CHAPTER 1: INTRODUCTION

1.0 Introduction

Islamic banking is now a well-known term and has emerged as one of the most important industries worldwide. Islamic banking is known for its interest free concept and operates in many countries including Bahrain, Pakistan, Jordan, Iran, Sudan, United Kingdom, Singapore and Malaysia. Islamic banking and finance has undergone rapid transformation and growth from an industry striving to satisfy the Muslim community needs, to a multibillion dollar industry upholding Islamic principles. Over recent decades the Islamic banking industry has emerged as one of the fastest growing industries and has spread to all corners of the globe, receiving wide acceptance from Muslims and non-Muslims (Iqbal and Molynex, 2005).

This chapter consists of six sections with section 1.1 presenting an overview of the global Islamic banking industry followed by section 1.2 which presents the background of the study. Next, the objectives of the study are described in section 1.3 and section 1.4 elaborates on the significance of the study. Section 1.5 explains the scope of the study and finally this chapter ends with section 1.6 which addresses the limitations of the study.

1.1 Overview of the global Islamic banking industry

Islamic banking started in earnest in the 1970s with the personal initiative of concerned Muslims to address the problem of *riba* (Tahir, 2004). Islamic banks are now well established in most countries in the Middle East like Bahrain, Kuwait and in
many countries in Asia and Europe. Moreover, Pakistan, Iran and Sudan have “Islamized” their whole banking system while others like Bahrain, Turkey, Malaysia and Jordan have adopted a heterogeneous banking system in which one or more Islamic banks compete with Western-type commercial banks (Karim, 1996).

The General Secretariat of the Organization of the Islamic Conference (OIC) defines an Islamic bank as a financial institution whose statutes, rules and procedures expressly state its commitment to the principle of *shariah*, and the banning of the receipt and payment of interest on any of its operations (Hasan, 1999). The Islamic Banking Act 1983 states that an Islamic bank is a company which carries on Islamic banking business. Islamic bank business here means banking business in which the operations do not involve any element that is not approved by the Islamic religion. Othman and Owen (2000) defines an Islamic bank as a non interest based financial institution that complies fully with Islamic Laws and has creative and progressive financial engineering to offer efficient and competitive banking. Islamic banking performs the same essential functions as banks do in the conventional system, except Islamic banks need to do business in accordance with the rules and principles of Islam (Henry and Wilson, 2004).

Islamic banking is based on interest free banking that conforms to the Islamic law or *shariah* that prohibits interest on all types of loans. The principle of interest free banking is profit and loss sharing. Both the supplier of the capital and the borrower share the risk and both suffer together when returns are poor. Islamic banks will fit only if one replaces “interest rates paid” with “profit-shares and fees” (Arif, 2007).
Islamic banking and prohibition of interest was not founded on the principles of economics. It was developed as a result of a decree sent by the almighty creator Allah (Ghannadian and Goswami, 2004). With the elimination of *riba*, appropriate mechanisms need to be developed to make feasible the workings of the Islamic financial system (Luqman, 1999).

Brenden Nelson, Global Chairman of KPMG, stated that Islamic finance has developed into a global phenomenon, which is highly dynamic and growing rapidly (KPMG 2006). There are now around 270 Islamic Financial institutions worldwide with assets estimated at more than USD265 billion, financial investments above USD400 billion and growth estimated to be around 15%. (KPMG, 2006). The prospects of Islamic banking have also encouraged some conventional banks to move into Islamic banking.

**1.1.1 Overview of Islamic banking in Malaysia**

The Malaysian Government established the National Steering committee to study the prospects of introducing Islamic banking in Malaysia. The first Islamic bank was introduced in 1983 through the establishment of Bank Islam Malaysia Berhad (BIMB), which was governed by the Islamic Banking Act 1983. The blue print for the modern banking system was established in 1983, with the enforcement of two new acts, known as the Islamic Banking Act and Government Investment Act (Kaleem, 2000). The Islamic Banking Act empowers Bank Negara Malaysia (BNM) to supervise and regulate Islamic Banks. The objective of the Malaysian government is to develop the Islamic banking system parallel to the conventional system (Ahmad
and Haron, 2002). Furthermore, the government does not intend to base the whole of the country’s banking system on Islamic principles or change the existing laws that pertain to banking (Osman, 1999). In January 1994, an Islamic interbank market was introduced to facilitate the interbank trading of Islamic financial instruments and Mudharabah interbank investments.

In Malaysia, because of its mixed ethnic and religious backgrounds, the BNM has approved a system of parallel Islamic and conventional banking. The past two years saw many conventional banks rushing to obtain a full Islamic licence in order to set up an Islamic bank in Malaysia. Malaysia is the first nation to successfully adopt a dual banking system, where a full-fledged Islamic system operates side by side with the conventional banking system within a single bank (Sadar, Noraini and Yahya, 2003). Currently, there are about twelve Islamic banks which run under a full Islamic licence. Of these, three are foreign Islamic financial institutions. In early Jan 2008, Bahrain’s Unicorn Investment Bank (UIB) received a Licence from Bank Negara Malaysia to operate an Islamic bank under the Malaysian International Islamic Financial Centre (MIFC) initiatives (BIS Review, 2006). Their licence is quite special because the authority is given to create any Islamic banking product and take deposits as long as they are in non-ringgit currency. In addition, other foreign banks like Al Rajhi Bank and Kuwait Bank have already set up branches in Malaysia.
1.1.2 MIFC (Malaysian International Islamic Financial Centre)

MIFC was launched on 14 August 2006 and the initiative was specially undertaken by the country’s financial and market regulators including the central bank. The MIFC was introduced to further strengthen Malaysia as an International Islamic Financial hub. There are certain keys and measures to serve as a catalyst in Malaysia’s effort to become an Islamic hub (BIS Review, 2006).

The objectives of MIFC

- Malaysia is a centre for origination, distribution as well as trading capital market instruments.
- Malaysia is a centre for Islamic Funds and Wealth Management.
- Malaysia is a centre for International Currency Islamic financial services.
- Malaysia is a centre for takaful and retakaful.
- Malaysia is a centre for education and training for Islamic base products.

(BIS Review, 2006)

The launching of MIFC shows the strong commitment of the government to further enhance Malaysia’s position as an international Islamic financial centre. In addition, the government is also giving an attractive tax package to ensure competitiveness in the global market, thereby ensuring that both the existing as well as the new players take full advantage of the opportunity.
1.2 Background of the study

Islamic banking is not something new in Malaysia, but, it is only because of the recent opportunities and growth that it has developed so fast. Nevertheless, the increase in oil prices has also further driven the countries involved in Islamic markets. That is why Islamic banks are taking advantage of the huge petrodollar surplus in the Middle East region, which is estimated at US250 billion a year (KPMG, 2006). Malaysia stands to gain because of its thriving banking sector and sound regulatory body. The year 2003 saw the introduction of an Islamic Hedge Fund that could tap in to the capital of Islamic families with a potential value of trillions of dollars in asset management (Butcher, 2003).

Currently, the Al Rajhi Bank, Kuwait Finance House and Bahrain Unicorn Bank have invested in Malaysia to increase their market share globally. This shows that Malaysia has good prospects for Islamic banks to grow significantly, which is why the Middle East banks chose Malaysia as an investment target. The idea of Islamic banking is to offer the majority Muslim population of Malaysia choices in financial products that comply with religious mores and at the same time carve out a niche as a global leader in Islamic banking (Prystay, 2002).

The demand for Islamic banking in Malaysia is increasing year by year. This is illustrated in Malaysia’s Ninth plan (2005 to 2010) where the financial services sector is expected to grow at an annual average rate of 7% with its share of GDP increasing to 15.8% by 2010 (Aseambankers, 2006). One of the key strategies in this plan is developing Malaysia as an International Islamic Centre for Islamic Banking and
Finance (Starbiz, Feb 2008). Figure 1.1 below, shows that the Islamic banking industry is expected to contribute 20% of the overall banking and insurance market.

![Figure 1.1 Islamic Bank Penetration](image)

Source: (International Centre for Education in Islamic Finance, 2005)

In Malaysia, there are issues in BBA financing that resulted in some of the Islamic banks facing legal action from customers. These cases include Affin Bank Berhad v Zulkifli Abdullah (1997), Bank Islam Malaysia Berhad v Adnan Bin Omar (1994) and Malayan Banking v PK Ralamani (1994). (Pheng and Detta 2007). These issues that related to legal and documentation resulted in some significant changes for Islamic banking.

As highlighted above, Islamic banking is one of the niche markets in Malaysia and is showing very good prospects. Although these prospects will eventually create a large demand they will inevitably introduce many challenges affecting the growth of
Islamic banking. In addition, past researchers like (Gerald and Cunningham), (Metawa and Almossawi), (Dusuki and Abdullah) also highlighted that Islamic banking has certain significant issues that can hurt its growth.

1.3 Objectives of the study

Islamic banks throughout the world have been facing a number of issues and challenges that can affect the growth in this sector. Because of this the researcher attempts to study the main issues, prospects and challenges for Islamic banking. Based on previous studies, there are many significant issues and challenges for Islamic banking. However, this study investigates the main issues, prospects and challenges in Islamic banking from the perspective of Senior Management and Vice Presidents from the Islamic banking world. The views of these people are considered significant because they are directly involved in the operations of Islamic banking, and, therefore, know the issues more intimately.

The four main areas of this study are:

a) To examine whether the common global issues and problems in Islamic banking are applicable in the Malaysian scenario or whether there are other issues that the Malaysian Islamic banking industry is facing.

b) To identify the problems faced during the setting up of an Islamic banking operation by a Malaysian bank. The findings are gathered from the views of the people who were directly involved in this process. This case study will give an insight into how the involvement of Bank Negara Malaysia (BNM)
has made a significant contribution to the progress and development of Islamic banking. BNM is actually among the best central banks globally in promoting Islamic Finance (Islamic News, 2008).

c) To explore the prospects in the Islamic banking industry and how government support has resulted in a significant change in the Islamic banking industry in Malaysia.

d) As there are many issues in the Islamic banking industry, this study will also investigate the challenges of the Islamic banking industry in Malaysia.

Past literature investigating Islamic banking issues was studied in order to understand the associated issues. Most of the studies focused on issues surrounding the Islamic banking industry globally such as:

- Customer awareness. In issues related to customer awareness, Hamid and Nordin (2001) highlighted high awareness of Islamic banking, but, poor self reported knowledge of specific Islamic banking products and customer failure in understanding the difference between Islamic banking and conventional banking.

- Bank Selection Process. There are lots of studies on the Islamic bank selection process. In Bahrain, Metawa and Almossawi (1998) found that the bank selection process is more on religious based decisions. Dusuki and Abdullah (2007) in their recent study in Malaysia highlighted that Islamic
bankers can no longer depend on a marketing strategy for attracting pious and religious customers. They also suggested that Islamic banking needs to enhance its service quality, which is now considered a critical success factor that affects an organization’s competitiveness. The bank selection process is an important aspect for the Islamic banking industry to explore to attract customers.

- **Standardization in Islamic banking.** Ainley (1997) found that the biggest problem in the Islamic banking industry is the various interpretations of what is and what is not Islamic banking. The various interpretations may confuse customers and may affect their selection of the Islamic banking services. Tahir (2003) suggested that standardization is urgently needed in terms of the vocabulary of Islamic financing, financing instruments and their documentation.

- **Lack of expertise and knowledgeable staff in Islamic banking.** In the United Arab Emirates (UAE), the bank personnel did not fully understand the *shariah* rulings and had difficulty advising customers (Kuehn and Bley, 2004). Moreover, Tahir (2003) found that lack of qualified personnel is the biggest hurdle for the Islamic banking industry. There is a need of qualified personnel for Islamic banks to further progress.

- ***Shariah* knowledge.** The knowledge of *shariah* is important in contributing towards the progress of the Islamic banking industry. There are findings that
Islamic banking staff needs to possess knowledge of *shariah* to carry out Islamic banking operations effectively (Kahf, 2002).

- The need for effective marketing. Kuehn and Bley (2004) found that Islamic banks need to improve their marketing effectiveness by addressing market ignorance about Islamic bank products and services.

- Islamic banking assets are more risky than conventional banking assets. Saiful (1999) stated that Islamic banks are less flexible on the asset side compared to conventional banks due to the fixed rate regime. In Islamic banking, the rates are predetermined upfront and the rate cannot be changed even though the benchmark rate changes. The banks have to absorb losses if the benchmark rate goes up and he also argued that Islamic bank customers will switch to conventional banking if benchmark rate declines.

- Risk Management. In this area, there is a need for serious attention due to global problems in the risk management area. Ebrahim and Joo (2001) insisted that there is a need to design and implement Islamic risk minimizing facilities.

This study is based on the Malaysian experience since Malaysia is an Islamic Hub in South East Asia (Starbiz, Feb 2008). Furthermore, the Malaysian population is about 60% Muslim making it a solid place for Middle East investors to invest their money in accordance with *shariah* principles (Prystay, 2002). The prospects for Islamic
banking are also good because of government support and the fact that Malaysia is an Islamic country.

The importance and prospects for Islamic banking globally can be seen in the Bush administration in the United States. President Bush has appointed a distinguished academic, Mohammed el-Gamal, from Rice University, to advise the US Government on Islamic finance (Janahi and Weir, 2005). The recognition by the US government of the prospects for Islamic banking and the Middle East investment needs demonstrates the importance of Islamic banking.

1.4 Purpose and Significance of the study

This study on Islamic banking issues, prospects and challenges will shed some light on the area of Islamic banking. The study is quite different from previous studies on Islamic banking in Malaysia because:

- This study is quite unique and more detailed because previous studies in Malaysia concentrated on specific issues like products, customer awareness, risk, and selection of Islamic banking. For instance, “Why do Malaysian customers patronize Islamic banks” (Dusuki and Abdullah, 2007), “Performance of Islamic and mainstream banks in Malaysia” (Rosly and Bakar, 2003), “Perceptions of Malaysian corporate customers towards Islamic banking product and services” (Ahmad and Haron, 2002) and “Key factors influencing credit risk of Islamic bank in Malaysian case” (Ahmad and Nizam, 2004)
• The researcher will obtain information through interviewing bankers or senior management who are involved in Islamic banking.

• This research also attempts to look into setting up Islamic banking in Malaysia by the local banks including problems faced during this exercise.

Therefore, the researcher expects that these findings will benefit various parties including Islamic banking providers, regulators, and staff of Islamic banks and encourage them to look into the current problems and challenges. Furthermore, the findings from this study will give some insights for consideration of the respective parties for achieving the Malaysian government’s objective of making Malaysia an Islamic hub (BIS Review, 2006). Some of the areas identified are listed below:

a) Islamic banking products: Islamic banks are not lacking in terms of products and services compared to conventional banks. This study will also give some information and increase the awareness of customers that Islamic banking is on a par with conventional banking in terms of products and services. However, there is a need for Islamic banking providers to venture into Musyarakah and Murabahah financing, which is in accordance with the Islamic way and will provide good returns.

b) Staff of Islamic banking: There is a need for experienced and shariah knowledgeable staff in the early stages, especially in the development stage. However, knowledge of shariah is not compulsory for the operation of
Islamic banking. Moreover, Islamic banking staff lack training and there is a need for Islamic banks and BNM to explore the setting up of an Islamic Training Centre for bank related staff.

c) Customer awareness: To assist the Islamic banking providers to understand customer behaviour and the criteria in the bank selection process. The customers choose Islamic banking not solely because of religious based decisions but more because of service quality and convenience. Islamic bankers need to increase their service quality and image.

d) Risk Management Area: There is a need for Islamic banks to give attention to risk management and the need to design Islamic hedging solutions to minimize the risk.

1.5 Scope of the study
The debate on Islamic banking is so important that the global financial system is expending great efforts to deal with the issues of the Islamic banking industry. The researcher’s intent is to cover the issues related to Islamic banking in Malaysia by obtaining information from people involved in Islamic banking. The study on Islamic banking in the UK found that the main problems facing the Islamic banks are due to the tight regulation of the UK Government. This is largely attributable to the fact that the UK banking regulations were designed to accommodate conventional banks. Other significant problems found in Islamic banking are operational issues (Karbhari, Naser and Shahin, 2004).
In Malaysia, Islamic banking will face fewer problems arising from regulatory issues, because the central bank of Malaysia encourages Islamic banking, which can be seen in the objectives of MIFC as highlighted in the earlier introduction section. Sarker, (1999) commented in his research that Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws and regulations. Subsequently, BNM was awarded for being the best central bank in promoting Islamic Finance (Islamic News, 2008). Consequently, issues on regulation and policy will not be the main focus; however, the regulation and policy will be discussed in the case study. The regulation and policy issues addressed here are restricted to BNM procedures or guidelines that need to be followed in setting up an Islamic unit. Due to the confidentiality of the issues involved, only certain issues that are significant are highlighted by the respondents.

Therefore, the scope of the study will concentrate on:

a) Operational issues in Islamic banking in Malaysia. This will also include marketing, Islamic banking products and staff of Islamic banking.

b) Secondly, this study will also look into the setting up of Islamic banking. However, in this area the focus will be on problems faced during the setting up of Islamic banking and the involvement of BNM.
c) The next level, this research will also explore prospects for the Islamic banking industry in Malaysia.

d) Lastly, this study will look into the challenges that Malaysia’s Islamic banking industry will face in future.

1.6 Limitation of the study

Focused interviews were conducted to collect information from the people who are directly involved in the field. Due to time restraints, only one bank from each category was selected. They were interviewed concerning operational issues, prospects and challenges. Regarding regulation issues and policy, as it is not very significant in the context of Malaysia, and furthermore because of the confidentially of the information, only one bank was selected as a mini research to address this issue. This will look into how the bank set up its Islamic unit and the guidelines that needed to be followed. The regulation and policy issues are restricted to BNM procedures or guidelines that need to be followed in setting up an Islamic unit only. The information is so confidential that only certain issues, which are significant and highlighted by the respondents, were addressed.
1.7 Organization of the study

This study comprises of five chapters as outlined below:

Chapter one: **Introduction Section**

The first chapter of this report provides an overview of the Islamic banking industry both globally and in Malaysia, the importance of Islamic banking and the factors that led the researcher to conduct research in this area. It highlights the background of the study, objectives of the study, purpose of the study, scope of the study and lastly limitations of this study.

Chapter two: **Literature Review Section**

This chapter presents a detailed discussion on the subject matter. This describes the nature of Islamic banking, Islamic banking products and past literature that is related to this study and forms the basis of the interviews. This section also highlights the findings of past researchers on issues in the Islamic banking industry and also secondary data information on the prospects for the Islamic banking industry.

Chapter three: **Research Methodology**

Following the literature review, the third chapter describes the research philosophy and research methodology used throughout the study. The methodologies used to meet the objectives of the study included interviews and the study of secondary data. The interviews were divided into two sections with one set of interviews focusing on the issues, prospects and challenges in the Islamic banking industry and the second set of interviews forming a mini case study relating to the setting up of an Islamic bank.
Subsequently, this section lists the respondents interviewed and lastly describes the data analysis criteria.

Chapter four: **Research Results**

This chapter presents the findings from the interviews and the analysis of secondary data. Subsequently it also describes the detailed findings on issues, prospects and the challenges facing the Islamic banking industry. Research indicates that there are some issues for the Islamic banking industry in Malaysia. These include a lack of awareness of Islamic banking, especially for finance based products; the bank selection process is founded on service quality, convenience and “economy of the products”; and that the religious factor is not a conclusive factor. In addition the findings also highlight that Islamic banking products are not lacking compared to conventional banking products but that there is a need for aggressive marketing. In terms of standardization of *shariah* in Malaysia there are different opinions, but standardization is not deemed an issue as customers look more at potential benefits. The respondents also suggested that a *shariah* audit would be a good solution for Islamic banking to avoid any incompliance by the Islamic banks. Concerning bank staff, the research indicates that there is a need for staff qualified in Islamic banking with conventional banking experience in order to add value to it. The findings also highlight the importance of proper risk hedging systems so that Islamic bankers can hedge with the assets mismatching mechanism to maintain a comfortable risk level. In setting up an Islamic bank, the findings suggest that it is a tough assignment; problems in product development, the supply of skilled workers, the need to develop a
new system and the proper documentation and infrastructure problems are highlighted.

The research also suggests that the prospects for Islamic banking in Malaysia are still very bright as the industry receives strong support from both the government and the MIFC, including government tax incentives to help boost the industry. There are certain challenges that the Islamic banking industry in Malaysia will have to face – competition from Middle East Banks, mergers, moral hazard problems, product innovation, need for experienced staff and effective risk management.

Chapter five: **Conclusion and Recommendations**

Following the research result the last chapter summarizes and concludes the findings of the research. Subsequently, this chapter highlights the issues, prospects and challenges from the research including the problems faced during the setting up of an Islamic bank. This chapter also presents the implications of the study as well as some recommendations for future research. Lastly, this chapter discusses the whole of the research findings and recommendations in the conclusion section.
CHAPTER 2 LITERATURE REVIEW

2.0 Introduction

The main aim of this chapter is to investigate the issues and challenges for the Islamic banking industry that were identified by previous researchers. The issues and challenges described in this chapter are from various countries that are related to the subject of the study. In addition, the researcher gathered data on the growth of Islamic banking in Malaysia related to deposits, financing and assets.

First, this chapter examines the nature of Islamic banking in section 2.1 followed by section 2.2, which provides a brief overview of Islamic banking products. Third, section 2.3 discusses past literature related to this study including the bank selection process, customer awareness of Islamic banking products, standardization of Islamic banking, staff of Islamic banks, marketing, competition for Islamic banks, tax on Islamic banks, accounting standards and this sub-section ends with the topic of risk management. This section also highlights some prospects for growth in the Islamic banking industry from secondary data.

2.1 Nature of Islamic banking

Islamic banks comply with the law of the Land (jurisdiction) and Islamic Law (shariah). The main aim of Islam is to guide human development along the correct lines and in the right direction. Islam deals with all aspects of economic development, but always in the framework of total human development and never in a form divorced from this perspective (Al-Harran, 1993). The main objective of Islamic
banking has been the prohibition of interest and the use of trade and commerce (Al-bay’). Islamic banking and prohibition of interest was not founded on the principles of economics but was developed as a result of a decree sent by the almighty creator Allah (Ghannadian and Goswami, 2004). This has led many people to think that Islamic banks operate without interest. Islamic banking has two sets of belief. These are that interest as a reward for saving does not have any basis as a moral foundation; abstinence from spending of present income does not deserve a financial reward and to benefit from money is to transform the money into investment. (Presley, 1988).

Interest free banks were established to conform to Islamic law, which prohibits interest on all types of loans (personal, commercial, agricultural, industrial) regardless of whether these loans are made to friends, private or public companies or any identity (Metwally, 1997). In addition to normal banking laws and prudential laws, Islamic banking is supervised by the shariah board to enforce the application of fair dealing and the avoidance of prohibited transactions (Arif, 2007). Taylor (2003) also stated that Islamic principles extend to all aspects of a Muslim’s life so as a result each practitioner of Islam is necessarily implicated by shariah principles.

The most important factor in the Islamic principles pertaining to banking is the prohibition of riba or any predetermined or fixed rate in financial institutions. As stated in the Quran “Allah forbids riba”. Riba means an increase and under shariah the term refers to the premium that must be paid by the borrower to the lender along with the principle amount as a condition for the loan (Omar and Abdel, 1996). The Quran states that interest constitutes an unfair business transaction as profits realized
from loans are risk free with no evidence of value addition by lenders (Rosly and Bakar, 2003). The dictionary meaning of Riba is an increase and the reference in the verse is to every increase against which there is no exchange or consideration (Haque, 1993). Islamic law states that money itself does not have any value and therefore it should not lead to more money. Some have interpreted riba as any interest payments, while others interpreted it to encompass only “excessive” interest payments.

“Those who devour interest become like the one whom satan has bewitched and maddened by his touch. They have been condemned to this condition because they say trade is just like interest, whereas Allah has made trade lawful and interest unlawful. Henceforth, if one obtains from taking interest after receiving this admonition from his lord, no legal action will be taken against him regarding the interest he had devoured before; his case shall ultimately go to Allah. But if one repeats the same crime even after this, he shall go o hell, where he shall abide forever.”

(Albaqarah, 1: 275)

As an alternative interest free techniques have been developed by Islamic banks. The main reason for the twentieth century re-development and growth of the Islamic banking system is the conventional banking system’s reliance on interest-based financing (Omar, 2004). The conventional financial system depends on interest but the Islamic economic system is based upon a number of principles founded in Islamic law (Seyed, 2003). Islam prohibits doing business with riba or usury/interest. The prohibition of interest means that Islamic banks cannot incur or earn interest in any of their financial transactions. (Karim, 1996) Islamic financing is based on two principles that are profit and loss sharing (PLS) and the mark up principle. The PLS principle allows the bank to earn a return on invested funds, provided that the bank shares the risk of investment and bears the loss if the investment fails. Participatory
finance through *musharakah* was one of the earliest forms of financing involving a partnership between the provider of the capital and the user or entrepreneur (Wilson, 1997). The mark up principle is considered as the reward of the risk for the financer.

In the mobilization of funds, Islamic banks depend on four main sources including shareholders’ funds, current accounts, investment accounts and savings accounts (Karim, 1996). There are more than 40 Islamic financial products and services offered by Malaysian banks based on Islamic concepts and in compliance with *shariah* principles. For the sake of clarity, some of the characteristics of the products are discussed below.

### 2.2 Islamic banking products

Islamic banking products are increasing day by day and previous studies found that Islamic banking products are on a par with conventional banking products (Haidi and Malik, 2006). According to BNM statistics 2007 (figure 2.1), *Al Bai Bithaman Ajil/BBA* financing is the most common in Islamic banking. There are a lot of Islamic banking products, however in Malaysia there are some famous Islamic products that will be discussed briefly in this section.

#### 2.2.1 *Al Bai Bithaman Ajil/BBA* (Deferred Payment Financing)

This involves the credit sale of goods on a deferred payment basis. As requested by the customer the Islamic bank will purchase certain assets on a deferred payment basis and then sell the goods back to the customer at an agreed price including some margin or profit. The customer will make payment by instalments over an agreed
period. A fixed rate BBA is a powerful hedging tool against interest rates (Rosly, 1999).

2.2.2 Murabahah

*Murabahah* is a contract of sale. The financial institution acts as a middle man and purchases the goods requested by the customer. The bank will later sell the goods to the customer in a sale and purchase agreement, whereby the lender re-sells to the borrower at a higher price agreed on by both parties. These are more for short term financing. According to Tarek al-Diwany, *Murabahah* is a form of trust sale since the buyer must trust that the seller is disclosing true costs (Haque, 1993).

2.2.3 Mudharabah

According to Kettel (2006), *Mudharabah*’s basic principle of profit and loss, where instead of lending money at a fixed rate return the banker forms a partnership with the borrower, thereby sharing in a venture’s profit and loss. *Mudharabah* is an agreement between the lender and entrepreneur, whereby the lender agrees to finance the project on a profit sharing basis according to a predetermined ratio agreed by both parties concerned. If there are any losses the lender will bear all the losses. It is one form of partnership in which one partner (*rab-ul-amal*) provides the capital required for a project, while the other party (mudarib) manages the investment using its expertise. The capital provider carries the loss in a *Mudharabah* contract unless it was due to the mudarib’s negligence or misconduct.
Mudharabah may be conducted with the Islamic bank as the provider of funds on behalf of the depositors. The bank pays its depositors all profits from the investment after deducting its fees.

2.2.4 Musyarakah

Musyarakah means partnership whereby the Islamic institution provides the capital needed by the customer with the understanding that they both share the profit and loss according to a formula agreed before the business transaction is transacted. In Musyarakah all partners are entitled to participate in the management of the investment but it is not compulsory. Musyarakah provides financing for large investments in modern economic activities but is unfortunately not actively practiced in Malaysia.

2.2.5 Al Ijarah

Ijarah is an Arabic term with origins in Islamic fiqh, meaning to give something on a rental basis. This is more in accordance with the shariah concept of leasing where the bank acquires ownership based on the promise and leases back to the client for a given period. The customer pays the rental but the ownership still remains with the bank or lender. As the ownership remains with the lessor (bank), who is responsible for its maintenance, it continues to give the service for which it was rented. Under this contract, the lessor has the right to re-negotiate the quantum of the lease payment at every agreed interval to ensure rental remains in line with the market rates (Hume, 2004).
2.2.6 Wadiah

This is a contract in which a person allows another to keep his property. *Wadiah* is a trust contract and the bank provides gift (*hibah*) and various types of benefits to the customer. This is exactly like a normal conventional savings account.

2.2.7 Istisna

*Istisna* is a new concept that offers future structuring possibilities for trading and finance. One party buys the goods and the other party undertakes to manufacture them according to agreed specifications. Normally, *Istisna* is used to finance construction and manufacturing projects.

2.2.8 Salam

*Salam* is defined as the forward purchase of specified goods with full forward payment. This contract is normally used for financing agricultural production. According to Hassan (2004), *Salam* based future contracts for agricultural commodities, supported by Islamic banks, will offer to overcome the agricultural financial problem.

2.3 Literature review

The intention of this section is to highlight the important issues revealed by the previous studies on Islamic banking. Subsequently, this section also explains the prospects for Islamic banking from a review of secondary data like BNM reports, MIFC reports and Business reviews.
2.3.1 Bank Selection Process

Islamic banking has been in Malaysia for the past 30 years. Haron et al., (1994) in their earlier studies in Malaysia found that Muslims in Malaysia had three main criteria for selecting banks – fast and efficient service, the speed of transaction and friendly bank personnel. In another study on banking selection process Erol and El-Bdour (1989) discovered that the most important criteria for customers were the provision of fast and efficient service, bank reputation and image and confidentiality. Surprisingly, in Jordan, it was found that religious reasons are not the main criterion in selecting Islamic banking services (Naser, Jamal and Al-Khatib, 1999). However, in Bahrain, the Islamic bank selection process is based more on a religious decision (Metawa and Almossawi, 1998). Other criteria include fast and efficient services, speed of transactions, friendliness of bank personnel, confidentiality of bank and lower interest charges on loans (Haron, 1994). In the context of the selection of Islamic banks some of the above may not play the same role. Hagazy (1995) found that selection of Islamic banks is based more on recommendations and advice, convenience of location, friendliness of personnel, and the banks vision of serving the community, regardless of the expected profitability, timeliness and efficiency. Dusuki and Abdullah (2007), in their recent study of “Why do Malaysian Customers patronize Islamic banks”, found that knowledgeable and competent personnel, friendly personnel, customer service quality, Islamic reputation and image, respect for human rights, Islamic working environment, convenience and product price are important factors. The study also indicated that the selection of Islamic banks was predominantly a combination of Islamic and financial reputation and quality of service offered by the bank. Furthermore, an earlier study in Malaysia found that the
religious factor is not conclusive enough to drive Muslims to use banking facilities; it is more the convenience based on the availability of branches, ATMs and location (Rosli and Afandi, 2003). These findings are also supported by Gerald and Cunningham (1997) in their study on Islamic banking in Singapore. To simplify, we can conclude that staff and the service quality (convenience, fast service, and parking) play an important role in the development of Islamic banks. However, religious motivation cannot be totally ignored. In Thailand, a survey on Islamic banking found that 98% of the respondents favoured the establishment of Islamic banks and were willing to become customers (Haron and Yamirudeng, 2003).

2.3.2 Customer Awareness on Islamic Banking

In Malaysia the majority of the population is Muslim. In order for Islamic banking to grow there is a need to encourage Muslims to use Islamic facilities first and then encourage non Muslims. A study on Islamic banking in Singapore found that only a small proportion of Muslims have any awareness of the Islamic banking culture and that for non Muslims the awareness is nearly non-existent (Gerrard and Burton, 1997). Dusuki and Abdullah (2007) in their recent study found that the substantial issue requiring attention is the need to intensify public education and awareness of the distinctive characteristics of Islamic banks and how they may engender the interest of customers in their financial dealings. A study by Haidi and Malik (2006) found that exposure and knowledge of Islamic banking is through one’s own effort prior to property purchase, recommendation by friends, through working experience and via promotions and advertisement. They also found that, the first impression of Islamic
banking is the fixed rate concept, “halal” loan being an alternative to a conventional loan.

In Bahrain, Metawa and Almossawi (1998) found the majority of Islamic bank customers are well educated and that most of them are aware of the deposit schemes that include current accounts, savings accounts and investment accounts. This study also found that a significant portion of bank customers, that is around 30%, are not aware of the financing schemes. Islamic banking in Malaysia has yet to exemplify the moral and ethical requirement for trade and commerce (al-bay’) as envisaged in the Quran to achieve efficiency (Rosli and Afandi, 2003). The study on Islamic banking in Jordan found that the people were aware of basic financial terms like Mudaraba, Musharaka and Ijarah (Kamal et al., 1999). They also found that in addition to an awareness of these products they also use these financing schemes. However, this is in contrast to the study by Gerrald and Cunningham (1997) who reported that Muslim respondents, though aware of the fundamental terms in Islam, were almost unaware of the meaning of specific Islamic financial terms like Mudaraba, Mushraka and Ijara.

Hamid and Nordin (2001) in their study of Malaysian banking customers, found a high awareness of Islamic banking but poor self reported knowledge of specific Islamic banking products, including poor understanding of the difference between Islamic and conventional banks. They also said that better consumer education will assist in making people more aware of Islamic banking products. This research supports a study in UAE, which found that students who had achieved a higher education tended to possess more knowledge of both conventional and Islamic banks.
Furthermore, a study in Bahrain shows that the majority of Islamic bank customers are well educated, with approximately 40 per cent holding high school certificates and about 50 per cent holding a bachelor degree or above.

2.3.3 Lack of Standardization
Karbhari et al., (2004) found that interpretation of shariah principles are left to Muslim schools and that different schools of thought have emerged in different cultures and Islamic societies. They also found that the lack of standardization and clarity makes it difficult for Western regulators to understand the idea of Islamic banking. Every Islamic bank appoints an Islamic Shariah Committee to evaluate whether the bank transactions and other activities are in accordance with the Islamic shariah. Ainley (1997) found that the biggest problem for Islamic banking was the various interpretations of what is and is not Islamic banking. Tahir (2003) insisted standardization is urgently needed in the vocabulary of Islamic financing, financing instruments and their documentation and pricing formulas for Islamic products. For example the majority of Islamic banks use the name “Murabahah” to stand for financing via sale on deferred payment while some call it Al Bai Bithaman Ajil /BBA (Deferred Payment Financing). Dr Zeti Akthar Aziz the Governor of Bank Negara Malaysia viewed one of the central issues towards developing a dynamic Islamic financial industry as people’s perspective of shariah (BIS Review, 2004). She believes that shariah should be viewed as an enabler to innovation and creativity rather than a constraint. There is also need for collaboration among the shariah scholars, practitioners, researchers and regulators to undertake in depth studies and research towards the development of Islamic banking in Malaysia (BIS Review,
Tahir, (2004) recommended that there is a need to develop *shariah* manuals, regular banking manuals and the formulas for pricing various Islamic financial products.

### 2.3.4 Expertise and knowledgeable staff in Islamic banking.

The staffs, or banking personnel, are important factors for the development of Islamic banking. In terms of banking concept, customer services are performed to assist the customers to achieve their needs and wants through tellers via banking counters, personal financial assistance, automatic teller machines, telephone banking and Internet banking (Wei and Nair, 2006). Tahir (2003) in his research in Pakistan found that a lack of qualified personnel or manpower is the biggest hurdle in the advancement of Islamic banking. He also commented that there is no training institute to meet the manpower needs of either the existing or the future needs of Islamic banks. A study in Bangladesh, found that to establish an Islamic bank in a village or small town is very unusual but one of the main problems that is faced is finding suitable staff (Hassan, 1999). The study in Malaysia found that the knowledgeable and competent personnel, friendly personnel and customer service quality gained the highest ranking in patronizing Islamic banks (Dusuki and Abdullah, 2007). In their research they also concluded that customers highly regard knowledgeable and competent personnel. Another study in Malaysia by Sadar *et al.*, (2004) found that Islamic banking requires a high calibre work force and management teams with expertise, leveraging on technology and strengthening research areas. This was also supported by Choudry and Hussain, (2005), who stressed that human resource development is a powerful instrument in Islamic banking but that it must first be developed. Islamic banks should not take for granted the expectations of their
clients by assuming they are prompted to deal with Islamic banks solely by their religious conscience, but should also promote a quality of service. The study in UAE found that bank personnel did not fully understand *shariah* rulings and had difficulty advising customers on the characteristics of different types of Islamic banking products. In UAE, consumers make decisions not simply on knowledge or the quality of service but on religious principles (Kuehn and Bley, 2004). The staff of Islamic banks need not only be Muslims; what is important is their knowledge of Islamic banking. Karbhari et al., (2004) in their research in the UK found that recruitment is not a problem and the knowledge of *shariah* or Islam is not a must to carry out Islamic banking. They also found that the lack of professional courses and training tailored for Islamic banking resulted in a lack of qualified staff. This is also supported by the earlier research by Iqbal (1997) who found that the lack of trained staff partly contributed to the slow innovation of Islamic banking products.

KPMG (2006) in their reporting on Islamic banking, found that due to the recent emergence of Islamic Finance, there is shortage of professional staff and managers with experience and knowledge of Islamic financial products and relevant *shariah* knowledge.

### 2.3.5 The Importance of Marketing

Islamic banks need to improve their marketing effectiveness by addressing the market ignorance about Islamic products and services (Kuehn and Bley, 2004). Gerrard and Cunningham (1997) insisted that Islamic banks in Singapore need to create awareness through marketing, like media advertising. Naser and Mouthino (1997) in their study on “Strategic marketing management in the case of Islamic banks” found that Islamic
banks have not made sufficient use of their natural competitive advantages within the Muslim Community and must also attract non-Muslims. They suggested that Islamic banks should look into developing effective marketing strategies through product innovation and market development. This was supported by Karbhari et al., (2004), who stated that it is important for Islamic banks to educate people about what they offer and the need to be heavily involved in the marketing of their products and services. There is a need to increase the awareness of Islamic products and services via brochures, pamphlets and seminars, which will enable Islamic banks to improve market share and retain financial resources in the nation (Ebrahim and Joo, 2001). Overall the main issue is that Islamic banks must have effective marketing and also make the effort to educate their customers.

2.3.6 Competition
Conventional banking has been established much longer than Islamic banking. In terms of experience and product choice conventional banks are more advanced. It is not clear that Islamic banks will provide more competition to conventional banks. (Aggarwal and Yousef, 2000). However, Kaleem (2000) found that Islamic banks not only have to compete among themselves but also with conventional banks. Recently, many of the key players in the conventional banks, such as OCBC, Citibank and HSBC, have begun to move into providing Islamic banking through Islamic windows. Moreover, foreign Islamic financial institutions like Kuwait Finance and Al-Rajhi Bank have also moved in. If many players come into the market it can be argued that the competition in the Islamic banking field has been greatly increased. As many players enter the field it will be difficult for the Islamic banks to survive. (Karbharie et al., 2004). In addition, the findings of Omar Khan (2004) who found that although
the inefficiency of Islamic banks is greater than conventional banks it is still relatively small and is not a major concern. Given the time, Islamic banks could be well developed like conventional banks.

2.3.7 Tax Discrimination
A study in the United Kingdom found that the tax system in the UK seems to favour conventional banks because the UK government encourages and gives preference to conventional banking. (Karbhari et al., 2004). This tax discrimination will not be a problem in Malaysia, however, because of the preference given to Islamic banks in keeping with Malaysia’s desire to make the country an Islamic hub. In 2008, Islamic banking transactions were provided with tax neutrality, whereby Islamic Finance would be tax neutral compared with conventional financing products. Also various tax exemptions and withholding tax exemptions given in line with conventional products (Budget 2007).

2.3.8 Accounting Standards
Tahir (2003) commented that accounting represents one of the challenges in the implementation of the Islamic financial paradigm. He identified some of the problems in the Islamic banking accounting method:

1) Income is not realized when it accrues, but when it is materialized like in *Murabahah* financing.

2) When depositors offer funds to the bank on a partnership basis they are dealing with the bank. The staff or the bank is responsible for providing investment services.
In this case Islamic banks cannot charge their establishment costs for operating expenses or deposits raised on the basis of *Musharakah*.

Accounting frameworks in the leading Islamic financial institutions are International Financial Reporting Standards (IFRS), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and some local GAAP’s. Standard and Poor’s report stated that disclosure practices among Islamic Financial institutions fall well short of international practice. “Standardization of financial reporting is a key challenge for the rapidly growing Islamic finance industry” (KPMG, 2007).

However, the establishment of the Accounting and Auditing organization for Islamic Financial Institutions (AAOIFI) has made a significant contribution in formulating and issuing accounting and auditing standards for Islamic Financial Institutions. The standards issued by AAOFII have contributed towards the improved quality of financial statements and reporting methodology (BIS Review, 2004).

### 2.3.9 Risk Management

According to Adil (2007), the Bahrain Islamic bank does face the same risks as conventional banks. This is supported by Nazir, the Vice President from CIMB Islamic Bank (MIF, 2007). There are unexpected losses to capital insulated by credit risk, market risk, rate risk, liquidity risk and operational risk. The credit risk of an Islamic bank is in the form of settlement or payment risk arising when one party to a business transaction pays money (*Salam* or *Istina* contract) or delivers assets (*Murabahah* contract) before receiving its own assets or cash, thereby exposing it to potential loss (Khan and Ahmed, 2001). Their research also found that the highest
Credit risk is in *Musharakah* products followed by *Mudarabah*. Tahir (2003) found that the nature of Islamic financial instruments implies that Islamic banks face the traditional commercial credit risks of their clients as well as other risks associated with their instruments. For instance, the market risk for *Salam* financing are potential damaging claims due to ownership of assets in lease financing. Credit risk is one of the main risks that seriously affect a bank’s viability; this can be seen from the latest 1997 financial crisis. To support this view, at that time Sarker (1999) found that the amount of bad debt in Islamic banking is growing. This is in contrast with the view of Aggarwal and Yousef, (2000) who claim that Islamic banks mainly structure their lending to short term and that it is heavily secured. Management efficiency and risk weighted assets such as size of total assets have a significant influence on the credit risk of Islamic banks (Hayati and Nizam, 2004).

Capital and liquidity requirement is another significant issue that cannot be avoided in Islamic banking. The Basel Committee overestimates the risk of Islamic banking assets (Karbhari et al., 2004). To be more specific we can say that assets of Islamic banks are more risky. Ainley (1997) indicated that the assets of Islamic banks are more risky than conventional banks because a large portion of the conventional banks assets are maintained in fixed interest bearing compared to Islamic banks that invest in long term projects and ventures that are difficult to value. The loans profit margin of Islamic banks decline during interest rate hikes because the BBA loans are run in a negative fund gap strategy and Islamic bank loans are not hedged like conventional loans. (Rosly, 2003).
Principles of capital protection, risk management and risk hedging are essentially acceptable to general principles of Islamic Law as long they are free from taking and paying interest, uncertainty in pricing and any clause which contradicts the very purpose of an underlying contract (Bakar, 2007). Growth in Islamic financing and treasury instruments is the key driver behind the demand for Islamic risk management tools (Kandasamy, 2007). There is a need to design and implement Islamic hedging and risk minimizing facilities like Islamic futures and Islamic swaps. This will enhance the profitability of Islamic banks while simultaneously reducing their risk exposure (Ebrahim and Joo, 2001). There is a need for serious attention to be given to risk management in Islamic banking and the establishment of the IFSB is timely to address this issue. (Hayati and Nizam, 2004). The rapid growth in the size and number of Islamic banks seems to have led regulatory authorities to appreciate the need to develop appropriate measures that would enable them to control their operation, which differs from Western banks. (Karim, 1996)

2.3.10 Policy and Regulation

Western writers make reference to Islamic banking behaviour as “traditionalism” and “conservatism” (Ahmad and Weir, 2005). In the UK, the major problem facing the development of Islamic banks is the legal structure. The lack of understanding causes tension between the regulators and the Islamic banks that affects the regulators willingness to support such organizations (Karbhari et al., 2004). The UK government is reluctant to grant a banking licence as Islamic banks cannot guarantee the customers’ deposits. Furthermore, they stand firm on their definition of a bank as an institution that can guarantee deposits and provide a declared return on them (Carlson, 1986). The regulation and control of Islamic banks is necessary to ensure
that they remain “Financial Institutions” (Tahir, 2003). Makiyan (2004) found that in Iran, government intervention played an important role in Islamic banking, more so than any economic factors.

In Thailand, the future of Islamic banking is very much dependent upon individual Muslims and Islamic organizations. Support from institutions such as Islamic private schools, mosques, Islamic centres, zakat funds and Islamic savings cooperatives are vital, especially during the growth stage (Haron and Yamirudeng, 2003).

In Malaysia, Islamic banking will face fewer problems on regulation issues because the central bank of Malaysia encourages Islamic banking, which can be seen in the objectives of the MIFC. The Malaysian government supports Islamic banks as can be seen in their projected ninth plan, where one of the key strategies is to develop Malaysia as an International Islamic Centre for Islamic Banking and Finance. In 2008, Islamic finance transactions were provided with tax neutrality, whereby Islamic Finance would be tax neutral compared with conventional financing products. Also various tax exemptions and withholding tax exemptions given in line with conventional products (Budget, 2007). The governor of Bank Negara Malaysia, Tan Sri Dr Zeti Akhtar Aziz said that Malaysia would make every effort to ensure the soundness and stability of Islamic finance as well as its resilience in an environment of financial stress (BIS Review, 2004).
2.3.11 Total Financing of Islamic Banks

Figure 2.1
Total Financing Islamic banking

Source: (www.bnm.gov.my, 2008)

Figure 2.1 above, shows an increase of 217% from 2001, which is from RM28.201 million to RM89.587 million in 2007, illustrating how important Islamic banking growth is in terms of total financing. The increasing trend in Islamic financing shows a lot of consumers are selecting Islamic banks as a source to finance their needs.
Figure 2.2 highlights that Islamic financing is more popular in BBA financing (39%) and *Ijarah Thumma Al Bai* (30%). Basically, these two forms of financing are more popular in Malaysia and are the main concentration for Islamic banks in Malaysia. Consumers are interested in BBA financing and *Ijarah Thumma Al Bai*, because this financing concept is not far from the conventional housing loan and leasing. *Musyarakah* (less than 1%) financing is very far behind, because local Islamic banks are not prepared to venture into this type of business because of the risk and expertise that is needed.

Source: (www.bnm.gov.my, 2008)
2.3.12 Total Deposits of Islamic Banks

The above figure 2.3 shows an increase of 159% from 2001 that is from RM47.106 million to RM121.705 million in 2007, and shows how important Islamic banking growth is in terms of total deposits. However, the increase in deposits is not as much as financing, due to the competition from conventional banks. Deposits are considered the main source of funding compared to other financial sources. The main sources of fund are savings and investment accounts.
From the above figure 2.4, it can be seen that general investments captured a major portion of the Islamic banking deposits, contributing 37% from the total Islamic banking deposits. These general investment accounts are shared based on a pre-defined ratio. The advantage of these investment based deposits are that they are considered as low risk with secure returns compared to other types of investment like stocks and unit trusts. Moreover, customers are more secure because of the adequate risk management practices undertaken by the Islamic banks.

Source: (www.bnm.gov.my, 2008)
2.3.13 Total Assets of Islamic banks

Assets of Islamic banking increased by 167% from 2001, that is RM58.929 million, to RM157.125 million in 2007. The increase in assets of Islamic banking is in line with the total financing. Assets of Islamic banking have shown a great improvement compared to the year 2001. This is partly attributable to the aggressiveness of Islamic banking in marketing Islamic banking products. According to Prystay (2002), BNM issued a master plan that aimed to have Islamic banking make up 20% of all assets by 2010.
CHAPTER 3 RESEARCH METHODOLOGY

3.0 Introduction
As discussed in Chapter 1, the researcher’s objective is to examine the current issues, prospects and challenges that surround the Islamic banking industry in Malaysia. Secondly, the researcher is also exploring the issues of setting up Islamic banking in Malaysia by local conventional banks.

Thus, this chapter discusses the research methodologies employed to achieve the above research objectives. Section 3.1 presents the research philosophy adopted by the researcher, followed by section 3.2 explaining the data collection methods – interviews and case study. Next, section 3.3 is the listing of the Islamic banks in Malaysia and subsequently sections 3.4 and 3.5 describe the summary of the respondents who took part in the interviews. This chapter further discusses the data analysis in section 3.6.

3.1 Research Philosophy
Research is an organized, systematic, data based, critical, objective, scientific inquiry or investigation into a specific problem undertaken with the purpose of finding answers or solutions to it. (Sekaran, 2003). Furthermore, he also stated that the research provides the required information that guides managers to make informed
decisions to successfully deal with problems. Rowley (2003) describes research as very important in responding to a changing environment.

Sekaran (2003) stated that data can be quantitative (as generally gathered through structured questions) or qualitative (as generated from the broad answers to specific questions through interviews, from responses to open-ended questions, from observation, or from already available information gathered from various sources).

This study is a qualitative based study that involves data collection from interviewing professionals who are involved in Islamic banking and reviewing secondary data that is related to Islamic banking. The intelligence gathering demanded by the inductive approach is translated using a combination of quantitative and qualitative methods (Swartz, 1997). Holbrook (1992) states that “consumer science” has put qualitative methods of various kinds in the pursuit of knowledge. Denzin and Lincoln (1994) suggested that the encyclopaedic treatment of qualitative research brings many methods and applications to the fore. Cahill (1995) stated that the use of qualitative techniques can bring quantitative information to life. Acquaintance with qualitative research methodologies provides an opportunity for understanding digital libraries and hybrid libraries (Rowley, 2004).

The researcher’s objective is to determine the issues in the Islamic banking industry and the prospects and challenges that these banks will face in future. To achieve this objective, the researcher employed the interview technique to collect information from people directly involved in Islamic banking.
In addition, a case study was conducted to explore the problems the Malaysian Islamic banks experienced in conjunction with setting up an Islamic bank. In order to achieve this objective, the researcher employed the interview technique and collected information from the people involved in setting up an Islamic bank in one of the premier banks.

3.2 Data collection method

Primary data refers to information obtained firsthand by the researcher on the variables of the interest for the specific purpose of the study. Some of the examples are individuals, focus groups and panels of respondents whose opinions may be sought on specific issues (Sekaran, 2003). One of the renowned methods of data collection is interviewing respondents and it can be structured or unstructured. Gill and Johnson (1991) stated that it is important that ideas are obtained by talking to practitioners and professionals. The interview can be conducted through face to face or telephone. Visual aids such as cards, drawings, pictures and materials are used to get a better response on significant information. A tape recorder will be a suitable accompaniment that needs to be carried when interviewing. However, in most situations the respondents will not want the tape recorders to be used and pre-approval from the respondents is needed before using a tape recorder.
Secondary data refers to information gathered from existing sources (Sekaran, 2003). For example in this research, secondary data is obtained by examining records such as government publications, web sites, company records and seminar write ups. Howard and Sharp (1983) recommended types of literature that are of particular use for generating ideas such as articles in academic and professional journals, reports and books.

3.2.1 Research Instruments

The research instruments used in this study are semi-structured interview questions. The interview questions were designed based on the review of earlier literature and ensures that all the relevant issues for this research are covered in the list of questions. The interview questions are attached as per Appendix 1.

3.2.2 Rationalization of Questions

The questions prepared for the interview are divided into two sets. The first set addresses the issues, prospects and challenges while the other focuses on setting up an Islamic bank.

The interview questions in the first set are divided into issues, prospects and challenges. Issues are divided into a few sub sections:

- Islamic banking customers and product: This part is to determine customer awareness, selection process of Islamic bank and marketing of Islamic banks. In addition, issues on standardization of interpretations are also examined. These questions will enable the researcher to understand the factors that
motivate Islamic bank customers and establish whether there is a lack of products compared to conventional banks. Furthermore, information on shariah standardization will also give the researcher some insights into whether standardization is needed. There are eight questions designed in this section.

- Staff of Islamic banking customers: There are three questions in this section to examine whether the Islamic bank staff are qualified and whether knowledge of shariah is a merit to conduct Islamic banking. The questions will enable the researcher to identify whether the staff are qualified in terms of Islamic knowledge and if there a need for knowledge of shariah.

- Risk: Questions on risk are related to the risk of Islamic banking assets and how the banks handle fixed rate exposure. Also, questions on the hedging mechanism are included. There are three questions in this section. This detailed information will enable the researcher to compare the risks between conventional banking and Islamic banking.

Questions on the prospects and challenges are included in one section to determine the prospects in the Islamic banking industry and the challenges in terms of competition and products. This information is to identify Islamic bank prospects from the view of Islamic bankers and what they predict as the challenges for the Islamic banking industry.
The second set of interview questions are for the case study in setting up Islamic banking. In this section there are six interview questions, which examine the problems in setting up Islamic banking and how the bank managed to overcome the problems. Furthermore, questions on government support and development on the legal structure are also included. This information will determine the problems in setting up Islamic banking as well as government support for the Islamic banking industry. In addition, the contribution of MIFC will also be analyzed in this section.

### 3.2.3 Semi-Structured Interview

A face to face interview method can get you the best, highest quality data because many questions can be asked for clarification. (Janes, 2001). There is a need to obtain the highest quality data and as a result of this the researcher can conduct semi-structured interviews to identify the critical problems and to elicit information of greater depth. This approach is less formal than a structured interview but can draw out more qualitative data. Furthermore, it identifies at the outset what information is needed. Basically, the researcher prepares the predetermined questions in advance and the respondents are asked the same structured questions in the same manner. The semi-structured questions were prepared based on various literature reviews on Islamic banking and the predetermined questions were discussed with the supervisor. Amendments were made in order to ensure the clarity of the questions.

When the respondents expressed their views, the researcher noted them down. As the information given by the candidates was confidential the respondents did not want the conversations to be recorded.
Currently there are ten local full-fledged Islamic banks, three Middle East Islamic banks and seven participating foreign based Islamic banks (www.bnm.gov.my). In order to study the empirical evidence on the prospects, challenges and problems facing the Islamic banking industry in Malaysia, it was important to obtain the correct information from the people directly involved in Islamic banking. As a result, the researcher decided to collect data by concentrating on a series of semi-structured interviews. The respondents were the Senior Management or the Vice President of Islamic bank operations who have many years experience in Islamic banking. Furthermore, the respondents were based in Kuala Lumpur and either work for Islamic banks or Islamic units within conventional or foreign banks.

The interviews were performed in the expectation that the experience of the respondents in the Islamic banking field will give valuable information on issues or problems facing the Islamic banking industry in Malaysia. In order to select the respondents the banks were divided into four sections to provide more valuable information pertaining to issues, prospects and challenges facing the Islamic banking industry in Malaysia. They were divided into:

1) Full Islamic bank licence (Full-fledged Islamic Bank)
2) Conventional bank which also runs Islamic Bank (who owns full licence)
3) Foreign Islamic bank which runs Islamic Bank in Malaysia
4) Participating banks in the Islamic Banking Scheme, Foreign Commercial Banks.
The banks were divided in certain categories to identify whether the issues or problems are different based on their status. Semi-structured interviews were conducted to collect information from the people who are directly involved in the field. Despite time constraints at least one bank from each of the above categories was selected to obtain the information. Prior to the interview, the respondents were called to seek their consent for an appointment. Before fixing the appointment, the respondents were briefed on the objectives of the interview and the significant contributions that the respondents could provide for this study. Also, the student identity card from University Malaya was shown to the respondents to reassure them that the data collection is purely for academic purposes. There were five respondents for the interviews and the time and location were fixed according to the respondents’ convenience. Even though appointments were rescheduled a few times the researcher eventually managed to carry out the interviews as planned. The interviews lasted between 45 minutes to 1 hour.

3.2.4 Case Study

On regulation issues and policy – only one bank was selected as a case study to address this issue. Case studies are a useful research approach for answering why and how questions, or when it is useful to seek to understand a situation. Furthermore, they can be used in professional research (Rowley, 2004). This study will explore how the bank set up its Islamic Unit and the problems that it faced during this period.
Data collection and interpretations are guided by successively evolving interpretations made during the course of the study that lead to the formulation of theory (Gummeson, 1993). According to Rowley (2004), case studies are more likely to involve a formal gathering of information from a range of records and personal sources and require the willing and conscious participation of other people. Fortunately, this engagement may influence how these people see their world.

The interview involved the person in charge of setting up the operations of the Islamic bank and the product development section. Only one local bank is selected to address this issue because of the limited time frame and also because of the confidentiality of the information. The bank that was selected to verify this issue is one of the premier banks and only recently fully set up its Islamic banking. By selecting a few key personnel who are involved in setting up the Islamic banking it will give a better understanding of the problems as a whole.

There were three respondents for this mini research or case study. The people selected were from a few important departments including Islamic product development and branch operations. Each interview lasted about 30 to 45 minutes.

### 3.3 List of Islamic banks in Malaysia

Listed below are all the Islamic banks that exist in Malaysia including window based Islamic banks:

#### 3.3.1 Full Islamic bank licence (Full-fledged Islamic banks)
1) Bank Islam Malaysia Berhad
2) Bank Kerjasama Rakyat Malaysia Berhad
3) Bank Muamalat Malaysia Berhad

### 3.3.2 Conventional bank which also runs Islamic banks (who owns full licence)

1) Affin Islamic Bank Berhad
2) EONCAP Islamic Bank Berhad
3) Hong Leong Islamic Bank Berhad
4) CIMB Islamic Bank Berhad
5) Maybank Islamic Bank
6) RHB Islamic Bank
7) AM Islamic Bank Berhad

### 3.3.3 Foreign Islamic bank which runs Islamic bank in Malaysia

1) Kuwait Finance House (M) Berhad
2) Al Rajhi Banking & Investment Corporation
3) Asian Finance Bank Berhad

### 3.3.4 Participating banks in the Islamic banking scheme commercial banks.

1) ABN AMRO Bank
2) Alliance Bank Berhad
3) Citibank Berhad
4) HSBC Bank Malaysia Berhad
5) OCBC Bank Malaysia Berhad
6) Public Bank Berhad

7) Standard Chartered Bank Malaysia Berhad


3.4 Summary of respondents who took part in the interview

Below is the list of respondents interviewed together with the position they hold:

<table>
<thead>
<tr>
<th>Group</th>
<th>Individual</th>
<th>Respondent Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Bank, Participating</td>
<td>1</td>
<td>Vice President</td>
</tr>
<tr>
<td>Full-Fledged, Islamic Bank</td>
<td>2</td>
<td>Head</td>
</tr>
<tr>
<td>Full licence Islamic Bank</td>
<td>3</td>
<td>Vice President</td>
</tr>
<tr>
<td>(Also runs conventional bank)</td>
<td>4</td>
<td>Senior Vice President</td>
</tr>
<tr>
<td>Foreign Islamic Bank</td>
<td>5</td>
<td>Head</td>
</tr>
</tbody>
</table>

3.5 Summary of respondents who took part in the interview on setting up Islamic banking in BANK A

Below is the list of respondents interviewed together with the position they hold:

<table>
<thead>
<tr>
<th>Individual</th>
<th>Respondent Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Vice President, Product Development, Islamic Banking</td>
</tr>
<tr>
<td>B</td>
<td>Head Islamic Banking Division, Branch Operations</td>
</tr>
<tr>
<td>C</td>
<td>Vice President, Islamic Banking, Operations</td>
</tr>
</tbody>
</table>

3.6 Data Analysis
Data that was obtained from semi-structured interviews was noted down by the researcher and documented on the same day. For information that was omitted, the researcher contacted the respondent on the same day for clarification to prevent any confusion in the data analysis section later. After all the respondents were interviewed the information was checked for any omissions or mistakes. Data from semi-structured interviews was gathered and analyzed in the same manner. Each question was analyzed to identify the pattern or any flow in the respondents answer. The analysis employed in this study was to obtain information on whether the respondent agrees or not with the researcher’s questions. The respondents were required to answer “yes” or “no” to avoid any subjective answer that can affect the data analysis findings. Regardless of whether the answer is “yes” or “no”, it must be supported by justification from the respondents. The respondents view is analyzed in table form for easy reference. Important views or suggestions are identified for discussion in chapter four. All the information given by the respondents was analyzed based on past researchers findings to identify whether the issues are consistent or otherwise. Any findings which were not consistent with past literature were analyzed for justification.

Besides analyzing the research from the given information by the respondents, the study also analyzed the prospects and challenges through secondary data like books, historical documents, speeches, BNM data and interviews. This information is analyzed simultaneously with interview findings.
CHAPTER 4 RESEARCH FINDINGS

4.0 Introduction

The semi-structured interviews were aimed at collecting information on the Islamic banking industry from the perspective of people who are involved in the daily operations of an Islamic bank. This chapter provides the findings on the issues, prospects and challenges that are faced by the Malaysian Islamic banking industry.

This chapter presents the detailed findings of the interviews and the analyses of the secondary data. The first section describes the findings on issues related to the Islamic banking industry (Section 4.1 to 4.11). The second section 4.12 presents the findings of the case study on setting up an Islamic bank, followed by section 4.13 the prospects of the Islamic banking industry. Lastly, section 4.14 gathers the information on the challenges for the Islamic banking industry.

4.1 Factors that attract Islamic banking customers

Table 4.1

<table>
<thead>
<tr>
<th>RELIGIOUS FACTOR</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No</td>
<td>Service quality and branch</td>
</tr>
<tr>
<td>2</td>
<td>No</td>
<td>Economy of the products</td>
</tr>
<tr>
<td>3</td>
<td>No</td>
<td>More on convenience</td>
</tr>
</tbody>
</table>
The respondents were asked whether religious factors can drive Muslims to use Islamic banking. The respondents interviewed argued that the religious factor is not conclusive enough to drive Muslims to use Islamic banking facilities. All the respondents agreed that the main factors that drive customers are convenience including service quality and branch availability. This is consistent with the findings by Saiful and Affandi (2003), Dusuki and Abdullah (2007) and also by Gerrald and Cunningham (1997) in their study in Singapore. However, respondent 2 concluded that the main factor that will attract customers depends on the “economy of the products”, what the product can offer and how it can give benefits to customers. Only after certifying these needs will convenience follow. Basically respondent 2’s view is correct because without the “economy of the product” the customers will not use Islamic banking facilities. The following explanation is provided by the respondents:

“In order to drive customers, non-Muslim or Muslim, depends on the economy of the product. What the product can offer and how it can give benefits to customers. Then only services will follow”, [R2]

“More on convenience in selecting banks, customers evaluate the service quality and the branch availability. The religious factor is not a conclusive factor”. [R1]

Nevertheless, all the respondents agreed that the religious factor is one of the criteria or factors that drive Muslims to use banking facilities, albeit not the conclusive factor. This is in contrast with the findings in Bahrain; where the Islamic bank selection process is more on religious based decisions (Metawa and Almossawi, 1998).
Furthermore, the introduction of Islamic banking is to do away with *riba* and it is obligation to customers.

<table>
<thead>
<tr>
<th>Table 4.2</th>
<th>Previous studies on Islamic bank selection criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Knowledgeable and competent personnel</td>
<td>Adherence to Islamic principle</td>
</tr>
<tr>
<td>Friendly Personnel</td>
<td>Advice and recommendations from family and friends</td>
</tr>
<tr>
<td>Customer Service quality</td>
<td>Convenience of bank location</td>
</tr>
<tr>
<td>Islamic Bank reputation and image</td>
<td>Return on investment</td>
</tr>
<tr>
<td>Economic reputation</td>
<td></td>
</tr>
<tr>
<td>Respect for human rights</td>
<td></td>
</tr>
<tr>
<td>Islamic working environment</td>
<td></td>
</tr>
<tr>
<td>Convenience</td>
<td></td>
</tr>
<tr>
<td>Involve in community</td>
<td></td>
</tr>
<tr>
<td>Environmental practice</td>
<td></td>
</tr>
<tr>
<td>Product Price factor</td>
<td></td>
</tr>
</tbody>
</table>

4.1.1 Research objectives findings summary of bank selection process

The Islamic bank selection process is one of the significant issues in many countries. To simplify, the researcher found the bank selection process in Malaysia is based more on service quality and convenience. This finding is consistent with the ranking in the study by Dusuki and Abdullah (2007) as per table 4.2, Rosli and Affandi (2003) and also Gerrald and Cunningham (1997). In addition, the findings also suggested
that the religious factor is not a conclusive factor to attract Muslims to Islamic banking which is in contrast with the findings of Metawa and Almossawi (1998).

In Malaysia, there is also the view that Islamic bank selection depends on the products that the bank offers and if the products satisfy the customer’s needs than they will select Islamic banking. In this scenario, the bank selection process depends on the products and services that the Islamic bank offers.

4.2 Education factor

Table 4.3

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Yes</td>
<td>Plays a big role</td>
</tr>
<tr>
<td>2</td>
<td>Yes</td>
<td>Not very significant</td>
</tr>
<tr>
<td>3</td>
<td>Yes</td>
<td>To some extent</td>
</tr>
<tr>
<td>4</td>
<td>Yes</td>
<td>Not very significant</td>
</tr>
<tr>
<td>5</td>
<td>No</td>
<td>More on product and services</td>
</tr>
</tbody>
</table>

The respondents were questioned whether education is a significant factor to drive customers to choose Islamic banking. Overall, the respondents agreed that education does play an important role in the selection of Islamic banking. This is consistent with the study in Bahrain by Metawa and Almossawi (1998) where education does play a role in selecting Islamic banking. Even though education is not a significant factor in attracting customers it is nevertheless one of the factors that contribute to the growth of Islamic banking. This reasoning is based on the following justifications:

“Education plays a big role because non Muslims also choose Islamic banking because they feel Islamic banks also pays interest and its equal with conventional. You do not lose if you bank with Islamic banking”. [R1]

“Education plays a role towards correcting the misconception about Islamic banking by Non Muslims. Education will eventually give some type of understanding of Islamic banking, the objective of Islamic banking and the differences with conventional banking”. [R3]
Only respondent 5 argued that the education factor is not significant or that he cannot see the factor contributing to the selection of Islamic banking because it is what benefits the product can offer and the service quality that is most important.

4.2.1 Research objectives findings summary on education factor

Metawa and Almossawi (1998), in their study in Bahrain, found that education is considered an important factor that can motivate customers to select Islamic banking. Findings from Malaysia found that education does play a role in selecting Islamic banking by giving some insight and answering misconceptions about Islamic banking. However, the education factor is not a conclusive factor to attract customers compared to service quality and convenience.

4.3 Awareness on Islamic banking products

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Yes</td>
<td>Only Muslims</td>
</tr>
<tr>
<td>2</td>
<td>Yes</td>
<td>Awareness is high</td>
</tr>
<tr>
<td>3</td>
<td>No</td>
<td>There is a need to create awareness</td>
</tr>
<tr>
<td>4</td>
<td>Yes</td>
<td>Awareness is very high for Muslims</td>
</tr>
<tr>
<td>5</td>
<td>Yes</td>
<td>Awareness is high</td>
</tr>
</tbody>
</table>

On the question regarding awareness, overall the respondents agreed that most Malaysians including Non-Muslims are aware of the necessity and benefits of Islamic banking. This is consistent with the study by Hamid and Nordin (2001) in Malaysia, which found a high awareness of Islamic banking. Furthermore Haron et al., (1994),
found almost 100% of the Muslim population was aware of the existence of Islamic banks; the sources are mainly newspaper, magazines, television, radio and family members.

Even though customers are aware of Islamic banking benefits they are reluctant to move from conventional banks because they are comfortable with the products and services of conventional banks. The respondent provides the following explanation:

“As the customers are used to conventional banking and banking with them for several years, new banking systems like Islamic banking cannot take over their past experience banking. Malaysians’ are very reluctant to move from conventional banking because they are very comfortable with the services and products. Overall, Malaysians are aware of Islamic banking”. [R4]

Respondent 1 also said that Non-Muslims think Islamic banking is for Muslims only. Moreover, Islamic banking customers are only aware of the basic products like Wadiah, BBA financing and Islamic personal financing. This is consistent with the study in Jordan by Naser et al., (1999) where customers were only aware of the basic financial terms of Islamic banking.

Customer awareness of Islamic banking can be seen in a rising interest rate scenario. Respondent 2 said during a rising interest rate scenario, the banks make good sales in BBA based financing because customers are aware that Islamic banking is without interest rates and customers come for BBA in order to peg their financing with the current benchmark rate.

Islamic banking needs to create more awareness through marketing in order to succeed. All the respondents agreed that Islamic banking needs to be more aggressive
in their business. For instance, Bank Islam has changed its image and started to be more aggressive by advertising and educating customers that Islamic banking is for all races not only for Muslims.

Respondent 3 was the only respondent who felt there is a need to create awareness among Muslims and non-Muslims on the necessity and benefits of Islamic banking. Currently, they choose Islamic banks because of the product prices and good service. Islamic banks should price the product competitively with conventional banks and give excellent service.

4.3.1 Research Objectives findings summary on customer awareness

On customer awareness, the researcher found that Malaysian are aware of the benefits of Islamic banking but that it was restricted to certain products and services like Wadiah and BBA. The customer awareness issue in Malaysia is consistent with the findings from Naser et al., (1999) where there was only awareness of basic financial terms. Overall, the awareness is there but there is a need to create more awareness on Musyarakah, Mudharabah and other Islamic bank products.

4.4 Islamic bank products and services

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No</td>
<td>Mostly all the basic products are offered</td>
</tr>
<tr>
<td>2</td>
<td>No</td>
<td>Products are there but market share is low</td>
</tr>
<tr>
<td>3</td>
<td>No</td>
<td>Overall conventional banks have more</td>
</tr>
<tr>
<td>4</td>
<td>No</td>
<td>Already par with conventional banking</td>
</tr>
<tr>
<td>5</td>
<td>No</td>
<td>There are some products not offered by conventional banks</td>
</tr>
</tbody>
</table>
The respondents were asked to evaluate the Islamic bank products and services compared to conventional banking. In terms of products all the respondents agreed that Islamic products are on a par with most of the conventional products, especially in consumer based products. This is consistent with the study in Malaysia by Haidi and Malik (2006) who found that the current product range is on a par with the conventional products. This is explained by one of the respondent:

"Nowadays there are already many Islamic bank products and services in the market and consumers can choose and compare these products against their conventional counterparts". [R4]

When Islamic banking was first introduced, the bank tried to study all the conventional products with the objective of trying to introduce them in Islamic banking. The product development people tried to take out the interest element and replace it with some other element like dividend and profit sharing. This is justified by the following reasoning:

"There are two types of product in Islamic banking that is shariah compliant, which is a replica of conventional banking and shariah based that 100% follows shariah rules". [R4]

One of the respondents also said there are some products like Musyarakah and Mudharabah based that are not offered by conventional banks. For example in Musyarakah financing the banker does not act like the intermediary but more like a partner and becomes involved in the decision making of the business. This is explained by one of the respondents below:

"Islamic banks offer a lot of products in Musyarakah concept. Profit sharing is very attractive, business partner, should see the design of the products, it is very popular and fair". [R5]
Table 4.6
Example of Islamic bank products

<table>
<thead>
<tr>
<th>Save &amp; Invest</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Save &amp; Invest</td>
<td></td>
</tr>
<tr>
<td>Savings &amp; Current Account- I</td>
<td></td>
</tr>
<tr>
<td>Islamic Basic Savings &amp; Current Account- I</td>
<td></td>
</tr>
<tr>
<td>General Investment Account- I</td>
<td></td>
</tr>
<tr>
<td>Premier Mudharabah Account-I</td>
<td></td>
</tr>
<tr>
<td>Foreign Currency Account-I</td>
<td></td>
</tr>
<tr>
<td>Financing</td>
<td></td>
</tr>
<tr>
<td>Financing</td>
<td></td>
</tr>
<tr>
<td>Home Equity-I</td>
<td></td>
</tr>
<tr>
<td>Home Financing-I</td>
<td></td>
</tr>
<tr>
<td>Maxihome-I</td>
<td></td>
</tr>
<tr>
<td>Shop house Equity-I</td>
<td></td>
</tr>
<tr>
<td>Shop house financing- Maxishop-I</td>
<td></td>
</tr>
<tr>
<td>Hire Purchase –I</td>
<td></td>
</tr>
<tr>
<td>Fixed Cash Line-I</td>
<td></td>
</tr>
<tr>
<td>Trade Financing</td>
<td></td>
</tr>
<tr>
<td>Trade Financing</td>
<td></td>
</tr>
<tr>
<td>Accepted Bills-I</td>
<td></td>
</tr>
<tr>
<td>Wakalah Letter of Credit-I</td>
<td></td>
</tr>
<tr>
<td>Murabahah Letter of Credit-I</td>
<td></td>
</tr>
<tr>
<td>Murabahah Trust Receipt-I</td>
<td></td>
</tr>
<tr>
<td>Export Credit Refinancing-I</td>
<td></td>
</tr>
<tr>
<td>Bank Guarantee-I</td>
<td></td>
</tr>
<tr>
<td>Shipping Guarantee-I</td>
<td></td>
</tr>
<tr>
<td>Foreign Bills Exchange Purchased-I</td>
<td></td>
</tr>
<tr>
<td>Wakalah Outward/Inward Bills For Collection-I</td>
<td></td>
</tr>
<tr>
<td>On- Shore Foreign Currency Financing-I</td>
<td></td>
</tr>
</tbody>
</table>

Source: (Maybank2u.com.my, 2008)

From the above, table 4.6 products and services, it is true that Islamic banking is not lacking in terms of products and services offered, compared with conventional banking.

Respondent 3 also mentioned that even though there are a lot of products and services offered by Islamic banks, in terms of market share, however, they are still well behind
conventional banks. Given time, the respondent thinks Islamic banking will catch up with conventional banking.

4.4.1 Research objectives findings summary on Islamic banking products and services.

The Islamic banking industry is considered quite new in Malaysia compared to conventional banking. The researcher found that Islamic banking is not lacking in terms of products and services compared to conventional banking. This is consistent with the study by Haidi and Malik (2006). In addition, the study also found that there are some products like *Musyarakah* financing that are not offered by conventional banks. From the research findings we can conclude that Islamic banking is not lacking in terms of products and services.

4.5 Marketing in Islamic banking

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Yes</td>
<td>Heavy marketing needed</td>
</tr>
<tr>
<td>2</td>
<td>Yes</td>
<td>Need to educate customers</td>
</tr>
<tr>
<td>3</td>
<td>Yes</td>
<td>Marketing is same like conventional</td>
</tr>
<tr>
<td>4</td>
<td>Yes</td>
<td>Without marketing will remain unpopular</td>
</tr>
<tr>
<td>5</td>
<td>Yes</td>
<td>The main tool to attract customers</td>
</tr>
</tbody>
</table>

Concerning the question on marketing, overall all respondents agreed that Islamic banks must have effective marketing and that there is a need to educate the customers
on the products. Without aggressive and heavy marketing, Islamic banks will remain unpopular and behind the conventional banks. Their comments are consistent with the study by Naser, K. and Moutnino L. (1997) on “Strategic Marketing Management in the case of Islamic banks”. This is explained as follows:

“Even though Islamic banks have been in Malaysia for very long, they are still considered new. Heavy marketing is needed, especially for housing loans and personal loans. In Wadiah based savings it is not a problem, because most of the customers understand. Basically, foreign banks are concentrating on personal loans and housing loans to gain market share in Islamic banking”. [R1]

“Without aggressive and heavy marketing and also promotions, Islamic banking will remain “unpopular” and remain behind conventional banking”. [R5]

Islamic banks are making a lot of effort in marketing Islamic personal loans and feel it is one of the popular means of consumers financing. This type of loan is concentrated by Islamic banks because under conventional banking there are fewer banks giving this type of loan.

“Marketing is needed but if you think that the products of Islamic banks are a replica of conventional products, with only the method or names different, then eventually the marketing is already done through conventional banking”. [R3]

From this respondent’s perspective, it is clear that the end product is the same and the marketing is already done through conventional banking. The differences are only in terms of the name or the approach.

4.5.1 Research objectives findings summary on Marketing

Marketing is another issue in the Islamic banking industry that needs serious attention and Gerald and Cunningham (1997) insisted that Islamic banks need to create
awareness through marketing. The researcher found that Islamic banks in Malaysia need to be aggressive in marketing Islamic banking products and services to create more awareness. Moreover, there is a need to educate customers of the products and services, which is consistent with the issue highlighted by Kuehn and Bley, (2004).

The study also found that Islamic banking concentrates a lot on marketing personal financing which is a popular means of consumer financing. Over concentration on this type of financing may result in high credit risk.

### 4.6 Lack of standardization in Islamic banking

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No</td>
<td>Customers are looking more at benefits</td>
</tr>
<tr>
<td>2</td>
<td>No</td>
<td>This is the beauty of Islamic banking</td>
</tr>
<tr>
<td>3</td>
<td>No</td>
<td>Customer is looking at end products</td>
</tr>
<tr>
<td>4</td>
<td>No</td>
<td>Cannot standardize shariah opinions</td>
</tr>
<tr>
<td>5</td>
<td>No</td>
<td>The main thing is the objective</td>
</tr>
</tbody>
</table>

The respondents were asked whether a lack of standardization of shariah opinion and interpretation could lead to consumer confusion in Islamic banking. The lack of standardization in terms of vocabulary and interpretations is not a defect in Islamic banking. Surprisingly, all the respondents agreed, which is inconsistent with the findings of Ainley (1997) and Tahir (2003), who insisted standardization is urgently needed in the vocabulary of Islamic and pricing formulas for Islamic products. Furthermore, one of the respondents commented that it is difficult to standardize shariah opinions and interpretations because there are lots of schools of thought. The reasoning is based on the following justifications:
“How can we standardize shariah opinions and interpretations? As long as each institution employs its own shariah scholars and councillors, it will remain. Even though Malaysian scholars tend to be from the same school of thought, different levels of knowledge, education and experience will result in different kinds of opinions and interpretations”. [R4]

“Lack of standardization in Islamic banking in terms of thought and interpretations is the beauty of Islamic banking. There are a lot of thoughts and a lot of interpretations but in the end it will benefit Islamic banking and will not confuse customers because they are looking at the benefits”. [R2]

Overall, we can conclude that different opinions and standardization is not an issue or problem because customers are looking more at the benefits such as comfortable or cheapest as well as the end product. Even the respondent of the Middle East bank that has its own shariah committee does not look at this as a problem because the main thing is the objective.

4.6.1 Research objectives findings summary on lack of standardization

Lack of standardization in shariah opinion and interpretation is one of the issues in Islamic banking that attracts serious attention from past studies. The research in Malaysia found that the lack of standardization of shariah is not an issue. The justification given is that customers are looking more at benefits and what the products can offer and not standardization. This finding is against the research of Ainley (1997) and Tahir (2003) who both highlighted there is a need of standardization in Islamic banking.

In addition, the researcher found it is difficult to standardize shariah interpretations because the Malaysian shariah councillors are from different schools of thought and education, furthermore the level of knowledge also varies.
4.7 There is a need of Shariah Audit.

Currently every bank has its own shariah committee to supervise the Islamic banks. There is a need of shariah audit and audit supervision which is under one roof. After going through the shariah councils, it is the audit and supervision that will ensure that the implementation is in absolute compliance with shariah principles. Besides that, the shariah audit will also monitor Islamic banks properly so that they are in line with Islamic rules. The reasoning is based on the following justifications:

“There is a need of shariah audit which will give more advantage to Islamic banking. Currently, people in Bank Negara Malaysia and lawyers are discussing the implementation of a shariah audit for the future of Islamic banking”. [R3]

“Audit and supervision should be under one roof. After going through the shariah councils, it is the audit and supervision that will ensure that the implementation is in absolute compliance with the shariah principles applied”. [R4]

4.7.1 Research objectives findings summary on shariah audit

Islamic banking is supervised by shariah councils and committees for its daily operation. The interview findings suggest that there is a need for a shariah audit to ensure the implementation is according to the principles of Islam. One of the
respondents also highlighted that currently Bank Negara Malaysia is examining the implementation of a *shariah* audit in Malaysia for the future of Islamic banking.

A *shariah* audit will be a good solution for Islamic banking to avoid any incompliance by Islamic banks which may harm the industry.

### 4.8 Islamic banking staff

<table>
<thead>
<tr>
<th>Table 4.9 LESS QUALIFIED STAFF IN ISLAMIC BANKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>RESPONDENT</td>
</tr>
<tr>
<td>------------</td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>5</td>
</tr>
</tbody>
</table>

Concerning questions relating to less qualified staff in Islamic banking, respondents 1, 2 and 5 agreed that Islamic banking has less qualified staff because the Islamic banking industry is still considered new compared to conventional banking. The respondents agreed that there is a need for competent and knowledgeable staff to provide a quality service in the Islamic banking industry. This view is consistent with the study by Dusuki and Abdullah (2007) who found that knowledgeable and competent personnel, friendly personnel and customer service quality gained highest ranking in patronizing Islamic banks.

In order to understand why there is less qualified staff in the Islamic banking industry; respondents were asked whether there is enough training in their bank internally.
Respondents from all the local banks commented that there is none or very little training in the Islamic banking environment. This is consistent with the study found in the UK where a lack of professional courses and training tailored for Islamic banking has resulted in a lack of qualified staff. (Karbhari et al., 2004). Only respondent 5 said that there is training, albeit on the job training, but for courses on Islamic banking they are normally sent overseas.

“There is very little training in Islamic banking, if there is it is only on product introduction. Over time there should be a lot. He suggested BNM should play a role by encouraging banks to have their own Islamic Training Centre for bankers”. [R3]

From the above view, there is a serious need for BNM to play a more active role by organizing Islamic banking courses and make it compulsory for banks to have Islamic banking courses. One of the respondents also commented that the banks should provide enough budgets for courses and should not make any excuse like there is a lack of budget.

“The staffs in their bank are less exposed to conventional ways and not competitive enough. There is a need of conventional experience in order to understand the conventional banking and succeed in Islamic banking. Now the bank is trying to invest in the staff by pinching from other conventional banks or Islamic banks”. [R2]

From the above we can summarize there is a need for conventional banking experience because this will help in terms of knowledge and experience that can be useful in product development and operation of Islamic banking. Reviewing the background of the respondents, it was found that all worked in conventional banking before coming into Islamic banking.

“Under window based Islamic banking the staffs are obliged to sell Islamic banking products and conventional banking products. The sales or the front office staffs have less knowledge of Islamic banking products and they value
Islamic banking the same as conventional banking products. They are more comfortable selling conventional banking products compared to Islamic banking products”. [R1]

This suggests that when given the chance the staff of Islamic banks prefer to sell conventional banking products because they are more confident and knowledgeable about conventional products.

Respondents 3 and 4 concluded that there are many qualified staff in Islamic banks and it is just that the Islamic banking industry is still considered new compared to conventional banking that has been in the market for many years. Over time Islamic banking staff will show their maturity. This reasoning is based on the following view:

“Actually, there is in fact many qualified staff in Islamic banks. It is just that Islamic banking is still considered new compared to conventional banking which has been in the market for many years”. [R4]

4.8.1 Research objectives findings summary on Islamic banking staff

The need for qualified Islamic banking staff is a significant factor in the Islamic banking industry. Tahir (2003) found that in Pakistan this is the biggest hurdle in the advancement of the Islamic banking industry. In Malaysia, the researcher found mixed views about Islamic banking staff. The overall findings indicated there was less qualified Islamic banking staff due to minimal and inadequate training in an Islamic banking environment, which is consistent with the findings of Karbhari et al., (2004). There were also findings suggesting that there is many qualified Islamic banking staff but that it is not realized as Islamic banking is quite new.
The researcher also found that Islamic banking staffs need to have conventional banking experience in order to add value to their services. Conventional banking experience will be an added advantage to the staff in Islamic banking product development and operation.

4.9 Knowledge of *shariah* for Islamic banking staff

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Yes</td>
<td>The training and staff initiative are important.</td>
</tr>
<tr>
<td>2</td>
<td>Yes</td>
<td>It is not a merit but it is an advantage.</td>
</tr>
<tr>
<td>3</td>
<td>Yes</td>
<td>Some basic knowledge is needed.</td>
</tr>
<tr>
<td>4</td>
<td>No</td>
<td>Need proper understanding of <em>shariah</em>.</td>
</tr>
<tr>
<td>5</td>
<td>Yes</td>
<td>There is a need but not compulsory.</td>
</tr>
</tbody>
</table>

The respondents were asked whether staff knowledge of *shariah* is a merit to carry out Islamic banking. Respondents 1, 2, 3 and 5 commented that staff knowledge of *shariah* is not a merit to carry out Islamic banking and that staff need not necessarily be Muslim. However, the majority of the respondents agreed that knowledge of *shariah* would be an advantage for the staff. This is justified by the following reasons:

“It is not a merit but will benefit in marketing, especially explaining to Muslim customers”. [R2]

“Some basic knowledge is needed but not compulsory. To carry out Islamic banking the staff needs more training”. [R3]
“There is a need for shariah knowledge because it will be an advantage, but not compulsory, because training and attitude of the staff will be a positive factor”. [R5]

The knowledge of shariah will be an added advantage but it is not a merit for staff in Islamic banking. This view is consistent with the study done in the UK by (Karbhari et al., 2004). The important element for Islamic bank staff is the training of and correct attitude of the staff. The knowledge of shariah will give benefit in marketing, especially explaining to Muslim customers. Overall, there is less non-Muslim staff applying for jobs in the Islamic banking division because they feel it is difficult and that they need to have knowledge of shariah or Islam. Actually, according to respondents 2 and 3 the bank does not restrict working in Islamic banks to Muslims.

However, respondent 4 has a different view and suggested that the knowledge of shariah is a merit to work in an Islamic banking environment. This view is consistent with Kahf, (2002) who noted that bank personnel did not understand shariah rulings and had difficulty advising customers on the characteristics of different types of Islamic finance products. This is explained below:

“To carry out Islamic banking, of course you need staff with shariah knowledge because without proper understanding of the shariah its implementation may be at risk”. [R4]

4.9.1 Research objectives findings summary on knowledge of shariah for Islamic banking staff

The knowledge of shariah among bank staff is another issue in the Islamic bank industry. The findings from the United Arab Emirates, found that staff did not fully understand shariah rulings and had difficulty advising customers (Kuehn and Bley,
2004). Therefore, it is suggested that knowledge of *shariah* should be compulsory for Islamic bank staff. However, the study in Malaysia found that *shariah* knowledge is not a merit to carry out Islamic banking and that the important criteria are the training and attitude of the staff. This finding is consistent with findings from Karbhari et al., 2004).

Although *shariah* knowledge is not a merit in Islamic banking, the findings in Malaysia highlighted that *shariah* knowledge among the staff of Islamic banks will be an added advantage. This will ensure Islamic bank customers receive better explanations and information from the staff.

### 4.10 Risk in Islamic banking

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>YES or NO</th>
<th>COMMENT/VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Yes</td>
<td>Especially if it is equity financing</td>
</tr>
<tr>
<td>2</td>
<td>No</td>
<td>There is hedging solution</td>
</tr>
<tr>
<td>3</td>
<td>No</td>
<td>Equally same</td>
</tr>
<tr>
<td>4</td>
<td>No</td>
<td>Islamic assets should be safer</td>
</tr>
<tr>
<td>5</td>
<td>No</td>
<td>Need to understand the risk</td>
</tr>
</tbody>
</table>

Risk is an important element of the banking environment because banks handle customers’ money or funds to generate income. The Islamic financial system must ensure that the surplus funds are attracted for worthwhile investments in accordance with the owners’ preference in terms of the extent of risk involvement, rate of return as well as the period of investments (Loqman, 1999). In the current situation, the credit crunch has surrounded conventional banking with a lot of problems. So many banks have had to write off debts because of sub-prime lending. To be more specific the poor management of risk has resulted in a very hard time for banks.
BNM has issued two frameworks – the Revised Weighted Capital Adequacy Framework, that is applicable to all banking institutions and the Capital Adequacy Framework, for Islamic banks (MIF 2007). These two frameworks took effect from 1 January 2008 and are consistent with the Basel II and Capital Adequacy Standards (CAS) issued by the Islamic Financial Services Board (IFSB).

The respondents were asked whether Islamic bank assets are more risky than conventional bank assets. However, the Islamic bank’s risk must be viewed differently; Respondent 4 gave his view on the risks for Islamic banking:

“Risk is viewed differently in Islamic banking and risk exposure is treated differently as well. In general under Islamic banking, the bank should not get involved in very risky business operations as they are handling customers’ funds and also focus is given to the risk associated with the customer not the asset. So, thus Islamic assets should be safer not riskier compared to conventional assets.”[R4]

Islamic banking assets are quite different from conventional banks assets. Islamic banking assets can be properties, machinery, vehicles or factories. The main idea is how the assets and liabilities are managed. Under Musyarakah financing Islamic banks will act like a partner in the business and they will get involved in business decision-making. For instance in Malaysia, one of the respondents said one Islamic bank joint venture under Musyarakah was used for financing the building of a well known shopping centre. The objective of the bank is to make sure the shopping complex is fully occupied and to generate rent. In this situation, the Islamic bank’s asset is the building and the fittings. One of the respondents commented how the bank will manage the risk:
“Risk is something very unique in Islamic banking. Before they venture into any business like Musyarakah financing or equity financing, they have a research unit that will look into every angle and will recommend the financing by assessing the risk. Currently they are in construction, shipping, plantation and engineering. Have to monitor the partner and need to have suitable resources or professionals in these areas. Need to first understand the risk, identify the risk and manage the risk”. [R5]

However respondent 1 stated, Islamic bank’s assets are riskier, especially if it is Musyarakah financing where the bank takes high risk by getting involved in business decision making and daily operations. There is also the possibility that the bank will make a loss on their investment. Khan, (2000) stated that for long-term investment, Islamic banks should take a position only after the technical, economic and financial viability has been examined and appraised. However, this is normal in conventional banking where the bank takes a view and invests in bonds and securities.

From the respondents’ comments, Islamic bank’s risk must be viewed differently but cannot insist that Islamic banks’ assets are more risky than conventional banking. This is opposite to the research by Ainley, (1997) who indicated that assets of Islamic banks are more risky than conventional banks because large portions of the conventional banks assets are maintained in fixed interest bearing compared to Islamic banks that invest in long term projects and ventures that are difficult to value.

In the current situation, we can conclude that conventional banking assets are more risky because of the sub-prime problems and that Islamic banking assets are much safer.
4.10.1 Research objective findings summary on risk in Islamic banking

Risk management is another debated issue in the Islamic banking industry, where the views of Ainley (1997) indicated that Islamic banking assets are more risky and in addition Sarker (1999) claimed that the amount of bad debts in Islamic banking is increasing. However, the findings from Malaysia are in contrast to the above views. The researcher found that Islamic banking assets need to be viewed differently and it cannot be concluded that it is more risky. The explanation being that Islamic banking assets are much different from conventional banking because of the characteristics of Islamic banking assets which are property, machinery and building.

In addition, the researcher also found that Islamic banking assets are much safer because of the current sub-prime problems in conventional banking.

4.11 Handling of fixed rate exposure

Table 4.12
HANDLING OF FIXED RATE EXPOSURE

<table>
<thead>
<tr>
<th>RESPONDENT</th>
<th>HEDGING TOOL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Take a view on benchmark rate and IPRS</td>
</tr>
<tr>
<td>2</td>
<td>IPRS</td>
</tr>
<tr>
<td>3</td>
<td>IPRS and view on benchmark rate</td>
</tr>
<tr>
<td>4</td>
<td>IPRS</td>
</tr>
<tr>
<td>5</td>
<td>IPRS</td>
</tr>
</tbody>
</table>

* IPRS – Islamic Profit Rate Swap

According to Lane (2006), adherence to shariah prevents Islamic investors from using conventional hedging tools like Interest rate swap, Forwards or Options. Islamic profit rate swap are based on two parallel Murabahah commodity structures. This
profit rate swap is a risk management instrument that delivers the same risk management profile like an interest rate swap. The objective of Islamic profit rate swap is to enable swapping of one set of dollar amount with another set of dollar amount with reference to the rate of return and predetermined principal. (Islamic Finance News, 2008)

The respondents were asked how the bank handles fixed rate exposure. Overall, all the respondents recommended that there is a need to hedge the entire fixed rate exposure based products in order to prevent fluctuations in benchmark rate. According to Kandasamy (2007), Islamic banks require the use of profit rate swaps, FX forwards and options to adequately hedge their financing or treasury portfolios. Nasiruddin (2007) from Standard Chartered Saadiq highlighted that derivatives are a recent trend in Islamic Finance and its aim is to insulate against price fluctuations. At the moment, he said there are profit rate swap, cross currency swap and forward rate agreements. One of the respondents commented as follows:

“Last time we did not have hedging solutions; all the fixed rate exposure based products like BBA were left open if there is no deposit to match. When the benchmark rate goes against the bank, then the bank has no choice but to take the loss. Nowadays, the bank doesn’t have to worry because the bank hedges all their fixed rate exposure by doing Islamic Profit Rate Swap (IPRS)”. [R2]

Currently, the banks will take a view on the benchmark rate and if they feel it is against the bank then it will go into IPRS. However, respondents 4 and 5 commented that the IPRS is not fully shariah compliant and it is not easy going into IPRS. IPRS is actually a replica of a conventional swap, the only difference being that it uses commodities rather than interest rates to calculate the differences. Another problem
arising from IPRS is that there is no one standard that needs to be followed like ISDA and it must be adapted to the counterparts’ needs, which is time consuming. This is explained below:

“The problem with Islamic profit rate swap is that it has to adapt to the counterparts. There is no one standard that needs to be followed like conventional swaps”. [R5]

The respondents were also asked whether there is enough hedging mechanism in Islamic banking. All the respondents commented that in the Islamic banking industry there are less hedging mechanisms to protect the bank exposure against the benchmark rate. This view is consistent with a study by (Ebrahim and Joo, 2001), that there is a need to design and implement Islamic hedging and risk minimizing facilities. Besides profit rate swap there is no other perfect hedging mechanism. Given time there should be some development in hedging products and there is a need for serious attention in this area. However, due to the nature of the Islamic banking industry whereby no interest rates are involved, hedging against interest rates are no longer needed but hedging requirements on the flow mismatches are required.

4.11.1 Research objective findings summary on handling fixed rate exposure

The Islamic banking industry is facing risk management issues because there are less hedging tools. Khan and Ahmad (2001) found the highest credit risk in Musharakah financing followed by Mudarabah. In Malaysia, the researcher found that there are less hedging tools in Islamic banking and that it depends a lot on Islamic Profit Rate Swap (IPRS) to hedge the flow mismatch. Furthermore, the respondents also highlighted that IPRS is actually a replica of a conventional swap and that there is a lack of standardization.
Hedging is a must in the Islamic banking industry to protect the fixed rate exposures. This will ensure that Islamic banks do not make losses when there is an adverse movement in the benchmark rate.

4.12 Case Study on setting up Islamic Unit

In this study, one bank was selected to identify what the problems were during the period of setting up an Islamic bank in a conventional banking environment. Respondents were asked what are the major problems faced during the setting up of an Islamic bank by Malaysian banks. Table 4.13 highlights the problems that the respondents went through during setting up the Islamic bank.

<table>
<thead>
<tr>
<th>Major Problem</th>
<th>How the bank managed to overcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Need to meet the BNM requirements</td>
<td>A lot of discussion and help from BNM</td>
</tr>
<tr>
<td>Need to develop Islamic bank products</td>
<td>Develop product par with conventional</td>
</tr>
<tr>
<td>Need supply of skilled people</td>
<td>Employ people with <em>shariah</em> background</td>
</tr>
<tr>
<td>Need to develop new system</td>
<td>Perseverance and manual entries</td>
</tr>
<tr>
<td>Need to have documentation/contract</td>
<td>Selecting good <em>shariah</em> lawyers</td>
</tr>
<tr>
<td>Infrastructure problem</td>
<td>Have to share resources and assets</td>
</tr>
</tbody>
</table>

4.12.1 Meeting BNM requirements

Islamic banks need to strictly follow BNM guidelines such as:

- Operational teams – This team is required to follow up with BNM on implementation of operational system.
- Treasury – Allowed to share the current dealing room and back office infrastructure.
- Risk Management – Need dedicated persons to monitor the risk management.
• Shariah Committee – Islamic banks need to have a shariah committee and must follow the guidelines on the governance of the shariah committee for the Islamic Financial Institution (GPS 1).
• Liquidity Framework – Need to comply with the New Liquidity Framework (NLF)

At an early stage the Islamic bank had certain difficulties because the unit is very new and needed to follow certain guidelines. The Islamic bank had certain problems but with the help of the government and BNM it managed to overcome them. BNM was identified as the best central bank, in promoting Islamic Finance, in the world followed by the Central Bank of Bahrain (Islamic News, 2008)

Islamic banking cannot grow without strong support from the government because it is quite new and growing from the roots. If compared to a conventional bank, the Islamic bank is well behind in terms of market share and only with government support can it achieve its objectives. For instance in the UK, the major problem facing the development of Islamic banks is the legal structure and the regulators (Karbhari et al., 2004). The followings are some of the comments:

“The strong support of the government is needed because the government is the key to the growth of Islamic banks. The support of government and BNM is needed to achieve a parallel system. Furthermore, the government has its own objective to make Malaysia an Islamic hub and is giving tax incentives”. [R ‘A’]

“The government is one of the reasons Islamic banking exists. BNM gives full support in technical, operational support, tax incentives and legal support”. [R ‘B’]

4.12.2 Need to develop Islamic banking products.
The product development department carries the biggest responsibility to come up with Islamic banks products. At this early stage, there is a need of skilled staff with shariah knowledge and conventional banking experience. There is a need to develop products that must be at least on a par with conventional banking. The developing of the products is one matter but getting approval from the BNM shariah committee is another because the bank must comply with all shariah rulings. The respondent’s explanation is as follows:

“There is a need to develop Islamic banking products at least on a par with conventional products. The main objective is not only offering Islamic products but must be equivalent with conventional products. These because customers in Malaysia are very demanding and will always compare with the conventional products.”[R ‘A’]

Currently product development is still coming up with new products. According to respondent C, at an early stage they will look into conventional bank products and try to take out the interest element and re-engineer as an Islamic banking product. The product development section needs strong support from the working committee and the involvement of the risk and credit committee is also needed. The bank’s ultimate success is largely dependent on its ability to identify the emerging needs of the customers and strategic product management. The bank needs to develop appropriate products and services to meet changing customers’ needs (Bhattacharyay, 1995).

4.12.3 Need experienced staff

In the early stages of setting up an Islamic bank there is a serious need of staff experienced in developing Islamic banking products and the operation of an Islamic bank. The respondent’s explanation is as follows:
“In Islamic banking, especially in the early stages there is a need for the supply of skilled people with a strong knowledge of shariah. One of the main problems the bank went through was the movement of staff or taken away by competitors when setting up their own Islamic business unit. Staffs of Islamic banks are from conventional banks that have moved to the Islamic banking division during the implementation of the unit. As a result the staffs are well trained and moreover the salary and benefits offered much higher around 30% to 50% increase. Islamic banking staffs are very marketable and the entrance of foreign Islamic banks also contributes to this phenomenon”. [R ‘A’]

From the above comment, clearly Islamic banks have the same problems as conventional banking where staff movement is very frequent. A lot of the problems the bank faced arose from staff being recruited by another bank and certain departments experienced difficulty in making decisions. Normally the person targeted is the Senior Officer or the Project Manager. To overcome this problem, the bank tried to find replacements as soon as possible but unfortunately this type of situation could not be avoided.

4.12.4 Need to develop new system

The main criterion for efficiency is to have a good system. At the early stages, there were a lot of problems, especially on the technical side where the current conventional system did not suit Islamic banking transactions. This in turn contributed to delays in coming up with certain products. The bank needs to have the system before the products are offered to customers for the efficiency of the business. Information Technology (IT) plays an important role in the advancement of Islamic banking. There is a need to provide more innovative products and services through IT. The following are the related comments:

“there were many problems on the technical side because there were many systems involved, system problems and constraints in setting up products to
be offered to customers. At one stage, there was one product already promoted, but the staff of the bank told customers that even though the product is already there the product still cannot be offered because of the system constraints and they were recommended to use the conventional product”.[R ‘B’]

To avoid system problems or awaiting the correct system to be implemented the bank did manual entries and used manual accounting.

4.12.5 Need to have proper documentation and contract

Contracts are drawn up to make sure there is a clear recognized guideline for all parties involved and it states the standings of all those involved and the conditions of the transactions that took place. The Shariah Law of Contract is primarily based on three principles: (Pheng and Detta, 2007)

- The Principle of Justice
- The Principle of Transparency
- The Principle of “Maslaha”

There is a need to make sure this contract for Islamic based financing is compliant with shariah and cannot legally be disputed to avoid customers suing Islamic banks in court. Some of the problems the Islamic banks face, especially in the Al-Bai Bithaman Ajil financing, relate to the following cases Affin Bank Berhad v Zulkifli Abdullah (1997), Bank Islam Malaysia Berhad v Adnan Bin Omar (1994) and Malayan Banking v PK Ralamani (1994). (Pheng and Detta 2007).

To avoid this problem, respondent C recommended the employment of dedicated and expert lawyers in shariah. Moreover, respondent C commented the time has come for
the shariah court to deal with Islamic banking issues or cases. Currently the
Malaysian government is seriously looking into this matter:

“For the Islamic bank to develop further, a few major amendments of the
current laws are required so that it is completely clear, segregated,
independent and above all, the current laws must not interfere or override
the shariah principles when it comes to Islamic banking”.[R ‘C’]

From the above comment, the time has come for Islamic banking cases to be
c Conducted in the Shariah Court without the interference of the Civil Court.
According to Sayid (2004), there were no serious efforts undertaken to implement the
necessary changes in banking laws and laws that affect the Islamic banking industry
in Malaysia or Pakistan.

4.12.6 Need to have proper Infrastructure

Islamic banks, which are also running conventional banking, do not have any choice
but to share resources. One of the advantages for Islamic banks, especially at the
early stage, is that they had an existing infrastructure, albeit of conventional banking,
whereby they did not have to wait for budget or resources. BNM allowed Islamic
banking cost sharing with its parent bank in terms of infrastructure, marketing,
building and operations.

The bank overcame the infrastructure problem by using the current branches and cross
selling Islamic banking products. The costs were charged fairly between the
conventional bank and the Islamic bank, based on agreed terms. In the head office
and treasury there were a few staff assigned to deal with the Islamic banking
transactions. In the Treasury Department there were two staffs and also two
Accounting Department staffs. Their cost including salary, computer and other facilities were charged to the Islamic banking section. In this way it is more cost effective to have a parallel banking business:

“The management or directors are from the conventional bank; they are not very keen because they do not want to separate their capital. They prefer doing banking through a window because it is still Islamic banking and does not waste the resources to duplicate their business. Only after strong persuasion from BNM, they are slowly building up branches”. [R ‘C’]

From the above comment, the main objective of the bank is profit. The management are so concerned about making profit that they are not very keen to meet the government’s objective of making Malaysia an Islamic hub (BIS Review, 2006).

4.12.7 Findings summary on issues in setting up of Islamic banking

In terms of setting up Islamic banking, it was found that there is a lot of support and moral suasion from BNM. In addition, BNM was lenient and allowed local banks to share its resources with its local subsidiary to avoid the high costs of setting up Islamic banking.

However, there were certain minor problems encountered such as staffing, product development, documentation and information technology. These problems still surround Islamic banking even after the initial setting up. Moreover, there were surprise findings including the preference of one of the Malaysian banks to run Islamic banking through a window base to avoid duplication of business.
4.13 Islamic banking prospects in Malaysia.

Figure 4.1

Islamic banking prospects in Malaysia

Figure 4.1 above shows that in 2001 there were only two full-fledged Islamic banks – Bank Islam Malaysia and Bank Muamalat. From 2005 there were drastic changes in Islamic banking. The business showed a lot of prospects and with government encouragement there were twelve full-fledged Islamic banks as at 2007.

Bank Islam Malaysia (BIMB), which was established in July 1983, was the first Islamic bank to be set up in Malaysia. From this era, the Central Bank and the government adopted a step by step approach to achieve its objective. For Islamic banking to grow, it needs many players and a variety of instruments. As a result
BNM decided to allow the existing banks to offer Islamic banking called “Skim Perbankan Tanpa Faedah” or “Interest Free Banking”. Moreover, banking licences were also granted by BNM to the Kuwait Finance House, Al Rajhi Bank, Asian Finance Bank and the most recent being the Bahrain Unicorn Bank.

“The Islamic bank prospects are very high because Malaysia is an Islamic hub and there is a strong support from government. If you make comparison with Singapore or Indonesia, Middle East investors which are cash rich prefer Malaysia because the country is politically stable and also an Islamic country”. [R1]

“With government encouragement, the prospect for Islamic banking to grow further is very high. The bank is increasing our branches base because Malaysia has a great market and a growing need for partnership business”. [R5]

“Malaysia has the framework and the track record. It is the right place – it has the transparency and will see more investments from GCC coming into this region”. [Salman Younis, Managing Director of Kuwait Finance House]

Source: (MIF, 2007)

Respondents were asked to comment on Islamic banking prospects in Malaysia. From the above comments, both the main increase in the number of Islamic banks and the growth in Islamic banks were due to government support. The government support can been seen in their launch of MIFC, the objective of which is to further strengthen Malaysia as an International Islamic Financial Hub (BIS Review, 2006). Furthermore, the government is giving tax relief for all profit from the International Currency Business Unit (ICBU) for the next ten years together with various tax exemptions given in line with conventional banking. This is in contrast with the UK, where UK government appears to favour and give preference to conventional banking (Karbhari et al., 2004). In Malaysia the government favours the parallel banking system by encouraging Islamic banking and also conventional banking
Table 4.14
Tax Incentives Related To Islamic banking

<table>
<thead>
<tr>
<th>Products</th>
<th>Tax exemptions and withholding tax exemptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profits</td>
<td>Tax deductibility on Islamic banking financial products</td>
</tr>
<tr>
<td>Sukuk</td>
<td>Issuance cost of Sukuk tax deductibility until 2010</td>
</tr>
<tr>
<td>Fund management</td>
<td>Exempted from tax until 2016</td>
</tr>
<tr>
<td>Stamp duty</td>
<td>Exemption from stamp duty relating to Islamic securities</td>
</tr>
</tbody>
</table>

Source: (PricewaterhouseCoopers, Budget 2007)

Table 4.14 indicates that there are a lot of tax incentives given to boost Islamic banking and such generous tax incentives have generated substantial interest from financial players to use Malaysia as their financial hub and platform in this region. This is explained as follows:

“The prospects are tremendous. The potential to grow and expand beyond conventional banking is always there. For example various tax incentives given to boost Islamic banks”. [R4]

“In order to encourage the structuring of new and innovative products, the Malaysian government introduced tax incentives for the globally accepted “shariah” structures. This issuance of Islamic securities based on these “shariah” principles is expected to draw greater interest from foreign investors particularly those from the Middle East”. [Dr Nik Ramlah Mahmod, Securities Commission]

Source: (MIF 2007)

Islamic banking can grow like conventional banking because all the local banks and foreign based banks market conventional and Islamic banking together. Islamic banks do not stand alone but they are using the conventional base to market all the products. Thus, these Islamic banks do not have to grow from the foundation by building up branches.

As highlighted in chapter 1, the MIFC was launched to further strengthen Malaysia’s position as an International Financial Centre. Based on the following comments the MIFC will definitely give an advantage for Islamic banking to grow:
“MIFC will encourage potential investment in our Islamic banks and more Islamic banks will set up in Malaysia. Furthermore, MIFC will also strengthen the capital market including PDS and Sukuk”. [R ‘A’]

“Through MIFC, standardizations of products and cross cooperation among market players from other countries involved will add further strength to the industry”. [R ‘B’]

From the comments, the launching of MIFC can increase the investment in Malaysia’s Islamic banks and furthermore more Islamic banks will come in, if allowed by BNM. The government shows a strong commitment to making Malaysia an Islamic hub (BIS Review, 2006). One of the respondents also mentioned that the MIFC will also strengthen Malaysia’s position in the Sukuk market.

**Figure 4.2**
*Global Sukuk Market in 2006*

![Global Sukuk Market in 2006](image)

Source: (International Islamic Financial Markets)

From figure 4.2 above, it can be seen that Malaysia is leading in global Sukuk issuance with about 84% of the total Sukuk issuance. Malaysia is moving quite aggressively in Sukuk issuance because of the government support in terms of tax incentives for the Issuance Company or the SPV (Special Purpose Vehicle), which are
given tax deductions on the Issuance cost of the Islamic securities and stamp duty exemption for ten years. These types of incentives have positioned Malaysia as a hub or attractive place for the Sukuk market. One of the MIFC objectives is for Malaysia to become the centre for trading capital market instruments.

In the Middle East countries, including Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates, after the oil and gas sector the Islamic banking and financial sector is the region’s main hope for future economic development (Bhattacharyay, 1995). Nevertheless, Malaysia can also expand Islamic banking for future economic development.

### 4.14 Challenges for Islamic banking in Malaysia

Islamic banking is growing from a niche market and eventually there are some challenges that it must overcome to succeed. These include competition from Middle East banks, mergers, product innovation, moral hazard, staff and also in the risk management area. As highlighted by Haron and Yamirudeng, (2003), Islamic banking is relatively new and as a result it faces many challenges.

This section describes the challenges that Islamic banks face from the view of the respondents and also from the secondary data.

#### 4.14.1 Competition from Middle East banks

Middle East Banks such as the Kuwait Finance House, Al Rajhi Bank and Bahrain Unicorn Bank started to invest in Malaysia due to growth and the political stability in Malaysia. Currently, BNM has relaxed the ruling for foreign investment and allowed
these banks to open up more branches. These banks are not new in the market; they have plenty of experience in Islamic banking and are an indirect threat to local Islamic banks. These banks have many products and capital that make them very unique. Local Malaysian Islamic banks have to be more innovative and prepared to compete with them. This is supported by the findings of Kaleem (2000) who found that Islamic banks have to compete with each other as well as with conventional banks. Besides foreign Islamic banks, these local Islamic banks have to also compete with conventional banks, which possess a much larger market share at present. There is a need for Islamic banks to meet more challenges in terms of competition from other banks and less rely on the support from BNM, especially when the banking sector is liberalized. This is explained as follows:

“We don’t really compete with other banks, because we are very unique because our business model is very different. Our strength in equity financing is irrelevant to conventional banking”. There is a need for Islamic banks to be more innovative and prepared to meet future competition and cannot rely too much on government support”. [R5]

“Against other Islamic banks, we must be able to provide “competitive” basic and structured products that focus on giving more benefits to customers in a very convenient manner. The products must fulfil whatever the needs of the customers and still comply with the Shariah principles. And if this is achieved, that will take care of the competition from conventional banks”. [R4]

“Local Islamic banks need to be prepared to compete with foreign Islamic banks which are far more experienced and their capital backing is also very significant compared to our local Islamic banks”. [R2]

4.14.2 Merger between Islamic banks

Why there is a need of merger between Islamic banks (Respondents’ view)

- Need more significant capital structure and to create Islamic bank giant.
• Need to merge in order to compete with foreign Islamic banks and conventional banks.

• Better if there is a Middle East Bank stake like the Dubai Investment Arm in order for capital backing.

• The only way to survive is through mergers as competition gets tougher.

• Mergers are better because it will create capital efficiency.

BNM also encourages foreign investment in Islamic banking to make the Islamic banks stronger. Foreign investors can hold up to a 49% stake in Islamic banks compared to only 30% for conventional banks (Bendeich, 2008). This relaxed ruling is to encourage more Middle East investors that are cash rich, to hold a stake in Malaysian Islamic banks.

Mergers cannot be avoided if the parent banks merge. In the current situation the Malaysian local banks are not very strong in terms of capital structure. Mergers between conventional banks may also cause their subsidiary Islamic banks to merge.

4.14.3 Need expertise in various lines.

Equity financing through Musyarakah or Mudharabah has been one of the jewels of Islamic banking. When the bank goes into this type of financing there is a need for this bank to have expertise in this line.

“In future Islamic banking needs to have expertise in various fields like engineering, plantation, construction, shipping, manufacturing and real estate because in equity financing Islamic banking will be a partner with the business entity or originator”. [R4]
In future, bankers need to have expertise in various fields because this type of expertise is needed to monitor and give solutions. If the bankers do not have expertise in engineering or construction it is very difficult for banks to make decisions in related business matters. The Islamic banks need to have skilled people with good operational and management skills to protect the bank’s interest.

4.14.4 Moral Hazard problems

The profit and loss sharing (PLS) based financing like Musyarakah and Mudharabah may create a moral hazard. When the bank goes into PLS, information uncertainty may lead the bank to choose an unproductive or dishonest company. This is consistent with the study by Khan (2004) who argued that equity contracts can create moral hazards and overestimation of risk by the bank. These companies look profitable but do not possess the skill to engage in the particular business. Musyarakah financing is long term financing and involves higher risk and there is a need to set up a research unit like the foreign Middle East banks, which evaluate the business and potential sectors before investing. There is a need to evaluate each project in terms of economic and financial viability. The respondent’s view is explained below:

“The challenges are more in equity contract. The risk is that banks may lose because of uncertainty in the business they venture. There is a need to evaluate each project by setting up a research unit”. [R5]

4.14.5 Challenges on Product Innovation

There is a need for Islamic banking to look into developing products and try to be more innovative. In the current situation, the banks are only replicating conventional based products and re-engineering them to become Islamic products. A study by
Haidi and Malik (2006) in Malaysia found that Islamic banking product development is quite weak. For instance Islamic bank innovation can been seen in the BBA floating rate where a variable rate was introduced in 2003 as an instrument to diversify the financial portfolio and over reliance on fix rate financing. Wilson (2003) recommended that Islamic banks should not emphasise price competition but stress the provision of unique quality products and services.

Furthermore, the bank must also be brave in doing Musyarakah financing and not rely too much on Murabahah financing and BBA financing. As highlighted in figure 2.2, less than 1% of total Islamic financing is Musyarakah financing. Although the Musyarakah type of financing is riskier, this type of business, if well evaluated, will provide a good investment. Those who promote Islamic finance often prefer partnership arrangements in which profits or turnover is shared as this conforms more fully to the goals of Islamic banking (Iqbal, 1997). This is explained as follows:

“Only Middle East banks are active in Musyarakah based financing because of their experience and the risk in it. Local Islamic banks are very selective and not prepared to take this type of challenges, which will affect the profit of the banks if there is any downfall”. [R4]

“Islamic products are competitive with conventional products. There is a need to further explore more innovative products and RD in order to be prepared for the future”. [R2]

“Islamic banking is still lacking in investment products compared to conventional products. There is a need to create Islamic investment products”. [R1]

4.14.6 Need experience staff in Islamic banking

One of the main factors that can hinder Islamic banking growth is their staff. One of the respondents said that the banks need to look into their growth and need to train
them as Islamic banking staff not as conventional banking staff that also sell Islamic banking products. Khan (2000) stressed that in Islamic banking the induction of trained and professional staff would be the number one necessity. The misleading view among the customers is partly due to the lack of experience and knowledge among the bank personnel in giving correct and satisfactory explanations about Islamic banks product. Ghannadian and Goswami (2004) argue that Islamic banks require a diligent management team to balance the different levels of credit (personal credit, secured credit, and letters of credit) and also function as specialists in estimating project risk and estimated returns.

“There is a need for BNM to encourage Islamic banks to have their own Islamic banking training centre, which will contribute to the staff quality”. [R3]

From this respondent’s suggestion, there is a need to have an Islamic bank Training Centre and BNM should play its role in implementing this centre. Currently most of the conventional banks have their own centre and it may be cost efficient for all the Islamic banks to merge and come up with an Islamic Training Centre. Only by training can the staff master Islamic banking and as a consequence benefit Islamic banking as a whole. In encouraging Malaysians to explore Islamic finance as a career choice, tax relief not exceeding RM5,000 is also provided on approved Islamic Finance courses by BNM or SC at local institutions. (Budget 2007)

The BNM governor Tan Sri Dr Zety Akhtar Aziz also commented that there is a crucial shortage of talent in the Islamic financial industry and collaboration between training institutions is vital to develop the pool of expertise in Islamic Finance (MIF report, 2007). The research by KPMG (2006) on Islamic bank staff in Malaysia found
there was a shortage of easily accessible, practical, professional and academic training or research in this field. They also stated that these factors have hindered the advancement of Islamic Financial institutions’ competitiveness, new product development and attraction of new customers.

4.14.7 Need to give priority in risk management area

There is a need for effective risk management systems and the system must be able to address the unique characteristics and attributes associated with Islamic financing operations. In Islamic banks the risk cannot be ignored totally and there is a need to manage it properly. This is explained as follows:

“Islamic banking needs to manage the risk properly because in the current situation most of the people are looking at this area, especially in conventional banking. Afraid that this problem will shift to Islamic banking”. [R4]

In Islamic banking, given that the assets often have different risk characteristics to conventional products and hence calculating the risk weights may not necessary be as straightforward as the Basel II proposals. According to Tahir (2006) Basel II is not directly applicable to Islamic banking as it is essentially a different way of banking. Furthermore, he also recommended that Basel II compliant arrangements need to be worked out and be recognized at the appropriate level.

“Given time there should be development because the need of hedging is very urgent in Islamic banking”.[R 3]

As per the above comments there is a need to create more “shariah” compliant based hedging tools like cross currency swap and profit rate swap. The BNM governor Tan Sri Zeti Akhtar Aziz recommended new hedging products that are scarce in the market and need to be developed in the quest to seek compatible risk mitigating
products. Indeed, the development of new hedging products is something that the Islamic financial community must address. (BIS Review, 2004). Furthermore, there is a need for a standard document for this type of hedging products. The new joint ISDA/IIFM Islamic Derivatives Master Agreement will be kept as close as possible to the ISDA Master Agreement (Pickel, 2007). This will decrease the documentation risk or “Battle of the Forms”.
CHAPTER 5 SUMMARY AND CONCLUSION

5.0 Introduction

This chapter comprises of five sections that is section 5.1 research objectives revisited followed by section 5.2 summary of findings. The summary of the findings includes the issues, prospects and challenges in Islamic banking. Section 5.3 discusses the implications of the study and subsequently section 5.4 gives some recommendations for future research. Finally, section 5.5 ends with a brief conclusion.

5.1 Research objectives revisited

The study focuses on three main areas – issues in Islamic banking, prospects in Islamic banking and lastly challenges faced by Islamic banking. This whole study concentrates on Malaysia and especially on the operational issues of Islamic banking. To get some insights on setting up Islamic banking a mini case study is carried out to evaluate the obstacles that are faced in setting up an Islamic bank.

5.2 Summary of findings.

In order to achieve the above objective, the researcher conducted a semi-structured interview, including a more in-depth interview and utilized secondary data like BNM Statistical Bulletin, MIFC reports, books, historical documents, speeches, and
interviews. The semi-structured interview was conducted by interviewing the individuals who are directly involved in Islamic banking.

5.2.1 Issues highlighted in Islamic banking

From the findings, the researcher found there are some significant issues in Islamic banking in Malaysia that need serious attention.

- Lack of Awareness. The awareness level of Islamic banking is there for basic products but in more complicated products like *Musyarakah* and *Mudharabah* the awareness is very poor. This is consistent with the study by Metawa and Almossawii, (1998) and Gerrald and Cunnigham, (1997) where awareness in Islamic financing based products is quite poor. Hamid and Nordin, (2001) suggested that better consumer education will make people more aware of Islamic banking products. This can be achieved by advertising and marketing.

- Factors that drive customers to Islamic banking. Islamic bankers should take measures on service quality and that the religious factor is not conclusive to drive customers to use Islamic banking facilities. This finding is similar with the earlier studies by Rosli and Afandi (2003). Their study found that the religious factor is not conclusive enough to drive Muslims and that convenience is more pertinent. There is a need for Islamic banking to increase the service quality in order to drive customers (Othman and Owen, 2001).
Marketing – There is a need to be more aggressive in marketing to increase market share. This finding is similar with studies by Kuehn and Bley, (2004) who found that Islamic banks need to improve their marketing effectiveness by addressing the market ignorance about Islamic products and services.

“Shariah” Audit – There is a need to implement a “shariah” audit to ensure that the implementation is in absolute compliance with “shariah” principles.

Islamic bank staff – Presently, there are less qualified staff in Islamic banking and there is a need for conventional experience that can be useful in product development and operation of Islamic banking. The findings on lack of qualified staff are also in line with the studies of Tahir (2003) and Hassan (1999). Furthermore, the study also found shariah knowledge is not a merit but that it is an advantage for Islamic banking staff. These findings are similar with the earlier study by Karbhari et al., (2004). However, conventional banking experience is a must for staff of Islamic banks to be more knowledgeable in product development and for the operation of Islamic banking.

Risk – Islamic banking assets are quite different compared to conventional banking. They need to be viewed differently and cannot be judged as more risky than conventional banking. These findings are consistent with the study by Aggarwal and Yousef (2004), who claimed that Islamic banks structure their lending mostly on short term and heavily secured.
• Hedging Mechanism – There are less hedging mechanisms in Islamic banking. Even though in Islamic banking hedging against interest rates is no longer required a flow on mismatches is needed. This is similar to the recommendation by Ebrahim and Joo (2001), which stated there is a need to design and implement Islamic hedging products.

• Products – The issue of the lack of Islamic products is not a problem because most of the basic products are there as per conventional banking. This is consistent with the study in Malaysia by Haidi and Malik (2006) who found that the Islamic banking product range is on a par with conventional products.

• Some of the issues like the lack of standardization in shariah were not deemed a problem from the respondents’ view as customers are looking more at the service quality and “economy of the products”. However, these findings are not consistent with the findings from previous studies that insisted that standardization in shariah was needed in the vocabulary and financing instruments. Tahir (2003), Karbhari et al., (2004) and Ainley (1997) all insisted on syariah standardization.

5.2.2 Issues highlighted in setting up Islamic banking

From the case study interviews, some of the problems identified during the setting up of an Islamic banking unit include:
• Need to develop Islamic banking products – There is a need to develop products that must be at least on a par with conventional products.

• Need experienced staff – In the early stages of Islamic banking there is a need for experienced and *shariah* knowledgeable staff in developing products and in the banking operation area. This finding is similar with the study by Sadar et al., (2004) who found that Islamic banking requires a high calibre workforce and a management team with expertise, leveraging on technology and strengthening the research area.

• Need to develop new system – In the early stage there were a lot of constraints in the system necessitating manual entries.

• Need to prepare documentation and contract – Need to make sure that all the documents comply and that the conditions are clear.

• Need to have a proper infrastructure – At the early stage must share resources with conventional bank.

In terms of regulation and policy, this study found that BNM and the government supports Islamic banking. The central bank or BNM was very helpful in setting up Islamic banking. In the early stage of Islamic banking there were certain problems but with the moral support and help from BNM, Islamic banking managed to overcome the obstacles.
5.2.3 Prospects highlighted on Islamic banking

This study found that Islamic banking prospects are very high because of Malaysia’s aim to be an Islamic hub and because of the strong support from the government. The launch of MIFC and government tax incentives offers a further boost for the Islamic banking industry. Malaysia can be seen as the dominant force in Islamic banking and its function as the link between the Middle East and Asian countries. Moreover, the parallel banking system by BNM is also a stepping stone because the conventional banking infrastructure and branding is used to develop Islamic banking growth and sales.

The good prospects for Islamic banking in Malaysia are due to the dual system where Islamic banks use the conventional base to market all their products. These Islamic banks do not have to grow from the roots by building up more branches. The image of conventional banking is already an advantage for local Islamic banks.

The investment by Kuwait Bank, Al Rajhi Bank and Unicorn Bank will also further strengthen Malaysia as a place of investment for Middle East investors who have surplus cash. These investors are actually looking for “halal” based investment return making Malaysia eminently suitable because of the labelling of Malaysia as an Islamic country and Islamic hub. (Starbiz, Feb 2008)
5.2.4 Challenges highlighted for Islamic banking in Malaysia

Some of the challenges identified from the study are:

- Competition from other Middle East Banks – Kuwait Bank, Al Rajhi Bank and Unicorn Bank are far more experienced and will give local Islamic banks very tough competition. This is similar to the findings of Kaleem (2000) who found that besides conventional banks, Islamic banks need to also compete among themselves. There is a need to increase service quality and take advantage of business opportunities especially in *Musyarakah* financing.

- Mergers between Islamic banks – Mergers among Islamic banks are anticipated in order to be more significant in capital structure, efficient and prepared to compete with other banks. The local banks need to joint venture to be stronger with better capital backing.

- Need for expertise in various fields – Equity financing through *Musyarakah* will require future bankers to have expertise in specialized fields like manufacturing, shipping, agricultural, engineering and construction. In future Islamic bank staff must have knowledge in engineering, agricultural and construction in order to make business decisions.
• Challenges in product innovation – There is a need to be more innovative and develop new products, not just duplicate conventional based products. This is similar with the study by Bhattacharyay (1995), who insisted that Islamic banks need to develop appropriate products and services to meet the changing needs of customers.

• Moral Hazard – To prevent this hazard banks need to properly evaluate the business and potential sectors before investing. This is consistent with the study by Khan (2004), who argued that equity contracts can create a moral hazard where carefulness is needed and that there is a risk of overestimation by the bank.

• Need experienced staff in Islamic banking – There is a need to train the Islamic banking staff in the Islamic way and BNM should play their role in setting up an Islamic Training Centre. This finding is also supported by Khan (2000) who stressed that in Islamic banking the induction of trained and professional staff would be the number one necessity.

• Priority given in risk management area – There is a need for an effective risk management system and more hedging tools. This is consistent with the study by Hayati and Nizam (2004); they commented that there is need for serious attention to be given to risk management in Islamic banking. The revised Basel II, according to Islamic banking, is also needed in the risk management area (Tahir, 2004).
According to Haron and Yamirudeng (2003), overcoming Islamic banking challenges involves hard work and diligent efforts from various parties.

5.3 Implications of this study

This study managed to point out some of the significant issues and challenges that Islamic banking will face and the prospects for Islamic banking. In addition, this study also provides some comparisons with other research on Islamic banking in other countries.

The results of this study will benefit Islamic banking organizations, management, staff of Islamic banks, the regulators, MIFC and customers of Islamic banks. These related parties must look into the issues of Islamic banking and take corrective action to be prepared for the challenges ahead. The regulator has to rigorously look into ways to streamline the problems faced by Islamic banks. This research also provides some insights on the prospects of Islamic banking in Malaysia and how it is performing in meeting the objectives to make Malaysia an Islamic hub.

5.4 Recommendations for future research

Future research can be undertaken to examine a number of issues that were not addressed in this study:

First, research is needed to examine the accounting treatment problems in Islamic banking and to look into this problem more thoroughly. The researcher was not able
to investigate this issue because of the confidentiality of the information and also because of the time factor.

Second, there is a need to look at Basel II treatment of Islamic banking in Malaysia. The Basel II treatment in Malaysia just started and is not fully used in Islamic banking. Future research needs to look at whether the Basel II can be applied to Malaysian Islamic banking.

5.5 Conclusion

Islamic banking is growing at an exponential rate in the Malaysian banking industry and has gained extensive support from both Muslims and non-Muslims in respect of shariah compliant financial solutions to their daily needs.

The purpose of this research paper is to identify the main issues, prospects and challenges of Islamic banking in Malaysia. Several interviews were held with personnel who are directly involved with the Islamic banking industry and a detailed mini case study pertaining to the difficulties encountered by a bank in setting up its Islamic banking unit was undertaken.

The findings of the research managed to reveal certain issues in Islamic banking in Malaysia that need to be addressed for corrective action. Due to the lack of public awareness of Islamic bank products, bankers should promote these products intensively via advertising and effective marketing strategies to increase the market share. Service quality of Islamic banking is an important factor driving bank
customers; emphasis on service quality is therefore essential to attract more customers. A “shariah audit” is also necessary to ensure that shariah compliant products are recommended to the public through the Islamic banking system. The staff involved in Islamic banking should be well trained to equip themselves with sufficient shariah knowledge and principles for the Islamic banking product development process as well as for the operation of the system. The Malaysian Islamic banking industry has a variety of products to satisfy their customers’ requirements independent of conventional banking products. Bankers have implemented an excellent risk management system by structuring most of their lending in the short term, which is highly secured by the relevant securities provided by the lender, to minimise the asset-mismatch risk and maximise the potential gain in the operation of Islamic banking. However, to maintain a comfortable risk level, proper risk hedging systems are still very important for Islamic bankers to hedge with the assets mismatching mechanism.

The setting up of an Islamic banking unit is a tough assignment; the case study managed to demonstrate the problems faced by the bank in the setting up process. The bank has to develop a range of Islamic banking products that are shariah compliant to compete with conventional banking products in the market and catch the attention of its customers. For the entire operation of the Islamic banking unit, the bank has to engage shariah knowledgeable and experienced staff, especially for the product development process. In addition, investment in the hardware and software of the IT system is important in the setting up process for the running of the daily operation and to maintain proper transaction records for report purposes.
Documentation and contracts under the Islamic banking transactions also have to be reviewed carefully to ensure they are *shariah* compliant, and that the content of the documents are factual and not ambiguous. As for the infrastructure, sharing of resources is commonly being practiced.

However, the prospects for Islamic banking in Malaysia are still very bright as the industry receives strong support from the government. The MIFC and government tax incentives help to boost the industry. Under the umbrella of BNM, bankers are allowed to exploit the parallel banking system (joint-operation of conventional banking system and Islamic banking system) in which both the conventional and the Islamic bank share infrastructure and resources to ease the development of Islamic banking. As Malaysia is a well-known Islamic hub worldwide, it also contributes to the successfulness of the industry. Strong financial investors from the Middle East have a preference for investing in Malaysia Islamic banking for “*halal*” investment returns.

Currently, Malaysia is one of the leading countries in Islamic banking. Intelligent solutions for the challenges in the industry are essential to entail its prestigious position in the Islamic banking world. From the micro view, excellent service quality is the priority for Islamic banking to be sustainable and for withstanding stiff market competition. Also, product innovation is much needed to fulfil the customers’ financial requirements. Skilled and knowledgeable staffs are also necessary to assist customers in making the right choice of products as well as for the operation of the Islamic banking system. In addition, bankers need to explore multiple knowledge and
expertise in equity financing through *Musyarakah* for decision-making. From the macro view, merger among Islamic banks is anticipated to jointly develop the industry and prevent failure. Nevertheless, Islamic banking should implement an enhanced risk management framework to reduce the risks i.e. operational risk, liquidity risk, market risk, exchange risk etc.

Looking ahead, Islamic banking is expected to grow rapidly in Malaysia with full support from all the stakeholders.
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