

**CHALLENGES AND PROSPECTS FOR FOREIGN
ISLAMIC BANKS IN MALAYSIA: A CASE STUDY
OF AL RAJHI BANKING AND INVESTMENT
CORPORATION (MALAYSIA) BERHAD.**

By

RUSIDHA THOUFEEK

Project Paper Submitted in Partial Fulfilment of the Requirement for the Degree of

Master of Business Administration

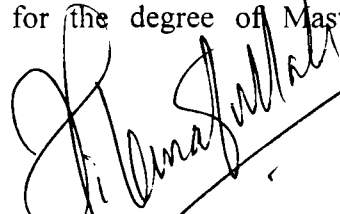
Graduate School of Management

International Islamic University Malaysia

2011

APPROVAL PAGE

I certify that I have supervised and read this Project Paper and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a Project Paper for the degree of Master of Business Administration.



Dr. Hikmatullah Babu Sahib
Supervisor



MUHAMMAD YUSUF SALEEM
Assistant Professor
Department of Economics
Faculty of Economics and Management Sciences
International Islamic University Malaysia

Dr. Muhammad Yusuf Saleem
Supervisor

This Project Paper was submitted to the Management Centre, IIUM and is accepted as partial fulfilment of the requirements for the degree of Master of Business Administration.



Professor Dr. Ahamed Kameel Mydin Meera
Project Paper Examiner

This Project Paper was submitted to the Management Centre, IIUM, and is accepted as partial fulfilment of the requirements for the degree of Master of Business Administration.

PROF. DR. ARIF HASSAN
Deputy Director
Graduate School of Management
International Islamic University Malaysia



Prof. Dr. Arif Hassan
Chairperson, MBA Committee
Graduate school of Management
IIUM

DECLARATION AND COPYRIGHT

Name : Rusidha Thoufeek
Matric Number : G0912430

I hereby declare that this research 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.

Signature..........Date.. 17-06-2011.....

© Copyright by *Rusidha Thoufeek* and
International Islamic University Malaysia

DEDICATION

To my ever loving parents and siblings who have always been a source of strength to me and also to a very special person in my life, who has always been there for me.

ACKNOWLEDGEMENT

In the name of Allah, the Most Gracious and the Most Merciful

I would like to express my greatest thanks to Almighty Allah, The Most Gracious and The Most Merciful, who had blessed me to complete this research and to those who read it. Besides, thanks are owed to many people for their kind advice, encouragement and patiently enduring with me whilst working on this project.

First of all I am greatly indebted to my supervisors Dr. Hikmatullah Babu Sahib and Dr. Muhammad Yusuf Saleem for their exceptional academic guidance, support and the attention they rendered to me in completing this project. May Allah SWT give them the best rewards in this world and in the hereafter.

Special thanks go to my family: parents, siblings and relatives, for their prayers, patience and unconditional love that gave me the strength and determination to complete my project. I am also obliged to thank those who furnished me with the information; especially the management of Al Rajhi Banking and Investment Corporation (Malaysia) Berhad, represented by Mr. Sabry Ghouse, Mr. Zulhisham Zailan, Dr. Azman, Sister Mariam and Bank Negara Malaysia and Security Commission Malaysia represented by Dr. Aznan Hasan.

I would also like to take this opportunity to thank all my MBA lecturers and the staffs of the Graduate School of Management for their kind help and generous encouragement they provided me: with special recognition to Prof. Dr. Arif Hassan, Dr. Mustafa Omar and Ms. Raja Nur Sabrina for their guidance and support, and to my classmate Sister Hermiza Hilmi, who helped me to contact Bank Negara Malaysia.

My sincere appreciation to my dear friends; Nazeefa, Ella, Hala, Fatoumata and Muqet for being there for me through the trying and celebrating moments of writing this dissertation, especially Ella, for her unwavering dedication and support whilst writing my project.

Finally, my sincere gratitude and appreciation to everyone who has contributed in one way or the other to this project. Jazakallahu Khair for your kind tolerance.

TABLE OF CONTENT

APPROVAL PAGE	ii
DECLARATION AND COPYRIGHT	iii
DEDICATION	iv
ACKNOWLEDGEMENT	v
LIST OF TABLES	xi
LIST OF MAPS	xii
LIST OF FIGURES	xiii
LIST OF ABBREVIATIONS	xiv
ABSTRACT	xv
1. INTRODUCTION	1
1.1 Background of Study	1
1.2 Research Objectives	4
1.3 Research Problems	5
1.4 Significance of Study	6
1.5 Organization of the Study	7
2. LITERATURE REVIEW	10
2.1 General Framework of Islamic Banking	10
2.2 Evolution of Islamic Banking and Finance: Challenges and Prospects	12
2.3 Non-Islamic Banks offering Islamic Banking Products in Malaysia	15
2.4 Overview of the Challenges and Problems Faced by Islamic Banking in Malaysia in Particular and the Rest of the World in General	17
2.4.1 Bank Selection Process	17

2.4.2	Customer Awareness on Islamic Banking	20
2.4.3	Lack of Standardization	22
2.4.4	Expertise and Knowledgeable Staff in Islamic Banking	23
2.4.5	The Importance of Marketing	26
2.4.6	Competition	27
2.4.7	Tax Discrimination	28
2.4.8	Accounting Standards	28
2.4.9	Risk Management	29
2.4.10	Policy and Regulation	31
2.4.11	Lack of Profit Sharing Finance	33
2.5	Future Prospects for Islamic Banks around the World	34
2.6	Al Rajhi Banking and Investment Corporation	38
2.6.1	Brief History of Al Rajhi Bank	39
2.6.2	Al Rajhi's International Presence	42
2.6.2.1	Malaysia (ARBM)	42
2.6.2.2	Kuwait (ARBK)	43
2.6.2.3	Jordan (ARBJ)	43
2.6.3	ARBM	43
2.6.3.1	Vision and Guiding Principles of ARBM	44
2.6.3.2	The Management Structure of ARBM	46
2.7	Summary	48
3.	RESEARCH DESIGN AND METHODOLOGY	49
3.1	The Research Type	49
3.2	Data Collection Method	50

3.3	Research Instruments	51
3.4	Sampling Method	51
3.5	Data Collection	52
3.6	Content Analysis	54
3.7	Limitation of Research	56
3.8	Summary	57
4.	DATA ANALYSIS AND FINDINGS	58
4.1	Theme 1: Attraction of Foreign Islamic Banks to Malaysia	58
4.1.1	Driving Forces of the Country	60
4.1.1.1	Size and Growth	60
4.1.1.2	Sound Regulatory System	62
4.1.1.3	Tax Neutrality	62
4.1.1.4	Product Innovations	62
4.1.1.5	Large Pool of Investors	63
4.1.1.6	Gateway to Asia and Middle East Market	63
4.1.1.7	Middle East Economics and Cultural Links	64
4.1.1.8	Global and Regional Centres for Islamic Finance Institutions	65
4.1.2	Regulatory and Supporting Frameworks	65
4.1.2.1	Regulation	66
4.1.2.1.1	Licensing and Supervision	66
4.1.2.1.2	<i>Sharī'ah</i> Advisory Council	66
4.1.2.2	Supporting Framework	67
4.1.2.2.1	Tax	67

4.1.2.2.2	Sovereign <i>Sukuk</i>	67
4.1.3	Guidelines and Procedure for the Entry of Islamic Banks	68
4.1.4	Islamic Banking Hub	69
4.1.4.1	Malaysian International Islamic Financial Centre (MIFC)	69
4.2	Theme 2: Entrance to the Market	70
4.2.1	Entrance Phase	70
4.2.2	Al Rajhi makes its Footprint in Malaysia	72
4.3	Theme 3: Strategies used to move forward	75
4.3.1	Core Banking Strategies utilized for expansion	75
4.3.2	Present position of Al Rajhi Bank in Malaysia	77
4.3.3	SWOT Analysis of ARBM	77
4.3.3.1	Strengths	78
4.3.3.2	Weaknesses	79
4.3.3.3	Opportunities	79
4.3.3.4	Threats	80
4.4	Theme 4: Challenges faced by Al Rajhi Bank Malaysia	80
4.4.1	Adapting to the market	80
4.4.2	Issues of being the strict <i>Sharī'ah</i> player	81
4.4.3	Introducing innovative products	81
4.4.4	Staying ahead of Competition	82
4.4.5	Retaining the talented workforce	82
4.5	Theme 5: Future Prospects and Directions of the Bank	82
4.6	Summary	84

5. CONCLUSIONS AND RECOMMENDATIONS	85
5.1 Discussions	85
5.1.1 Regulatory concern	86
5.1.2 Transparency Issue	86
5.1.3 Tax Issues	87
5.1.4 Supply of Competent Human Resources	88
5.1.5 Widening the Range of Products to Compete Successfully	88
5.1.6 Future Prospects for Foreign Banks in Malaysia	89
5.2 Recommendations	89
5.3 Future Research	90
5.4 Summary	91
BIBLIOGRAPHY	93
APPENDIX – A	104
APPENDIX – B	134
APPENDIX – C	136
APPENDIX – D	138
APPENDIX – E	150
APPENDIX – F	197

LIST OF TABLES

Table 3.1	– Interview Summary	53
Table 3.2	– Data Analysis Themes	56

LIST OF MAPS

Map 2.1	- Al Rajhi Bank, geographical locations around the world	42
Map 2.2	- Al Rajhi Bank Malaysia branches nationwide	44

LIST OF FIGURES

Figure 2.1	– Malaysia’s Progress in Islamic Banking	15
Figure 2.2	– Breakdown of the Assets of Islamic Banks around the World	35
Figure 2.3	– Market Share of Islamic Banking around the World	35
Figure 2.4	– Timeline of the Establishment and Development of Al Rajhi Bank	40
Figure 2.5	– Key Areas of Operation of Al Rajhi Bank Saudi Arabia	40
Figure 2.6	– Financial Performances of Al Rajhi Bank Saudi, A Comparative Index	41
Figure 2.7	– Products and Services offered by Al Rajhi Bank Malaysia	46
Figure 3.1	– The Process and the Relationship of Qualitative Data Analysis	54
Figure 4.1	– Malaysian Islamic Banking Industry Data	59
Figure 4.2	– Malaysia’s Relative Position in the Global Islamic Finance	60
Figure 4.3	– Total Assets, Financing, and Deposits of Malaysian Islamic Banking Institutions	61
Figure 4.4	– Market Share of Islamic Banking in Malaysia in 2009	61
Figure 4.5	– Regional 5-Year GDP Growth Forecasted	64
Figure 4.6	– Islamic Regulatory and Supporting Framework	68
Figure 4.7	– Market Entry Procedures for Islamic Banking in Malaysia	69

LIST OF ABBREVIATIONS

AAOIFI	:	Accounting and Auditing Organisation for Islamic Financial Institutions
AASB	:	Australian Accounting Standards Board
ARBJ	:	Al Rajhi Bank Jordan
ARBK	:	Al Rajhi Bank Kuwait
ARBM	:	Al Rajhi Banking and Investment Corporation (Malaysia) Berhad
ARBS	:	Al Rajhi Bank Saudi Arabia
ATM	:	Automated Teller Machine
BBA	:	Bai Bithaman Ajil
BIMB	:	Bank Islam Malaysia Berhad
BNM	:	Bank Negara Malaysia
BOD	:	Board of Directors
FIB	:	Foreign Islamic Banks
GAAP	:	Generally Accepted Accounting Policies
GCC	:	Gulf Cooperation Council
HSBC	:	Hong Kong and Shanghai Banking Corporation
IDB	:	Islamic Development Bank
IFSB	:	Islamic Financial Services Board
IiBF	:	International Institute of Islamic Banking and Finance
IMF	:	International Monetary Fund
INCEIF	:	International Centre for Education in Islamic Finance
ISRA	:	International <i>Sharī'ah</i> Research Academy for Islamic Finance
KFH	:	Kuwait Finance House
KPMG	:	Klynverd Peat Marwick Goerdeler
MSC	:	Multimedia Super Corridor
OCBC	:	Oversea-Chinese Banking Corporation
OIC	:	Organization of Islamic Countries
POS	:	Point of Sale
RM	:	Ringgit Malaysia
SAC	:	<i>Sharī'ah</i> Advisory Council
SCM	:	Security Commission Malaysia
STC	:	Saudi Telecom Cooperation
UAE	:	United Arab Emirates
UK	:	United Kingdom

ABSTRACT

In recent years, Islamic Banking and Finance has become the fastest growing sector in the global finance and banking industry. This industry in Malaysia has witnessed a tremendous growth in terms of demand, acceptance and development since it was first introduced in 1963. At present, Malaysian government has plans to make Malaysia as an International Islamic banking hub in the region by further liberalizing the industry by offering licenses to qualified foreign Islamic banks to operate in Malaysia. This research is principally a study of the survival of the foreign Islamic banks in Malaysia. Although, Islamic banking industry in Malaysia has survived well despite the obstacles and constraints of dual system, they continue to face challenges and foresee better prospects as well. Accordingly the study has focused on the establishment and performance of Saudi-based Al Rajhi Bank in Malaysia. A thorough study is undertaken of the bank and first hand interviews were conducted with all those concerned personnel of Al Rajhi Bank Investment Corporation Berhad and selected individual regulators. The researcher identifies the challenges and the strategies which have been adopted by the bank to further expand its horizon in Malaysia. The challenges that were pertinent to the foreign Islamic banks include the issue of being a strict *Sharī'ah* player, regulatory concerns, tax issues and the shortage of talented experts in the country. Meanwhile the growth prospects for Islamic banking industry in Malaysia look promising, particularly given the fact that the region is expected to be a major driver of economic growth. This study is concluded with several recommendations to address these challenges for better economic integration and partnership so as to attain the status of a comprehensive bank that integrates and mergers with other Islamic banks in the country.

CHAPTER ONE

INTRODUCTION

1.1 Background of Study

One of the significant developments in the Muslim world during the last two decade and a half is the emergence of Islamic banking, which has appeared as a powerful movement. Although some attempts to reorganize banking activities along Islamic lines go back to the early sixties, the concept of Islamic banking is even older.

Islamic banking theory and practice ideally draw upon central tenets of Islam. The basics thus dates back to the Noble Prophet Muhammad (Peace be upon him and his descendants) who emphatically taught his followers to keep economic considerations subordinated to moral consideration. Islam lays great emphasis on maintaining a balance between the conflicting interest of individuals and the different sections of society. Islamic banking is therefore differentiated from much narrower concept of interest-free banking, which essentially deals with instruments, services and operations devoid of interest (Hussain, 2005).

Islamic banking refers to a system of banking, which is consistent with *Sharī'ah* (Law), and guided by Islamic economics. Islamic law prohibits the payment and collection of *ribā* (interest or usury). The main argument against interest is that money is not used as a commodity with which to make more money but that it should be earned on goods and services only. Features of Islamic banking are based on ethical

principles. *Sharī'ah* allows all economic activities in the framework of protecting public interest and safeguarding it. Further, in Surah al-Baqarah, Allah (swt.) says:

“O you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing. Let him who incurs the liability dictate, but let him fear his Lord God, and not diminish aught of what he owes” (2:282)

Further the main objective of the *Sharī'ah* framework is to ensure a society that is free from all traces of injustice (*zulm*), in order to achieve socio-economic justice. As such, the *Sharī'ah* explicitly prohibits transactions involving *ribā* (usury), uncertainty (*gharar*), price manipulations, hoarding, market interference, exploitation and fraud. In addition, the obligation of *zakāt* from the social perspective is considered as an important tool to alleviate poverty by making the rich alive to the social responsibilities.

Islamic Banking and Finance industry has emerged on the international financial landscape in a relatively short time. The same was echoed by Dr. Asutay (2008) in his article “The ways ahead in Islamic Investment Banking” wherein he observes that the phenomenal growth of the Islamic banking and finance industry has been remarkable since it came into existence just over thirty years ago.

From the humble beginning in 1970s when the first commercial Islamic Bank was established in Dubai followed by Jeddah-based set up of multilateral development institution, the Islamic Development Bank (IDB), in 1975. Since then the Islamic financial industry has enjoyed consistently high growth and continues to grow rapidly around the globe. Islamic banking and finance has undergone rapid transformation and growth from an industry striving to satisfy the Muslim community

needs, to a multibillion dollar industry upholding Islamic principles. At present there are more than 300 Islamic Banking institutions in over 65 countries and according to some conservative estimates the total assets classified as Islamic exceeds over US\$600 billion (Askari, Iqbal and Mirakhor, 2009). Islamic banking and finance industry is now in its fourth decade and has developed rapidly. According to Dr. Zeti Akhtar Aziz¹, the Islamic banking and finance is ascending to greater prominence in the global financial system and has fast extended beyond the traditional predominantly Muslim economies to major industrial economies.

However with the rapidly changing international Islamic financial landscape, Islamic banking in Malaysia is now becoming increasingly integrated to the international financial system (Zeti, 2008). Islamic banking in Malaysia differs from Islamic banking in the Gulf and the rest of the world (Samad, Gardner, and Cook, 2005). The country's first Islamic bank, Bank Islam Malaysia Berhad (BIMB), was established in July 1983. A decade later, the government introduced the Interest Free Banking Scheme, which made Malaysia among the first to have a full-fledged Islamic banking system operating side-by side with the conventional banking system. With Malaysia pioneering in the Islamic Banking industry globally and being the main driver for drawing up the framework for setting up of the Islamic Development Bank. The country is leading its way to become the international hub for Islamic banking and finance.

Over the decade cumulative government policies, action and initiatives have resulted in Malaysia being at the forefront of the Islamic finance as well as having one

¹ Current Governor of Bank Negara Malaysia

of the largest Islamic finance markets in the world. The Malaysian government has taken several key initiatives to position Malaysia as an Islamic banking and finance gateway, between the Middle East and Asia Pacific. Among Malaysia's key Islamic financial initiatives are the issuances of new licenses to foreign Islamic banking institutions and *Takaful* operators. Bank Negara Malaysia has issued three new Islamic banking licences to major Gulf Islamic banking institution such as Saudi-based Al Rajhi Bank Saudi (herein after referred to as ARBS), Kuwait Finance House and Gulf based Asian Finance Bank. Besides participating in the local market, the foreign banks have the opportunity to use Malaysia as the platform to expand the operations to the rest of Asia.

Islamic banking industry in Malaysia is currently facing serious competition as foreign Islamic banks have moved into establishing their branches in this fast developing country. This research will be focusing on Al Rajhi Banking and Investment Corporation (Malaysia) Berhad (herein after referred to as ARBM) to understand the challenges it has undergone in setting up its operation in Malaysia as the first foreign Muslim-owned Islamic Bank and its future prospects in Malaysia.

1.2 Research Objectives

The aim of this research is to find out the main challenges and the prospects for the future development of ARBM. The specific objectives of the study are as follows:

- a. To evaluate the present status of ARBM in the Malaysian Islamic Banking industry and identify the factors that influenced ARBS to set its branch in Malaysia.

- b. To critically discuss the barriers or limitations faced by ARBM in setting its foothold in Malaysia and the future development of foreign Islamic Banks in Malaysia.
- c. To explore and study the strategies that ARBM has adopted to expand its operations in Malaysia.

1.3 Research Problems

Islamic Banking and Finance today exist in all parts of the world, and are looked upon as a viable alternative system which has many solutions to offer. This system initially was introduced to fulfill the needs of Muslims, and at present it has been transformed into a multibillion dollar industry upholding Islamic principles. This paper aims to study the challenges ARBM has undergone in setting up its operation in the foreign soil and future prospects of the bank. The following research questions will help towards a thorough analysis of the bank:

- (i) How does ARBM position itself in the Malaysian Islamic Banking Industry?
- (ii) What were the factors that persuaded ARBM to setup its branch in Malaysia?
 - (iii) How ARBM dealt with the challenge of meeting the needs and wants of Malaysian market?
 - a. Regulatory aspect
 - b. Market Penetration, Segmentation and Positioning?
- (iv) How does ARBM view the future development of foreign Islamic Banks in Malaysia?

- (v) What are the barriers faced by ARBM to gain the competitive advantage in terms of expanding their operations?

Answers to these questions would help us to achieve the objectives of this research.

1.4 Significance of Study

This research has some significance to several parties:

1. Malaysian Government: The research will provide references for the Malaysian Government to assess its long term planning in supporting the Islamic Banking industry and making the industry more conducive for attracting the foreign players into the country.
2. Foreign Islamic Banking players: The research can provide an insight into the existing and potential foreign players who are planning to enter the Malaysian Islamic Banking industry as to the challenges and prospects ahead.
3. Academician/Researchers: The research can be used by prospective researchers in the academic field as a reference for future research.
4. Public: Public both the employees and students in the field of Islamic Banking can use this research to understand the prospects of the Islamic Banking industry in the near future in Malaysia and how attractive it is for foreign players to enter the industry.

1.5 Organization of the Study

This research paper is organised into six chapters, where each chapter has its own distinctive objective and the sequences of the chapters are based on the logical flow of the research process. The following is a brief explanation of each chapter that would serve as a road map through this research process.

Chapter One: Introduction

This introductory chapter provides a brief discussion on the background to the study, an outline of the objectives of the study, a significant issue of the study and the limitation of the study throughout the completion of the research and a guide to the remaining chapters of the thesis.

Chapter Two: Literature Review

The theoretical bases for the research are established by studying previous works and researches related to Islamic banking industry. Moreover, the study looks into the backgrounds of the non-Muslim Islamic Banks offering Islamic banking products and the historical evolution of Islamic banks. For comparison purposes a study on the challenges and prospects of Islamic banking institutions in various countries around the globe will be presented prior to concluding this chapter. The main aim of this chapter is to find areas that are not addressed by previous studies. A detailed background study of ARBM bank will also be presented, giving an insight about the background of the interviewees. Furthermore, chapter gives an insight into the

establishment of ARBM and its development in Malaysia. In addition, a comprehensive SWOT analysis was carried out.

Chapter Three: Research Design and Methodology

This chapter will look into explanation of the research type, approach, sampling and data collection methods used for this study. The method used to meet the objectives of the study includes interviews and thorough study of the secondary information. The interviews are divided into two sections:

- a- Interviews focusing on the challenges and prospects experienced by ARBM in Malaysia.
- b- Interviews targeted at personnel from BNM and SC to learn about the future policies formulated to develop this industry as a whole.

The Research instruments are semi-structured personal, email and telephone interviews to be conducted with the ARBM unit's managers and personnel under study.

Chapter Four: Data Analysis and Finding

This Chapter synthesizes all the data collection methods and presents a summary of the data and information. Subsequently, the data analysis will be carried out using various themes to get a clearer picture of what the ARBM has experienced in Malaysia and the future prospects of the bank.

Chapter Five: Conclusions and Recommendations

The researcher provides the final conclusion on the whole paper and the necessary recommendation. This chapter also looks in a summary of the limitations of the research and the future direction for the relevant research is proposed as a supplement to this paper.