growth and exports, and at the same time, the use of credit for consumption should be moderated and speculation discouraged, including investment in 'soft' projects.

A new mile stone in the evolution of the banking system in Malaysia was reached with the coming into effect of the Islamic Banking Act, 11th of March, 1983, to provide for establishment of Islamic banks in the country. The Islamic banks commenced its operation only on the 1st of July, 1983, with a branch in Kuala Lumpur. It was established based on Islamic principles to fill the void in the existing banking system and to meet the banking and credit needs of the Muslim population in Malaysia according to the rules of Shari'ah which prohibits interest. The Shari'ah instead provides such non-interest based concepts <sup>such</sup> as the mudharabah, musyarakah, murabahah, wadi'ah, al-bai bithamam ajil, al-ijarah, al-tajkiri, al-wakalah and many others.

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<sup>2</sup>Bank Negara Report, Silver Anniversary, page 58

Report for 1984 :

From the Economic Report 1984/85 issued by Ministry of Finance, there seems to be a slower growth in the commercial banks. The loan portfolio of the commercial banks expanded at a slower pace compared to the first 6 months of 1984 to the same period of 1983. The loans granted in 1984 increased by 8.3 % compared to an increase of 11.3 % during the corresponding period in 1983.

However, as the growth was relatively faster than that of deposits, the 'overhang' of unutilised portion of overdraft facilities in the banking system recorded a decline from 20.3 % of total outstanding loans at the end of June 1983 to 18.3 % at the end of June 1984.

On March 31, 1984, new guideline of lending by commercial banks were introduced. The banks are required to meet quantitative targets prescribed for loans to the Bumiputera community, small-scale enterprises under the Special Loan Scheme (SLS) of the Credit Guarantee Corporation and for agricultural food.

Bank Islam Malaysia Berhad (BIMB) which started its business on July 1983, stated a strong growth in 1984. Its total assets increased from \$ 170.6 at the end of 1983 to \$ 369.8 at the end of 1984. In 1984, BIMB, opened 3 more branches i.e. in Kota Bharu, Alor Setar and Butterworth and with this its branches amounted to 5 at the end of 1984 where before this another branch was opened in November 1983, in Kuala Terengganu.

Report for 1985 :

1985 represented a challenging year for the commercial banks. The sharp fall in commodity prices during the year led to a significant slowdown in growth of deposits, particularly in the second half of the year.



In the second half of 1985, deposit growth stopped to 3.7 % from 16 % in the year before, well before the annual rate of 21.3 % for 1975 - 1983 period. At the same time, commercial banks lending rose 12.6 %, mainly to the construction of real estate sectors. Coupled with intense competition for deposits between the banks, finance companies, and co-operatives, the growth resulted in a tighter loan-deposits ratio of 96 % (compared with 92.7 % in 1984)

As the economic slowdown began to have an impact on cash flow of borrowers and loans growth began to slacken, the commercial banks were pre-occupied with meeting the challenges from several fronts. They have to face a barrier of new regulations imposed by Bank Negara in the long-run. These rules will strengthen Malaysia's financial system and promote monetary stability but their implementations spawned a number of short-term problems for the banks. Although the new rule took effect from 1986, commercial banks were required to adjust their accounts respectively.

Predictably, commercial banks have become highly selective in approving new loans. Now they face a new dilemma of contending with Bank Negara's pressure to support industrial expansion within Malaysia. Furthermore, Bank Negara's priority lending guidelines earmark about 25 % of each bank's total loans outstanding to Bumiputera enterprises and low-cost housing projects.

BIMB enjoyed a year of strong growth in 1985. Total assets of the bank increased by 88.6 %. Total resources rose \$ 214.4 million during 1985 to \$ 584.2 million at the end of the year, with the bulk of the increase (95.3 %) being generated by deposits mobilised. More than 3/4 of the growth in the deposit base were in the form of general investment deposits.

Credit extended by BIMB increased about 42 % at the end of 1985. As at the end of December 1985, loans to the property sector, including housing for individuals accounted for 33.9% of total loans outstanding, while general commerce and financing, insurance and business services accounted for another 25 % and 12.3 % respectively.

## 1.2 Objective of the study/project paper

The objective of the paper can be divided into 2 parts :-

- a) general objective
- b) specific objective

### a) General objective

Generally, the paper is to look into the operations and analyze the investment activities and loans in the commercial banks. It will discuss the modes of the investment and will then look at the achievement of the commercial banks. Special reference has been made to the Malaysian economy regarding the activities of the interest-based conventional commercial banks as compared to Bank Islam Malaysia Berhad which is essentially non-interest based.

### b) Specific objective

The paper specifically is to look into investment/loan activities on both interest and Shari'ah based system and to differentiate between them. It will try to show the differences on how the Islamic and non-Islamic banks evaluate and predict the profit and criteria that are being used before investing. Furthermore, the paper is to prove that investment in Islamic context is more profitable and better than the conventional system in exploiting the bounties of Allah SWT since it does not allow concentration of wealth in few hands and discriminating others rights.

### 1.3 Outline of the paper

Chapter 1 is an introduction where it reviews the growth of commercial banks since 1983 to the end of 1985. This chapter also reviews the general and specific objectives of the paper.

Chapter 2 is about research methodology. Research methodology for this paper will be from library and field study. It will also list the advantages and disadvantages of the methods taken. Lastly, it will tell about the problems encountered during the research.

For Chapter 3 will be literature review of the paper. This chapter mainly gives the opinions of some scholars on Islamic bank and types of investment in part II. For part I of this chapter will be on conventional banks which will be discussed on the sources and operations of incomes of the banks. It will also be on the considerations of banks loan.

Chapter 4 of this paper will be the survey on the conventional banks. It will be about the historical development of the commercial banks, sources and uses of funds and the direction of bank's credits/ investments.

Chapter 5 will be the survey on Islamic bank. The development of the bank, its sources and uses of funds and its direction of investment/lending will be the main discussion of this chapter.

Lastly, Chapter 6 will be the comparisons and conclusion from the study. There will be few recommendations for the benefit of Malaysian economy.

## CHAPTER 2

### 2.1 Library research

The research will focus on conventional banking system as well as Islamic banking system. Relevant material such as books, articles, annual report from Bank Negara Malaysia and paper written during the past conferences by certain scholars will be use as references for this project paper.

The materials will contribute to the theory in banking such as in Chapter 1, Chapter 3 and Chapter 4 but mainly it provides the literature review which is in Chapter 3.

#### Advantages

One of the advantage of library research is that it is time-saving in <sup>the</sup> sense that many materials can be obtained simultaneously and at one place.

There are also many libraries to go which can contribute materials to the project paper. Besides that it is easier to get secondary data from this method since many informations can be obtained at the same palce and at the sametime.

#### Disadvantages

One of the main disadvantages is that not all required materials are available especially in the university own library. This may due to the utilisation of other students as well as lack of books for reference especially Islamic books.

Since there are not many books in university's library one has to search from other public libraries. The problem arise then is that not all materials can be borrowed and have to do photocopying which is so expensive.

Other than that, the disadvantage is spending long hours in the library to do the reading and selecting the relevant informations.

## 2.2 Field study

For this method, it is hopeful that an interview can be held with the Director of BIMB and the Manager of the conventional bank. By this, the investment activities of commercial banks can be obtained i.e. how it is being done in reality or practically. This is important so that the paper can differentiate the investment activities of the conventional to the investment activities of Islamic bank.

For BIMB, since it is known that there are many types and methods of investment and also there are few problems encountered in doing the activities, only some methods are being used and <sup>there</sup> are reasons for choosing the certain methods. Also by interview, informations can be obtained on the contribution of investment activities to Malaysia economy as well as the Muslim community.

### Advantages

The assets of field study, are the ability to develop a personal contact and also obtain first hand information. This will lead to better understanding in all aspects through the discussion. Through this also, views can be exchanged and a certain degree of cooperation is envisaged.

### Disadvantages

This method is time-consuming in a sense that one has to fix for appointments with the managers of the bank. It is also costly because one has to travel to the place for the interviews.

### 2.3 Problems encountered during the writing of the project paper.

One of the problems is lack of materials for references. Most materials especially Islamic books and articles talks about the same thing i.e. Islamic bank as a whole and methods of the investment in general and not much emphasis is placed upon the detail of the investment activities which is going to be the main discussion of this paper.

Few relevant materials were found in other public libraries and would be too costly to photostat it. The problem is that it needs a lot of expenditure in writing this paper such as for photostating and for travelling to get the information. Besides being costly and time-consuming to make an appointment and to make an interview. It needs time to organise the interview and to fix time among friends to meet the manager/director since everybody is busy with their own work and responsibilities.

Other problems arise when the typing of the paper needs to be done for it involves careful scrutiny, attention and neatness. Besides the problem of language arise in which the paper must be written in English and needs a person to check the grammar and the sentences.

Literature review - part 1

Banks, like any other businesses, will come upon a time when they could use more hard cash. When a bank wants money, say to meet a cash outflow, it has many sources to tap. Sources of bank income are the interests, fees and similar charges levied against all assets classified as loans and discounts. This income category includes interest on acceptances, commercial papers purchased in the open market, paper sold under resale agreement, investigation and service charges, renewal and past-due charges, commitment fees and fees charged for the execution of mortgages or agreements securing the bank's loans.<sup>1</sup>

Loans rank ahead of investments in the allocation of assets because they generally have higher yields and because they facilitate and stimulate local economic development, which enhances the future growth of deposits and loans in the bank. Interests and fees on loans are by far the larger source of operating income to banks. Included under the heading of interest and dividends and are such as:-

- interests on Treasuries

The bank owns a majority of the Treasury securities, in the form of short-term issues, and are held prominently for liquidity purposes, that is, to meet possible withdrawals, loan demands, and maturing liabilities.

- interests and dividends on agencies

Securities on agencies involve no or little credit risk and agencies are also attractive because they tend to carry a higher yield than Treasuries.

<sup>1</sup>

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Oliver G. Wood. Jr., Commercial Banking-policy and practice,  
University of Carolina, Page 61.



- interests on municipals

The principal feature of municipals is that the interest income from these obligations is not subject to federal income taxes or to state income taxes in the state which they are issued.<sup>2</sup>

- interests and dividends on other securities

That is, income from holdings of all stocks, bonds, notes and debentures that have not been reported under other security income categories, shares in savings and loan associations and credit unions.

Operating income that are included under service charges are such

as:-

- service charges on deposit accounts

These fees, although do not cover fully the expenses of providing demand deposit account and of deposit transfers, it does off set, to some degree, the large cost incurred.

- other service charges, collection and exchange charges, commissions and fees.

Other sources of income under this heading include commissions on the sale of credit life insurance policies and the collection of premiums; the collection of bills for public utilities and other firms; the sale of bank drafts; the purchase and sale of securities, acceptances, commercial paper for domestic bank and other customers; the negotiation of loans for correspondent customers; the underwriting and sale of securities owned by the bank; the servicing of real mortgages or other loans held by others; percentage charges to merchants for handling credit-card

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Oliver G. Wood. Jr., Commercial Banking-policy and practice,

University of Carolina, page 64.

or charge sales; equipment leasing and rental fees; data processing services; and reimbursements received for services in redeeming savings bonds.<sup>3</sup>

As any profit-seeking businesses, the income statement is the focal point for commercial bank management and all these principal sources of bank income are shown on this statement. Besides that, this statement also report the explicit costs or major expenses items realized by the bank.

Expenses on all retail accounts include all costs associated with processing the account and interest paid on the funds deposited by retail customers. Processing cost include all of costs associated with clearing checks, preparing and mailing monthly statements as well as the direct costs of services provided with the retail account. Among the operating expenses are:-

- salaries, wages, pensions and other benefits
- interests on deposits in time and saving deposits
- net occupancy expense

"Net occupancy expense" is equal to "Gross occupancy expence" less rental income. "Gross occupancy expence" includes the following; compensation for those officers and employees of a bank and its consolidated bank premises subsidiaries who spend major part of their working time on bank buildings and related "housekeeping" functions regardless of whether the bank has a building investment; all supplementary benefits, other than direct compensation, paid or accrued on behalf of building department personnel, normal and recurring depreciation change; ordinary repair to bank premises and lease hold improvements; all current expenses such as the cost of heat, high, water, outside janitor services, janitor supplies,

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<sup>3</sup>  
Oliver G. Wood. Jr, Commercial Banking-policy and practice,  
University of Carolina, page 65.

fire insurance, and similar expenses; and all rents paid on bank premises and parking lots, interest on liens or other encumbrances on bank premises owned, and all property and other taxes paid or accrued related to bank premises.<sup>4</sup>

- furniture and equipment, depreciation, rental costs, servicing, and similar expenses.
- provision for loan losses.

The control of loan losses is an important facet of bank operations because a poorly administered loan portfolio can have significant negative impact on earnings and capital.

After acquiring adequate fixed assets and meeting their cash or primary reserve requirements, and subject to the constraint of maintaining adequate short-term and long-term liquidity, banks attempt to satisfy the legitimate loan demands in the communities or specialized credit markets that they serve. Several general considerations in bank lending are:-

- external considerations
- internal considerations
- bank loan policy
- regulation of bank lending

Bank lending: External considerations

This includes factors such as the size and location of the bank, national economic conditions, local economic conditions, the direction of monetary and fiscal policy and international economic conditions.

The location of a bank determines, to a great extent, the composition of its loan demand, such as loan portfolios of the money market banks will contain primarily commercial loans, and loans to farmers

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<sup>4</sup>  
Oliver G. Wood, Jr., Commercial Banking—policy and practice, University of Carolina, page 68.

constitute most of the credit extended by a rural bank.

The demand for most types of bank loans is related directly to the stage of the business cycle. The demand for commercial loans is particularly responsive to changes in national economic conditions. If the economy is expected to enter a boom period, then businesses would have a greater demand for funds to finance long-term working capital needs.

With regard to the direction of monetary and fiscal policy, bank lending officers typically become more willing to grant loan requests when the outlook is for an expansionary of monetary and fiscal policy, since there will be fewer loan defaults during periods when monetary and fiscal policy are stimulative.

International economic conditions have an important bearing on commercial loan demands for those firms with foreign subsidiaries or for whom time constitute a significant part of output.

Bank lending: internal considerations

These include fixed and other asset requirement, legal and working reserve requirement, size of cash items in the process of collection, short-term and long-term liquidity requirements, capital adequacy and size, maturity, composition and cost of the various sources of funds.

The volume of funds available for the loan portfolio is reduced by the amount of fixed and other assets the bank must hold. The legal and working reserve requirement are the next priority in the use of funds is to provide for short and long-term liquidity requirements.

Bank loan policy:

The primary objective of bank policy is to specify the types of loans and the terms on those loans that will benefit both the communities the bank serves and the bank itself and with this it is important that every bank have a written loan policy.

The purposes of a written loan policy are:-

- 1) to assure compliance by lending personnel with the bank's policies and the objectives regarding the portfolio of loans; and
- 2) to provide personnel with a framework of standards within which they can cooperate.

The advantage of a complete written policy is that it forces management to clearly identify and formulate policies concerning lending. The more specific and exact the written policy is, the better the chance of compliance and the more efficient the lending operation will be.

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Frank P. Johnson, Richard D. Johnson, Commercial Bank Management,  
The Dryden Press.

Banking operation as a whole, may be classified into two main parts: services and investment operations. The conflict between banking operations - service or investment - and the Islamic Syariat lies in the means and objectives. As it is well-known, the means are often varied, which helps to enable the better choice of the means which are appropriate for achieving the same objective.

Dr. Gamal Attia of Islamic Banking system, Luxemborg, in his paper during Islamic Banking Conference in London said, that, as interest is prohibited for all purposes and in all its forms as far as Islamic framework of thought is concerned, we have to look for guidance for a system of banking which is in consonance with Islam. He further on said that the conceptual basis for a better banking system even according to general economic theory would be one wherein capital is a part or partner or instrument of factors of productions known as entrepreneur. Hence, we have to look in Islamic literature for a permissible form of business relationship between those who provide the funds and those who utilise the funds on the basis sharing profit or lose as the case may be.

He quoted the definition of the institution of mudharabah by Imam Sarakhsi, based on Al-Quran and Sunnah which is as follows:

"The word mudharabha is derived from 'Darb on Earth'. It has been so because the mudharib (user of others capital) qualifies to get a share of the profit on account of his undeavours and work. He thus participate in the profit as well as having the right to use capital, and strive according to his discraticion. People of Madinah call this contract Muqāradah which is derived from the word Qard, meaning 'surrendering'. The owner of capital, thus, surrenders his own rights over that of capital, to the āmil (user of capital)<sup>6</sup>

The legality of mudharabah or partnership between the supplier of capital and the user of capital is also recognised by other jurists of Islam as Burhānūl-Dīn 'alī b. Abū Bakr al-Maghīnānī (in his work al-Badā'ī was - Sanā 'i li Tartīb ash-Sharā'i).

Furthermore, Dr. Gamal Attia said that Islamic bank performs the role of proxy of depositors vis-a-vis the users of funds and it did not guarantee neither the principle nor a pre-determined yield. The proxy has two kinds:-

1) A proxy including allegation from depositors to invest their deposits in any project, called "General Deposits", where Islamic bank invest with numerous users of funds and profits of the investment are the redistributed among depositors.

2) the proxy where the delegation from depositors is specified to investment of deposits in particular projects after approval and acceptance of the risks involved and the profit are distributed after deduction of management fees of the bank.<sup>7</sup>

As for financing on a Murabahah basis (cost plus margin profit) it does not raise any problem from the point of view of the existing bank. The ownership of a commodity is transferred immediately after the bank obtains its title to the next buyer as the Qur'an, do allow this type of investment.

Another way by which Islamic banks can invest their resources is by establishing subsidiary companies with the capital and could be wholly owned by the bank or it can have the controlling share in different sectors.

In the book "Issues in Islamic Banking", Siddiqi as his conclusion for Chapter 3 focus on why it is necessary to banish interest from

<sup>6</sup>  
Dr. Gamal Attia, Islamic Banking System, Islamic Bank Conference, Luxembourg.

<sup>7</sup>  
Dr. Gamal Attia, Islamic Banking System, Islamic Bank Conference, Luxembourg.

the system and build a new banking system based on syari'ah. Siddiqi gives reasons to banish interest as follows:-

- inefficiency in debt finance

Investible funds may, fail to flow into avenue which carry a higher expected rate of profit but involve a large degree of uncertainty as the enterprise under obligation to repay the capital with a return that is contractually fixed. The refusal of the supplier of capital to share the uncertainties involved deprives the society of possible gains in the productivity of capital through innovation and adoption of new techniques.

- injustice of debt finance

The possibility of loss in business enterprise comes not only from the quality of entrepreneurship but from the nature of the world in which the enterprise is carried. There is no justification for prescribing a certain returns in the nature of things it is uncertain. Money capital seeking a positive returns through enterprises ought to and must bear this uncertainty.<sup>8</sup>

Sometimes the productive employment of capital borrowed from banks may result in a very large profits , accruing to businessmen, of which only a meagre shares comes to the banks in the form of interest. A change in the terms of which capital is supplied, so that the return to capital is proportionate to the profits actually realised would promote justice. It would also contribute towards greater allocative efficiency by making the banks look for and finance projects carrying higher expected profits.

Siddiqi also mentioned the types of investment in Islamic bank and according to him deposits in investment accounts may be for specific projects, or left to the discretion of the bank for suitable investment. Investment of banks may take the form of partnership, the banks actually participate in the management of the enterprise, or of profit-sharing

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M.N. Siddiqi, Issues in Islamic Banking, The Islamic Foundation, Lahore, page 67.