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The American University in Cairo
School of Business, Economics, and Communication

ISLAMIC FINANCE: A STUDY OF MALAYSIAN BANKS FROM 1999-2006

A Thesis Submitted to

The Department of Economics

In partial fulfillment of the requirements for

The degree of Master of Arts

By

Tamer ElGindi

BA in Economics

Under the supervision of

Dr. John Salevurakis, Assistant Professor

May 2007

ABSTRACT

The American University in Cairo

Islamic Finance: A Study of Malaysian Banks from 1999-2006

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Supervisor: Dr. John Salevurakis

Islamic finance has been developing rapidly in the last forty years with Islamic financial institutions expanding at enormous rates all over the world. Islamic finance offers both an equity based system dependent on profit-and-loss sharing modes along with other debt-based instruments that facilitate trade. Comparison between the performance of Islamic banks and conventional banks has been under study for several years with some studies suggesting that Islamic banks were able to outperform conventional banks in certain areas, other studies suggest the opposite. This study focuses on eight banks in Malaysia that are incorporated under the Islamic Banking Scheme and offer both conventional and Islamic banking operations. The comparison between both types of operations is conducted in terms of profitability, liquidity, and asset quality using several financial ratios such as return on assets (ROA), return on equity (ROE), return on deposits (ROD), cash deposits ratio (CDR), loan deposits ratio (LDR), net non-performing loans ratio (NPL), and write-offs as a percentage of total assets. The null hypothesis is that both population variances and means are equal against the alternative that both are not equal. Results suggest that four out of the seven ratios were statistically significant when comparing population variances, and also suggest that all seven ratios were statistically significant at the 99% confidence level when comparing population means. This means that the null hypothesis was rejected in those cases implying that the

two populations are not equal. Further, the results are consistent with the arguments offered in favor of the benefits of the Islamic banking system as opposed to the negative social and economic outcomes of the conventional system.

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Chapter One

INTRODUCTION

Islamic finance can be described as a system offering financial services that are compliant with the Islamic law (*Shari'a*) which is a comprehensive set of regulations, which largely deals with commercial jurisprudence (*fiqh al mu'amalat*). The importance of this branch of *Shari'a* lies in the fact that it outlines the different transactions that are valid and permissible in an Islamic context. Two major prohibitions stand out as the most important. These are *riba* and *gharar*.

Gharar, translated to mean “risk” or “uncertainty”, describes a situation where there exists a win-lose situation between different parties. Ibn Taymiah indicates that “*gharar* describe things with unknown fate”, and his student-Ibn Al-Qayyim- defines it to be “the possibility of existence and non-existence” (as cited in Al-Suwailem, 2000). Examples of *gharar*, given by some of the *hadiths* of the Prophet (PBUH), include the selling of bird on trees or fish in the sea. In other words, these are sale transactions where both quantity and quality are not exactly identified.

Riba, the focus of this research, is translated to mean an “increase” or the “process of increase”. In practical terms, it is defined to be “interest on loans and exchange of unequal quantities of similar fungibles” (Siddiqi, 2001a). In this regard, it is worth noting that the term *riba* cannot be equated with the Western term of “usury”. The term “usury” is defined as the practice of charging an “excessive” rate of interest for the loan of money. Conversely, *riba* can be defined as any increase on loans regardless of the rate of interest charged. Lawai (1994) mentions that most Muslim scholars have considered

all types of *riba* to be illegal regardless of the amount of interest charged. Further, Muslim scholars do not differentiate between nominal and real interest rates, according to Dhumale and Sapcanin (1999). They considered it to be all interest rates that could hinder investment and thus employment. However, Islamic finance does not prohibit paying a reward to capital per se. It links this reward to actual profits and not predetermined interest rates, and thus is a reward for actual returns rather than potential ones. Therefore, all parties are vulnerable to both rewards and losses and this theoretically yields more social justice.

Islamic financial instruments are divided into two major categories, profit-and-loss sharing (PLS) modes and non-PLS modes. PLS modes are considered equity based financing instruments in which all partners share the risk of investment. As evinced by its name, all partners in such modes share the profits as well as the losses. The non-PLS modes are considered trade debt based modes, in which prices for goods are fixed at the beginning and not subject to any increases. The PLS system includes two major types of partnerships, *mudarabah* (silent partnership) and *musharakah* (active partnership). Both types of partnerships function through equity rather than debt based financial modes. Simply speaking, in the PLS principle both lender and borrower bear the risk of investment.

The second category of Islamic modes of financing are non-PLS modes such as *bai' bithamman ajil* (deferred payment sales), *murabaha* (cost-plus sales), *ijarah and ijarah thumma al bai'* (leasing and lease purchase), and admissible Islamic forwards such as *istisna'* (commission to manufacture) and *salam*. Although these financing modes are considered debt based modes, they are only traded at par values and not allowable to any

further increases. Ismail and Ahmad (2006) clarify that those types are considered to be mark-up financing, meaning that they are "loanable funds" that comply with Islamic law. In this case, interest is replaced by current profit and the price is agreed upon with the buyer at the beginning with a mark-up price not subject to any increases. In the conventional system, bank loans function with a credit system, in which interest rates are compounded and are subject to fluctuation. Conversely, in Islamic financing, profit replaces interest rates and a mark-up price is accepted by the borrowers in the current period. In sum, the Islamic financial system tackles two major difficulties that are apparent in the conventional system and which may cause economic instabilities. These two difficulties are the great reliance on debt based modes for the purpose of financing projects and the interest based system existing in the financial sector.

In the conventional system, debt based modes along with interest rates play a crucial role in the economic life of societies. Most projects are usually financed through debt based modes such as loans from banks or through issuing bonds on the stock market. Interest rates are also theorized to be a major determinant of investment and they are used among other tools by central banks to control prices. In classical economic theory, interest rates are obviously considered to be very important in determining the level of investment and are used as a tool by central banks in order to influence investment. However, some of the instabilities that appeared in several markets can be to some extent attributed to those debt based modes. High leverage ratios might be one of the causes of economic instabilities that occurred in markets such as Asia and Latin America. Economists such as Fisher (1945), Simons (1948), and Friedman (1969) have all pointed out to this instability feature of the current interest-based financial system. This was to be

clearly seen in the American Savings and Loans crisis in the early 1980s along with financial turbulence in Latin American countries in the 1990s (as cited in El Gamal, 1997). In addition to the negative effects of debt based modes, the level and effect of interest rates on levels of investment and savings has also been a debatable issue as early as the classical era and continues to be during the neo-classical era of economic theory. Adam Smith was actually in favor of putting a certain ceiling for interest rates, but rejected their elimination (as cited in Visser and McIntosh, 1998). Keynes also criticized the overly influential role played by interest rates and bank credit in affecting business cycles (as cited in Dar and Presley, 1999).

In contrast, Islamic finance may solve some of these problems due to its equity based nature. Depending on equity based modes rather than debt based ones, stability of financial markets is expected to improve as there would be no more room for speculation and gambling. Rewards are also only based on accrued results rather than hypothetical or future ones. Bringing commodity and financial markets into harmonic unison with one another could also help in curbing inflationary pressures. Even in cases of debt based modes of finance, goods are expected to be traded according to pre-defined values not allowable to any increases and this further strengthens the argument of curbing inflation. Typically in Islamic finance loans are not considered as means of financing, but rather as a charitable act. In the case of their existence, they are supposed to be returned back at par value without any increase. A final and most important factor characterizing Islamic finance is that it cannot be only considered as a pure economic system. Rather, it is a mix between economic and social factors that impact the whole economy. In Islamic finance there is no exclusion of a certain class of people from the financial system. The entire

society is considered to be a collection of productive units that should be individually integrated in the broader economic system. This feature is very clear if we observe the type of partnerships that are promoted in Islamic finance. These encourage cooperation between the different partners of the society whether they be the owners of the money or the persons working with it. By doing this, the poorer segments of society also gain access to the financial system as extant collateral is no longer a restriction as in the conventional system. As a result, Islamic finance pays attention to small and medium-size enterprises as well as larger ones. This means that, on a societal level, more employment opportunities and more growth can be generated. Although this feature of integration between both economic and social factors is incorporated in Islamic finance since its beginning, Western economies have just recently paid more attention to this possibility by encouraging microfinance projects. In general, microfinance as explained by Segrado (2005) is directed towards “people who are traditionally considered non bankable, mainly because they lack the guarantees that can protect a financial institution against a loss risk”. In this regard, Islamic financial instruments resemble a great opportunity that can be utilized for financing this segment of the population.

In general, this research tends to present the theoretical differences underlying both conventional and Islamic financial services. Further, it examines the actual differences existing in the performance of both conventional and Islamic banking operations in the case of Malaysian banks. The paper is divided into ten chapters beginning with an introductory chapter. The second chapter offers a brief description of the literature review on Islamic finance in the last 50 years. It also presents the different studies conducted regarding Malaysian banks in which the performance of both Islamic

and conventional operations are compared. The third chapter indicates the importance of financial intermediaries in influencing the economic development in economies and presents the differences between conventional and Islamic banking. The fourth chapter describes the history of Islamic finance up to the present. The fifth explains the meaning of *riba* along with its types. Further, it discusses the economic explanations behind its prohibition along with the negative outcomes that have resulted from both debt based modes of finance and interest rate based systems. This is followed by the sixth chapter, in which different available Islamic financial instruments are presented and explained. The chapter also indicates the benefits and advantages that would accrue from adopting such a system by highlighting two major features. These are risk sharing among all partners, and the availability of finance to different classes of people (as is the case in microfinance). The seventh chapter offers a brief outlook on the Malaysian economy. A brief macroeconomic outlook for the whole country is outlined and then the discussion is narrowed to an exploration of the financial system with special emphasis on Islamic finance. The eighth chapter provides the methodology and data adopted in this specific research, which analyzes different financial ratios in order to compare between both types of banks' operations. The ninth chapter tests the hypothesis that there exist statistically significant differences between variances and means of both conventional and Islamic banking operations as described by profitability, liquidity, and asset quality indicators. Finally, the last chapter offers conclusions and suggestions regarding the Islamic financial system in Malaysia.

After presenting both systems and statistically comparing the performance of each, it would be interesting to discover whether empirical data supports the theoretical

arguments put forth or not. Would an equity based system dependent on actual realized profits yield different results than a debt based system dependent on interest rates and hypothesized profits? Can the Islamic banking system outperform its conventional counterpart regarding the different measures under study?

Chapter Two

A REVIEW OF THE LITERATURE

Islamic finance is a concept naturally as old as Islam itself. During the early years of Islam, most of the financial transactions took the form of trade and loans. According to Ahmed (2000) most of the trade during the Prophet's (PBUH) time was mainly trade in goods and services. The Prophet (PBUH) did not come up with new economic or financial theories, instead he regulated the existing market at that time according to the Islamic law. At that time of course, financial transactions did not take very complicated forms and were mainly concentrated in trade and loans. The money used at that time was mostly either silver or gold coins.

The earliest writings found discussing Islamic financial transactions date back to 80 (AH), and which are attributed to Abu Hanifa, the founder of the first Islamic school of thought. He was followed by other Muslim scholars, such as Abu Yusuf, Ahmed Bin Hanbal, Al-Ghazali, Ibn Taymiah and Ibn Khaldun, just to mention a few. In their writings, they dealt with different topics such as the role of money, pricing issues, interference by the government, market imperfections as well as other topics. It is worth noting here, that during this time, all of the financial transactions conducted between Muslims and their counterparts from other countries did not include any banks. However, things began to change with the establishment of banks in the 16th and 17th centuries. After decades, in which the Islamic nation was ruling the world, the center of power shifted towards European countries.

With the beginning of the 17th century, financial institutions, in their modern sense began to evolve in Europe. According to Archer and Abdel Karim (2002), the

development seen at that time, notably in Britain, was mainly due to the development of new techniques in the fields of finance and risk management. This was further activated with the industrial revolution taking place at the late 18th century and continued on through the 19th century and thereafter. It is worth noting here, that Islamic nations at that time were lagging behind in terms of development in economic thought. However, this can be explained by the occupation existing at that time in several Muslim countries. According to Siddiqi (2001b), the colonization by European countries led to dominance over all financial and economic aspects of those Muslim countries. As a result, the dominant form of financial transactions at that time was of course based upon Western models and theories, which relies to a great extent on debt based instruments.

It was not until the 1940s that Muslim countries began to gain their independence such that we can see some contributions by Muslim scholars and writers in the fields of economics and finance. Kuran (1995) adds that the goal of the first Indian Muslims who began writing in this field was to regain the self-confidence of the Islamic identity against the increasing foreign influence of Westerns ideas. The first theoretical literature according to Siddiqi (2001b) began to appear in the 1940s and throughout the 1960s, and was mostly written in Arabic, Urdu and English. Most of the writers at that time dealt mainly with macro views, in the sense that they criticized both capitalist and socialist systems. They then identified the major principles of Islamic finance and emphasized the importance of prohibition of *riba*. Some writers focused more on the banking sector and felt that early Islamic contracts, as given by profit-sharing agreements, provided a cornerstone for a whole restructure of the banking system. PLS modes are equity based instruments that facilitate financing without giving any loans. It rather takes the form of

partnerships in which all partners share the risk of investment. Some studies comparing profit-sharing with interest-based systems have shown that the former has yielded superior results compared to the latter, as indicated by Al-Jarhi and Iqbal (2001).

Moreover, other studies have tackled the issue of microfinance which is a major feature characterizing Islamic finance. Studies such as Dhumale and Sapcanin (1999), Ferro (2005), and Segrado (2005) have all drawn analogies existing between Islamic finance and microfinance, and have also presented different successful examples that were implemented in several developing countries adopting Islamic finance principles. Although the number of studies in this arena are few, they are currently increasing as more focus is directed toward microfinance especially from large international banks (such as Citigroup, Deutsche Bank, ABN Amro, BNP Paribas, etc) as well as toward international organizations such as the US Agency for International Development (USAID). Of course, the emphasis put forth by Islamic finance towards all classes of people resembles a major feature that characterizes Islamic finance compared to its conventional counterpart. In general, the major common denominator in all these financial instruments is the ban of *riba*. Although this ban is very obvious in Quran, the bigger challenge remained on how it will be applied to modern finance.

Of course, one can notice that the current conventional banking system runs contrary to that system. The modern banking system according to Usmani (2005) dates back to the 16th century. At that time people used to store gold in safe deposits at Goldsmiths in exchange for a receipt. Whenever people wanted to regain their gold, they would simply present a receipt and receive their gold back. After some time, the Goldsmiths discovered that it is very unlikely that all people would show up

simultaneously to receive their gold, and thus began to print additional paper without backing that increase with additional gold. This led to the initiation of the fractional reserve system that can be defined as a “system which allows an expansion in the supply of paper money without a corresponding rise in the assets held by the bank” (Usmani, 2005), yielding eventually to a system of fiat currency where there is no gold backing. Further, commercial banks are most popular for offering loans for the sake of establishing projects as well as for private consumption based on credit terms that includes fluctuating interest rates.

Still, it has been argued that several economic failures are considered to be outcomes of the instability of interest-based mechanism. For example, Tomlinson (1993) argues that, throughout history, this “money-lending mechanism” has been taken as given, and suggests that inflation happens to be a major outcome of this system along with heavy debts and severe business cycles. This instability and the vulnerability to recurrent crises has been also tackled by Minsky (as cited in Siddiqi 2001b). In addition to Minsky, Greenwald and Stiglitz have also related cyclical fluctuations to interest rates (as cited in Bellalah and Ellouz, 2004).

Although discussed literature has been written with regard to the impact of interest rates upon different economic phenomena such as inflation, unemployment and business cycles, it remains to be seen whether adopting a free interest rate system, as promoted by Islamic principles, could help cure some of these economic inefficiencies. It is worth noting that very few studies were able to show, through empirical evidence, that a free-interest rate system could yield better results than an interest-based mechanism. In order to conduct a research examining the influence of adapting the Islamic system, we

must find a country that has totally abolished the use of the interest based system and adopted a zero-interest rate system. Until our present time, only three such countries exist, Pakistan, Iran, and Sudan¹. Darrat (2002) was able to test the behavior of the two economies of Iran and Pakistan before and after they implemented an interest-free banking mechanism by using empirical data along with inferences from statistical data and by conducting time series analysis. The overall economic performance such as the real GDP and the inflation rate along with the velocity of money were examined, and the free interest rate system has found to yield better results after the implementation. However, he mentions that his results are only “suggestive” of certain relationships and cannot be used as definitive explanations for the implementation of a free interest rate mechanism as some of these macroeconomic indicators could have improved due to other factors. Still, he argues that one can infer from those results that the implementation of a free-interest rate system did not at least hinder any of the two country’s economic performance.

Other studies tend to focus on the performance and efficiency of Islamic banks or compare them with conventional ones by using different financial ratios. This can be attributed to the fact that, in most Muslim countries, Islamic banks tend to operate side by side with conventional ones. Studies such as Samad and Hassan (1999), Rosly and Abu Bakar (2003), Samad (2005), Mohsin (2005), Ibrahim (2006), and Moktar, Abdullallah and Al-Habshi (2006) examine the performance of Islamic banks across time as well as their performance compared to conventional banks in countries such Bahrain, Sudan, Malaysia, etc. Several financial ratios are used in this regard that can be categorized

¹ Pakistan, Iran and Sudan have totally abolished the interest rate based mechanism in 1979, 1983, and 1988, respectively.

under a number of major headings, such as profitability, liquidity, risk solvency and asset quality ratios. The major ratios used therein are return on assets (ROA), return on equity (ROE), return on deposits (ROD), cash deposits ratio (CDR), loan deposits ratio (LDR), asset utilization (AU), etc. Naturally, results tend to differ from one study to another and from one ratio to another. While some studies show that Islamic banks have performed better than their conventional counterparts, other studies suggest the opposite.

Studies concerning Malaysia, the focus of this thesis, have mainly focused on two major aspects. The first aspect is studying the performance of Islamic banks throughout a certain time frame, and then testing whether it has been improving or not. The second aspect is comparing the performance of Islamic banking operations with conventional ones. Wong (1995) evaluated the performance of Bank Islam Malaysia Berhad (BIMB) after 10 years of its operations². He found out that the bank depended heavily on credit finance. Still, he acknowledged that the bank was able to maintain its growth in a capitalistic financial environment. Dirar (1996) compared BIMB with two other conventional banks. He focused on ratios of growth, profitability, liquidity and capital adequacy. His findings parallel those of Wong that BIMB depended strongly on credit-based investments.

Two major studies are of main concern of this research. The first was conducted by Samad and Hassan (1999) and it examines inter-temporal as well as interbank performance of BIMB during the period 1984-1997. They use four major categories, namely profitability, liquidity, risk and solvency, and community involvement. In the first part of study, they examine the performance of BIMB by comparing two time periods, 1984-1989 with 1990-1997. All profitability measures used here {return on

² BIMB was the first fully Islamic bank to be established in Malaysia in 1983.

assets (ROA), return on equity (ROE), and profit expense ratio (PER)} showed a significant progress during the second time period, which was statistically significant in the case of ROA and ROE. This statistical significance reveals that the bank's performance has been improving with time. However, the comparison of BIMB with a group of conventional banks did not reveal any statistical significance in any measure.

The second study of concern for this research is by Rosly and Bakar (2003). In their study, they evaluate the performance of Islamic banking scheme banks (IBS)³ with mainstream banks during the period from 1996-1999. Before discussing their results we first have to highlight that theoretically a higher ROA should lead to a higher asset utilization (AU) ratio. However, in their study they concluded that IBS banks are not efficient in comparison with mainstream banks even though they recorded higher ROA ratios due to the lower AU ratios experienced in IBS banks compared to mainstream banks. Further, they add that the higher ROA evident in IBS banks can be explained by the fact that IBS banks are able to utilize existing overhead expenses used by the parents' banks.

It is clear from the previous studies that, while most of them have focused solely on BIMB and evaluated its performance, only one study examined the performance of IBS banks and compared their conventional with their Islamic banking operations. In this regard, this research will expand on the previous study in several ways. First, the time frame studied here is longer; this study will examine a period of eight years as compared to the four years examined in the previous study. The number of banks in this study is

³ Islamic banking scheme (IBS) banks are considered originally as conventional banks that have later offered Islamic banking services since the establishment of "Islamic Windows" in 1993. It includes three types of banks, which are commercial banks, finance companies, and merchant banks. Commercial banks deal mainly with trade and corporate finance, finance companies handle automobile financing and home mortgage, and merchant banks deal with the underwriting of new stocks and bond issues.

eight banks as compared to 16 in the previous work. However, this decrease in the number of banks is mainly a result of the merger of several banks in recent years. This study examines three broad categories with which banks are usually evaluated: profitability, liquidity, and asset quality measures while the previous study only focused on profitability performances as indicated in their research. This could be because at that time (mid to late 1990s), data on Islamic banking operations was still not fully developed and published in banks' reports. However, since 1999 (the last year studied in the previous study) data has been available and more detailed.

It should be clear from the above discussion that the new trend of Islamic finance is currently gaining more and more ground every day, not only in Muslim countries but also in Western countries. Of course, the evident increase in the number of Islamic financial institutions operating all over the world and the increase in assets cannot only be justified through the superiority of Islamic financial methods as opposed to conventional ones. Rather, there are other important factors that should be taken into consideration. With the increasing demand of many Muslims to abide by *Shari'a* law, international banks have seen that as a great opportunity to fulfill those people's needs as well as entering new markets and generating more profits through offering *Shari'a* compliant services⁴. Still, this is not to undermine the success achieved by Islamic banks, and the role played by Islamic financial institutions in exploring new areas of financing. Given that Islamic finance focuses on maximizing social benefits rather than maximizing profits, it paves the way for a new era of financing in which more society commitment is

⁴ It is worth noting that Islamic banks are not excluded for Muslims. As a matter of fact, lots of non-Muslims who would like to put their money into "ethical" investments can choose to invest in Islamic banks. "Ethical" here means that Islamic banks restrain from investing in certain sectors such as pornography, tobacco, gambling, weapons, and alcohol industries.

integrated with pure economic goals. The role of those financial intermediaries is very important and essential in the economic as well as social development of countries. In this regard, we begin first by identifying the importance of financial intermediaries in people's lives as well as explaining the major differences between conventional versus Islamic banking operations.

Chapter Three

THE IMPORTANCE OF FINANCIAL INTERMEDIARIES

Before explaining the major differences existing between conventional banking and Islamic banking operations, it is first necessary to indicate whether or not we need such banks in the first place. It can be seen that since almost the 16th century, financial intermediaries began to play a major role in people's lives whether this was done through banks or insurance companies. Before that time, the international market was not as integrated as was the case afterwards. With the discovering of new trade routes, international trade began to flourish and more transactions began to take place all over the world. This new trend of transactions, along with the complexity of some of those transactions, meant that there was a need for the development of such financial intermediaries.

III.I: Do We Really Need Banks?

The importance of financial intermediaries lies in the fact that they do influence the economic development in economies. Ismail and Ahmed (2006) cite several economists that share this point of view. For example, Schumpeter (1911), Gurley and Shaw (1955), Tobin (1956), Goldsmith (1969) and McKinnon (1973) all agree that financial intermediaries are crucial factors in economic development. Schumpeter (1911) believes that the role played by financial intermediaries in channeling savings, evaluating projects, and facilitating transactions is essential in order for technological innovation and economic development to take place. Further, Tobin (1956) mentioned that financial intermediaries play an essential role in facilitating transactions particularly in the

matching of interests between borrowers and lenders. We can say that the basic role of financial institutions is to utilize funds through the transfer of funds from surplus units to deficit units. This usually takes two forms; either it is made directly through direct finances in securities market or indirectly through financial intermediaries such as banks. Al-Jarhi and Iqbal (2001) further explain it by dividing the economy into two major segments. The first, called the investors or entrepreneurs, are a group of people that would like to exploit more investment opportunities than they are currently investing in. The other segment, namely the savers, have more financial resources than their actual needs. Financial intermediation in this regard helps to transfer those surplus units from savers to deficit units, be it the entrepreneurs, through several channels, most important of which are banks.

Financial intermediaries help to cure the mismatch that would occur in the savings/investment process. Savers are usually small households that acquire small amounts of savings, while entrepreneurs are usually large corporations that require large amounts of money. As a result, financial intermediaries are able to solve this mismatch process by gathering those small funds and giving them to large corporations. This being done, both parties will benefit. A second feature mentioned is that the risk preference differs from one segment to another. While small savers prefer risk averse investments, large corporations usually tend to take on risky projects. Small savers also are not really in a position where they can collect information about those large corporations to be able to put their savings in less risky projects. Here again arises the role of financial intermediaries, which can be implemented by different techniques in proper risk management and through gathering data and information about those large corporations,

reduce the possibility of risks. In this regard, the role of financial intermediaries seems to be very desirable and helpful on a personal as well on a social level.

III.II: How Does Islamic Banking Differ from Conventional Banking?

Before proceeding in answering this question, a major distinction should be made with regard to conventional banking. Conventional banking does not follow one model. Whereas commercial banking is dominating in Anglo-Saxon countries, universal (or investment) banking is dominant in European countries such as Germany, Switzerland, and the Netherlands. According to Al-Jarhi and Iqbal (2001), there are several differences that exist between both patterns.

Commercial banking is simply a financial intermediary where the bank borrows money from savers and lends it to corporations. Their profit arises from the differences in the rates with which they borrow and lend. Besides this, they offer a couple of banking services such as letter of guarantees and letter of credits. A major prohibition is that they are not allowed to engage in any trading activities.

This process of bank lending is however viable to certain problems as indicated by Al-Jarhi and Iqbal (2001). Borrowers usually know more information about the projects than lenders. Banks, considered to be lenders, face the problem of information asymmetry. This leads sometimes to what can be called as moral hazard problem; borrowers are in a position in which they might hold back some information from banks, which could lead to unexpected risks to be taken by the bank if the borrower uses the money in other purposes than the previously agreed ones. This in turn, might lead to excessive risks to be taken by the bank. It is really important that the loan is used in an effective manner for its prescribed purpose, so that the bank is able to secure its

repayments. Talking even about governments, we can witness that the misuse of loans have resulted in terrible outcomes that made those countries even more indebted after the usage of the loans.

Conversely, universal banking tends to have a larger base of operations than its commercial counterpart. Universal banks engage in trading as well as insurance activities, and they are also allowed to hold equity. Their financing methods are divided between shareholding and lending. Their shareholding allows them to be on the board of directors of their customers' business, which allows them in turn to be close to their funds and to be sure that their funds are used in an efficient manner.

Islamic banks would in turn be more similar to universal banks than commercial ones. Islamic banks depend mainly on two modes, the PLS financing modes and non-PLS financing modes. A major feature of Islamic banks would be providing finance through equity and shareholding, while there would also be other modes to facilitate trade-based transactions. The different modes of Islamic finance are to be explained in a following chapter. But before presenting those Islamic financial alternatives, a brief outlook is offered with regard to the evolution of Islamic finance throughout history.

Chapter Four

THE EVOLUTION OF ISLAMIC FINANCE THROUGHOUT HISTORY

Islamic finance dates back since the introduction of Islam a hundred of years ago. Some of the financial modes used in Islamic finance existed even before Islam such as the case of the profit and sharing agreement known by *mudarabah*. According to Al-Salous (2005), *mudarabah* agreements date back even before the existence of Islam. These agreements depend on the PLS principle and represent a sharing of risk and return that is tangible at the maturity of the transaction and does not exist as a hypothetical result of the investment process. Actual profits in this case are divided between the owner of the money and the agent-manager, the person who manages this money, at pre-determined percentage rates of the profit. In the case of a loss, the owner loses his money, while the agent-manager loses his time and effort. In this way, both parties are vulnerable to both profits and losses.

This type of agreement along with other ones that were approved by Islamic law (*Shari'a*), existed since the Prophet's (PBUH) time and continued thereafter. With the increasing expansions of the Islamic nation in the Mediterranean society afterwards, Islamic financial instruments were dominant at that time. This evidence is supported by Goitein, who acknowledges that during the 12th and 13th centuries the dominant forms for commerce and industry in the Mediterranean society were profit sharing and partnerships agreements rather than debt based instruments (as cited in Siddiqi, 2001a). This continued all through the Middle Ages and was accomplished by Islamic merchants, who were able to conduct different business activities based on credit basis with their counterparts in Spain, the Mediterranean and Baltic states (Iqbal, 1997). The superiority

of Islamic financial instruments lasted almost until the late 16th and early 17th century. However, beginning from the 17th century onwards, one can witness that this superiority began to deviate away from Muslim countries to their European counterparts. At that time, modern financial institutions (such as banking and insurance) were beginning to evolve, according to Archer and Abdel Karim (2002). The development of mathematical techniques in the fields of finance and risk management helped to establish this development, specifically in Britain. This was further on accelerated during the industrial revolution in the late 18th and early 19th centuries. From that time onwards until the middle of the 20th century, one can witness that economics as a science was much more developed in Western countries compared to Muslim countries. According to Siddiqi (2001b), the colonization by European countries led to dominance over financial and economic aspects of these Muslim countries by Western capitalists, which of course adopted Western style economic and financial instruments.

With the beginning of the 1940s Muslim countries began to gain their independence, and as a result we can see some contributions put into effect by Muslim scholars and writers in the fields of economics and finance. Their major focus was trying to revive the Islamic culture, and trying to implement financial instruments that were compliant with *Shari'a*. Of course, the prohibition of *riba* is very obvious in Quran. Still, its implementation in modern life transactions remained a great challenge.

The first experiment mentioned by Wilson (2002) took place in Pakistan. A group of Pakistani economists established a small cooperative bank based on *mudarabah* profit sharing agreements but not much has been revealed in this regard. The second experiment was conducted by an Egyptian, called Ahmed El Naggar in the town of Mit Ghamr in

Nile Delta in 1963, and took the form of a saving bank. Ahmed El Naggar is considered by several Muslim scholars as the father of Islamic economics. Wilson (2002) mentions that he was able to attract more than 10,000 depositors and directed those savings in agricultural investments. Further, Ariff (1988) acknowledges that those deposits included also trade and industry fields and that the banks (they later increased to reach nine banks and lasted until 1967) did not charge or pay interest to its customers. Rather, they invested either directly or with others and shared profits with their depositors (as cited in Zaman, 2001). His project was later terminated and he went into exile. Nonetheless, he was able to reach afterwards to several political and economic figures, and tried to convince them with the importance of establishing Islamic banks that do not deal with *riba*. According to Thomas, Kraty, and Cox (2006), King Faisal of Saudi Arabia, Tengku Abdul Rahman of Malaysia, and Saeed Lootah of Dubai stood out among these political and economic figures. It also seems that his efforts along with others of course resulted later in the establishment of the first Islamic bank.

Three major reasons, mentioned by Wilson (2002), helped in the emergence of modern Islamic banking in the early 1970s. The first was that finance ministers of the Organization of the Islamic Conference agreed to establish the Islamic Development Bank (IDB) in December 1973 in Jeddah, Saudi Arabia. IDB's major role was to promote Islamic banking operations worldwide along with its other developmental activities. The second reason was the increase in the oil prices during 1973-4, which in turn helped to increase the financial resources available to the Gulf countries. The third reason was the vision and effort offered by Islamic scholars, as we mentioned earlier in the case of Ahmed El Naggar. Soon after the initiation of the IDB, the Dubai Islamic Bank was

established in 1975, the Kuwait Finance House in 1977, the Faisal Islamic Bank of Egypt and Sudan in 1977 and 1978 respectively, the Bahrain Islamic Bank in 1981, and the Qatar Islamic Bank in 1983.

It is worth mentioning that it sounded very strange for most people to accept the fact that a bank could operate without charging or receiving interest. In fact, DeLorenzo (2002) indicates that almost forty years ago when the first Islamic banks were beginning to operate, people wondered how Islamic banks would be able to succeed without receiving interest. Further, most of them anticipated that those banks would run out of business in a couple of years. Time has proved those people wrong and according to El Qorchi (2005) the number of Islamic financial institutions has increased from only one in 1975 to 300 in 2005 operating in 75 countries. While most of these institutions are mainly operating in the Middle East and Southeast Asia, there are some that exist in the United States and Europe. They have assets worth more than \$250 billion and are growing at a rate of 15% annually.

Further, Islamic banks were a major developer of several major innovations, the feature of risk sharing among its partners being the most important. This feature stands to be a distinctive one that differentiates it from typical conventional methods. In addition to this feature, there are others that were indicated by Kahf (1999) (as cited in DeLorenzo, 2002). The first innovation was the replacement of the lending-borrower relationship existent in commercial banks with a relationship of partnership and cooperation. A second major innovation is the linkage brought between financial and real markets. In the Islamic financial system, when a client loses, the bank also loses and vice versa. This assures a direct relationship between production and the exchange of goods and services.

According to the Islamic belief, money in itself does not generate profits and thus there must be a certain amount of risk involved in order for capital to be rewarded. The concept of risk taking does not contradict with the concept of profit. On the contrary, people tend to take things more seriously when there exists a certain amount of risk (even if it is a minor one), according to DeLorenzo (2002). People would tend to be keener and more attentive about their investments and make sure that they are investing in the right projects. When this insistence on good performance is achieved, more cooperation and transparency will be evident. Management, from its side, will also tend to achieve good results, and profits will eventually occur.

One of the major restrictions governing Islamic banks is the prohibition of *riba*. Islamic finance is based upon the productive and efficient use of money for personal as well as societal benefits. In the next chapter, we will explain the meaning of the term *riba* and its different types. We will also address the several negative outcomes that are associated with debt based systems as well as interest rate based systems as given by Muslim as well as non-Muslim economists.

Chapter Five

RIBA

V.I: Definition and Types

The Islamic law (*Shari'a*) emphasizes just transactions that help protect peoples' private property and ownership. In order to ensure this notion, *Shari'a* puts forth several limitations that help protect this important feature. A major prohibition indicated earlier is *riba*. "The word *riba* as a noun literally means in Arabic, an increase, and as an adjective, it means the process of increasing", as identified by Al-Jarhi and Iqbal (2001). Muslim scholars have identified two types of *riba*, *riba al-fadl* and *riba al nasi'ah*. According to the same source, *riba al fadl* relates to the purchase and sale of commodities. It is defined to be the surplus or excess taking by one of the trading parties when dealing with six commodities that were mentioned in one of the authentic *hadiths* by the Prophet (PBUH). Of those six commodities, two of them gold and silver, were used during that time as commodity money. It has also been argued that the remaining four were also used at some point of time as commodity money. The second type is *riba al nasi'ah*, upon which most of the modern finance has been built. It refers to any increase taken in a loan due to some delay or postponement in payment. Financial intermediaries, such as banks, tend to lend people for a certain amount of time. This time value of money is translated into interest payments, which is totally forbidden in Islam. Still, this is not to say that Islam disregards the time value of money. Conversely, El Gamal (2001) indicates that several classical jurists have emphasized the notion of the time value of money by saying that "time has a share in the price". The most important

point that should be clear in this part is that loans are not considered as the right means for investment in the Islamic point of view. This is explicitly indicated by El Gamal (2001) by saying that in Islam one does not borrow to invest. The question remains: Why then is *riba* forbidden in Islam?

V.II: Economic Explanations behind the Prohibition of *Riba*

The answer to this question includes different arguments with respect to both debt based modes along with interest rate systems as both are considered to be correlated in some way. To begin with, we have to mention that the Islamic vision with regard to money is that money does not generate profits on its own. There must be some sort of effort and risk associated with a certain act, in which money is generated. Money in Islam, as written by one of the classical Muslim scholars, Abu Hamid Mohamed Al Ghazali, can be described as follows (as cited in Thomas, Kraty, & Cox, 2006):

Money has been created so as to be a measure of values and an instrument for exchange. Money itself has no intrinsic value. Had it an intrinsic value, it could not have played its role as money and would have become like other commodities.

*Hoarding of money, as well as collecting *riba* on money, means man has turned money into something desirable for its own sake.*

Further, economic activity has faced several fluctuations throughout history.

Some of which as mentioned by Chapra (2001), are considered to be natural phenomena, while others he argues, seem to be outcomes resulting from the instability of financial markets. This fact has been also acknowledged by El Gamal (1997), in which he mentions that the abolition of this debt based system is not considered as an “alien” to western economics. Economists, such as Fisher (1945), Simons (1948), Friedman (1969), and others have all pointed out to the instability of the current debt based system. Further, Friedman (1982) has drawn a relation between instability and the behavior of interest

rates (as cited in Chapra, 2001). The volatility of interest rates leads in turn to uncertainty into the investment market, which in turn leads to difficulties for investors who must take long term investment decisions with some kind of confidence. In the short term, borrowers as well as lenders tend to act in a similar manner. The result, he argues, is “a steep rise in highly leveraged short-term debt, which plays an important role in destabilizing financial markets” (Chapra, 2001). Several recent financial crises were caused by this debt based system. The 1997 East Asia crisis verifies this argument. At the beginning, there was a great inflow in short-term foreign funds, which enabled banks to expand their credit activities to the private sector. This increased inflow led to great speculations, specifically in the areas of stock and property markets. The minute there was a shock, there was a rapid outflow of funds from those banks, which were originally deposited on a short-term basis.

A further example mentioned was the collapse of the Long Term Capital Management (LTCM) hedge fund. The reason was also similar, which was the high leverage taken on a short-term basis. Leverage ratios, which indicate the extent of borrowing on the basis of equity, increased from 25:1 before the crisis, to 50:1, and finally to 167:1 after the crisis. Further, the Latin American countries witnessed a financial crisis, in which banks were a major player. El Gamal (1997) mentions that the crisis was “instigated by the ambiguity of the financial positions held by banks seeking higher interest rates on foreign currency denominated bonds”. Another example was given by Ahmed (2000), in which he mentions that Japan, an economy based upon debt based instruments, has suffered a lot of recession due to this system. He mentions that a major part of the economy is financed through debt financing rather than equity

financing. The problem occurs when one entity is unable to repay its debts to another firm. Consequently, this second firm will face the same problem and a “chain reaction” will take place, thus pulling the whole economy down.

A further explanation is given by Siddiqi (2002). He mentions that by abiding to this interest based mechanism; firms are forced to pay back their initial amounts in addition to the interest accrued at certain deadlines without taking into consideration the well-being or the health of the project at that specific time. This in turn might force the company to choose between three alternatives. The first is to borrow money, which is usually done at a higher rate. The second is to sell its products at a cheaper price than the expected one. The final is “default”, which sends negative shocks to the system and helps increasing this instability problem.

A further argument is stipulated by Usmani (2005), in which he mentions that the current system allows banks to have too much power. Central banks are allowed to create money, and thus creating artificial wealth without being backed by real economic activity. Keeping this in mind, central banks are given an enormous amount of power and authority over their societies, which could lead to several problems, for example heavy debts incurred by third world countries, in case this power is misused. A further explanation to this argument is that loans are considered as ways of financing according to the conventional system. However, in several cases especially in third world countries this proves not to be true. According to the Global Development Finance Report (2001) published by the World Bank, “in 1999 Angola received \$261 million in aid but paid \$549 million in debt service, Kenya received \$195 million in aid but paid \$716 million in debt service, and Vietnam received \$257 million in aid but paid \$1,410 million in debt

service” (as cited in El Diwany, 2006). These countries are usually encouraged by different organizations such as the World Bank (WB) and the International Monetary Fund (IMF) to accept taking loans in order to solve their economic difficulties. Ironically, by doing this they are adding more debt burden on the country’s debt balance.

Another argument is that the interest based mechanism is considered to hinder economic performance. As banks tend to profit from the interest with which they lend, banks will tend to lend those people who have the greatest collateral. By default, as Usmani (2005) explains, those with the greatest collateral resemble the lowest risk. However, this does not imply that those with the greatest collateral are those with the most viable and profitable projects. Thus, banks could be hindering economic performance by not lending other people that might possess better business ideas. Interest rates ration credit for people who already own it, and not to those who deserve it. Ahmed (2000) adds that at times when interest rates are high, savings are encouraged while investment is discouraged. Small and medium-size entrepreneurs are not able to borrow more money or expand their existing businesses. As a result, the country loses the efforts of those small and medium-size entrepreneurs who are not able to absorb wastages and losses as is the case for large businesses. Further, the normal man who cannot afford to make his own investments due to the high interest rates will tend to increase his money by one of two ways. He either invests indirectly by lending to large corporations through banks, or directly by investing in the capital market. In turn, large corporations are the ones that are able to repay those high rates of interest, and sometimes due to their increasing bargaining power they are able to negotiate the rates of interest with the corresponding banks. This being done, the country tends to depend on few large

corporations and squeezes the small and medium size enterprises. Usually, those large corporations are the multinational companies that come into a position, in which they exert monopolistic power on a certain sector. As a result, many small and medium-size enterprises are not able to face competition and are thrown out of business. It is concluded by Ahmed (2000) that the interest based mechanism favors large corporations and hinders the development of other small and medium-size enterprises.

The inequitable distribution of financial resources existent in the interest based system stands to be a major negative outcome. According to Usmani (2005), the notion of inequitable distribution further increases the gap between the rich and the poor. He says that by definition, people with the highest collaterals are the wealthiest among the society. By giving those people a privilege as opposed to others; they are the ones who are always on the verge of making more and more profits. This is simply as saying the rich getting richer and the poor poorer. This fact is supported by recent empirical evidence published in the United States of America. According to Krugman (2007), the American society is becoming unequal. Median income has only increased 17 percent since 1980 while the income of the richest 0.1 percent of the population has quadrupled. He also adds that the gap between the rich and the poor is currently as wide as it was during the 1920s depression. As a matter of fact, although money deposits come from a wide range of people across the whole society, a big portion of their benefits accrue to a specific segment of people, namely the rich ones. And this result should not be surprising as “it would be irrational for the lender to be willing to lend much to the impecunious as to the richer members of society, or to lend the same amounts on the same terms to each”, as indicated by Mishan (1971) (as cited in Chapra, 2001). Further, Ahmed (2000) adds

that interest based systems hinder the growth of small and medium-size enterprises, and more economic inefficiency comes to exist. This system only allows a small number of people to own many resources, and thus leading to inequality. In sum, the system leads to both economic inefficiency and inequality among the society.

The decreasing rates of savings represent a major outcome of this system as well. The fact that this interest based system has facilitated living beyond ones personal means due to the availability of credit, have led to an obvious decrease in the savings rate as a percentage of GDP. This fact is demonstrated by Chapra (2001), in which he mentions that gross domestic savings as a percentage of GDP have decreased from 26.2% in 1971 to 22.3% in 1998 worldwide. One of the major reasons behind this decrease is the evident increase in consumption rates whether it is in the public or private sector. Consequently, this has led to decreases in the rates of investment, which in turn along with other factors led to high unemployment rates. It is believed that a rise in the savings rate resulting from a decrease in wasteful consumption could yield better results for the society as a whole.

To summarize, in modern economies, debt based modes along with interest rates have become so essential that they would hinder economic development if not applied. In our daily lives, as DeLorenzo (2002) indicates, interest rates are integrated in every part of it. Governments use interest rates to stimulate demand and investments, and thus the business community reacts to those decisions. Companies borrow to finance their activities whether for building new plants or refurbishing old ones. They borrow using debt based methods either from banks by taking loans or through the capital market by issuing bonds. It can be simply said that “corporate debt and borrowing have become a way of life” (DeLorenzo, 2002). We tend here to question this argument and challenge it,

and see whether there could be other financial instruments with which businesses and ordinary people can finance their activities. In other words, does the Islamic financial system, as advocated by Islamic principles, offer different and more efficient methods than the ones offered in the conventional system?

Chapter Six

THE ISLAMIC FINANCIAL SYSTEM

After demonstrating the different arguments that specify reasons behind the prohibition of *riba* and their negative outcomes, both economic and social, we will explore in this section the available Islamic financial alternatives compared to this interest based system. The discussion here is divided into two major sections. The first section deals with PLS modes that suggest equity based modes as means of financing as opposed to conventional debt based ones. The second section are non-PLS modes and that deals with admissible debt based instruments that are not subject to any further increases. Further, we try to deduce the possible positive results that would accrue if this system was to be adopted in the following part. To begin with, we give a brief description of some of the available Islamic financial modes that facilitate investment as well as trade.

VI.I: Islamic Financial Instruments

Islamic finance offers a wide spectrum of financial alternatives in different fields such as trade, agriculture and industry, mentioned here are the most popular and used instruments by Islamic financial institutions. A major distinction is made here between PLS modes and non-PLS modes. The first type includes two major types of partnerships, namely *mudarabah* (passive partnership) and *musharakah* (active partnership). The second type includes *bai' bithamman ajil* (deferred payment sales), *murabaha* (mark-up or cost plus sales), *ijarah* and *ijarah thumma al bai'* (leasing and lease purchase),

admissible Islamic forwards such as *salam* and *istisna'a*, and lastly *qard hassan* (beneficence loans).

VI.II: Profit-and-Loss Sharing Modes

PLS modes are mainly equity based methods that help facilitate investment through different types of partnerships, which are *mudarabah* and *musharakah*. *Mudarabah* refers to passive or silent partnership as indicated by El Gamal (1997). It is a partnership of capital and work between two parties. The first party is the investor or the provider of capital, and the second is the entrepreneur, who provides his time and effort. Profits are divided according to pre-negotiated ratios, while losses are borne totally by the investor. The entrepreneur in that case loses his time and effort. However, if the entrepreneur is found to be responsible for mismanagement, he can be held responsible for those financial losses. The *mudarabah* contract can be executed in two ways as indicated by DeLorenzo (2002). The first way is executed between the investment account holders (as providers of funds), and the Islamic bank, which is considered to be a *mudarib* (managing partner). The Islamic bank agrees to take the investments of those account holders on the basis that profits are to be shared according to certain predetermined rates and not lump sum amounts, while losses are to be totally borne by the account holders, except in the cases of managerial misconduct. The second way takes another form, in which the Islamic bank would be the provider of funds on behalf of itself or other account holders and business owners.

Musharakah, the second type of partnerships, occurs when the Islamic bank along with other parties contributes to the capital partnership in equal or varying amounts. All parties have the right to participate in the management of the partnership,

unlike *mudarabah* where the entrepreneur has the sole management of the enterprise. Profits are shared according to pre-negotiated percentages, and losses are shared in relation to the respective capital contributions.

VI.III: Non-Profit-and-Loss Sharing Modes

The second type of Islamic modes of financing is the non-PLS modes. The first type of which is *bai' bithaman ajil* (deferred payment sales). The seller in this case, as explained by Kazarian (1993) and Iqbal and Mirakhor (1987), can sell the product on basis of deferred installments. The price of the product is agreed upon between the seller and the buyer in the first place, and no increases are to be charged for deferred payments.

A second, and much similar type, is *murabaha* (mark-up or cost plus sales). In this type of sale, the buyer knows the price of the product and agrees to pay a premium over that initial price. There are two types of *murabaha* as indicated by DeLorenzo (2002). In the first type, the Islamic bank buys the product and makes it available for sale without any prior promise by the customer to buy it. The second type includes the customer's promise to buy the good after it is purchased by the bank at a deferred price with an agreed upon premium for the bank. It is worth noting here that *murabaha* along with other trade based modes of finance do create debts. However, according to Siddiqi (2001b), "these debts cannot be traded except at par value which prevents them from ballooning into several times their original volume".

The third type of non-PLS modes is *ijarah* and *ijarah thumma al bai'* (leasing and lease purchase). *Ijarah* (leasing) cannot be considered a sale of an object, rather; it is the sale of the use of this object for a specified period of time. *Ijarah thumma al bai'* (lease purchase) is a specific type of leasing, in which the lessor promises to transfer the

ownership of the leased property to the lessee at the end of the term at a pre-determined residual value.

The fourth type of non-PLS modes consists of admissible Islamic forwards, *salam* and *istisna'a*. According to El Gamal (2000), these two types are very rarely used, and this is due to the existence of some element of *gharar*, which is the sale of non-existing objects. However, two conditions must be met; they are that the price paid be paid in full in advance, and that the well-defined object be delivered at a specific point of time. This applies to agricultural products in the case of *salam*. *Istisna'a* (contract to manufacture) “is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract” (Al-Jarhi & Iqbal 2001).

The final type of non-PLS modes, considered as a charitable act, is *qard hassan* (beneficence loan). It is a loan with no interest charged and is considered as a gratuitous contract. An important remark here worth mentioning is that “in Islam, one does not lend to make money, and one does not borrow to finance business” (El Gamal 2000). Rather, business financing is based upon PLS modes that were discussed earlier.

After clarifying the different available Islamic financial modes in investment and trade, it remains to be seen the benefits that these modes would offer in the case that they were correctly applied. Several theoretical studies, as indicated by Al-Jarhi and Iqbal (2001), have indicated that profit sharing models can yield better results compared to pure debt based ones. In addition to those studies, empirical evidence also supports this argument. According to the same source the following table supports the previous argument.

Table 6.1: Key Financial Indicators: Islamic Banks vis-à-vis Conventional Banks (1996)

(Percentages)

Indicator	Top 10 World	Top 10 Asian	Top 10 Middle Eastern East	Top 10 Islamic
Capital/Asset Ratio	4.8	4.2	7.6	9.7
Profit on Capital	16.1	17.2	16.3	21.8
Profit on Assets	0.9	1.1	1.5	1.4

Source: Iqbal, Ausaf, and Khan (1998)

VI.IV: Benefits and Advantages of an Islamic Financial System

In the case where returns and risks are shared among the money owner (the depositor) and the money manager (in this case the bank), banks will tend to search to invest in profitable projects as they no longer believe that profits will accrue regardless of the status of the project. Capital is not allowed to earn a fixed income in this case. As a result, banks will be encouraged to search for those projects that would generate more profits instead of just depending on those that offer the greatest collaterals, as indicated by Usmani (2005). In sum, financial resources are allocated based on their profitability rather on their creditworthiness. If this is correctly implemented, more fairness and justice are achieved as explained by Siddiqi (2001b). He argues that the current conventional system is not fair, in the sense that an entrepreneur is obliged in some cases to return the principal amount borrowed although part of it might of have been lost due to circumstances out of the hands of the investor as when a country's economic conditions deteriorate. This does not exist in the case when both parties share the profits and losses. Islamic finance tends to allocate resources more efficiently and relates it to the expected returns rather than just the creditworthiness of the investors. No one guarantees that the

most profitable projects will come from the wealthiest. Schumpeter even adds that “the most innovative may be empty handed” (as cited in Siddiqi, 2001b).

A further argument is that the PLS principle leads to more stability in the financial system. El Gamal (1997) acknowledges that a number of writers, such as Zarqa (1983) and Khan (1986), have depicted the stability occurring in this proposed system. This is further explained by Siddiqi (2001b) in which he mentions that this stability is only achieved under a PLS system. In other words, it occurs when the investor is obliged to repay back certain amounts based on the actual profits realized. Should the economic conditions deteriorate, cost of capital will automatically adjust itself to the new situation. On the contrary, in the interest based system there are certain deadlines that the investor has to meet regardless of the performance of his project. If a project is not able to achieve profits and the businessman defaults, the financial institution will also default, and thus leading to destabilize the whole system. Siddiqi (2001b) further adds that a rumor in a conventional bank that its investments are not performing that well might lead depositors to rush and take their deposits in the interest based system. However, on the contrary, in the Islamic system people will just tend to wait till the situation improves as they know that they are not allowed anything more than what the bank has actually achieved.

While debt based instruments are more likely to lead to inflation and speculations, Islamic finance will be less prone to face those factors. Siddiqi (2001b) mentions that both inflation and gambling-like speculation are triggered through debt based instruments. He adds that “debt instruments function as money substitutes while equity based financial instruments do not” (Siddiqi 2001b). The PLS model assures that money supply does not exceed the supply of goods and services, and thus curbing inflationary

pressures, unlike conventional banks where the supply of money could overstep the real productivity in goods and services.

Allocating projects solely on their productivity and profitability and not on their creditworthiness opens the door for employment. Ismail and Ahmad (2006) explain that in the conventional system only those projects that are capable to repay back the initial amounts along with the interest charged would be selected for credit. This means that other projects might be ruled out although they might be profitable but maybe not to the same extent as the selected ones. Adopting a PLS system could increase the volume of investments, and thus increase employment opportunities.

The final argument is that the PLS principle distributes wealth more equally, and accordingly should decrease the gap between the rich and the poor. As collaterals do not represent a barrier in the Islamic system, poor people are also allowed to be financed, which helps improve their living standards. Keeping the money in the hands of a few people would lead to an oligopolistic situation, in which competition is reduced, according to Ahmed (2000). This totally contradicts the economic argument that efficiency is a result of competition. In the debt based system, too much emphasis is given to people who already own capital and resources, while other segments of the society are deprived from this right. Ahmed (2000) acknowledges that people who do not own the initial resources or capital are not, by definition, unintelligent or are not able to conduct successful projects. On the contrary, several experiences like the Grameen Bank in Bangladesh have shown that poor people could be very efficient and productive when conducting business; they are faced with limited amounts of money, and thus they cannot afford to face any sorts of inefficiency.

It is worth mentioning in this regard that several analogies can be drawn between Islamic finance and microfinance. Both systems reach to a wider segment of the society and do not lead to financial exclusion of a certain segment of the society as is the case in the conventional system. According to Ferro (2005), both systems are open for all customers and they can be considered as unconventional ways for financing the poor. Both systems also share the sense of social commitment towards the entire society. In Islamic finance the aim is maximizing social benefits, while in the conventional system it is maximizing profits. As a result of this conventional stance towards the end goal of economics, commercial banks have been largely excluded from microfinance projects, or rather they did not want to participate, according to Ferro (2005). Several reasons have made commercial banks stay away from those kind of projects as mentioned by the same source. The first reason was concerns and doubts about the profitability of projects. The second reason was the high risk envisioned in those types of small and short term lending. The third reason was the common belief that the poor are poor because they lack the necessary skills and this reason has been proven to be wrong in many cases around the world. Dhumale and Sapcanin (1999) further illustrate that successful microfinance projects with poor, when managed in a correct business manner, can also turn out to be successful in terms of profitability and sustainability. These types of projects help to generate more employment opportunities especially between poorer classes of people, and thus might eventually alleviate poverty. Islamic finance does offer, in this specific area, several instruments that can be utilized for financing such people. Dhumale and Sapcanin (1999) mention three models that can be applied using different Islamic financial instruments: *mudarabah* (trustee financing), *musharakah* (equity participation),

and *murabaha* (cost plus mark-up) models. In the *mudarabah* model both the microfinance program and microenterprise are partners. The former invests money while the latter invests in labor, and profits are distributed according to predefined ratios. In a *murabaha* model the microfinance program buys certain commodities and then resells them to the microenterprise for the cost of goods in addition to a mark-up price for administrative costs. The microenterprise is required to repay back that price of goods according to equal installments. In actual experiment there was a successful example based on this model implemented in Yemen. According to Segrado (2005) a *murabaha* model was successfully implemented in Hodeidah, Yemen in 1997. In this example people would file for an application in order to receive credit for a certain project. After that a credit officer checks the loan application and conducts his own feasibility study. If the study turns out to be positive, the client then identifies the major equipment or commodities that he would like to acquire. The credit officer offers to buy those sources and resell them immediately at that price to the client. Finally, the client begins to repay back the loan received through installments. It is worth mentioning that by June 2000, 1770 clients were active in this program, 23% of which were women. This example, along with several others, has shown that Islamic finance can be very feasible in reaching out to broader segments of the population especially the poorer segment. Currently, several commercial banks have also been active in this front. According to Ferro (2005), international banks such as Citigroup, Deutsche Bank, ABN Amro, BNP Paribas, etc have all been establishing new microcredit units that deal with such types of finance.

After demonstrating the different Islamic financial alternatives along with the expected benefits and advantages that would accrue from this system, we continue on by

exploring the case of Malaysia. Malaysia is currently considered by most economists and analysts to be a hybrid market that was able to incorporate the Islamic financial system into its banking system in a very smooth manner. Since that incorporation back in 1983, the Islamic financial system was able to achieve remarkable results in different aspects whether it is in its total assets, deposits, or financing. The next chapter explains the macroeconomic outlook of the country and explores the development occurring in the Islamic financial system.

Chapter Seven

MALAYSIA

VII.I: Macroeconomic Outlook

Considered as one of the Asian tigers, Malaysia was able to achieve great economic developments within the last fifty years. According to the BNM Annual Report (2006) the following major features can be identified. Malaysia is a country with a population of 26.6 million and a labor force of 11.5 million. The unemployment rate stands at 3.5%, which has been prevailing for six years since 2001 (the only exception was in 2003: 3.6%). The growth rate for real GDP achieved in 2006 was 5.9% and it is expected to reach 6% in 2007. Inflation rate increased to 3.6% in 2006 (2005: 3%) due to the strong performance of the global economy which contributed to the upward pressure on the prices of commodities. The greater increase was due largely to the increase in prices of fuels and lubricants, which in turn increased prices of transportation in general.

As mentioned earlier, real GDP growth rate was 5.9% in 2006 (2005: 5.3%) while real GNP growth rate was 6.4% in the same period (2005: 5.5%). Growth was mostly achieved through robust domestic demand and strong exports. Gross national savings as a percentage of GNP was 38.1% in 2006 (2005: 37%), which resembles a huge percentage that is translated into productive investments. Exports and imports have both increased during 2006. Exports in 2006 reached RM 590 billion (2005: RM 537 billion), while imports reached RM 455 billion (2005: RM 411 billion). The growth rate in imports was slightly higher than exports with growth rates of exports and imports 10.3% and 10.8% respectively. The overall balance of payments recorded a higher surplus due to a larger

current account surplus. The larger current account surplus reflected the strong trade surplus, attributable to continued expansion in both manufactured and commodity exports, as well as improvements in services and income accounts. The overall balance was RM 25.3 billion in 2006 (2005: RM 13.6 billion). Foreign direct investment (FDI) increased significantly to RM 37.2 billion in 2006 (2005: RM 26.8 billion). FDI into the manufacturing sector remained high, particularly for investments to increase capacity and diversify product lines. Higher investments were also undertaken in the petroleum refining and petroleum-related products industry. Meanwhile, FDI in the services sector was mainly in finance, insurance, real estate and business services, followed by wholesale and retail trade, hotels and restaurants sub-sector as well as transportation and communications sub-sector. Bank Negara Malaysia also changed its exchange rate system beginning from 21 July 2005 from a pegged exchange rate against the US dollar to a managed float. Further, international reserves have increased to RM 290.4 billion (USD 82.5 billion) at the end of 2006 (2005: RM 265 billion)⁵. Finally, Malaysia's external debt decreased to RM 179 billion in 2006 (2005: RM 196 billion). This was achieved by higher repayment of external loans both from the Federal Government and the non-financial public enterprises (NFPEs).

In sum, one can observe improvements in the Malaysian economy whether due to government's management or to favorable financial conditions. The current account remained to be in surplus, savings rate remained high, international reserves increased, and external debt declined. Next, we turn to focus on the financial system in specific and see the recent trends as seen in the banking system, with a special emphasis on the Islamic banking system.

⁵ The exchange rate used here is USD 1 = 3.52 RM

VII.II: The Financial System

The economic expansion witnessed in the Malaysian economy can be seen in the figures reflected in the financial system. The financial system in general is divided into two major categories: the banking system and non-bank financial intermediaries. The banking system includes several types of banks: Bank Negara Malaysia, commercial banks, finance companies, merchant banks, Islamic banks, and discount houses. The non-bank financial intermediaries include provident, pension and insurance funds, development financial institutions, and other financial intermediaries. According to the BNM Annual Report (2005) the following features are identified⁶. Total assets for the financial system in 2005 was RM 1.9 trillion, of which RM 1.3 trillion comes from the banking system and the rest comes from non-bank financial intermediaries. Our focus for this research lies in the banking system. The largest component in the banking system is commercial banks followed by Bank Negara Malaysia, and followed by Islamic banks. The share of commercial banks stands at 44.1% of the total financial system in 2005 (2004: 41.7%). The share of Islamic banks' assets has reached 2.3% in the same period, up from 1.4% in the previous year. There is a continuous focus by the Malaysian government to expand on this sector, and this was seen in the establishment of four additional Islamic banks during 2005 as a result of measures adopted by the government to further liberalize and accelerate this sector.

Total deposits within the financial system increased by 10.4% reaching RM 922.2 billion at the end of 2005 (2004: RM 835.6 billion). In this regard, the banking institutions remained the largest supplier of deposits accounting for 77.5% of total

⁶ The figures used in this section are based on the BNM Annual Report (2005) rather than 2006. The reason is that the 2006 report does not anymore longer include the segregation required between conventional and Islamic banking operations.

outstanding deposits in the whole financial system. Loans and advances supplied by the financial system grew by 10.1% during 2005 and remained to be the largest component of total assets with a 37.8% share of total assets. Of these loans and advances, the banking institutions remained to be the largest provider with a 77% share. The main driver for those loans and advances was the household sector, specifically for the purchase of residential properties and consumption credit. Meanwhile, the Islamic banking sector has remained to expand with regard to all different indicators, which will be seen explicitly in the next section.

VII.III: The Development of Islamic Finance in Malaysia

Before analyzing the Islamic financial system in Malaysia, we offer a brief outlook about the system and mention how it was established and how it evolved during time. The first financial institution that can be labeled to be Islamic was established in 1969. An organization, by the name of Tabung Haji, was established for Muslims to facilitate pilgrimage to Mecca. It collected money from Muslims and invested it according to *Shari'a* law in order to make them able raise the required money for pilgrimage. However, the major development in the field of Islamic finance was adopted by Bank Negara Malaysia (BNM), the Central Bank of Malaysia, in 1983. Two major acts were enforced by BNM in 1983, the Islamic Banking Act (IBA) and the Government Investment Act, which enabled the government to establish Islamic banks and to issue non-interest bearing certificates, respectively. According to the 2005 Annual Report published by BNM, Islamic banks under the IBA are allowed to conduct different Islamic banking business types in alliance with *Shari'a* principles. These businesses vary in their range from retail based banking business to more complicated business activities such as

corporate finance, private equity and wealth management. Bank Islam Malaysia Berhad (BIMB) was the first full-pledged Islamic bank to be developed under these guidelines in 1983. BIMB was so successful that it was floated in 1992 on the Kuala Lumpur Stock Exchange, according to Wilson (2002).

As a further step to encourage more banks to take part in the development of the Islamic financial system in Malaysia, BNM introduced an Interest Free Banking Scheme (Skim Perbankan Tanpa Fardh) in 1993. Under this scheme, conventional banks were also allowed to open “Islamic windows” and to offer Islamic financial services. When the scheme was first introduced 14 commercial banks, 10 finance companies, five merchant banks, and seven discount houses participated. Currently, there are 11 commercial banks, one finance company, four merchant banks, and seven discount houses. The decrease evident in the numbers is due to the merging of several institutions with each other. Moreover, as indicated by Kaleem (2000), separate Islamic Clearing House and Islamic Interbank Market were also established in 1993. Further, in 1996, banks were required to offer an additional section with regard to the Islamic banking operations in their annual account reports. Lastly, BIMB was able to stand throughout the Asian Crisis in 1997, which in turn increased the confidence in Islamic banks by the Malaysian government.

VII.IV: The Performance of the Islamic Banking System in Malaysia

In order to see and analyze the progress existing in the Islamic financial system, a couple of points should be clear. As mentioned earlier, the Islamic banking system consists of commercial banks, Islamic banks, finance companies, merchant banks and discount houses. Commercial banks, along with merchant banks and finance companies, are grouped under the umbrella of the Islamic Banking Scheme (IBS) banks. The role of

each type usually differs from one another. Commercial banks in general deal with trade and corporate finance, finance companies deal with automobile financing and home mortgages, and finally merchant banks handle the underwriting of new stocks and bonds issues.

The Islamic financial system has been showing laudable results in the last years. Bank Negara Malaysia has been able to incorporate the Islamic system in its financial system. Moreover, the system was also incorporated in the global Islamic financial system. According to BNM Annual Report 2005, the market share of the Islamic financial system in Malaysia has expanded in terms of assets, deposits, and financing as a percentage of total assets, deposits, and financing of the whole banking system⁷. In 2005, the market share of Islamic assets has increased to reach 11.3% of total assets (2001: 8.2%), total deposits reached 11.7% (2001: 9.5%), and total financing reached 12.1% (2001: 6.5%). The increases in the absolute figures for each component can be seen in the following table.

Table 7.1: The percentage increase in terms of total assets, total deposits, and total financing during the period 2001-2005

Description	2001 (RM billion)	2005 (RM billion)	Percentage increase
Total Assets	60.2	111.8	86%
Total Deposits	47.1	83.8	78%
Total Financing	28.3	67.3	138%

Source: Bank Negara Malaysia (BNM) Annual Report 2005

⁷ The years under comparison here are from 2001 to 2005 rather than from 1999 due to the lack of complete data at that period of time.

The performance of the entire Islamic banking system will be evaluated using five different indicators: profitability, assets, financing activities, asset quality, and liquidity. In terms of profitability, net income of the Islamic banking sector has reached RM 3.2 billion at the end of 2005 recording a 134% increase compared to 2001 (2001: RM 1.4 billion). At the same time, pre-tax profits increased to reach RM 1.5 billion in 2005 with an increase of 84% compared to 2001 (2001: RM 845 million) (Figure 1). The better profitability has resulted in an increase in return on assets, which reached 1.5% in 2005 (2001: 1.4%), while return on equity decreased slightly to 21% (2001: 24.6%).

In terms of assets, they surpassed the 100 billion benchmark for the first time and reached RM 111.8 billion at the end of 2005 signaling an 86% increase compared to 2001 (2001: RM 60.2 billion) (Figure 2). The largest market share of total Islamic assets remains to be in commercial banks. Their market share increased from 45% in 2001 to 53% in 2005. This was followed by Islamic banks, whose share increased from 29% in 2001 to 39% in 2005. However, the growth rates evident in both types of banks, reveal that the growth rate of commercial banks and Islamic banks during the same period were 18% and 34%, respectively, which reveals higher growth rates associated with Islamic banks.

Total financing has reached RM 67.4 billion recording an increase of 138% compared to 2001 (2001: RM 28.3 billion) (Figure 3). Strong consumer spending helped to increase consumer financing dramatically in the specified period. Two major components stand out to be the major drivers for this sector; purchase of residential property and purchase of passenger cars. Purchase of residential property has increased to reach RM 15.9 billion in 2005 recording a 133% increase from 2001 (2001: RM 6.8

billion). Purchase of passenger cars reached RM 20.1 billion at the end of 2005 recording an increase of 232% (2001: RM 6.1 billion). As for the major financing concepts, credit sales (*bai' bithamman ajil, ijarah, murabaha, and istisna'a*) remains to be dominant in the Malaysian market. According to the BNM 2005 Annual Report, nearly 70% of the financing granted by Islamic Banking Institutions are sales and lease-based modes, in specific for the purchasing of passenger cars and residential property. The major financing concept remains to be *bai' bithamman ajil* even though its market share decreased from 48% in 2001 to 41% in 2005. In the second place is *ijarah*, which increased from 27% to 32% during the same period. *Murabaha* comes in third place with its market share almost the same during that time (7% in 2001 and 6.9% in 2005). *Musharakah* and *mudarabah* remain to resemble a very small percentage (1.4% in 2000 and 0.3% in 2005) (Figure 4).

The asset quality of the Islamic banking system has further improved during the period from 2001 until 2005. Although the absolute figure of the non-performing financing has increased, the non-performing financing ratio as a percentage of total loans has decreased. Non-performing financing has increased from RM 3.1 billion in 2001 to RM 5.9 billion in 2005. However, the increase is normal given that financing has increased by a 138% increase. Looking at the net non-performing financing ratio, we can see that it has declined from 7.5% in 2001 to 6% in 2005 (Figure 5). The decrease is an evidence of the improvement in the asset quality of the Islamic banking system.

Finally, there was ample liquidity in the Islamic banking system. Total deposits increased to RM 83.9 billion at the end of 2005 recording a 138% increase from 2001 (2001: RM 28.3 billion) (Figure 6). The major bulk of deposits remain to be seen in IBS

commercial banks followed by Islamic banks. IBS commercial banks represented 47% of total deposits in 2001 and increased to reach 51% in 2005. Islamic banks' share increased from 31% in 2001 to 42% in 2005. The growth in deposits reflects public confidence and acceptance of Islamic banking as well as competitive rate of returns. Total deposits can be categorized into three major categories: demand, savings, and investment deposits. Investment deposits remains to capture the largest proportion of total deposits although its share of total deposits decreased from 71% in 2001 to 53% in 2005. The second largest share of total deposits is demand deposits, its share increased during the same period of time from 14% to 18%. The third share was occupied by savings deposits, which increased from 9% in 2001 to 11% in 2005. Although savings deposits represents the smallest share as a percentage of total deposits, this sector witnessed a growth rate of 126% in absolute figures during the specified time. Demand deposits increased by 128%, and investment deposits increased by 82%.

After exploring the different features of the Islamic financial system in Malaysia in the recent years, we focus in the next chapter on the research under study in which conventional and Islamic operations of eight banks in Malaysia are compared. The next chapter offers the methodology adopted and type of data used for the purpose of this research.

Chapter Eight

METHODOLOGY AND DATA

Since the beginning of Islamic finance in 1983 until the present time wholly Islamic banks have operated alongside commercial banks. It is worth noting here that there are a couple of reasons behind the choice of Malaysia for the focus of this research. The first reason is that the development of Islamic finance in Malaysia was not just through the establishment of Islamic banks, but there was a complete framework that was adopted by the Malaysian government represented in its central bank. BNM publishes annual reports with regard to the financial system as a whole, and a specific section on Islamic finance. The data includes several financial indicators as well as ratios that are considered to be both an available and a reliable set of data. The second reason is that Malaysia is classified by several economists and analysts as a hybrid market in the field of Islamic finance.

This study will examine the performance of eight commercial banks that offer Islamic financial services alongside their conventional ones for a period of eight years. These banks began to offer Islamic financial services after the introduction of the “Islamic Windows” in 1993 in Malaysia. The study will then compare the performance of each sector and test whether there are any statistically significant differences with regard to several financial indicators. These banks are: Standard Chartered Bank Malaysia Berhad, Overseas Chinese Banking Corporation Limited (OCBC) Malaysia Berhad, HSBC Bank Malaysia Berhad, Affin Bank Berhad, Citibank Berhad, AmBank Group,

Maybank, and Hong Leong Bank. The data used here stems from the annual audited financial statements for each bank starting from 1999 until 2006.

The performance of the Islamic banking system, as analyzed in the BNM annual reports, usually focuses on six major categories: profitability, financing activities, non-performing financing ratio, liquidity, rates of return, and capital adequacy. This study utilizes three of those six major broad categories, in which banks are evaluated. The first category is profitability ratios, which includes return on assets (ROA), return on equity (ROE), and return on deposits (ROD). The (ROA) indicates how efficiently the management is able to transfer its assets into net earnings. The (ROE) measures net earnings per Malaysian ringgit equity capital. Both ratios measure the managerial efficiency. The (ROD) measures the percentage return on each ringgit from customers' deposits. It is expected that a higher ROA will yield a higher ROD.

The second category is liquidity ratios, cash deposits ratio (CDR) and loan deposits ratio (LDR). A higher CDR indicates that a bank is more liquid than one with a lower ratio. Further, a higher (LDR) indicates that a bank is taking more financial pressure by providing excessive loans.

The third category deals with asset quality ratios. This consists of net non-performing loans (NPL) ratios as percentage of total loans and write-offs as a percentage of total assets. A loan is considered to be nonperforming if it is in default or close to being in default. Usually, it reflects the situation when the payment of interest and capital are passed by 90 days or more depending on the contract terms. The write-offs describe those amounts that the bank believes are not going to be repaid at a later time.

In the three cases mentioned above, variances and means are calculated and the null hypothesis is tested in order to see whether differences exist between conventional and Islamic banking operations. The null hypothesis tested here is that both population variances ($H_0: \sigma_{CB} = \sigma_{IB}$) and means ($H_0: \mu_{CB} = \mu_{IB}$) are equal against the alternative that they are not, where CB refers to conventional banking and IB refers to Islamic banking operations. This is to be tested using different confidence levels and finally it will be concluded whether the null hypothesis is to be rejected or not rejected.

Something worth mentioning here is that all the financial statements for the eight banks reveal a separate part regarding the figures of the Islamic banking operations. However, they don't give a separate part about conventional operations, but it is mentioned as a consolidated figure. Accordingly, in order to reach the figures regarding the conventional part, the Islamic banking figures have been subtracted from the consolidated figures to yield more accurate results for the conventional figures. In the next chapter a brief description of each bank will be offered, and this will be followed by the analysis of the performance of both conventional and Islamic banking operations regarding their variances and means.

Chapter Nine

A STUDY OF MALAYSIAN BANKS FROM 1999-2006

The eight banks as mentioned in the previous chapter have been adopting Islamic financial services after the introduction of the concept of “Islamic Windows” by BNM. Thus, they are currently offering both conventional and Islamic banking operations. In the next section, we give a brief description of each bank.

IX.I: Description of Each Bank

1) Standard Chartered:

Standard Chartered was the first bank to be established in Malaysia back in 1875. However, Standard Chartered Bank Malaysia Berhad was incorporated to Standard Chartered Group in 1994. It has a network of 37 branches covering Malaysia with its main focus on consumer banking and wholesale banking. Further, it was the first foreign bank to offer Islamic financial services in 1993 when the Interest Free Banking Scheme was introduced by BNM. Along with other commercial banks, Standard Chartered was able to offer banking products complying with *Shari'a* law. After establishing this Interest Free Banking Unit in 1993, the bank upgraded this service in line with the directive from Bank Negara Malaysia and established an Islamic Banking Division in 1998. The bank is working along with other institutions and regulators to let Malaysia be an Islamic financial hub for countries all over the world.

2) Overseas Chinese Banking Corporation Limited (OCBC):

OCBC bank was a result of the merger of three banks in 1932, the Chinese Commercial Bank Limited (1912), the Ho Hong Bank Limited (1917), and the Oversea-Chinese Bank Limited (1919). OCBC Bank was able to be one of the largest banks operating in both Singapore and Malaysia. Currently, OCBC Bank has been operating in Malaysia since 70 years ago and it has a network of 28 branches covering different areas in Malaysia. Its total assets, worldwide, are worth more than \$128 billion operating in 15 countries. Along with the traditional consumer banking, business banking, and investment banking services it has also introduced Islamic banking services since 1995. Islamic banking services were developed based on their compatibility with the *Shari'a* law enforced by Islamic principles.

3) HSBC Bank:

The relationship of HSBC Bank with Malaysia dates back to 1884. At that time, the first branch was opened in the city of Penang. Today, there are 36 branches extending across Malaysia to provide different financial services. HSBC Holdings was established as recent as 1991. However, most of the members of this group have been in operation for over a century. The Group's services varies to cover a wide range of banking services such as commercial banking, merchant banking, capital markets, consumer finance, securities investment, insurance, and recently also Islamic banking services.

4) Affin Bank:

Affin Bank Berhad is considered one of the subsidiaries of Affin Holdings Berhad. It began its operations in 2001 after a merger between the former Perwira Affin bank Berhad and BSN Commercial Berhad in August 2000. Further, in June 2005 it merged with Affin-ACF Finance Berhad. Currently, its network consists of 82 branches nationwide. The bank's total assets come in the last place compared to the other banks in this study. The bank offers different banking services such as enterprise banking, consumer banking, debt and capital markets, and hire purchase. It has also incorporated Islamic financial services within its services since several years. Moreover, it established a full-pledged Islamic bank (Affin Islamic Bank Berhad) as a subsidiary of the group, which began operations in April 2006.

5) CitiBank:

Citibank is considered one of the subsidiaries of Citigroup. Citigroup has been in operation in Malaysia since 1959. It offers a wide variety of banking services that covers all areas such as corporate finance, sales and trading, foreign exchange, corporate clients, governments and financial institutions. Today, Malaysia is considered the center for Citigroup operations in the Asia Pacific region covering 13 countries.

6) AmBank Group:

The AmBank Group is one of Malaysia's leading financial services groups entrenching in different areas such as commercial banking, investment banking and insurance sectors. It offers a wide range of financial services and owns 200 offices in Malaysia. In general, it

is considered the fifth largest banking group in Malaysia, and it is the second largest among the banks under study in terms of total assets.

7) Maybank:

The Maybank Group is the largest banking group in Malaysia and has been leading the banking industry for three and a half decades. Maybank has offices all around Malaysia reaching 378 offices. Maybank Group is engaged in all different financial services such as commercial banking, insurance, asset management, investment banking, and lately Islamic banking services.

8) Hong Leong Bank:

Hong Leong Bank is a member of the Hong Leong Group Malaysia. The group has been operating in the financial services industry since 1968. The group has a combined market capitalization in excess of USD 11 billion. It is considered one of the largest groups in Malaysia as well as internationally. The group consists of 14 listed companies worldwide. It offers a wide range of financial services such as personal financial services, wholesale banking, and Islamic financial services.

IX.II: Analysis of the Performance of the Banks

As indicated earlier, our analysis of performance will focus on three areas: profitability, liquidity, and asset quality. The reason behind choosing each of these categories can be explained by the following. First, it was argued earlier that Islamic banks tend to invest in the most profitable projects as they know for granted that profits would not accrue otherwise. On the contrary, in the conventional system more emphasis is put upon the creditworthiness and the collaterals given by the client, and thus profitability of the project is not the first priority for conventional banks. As a result, it is

expected that Islamic banking operations will be more profitable than their conventional counterparts, and this can be validated by comparing the different profitability ratios under study here.

In the second set of ratios, liquidity ratios, liquidity along with the stability of the bank is examined. Once again, this brings us back to an earlier argument that an Islamic banking system is more stable compared to a conventional one which is largely dependent upon a debt based system⁸. Excessive low levels of liquidity would in turn mean, in some cases, that an entity could run out of business due to its overdependence on loans. This can be examined by testing both the cash deposits ratio (CDR) and loan deposits ratio (LDR). It is expected that the conventional banking system would encounter a lower CDR and higher LDR compared to the Islamic system due to the greater dependence of conventional banks on loans as means of financing, which leads to high LDR ratios and in turn leads to lower CDR ratios as less cash is available.

The third set of ratios tests the asset quality of the banking system. This adds up to the previous argument of high LDR for conventional banks. As more loans are given to clients, the risk that more projects would be set to default is higher due to different conditions such as economic or political conditions. The net non-performing loans ratio (NPL) shows in some way the efficiency of the bank's management to offer loans in likely profitable projects. However, as the size and share of loans is much higher in the conventional compared to the Islamic system, it is expected that the conventional system will experience higher net NPL ratios due to the greater possibility that more projects will not be able to repay their initial amounts along with the compounded interest rates. Once

⁸ In several cases, the loan deposits ratio exceeds 100%, which shows the excessive use of loans in conventional banking.

again, this takes us back to the first argument that conventional banks tend to focus more on projects with higher collaterals rather than profitable ones, which means that they are more viable to experience more losses. The final ratio, write-offs as a percentage of total assets, does also in some way relate to this profitability argument. Islamic banks, knowing that they are not allowed anything more than the achieved profits, will tend to wait in case their projects face any difficulties until things are adjusted and profits return to accrue. On the contrary, conventional banks might write off some of its assets or capital as they are not considered as partners in their projects, but rather lenders. It is expected to have lower ratios for Islamic banks compared to conventional ones. In general, the figures used for the tests here are extracted from the annual audited financial reports for each bank. To begin with, we show how the different ratios were calculated.

a) Profitability Ratios:

1) Return on assets (ROA) = Net profits after taxes / total assets

2) Return on equity (ROE) = Net profits after taxes / shareholder's equity

3) Return on deposits (ROD) = Net profits after taxes / total deposits⁹

b) Liquidity Ratios:

1) Cash deposits ratio (CDR) = Cash and short term funds / total deposits

2) Loan deposits ratio (LDR) = Loans¹⁰ / total deposits

c) Asset Quality:

⁹ Total deposits includes both deposits from customers and deposits and placements of banks and other financial institutions

¹⁰ Loans includes loans, advances and financing

1) Net non-performing loans (NPL) ratio = Net non-performing loans / total loans¹¹

2) Write-offs as a percentage of total assets = Write-offs / total assets

The two hypothesis tested here are the equality of variances and means among the two populations of conventional and Islamic banking operations. This can be seen in the following equations.

The null hypothesis tested here is that:

$H_0 : \sigma_{CB} = \sigma_{IB}$ against the alternative $H_A : \sigma_{CB} \neq \sigma_{IB}$ (σ = variance)

$H_0 : \mu_{CB} = \mu_{IB}$ against the alternative $H_A : \mu_{CB} \neq \mu_{IB}$ (μ = mean)

where CB refers to conventional banking operations and IB refers to Islamic banking operations. The first step is to calculate the variances and then the F-values are calculated and compared to the critical F-value. The following table represents a summary of the results.

¹¹ It is stated in the annual statements for each bank under the section of movements in the non-performing loans as a percentage of total loans less specific allowance and interest / income-in-suspense

Table 9.1: Testing for the equality of variances between conventional and Islamic banking operations (1999-2006)

Description	CB	IB	Calculated F- Value	No. of Observations
I. Profitability				
1. ROA	0.000094	0.000086	1.11**	N = 52
2. ROE	0.028486	0.011722	2.43*	N = 52
3. ROD	0.000147	0.000149	1.01**	N = 52
II. Liquidity				
1. CDR	0.004822	0.039350	8.16*	N = 52
2. LDR	0.014784	0.130309	8.81*	N = 52
III. Asset Quality				
1. Net NPL ratio	0.004545	0.005423	1.19**	N = 41
2. Write-offs / total assets	0.000196	0.00005	3.88*	N = 35

*Significant at the 99% confidence level

**Significant below the 90% confidence level

Before analyzing the variances seen in the above table, an important point should be mentioned. The number of banks under study is eight, and the number of years under study is also eight which means that the total number of observations should be 64. However, as seen from the previous table, the number of observations is always less than 64. The reason is that not all the data is complete for each bank along the eight years regarding all ratios under study. In order to be able to compare the two populations without any biases, the number of observations is set to be equal in the two populations throughout all the ratios. This means that, if in any of the two systems (whether Islamic or conventional), a certain figure is missing regarding a certain indicator, it is automatically deleted from both systems in order to arrive at a similar number of

observations at the end. In the above table, four out of the seven indicators used have shown statistical significance at the 99% CL. As a result, the null hypothesis in those four cases is rejected, i.e. the variances in the two populations are not equal.

The first statistical significance is seen in the ROE ratio where the variance of CB is larger than IB operations. This means that the measures are more widely dispersed from the mean in the CB system than in the IB system. This result favors our previous discussion in which it was mentioned that the IB operations would tend to have a higher equity base, and thus more stability is achieved. On the contrary, in the CB system the wider dispersion reflects the less stability experienced by such type of banks which further strengthens our earlier argument stating that the conventional system is more prone to face instabilities.

The second set of ratios, being statistically significant, was liquidity ratios. Variances in both ratios (CDR and LDR) are higher in the IB operations compared to CB operations. By looking at the actual data extracted from the banks' accounts, one can notice that variability in IB operations is very high both in the same bank across the years and among the different banks themselves. In certain years, there are big inflows of cash in the banks' statements while in other years it is exactly the opposite. This, of course, is inconsistent with our previous expectation that IB operations would be more stable in terms of cash inflows. Regarding the higher LDR experienced in IB operations, it can be seen from the original set of data that this variability is extremely evident in the first four years of operations (1999-2002). This high ratio can be explained by the immaturity of the IB system in some aspects as there are a few cases where the LDR exceeds 100%. However, in more recent years (2003-2006) the ratio has been decreasing and variability

started to decrease, which further assures the fact that the early years could have been experiencing high ratios due to the immaturity faced by Islamic banks in their early years of operations.

The final ratio in which we can observe a statistical significance between the two populations is the write-offs as a percentage of total assets. As discussed earlier, Islamic banks would tend to wait, should the conditions of its projects deteriorate, until the situation improves and profits starts to occur because they are only allowed to benefit from the actual realized profits. On the contrary, conventional banks tend to act in a different manner because their profits are pre-determined in the cases of loans that they give for their clients. This difference in behavior is reflected in the higher variances seen in CB compared to IB operations.

In general, the ratios are to some extent consistent with our previous expectations. However, there are two ratios which turned to be inconsistent; still they can be attributed to the immaturity in some way of the Islamic financial system in these aspects. This is clarified by looking at the original data in which one can observe that the high variations were mainly in the first year of operations, which means that IB operations were still in the early years of operations.

After examining for the equality of variances, the test for the equality of means is conducted and the results along with the calculated Z-values are given in the following table.

Table 9.2: Testing for the equality of means between conventional and Islamic banking operations (1999-2006)

Description	CB	IB	Calculated Z-Value	No. of Observations
I. Profitability				
1. ROA	0.94	1.3	-189.5*	N = 52
2. ROE	13.47	16.20	-98.2*	N = 52
3. ROD	1.20	1.69	-213.1*	N = 52
II. Liquidity				
1. CDR	17.38	18.93	-51.7*	N = 52
2. LDR	77.69	66.08	219.1*	N = 52
III. Asset Quality				
1. Net NPL ratio	7.57	5.02	163.6*	N = 41
2. Write-offs / total assets	-1.31	-0.43	-332.1*	N = 35

*Significant at the 99% confidence level

Two remarks are worth mentioning regarding this table. The first remark is the same as the one mentioned in testing for the equality of variances regarding the number of observations, which also applies to this table. The second remark is that write-offs figures are always put on the banks' statement as a negative figure (as they are subtracted from their accounts). Accordingly, dividing these figures by a positive number yields a negative figure at the end as seen in the last row in the table.

By looking at the figures of the previous table, we can conclude the following. In general, Islamic banking operations have outperformed conventional ones across all indicators. In terms of profitability, ROA, ROE, and ROD in the Islamic banking operations (IB) were larger than in conventional banking operations (CB). Still, there is an important point worth mentioning with regard to the ROA. One should take this figure with some precaution even though it is higher in IB operations compared to CB operations. As indicated by Rosly and Abu Bakar (2003), it is not surprising to have a higher ratio of ROA for IB operations. The reason, as they argue, is that “Islamic Windows” are able to spend less on several overhead expenses as they benefit from the parent bank, which covers most of these expenses such as offices, computer systems, etc. As a result, we also believe that the figures provided here should be taken with some precaution. This still does not undermine the performance of Islamic banking operations as the figures revealed here show that they are almost higher with 40% than their conventional counterpart. Even if we take into consideration the above reasoning they are still to some extent able to achieve a better performance. The ROE figures are also higher in IB compared to CB operations. This can be considered as a plus for IB operations; usually Islamic banks are expected to have a larger equity base as compared to conventional ones. Finally, the higher ROD for IB operations reflects the higher ability of Islamic banks to turn deposits into net earnings. Further, this stresses the fact that a higher ROA would normally lead to a higher ROD, which is the case here.

By analyzing the second set of ratios, we can observe the following. Figures for IB operations are higher in CDR and lower in LDR. Higher figures for CDR show that Islamic banks are more liquid as they have more cash than their conventional

counterparts. This means that they are less likely to fail as they don't technically lend. Further, a lower LDR indicates that Islamic banks face less financial pressure as they don't technically lend as much as conventional banks. This is consistent with the higher CDR.

The indicators for asset quality of both systems are also in favor of Islamic banking operations. The net NPL ratio is lower in IB operations compared to CB operations, which reflects a better asset quality management. Regarding the write-offs as a percentage of total assets the result is very logical by putting into consideration that Islamic banks are usually partners in the projects that they finance rather than just financial intermediaries. This means that there is no reason for them to write-off any of the unrecovered amounts. Rather, they wait until the project adjusts itself and begins to achieve profits once again.

The study of those financial ratios and indicators has revealed the superiority of Islamic banking operations as compared to conventional ones. Four out of seven indicators have shown statistical significance on the 99% CL regarding population variances, while all seven indicators have shown statistical significance regarding population means. Based on these results the next chapter offers a conclusion regarding the performance of those banks. By putting theoretical and empirical evidence together we tend to answer earlier question posed at the beginning of the research about whether there would exist any differences in performances among Islamic and conventional banking operations, both in theory and in practice.

Chapter Ten

CONCLUSION

In the previous studies that compared conventional and Islamic banking operations with each other, results were to some extent mixed. While Islamic banking operations outstripped their conventional counterpart in some ratios, conventional banking also outperformed Islamic banking operations in other ratios. This study however shows that Islamic banking operations outperformed conventional banking operations in all aspects. A general explanation could be that the Malaysian market is getting more mature in terms of Islamic banking compared to its early start. In previous studies “Islamic Windows” were in their early years; currently more than a decade has passed since their operations. With the increasing number of banks offering Islamic financial services more competition is brought to the market and thus better performance is achieved by banks in terms of different financial indicators.

The three profitability ratios (ROA, ROE, and ROD) under study have revealed statistical significance and were higher in Islamic banking operations compared to conventional ones. This supports the argument of better and more efficient management that is able to turn customers’ deposits into net earnings and profits. This also supports our previous argument that Islamic banks will tend to search to invest in the most profitable projects as they know, for granted, that profits will not accrue regardless of the status of the project. Higher profits would in turn influence the ROA, ROE, and ROD positively. However, the high ROA should be taken with some precaution as mentioned

earlier because those banks do benefit from the parent banks in terms of some of the shared assets such as offices, computer systems, etc.

The second set of ratios, namely those describing liquidity, have also shown superior performance in favor of Islamic banking operations. This is very consistent with our previous belief that Islamic banks do not depend mainly on loans as is the case in the conventional system. In the conventional system loans represent a very essential part in the well-being of the bank. Sometimes, conventional banks have a loan deposits ratio of more than a 100% which shows their dependence on excessive loans as means for financing. As a result, less cash is available at those banks compared to Islamic ones. Once again this is supported by the higher cash deposits ratio revealed in Islamic banking operations compared to conventional ones. Islamic banks also face less financial pressure as they do not engage in excessive loans as their counterparts. However, it must be mentioned in this regard that a big proportion of Islamic banking operations is dominated by credit sales methods such as *bai' bithamman ajil* (deferred payment sales), *ijarah* (leasing), and *murabaha* (cost-plus sales). Although these types are classified as debt based modes there is one major difference between them and their conventional counterpart. In the conventional system the majority of the loans are used for the purpose of establishing new projects or refurbishing old ones and a smaller part is used for personal credit. By definition, loans for projects are larger in size and also riskier in nature. However, in the Islamic banking operations, most if not all debt based modes are used for personal purposes mainly in the purchase of passenger cars or residential property. These types of financing are usually less risky than is the case in financing projects. However, this dominance of credit sales regarding Islamic banking operations

hinders some additional benefits that could accrue from the Islamic system if more partnerships were to be implemented. These benefits are not only economic but also social as these partnerships would in turn represent more commitment to the society and might be able to have a trickling effect on different segments of the society. On the contrary, in credit sales most of the benefits usually accrue to a specific person or household who would like to acquire a certain commodity or property.

The third set of ratios dealing with asset quality has also revealed superior performance in favor of Islamic banking operations. This is once again consistent with our previous discussions about the negative outcomes from the conventional system and the benefits of the Islamic system. The lower net NPL ratios for Islamic banking operations reveal a better asset quality management. In this regard, there is one major reason that could help explain the lower ratios evinced in Islamic banking operations compared to conventional ones. In the conventional system, a big proportion of the loans offered to clients are mainly business loans. This means that they are used for the sake of building new plants or refurbishing old ones. Should the economic conditions deteriorate or the project face any difficulties, the investor will not be able to repay his initial loan, not to mention the compounded interest sums. A smaller proportion of those loans are offered to customers for personal needs such as purchasing a car. In Islamic banking operations all the debt based modes are usually used for this second purpose, which is personal usage. The risk, evident in this type of financing, is to some extent lower than the one taken for the establishment of new projects. As a result, net NPL ratios are lower in Islamic banking operations compared to conventional operations. Further, Islamic banks also encounter a smaller ratio of write-offs as a percentage of total assets which

also supports one of the previous arguments. Islamic banks are considered partners in the projects in which they are engaged, and thus there is no incentive for them to write-off any of their accounts in case the project faces some difficulties. In contrast, they will tend to wait until the project adjusts itself and profits return to accrue once again.

In general, the study of Malaysian banks has supported almost all the arguments in favor of Islamic banking. By depending on equity based modes, compared to debt based modes, the risk among different business partners is reduced and thus yields higher returns. Offering other financial solutions as means of financing reduces the dependence among loans, keeps banks more liquid and make them face less financial pressure. Allocating projects based on their profitability rather than creditworthiness gives the incentive for banks to search for the most profitable projects and for its clients to be more keen and attentive about their investments. Finally, Islamic banking operations facilitate several financing opportunities that are reachable for a wider segment of the population. In conclusion, the data used here regarding the eight banks has proved our previous theoretical discussion of the superiority of Islamic banking operations compared to conventional ones, and it also emphasized the previous arguments of the negative outcomes of such a debt based system compared to the potential benefits and advantages of an Islamic financial system.

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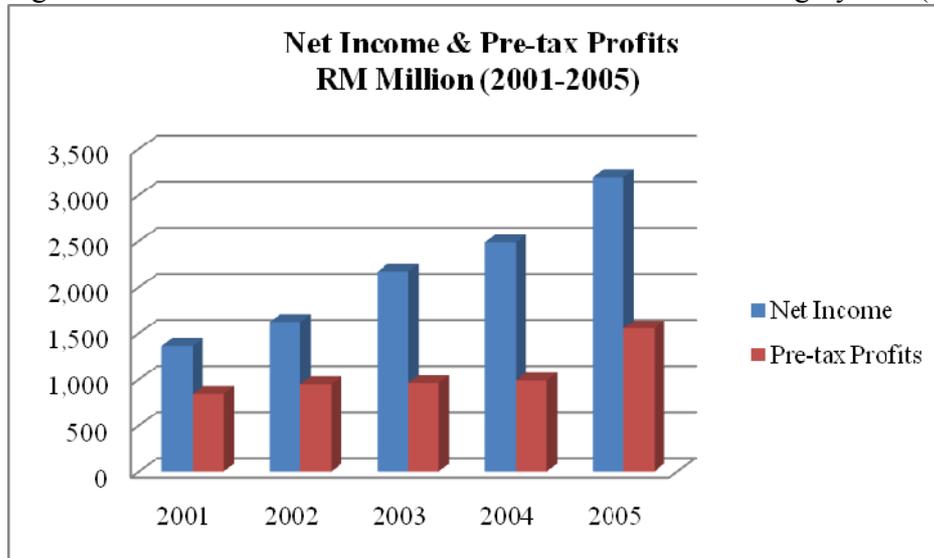
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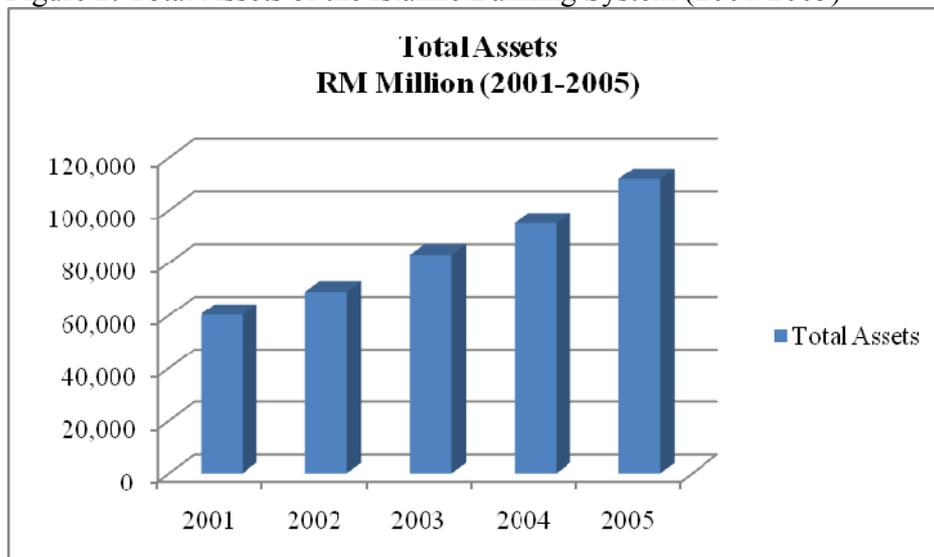
FIGURES

Figure 1: Net Income and Pre-tax Profits of the Islamic Banking System (2001-2005)



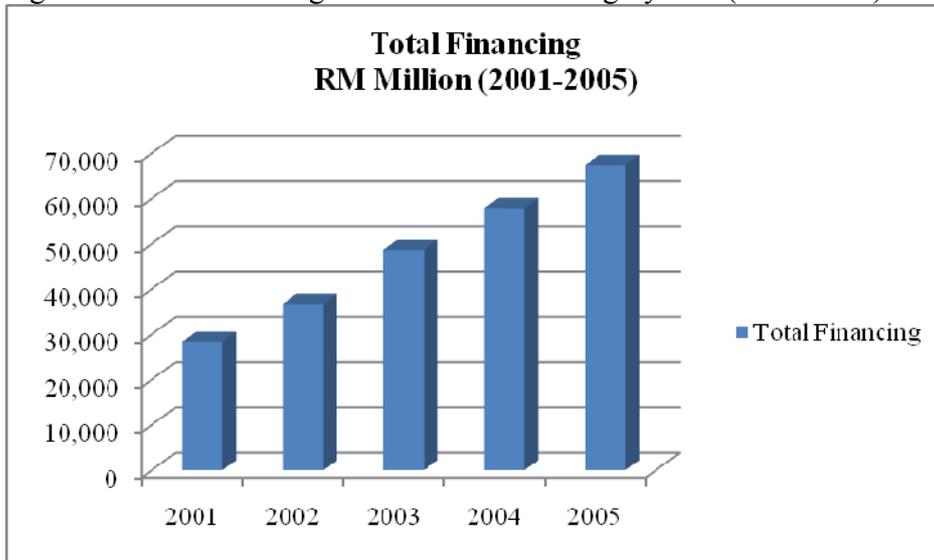
Source: BNM Annual Report, 2005

Figure 2: Total Assets of the Islamic Banking System (2001-2005)



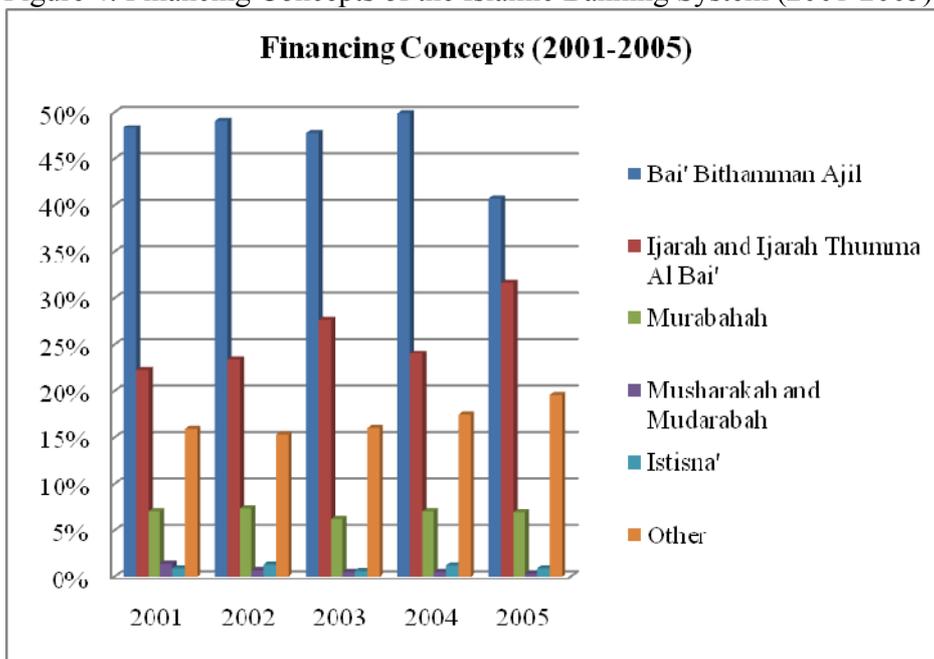
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Figure 3: Total Financing of the Islamic Banking System (2001-2005)



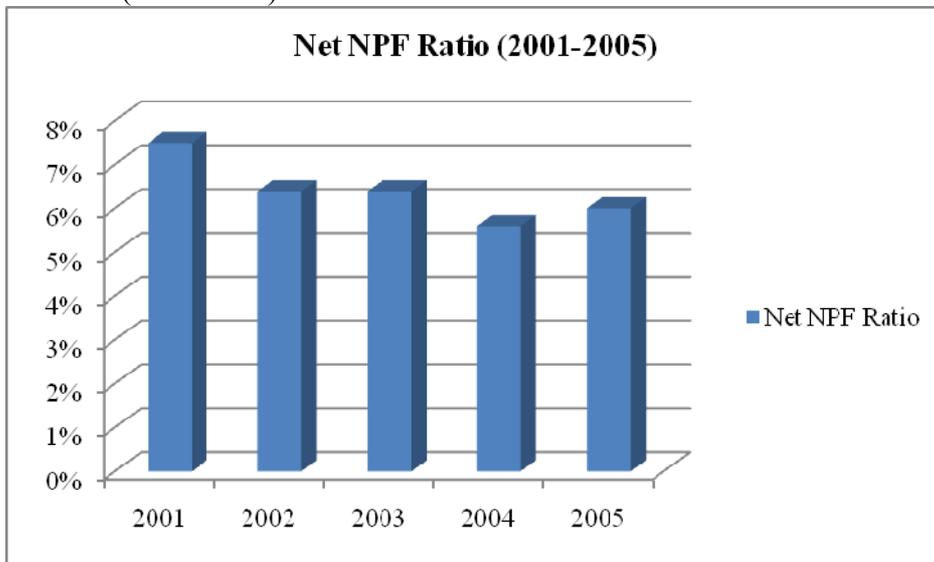
Source: BNM Annual Report, 2005

Figure 4: Financing Concepts of the Islamic Banking System (2001-2005)



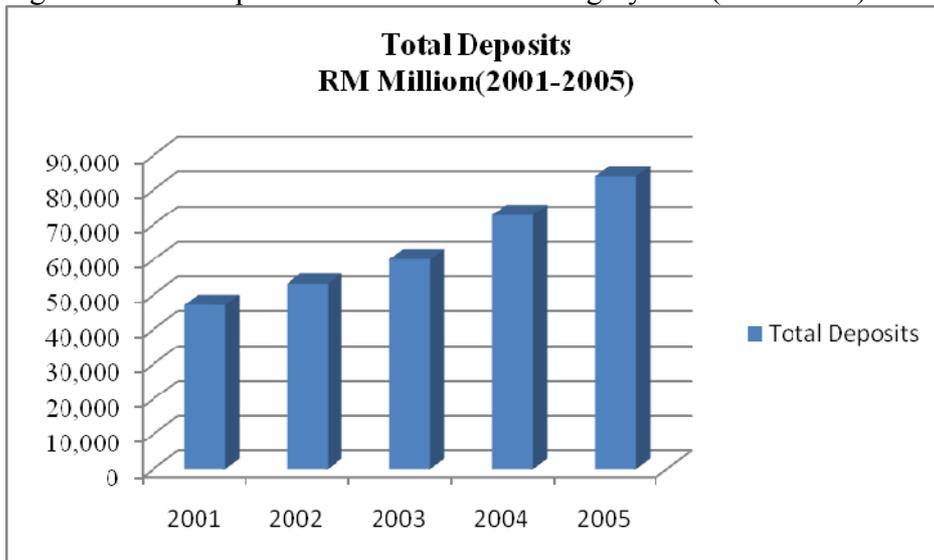
Source: BNM Annual Report, 2005

Figure 5: Net Non-Performing Financing Ratio of the Islamic Banking System (2001-2005)



Source: BNM Annual Report, 2005

Figure 6: Total Deposits of the Islamic Banking System (2001-2005)



Source: BNM Annual Report, 2005

