Research Highlights:

RESEARCH ON ISLAMIC BANKING IN MALAYSIA: A GUIDE FOR FUTURE DIRECTION

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Islamic banking has experienced some success globally, with an annual double digit growth rate (an average of 15% to 20% annually) in the last decade. But to maintain the momentum, the industry has to improve on a number of pertinent aspects. For instance, establishing a common regulatory, legislative, tax, and legal foundation, addressing cost-efficiency and integration issues for all Islamic financial markets in general and the Islamic banking sector in particular. Retrospectively, Malaysia – a rapidly developing vibrant economy – has positioned itself as an international hub for Islamic banking and finance. The research interest on Islamic banking in Malaysia has been intensive but on a piece-meal basis, without a comprehensive focus to chart the needed direction to support the government's initiatives to further develop this niche sector. . This article takes stock of the past documented research on the Malaysian Islamic banking sector and deliberates on the required future direction.

In the context of corporate governance, Hassan and Christopher (2005) discovered that, despite the religious nature of Islamic banks and being managed by mainly Muslim individuals, Islamic banking institutions were not distinguished by better corporate governance. Satkunasingam and Shanmugam (2004) highlighted the need for greater corporate disclosure requirements for Islamic banks, citing the prevalence of exceedingly poor corporate governance standards at the time. Meanwhile, from Shariah governance perspective, great interest is on the compliance status of Islamic financing products; Abdul Razak and Ismail (2010), for example, discussed how diminishing musharakah (an equity-based financing product) was considered to be more Shariah compliant and conducive towards the fulfilment of Shariah goals than other debt based financing products. In contrast, Smolo (2010) argued that in truth the product constituted a legal device and threatened the Shariah integrity of Islamic banking by allowing the material convergence of Islamic banking practices with conventional banking practices. Smolo and Hassan (2010) further suggested the use of musharakah mutanaqisah over alternative financing methods of BBA and murabahah on the basis of the Shariah-sense superiority of the former. The Shariah integrity of another local financing product – al ijarah thumma al-bai (or AITAB) was questioned by Abdullah and Dusuki (2004). Another issue of concern is proper benchmarking for pricing of financing products, as currently the most widely used pricing benchmark is the conventional interest rate, which arguably renders the products non-Shariah compliant (Chong and Liu, 2009).

For a more effective Shariah governance framework, there is a need for vigorous Shariah audit and review system. Besar et al., (2009) investigated the quality of Shariah review processes in selected Islamic banks in Malaysia and concluded that a more methodological approach is needed to ensure the Shariah Supervisory Boards discharged their responsibilities with integrity. Yussof (2013) looked at the necessity for Islamic banks to develop an internal Shariah audit infrastructure and train professionals qualified in both finance and the Shariah law. Rosly (2010) urged the Shariah audit to be conducted in an integrated manner by ensuring the Shariah adequacy in the four parameters of Maqasid al Shariah, financial reporting, legal documentation, and contract.

Another pertinent issue is the operational performance of Islamic banks and the relative operational performance of Islamic banking institutions vis-à-vis their conventional counterparts, particularly in countries like Malaysia with a dual-banking system. One of the earliest performance studies documented in the area of Islamic banking in Malaysia by Ariff (1989) was on the performance of Bank Islam Malaysia Berhad [BIMB] during the first six years of its operations. Highlighted were some of the bank's achievements, such as the absolute increase in deposit accounts, the relative rise in investment deposit accounts, and the gradual growth in rates of return to the accountholders. Amongst the criticisms was its overwhelming dependence on BBA and ijarah in financing (at the expense of mudarabah- and musharakah-based equity financing) and its provision of uncompetitive return rates (in comparison to conventional banking institutions) to both investment account holders and shareholders. Wong's (1995) analysis of BIMB disclosed its overdependence on credit based financing. A similar study on BIMB – with a focus on its comparative banking efficiency in fund sourcing and utilisation by Samad (1999) – found that BIMB lacked the managerial efficiency in comparison to conventional competitors but was inconclusive on productive efficiency.

After ten years of moratorium, the government introduced the Islamic Banking Scheme [IBS] in 1993 that allowed existing conventional banks operate Islamic banking windows or subsidiaries and ended BIMB's monopoly in the Islamic banking industry in Malaysia. Rosly and Abu Bakar (2003) analysed the comparative performance of IBS banks (or banks that had Islamic windows) in the country and reported that they had a higher return on assets (explicated by their overheads being allocated to their parent companies) but lower asset utilisation and investment margin ratios, implying that due to their heavy reliance on interest-like credit finance, IBS are not competitive in terms of efficiency if compared to conventional banks that have an advantage of a larger market size and greater maturity. On the contrary, Abdul Majid et al. (2003) documented that there were no significant differences in efficiency scores between Islamic banks (IBS banks and fully-fledged Islamic banks taken together) and conventional banks.

Financial liberation of the Islamic banking industry envisioned in the Financial Sector Master Plan 2001 led to granting licences to qualified IBS banks to set up fully-fledged Islamic banks. Mokhtar et al. (2006) analysed this new competitive environment and showed that the average efficiency of Islamic banks increased over the years, while that of conventional banks remained stable but was still comparatively higher; it was documented that fully-fledged Islamic banks were more efficient than IBS banks, with domestic IBS banks being less efficient than foreign Islamic windows.

Muslim customers citing religion as the main reason for patronizing Islamic banks

The nature of banking business is inherently risky, irrespective of being conventional or Islamic. Islamic banks, due to their peculiar foundational base, face a unique amalgam of risk challenges. The common risks Islamic and conventional banks encounter are market, credit, liquidity, and operational risks. However, Islamic banks are subjected to extra elements of Shariah non-compliance, fiduciary, and rate of return (including related displaced commercial) risks.

The most consequential element of market risk for most Islamic banks is arguably the interest rate risk, notwithstanding the imperative interest free nature of Islamic banking. The interest rate risk in the Islamic banking context translates into the rate of return risk for Islamic banking institutions. Haron and Ahmad (2000) maintained that Islamic banks, in their setting of profit rates for investment account holders, were strongly influenced by the level of interest rates used by conventional banks for investments of equivalent risk profiles. A similar finding was disclosed by Kaleem and Isa (2005) who suggested that deposit rates offered by conventional banks were used as predictors of deposit returns in Islamic banks. On the same issue, Rosly and Zaini (2008) studied the differences in yields between deposits or investment accounts and capital in conventional and Islamic banks and reported that the variance in yields was adequate in conventional banks, it was significantly smaller in Islamic banks and hence did not reflect their risk properties.

A related perspective was brought in by Bacha (2008) that shows the profit rates prevalent in Malaysia's Islamic Interbank Money Market (IIMM) were highly correlated with conventional money market rates, which lead the author to conclude that the IIMM, due to its being operated in a dual-banking environment, could not possibly sterilise itself from the interest rate risk. In a more recent paper, Khairul, Shamsher and Eskandar (2014)

documented that profit rates of Islamic banks are not only significantly linked with interest rates of conventional banks but are affected by the movements of interest rates of conventional banks and not vice versa. The findings imply that there is a gap between Islamic banking theory and practice.

Abdul Kader and Leong (2009) and Zainol and Kassim (2010) confirmed that inevitably, on account of the rate of return risk, Islamic banks were subjected to the displaced commercial risk, which, in turn, put their capital base and their solvency in jeopardy. In terms of insolvency, Abdul Rahman et al. (2009) noted that real estate lending reduced the insolvency risk exposure of Islamic banks and increased the risk for conventional banks; and suggested appropriate amendments in capital adequacy regulations to alleviate the insolvency risk of Islamic banks.

With regard to operational risk, Abdullah et al. (2011) noted that conventional risk measurement and management practices needed substantial adaptation to suit the specific characteristics of financing and investment activities of Islamic banks. In the same area of interest, Abdul Rasid et al. (2011) reported that a

typical Islamic bank in Malaysia (unlike most conventional banks) would normally develop and adopt an integrated enterprise system which boded well for the bank's operational efficiency.

Ariffin (2012) estimated that the average exposure of Islamic banks to liquidity risk and reported a stable but below that of comparable conventional banks; it was also affirmed that the extent of liquidity risk had a positive correlation with financial performance. These findings are consistent with How et al. (2005) that Islamic commercial banks had significantly lower liquidity risk than their conventional counterparts.
From the perspective of marketing Islamic financial services and products, Haron et al. (1994) studied the bank patronage factors of Muslim and non-Muslim customers in Malaysia and reported

Customer perception of complete Shariah compliance of Islamic banks

that the two groups of customers had no significant differences in their bank selection criteria. The relevant determinants for selecting the services of Islamic banks were the operational efficiency and the quality of service, with only 40% of Muslim customers citing religion as the main reason for patronizing Islamic banks. Similarly, Hamid and Azmin (2001) postulated that to build the customers' knowledge on Islamic banking, there is a need to revise the national schooling curriculum to incorporate muamalat (or the application of Islamic law in business transactions) related courses. Ahmad and Haron (2002) examined the perceptions of corporate customers towards Islamic banking and suggested that corporate customers gave priority to competitive pricing of banking products and services consistent with profit maximisation objective. However, their knowledge on Islamic banking products and services was below expectation, probably due to Islamic banks' inadequate marketing efforts.

Several years forward, with greater proliferation of Islamic banking institutions, Dusuki and Abdullah (2007) studied the factors motivating customers to deal with Islamic banks reported that the amalgamation of Islamic social credentials and service quality to be most important. In related research, Dusuki and Dar (2007) analysed the perceptions of various stakeholders on Islamic banks' corporate social responsibility practices and

documented a positive conception of Islamic banks' engagement in active corporate social responsibility practices, in line with its ethics based fundamentals. In another study, Dusuki (2008) posted that the stakeholders of Islamic banks viewed the latter as socially-integrated institutions with certain welfare and moral obligations towards communities in which they operated.

For the practice of advertising of their financial services and products, Islamic banks in Malaysia, Shariah-toned promotions were either totally absent or deficient, which contributed to the lack of customer unawareness (Haque et al. (2010)). Ahmad et al. (2011) suggested that Islamic banks should concentrate efforts on building Islamic-banking-as a brand to garner greater customer support from both domestic and global market. . Amin et al. (2013) purported that customer loyalty in the context of Islamic banking hinged heavily on the customer perception of complete Shariah compliance of Islamic banks they patronised.

Naturally, there are a number of commonalities in the research activities related to both conventional and Islamic finance, as both banking system operates on a premise of commercial viability within the predominantly conventional banking infrastructure. A common research call is in this dual banking system is for regulatory (and supervisory) support to address current challenges in the interest of future growth of this niche industry.

Albeit the similarities, research in conventional finance reflects the maturity of its subject matter and is not constrained by perennial issues highlighted in Islamic financial research. One such issue is the standardisation and harmonisation of rules and regulations (including those on the interpretive Shariah law and accounting) across both domestic and global Islamic financial institutions. The frequently featured issues in Islamic banking and finance are the lack of qualified human talent and the specificities of risk management practices in Islamic banking. In contrast, topical themes in conventional financial research are corporate governance (with the increased accent on self-regulation), technological and product innovation, competition, and prudential regulation.

An objective assessment of the preferred future direction of research in Islamic banking would not be possible without analysing the published literature on Islamic banking in Malaysia in the context of BNM's second 10-year Financial Sector Blueprint which is designed to reinforce the government's initiatives to achieve a fully-developed nation's status by 2020.

The first focus area for research is the moulding of a more seamless legislative and regulatory environment. This will

This will allow for much needed scope and depth of Malaysia's Islamic banking industry

provide a stable environment for Islamic banking institutions to grow, unhampered by unjustified legislative or regulatory constraints but instead supported by flexible and effective regulation and supervision, and market transparency. Indeed, country experiences show that accommodative legislation and regulatory clarity are key factors to accelerating growth and market share of the Islamic banking sector. This includes the populace's financial inclusion and literacy, and the consumer protection framework.

The second focus area for research concerns the strengthening of the industry's core business activities. The top priority of the government and the regulators is to ensure that Islamic banking

and other financial institutions achieve and maintain competitive vibrancy and efficiency. This relates to the issues of economics of scale and economics of scope of commercial banking in Malaysia. A crucial aspect concerning the industry depth is in enhancing liquidity in the markets (including the global Islamic liquidity management). Alongside this objective goes the strategy for active development of innovative products and services (especially if equity- or hybrid-based), together with the evolvement of permissible risk management tools and technological operative advancements (such as e-payment and e-banking gateways).

The third focus area for research is the fostering of regional Islamic bank champions. A major theme of BNM's and SC's blueprints is the regional and international expansion of home-grown Islamic banks, in a meaningful and prudent manner, by taking advantage of the ever accelerating global economic integration (with focus on mainly ASEAN, Greater China and South Asia). This will allow for much needed scope and depth of Malaysia's Islamic banking industry (that is currently highly dependent on domestic resources) and consequently will also help manage risk through international diversification. Malaysia's global share of Islamic banking assets is expected to increase from 8% in 2009 to 13% in 2020. Though there were plans to create a mega – Islamic bank that was forecasted to reach the global top 10 by asset size by 2020, these plans were aborted after due deliberation and diligence.

The fourth focus area for research concerns the codification and standardisation of Shariah guidelines. This is part of BNM's ongoing initiatives in providing process of Shariah parameters for standard documents. The objective is to achieve uniform understanding of Shariah principles, which will ensure consistent interpretation of Shariah contracts and facilitate the development of globally acceptable Islamic banking products and services that will also contribute towards increasing the liquidity and depth of this industry.

The fifth area for research in focus is the promotion of global convergence and mutual recognition of Islamic banking standards. This is central to unleashing the full potential of Islamic banking and finance on a global scale. Such convergence and recognition of standards can be facilitated through the support of the international standard-setting bodies, such as the Islamic Financial Services Board [IFSB], the Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI], the International Islamic Financial Market [IIFM], etc. These agencies were created to help facilitate promote the global convergence of Islamic banking standards, which to date, though have made some progress, but are far short from expectations.

The other area of research that requires some serious thought is towards setting-up a reference centre for Islamic banking and finance research, development and education. The government's role in further promoting Malaysia as the international hub of intellectual excellence in Islamic banking and finance will be better sustainable with an effective support from the centre. The priority areas are legislation (specifically considered matters include the re-engineering of the KL Regional Arbitration Centre into a global arbitration centre with specific expertise in Islamic banking and finance, and the expansion of the legal framework to accommodate more innovative Islamic products); human capital (specifically considered matters include the creation of globally recognised accreditation and certification programmes, the increase in scholarship and research grants, and the grooming of talent pool well-grounded in both conventional finance and the Shariah that is currently the responsibility of the International Centre for Education in Islamic Finance [INCEIF]); research, development and innovation (by leveraging on research and innovation capabilities of faculty at INCEIF and ISRA).

There is also need to research in the possibility of developing of new integrated growth sectors. This encompasses the closer integration of Islamic banking with other Islamic financial sectors such as Islamic money and capital markets, takaful (including retakaful), waqf (or trust) and Islamic fund (asset and wealth) management, through mutual cooperation within the liquidity framework and joint product and service offerings (such as bancatakaful and mortgage securitisation transactions) to retail and corporate customers.

This guide to future research is in consonance with the commitment to develop the industry and promote Malaysia's reputation as the global hub for Islamic banking and finance. Though there is a long and challenging road to achieve the desired goal of becoming a global reference point on Islamic finance, the research support will provide inputs for r greater practicality and innovation in the industry. An important consideration should also be given to actively championing the social and ethical identity of Islamic banking besides seeking a more competitive operational mechanisms.