Research On Islamic Banking In Malaysia: A Guide Forfuture Directions

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Abstract

Although not a near equivalent of conventional banking in terms of size, the global Islamic banking industry has grown at a very rapid pace in the last three decades. Malaysia has been at the forefront of this development since early 1980s and has earned a reputation of a global hub for Islamic banking. Since its inception, much research has been carried out in this area but there is no systematic documentation of research findings in Islamic banking, though much focus has been on aspects of efficiency and performance vis-à-vis the conventional counterparts. This warrants our relooking at the research –both theoretical and empirical –in different areas of Islamic banking in Malaysia, as to provide a road-map for the structured long-term development of the industry in consonance with the country's global leadership position in Islamic banking. This paper surveys and analysesthe published works on Islamic banking in Malaysia with the goals of evaluating their contribution and usefulness to various stakeholders and charting the future directions for research that could sustain Malaysia's global leadership position in Islamic banking.

Keywords: *Malaysia, Islamic banking, academic literature, research, survey.*

Introduction

The body of literature on Islamic banking has expanded significantly in the recent decades. A cursory overview of it paints a picture of an uncertain future for the industry.

Admittedly, Islamic banking has experienced some success globally, with an annual double digit growth rate (an average of 15% to 20% annually) in the last decade. But to maintain the momentum, the industry has to improve on a number of pertinent aspects. For instance, establishing a common regulatory, legislative, tax, and legal foundation, addressing cost-efficiency and integration issues for all Islamic financial markets in general and the Islamic banking sector in particular.

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Retrospectively, Malaysia– a rapidly developing vibrant economy – has positioned itself as an international hub for Islamic banking and finance. The country's current share of Islamic banking assets is at a significant level of 16%, which makes it a leading Islamic banking player amongst its counterparts (Bank Negara Malaysia [BNM], 2012). Naturally then the research interest in this area has been intensive, although piece-meal, and the literature on Islamic banking in Malaysia abounds. This paper takes stock of the past documented research on the Malaysian Islamic banking sector and suggests the most objective future directions in consonance with the Malaysian government's initiatives in the Islamic banking industry as gazetted in the Financial Sector Blueprint 2011-2020 and the Financial Services National Key Economic Area [NKEA]. A systematic documentation of past research and findings in this area could help researchers identify and select research areas of inadequate coverage and those that will guide a more structured development of this industry in the future.

The surveyed literature of 114 papers covering the period from 1989 to 2013is sourced from reputable English-language resources on the topic of Islamic banking in Malaysia.

The paper starts with a brief introduction followed by a summary of published papers and identification of gaps, and concludes by charting the possible directions for future research in the Malaysian Islamic banking sector in view of the planned government initiatives as the benchmark.

Literature Survey

The discussion of survey findings is classified based on the main issues addressed by the research papers. This provides a better understanding of the research focus over the years and facilitates the identification of gaps that will be benchmarked against the government initiatives to chart the future research directions.

Governance Issues

Governance issues relate to the expected norms and practices that Islamic banks need to comply with in their activities. In an Islamic bank, there are two facets of governance –Shari'ah governance and corporate governance. The first is the unique feature of Islamic banks, and the second is the traditional feature of conventional banks, but both are absolutely crucial in facilitating the functioning of Islamic banks. The Shari'ah governance ensures the Shari'ah compatibility of Islamic banking operations and conduct, while corporate governance promotes accountability, robust performance and efficiency. Therefore, governance in the Islamic banking context is holistic and covers a wide range of issues.

Hassan and Christopher (2005) who appraised the influence of the religious factor on corporate governance practices of Islamic banks vis-à-vis their conventional competitors bereft of the same factor. They discovered that, despite the religious nature of Islamic banks and their being managed by mainly Muslim individuals, Islamic banking institutions were not distinguished by better corporate governance

records. Satkunasingam and Shanmugam (2004) were of the same opinion and hence called for greater corporate disclosure requirements for Islamic banks, citing the prevalence of exceedingly poor corporate governance standards at the time. The importance of religiously-enhanced corporate governance in Islamic banking organisations was also recognised by Alnasser and Muhammed (2012).

An important part of corporate governance in Islamic banking institutions is the establishment of a relevant accounting policy. The absence of harmonised accounting regulations for Islamic banking, in the light of weak adoption of the Accounting and Auditing Organisation for Islamic Financial Institutions [AAOIFI] standards, as commented Shariff and Abdul Rahman (2003), affects the quality and comparability of accounting information pertaining to Islamic banking transactions across different political jurisdictions. The comparison of reporting standards issued by BNM (specifically, Financial Reporting for Licensed Islamic Banks (GP8-i)) and AAOIFI was performed by Abdullah (2012). Of the top 20 countries in the Islamic financial industry, only five (namely Bahrain, Qatar, Sudan, Pakistan, and Syria) use AAOIFI standards, while the rest uses International Financial Reporting Standards [IFRS] or a combination of both sets of standards. The main reason for the jurisdictional preference for IFRS is greater investor acceptability, for these standards are internationally accepted and hence increase the potential market size for Islamic financial instruments.

Fulfilment of social obligations such as paying *zakah*is anotherkey element of Islamic corporate governance. As a legal entity that conforms to the Shari'ah, an Islamic bank is obligated to pay *zakah*, argued Alhoul (2011); the author discussed the importance of this act and offered solutions to the common juristic and practical issues faced by institutions when dispensing this responsibility.

Perhaps the most essential component of sound Shari'ah governance is the Shari'ah compliance of individual Islamic banking products and services. Much controversy surrounds this topic; for example, Chong and Liu (2009) held that Islamic banking was not any different from conventional banking due to the low usage of profit-and-loss sharing mechanisms in the former. This finding infers not the unavailability but the choice not to use Shari'ah-based alternatives available in Islamic banking. Nonetheless, there exist many genuine Shari'ah compliance issues of a lesser scale.

Of great interest is the compliance status of Islamic financing products; Abdul Razak and Ismail (2010), for example, discussed how *diminishing musharakah* (an equity-based financing product) was considered to be more Shari'ah compliant and conducive towards the fulfilment of Shari'ah goals than other debtbased financing products. One of the most common types of the latter is *BBA*, on which commented Dahlan and Alias (2011) by opining that, because of the way *BBA*was practiced in Malaysia (in particular, its evoking of *gharar* or uncertainty situations), it could be deemed non-Shari'ah compliant. Of the Shari'ah issues in *BBA*, Smolo (2010) argued that in truth the product constituted a legal device and threatened the Shari'ahintegrity of Islamic banking by allowing the material convergence of Islamic

banking practices with conventional banking practices. Smolo and Hassan (2010) further suggested the use of *musharakahmutanaqisah* over alternative financing methods of *BBA* and *murabahah* on the basis of the Shari'ah-sense superiority of the former. Haneefet al. (2011) studied the legal issues existent in *musharakahmutanaqisah* (such as those related to ownership registration and properties under construction) but offered no suggestions for their resolution. A similar expositional paper on the same topic was written by Naim (2011).

A critical analysis of the existing home financing products was done by Hasan (2011) who then proposed a new financing model that meets the norms of equity, fairness and Shari'ahcompliancy;Meera (2012) proposed further improvements on this new proposed product.

With regard to criticisms levied on Islamic financing products, Abdul Khir (2010) highlighted the significance of *hilah* (that is, a legal device used to avoid difficulty in one's commitment to Shari'ah rulings in economic matters),specifically in the application of permissible *hiyal* in Islamic banking and outlined the parameters of its acceptability.

In view of the different aspects of Islamic banking transactions in the light of *Maqasid al Shari'ah*, Azliet al. (2011) encouraged the contractual parties involved to have a clear understanding of Shari'ah objectives; in a subsequent paper, Azliet al. (2012) looked at legal cases on *BBA* from the viewpoint of*Maqasid al Shari'ah*, or rather the non-fulfilment of the same, in real legal cases. Laldin (2010) analysed the related concept of *maslahah* (that is, consideration of public interest) and its importance in the context of *Maqasid al Shari'ah*for Islamic banking regulators and corporate entities. On a more objective note, Ahmed (2011) offered a classificatory system to ascertain whether an Islamic banking product was 'Shari'ah compliant', 'Shari'ahbased' or 'pseudo-Islamic', based on their fulfilment of the *maqasid*. In the case of an Islamic credit card, Laldin and Furqani (2012) and Kenjebaev (2012) held the product to be non-compliant because of its heavy reliance on*bay al inah* and *tawarruq*.

The Shari'ah integrity of another local financing product –*al ijarahthumma al-bai*(or *AITAB*) was questioned by Abdullah and Dusuki (2004).They criticised the product (primarily due to its atypical but still conventional character)but foresaw positive future prospectsdue to the strong customer backing and the upcoming legislative support for the product in the form of the Islamic Hire Purchase Act. The use of *wa'd* (or unilateral promise) and *muwa'adah*(or bilateral promise) principles in products such as *AITAB* and others (*murabahahfor a purchase orderer*, *diminishing musharakah*, etc.) was researched by Hasan and Muhammad (2011).

A certain Shari'ah compliancy aspect of *mudarabah* financing – the issue of capital guarantee by a *mudarib* – was discussed by Abdul Khir (2012)who suggested its permissibility in case it was a voluntary initiative.

Another issue of concern is proper pricing of financing products, as currently the most widely used pricing benchmark is the conventional interest rate, which arguably rendersthe products non-Shari'ah compliant.Yusof et al. (2011) suggested an alternative benchmark in the form of a market rental rate; the authors maintained that the rental price, aside from being Shari'ah compliant, better reflected the economic fundamentals and was more resilient to short-term volatility.

Another pertinent area of concern is related to Islamic deposits; among papers on this topic was that of Sawariet al. (2011) who doubted the Shari'ah compliancy of a *wadiah*based deposit product of Bank SimpananNasional, arguing that its prize-giving feature was not permissible. Othman et al. (2010) discussed the Shari'ah-motivated issues and criticised the application of conventional UCP 600 rules to the Islamic letter of credit in trade financing.

The growing popularity of Islamic microcredit products calls for a special review. This was recognised by Abdul Khir (2011) who studied the *rahn*based microfinancingproduct for Shari'ah compatibility; to rectify the issues uncovered, the author suggested the embedding of various *takyiffiqhi* models into the existing product.

For the Shari'ah governance framework to be effective, a vigorous Shari'ah audit and review system needs to be in place. Besaret al., (2009) investigated the quality of Shari'ah review processes in selected Islamic banks in Malaysia and concluded that a more methodological approach had to be adopted to ensure the Shari'ah Supervisory Boards discharged their responsibilities moreobjectively. This is in line with the recent BNM-issued Shari'ah Governance Framework which makes it compulsory for Islamic banks (and other Islamic financial institutions) to perform regular internal Shari'ah auditing checks. Yussof (2013) looked at the necessity for Islamic banks to develop an internal Shari'ah audit infrastructure and to train professionals qualified in both finance and the Shari'ah law. Abdul Rahman (2011) detailed the efforts by ISRA [the International Shari'ah Research Academy in Islamic Finance] to complement BNM's Shari'ah Governance Framework by preparing and issuing the Shari'ah Audit Framework; the authors also suggested some institutional arrangements to ensure effective implementation of the mentioned framework. Relatedly, Kasim and Sanusi (2013) highlighted some of the challenging issues in the field of Shari'ah auditing, such as that of self-review and independence, and recommended the regulators to revise the existing Shari'ah audit guidelines accordingly and to devise mandatory professional certification for Shari'ah auditors. Meanwhile, a new format of disclosure guidelines was proposed by Ameer et al. (2012) to increase the Shari'ah-connected disclosure of profit sharing investment accounts. Rosly (2010) urged the Shari'ah audit to be conducted in an integrated manner by ensuring the Shari'ah adequacy in the four parameters of *Maqasid al Shari'ah*, financial reporting, legal documentation, and contract.

Acknowledging the achievements of the national regulator, Hasan (2010) observed that the passing of the Central Bank of Malaysia Act 2009 substantially improved the

Shari'ah governance framework for Islamic banks in Malaysia by creating a central Shari'ah governance body and thus unifying the Shari'ah pronouncements across the industry. BNM also issued a number of product-specific Shari'ah parameters aimed at harmonising Islamic banking market practices in Malaysia; one such parameter, on *musharakah*, was critically reviewed by Arshad and Abdul Ghafar (2010). In the similar context, Wilson (2009) discussed themerits of a centralised Shari'ah governance system – based on the Malaysian experience – versus its institutional relegation alternative.

In summary, the importance of sound Shari'ah governance in Islamic banking institutions, has been duly recognised by the academia, theindustry and research community. Though much progress has been made in Malaysia towards raising the standards of Shari'ah governance,there is muchroom for improvement. Conducting an independent Shari'ah audit is among the current challenges for the regulator and the Islamic banks, for it is in the interests of all stakeholders to amplify the trust of Islamic banking customers in the complete Shari'ah compliancy of their banks through enhancedShari'ah governance review procedures and disclosure practices. Many other Shari'ah and corporate governance issues have also been extensively discussed but greater focus needs to be on practical solutions and definitive outcomes. In the long-term, more initiatives must be undertaken continuously to improvethe quality and compliance of Islamic banking practices.

PerformanceIssues

One of the most pertinent issues in Islamic banking is operational performance, especially the relative operational performance of Islamic banking institutions vis-à-vis their conventional counterparts, especially in countries like Malaysia with a dual-banking system. In the banking context, 'performance', 'efficiency', and 'profitability' are used interchangeably to denote various measures employed in assessing banking operations.

One of the earliest performance studies documented in the area of Islamic banking in Malaysia by Ariff (1989) studied the performance of Bank Islam Malaysia Berhad [BIMB]– Malaysia's first Islamic bank – during the first six years of its operations. Highlighted were some of the bank's achievements, such as the absolute increase in deposit accounts, the relative rise in investment deposit accounts, and the gradual growth in rates of return to the accountholders. Amongst the criticisms of the bank were its overwhelming dependence on *BBA* and *ijarah* in financing (at the expense of *mudarabah*- and *musharakah*-based equity financing) and its provision of uncompetitive return rates (in comparison to conventional banking institutions) to both groups of investment account holders and shareholders. BIMB appeared to be absolved of its shortcomings to some extent given its nascent development stage at that time but impelling efforts in intra-bank research activities were encouraged to fix the bank's flaws. An analogous study on BIMB of Wong (1995) once again disclosed its overdependence on credit based financing. A similar study on BIMB – with a focus on its comparative banking efficiency in fund sourcing and utilisation by

Samad (1999) – found that BIMB lacked in terms of managerial efficiency in comparison to conventional competitors but discovered mixed results in terms of productive efficiency. Samad and Hassan (2000) added that BIMB was relatively more liquid and less risky than most conventional banks in the country.

The introduction of the Islamic Banking Scheme [IBS] in 1993 (that allowed existing conventional banks operate Islamic banking windows or subsidiaries)endedBIMB's monopolistic existence in the Islamic banking industry in Malaysia.Studies on performance of BIMB alone will make not much contribution as it will not represent the overall industry performance. However, Rosly and Abu Bakar (2003) analysed the comparative performance of IBS banks (or banks that had Islamic windows) in the country and reported that they had a higher return on assets (explicated by their overheads being carried by their parent companies) but lower asset utilisation and investment margin ratios, implying that IBS banks, due to their heavy reliance on interest-like credit finance, could not possibly effectively compete in terms of efficiency with conventional banks that had a larger market size and greater maturity to their advantage. In contrast, Abdul Majid et al. (2003) asserted that there were no significant differences in efficiency scores between Islamic banks (IBS banks and fully-fledged Islamic banks taken together) and conventional banks. Batchelor and Wadud (2004) analysed IBS banks from the perspectives of technical and scale efficiencies, and reported that IBS banks under foreign conventional banks exhibited greater efficiency than those under domestic conventional banks. It was also suggested that overall IBS banks in Malaysia were more efficient than the two fully-fledged Islamic banks of that time.

Financial liberation of the Islamic banking industry envisioned in the Financial Sector Master Plan 2001 entailed the granting of licences to qualified IBS banks to set up fully-fledged Islamic banks. Mokhtaret al. (2006) analysed this new competitive environment and showed that the average efficiency of Islamic banks increased over the years, while that of conventional banks remained stable but was still comparatively higher; it was also revealed that fully-fledged Islamic banks were more efficient than IBS banks, with domestic IBS banks, in turn, slightly less efficient than foreign Islamic windows. Contrary to the findings of Mokhtaret al. (2006), Sufian (2007) established that IBS banks were technically more efficient than fully-fledged Islamic banks. During the same time period, Sufian (2006) studied the efficiency characteristics of domestic Islamic banks versus foreign Islamic banks and related the latter's relatively higher technical inefficiency and higher scale inefficiency in the former. From a perspective of efficiency, Kamaruddin et al. (2008) examined the cost and profit efficiencies of fully-fledged Islamic banks and the same of IBS banks and found that fully-fledged Islamic banks were comparatively more cost efficient (stemming from resource management), while IBS banks exhibited greater profit efficiency (due to economies of scale). Sufian (2010) researched the impact of foreign banks' entry on incumbent Islamic banks in

Malaysia and estimated that domestic Islamic banks were more profitable in the post-entry period, inferring from this a positive impact of foreign banks' existence on the Islamic banking industry.

Masrukiet al. (2011)madea comparative performance analysis of BIMB and Bank MuamalatMalaysia Berhad [Bank Muamalat] with mainstream banks; they expectedly asserted that the mentioned Islamic banks were less profitable (due to lower net financing figures and lower asset quality) than sampled conventional banks. Ahmad and Abdul Rahmat (2012) revealed that conventional commercial banks outperformed Islamic commercial banks in all efficiency measures due to greater managerial effectivenessand technological advancements in the former group. On the contrary, Yahyaet al. (2012) showed no significant performance differences between the two segments of the banking sector. Ismail et al. (2013) suggested that conventional banking institutions in Malaysia were more technically efficient (that is, in their use of technology), while Islamic banking institutions were more advanced in terms of allocative efficiency (that is, in their use of resources). Wasiuzzaman and Gunasegavan (2013) compared Islamic and conventional banks based on a number of bank-specific variables and came up with contrasting results, with conventional banks being more profitable and Islamic banks – more operationally efficient and liquid. Sapuanet al. (2013) then extended the subject matter of bank-specific variables in an empirical study which established that bank profitability and bank-specific variables (including financial structure) shared a common long-term path.

Finally, in the light of past and recent financial shocks, Kassim and Abdul Majid (2010) discovered that Islamic banking was as vulnerable to financial shocks as was conventional banking, despite the popular allegations of Islamic banking's being relatively more resilient. In a related study, Abdul Karim et al. (2012) tested the impact of the subprime mortgage crisis (that led to the financial meltdown of 2008) on the performance of Islamic banks in Malaysia and concluded that Islamic financing,but not Islamic deposits, was susceptible to financial crises.

*In summary,*the empirical literature on the performance of Islamic banks in Malaysia is ample and coverspredominantly performance, efficiency, and profitability issues.Overall, this research focused on the inter-industry differences in performance between Islamic and conventional banks; the intra-industry differences in performance between fully-fledged Islamic banks and Islamic banking windows or subsidiaries; and the differences in performance between domestic and foreign Islamic banks. With few exceptions, the findings of most studies are consistent: conventional banks are more profitable given their market size and maturity; efficiency scores – in all test groups (that is, conventional and Islamic banks; fully-fledged Islamic banks and Islamic windows or subsidiaries; domestic and foreign Islamic banks) are rather inconclusive; and Islamic banks are as vulnerable to financial shocks as conventional banks.

Risk Management Issues

The nature of banking business is such that, irrespective of being conventional or Islamic, it isinherently risky. Islamic banks, due to their peculiar foundational base, face a unique amalgam of risk challenges. The common risks Islamic banks encounter are market, credit, liquidity, and operational risks. Risks that may be considered exclusive to Islamic banking are Shari'ah non-compliance, fiduciary, and rate of return (including related displaced commercial) risks.

The most consequential element of market risk for most Islamic banks is arguably the interest rate risk, notwithstanding the imperative interest free nature of Islamic banking. The interest rate risk in the Islamic banking context translates into the rate of return risk for Islamic banking institutions. Haron and Ahmad (2000) maintained that Islamic banks, in their setting of profit rates for investment account holders, were strongly influenced by the level of interest rates used by conventional banks for investments ofequivalent risk profiles. A similar finding was disclosed by Kaleem and Isa (2005) who suggested that deposit rates offered by conventional banks could be used as predictors of deposit returns in Islamic banks. On the same issue but with a comparative twist, Rosly and Zaini (2008) studied the differences in yields between deposits or investment accounts and capital in conventional and Islamic banks. Theydiscovered that, while in conventional banks the variance in yields was adequate, in Islamic banks it was significantly smaller and hence did not reflect their risk properties. A related perspective was brought in by Bacha (2008) that shows the profit rates prevalent in Malaysia's Islamic Interbank Money Market [IIMM] were highly correlated with conventional money market rates, which lead the author to conclude that the IIMM, due to its being operated in a dual-banking environment, could not possibly sterilise itself from the interest rate risk.

To that end, Abdul Kader and Leong (2009) and Zainol and Kassim (2010) confirmed that inevitably, on account of the rate of return risk, Islamic banks were threatened by the distressing magnitude of displaced commercial risk, which, in turn, put their capital base and their solvency in jeopardy. On the topic of insolvency, Abdul Rahman et al. (2009) noted that real estate lending reduced the insolvency risk exposure of Islamic banks and increased the same for conventional banks; therefore, the authors advised that appropriate amendments in capital adequacy regulations should be made to alleviate the disproportionate stress put on Islamic banks.

Another element of market risk is foreign exchange risk. One of the tools currently utilised for its management is the Islamic FX Swap with the necessaryShari'ahparameters (Dusuki, 2009). Kunhibava (2009) provides a summary of the various Islamic derivatives that are available for risk management.

For research on credit risk, Bacha (1996) reasoned that *mudarabah* was unpopular in trade financing because of the excessive agency costs involved, depicted in the framework of the signalling theory and the control hypothesis in corporate finance.

Ahmad and Ahmad's (2004) exploratory studyfound that for Islamic banks major risk determinants were managerial efficiency and amount of risk weighted assets, while for conventional banks they were loan exposure and loan loss provision. It was thus recommended that a specialised approach in managing credit risk in Islamic banks should be promoted by regulators and adopted by risk managers in Islamic banks. The issue of conflicts of interests in Islamic banks in the present system of prudential standards was highlighted by Musa (2010). In an associated study on Islamic financing by Zakaria and Ismail (2008), it was established that Islamic banks' increased involvement in securitisation activities resulted in a fall in their financing activities but an overall riskier portfolio composition, implying the need for stricter regulatory control of securitisation practices.

Most Islamic financial contracts contain a myriad of various risks, posing a special challenge to risk managers at Islamic banks. Muneezaet al. (2011) theorised that *salam*was the most risk susceptible contract, thus explaining its non-utilisation in Islamic financing. However,they held *salam* to be a viable financing alternative and therefore proposed a new model of *salam* financing for agrarian ventures.

With regard to operational risk, Abdullah et al. (2011) noted that conventional risk measurement and risk management practices needed substantial adaptation to suit the specific characteristics of financing and investment activities in Islamic banks. Therefore, the authors contended the applicability of the Basel II methodology for Islamic banks. In the same area of interest, Abdul Rasid et al. (2011) reported that a typical Islamic bank in Malaysia (unlike most conventional banks) would normally develop and adopt an integrated enterprise system which boded well for the bank's operational efficiency.

Ariffin (2012) estimated that the average exposure of Islamic banks to liquidity risk was stable and below that of comparable conventional banks; it was also affirmed that the extent of liquidity risk had a positive correlation with financial performance. These findings were earlier validated by How et al. (2005) who noticed that Islamic commercial banks had significantly lower liquidity risk that their conventional counterparts. To establish an effective Islamic liquidity management system, Ibrahim and Mokhtar (2012) advocated regulatory efforts in building linkages among Islamic financial markets, developing joint funds, strengthening information sharing and human talent management, as well as creating a relevant private-sector-driven association. On a currently pertinent liquidity-related issue – the adoption of Basel III regulations –Dongcheol (2012) warned against the implementation of the new liquidity rules in their original form without the incorporation of Islamic banking specific features.

*In summary,*the studies conducted on various risk related topics in Islamic banking in Malaysia are of reasonable rigour and standard; most of the pertinent issues have been addressed, and for each risk exposure the mitigating solutions have been offered. The unique risks faced by Islamic banking institutions have been readily recognised and widely studied. The main existent issues of concern that have been

identified by researchers include the lack of harmonised regulatory standards, the absence of suitable risk methodologies, the dearth of allowable risk mitigation techniques, and the insufficient risk disclosure levels.

Marketing Issues

Given the unique nature of Islamic banking and its relative nascence, it is essential to market it in an effective and distinctive manner, raising the awareness and dispelling the myths. This is especially true in an environment where Islamic banks have to compete with conventional banks that offer similar products and services to the populace (both Muslim and non-Muslim).

On this topic of Islamic marketing, Haronet al. (1994) set out to determine the bank patronage factors of Muslim and non-Muslim customers in Malaysia and discovered that the two groups of customers had no significant differences in their bank selection criteria. The relevant factors of importance were the operational efficiency and the quality of service, with only 40% of Muslim customers citing religion as the main reason for patronizing the Islamic banks. The authors recommended Islamic banks to improve their customer service operations and to be more information-oriented with prospective customers. This sentiment was shared by Hamid and Azmin (2001) who, in order to build the customers' knowledge on Islamic banking, urged the enhancement of the national schooling curriculum to incorporate *muamalat*(or the Islamic law of transactions) related courses. Ahmad and Haron (2002) examined the perceptions of corporate customers towards Islamic banking and suggested that corporate customers valued competitive pricing of banking products and services the most, in line with common business motives of cost minimisation and profit maximisation; however, their knowledge of available Islamic banking products and services was rathershallow– this the authors attributed to Islamic banks' inadequate marketing efforts.

Several years forward, with greater proliferation of Islamic banking institutions, Dusuki and Abdullah (2007) studied the factors motivating customers to deal with Islamic banks specifically and found the amalgamation of Islamic social credentials and service quality that to be most important.In related research, Dusuki and Dar (2007) analysed the perceptions of various stakeholders on Islamic banks' corporate social responsibility practices and documented a positive conception of Islamic banks' engagement in active corporate social responsibility practices, in line with its ethicsbased fundamentals. In another study, Dusuki (2008) posted that the stakeholders of Islamic banks viewed the latter as socially-integrated institutions with certain welfare and moral obligations towards communities in which they operated.

Having studied the savings behaviour of customers in both conventional and Islamic banks in Malaysia, Haron and Azmi (2008) concluded that depositors in the former generally behaved in conformity with traditional theories, while depositors in the

latter exhibited a slightly different attitude, which the authors ascribed to their being influenced by religious beliefs.

A positive assessment of Islamic banks' quality of services was released by Amin and Isa (2008) who reported that the majority of Islamic banking customers were satisfied with their Islamic banks in terms of customer service quality. The importance of good customer relations to secure customer satisfaction and loyalty was echoed by Haque et al. (2009) and Osman et al. (2009).

Haque (2010) advised Islamic banks to develop new product and service offerings based on the attitudinal differences discovered between different customer categories (for instance, based on racial and gender divisions). Continuing with the topic of heterogeneous customer categories, in particular given Malaysian-like multiracial societies, Muhamat et at (2011) recommended Islamic banks to reconsider their often exorbitant and clearly superfluous use of Arabic terminology in naming Islamic banking products and services.

In terms of advertising practices of Islamic banks in Malaysia, Haque et al. (2010) noticed that Shari'ah-toned promotions were either totally absent or deficient, which inescapably contributed to general customer unawareness of differentiating features of Islamic banking. Ahmad et al. (2011) concurred and suggested that Islamic banks should concentrate efforts on building Islamic-banking-exclusive branding to garner greater customer support. These views were also supported by Amin et al. (2013) who purported that customer loyalty in the context of Islamic banking hinged heavily on the customer perception of complete Shari'ah compliance of Islamic banks they patronised.

A comparative study by Taapet al. (2011)on the issue of service quality: it was found that there exist a major intra-industry gap in both types of commercial banks (that is, Islamic and conventional) in the service quality aspects of competence and convenience.

Of special importance among individual banking products are Islamic financing products. Amin et al. (2009) and Amin et al. (2011) documented that pricing, and not religion, wasthe most important factor influencing customers' use of Islamic financing products. Meanwhile, Abdul Razak and Taib (2011) stated that Islamic banking customers preferred financing based on *diminishing musharakah* (that is, equity financing) to financing based on *BBA* or *murabahah*(that is, credit financing) and hence suggested that Islamic banks should move away from their dependence on the latter towards greater use of the former.

Among the very few studies that claimed the superiority of the religious factor in Islamic banking customer preferences were those of Echchabi and Olaniyi (2012) and Amin (2012).

From the latest research entries, Kamarulzaman and Madun (2013) presented a critical overview of the marketing practices of Islamic banks, claiming they were much less effective than those of conventional banks.

In summary, the literature on the various marketing aspects of Islamic banking in Malaysia abounds which may appear warranted due to the special importance of this matter in the dual-banking environment of the country. The quality of papers, however, is disconcerting; among the foremost flaws are the low sample sizes, the prevalent use of convenience sampling (rather than random samples), the failure to address the issues of non-response bias, and the use of poor scenarios, all of which render research design poor and make generalizability problematic. The actual findings are rather uniform: the religious factor cannot be overly relied upon by Islamic banks in their customer attraction and retention strategies; instead, Islamic banks should strive to find an optimal balance in their offerings between efficient and quality services, on one hand, and absolute Shari'ah compliance, on the other, to ensure customer satisfaction and loyalty.

Monetary Policy Issues

BNM, the monetary authority in Malaysia, is endowed with the mandate to regulate both the conventional and the Islamic financial industries and thus faces unique challenges. In its pursuit of attaining economic growth and stability (through stable prices and low unemployment), it uses instruments that are Shari'ah compliant when using Islamic banking elements as monetary policy transmission variables.

Kaleem and Isa (2006) raised several issues of contention with the current mechanism of monetary policy transmission and suggested an alternative methodology (of calculating the demand for money function) to suit the nature of the domestic dual financial environment. The authors noted that conventional money market rates had a potent effect on Islamic intermediate aggregates. Similarly, Kassimet al. (2009) found that the balance sheet items of Islamic banking institutions exhibited greater sensitivity to monetary policy shocks than those of conventional banking institutions, very much contrary to general expectations.

A study on the Islamic money market was conducted by Kassim and Abdul Manap (2008) who concluded that the IIMM could be used as an effective tool or variable for monetary policy implementation due to its high informational content with respect to several macroeconomic indicators. Kaleem(2000)concurred, for in this examination was proven the effectiveness of Islamic monetary instruments, comparably to traditional policy instruments; to preserve the validity of Islamic monetary variables, the author (2000) argued against the application of Basel rules on Islamic banks and promoted the formulation of separate liquidity and reserve ratios. Relatedly, Sukmana and Kassim (2010), based on their findings of the monetary importance of Islamic banking financing and deposits, proffered the imperative to ensure the stability of Islamic banking institutions, on par with their conventional counterparts.

Hence, it has been so far agreed that Islamic banks are very much relevant in channelling the monetary policy effects to the real economy. This is true with regard

to both of the twin monetary targets, that is, price stability and economic growth. Among the papers on the causal relationship between Islamic banking and economic growth was that of Furqani and Mulyany (2009)who concluded that in Malaysia the growth in the economy supported the growth of Islamic banking (and not vice versa), implying that the rapid expansion of Islamic banking in the country was supported by the robust demand for Shari'ah compliant financial intermediation.

In summary, it has been noted that active efforts are being made by the monetary authority to accommodate the peculiarities of the dual financial environment (through the development of Shari'ah compliant Islamic money market instruments), although not all experts agree with BNM's adoption of conventional methodologies (specifically, that of Basel).

Trends

This section identifies trends in the surveyed literature (Table 1). The trend issues are classified into several research areas; their coverage is evaluated on a subjective scale and graded as either one of the following: 'Exorbitant' (implying excessive focus with more than 10 more journals on the topic), 'Adequate' (implying ample focus with five to 10 journals on the topic), 'Average' (implying satisfactory focus with three to five journals on the topic), or 'Poor' (implying insufficient focus with fewer than three journals on the research areas).

Table 1: Trends in the surveyed Islamic banking literature.

Area	Primary issues	Topics covered	Coverage assessment
Governance	Shari'ah governance model	Centralised versus decentralised models, Central Bank of Malaysia Act 2009	Average
	Shari'ah audit	Framework, independence, qualified experts	Average
	Shari'ah compliance of products	Financing and deposit products	Adequate
	Maqasid al Shari'ah	Strategic alignment with *Maqasid al Shari'ah*	Average
	Corporate governance	From an Islamic perspective	Average
	Disclosure and transparency	Information asymmetry, corporate governance statement disclosure, Shari'ah review disclosure	Average
Performance	Efficiency	Profit, cost, technical, and scale efficiencies	Adequate
	Profitability	In the absence of or during financial crises or shocks	Adequate
	Performance determinants	Bank-specific variables	Average

Area	Primary issues	Topics covered	Coverage assessment
	Comparative performance	Islamic versus conventional banks; domestic Islamic versus foreign Islamic banks	Exorbitant
Risk management	Regulation	Basel II, Basel III, prudential requirements, supervision	Average
	Credit risk and management	Factors of influence, comparative analysis between Islamic and conventional banks	Adequate
	Market risk and management	Exposures, rate of return risk, interest rate and displaced commercial risks	Adequate
	Liquidity risk and management	Government Funding Act 1983, IIMM	Average
	Operational risk and management	Management accounting systems, Basel III	Poor
	Islamic hedging instruments	Shari'ah compliancy, product innovation	Average
Marketing	Public awareness	Surveys, awareness campaigns	Exorbitant
	Public perception and acceptability	Retail and corporate customers	Exorbitant
	Patronage factors	Comparative evaluation between Islamic and conventional banks	Exorbitant
	Marketing strategies	Traditional marketing tools, niche development	Adequate
Operations	Accounting	IFRS versus AAOIFI, profit recognition and allocation, ethical accountability	Inadequate
	Contractual terminology	Arabic terms, standardisation	Average
	Pricing	Use of interest rates versus rental rates, pricing formulas	Inadequate
	Harmonisation of standards	Intra- and inter-country	Average
	Product innovation	Competitive product innovation	Poor
	Banking professionals	Qualification, training, educational institutions	Average
Legislation	Laws	Transaction costs, amendments	Poor
	Judicial jurisdiction	Shari'ah versus civil	Average

It is evident from the above classification summary that the research focus has been skewed in favor of some areascompared to others: as such issues on Shari'ahgovernance,performance, and marketing have been given much more attention to than those on product innovationand risk management.Governance themed papers made up 30% of the reviewed literature, followed by performance at 24%, marketing (23%), risk management (17%), and finallypapers on economic growth and policy transmission represented just 6% of all studies.

It has been learned that the surveyed literature consisting of 114 published papers was written by a total of 171 authors, among whom 136 authored just one paper each, 28 penned two to three studies, and only seven academics are attributed four to six publications. These results show thatonly a relatively small number of academicsare actively engaged in quality Islamic banking research.However, this situation is expected to change for the better in view of government's initiativeson knowledge based economic transformation.

Naturally, a number of common parallels run through the research activities in both conventional and Islamic finance, due to their belonging to the shared orbit of finance. In the aftermath of the global financial downturn, these common features relate to, first and foremost, the encouragement of prudential aptitude balanced with the pursuit of commercial viability. A call regularly voiced out through research on this topic is that for regulatory (and supervisory) accommodation of current challenges without harming the profitability and the growth prospects of individual financial institutions.

Albeit the similarities, research in conventional finance reflects the maturity of its subject matter and is hence free from many perennial issues highlighted in Islamic financial research. One such issue is the standardisation and harmonisation of rules and regulations (including those on the interpretiveShari'ah law and on accounting) across Islamic financial institutions inside and outside of national borders. Also frequently featured are the human talent shortcomings in Islamic banking and finance and the specificities of risk management practices in thisarea.In contrast, topical themes in conventional financial research are corporate governance (with the increased accent on self-regulation), technological and product innovation, competition, and prudential regulation.

Possible research directions

To yield practical benefits, this analysis of published literature on Islamic banking in Malaysia has been benchmarked against the relevant parts of BNM's second 10-year Financial Sector Blueprint which is designed to reinforce the government's initiatives to achieve a fully-developed nation's status by 2020. Additionally, the applicable sections of the Financial Services NKEA – one of the 12 identified drivers of growth and economic activity under the ETP –are also considered.

The nine focus areas of the Blueprint are (PwC, 2012): *effective intermediation for a high value-added and high-income economy*; *deep and dynamic financial markets*; *financial inclusion for greater shared prosperity*; *regional and international financial integration*; *internationalisation of Islamic finance*; *regulatory and supervisory regime to safeguard the stability of the financial system*; *electronic payments for greater economic efficiency*; *consumer empowerment*; and *talent development to support a more dynamic financial sector*. The 10 Entry Point Projects [EPPs] – or the high impact projects involving specific action plans – of the NKEA are (ETP, 2011): *revitalising capital markets*; *transforming development finance institutions*; *creating an integrated payment ecosystem*; *insuring most of the population*; *accelerating the growth of the private pension industry*; and *spurring the growth of the nascent wealth and asset management industries*.

The first focus area for research is the *moulding of a more seamless legislative and regulatory environment.* This will provide a stable environment for Islamic banking institutions to grow, unhampered by unjustified legislative or regulatory constraints but instead supported by flexible effective regulation and supervision, and market transparency. Indeed, country experiences show that accommodative legislation and regulatory clarity arekey to accelerating growth and increasing market share in Islamic banking. Among regulators' and legislators' plans is the reinforcement of the populace's financial inclusion and literacy, and the consumer protection framework.

Research in this area could propose further amendments to the current Islamic banking legislation, introduce new Islamic banking regulation and better supervisory methods (in particular, through cross-border coordination with regional regulators for local banking institutions already operating or aspiring to set up business abroad), ways of improving corporate governance standards in Islamic banking institutions to achieve greater market transparency and disclosure, and also modes of educating the populace.

The second focus area for research concerns the *strengthening of the industry's core business activities.*The top priority of the government and the regulators is to ensure that Islamic banking and other financial institutions achieve and maintain competitive vibrancy and efficiency. This relates to the issues of economics of scale and economics of scope of commercial banking in Malaysia. A crucial aspect concerning the industry depth is in enhancing liquidity in the markets (including the global Islamic liquidity management). Alongside this objective goes the strategy for active development of innovative products and services (especially if equity- or hybrid-based), together with the evolvement of permissible risk management tools and technological operative advancements (such as e-payment and e-banking gateways).

This research could develop new Islamic banking products as well as novel ways of Shari'ah compliant risk hedging. In risk management, a significant area of study may be related to the imperative modification for Islamic banking institutions based on the Basel III requirementsthat are planned for the period between 2013 and 2019; in like

manner, managing new risk challenges stemming from greater regionalisation and internationalisation of Malaysian Islamic banks will also be pertinent. Creative recommendations on liquidity management and on Islamic banking e-systems (for example, on BNM-endorsed topics such as ASEAN-wide ATM networks, expanded use of the Internet and mobile banking, and IT security reinforcement) would be a value-added to research in this area.

The third focus area for research is the*fostering of regional Islamic bank champions.* A major theme of BNM's and SC's blueprints is the regional and international expansion of home-grown Islamic banks, in a meaningful and prudent manner, by taking advantage of the ever accelerating global economic integration (with focus on mainly ASEAN, Greater China and South Asia). This will allow for much needed broadening of Malaysia's Islamic banking industry (that is currently highly dependent on domestic resources) and consequently will also help manage risk through international diversification. Malaysia's global share of Islamic banking assets is expected to increase from 8% in 2009 to 13% in 2020; also, at least one Islamic banking institution (hoped to become Malaysia's first mega-Islamic bank) is forecasted to reach the global top 10 by asset size by 2020.

This research may relate to competitive strategies that could inspire local Islamic banks to go global. Due to the currently negative international perception of Islamic banks (because of their originating from emerging economies and their being Islamic organisations), this has to be done strategically under the guise of socially responsible or ethical banking. Of special highlight is the search for niche or specialist capabilities by new foreign or existing local banking institutions.

The fourth focus area for research concerns the *codification and standardisation ofShari'ah guidelines.* This is part of BNM's ongoing issuing process of Shari'ah parameters for standard documents. The goal of this process to achieve uniform understanding of Shari'ah principles, which will ensure consistent interpretation of Shari'ah contracts and enable more consistent product development and therefore globally acceptable Islamic banking products and services that will also contribute to the liquidity and depth of this industry.

The research could be on the mechanisms of implementing the mentioned standardisation, since coordinating the interests of multiple parties (such as those of different Islamic schools of jurisprudence) has invariably been a delicate act of financial diplomacy. Strategic initiatives could include the promotion of cross-border regulation and supervision, of greater financial integration through international liquidity management (via the International Islamic Liquidity Management [IILM], among others) and risk management schemes, and of mutual research interdependence.

The fifth focus area for research could be the*promotionof global convergence and mutual recognition of Islamic banking standards.*This is central to unleashing the full

potential of Islamic banking and finance on a global scale. Such convergence and recognition of standards can be facilitated through the governments' supporting of international standard-setting bodies, such as the Islamic Financial Services Board [IFSB], the Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI], the International Islamic Financial Market [IIFM], etc. These agencies have existed for some time now but no real efforts have been forthcoming to promote the global convergence of Islamic banking standards.

The research could devise strategies aimed at enhancing international cooperation within the banking fraternity that would require creation of transnational agencies acceptable to all stakeholders. Studying the various available options in amplifying the significance of multilateral standard-setting organisations in Islamic banking and finance and advising policymakers in their harmonisation endeavours (through enhancing financial linkages between different jurisdictions, for instance) would be commendable.

The sixth focus area for research is the motive to be the *reference centre for Islamic banking and finance research, development and education.* The government's role in further promoting Malaysia as the international hub of intellectual excellence in Islamic banking and finance is set to continue. The priority areas are legislation (specifically considered matters include the re-engineering of the KL Regional Arbitration Centre into a global arbitration centre with specific expertise in Islamic banking and finance, and the expansion of the legal framework to accommodate more innovative Islamic products); human capital (specifically considered matters include the creation of globally recognised accreditation and certification programmes, the increase in scholarship and research grants, and the grooming of talent pool well-grounded in both finance and the Shari'ah that is currently the responsibility of the International Centre for Education in Islamic Finance [INCEIF], a university of Islamic finance set up by BNM); research, development and innovation (by leveraging on research and innovation capabilities of institutions such as ISRA among others).

The research could be on initiating practical propositions for the mentioned issues, with the ambition of promoting the Malaysian Islamic banking industry as the benchmark for best global practices in Islamic banking in terms of legislation, regulation, governance, education, and research. In the area of human capital, as an illustration, it would be interesting to assess the consequences of impending talent shortages and to suggest strategies for Islamic banks and regulators for the management of the issue.

The seventh focus area for research could be the*developing of new integrated growth sectors.*This encompasses the closer integration of Islamic banking with other Islamic financial sectors such as Islamic money and capital markets, *takaful* (including *retakaful*), *waqf* (or trust) and Islamic fund (asset and wealth) management, through mutual cooperation within the liquidity framework and joint product and service

offerings (such as *bancatakaful* and mortgage securitisation transactions) to retail and corporate customers.

The research could recommendexactly how Islamic banking institutions can leverage on the development of other sectors in Islamic banking and finance in a mutually beneficial way. This could be done by identifying niche complementary areas in the various Islamic financial sectors and initiating the most potent ones for Islamic banking and devising collaborative policies and individual bank strategies accordingly.

Conclusion

Seven focus areas of Islamic banking in Malaysia– ranging from core strengthening and international expansionary activities to advancement of educational and knowledge bases – have been highlighted with details of research needs for each area.

This guide to future research is in consonance with the commitment to develop the industry and promote Malaysia's reputation as the global hub for Islamic banking and finance. The crux of research suggestions relates to a call for greater practicality in research exercises and greater innovation in the industry. An important consideration should also be given to active championing of the social and ethical identity of Islamic banking in addition to naturally sought betterment of its operational mechanisms.

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