CHAPTER 1

INTRODUCTION

1.1 Overview

There is a growing interest in Islamic banking and Islamic financial products in recent years in the industry of banking and finance. Financial institutions are discovering a relatively untapped market in the demand for Islamic-based financial products. It is a commonly acknowledged fact that the religion of Islam prohibits Muslims from dealings which contain the element of *riba* or interest, of which is practised by conventional banks. However, due to the relatively non-existent Islamic banking for many years, Muslims have very little choice but to use services of conventional banks or to avoid placing their money in depository institutions. Therefore, there is an unfulfilled need sought after by the Muslim community, of which can be met by pure Islamic banks or by conventional banks offering non-interest Islamic financial products.

In Malaysia, both types of banking services are available. There are currently two Islamic banks in Malaysia, namely Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB). BIMB has been the sole Islamic bank in Malaysia for the last seventeen years whereas BMMB started in 1999[1] . In addition, there are currently 54 financial institutions offering Islamic-based banking services and financial products.

[1] Bank Bumiputra Malaysia Berhad merged with Commerce Asset Holdings to become Bumiputera-Commerce Bank in 1999. The Islamic arm of Bank Bumiputra was re-organised as Bank Muamalat Malaysia Berhad.

Commercial banks compete directly with Islamic banks for deposits and loans as the majority of Muslims are customers of conventional banks. Based on Bank Negara Malaysia's [2] statistics, commercial banks make up 71% (RM 287.6b) of the total deposits in the entire banking system and 76% (RM 285.1b) of the total loans as at June 1999. There are in total 34 commercial banks of which 21 are local banks while 13 are locally incorporated foreign banks. To survive in an environment dominated by commercial banks, Islamic banks must prove that they are financially viable.

1.2 Problem Statement

The purpose of this research is to do a comparative study between the performance of Islamic banks and conventional banks and to gauge the competitiveness of Islamic banks within a banking sector dominated by conventional banks. It is also hoped that this study can highlight some of the strengths and weaknesses of Islamic banks and perhaps provide recommendations on how these weaknesses can be overcome.

In this study, a comparative analysis on the performance of Bank Islam Malaysia Berhad (BIMB) and other commercial banks in Malaysia between 1989-1999 will be carried out. In many ways, this analysis is similar to the analyses by Samad and Hassan (1999), Wong (1995), Radiah (1993) and Man (1988).

[2] Bank Negara Malaysia is the Central Bank of Malaysia

However, there are three main differences. Firstly, this performance comparison involves more commercial banks. In previous analyses, most comparisons have been done with fewer banks. A larger sample of study can help to give a more accurate position of BIMB's competitiveness within the commercial banking sector.

Secondly, the methodology used in this analysis is more comprehensive compared to the ones carried out by previous researchers. BIMB's performance comparison is made based on the comparison of seven main indicators: growth, profitability, liquidity, solvency, credit risk, earnings risk and sectoral contribution.

Thirdly, this analysis also hopes to shed more light on BIMB's performance and recovery during the period of the financial and economic crises of 1997-99. Comparison of BIMB's pre and post crisis performance with other banks will indicate how resilient BIMB is relative to other commercial banks in facing the financial crisis.

1.3 Theory of Banking : Conventional and Islamic

1.3.1 Conventional Banking: Principles and Operations

a. Source of funds

Conventional banks are credit-based. Funds are acquired through three major types of deposits: savings, current and fixed deposit accounts. For the savings and fixed deposit accounts, depositors earn interest on their deposits. The difference between savings and fixed deposits is the time period. For fixed deposits, money is placed at fixed periods from one month to two years or as negotiated where fixed interests are earned. The savings account earns interest on a daily basis and is repayable immediately upon demand. The third account, the current account allows cheque facilities but no interest is paid on the deposits. From the deposits, only a certain proportion of it is retained in liquid and near-liquid form, which is repayable upon depositors' demand.

b. Use of funds

The balance of the total deposits is loaned to customers in the form of overdraft facility, mortgage for house purchases, purchase of consumer durables, project financing for businesses and industries, education loans etc. Interest is charged on these loans. Loan services provided by conventional banks work on the principle that the borrower is able to repay the principal together with interest over a period of time. Collateral is required as a security by the clients are shared between the principal and agent in a pre-agreed formula.

a. Source of Funds

Like conventional banks, Islamic banks also accept deposits. However, they regard themselves as *wadiah* or safekeepers of the deposits received. Three types of accounts namely, savings, current and investment account facilities are provided. In the savings and current accounts, depositors do not earn an interest but Islamic banks may choose to give 'gifts' whether monetary or non-monetary at their discretion. On the other hand, the investment account operates on the principle of *mudarabah*. Here, the Islamic banks invest depositors' money in selected business ventures approved by Syariah principles whereupon profits gained will be shared between the customer and the bank on a pre-agreed ratio.

b. Use of funds

The main difference between Islamic and conventional banking lies in the methods of financing. In Islamic banking, there are three broad areas of financing namely, project financing, financing the acquisition of assets and trade financing.

Project financing is operated on either one of the principles of *musharakah* or *mudarabah*. Under *musharakah* or equity participation type of financing, the bank finances the project or investment and the client manages it in a joint-venture fashion. Profits or losses are shared according to pre-agreed ratios.

Under *mudarabah*, profits from the project are shared on a pre-agreed basis but losses are borne entirely by the financier i.e. the bank.

Financing the acquisition of assets is carried out through five main modes. The first mode of trade financing is *murabahah* or mark-up. The bank first buys an asset for the client and then adds a profit margin to the sale price to its client. The second mode of financing is *bai' bithaman ajil* or hire purchase. This is similar to murabahah where the bank first buys the asset for its client, the client will later repay the bank the price of the asset plus the profit margin but on an instalment basis.

The third mode of asset acquisition financing is *ijara* or leasing. The bank first buys the asset for a client and then leases it to him for an agreed period and for an agreed rental. Or the client could at the end of the period, pay back the bank the balance of the price and become the owner of the asset. This variation of ijara is called *ijara al-istigna.* Finally, qardul hasan is a benevolent loan given out for welfare purposes. Banks are expected to set aside a portion of their funds for this purpose. Here, the borrower is only required to pay the principal, any extra amount that he pays is considered a token of appreciation.

In trade financing, the bank provides mainly short-term facilities for the purpose of facilitating trade or working capital for its customers. Among the facilities provided include letters of credit under principles of *wakala*. Here customers request for the letter of credit and the bank will do so upon when the customer places a deposit at the bank which is of equal value to the goods to be purchased or imported. A fee and commission is charged for this service. Letters of credit are also issued based on musharakah and murabahah principles. Finally, the bank also provides letters of guarantee for its customers. Customers will be required to place a certain amount of deposit with the bank and a fee is charged for this service.

c. Other services

In addition to financing activities, Islamic banking also provides services like selling bank drafts, buying and selling of foreign exchange, traveller's cheques, remittances and transfers. Islamic banking has also ventured into the trading of secondary market instruments.

From the viewpoint of banking principles and operations, it can be seen that the framework of Islamic banking is oriented toward non-exploitation, participation and equitable profit-sharing. This is different from conventional banks where the general objective is to generate maximum returns from the use of funds. This is the underlying difference between Islamic banking and conventional banking.

1.4 Historical Perspective of the Development of Islamic Banks

Internationally, Islamic banking officially began with the establishment of the Islamic Development Bank in Jeddah in 1974. The Islamic Development Bank was an inter-governmental bank which provided development funds for projects in less well off member countries. By late 70s, private Islamic banks like the Dubai Islamic Bank, Faisal Islamic Bank of Sudan, Faisal Islamic Bank of Egypt and the Bahrain Islamic Bank also came into existence.

In Malaysia, the first Islamic financial institution was the Pilgrim's Management Fund (Lembaga Tabung Haji) established in 1962. The purpose of this institution was to help prospective pilgrims to save for the *haj*[4].

Malaysia's first Islamic bank is Bank Islam Malaysia Berhad (BIMB) established in July 1983. For the last sixteen years, BIMB has remained the sole Islamic bank in the country. This is in line with Bank Negara Malaysia's long-term objective of developing an Islamic banking system parallel with the conventional banking system. Because Islamic banking is a very new area even at international level, the central bank gave BIMB a grace period of 10 years to develop as an Islamic bank without any undue hindrances from competing Islamic banks. This is the first stage in the development of Islamic banking in Malaysia.

[4] The haj is a pilgrimage to the Holy Land of Mecca performed by able Muslims at least once in their lifetime.

The second stage in the development of Islamic banking was to deepen the Islamic banking base. To achieve this, conventional banks were gradually given the approval to offer Islamic banking services and products under the Islamic Banking Scheme (Skim Perbankan Islam). In March 1993, the first phase of SPI was launched involving three large domestic banks namely, Malayan Banking Berhad, Bank Bumiputra Malaysia Berhad and United Malayan Banking Corporation.

The third stage in the development of Islamic banking in Malaysia was the undertaking of several measures to strengthen the Islamic banking system. This included the introduction of the Islamic money market in January 1994, separate disclosure for SPI banking operations in October 1996, the opening of full-fledged SPI banking branches beginning 1996 and the formation of the central Syariah advisory council to BNM in May 1997.

By the end of June 1999, there were 21 commercial banks offering the SPI of which four were foreign-owned. In addition to the commercial banks, the other financial institutions participating in the SPI are 18 finance companies, 5 merchant banks and 7 discount houses. The assets of Islamic banking grew to RM29.9 billion at the end of May 1999 and deposits increased to RM22.9 billion in the same period.

1.5 Banking and Economic Conditions in Malaysia from 1989-1999

The period of study (1989-99) is characterised by banking reforms aimed at increasing the competitiveness of commercial banks in the light of foreign competition and rapid changes in the international financial markets. This period is also noticeably affected by the financial and economic crisis.

Among the reforms undertaken includes, the relaxation of the Base Lending Rate (BLR) in 1991 where individual banks are allowed to determine their own BLR. The BLR framework was modified further in 1995 in that, banks can quote lower individual BLR than that computed for the industry. The implication of this move is, lower interest rates can be offered by commercial banks to attract more loans. This move would directly affect BIMB's competition for loan customers.

The Two Tier Regulatory System (TTRS) was also introduced during this period. The objective of the TTRS is to provide an impetus for the establishment of a core of strong and well managed banking institutions who are able to compete domestically and abroad. Banks who fall under the Tier 1 category were allowed to carry out new activities under a more liberal regulatory environment. The TTRS sought to accelerate consolidation in the banking industry where mergers among banks were encouraged with the purpose of widening their capital base. However this system was abandoned in 1999 because it was perceived to encourage aspiring banks to rapidly increase their asset base for the sake of achieving Tier 1 status. Nevertheless, the TTRS marked an important step toward attempts to consolidate the banking industry and this process was to continue after the economy recovered from the

1997-98 crisis. This move implies that BIMB has to be aggressively competent in order to exist alongside bigger banks in the future.

From the economic perspective, the decade 1990-1999 has been economically an impressive and yet turbulent decade for Malaysia. After the 1985-86 recession, GDP growth shot to a high of 9.9% in 1988. Between then and 1997, GDP growth has averaged 9% annually. This high growth boosted the commercial banking sector, which experienced high pre-tax profits growing fourfold from RM 1.4b (1990) to RM 6.2b (1996). In addition, non-performing loans (NPL) fell from a high of 8.8% of total loans (1990) to 1.9% (1996).

However, this trend did not continue as the year 1997 saw the unfolding of the currency and financial crisis, which hit East Asian economies, including Malaysia. In 1997, GDP growth fell to 7.5% and plummeted to -7.5% in 1998. The crisis affected the banking sector greatly although as a whole the banking sector remained sound and resilient.

One of the biggest problems that arose was the liquidity and credit squeeze experienced by banks due to the rise in many non-performing loans. This led to Bank Negara Malaysia having to assume control over four banking institutions to minimise the possibility of systemic failure. During the year 1998 when the full impact of the recession was felt, access to financing became increasingly difficult. Banking institutions froze their lending activities while they focused on managing the deterioration in the quality of their loan portfolio. This caused loan growth to be virtually zero in that period. Annual loan growth expectations were revised from earlier projections of 15% to 8%. Even with these revisions, banking institutions facing difficulties were not expected to meet these expectations. This is the economic context and environment which characterise the period of the study.