

Chapter 1

Introduction

1.1 Overview

The participation of foreign-based banks in the Islamic Banking Scheme or Skim Perbankan Islam (hence after IBS) is a recent phenomenon. The banks, like Hongkong-Shanghai Banking Corporation (HSBC), Oversea-Chinese Banking Corporation (OCBC) and Standard Chartered Bank Malaysia Berhad (SCBMB) are relatively new to Islamic banking, compared to their involvement in banking industry in general.¹ In fact, it is in Malaysia that some of these banks started to adopt this new banking system.

OCBC, for one, started Islamic Banking operations in Malaysia and operates it in a large scale, but not elsewhere.² In its home base, Singapore, OCBC is a purely conventional bank catering mostly the Republic's Chinese majority.³ OCBC commenced its first Islamic banking operations in June 1995. This is the year when the bank officially launched the Interest Free Banking Scheme or Skim Perbankan Tanpa Faedah (SPTF, as it is famously known; and will used in all parts of this study), however the bank started to offer Islamic banking facilities much earlier, although very modest.⁴

Meanwhile, Standard Chartered Bank does offer Islamic banking in other places, especially in the Gulf Countries and in its headquarter in London. In Malaysia,

¹ This is also due to the fact that Islamic Banking itself is a recent phenomenon. The first Islamic bank, Mit Ghamr Savings Bank started its operations in 1963 in Ghamr, Egypt. On contrary, the conventional banking operations started way back in 18th century in Italy.

² Apart from its home Singapore, OCBC is operating in several other Asian countries like China, India and Hong Kong. However, its core markets are Singapore, Malaysia and China.

³ OCBC does offer al-Wadiah savings and current accounts in Singapore, but only in few branches where Malay/Muslim is majority. The figure, however, is insignificant and somehow negligible.

⁴ This information and some others are based on unstructured interview with OCBC's Head of Islamic Banking Division.

Standard Chartered Bank Malaysia Berhad (hence after SCBMB) was the first foreign bank to offer Islamic banking in 1993. Nevertheless, its Islamic banking operations have not been significant and grew rather slowly compared to OCBC. This will be elaborated later.

Likewise, HSBC is a new convert to Islamic banking. Its Malaysian subsidiary is the first attempt of HSBC to embrace interest free banking system in the Asian markets⁵, and it does so in an innovative way. Among its bold innovation was the introduction of Amanah Charge Card in 2000, which puts HSBC as the second bank in the country to offer such a card after Arab Malaysian Bank.⁶ The card, in collaboration with Master Card, is so-called 'Islamic Credit Card' and features the same facilities as any other credit cards, but with the absence of interest rate.⁷

These three banks have also complied with the Bank Negara Malaysia's (BNM) directive to improve their Islamic banking services. The banks have upgraded their Islamic Banking Units to Islamic Banking Divisions in their respective head offices recently.⁸ In line with this, HSBC, OCBC and SCBMB have also improved their Islamic banking operations, from just offering a few Islamic banking products to a full-fledged division of Islamic banking. This new scheme allows them to offer a wide variety of Islamic banking products and services to customers. In turn, the Islamic Banking Division also has greater authority and importance to the bank's whole operations.

⁵ Not including West Asia or Middle East (Gulf countries).

⁶ However, there is a slight different between Arab Malaysian Al-Taslif Visa and Amanah Charge Card. The former is just like the conventional credit card but without interest charge, instead there is a fixed charge and all transactions are considered as trade. It is based on the Bay al-Inan concept. While the Amanah Charge Card concept is similar to that of American Express. But, of course, interest charges are also absent from Amanah Card.

⁷ www.hsbc.com.my

⁸ This is in line with the changes from SPTF to SPI. This issue will be discussed in details in Chapter 2.

1.2 About this study

At the outset, this study seeks to find out why foreign banks choose to offer Islamic banking. Among questions asked are; what are their main considerations and purpose? Was it a mere obedience to Bank Negara's directive, or was it simply driven by profit?

The scope of this study covers the period 1996-2000. This period is chosen based on data considerations, in the sense that financial statements of Islamic banking operations are only reported in the bank's Annual Report as from 1997.⁹ It is worth noting that the Asian Crisis began in 1997. Hence with the available data, it is possible to examine and evaluate the impact of the crisis on the financial performance of Islamic banking *vis-à-vis* its conventional counterpart at individual banks.

1.3 Objective of the study

This research attempts:

1. To find out why the foreign based banks in Malaysia participated in the Islamic Banking Scheme or SPTF.
2. To examine the performance of the Islamic banking scheme *vis-à-vis* conventional banking during and after the Asian Crisis.
3. To identify factors that lead to the findings in 2).

1.4 Literature Review

There are a number of studies done on Islamic banking in Malaysia. Many have focussed on Bank Islam Malaysia Berhad (BIMB) with different analysis on its development, such as historical assessment (Man, 1998), performance evaluation (Wong, 1995) and market implications (Kader, 1993). Some others are more

⁹ As it is known, the Annual Report of 1997 also includes the statements for 1996.

interested on the development of the Islamic banking system itself (Yakcop, 1996) and the development of Islamic finance in general (Wilson, ed., 1990). These studies have laid down appropriate and adequate foundations for macro-like analysis, although once again fall into the same trap of focusing on BIMB at large.¹⁰

While BIMB study has not, in any way, been exhausted, the study on contribution and involvement of non-Islamic financial institutions in Islamic banking is way from adequate. There are various aspects that have not been properly analysed, assessed and evaluated. It is more so in the contexts of foreign banks, as they have just entered the Islamic banking scheme quite recently. However, few notable studies are worth mentioning. (Saad, 2001) who focused on SCBMB, offered some interesting findings on the Islamic Banking Scheme practices, such as its robust and sustained growth. However, the study lacks detailed analysis on the performance of the bank, and for this matter the proxy to foreign banks in Malaysia.¹¹ It also did not elaborate factors that induced SCBMB to offer Islamic banking in the first place.

This is one of the aspects that this study will try to address, apart from having a detailed analysis of foreign banks' involvement in Islamic banking in Malaysia. In addition, this study would contribute to the on-growing literature in Islamic banking, while specializing on the performance of conventional banks involved in Islamic banking.

Further, broader studies on Islamic banking worldwide also merit attention and somehow influence this research. One of them (Iqbal, 2001), evaluated the performance of Islamic banks by using trend and ratio analysis in comparison with conventional banks of the same size. He found that "Islamic banks have done fairly well during the period under study", which is 1990-98.

¹⁰ This might also due to the fact that only BIMB has a good record of Islamic banking operations since its inception in 1983.

¹¹ Standard Chartered (SCBMB) was the first foreign bank to offer Islamic banking services in 1993.

This study will largely follow Iqbal's approach, but not as exhaustive and comprehensive in analysing the performance. While Iqbal analysed 12 banks, Islamic versus conventional, from 10 Muslim countries, this study will limit the comparison between Islamic and conventional banking to the foreign bank's own banking operations, except when otherwise is needed.

The empirical nature of this study would also contribute to a growing number of empirical researches on Islamic banking, as the bulk literature on this subject is mostly conjectural and theoretical. Iqbal (2001) noted, "There is a serious shortage of empirical studies on Islamic banking." Thereby, this study is an attempt to fill that gap and would in a way contribute to the growth and development of the Islamic banking industry at large.

1.5 Methodology

This research paper will rely on an extensive literature research and interviews with officers at HSBC, OCBC and SCBMB. The former would include analysis on financial statements, annual reports and any other sources of information on banking performance. The latter would be done using both face-to-face meetings and written communication; whichever method is convenient to the bank officers. In brief, the research would be conducted using the followings:

Sources of Data

1. *Secondary Data*: Bank Annual Report, Financial Statements and other published data from various sources.
2. *Primary Data*: To be obtained from the bank managers. Unstructured interviews will be conducted with the bank managers, otherwise, questions will be sent to the manager through electronic and postal mail.

Data Analysis

1. Trend Analysis

It includes deposits growth, financing and percentage of the foreign banks Islamic banking operations relative to their overall business. Concurrently, this analysis will be evaluated along with the performance and trends of the Islamic banking sector at large. The data from BNM Annual Reports will be used to measure these trends.

2. Ratio analysis

One of the most common and the most effective is Return on Assets (ROA), since we would like to investigate the banking productivity and profitability. Here we will *not* evaluate the banks' Returns on Equity (ROE), because it might not be relevant since Islamic banking is only part of the banks' business unit.