



Performance of Islamic and mainstream banks in Malaysia

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banks in
Malaysia

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Abstract The study found that Islamic banking scheme (IBS) banks have recorded higher return on assets (ROA) as they are able to utilize existing overheads carried by mainstream banks. As this lowers their overhead expenses, it is found that the higher ROA ratio for IBS banks does not imply efficiency. It is also inconsistent with their relatively low asset utilization and investment margin ratios. This finding confirmed our contention that Islamic banking that thrives on interest-like products (credit finance) is less likely to outshine mainstream banks on efficiency terms. Although Islamic credit finance products may have complied with Shariah rules, their lack of ethical content is not expected to motivate IBS banks to strive for efficiency through scale and scope economies.

Introduction

The interaction between religion and economics has always been a challenging subject in the study of business ethics. However, when the benchmark to corporate performance is money, it is often hard to place ethics before self-interest, even when an Islamic system is in place as the case in Malaysia. Even though the religion of Islam provides some guidelines on how this can be achieved, making a choice, especially one that involves religious values, is often deterministic. That is, the Muslim people in general tend to follow the letter of the law, but with less ethical concern. Islamic banking is not an exception.

Islamic law invites mankind to value actions not only on faith, but also on rational ground. This is done by initially looking at the benefits (*manfaah*) and disbenefits (*mudarah*) generated from a particular human action. In principle, the *mudarah* component in a prohibited action (*haram*) is larger than the *manfaah* component. Rationally, this makes sense since reason is also instrumental in determining ethical values. An action from which a *mudarah* is created can be considered unethical since it hurts both the individual and society. Likewise, an ethical action can be defined in the manner it generates *manfaat* to human beings. Thus, an ethical action can be inferred by way of reason as well as revelation. The problem remains paradoxical when Muslims tend to ignore ethics when the value of human action is defined by God. They tend to discount reason (*‘aql*) for which God has created for man to think and ponder about his creations and their manifestations. This rigid adherence to the letter of the law has jeopardized the image of Islamic banks as they began to emulate the practices of mainstream banking.



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As an example, the *Qur'an* prohibits the taking and receipts of interest (*riba*) while making trade and commerce (*al-bay'*) permissible (*halal*)[1]. The *Qur'an* argued that interest constitutes an unfair business transaction as profits realized from loans are risk-free with no evidence of value-addition by lenders. This is an ethical concern. But although such concern for the general welfare in Islam preceded personal self-interest, in no way it leaves the self into oblivion[2]. The prohibition of interest is Islam's response to arrest social imbalances arising from inequitable distribution of income created by the credit system. Although, the *riba* system generates some benefits it is only confined to a limited few while the general public stands to bear the costs. In this way, the ethical factor namely justice (*'adl*) and cooperation (*ta'awun*) is the rationale behind the *Qur'an's* prohibition of *riba*. However, this is not how *riba* found its illegitimacy in Islamic banking. Rather, *riba* is legally defined as a contractual increase arising from a loan (*qard*), whether in money or barter. The ethical content of the prohibition of *riba* is uprooted in such a manner that even trade and commerce (*al-bay'*) as an alternative to *riba* has been interpreted in a legalistic fashion, thus downplaying its ethical content.

The Islamic initial response to prohibition of *riba* has been the rationalization of Islamic banking. Malaysia has first embarked on Islamic banking in 1983 with the establishment of Bank Islam Malaysia Pte (BIMB) with operations governed by the Islamic Banking Act 1985. In 1992, Islamic counters in mainstream banks were introduced to the public providing similar interest-free facilities. The Malaysian Government has further pushed Islamic finance into the bond market, which now commands more than 30 per cent market share.

However, the common trend in Islamic banking operations in Malaysia has been the application of credit sale in financing (*al-murabahah* and *ijara wa iqtina*). Presently, it constitutes more than 90 per cent of Islamic banking assets. In credit sale finance, an Islamic bank will purchase goods on a cash basis and sell them on credit terms. In this manner, no loan is given away since what the customer wants is met by way of a sale and purchase agreement. The bank assumes the role of a seller while the customer stands as a buyer. Unfortunately, this has been widely practised in most Islamic banks in Muslim countries. The essence of risk-taking and value-addition, which is an indispensable social imperative and hence Islamicity, seem lost. Ethics again takes a back seat making way for legal rules to dominate Islamic banking juristic opinions. As ethics (*akhlak*) and law (*fiqh*) do not seem to mix, the *Qur'anic* spirit of justice and mutual aid is compromised to pave way for financing techniques that may look Islamic on the outside only.

The overuse of credit and hire purchase transactions (*al-murabahah* and *AITAB*) may not be able to show that Islamic banking really matters, since it replicates a mainstream banking model. This paper attempts to show that the performance of credit-intensive Islamic banks has no significant advantage

over mainstream banks. This is because Islamic credit finance retains mainstream attributes such as end-financing, banks' legal charge on asset purchase and taking contractual profits by virtue of time value. The same applies to Islamic hire purchase which applies financial leasing instead of true leasing. Among Muslim jurist (*fuqaha*), these contracts remain controversial since both allow profit taking by virtue of time value. Since this resembles mainstream banking practice, there is no strong reason to expect Islamic banks to display a better performance. If any, it may be caused by non-religious factors such as government policy and operational issues. The study looks at the experience of Islamic counters of mainstream banks in Malaysia between 1996 and 2001.

Islamic banking with a social orientation

Ethics and social orientation of business enterprises do not imply that they are providing charity for the care of the unprivileged alone. To some extent businesses responded to ethics in this manner, but only to isolate it from the production process. Likewise in Islamic banking, the prohibition of interest does not on its own right allow banking operations to ignore ethical choice. Ethical choice in this context refers to the desire to use resources in the most efficient manner. It is driven by man's desire to achieve ultimate happiness (*sa'ada haqiqiya*) by way of submitting his or her desire to the Will of the Creator. The concept of X-efficiency for example, deals with the management of banks' inputs, namely deposits, labour and capital while scale and scope examines how the size and type of bank assets are able to reduce costs and there by increasing profits. In this way, an Islamic banking manager who pursues efficiency is expected to attain personal happiness as well as securing happiness of the general public who will enjoy better services at lower costs.

Ethics also refers to the conduct of a business, which favours a system of distribution that embraces risk-sharing and value-addition by participating agents. In this manner, the taking and receipt of interest in Islam is considered immoral as it secures a future income stream for the lender who negates the perils of uncertainty. In a similar fashion, the contract of credit sale (*al-murabahah*) and financial leasing (*ijarah thumma al-bay'*) resembles a loan since it secures the seller a margin and capital without assuming significant market risks.

The essence of the *Qur'anic* theory of profit, whether in banking or the non-banking business, is the concept of equivalent countervalue (*'iwad*). Any profit created from a trade and commerce (*al-bay'*) must contain an equivalent countervalue. In practical terms, through *'iwad* profit creation must embrace risk-taking (*ghurmi*). Work and effort must be evident in trading as a trader is expected to exert his skills and know-how (*ikhtiyar*) in fulfilling his business obligations. He must provide warranties on the goods sold (*daman*) such that the welfare of customers is not undermined when goods sold are found defective and useless. When these conditions are met, trade and commerce

should remove social imbalances as both seller and buyer have fulfilled their respective moral obligations, thus bringing both self- and public interest into harmony.

Profits derived from fixed income instruments however are created without *'iwad*, since loans are collateralized and contractual interest earned implies that banks hold no obligation to compensate losses of the borrowing party. In addition, banks add no value to the financial contract. They are prudent in debt collections and charge customers on all overhead expenses incurred such as expenditure on computer and security systems, checking accounts and credit card facilities. These charges, known as resource cost, constitute a component of the interest rate on loans. When a bank is worried about interest rates or currency risks, it uses derivatives for hedging purposes, the cost of which is borne by customers. The neglect of risk-taking and adding value to the financial contract, has removed morality from the banking business, since the bank gets the most from the loan deal. For this reason, Islam has forbidden the taking and receipt of interest as *riba*.

When Islamic banking applies credit sale (*al-murabahah*) and financial leasing (*ijarah thumma al-bay*) supported by debt trading (*bay' al-dayn*), it is hard to say that it can fulfil the *Qur'anic* objective of equity and fairness as expounded by the theory of *'iwad*[3]. Another mode of financing with an interest-like resemblance is sale plus buy-back (*bay al-'inah*). To legitimize interest, the bank sells an object to a customer at a credit price payable on equal installment. The latter instantly sells the same object to the bank at cash price. In this way, the customer obtains the cash needed while the bank earns profit when all payments are made. It resembles a term loan and retains mainstream practices in all aspects, except the manner in which contracts are formulated. On legal grounds, these contracts are valid (*sahih*), but bearing the likeness of the contract of debt with interest.

In view of the above, like mainstream banks, we can expect the performance of Islamic banks in Malaysia to be explained by operational and strategic factors alone such as asset-size and resource management, while religious ethics take a backseat. By religious ethics, the authors refer to the implicit manifestation of obedience to the Islamic law (*Shariah*). In this manner, the religion factor is expected to increase asset size or reduce the resource cost by way of ethical choice, namely cutting down on credit transactions and expanding genuine trade and commercial activities (*al-bay'*) in banking[4]. Ethical choice invites Islamic banking to embrace profit-sharing framework (*mudarabah*) as conducted by Prophet Muhammad (*pbuh*) and other classical transactions such as sale by order (*salam* and *istisna*) and true leasing (*ijara*). The elements of *'iwad* are evident in these contracts, thus capable of nourishing the spirit of mutual-aid (*ta'awun*) among contracting parties.

However, this has not been the case in Malaysia as legal rules takes precedence over ethics. Islamic banking has chosen to take the easy way out

but at a price. In doing so, it is expected to inherit the limitations of mainstream banking. First, the pro-cyclical behaviour of mainstream banking is known to frustrate attempts by central banks to stabilize the economy. For instance, to control inflation, a central bank may increase the reserve requirement to reduce lending. With lower excess reserves banks are not able to make more loans. But banks can sell bonds and use the cash proceeds to increase lending. In this manner, to maximize profits, bank asset management supports inflationary pressures[5]. Secondly, in minimizing exposure to risks, financial contracts using only debt instruments are not expected to enjoy the benefit scale and scope economies. It will not help to lower the cost of borrowings even when the bank is earning high interest spreads. Third, the adverse distributional impact on the general consumer is evident when loans are easily accessible to big corporations as they are able to secure loans with strong collateral.

Our contention that Islamic banking in Malaysia will not show commendable performance, especially on the management of assets and efficient use of resources will be tested by examining their profitability financial ratios. Since Islamic banking financial products resemble their mainstream counterparts, it is unlikely that they will perform in a superior way. Since both systems operate under one monetary regime, the fractional banking and money multiplier implications do not differentiate Islamic from mainstream banking. Unless an Islamic banking scheme (IBS) bank uses the partnership framework or embraces transactions yielding an equivalent counter-value, their risk-exposure will be similar to the mainstream system. As a result, returns on Islamic deposits may not be able to exceed interest on conventional deposits[6].

IBS banks

As at the end of 1999, Malaysia has two fully-fledged Islamic banks and 46 IBS banks[7]. In Malaysia, mainstream and IBS banks are governed by the Banking and Financial Institution Act 1992. The Malaysian Central Bank however, provides certain guidelines for IBS banks such that they too can operate along Shariah principles with similar privileges to BIMB and Bank Muamalat.

IBS banks are categorized into three groups, namely the commercial banks, finance companies and merchant banks (Table I). Commercial banks generally deal with trade and corporate finance, while finance companies handled

Islamic banking products	Mainstream products
<i>Al-Bai-bithaman Ajil</i>	Housing loan
<i>Al-Ijarah Thumma Al-Bay'</i>	Vehicle financial lease
<i>Bay' al-'Inah</i>	Term loan and overdraft
<i>Bay' al-'inah plus</i>	Certificates of deposits
<i>Bay al-Dayn</i>	Bill of exchange

Table I.
Interest-like Islamic
banking products

automobile financing and home mortgages. Merchant banks usually focus on the underwriting of new stocks and bonds issues. This study will examine the performance of IBS banks. An IBS bank can be defined as a mainstream bank that participates in the Islamic banking operations. For example, Maybank Pte as a mainstream bank, opened an Islamic banking operation in 1993 with similar facilities as BIMB. It is neither a full-fledged Islamic bank nor a subsidiary of Maybank Pte. Likewise, a mainstream bank can be defined as the larger component of Maybank that offers interest-bearing facilities. The head of the Islamic banking division (IBD) reports to the chairman who is also the CEO of the mainstream bank. A *Shariah* committee was formed to ensure that operations run along *Shariah* principles. The deposits and assets of IBD are separated from the mainstream counterparts. Financial statements are also split into two. In this manner, it is possible to compare Islamic and mainstream banking performance[8].

However, differentiating fixed assets and overhead expenses can be problematic in IBS banks. Usually, an IBS bank consists of a team overseeing Islamic banking transactions. Product development, marketing and other policy issues are conducted at the respective headquarters with full-time officers taking charge. At the branch level, there is no delineation over Islamic and mainstream transactions since each officer is expected to deal with both systems. Computers and security equipments serve Islamic and mainstream operations alike. To some extent, overhead expenses on wages and salaries and office equipment and furniture and motor vehicles can be accounted for at the bank's headquarter, but not at the branch level. Computer solutions and automated teller machines (ATMs) facilities are bound to serve all transactions. As an example, mainstream and IBS banks share the same computer server, and maintenance and upgrading process. The same applies to security systems, land and office premises as these cannot be divided into the Islamic and mainstream individual components.

The market proportion of Islamic banking assets, deposits and financing is relatively small. By June 1999, the proportion of Islamic banking assets was 5.48 per cent with deposits and financing by the end of 2000 amounting to only 6.83 per cent and 5.06 per cent, respectively. Looking closer, the IBS banks' share of assets and deposits exceeded the two full Islamic banks combined (Table II). The financing-deposit ratio for IBS banks is also higher than that for the two Islamic banks. To some degree, IBD banks are able to use their funds more than the Bank Islam Malaysia Bhd and Bank *Muamalat*.

Empirical findings on Islamic banking performance for Malaysia

Most empirical studies on Malaysian Islamic banking are limited to BIMB. Samad (1999) evaluates BIMB's productivity and managerial efficiency in the sources and the uses of the bank's funds. He found that managerial efficiency of mainstream banks is higher than BIMB. Productive efficiency or the average

fund utilization rate and profit earned by BIMB were also found to be lower than those for mainstream banks. All profitability indexes indicate that profits earned by BIMB are lower than those for the mainstream banks.

Rosly (1999) examined the possible outcomes of a dual-banking system on Islamic banking performance and the benefits to customers during a rising and falling of interest rates. During economic prosperity, the demand for BBA by non-Muslims increases relative to loans. A fixed rate BBA is a powerful hedging tool against interest rate. He also argued that over-dependence on BBA financing has somewhat made Islamic banking fall into employing a negative-fund gap strategy during both the periods of economic boom and slowdown. At the macro-level, Islamic banks with high dependence on BBA financing tend to behave in a pro-cyclical manner. In his study, he finds that BIMB's profit margin (PM) declined relative to mainstream banks during the 1996/97 interest rate hike[9].

Dirar (1996) evaluates the performance of BIMB and compares it with that of Maybank Berhad and BSN Commercial. In his study, growth, profitability, liquidity and the capital adequacy ratio of the three banks are compared. He finds that BIMB's major financing is concentrated on credit-based investment compared to the other two banks. Wong (1995) evaluates the performance of BIMB after 10 years of its operations. He showed that BIMB's achievements are commendable, although the over-dependence on credit finance remains its major shortcoming. His study has proven that Islamic bank has the ability to maintain its viability and growth in a capitalistic financial environment. In terms of the social obligations, generally, BIMB has not made enough significant contribution in achieving the equitable distribution of income in Malaysia.

Kader (1995) conducted a survey on BIMB's Muslim depositors and found that 61.4 per cent of them also hold accounts in the mainstream banks for reasons related to the financial deepening factors. As the banking industry is further developed, the willingness and the opportunity of the public to utilize the system is directly affected by factors such as accessibility to, and the attractiveness of, the financial instruments and the kind of services they are able to provide. Kader (1995) also showed that Muslims hold accounts in the mainstream banks mainly due to convenience

Islamic banking institutions	Total asset	Total deposit	Total financing	Financing deposit ratio (per cent)	No. of financial institutions	No. of counters
IBS banks	28,751	22,351	14,465	64.7	40	2,087
Islamic banks	14,029	11,304	6,426	56.8	2	122
Discount houses	4,288	2,268	-	-	7	7
Total	47,068	35,923	20,891	-	49	2216

Source: Bank Negara Malaysia (2000), Annual Report

Table II.
Islamic banking in
Malaysia 2000: key data
(RM million)

such as the availability of more branches (22.5 per cent) and ATMs (21.2 per cent) as well as and location convenience. The religious factor is not conclusive enough to drive Muslims to use Islamic banking facilities.

As BIMB was the only focus in Malaysian Islamic banking studies, any conclusions made cannot imply the overall impact of the Islamic banking business. The performance of IBS in mainstream banks has not yet been studied. It is therefore critical to examine how it has performed as it now competes with BIMB as well as the parent banks.

Methodology and data

The evaluation of profitability performances of IBS banks is made using some widely used indicators of measuring banking performance, namely financial ratios[10]. Studies involve comparing the profitability performance of selected IBS and mainstream operations in commercial banks and finance companies. The selection of IBS banks is made on the year the operations began i.e. 1992. See Appendix for a list of the financial institutions selected for this survey. Even though IBS banks began in 1992, full data are only available between 1996 and 1999. This is the only limitation of the study. We have difficulty in collecting data starting from 1992 as IBDs then were small in number.

Firms generally report their financial position and performance by way of two basic financial statements, namely the Report of Condition (balance sheet) and Report of Income (income statement). In general, the financial ratio analysis provides a method for assessing the financial strengths and weaknesses of the firm using information found in its financial statements. The ratios measuring bank profitability performances used in this study are as follows.

- return on asset (ROA) = Net profit to total asset ratio;
- return on deposit (ROD) = Net profit to total deposits;
- PM;
- asset utilization (AU) = Total operating income to total asset ratio;
- operating efficiency ratio (OER) = Operating expenses to total operating income ratio; and
- investment/interest margin = (interest revenues - interest expense)/ Earning assets.

The study does not utilize the return on equity (ROE) ratio, since it is difficult to gauge how the IBDs obtained the capital needed to begin operations. It is a common practice for the parent bank to grant IBS banks a seed capital, but still allows it (i.e. IBD) to use the existing mainstream banking overheads such as branch office premises, and computer and security systems. In this way, the IBS bank may have benefited from the parent's capital base and thus is expected and is able to report bigger ROE in view of the relatively smaller

capital base it holds. On the other hand, ROA, which measures the net income per ringgit of average asset is a realistic choice. Since financing was made from deposits rather than capital, ROA is a better choice over ROE. The ROA primarily indicates efficiency in the manner bank management converts assets into net earnings.

ROD measures the percentage return on each ringgit of customer deposits. It indicates how effectively the management of a bank is able to turn deposits into net earnings. Generally, the higher the ROA, the higher should be the ROD. We expect that earnings will not differ in a dramatic way from loans in view of the vast similarities observed in the two systems. In addition, the nature of Islamic deposits that put no guarantee on profits would not help explain the positive relationship between the bank's earning and ROD.

PM measures net profit after taxes per ringgit of total operating income. In mainstream banks, the latter is equal to interest income plus non-interest income. For Islamic banking, the total operating income consists of investment income and fee income. It reflects the effectiveness of expenses management (cost control) and service pricing policies. The PM is also subjected to some degree of management control and direction. Banks can increase their earnings and their returns to their shareholders by successfully controlling expenses and thus, maximizing revenues. Similarly, by carefully allocating the bank's assets to the highest yielding loans and investment while avoiding excessive risks, the management can raise the bank's average yield on its assets. The higher the PM ratio, the more efficient a bank is in reducing expenses or taxes or both. Similar measure is the AU. It indicates a bank's gross yield on assets resulting from total operating income. It reflects portfolio management policies (especially the mix and yield on the bank's asset).

The net operating margin (NOM) is a measure of efficiency and profitability. NOM indicates how well banks have been able to keep the growth of revenues which (primarily comes from the bank's loans/financing, investment and services fees) ahead of the rising costs (principally the interest on deposits for mainstream banks or income attributable to depositors for the Islamic bank, money market financing, employee salaries and benefits).

OER is the measurement of effort to maximize profitability and the value of the shareholders' investment in the institutions. It shows how well the institutions reduce operating expenses and increase productivity. In an effort to maximize profitability and the value of shareholders' investment in a bank, many banking organizations recognize the need for greater efficiency in their operations. This simply means reducing operating expenses and increasing the productivity of their employees through the use of automated equipment and improved employee training.

In order to determine reliability of the profitability measure the ratio measure is supplemented by paired-sample *t*-test[10]. In this paper, the *t*-test is

used in testing the null hypothesis for equality of means of IBD and mainstream banks. The *t*-test will indicate whether the means of the subject under study were significantly different, that is, the observed difference between the sample value and the hypothesized value is true and cannot be due to mere chance[11].

The next section provides the empirical evidence of the profitability performance of IBS banks. It attempts to evaluate the profitability performance of IBS banks compared with mainstream banks in Malaysia. It examines whether the performance of IBS banks is superior, equal to or lower than that of the mainstream banks[12].

Comparisons of profitability performance on IBS banks and mainstream banks

This section provides the empirical evidence of the average profitability performance of selected financial institutions that provide the IBS banks compared with the interest based banking or simply the mainstream bank between the years 1996 and 1999. Tables III and IV provide the descriptive statistics and the *t*-test of the average profitability performance tests. To determine whether the differences in means were significant, the *p*-value (located in the column label sig.) must be less than the 0.05 or 5 per cent level. If the *p*-value is less than 0.05 the null hypothesis (i.e. no difference among the groups mean) will be rejected.

Table III.
Descriptive statistic on IBS banks and mainstream banks average financial ratios (1996-1999)

Variables	IBS banks		Mainstream banking	
	Mean (per cent)	Std deviation	Mean (per cent)	Std deviation
ROA	1.1664	2.2945	0.4070	1.5954
ROD	4.2975	24.8765	0.6498	2.3778
PM	19.7835	24.4684	5.9217	16.5291
AU	6.5785	4.2296	8.9751	1.5756
NOM	1.3706	2.3675	0.7039	1.7766
OER	75.5364	25.9594	91.1497	18.8720

Source: Computer generated

Table IV.
Test of significance for the equality of means between IBS banks and mainstream banks

Variables	Mean (per cent)		<i>t</i> -test for equality of means		Inference
	IBD	Mainstream banking	<i>t</i> -value	Sig. (2-tailed) <i>p</i> -value	
ROA	1.1664	0.4070	2.612*	0.011	REJ H ₀
ROD	4.2975	0.6498	1.396	0.166	ACC H ₀
PM	19.7835	5.9217	4.882*	0.000	REJ H ₀
AU	6.5785	8.9751	-5.400*	0.000	REJ H ₀
NOM	1.3706	0.7039	2.219*	0.029	REJ H ₀
OER	75.5364	91.1497	-5.148*	0.000	REJ H ₀

Note: *Significant at 5 per cent level

The first profitability ratio, the ROA, shows a higher value for IBS banks when compared with mainstream banks. The ROA for IBS is 1.16 per cent while mainstream banks levelled at 0.41 per cent. The difference is statistically significant with p -value = 0.011. As mentioned earlier, ROA is operating profit after tax divided by total assets. It reflects the bank management's ability to utilize the bank's financial and real resources to generate operating profit. To most analysts, ROA is the best measure of bank efficiency. This finding is not surprisingly startling since as indicated earlier, the IBS banks were able to spend less on overheads, namely people and premises, as the parent banks covers' these expenses[13]. This could have reduced the operating profit after tax (net income minus overhead and tax). Thus the higher mean value for IBS banks does not imply efficiency.

Our suspicion that the high ROA for IBS banks does not reflect efficient use of resources is further supported by the lower AU in IBS banks compared with mainstream banks. The AU ratios for IBS banks and mainstream banks are 6.75 and 8.97 per cent, respectively. The difference between these two means is statistically significant with p -value = 0.000. AU, which is revenues divided by assets, reflects how many assets are employed as earning assets and the yields earned on these assets. The lower AU ratio for Islamic banking indicates problem areas in marketing and convincing customers to use the new products. Since these products project interest-like features, it is likely that consumers are less interested in switching to IBS banks.

Further evidence is provided by the interest and investment margin ratio in mainstream and IBS banks. Interest margin is the difference between interest revenues and interest expense divided by earning assets. Investment margin is the difference between revenues from financing and payments on deposits divided by earning assets. It is a more accurate measure of efficiency given that fixed assets are excluded since it does not earn interests or profits (Table V).

Table VI shows the results of t -tests on the equality of means for IBS banks and mainstream banks. In commercial banks, the interest margin is higher than the investment margin, although significant differences hold for only 1999 at p -value = 0.041. Between 1996 and 1999, interest margins in finance companies are higher than investment margins with differences in 1996 and 1999 found

Year	Mean (per cent)		t -test for equality of means		Inference
	IBS banks	Mainstream banking	t -ratio	p -value	
1996	2.5245	3.3843	-0.985	0.340	ACC H_0
1997	2.3422	3.5695	-1.430	0.173	ACC H_0
1998	2.1960	3.7443	-1.480	0.158	ACC H_0
1999	1.4320	3.0195	-2.196*	0.041	REJ H_0

Note: *Significant at 5 per cent level

Table V.
Commercial banks: test
of significance for
equality of means on
investment and interest
margin in IBS banks
and mainstream banks

statistically significant at p -value = 0.012 and 0.049, respectively. This evidence further proved that the somewhat higher ROA in IBS banks is not caused by efficient use of assets.

Increasing banking profits by way of increasing productivity is measured by the OER, which is equal to operating expenses divided by revenues. Since the bulk of operating expenses were borne by the parent bank, the results are predictable showing higher revenue generation by the IBS banks at a lower operating expense compared with the mainstream bank. The Islamic bank's average OER was 75.54 per cent compared to 91.15 per cent of the mainstream bank. The differences between the two means under study are statistically significant at the 5 per cent level. Further impact on of the IBS banks is given by the profit-margin ratio. Our results show that the PM for IBS banks is higher than mainstream banks at 19.78 per cent and 5.92 per cent, respectively. Similar to the above reasoning, the higher ratio for IBS banks can be explained by the overhead factor.

Finally, ROD ratios for IBS banks and mainstream banks were inconclusive since the difference in means is not statistically significant. Thus, the higher ROD ratios reported for IBS banks have occurred by chance. This is true because stylized facts have shown that the ROD for IBS banks has been relatively lower than mainstream banks. See Tables VII and VIII.

As an example, between 1996 and 1988, interest rates on fixed deposits have been consistently higher than dividends on Islamic investment deposits in both commercial and finance companies. However, in 1999 Islamic deposits for

Table VI.
Finance companies:
 t -test for equality of
means on investment
and interest margin in
IBS banks and
mainstream banks

Year	Mean (per cent)		t -test for equality of means		Inference
	IBS banks	Mainstream banks	t -value	p -value	
1996	2.1986	3.93	-3.165	0.012	REJ H_0
1997	3.4430	3.5608	-0.150	0.885	ACC H_0
1998	1.9281	2.3668	-0.632	0.538	ACC H_0
1999	2.0053	3.2425	-2.341	0.049	REJ H_0

Source: Computer generated

Table VII.
Average interest rates:
mainstream banks
(1996-1999)

Institution Year	Commercial bank (average)				Finance company (average)			
	FD	SD	BLR	LR	FD	SD	BLR	LR
1996	7.224	4.10	9.18	10.12	7.33	5.02	10.65	11.93
1997	7.79	4.18	9.53	10.63	8.086	5.18	11.09	11.80
1998	8.508	4.26	10.61	12.13	9.312	5.37	12.65	12.66
1999	4.17	3.1042	7.2525	8.56	4.395	3.957	8.5618	11.58

Source: Bank Negara Malaysia (1997, 2000), Monthly Report, January

Notes: FD - fixed deposits, SD - saving deposits, BLR - base lending rate, LR - lending rate

commercial banks gave a higher return at 4.67 per cent compared with 4.17 per cent in IBS banks and mainstream banks, respectively. The same is true for finance companies. This is perhaps explained by the nature of Islamic credit-finance where the profit rate is locked for the entire duration of instalments. Thus, when the interest rate declines, existing credit-finance contracts were still charging customers the contractual rate, which is higher than the prevailing market rate. In this manner, IBS banks were able to give depositors relatively higher dividend rates than interest-bearing deposits. The latter was unable to do so since mainstream loans are based on floating or variable interest rates.

Our findings reveal a certain paradoxical state of affairs in the IBDs (IBS). At one point, the study shows that IBS banks are more efficient than mainstream banks, but evidently seemed to suggest that structural factors rather than efficiency as the cause. As an example, the ROA, PM, NOM and OER ratios for IBS banks are significantly higher than mainstream banks. Theoretically this should imply that the AU and IM ratios should also be higher in IBS banks than mainstream banks.

However, our findings show the reverse scenario. We can explain this by looking at the operating expense factor. First, operating expense or overhead is used to calculate the ROA, PM, NOM and OER ratios. Second, these expenses were small in the IBS banks because the larger bulk of the expenses is carried by the parent bank, namely the mainstream bank. In this manner, there is no cause to say that religion has a significant role in making IBS banks more efficient than mainstream banks. From this evidence, it is found that the commendable performance of Islamic banks from 1996 to 1999 as shown by the ROA, PM, NOM and OER ratios were not caused by efficient investment policies. Rather it is caused by a mere technical default in view that most overhead expenses were borne by the parent bank.

Conclusion and proposals

The experience of IBS banks in Malaysia is found to be similar to BIMB in that both banks performed less convincing even when rules and regulations are based on the teaching of Islam. By using credit finance (*bay' muajjal*) under the disguise of trade (*al-bay'*) as commanded by the *Qur'an* as opposed to *riba*,

Institution Year	Commercial bank (average)		Finance company (average)	
	Invest. deposits	Saving deposits	Invest. deposits	Saving deposits
1996	5.756	3.9858	6.8238	4.9108
1997	6.437	4.4133	6.6207	4.8942
1998	7.5293	4.7833	7.4447	5.4025
1999	4.6737	3.2942	4.6908	3.8433

Source: Bank Negara Malaysia (1997, 2000), Monthly Report, January

Table VIII.
IBS banks – rate of
return to depositors
(1996-1999) (average)

Malaysian Muslim jurists at the supervisory level have to, some extent, failed to direct Islamic banking away from the path of mainstream banking. Complying with legal rules (*fiqh*) arising from the system of public interest (*maslahah*) but without imputing its ethical content has amplified the application of credit finance, thus injuring the social and equitable implication of trade and commerce (*al-bay'*) desired by the *Qur'an*[14]. It is not on Islam that one puts the blame, but the Muslims themselves who seemed to ignore the basic ethical precepts of Islamic law. Thus, the interest-like Islamic banking operations are not expected to show a superior performance as should be. Instead, this study has shown that mainstream banking performed better than IBS banks. This is explained by the larger market size, long-term experience and financial deepening factor, which IBS banks have yet to develop. The AU and interest/investment margin for mainstream banks are found significantly higher than that for IBS banks. Although the ROA, PM, NOM and OER are found to be significantly higher in the IBS banks, this could have happened by technical default in view of the large overhead carried by the parent bank. In this way, overhead expenses of IBS banks were discounted even though they have benefited in using the facilities. Based on this study, using ROA and other profit ratio performances such as ROD, PM, NOM and OER will be inaccurate for IBS banks. However, they are still a reliable measure of performance for BMB and Bank Muamalat.

This paper is able to show that Islamic banking in Malaysia has yet to exemplify the moral and ethical requirement of trade and commerce (*al-bay'*) of the *Qur'an* to achieve efficiency. Doing so would mean addressing distributional issues that can help reduce income gaps over time. In addition, risk-taking ensures cautious and prudent spending which is vital in determining corporate success. It is urgent for Malaysian Islamic banks to pursue diversification by promoting ethical banking via partnership arrangements such as trustee partnership (*mudarabah*) and joint ventures (*musyarakah*). Further applications of sale by order (*salam* and *istisna'*) will see greater Islamic banking exposure to risks as a constructive step in addressing distributional issues as it can open new for growth in start-ups and entrepreneurship. In this manner, Islamic banking can generate the much-needed scale and scope economies to increase profitability as well as impacting the well-being of society in a positive way. Only on this ground the twin goals of efficiency and equity can be achieved in the banking business. Finally, Islamic banks can make new inroads into the Malaysian banking system only when it is ready to exploit the Islamic banking law to its favour. By putting ethics in its proper place, the structure of Islamic finance in Malaysia is likely to change significantly when the desire to diversify beyond credit finance is put into practice.

Notes

1. The *Qur'anic* alternative to *riba*, namely trade and commerce (*al-bay'*) signifies the importance of risk capital and labour in Islam. Islam enjoins risk-taking, but prohibits risk-avoidance. Risk-aversion is one form of risk-taking. Risk-averse individuals will take more risks with higher expected return. But risk-avoidance individuals demand contractual profits with full capital protection. This violates the law in nature in Islam, since everything except God must depreciate and money is not an exception. When money is not subjected to the law of depreciation, man has put money equal to God. In Islamic law, this amounts to idolatry (*shirk*). For this reason, God has declared war on Muslims who consume *riba*. The *Qur'an* says, "O ye who believe observe your duty to Allah and give up what remaineth (due to you from usury, if ye are (in truth) believers and if ye do not, then be warned of war (against you) from Allah and His Messenger" (*al-Baqarah*: 278-279).
2. The concept of the self in Islamic philosophy oozes mystical concern, which the neoclassical self is restricted from.
3. For full discussion on the theory of *'iwad*, see Rosly (2001). This is a new theory of *riba* constructed to restrict a wholesale application of credit finance in Islamic banking. Existing theory that defines *riba* as a prefixed increase over a loan is unable to stop Islamic banking from making interest-like profits via credit finance (*al-murabaha*) by using the contract of sale (*al-bay'*) instead of debt. Since *al-murabaha* is one form of *al-bay'*, profit creation no longer implicates the contract of debt.
4. See Rosly and Sanusi (2001) for further discussion. The contract of *bay' al-'inah* is invalid to the Middle-eastern school of jurisprudence (*fiqh*). Hence, a large number of Malaysian Islamic banking products will not find markets in the Arab states.
5. The Islamic Banking Act 1983 theoretically allows Islamic banks in Malaysia to adopt the universal banking model to benefit scale and scope economies. However, banks prefer credit-finance (*murabahah*) to minimize their exposure to risks.
6. Unable to expand market size usually means excess balances in Islamic banks invested in low-yield money market instruments. See Rosly (1989).
7. Using a cross-section data, Samad compares the profitability means of BIMB with the mainstream banks. In this approach one Islamic bank is compared with 15 mainstream banks.
8. The term *al-bai-bithaman ajil (BBA)* is synonymous to *al-murabahah*. Credit finance is called *bay' muajjal* in Pakistan, *al-bai-bithaman ajil (BBA)* in Malaysia and *al-murabaha* in the Arab states including Iran and the Sudan. In a nutshell, they all mean credit finance or simply "credit sale payable by equal installment payments".
9. The two full-fledged Islamic banks, namely Bank Islam Malaysia and Bank *Muamalat* are different from IBS banks. IBS banks are able to expand at a rapid rate since a nationwide branch network is already in place. The two Islamic banks, however are expected to incur high expenditure to increase regional branches. In this way, the fixed assets and subsequent overhead expenses for them are exceedingly high compared with IBS banks.
10. Financial ratio procedure to evaluate the bank's performance was introduced by Cole (1972).
11. On this point the authors would like to thank Salamah Abdullah for her helpful comments.
12. $H_0 : \mu_{IBD} = \mu_{CB}$. There are no differences between the mean profitability ratio of IBS banks and mainstream banks. $H_1 : \mu_{IBD} \neq \mu_{CB}$. There are differences between the mean profitability ratio of IBS banks and mainstream banks. μ is the mean of the profitability ratios. IBS banks, the Islamic Banking Division in mainstream banks. CB stands for mainstream or interests-based banking.
13. For full discussion see Shamugam *et al.* (1992).
14. See Rahman (1998).

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Appendix. List of financial institutions offering Islamic Banking services selected for this study

Commercial bank

- (1) Arab-Malaysian Bank Berhad (AMMB)
- (2) Ban Hin Lee Bank (BHL)
- (3) Bank Bumiputera Malaysia Berhad (BBMB)
- (4) Bank of Commerce (BoC)
- (5) Hock Hua Bank (HHB)
- (6) Hong Leong Bank (HLB)
- (7) Maybank Berhad (MAYB)

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- (8) Multi-Purpose Bank Berhad (MPB)
 - (9) Oriental Bank Berhad (OB)
 - (10) Pacific Bank Berhad (PcB)
 - (11) Perwira Affin Bank (AFB)
 - (12) Public Bank (PB)
 - (13) Southern Bank Berhad (SBB)
 - (14) Rashid Hussain Bank (RHB)
 - (15) Hongkong Bank Malaysia Berhad (HSBC)
 - (16) Standard Chartered Bank Malaysia Berhad (SCB)

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Finance company

- (1) Arab-Malaysian Finance Berhad (AMF)
- (2) Credit Corporation Malaysia Berhad (CCM)
- (3) Hong Leong Finance (HLF)
- (4) Maybank Finance Berhad (MAYF)
- (5) MBf Finance Berhad (MBf)
- (6) Perwira Affin Finance (AFF)
- (7) Public Finance (PF)
- (8) United Merchant Finance Berhad (UMF)