

in 1996. We are not sure whether the current market is saturated or the competition is getting stronger and tougher. But one thing, which we are sure, is that it is now more difficult for the bank to set up a branch than before.

6. Its Operations

The primary objective of an Islamic Bank is to provide banking, financing and trading related facilities to Muslims who are eager to engage their business activities under Shariah principles, as the conventional banking system in anyway involves the element of interest or Riba which is prohibited by Islam in any formation. Whenever there is a Muslim community, there is always a need for them to follow Shariah principles. No matter where these Muslims live, no matter whether they are a majority or minority in a community, state, country or in a region, and no matter in what social system they live. If they choose to live as Muslims, they have to deal with interest in this so-called modern society. Interest, like invisible hand, is everywhere in the conventional banking system. Whether they like it or not, they have to face it. The need of Islamic Banking facilities comes naturally. Even Muslims, who are living under Communist regime in China, are often annoyed with the "invisible hand". When they receive interest from banks, they often do not feel comfortable with it, if they choose to use it as ordinary money, for them it means to take "Haram". Of course, one has the free will to ignore the

problem. However, we are here talking about Muslims who are facing a dilemma of practising Shariah Laws in their daily life. In Islam, interest is "Haram", and everyone knows it. The question is how to convert "Haram" to "Halal". Hence, from consumers' points of view, there is a need of Islamic banking services, which should help the consumers to solve the problem of interest. Hence, it is marketers' job to fulfil that need with right tools at right time. One of the right tools is to operate and implement an Islamic Banking System in that community.

6.1 How it collects funds

Based on Islamic principles, the bank accepts deposits from customers through the following operational instruments:

- (a) Al-Wadiah Saving Account
- (b) Al-Wadiah Current Account
- (c) Al-Mudharabah General Investment Account
- (d) Special Investment Account
- (e) Al-Mudharabah Saving Account

The bank's operations to collect funds mainly were dominated by accepting customer's deposits and utilising the funds through financing activities permitted by the Shariah-Islamic law. The bank and its customers share profit margin jointly if any. The difference between

Islamic Bank and conventional banks is that the Islamic bank accepts customers' deposit by offering no interest and conventional banks offer interest to its customer.

Bank Islam operates by utilising the following instruments to collect funds from Muslim individuals, institutions as well as from non-Muslims and the general public.

(a) The Principles of Al-Wadiah Saving Account

- (1) The bank accepts deposits from the customers for safe custody.
- (2) The customers have full right to withdraw their savings with the bank at any time and the bank guarantees to refund.
- (3) The bank may ask permission from the customers to use the funds so long it remains with the bank.
- (4) Any profit if generated from such utilisation belongs to the bank.
- (5) However, the bank may allocate certain amount of the profit generated through such utilisation to reward the customers for saving their funds in the bank.

(b) The Principles of Al-Wadiah Current Account

- (1) The bank accepts customers' deposits in the form of

current account under this principle.

(2) The bank may ask permission from the customer to utilise any fund remained with the bank.

(3) If any profit generated by utilising such fund belong to the bank.

(4) The customers have the full right to withdraw any fund remained with the bank and the bank guarantees to refund.

(5) The bank provides services and cheque books associated with Current Account.

(c) The Principles of Al-Mudarabah Investment Account

(1) The bank accepts deposits from customers who are looking for Investment opportunities for their funds in the form of general Investment Account under the principle of Al-Mudharabah.

(2) The deposits must be fixed for a period of time as agreed by the bank.

(3) The bank acts as " Financial Agent " or " Entrepreneur " and the customers act as " providers of capital ". Both parties agree on how to share profit if any from such investment. At the moment, the bank and customers profit sharing ratio is 3:7.

(4) If any loss incurred, the customer will have to bear.

(5) The customers shall not interfere with the bank on how the fund should be managed and invested.

(d) The Principles of Special Investment Account

(1) The bank accepts deposits from customers who are looking for investment opportunities for their funds in the Special Investment Account under the principle of Mudarabah.

(2) The bank may select projects when it deems profitable, and these projects are mostly from government or corporate.

(3) Both parties negotiate profit and loss sharing ratio.

(4) The bank may also provide certain amount of capital, thus, acting as a capital provider as well as an agent, while the customers act as one of the " capital provider parties".

(e) The Principles of Al-Mudarabah Saving Account

(1) The customers deposit their money into the Saving Account and the bank will invest it.

(2) The profit , if any, gained from the investment will be shared between the customer and the bank based on an agreed ratio. This profit will be calculated monthly based on the average daily balance and credited into the customers account monthly.

(3) The customer can withdraw the fund at any time and the bank guarantees to refund any balance remained with the bank.

6.2 How efficient it is in collecting funds

The bank collects fund through above mentioned instruments from the general public which can be from Muslim individuals, families, communities, organisations, government agencies as well as Non-Muslims in a competitive market which consists of conventional banking system and Islamic banking system. Can an Islamic bank accept Non-Muslims deposits? The Answer is affirmative. Below is a series of performance ratios to measure the bank's performance and customers acceptance to the bank. First, to see the bank's performance, we should evaluate its total deposit value, growth rate and total assets. If the bank does not operate well, it will not collect significant funds from public. Secondly, we should examine its profitability and returns to its depositors and shareholders, even though, being an Islamic bank, profitability is not its primary objective, but the general public and investors do care about the returns, which will have an impact on the management performance. Thirdly, we should measure the utilisation of it collected funds because it will reveal to us how Islamically and efficiently the bank is in its operations and management.

6.2.1 General Performance Evaluation

To measure the bank's fund collections from the general public, some researchers evaluate the number of depositors to explain its popularity and to show how the bank is accepted. But, I do not agree on this measure. Increasing in the number of depositors can show its popularity and acceptance. The measurement of the bank's performance should be based on how much fund it collected. For example, an increase in the number of depositors from 1,000 to 10,000 (growth rate 900%) does not prove that the bank performed well. But, if the total deposited value increases from RM100 million to RM1,000 million (growth rate 900%) in the same period, this means the bank is an attractive institution to its customers.

Table 2 Amount of Deposits (RM million), Growth Rate (%) and Return on Deposits (%)

Y e a r	D e p o s i t (m i l l i o n)	G r o w t h (%)	R e t u r n (%)
1 9 8 9	1 , 2 2 9		4 . 6 4
1 9 9 0	1 , 2 2 1	- 0 . 6 0	4 . 7 2
1 9 9 1	1 , 1 7 5	- 3 . 7 6	5 . 3 6
1 9 9 2	1 , 3 2 1	1 2 . 4 0	5 . 8 4
1 9 9 3	1 , 6 1 2	2 2 . 0 0	6 . 3 8
1 9 9 4	2 , 5 5 1	5 8 . 3 0	5 . 6 0
1 9 9 5	2 , 8 7 0	1 2 . 5 0	5 . 1 6
1 9 9 6	3 , 2 0 2	1 1 . 6 0	5 . 8 3

Sources: BMB Annual Reports 1989-1996

Table 2 shows us the general performance of the bank in terms of amount of deposits, growth rate of deposits and return on deposits. When

the return, for example, increased from 4.72% in 1990 to 6.38% in 1993, the corresponding deposited value increased from RM 1,221 million in 1990 to RM1, 612 million in 1993. This positive correlation between the return to depositors and deposited value was valid before 1993, which was also the 10th Anniversary of the bank. After 1993, even though, the annual deposit value increased significantly from RM1, 612 million in 1993 to RM3, 202 million in 1996, but the return to depositors decreased from 6.38% in 1993 to 5.83% in 1996. In another word, after 10 years of operation, the rate of return would not be an incentive tool being used to attract deposits.

We have noticed that there was a positive correlation between the return on deposits and deposited value before 1993. One might argue that we should not forget the Law of Diminishing Return, but it is not necessarily true. Logically, the higher the return the depositors receive, the more the customers would deposit their funds into the bank. In the case of Bank Islam Malaysia, for example, the annual total deposited value was RM2, 870 million in 1995 which was higher than the deposited value (RM1,612 million) in 1993, but the return to depositors declined from 6.38% in 1993 to 5.16% in 1995. What can we say in such situation? There is a possible explanation that the bank's management is very conservative on the payment of return to depositors in order to ensure the bank grows gradually and steadily.

6.2.2 Sources of the funds

In order to measure its fund utilisation, we should know how much it collected from customers annually and how fast it was in collecting fund. Then, we can make a meaningful study. Table 3 shows us how much it collected annually and its growth rate.

Table 3 Deposits from Customers (RM Million) and Annual Growth Rate

Year 19xx	86	87	88	89	90	91	92	93	94	95	96
Current A/C	57	123	142	141	197	220	262	349	440	595	734
Growth Rate		117%	0.16	-1.2%	40%	12%	19%	33%	26%	35%	23%
Saving A/C	78	114	153	182	213	250	275	325	383	468	612
Growth Rate		46%	34%	19%	17%	17%	10%	18%	18%	22%	31%
Investment A/c	441	589	748	950	849	705	566	607	1,278	1,801	1,847
Growth Rate		33%	27%	27%	-11%	-17%	-20%	7%	111%	41%	2.6%
Total funds	576	826	1,043	1,273	1,259	1,175	1,103	1,281	2,101	2,864	3,193
Growth Rate		43%	26%	22%	-1.10%	-7%	-6%	16%	64%	36%	11%

Sources: BIMB Annual Reports 1986-1996

Table 3 shows that the bank had negative growth for three consecutive years, which were 1990, 1991 and 1992. The negative growth over the three-year period might be unusual and it might relate to some internal problems. It was expanding aggressively in the early period. However, it slowed down in the early 1990s and this might be also influenced by external factors, for example, liberalisation of the base lending rate might have contributed to the decrease in the growth of

deposits. When conventional banks were allowed to set the rate of return to deposits freely, the higher rate of return offered by them might be attracting those BIMB depositors whose primary objective was seeking high return to switch to conventional banks.

In the later years, which were 1993, 1994 and 1995, the growth of deposits were very encouraging. Due to the country's robust economic growth, commercial banks and finance companies recorded good profits. Total deposits in the industry during this period averaged 10% and Bank Islam Malaysia performed very well (36% in 1995) compared to the industry (Malaysian Business 1995).

The figure in 1996 shows us that this good time will not last forever. Local banks and finance institutions have been operating in a sheltered environment. Current figures (1996) should serve as a warning. Foreign participation in the Malaysian commercial banking industry is quite high, for example, foreign participation accounted for 32% of total paid up capital, 35% of total deposits, 36% of total loans, 37% of total trade financing business and 46% of total pre-tax profits (Malaysian Business 1996). In the next 10 years, we can expect to see that the local banking industry has to face challenges from outside competitors. Local banks are now allowed to provide Islamic services, as a result, Bank

Islam Malaysia will lose its privileges and market power. Hence, it will face more serious challenges in the future.

6.3 How it utilises the funds

Bank Islam Malaysia uses a number of instruments to finance its customers. They are divided into following categories:

a. Projects Financing Instruments

- (1) Bai House Financing
- (2) Land Financing
- (3) Shop and Shop-house Financing
- (4) Umrah and Ziarah Financing
- (5) Tour Package Financing
- (6) Personal Computer Financing
- (7) Naqad Overdraft Facility
- (8) Vehicles Financing
- (9) Leasing of Equip. & Machinery

b. Trade Financing Instruments

- (1) Letter of Credit
- (2) Murabahah Working Capital Financing
- (3) Islamic Accepted Bill ----Import
- (4) Islamic Accepted Bill-----Export

- (5) Islamic Export Credit Refinancing Scheme

c. Other Financing Instruments

- (1) Zakat Payment
- (2) Remittance
- (3) Sales/Purchase of Foreign Currency
- (4) Sale/Purchase of Traveller's Cheque
- (5) Investment/Portfolio Management

Even though so many instruments were used by the bank to channel its collected funds, but in terms of utilising the collected funds, there are only six most significant modes of financing. They are:

- (a) Al-Bai Bithaman Ajil
- (b) Al-Murabahah
- (c) Al-Ijarah
- (d) Al-Mudarabah
- (e) Al-Musharakah
- (f) Al-Qardhul Hassan

Table 4. Funds Utilisation and Modes of Finance (%)

Instruments	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Al-Bai Bi'haman Ajil	77	79	76	76	71	74	72	72	72	61	67
Al-Murabahah	16	15	19	21	18	13	19	17.6	18.8	31	24
Al-Ijarah	4.9	3.4	2.9	3.1	11.2	13	11	10	9.2	6.9	7.3
Al-Mudarabah	0.3	0.3	0.3	0.06	0.04	0.04	0.22	0.2	0.3	0.79	0.99
Al-Musharakah	2.2	2.1	1.8	0.01	0.01	0.01	0.39	1.85	1.8	1.2	1
Al-Qardhul Hassan	0.1	0.5	0.4	0.06	0.07	0.07	0.1	0.12	0.09	0.11	0.08
Total	100	100	100	100	100	100	100	100	100	100	100

Sources: BIMB Annual Reports 1986-1996

(a) Al-Bai Bithman Ajil

As Table 4 shows, Al-Bai Bithman Ajil claimed the highest portion of financing. In the past 10 years, its proportion was more than 70% of total financing. This mode of financing recognises payment by instalments. Suppose you want to buy a house which is being sold at current market price RM7,000 and you do not have that money, you approach the Islamic bank, the bank will buy the house on your behalf at that market price. You then purchase the house from the bank with an offering price of RM10,000 on an instalment basis, for example, you may pay the bank with an amount of RM500 monthly instalment within 20 month-payback period ($RM500 \times 20 = RM10,000$). The total payment to the bank will be RM10,000 after 20 months. You knew the market price (RM7,000) of the house and the bank's offering price (RM10,000), you are free to accept or decline the offer and the transaction is absolutely Halal. If you do not pay back that amount of money within 20 months, the bank will have right and call back the title of the house.

Now, the scholars and researchers are asking on what basis the bank calculates that extra RM3,000 ($RM10,000 - RM7,000$). Because, for example, if a customer makes a loan from a conventional bank, let's assume the annual lending rate is 10%,

so the monthly lending rate will be 0.83% ($10\% \div 12$), the total amount of loan is RM7,000, after 20 months the customer will have to pay back to the conventional bank with a total amount of $p=7000(1+0.0083)*20=RM8,258$, which is lower than RM10,000. Clearly, Bank Islam Malaysia charges higher than conventional banks by an amount of RM1,742 ($RM10,000 - RM8,258 = RM1,742$). Perhaps Bank Islam Malaysia will argue that its operation is based on Shariah Principles, and conventional banking operation is "Haram". But, the fact is that Bank Islam charges a high instalment than the conventional banks. Hence, it is widely criticised by the scholars and researchers.

This situation was explained by Zakaria Man, Dean of Postgraduate Studies, International Islamic University, Malaysia in this way when he shared with me his experience on Islamic Banking System: " Under Al-Bai Bithaman Ajil, the customer is like a chicken. Under conventional banking system, the chicken is slaughtered with a very sharp knife, so the chicken does not feel painful, even though it is 'Haram'. Under the Islamic banking system, the chicken is slaughtered with a wooden knife, even though it is 'Halal', it is very painful. But why do we have to slaughter a chicken 'Halal' with a wooden knife ? "

(b) Al-Murabahah

As Table 4 shows, Al-Murabahah claimed the second largest portion of the total financing. Al-Murabahah financing mode is similar to Al-Bai Bithaman Ajil. The difference between Al-Murabahah and Al-Bai Bithman Ajil is that Al-Murabahah does not recognise payment by instalments. Under Al-Bai Bithman Ajil financing mode (defer instalment sale), the bank finances the customers who wish to buy an asset but defer payment for a specific period or pay by instalment. The bank buys the asset and sells it to the customer at an agreed price which comprises the asset's actual cost to the bank and its profit margin to the bank. The customer settles the amount by instalments. Whereas, under Al-Murabahah financing mode (defer lump sum sale), all procedures are similar to Al-Bai Bithman Ajil financing mode except that the customer who wish to buy the asset at the an agreed price must settle down the payment without instalments.

Both instruments constituted over 90% of the total financing. Both of them were criticised by scholars and they suggested that these two tools should be phased out. Their profit margin calculation is very much similar to interest. As a result, the scholars questioned whether the bank's operations were based on Shariah principles. Due to this reason, it gave the public a wrong

impression that Bank Islam Malaysia is similar to a conventional bank.

(c) Al-Ijarah

Al-Ijarah financing claimed the third largest portion of the total financing as Table 4 shows. Al-Ijarah grew significantly from 4.9% in 1986 to 13% in 1991 which was the highest rate during the period of evaluation, after that, it declined in the next five years until in 1996 it began to climb again.

Under this financing mode, the bank finances its customers to acquire the right to use the services of an asset. The bank buys the asset and leases(lease rentals and other terms as agreed) to the customer for a fixed period. Hence, it is called as Islamic leasing.

(d) Al-Mudarabah

This is the most preferred financing mode by Islamic scholars and researchers. Because it is directly based on Shariah principles, it is the core concept of Islamic financing. It is based on profit sharing, based on partnership. It is very Islamic and an ideal business relation between the lender and the borrower. Unfortunately, it became the least choice of the bank. As Table 4 shows, that in the past 10 years, Al-Mudarabah financing

constituted less than 1 percent of the total financing. It is quite surprising that while it is the most favourable tool in Islamic financing yet it was the least attractive financing tool to the bank.

Al-Mudarabah Financing is based on trust and partnership. If it is a small amount of money, you can take risk to trust a person to finance his/her project/business. However, if it is a big amount of money, you cannot afford to take risk. No one dares to finance your project with million dollars without guarantee. As one of retailing managers claimed that there was lack of honest and trustworthy entrepreneurs. BIMB was cheated by some of its customers in the past. The agency problems, as we discussed before are very serious under Al-Mudarabah Financing, since the financier cannot interfere the entrepreneur's operation and the entrepreneur will try best to maximise his project cost as much high as possible, otherwise, there is no incentive for him. For example, consider the profit and loss sharing ratio is 7:3 between the financier (an Islamic bank) who provides the capital and the financee (an entrepreneur) who receives the capital from the financier to do business. If the entrepreneur makes RM1.00 profit within a period, the financier will share 70 sen, and the entrepreneur will share 30 sen. If the entrepreneur then increases the project cost by 10% (assuming), the profit will be reduced to 90

sen to be shared between the two parties. The project cost can come from the entrepreneur's subsidiaries or the entrepreneur simply increases his or her operation cost. The financier now can share 63 sen and the entrepreneur actually shares 37 sen (27 sen +10 sen =37 sen). So the actual sharing ratio would be 63:37 instead of 70:30 in favour of the entrepreneur. Under Al-Mudarabah financing mode, the financier cannot interfere with the entrepreneur's project activities.

As the former Managing Director said that Bank Islam is commercial bank and it has to make profit to satisfy both its depositors and shareholders. Once, the profit maximisation becomes its objective, it will put all its sources where it deems profitable. As a result, if the Mudarabah financing is too risky, of course, it will not invest a project under this mode.

Regarding financing long term projects/businesses under Mudarabah principle, the bank also argued that long-term financing projects were risky and the bank did not have sufficient and qualified personnel to undertake those projects under Mudarabah principle.

(e) Al-Musharakah

Al-Musharakah mode is an easy way out for Islamic banks to abolish *riba* and it is similar to joint-venture profit sharing. Under this mode, the bank and project's initiator both provide the whole financing in agreed proportions. Both parties have the right to participate in the management. However, they also have the option to waive such a right. In the event of a loss, both parties will have to bear it in proportion to their shares in the financing.

(f) Al-Qardhul Hassan:

Under this mode, the bank provides loans to those deserved customers without any charges. It reflects on how the organisation discharges its social responsibility while making profit.

Table 4 shows us that the contribution of Qardhul Hassan has been declining from 0.1 per cent in 1986 to 0.08 per cent in 1996. This shows that the bank does not like to provide loans to deserved customers without a charge, even though it is making a profit (see Table 5). Thus, it has been accused of concentrating on profit maximisation and ignoring social responsibility.

Now, we understand why Halim, its former Managing Director, stressed that the bank belonged to commercial sector whose main task was to make profit under Shariah principles.

By analysing the Al-Bai Bithman Ajil, Al-Murabahah and Al-Ijarah above, we now understand why some people claimed that in many respects, Bank Islam Malaysia is similar to the conventional banks.

6.4 Efficiency in Fund Utilisation

Table 5 Sources of Funds, Financing (RM' 000), Utilisation Ratio (%) and Profits (mil)

Year	1992	1993	1994	1995	1996	Average
Total Deposits(TD)	1,320,509	1,611,682	2,547,799	2,865,963	3,196,281	2,308,447
total Financing(TF)	1,052,242	1,037,634	1,027,096	1,495,267	2,046,435	1,331,735
Utilisation TF/TD	80%	64%	40%	52%	64%	60%
Profit	16	26	32	42	38	31
All Banks TL/TD	93.9%	83.50%	84.40%	89%	89.10%	86%
Islamic banking TF/TD	83.60%	79.70%	70.90%	83.60%	71.60%	79%

Profit: before Zakat and Taxation, Deposits: more than one year

Sources: BIMB Annual Reports 1992-1996

On average, the utilisation (financing to deposits) ratio is 60%, which means that the bank receives RM1.00 as deposit from a customer as one year basis, 60 sen will be utilised to finance projects/businesses. As Table 5 shows, that there was no relation between utilisation ratios

and profit growth rates. Rationally speaking, the more money invested in projects/businesses, the more profit will be made. Otherwise, It would be purposeless to invest more money. However, this may not be true in the case of Bank Islam Malaysia.

6.5 Social Obligation

Evaluation of an organisation's performance should not be merely based on how much profit it has earned. We should also be concerned with its social duties. Even though its former Managing Director claimed that Bank Islam was a commercial bank and not a social welfare organisation, no organisation could be separated from its environment. The initial objective of setting up an Islamic bank in the country was to provide banking facilities to the Muslim customers under Shariah principles. Now, this noble objective has been changed or shifted towards the road of profit maximisation.

Table 6 Zakat Payment/Social Contribution (RM'000)

Year	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Zakat Payment	377	381	368	467	449	663	662	662	662	662	662
Growth Rate		1.10%	-6%	30%	-4%	48%	-0.15%	0%	0%	0%	0%

Sources: *BIMB Annual Reports 1986-1996*

The Zakat (social charity) payment is a religious duty in Islam, whether you like or not you have to pay. It is a direct contribution to the

poor and needy, the Zakat payment ratio is 2.5% on one's properties according to market value. All tangible assets are subject to pay Zakat, the more you have, the more Zakat you have to pay. It is the taxation from the rich to the poor.

Table 6 shows that Bank Islam's Zakat payment grew significantly from RM377,000 in 1986 to RM622, 000 in 1996. But, if you compare the figures in Table 6 and 7, you will find that Zakat payment did not follow the profit growth. For example, the profit grew from RM16 million in 1992 to RM26 million in 1993, but the Zakat payment was the same during the two years. Zero growth in Zakat payment from 1992 to 1993 corresponding 63 percent growth in profits in the same period. Logically, the Zakat payment should have a positive correlation with the income level. However, you can not find this relation existing within the bank.

Table 7 Profits (RM mil) and Rate of Dividends(%)

Year	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Profits*	3.7	4.5	6.2	10	13.4	14	16	26	32	42	38
Growth Rate		22%	38%	61%	34%	5%	14%	63%	23%	31%	-10%
Dividends			20%	30%	40%	50%	60%	80%	90%	90%	90%

Profits *: Profits before Zakat and Taxation

Sources: BIMB Annual Reports 1986-1996

As table 7 clearly shows that Bank Islam may have been allocating its sources on short-term financing or debt financing, as a result, its profit was good in one year and bad in another year. Fluctuation range was mostly within one year, for example, the profit in 1992 was