Why The Rate Of Financing In Islamic Banks Is High? An Analysis Based On Malaysian Case

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Abstract

Islamic banking has grown rapidly and has become financial-nerve centre in today's world economy, particularly in the last three decades. It has attracted various entrepreneurs and enterprises to get its financing. However, Islamic banks tend to have a higher rate of financing compared to the conventional ones. This less competitiveness encourage the demand for Islamic products may fall leaving the Islamic banks. Good debtors opted for conventional loans since the interest rates paid were relatively lower and the rest (the bad debtors) successfully made their way to Islamic banks. Therefore, the non-performing financing of Islamic banks is high. This paper attempts to analyze factors that determine high rate of financing in Islamic banks, by taking the case of Malaysian Islamic banks. In this paper, the top three of Islamic banks and conventional banks are selected for comparison. It finds that high default premium and overheads per capital contribute significantly to the high financing rate. Hence, the Islamic banks should diversify their assets and implement universal banking concept.

JEL Classificiation: G20, G21
Key words: *Islamic bank, rate of financing, NPF (Non-Performing Financing), universal banking system*

1. Introduction

The development of Islamic economic system for the last three decades has been showing a tremendous growth, particularly in the area of Islamic banking and finance. Today, the total number of Islamic funds in the global markets is estimated to be at 1.3 trillion US dollar, while the Islamic financial market is estimated to be at 230 billion US dollar in size, with the annual growth rate between 12 % and 15 %. There are approximately 250 Islamic financial institutions currently operating in about 75 countries worldwide, with more than 100 equity funds managing assets in excess of 5.0 billion US dollar (Bursa Malaysia Report, 2005). This has become undeniable fact and

it shows that the world interest towards Islamic financial institution tends to rise from year to year.

Malaysia is one of the pioneers of Islamic economic development. Malaysian Islamic banking industry has been showing impressive performance. Their assets today have reached 10 % out of total banking assets. They have planned to increase this number to 20 % within the next 5 to 10 years. This is a realistic target. It is expected that Islamic banking industry will be the backbone of Malaysian economy. Therefore, any effort is made in order to realize this aspiration.

However, one of the problems faced by Malaysian Islamic banking industry is high financing rates. This, on other side, can be the obstacle of achieving their target. As we know that Islamic banks nowadays are in tight competition with their conventional counterparts. It, of course, requires Islamic banks to overcome any factor that can reduce their competitive power. Therefore, it is in the interest of Malaysian Islamic banking industry to have lower financing rate so that it can boost Malaysian economy to a better position.

This paper tries to examine the factors or variables that contribute to the high rate of financing of Malaysian Islamic banks. This paper comprises five sections including the introduction as the first one. The second section shall discuss theoretical foundation for Islamic banking system followed by methodology explanation in the third section. Findings and analysis will be elaborated in the fourth section, while section five concludes the paper.

2. Theoretical Foundation

Islamic bank has unique features compared to its conventional counterpart. It has been theoretical aspiration of Islamic economists that Islamic banks should operate on the basis of profit-sharing principles. This means that on the liability side, Islamic bank has only investment deposits while on the asset side; these funds will be channelled through profit-sharing contracts. However, in the practice of Islamic bank, practical aspect is different from theoretical aspirations. Ariff (1995) found that Islamic banks around the world offer three main types of depository services, such as current account, savings accounts and investment accounts. Current accounts and savings guarantee depositors the nominal value of the deposit, but provide no guarantee on returns. The investment accounts operate fully under the profit/loss sharing (PLS) scheme where capital is not guaranteed neither any pre-fixed returns. Ariff also observed considerable variations within investment accounts. For instance, the Islamic Bank of Bangladesh has been offering PLS Deposit Accounts, PLS Special Notice Deposit Accounts, and PLS Term Deposit Accounts, while Bank Islam Malaysia has been operating two kinds of investment deposits, one for the general public and the other for institutional clients.

It is already known that modes of financing in Islamic banking system can be divided into two parts, i.e. profit-sharing modes of financing and fixed-return modes of financing. The former is based on the *musharakah* and *mudarabah* financings,

while the latter deals with other types of financing, such as BBA (Bay Bithaman Ajil), Murabaha (cost plus or mark up sale), installment sale, Istisna/Salam (object deferred sale) and Ijarah (leasing). This is a conventional division since product development and innovation which combines two or more financing modes has taken place.

Musharakah is basically a partnership contract, formed to carry out a specific project. All parties involved agree to share on both profit and loss at certain ratios. They also contribute to management aspects. Many scholars have regarded musharakah as the purest Islamic financial instrument since it reflects the "true" Islamic spirit, i.e. *at-ta'awwun* (helping each other) and cooperation. Meanwhile, mudarabah is a contract whereby one party, the *rabb al-mal* or *sahib al-mal* (beneficial owner or the sleeping partner), entrusts money to the other party called the *mudarib* (managing trustee or the labor partner). Both agree to share profit at certain ratio while all financial losses will be borne by the rabb al-mal. The mudarib, on the other hand, bears the time and labor losses. The practice of mudarabah has been known since the pre-Islamic era and it was then legalized by the Holy Prophet Muhammad (PBUH).

Islamic bank actually is an asset and production based system. Musharakah and mudarabah are the most suitable financing reflecting this principle. They are believed to be able to boost real sector investment since Muslim countries need more investment in the real sector. An increase in the investment will lead to a rise in the employment rate which eventually enhances income level of the society. Both financings are believed to be able to stimulate the growth of new firms and raises productivity level of a country. Meanwhile, all fixed-return financing modes should be placed as complement to profit-sharing modes. This does not mean that those modes are not shariah-compliance or have no significant effect on a country‟s economic development since there are no Quranic verses or hadits prohibiting their practice. However, achievement of policy of raising productivity as well as reduction of unemployment and poverty will be more effective if all Islamic banks use musharakah and mudarabah as their main financing modes.

Another advantage of mudarabah and musharakah is that both are the major instrument that can stabilize monetary sector and real sector. The reason is very simple. In profit-sharing mechanism, return on monetary sector is determined by return on real sector. The greater the return on real sector, the greater is the return on monetary sector. Meanwhile in the conventional system, return on monetary sector is not determined by return on real sector, but interest rate. Both sectors may not have direct channel, while in Islamic system both sectors will always interrelate each other. Thus, position of real sector is vital in Islam. It determines the performance of monetary sector.

Nevertheless, the use of profit-sharing financing modes is very limited in the practice of Islamic banks worldwide. It is, perhaps, because of the risk that Islamic banks face. Musharakah and mudarabah are riskier compared to all types of fixed-return financing modes. This fact can also be observed in the case of Malaysia. If we look at the percentage of BBA (Bay Bithaman Ajil) financing, then the data shows that it stays at the top rank of financing which is widely used by Islamic banks in Malaysia. The table 1 below shows the use of each type of financing in Malaysia.

Table 1: The Percentage of Each Financing Modes in Malaysian Islamic Banks

Type of Financing	Dec 2002	Dec 2003	Dec 2004	Sep 2005
Bai Bithaman Ajil (BBA)	49.20	47.68	49.89	42.55
Ijarah	2.97	1.37	0.8	0.7
Ijarah thumma al-bai	23.28	27.63	23.18	29.62
Murabahah	7.27	6.25	7.00	6.70
Musharakah	0.7	0.5	0.4	0.3
Mudarabah	0.04	0.07	0.06	0.02
Istisna	1.27	0.6	1.23	0.10
Others	15.30	15.87	17.40	19.16

Source: Bank Negara Malaysia, 2005

According to the table above, musharakah and mudarabah are not significant. They are still below 1 %. Meanwhile, fixed-return financing modes are very significant, especially BBA scheme which reaches almost 50 % from year to year.

BBA is basically a long term credit murabahah, i.e. a credit sale with purchases settled by installment payments (Rosly, 2005:88). The Bank Negara Malaysia (2006) defines BBA as the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties involved.

3. Methodology

3.1. Selection of Islamic and Commercial Banks

The first step is to choose the best three of Islamic banks as well as the best three of commercial banks in Malaysia. They are selected based on three criteria, i.e. total assets, total deposits, and total financings. This selection is needed in order to make fair comparison among them with respect to their financing rates.

3.2. Variable Identification

In the second step, the variables which are going to be compared will be identified. Since BBA financing scheme becomes the most widely used financing in Malaysian Islamic banking industry as has been shown in the Table 1, the formula determining BBA profit rate will be used. This formula, according to Rosly (2005), is as follow:

BBA profit rate	**=**	**cost of Islamic deposits + overheads + inflation risk premium + default risk premium (spread)**

It is indeed similar to the formula of interest rate on loans which is used by conventional banks in Malaysia (Rosly, 2005). The conventional formula is as below:

Interest rate on loans	**=**	**cost of deposits + overheads + inflation risk premium + default premium (spread)**

Thus, based on the two formulas above, there are three variables that can be compared and analyzed: cost of deposits, overhead expenses, and default premium (spread). Another variable, i.e. inflation risk premium, is assumed to be identical for both Islamic and conventional banks. It is because all banks consider the same inflation rate which takes place in Malaysia.

Default premium (spread) is indicated by the Non-Performing Loan (NPL) of the conventional banks and the Non-Performing Financing (NPF) of the Islamic banks. The higher the NPL/NPF, the greater is the default premium.

3.3. Comparative Analysis

This step tries to compare the performance of selected Islamic banks and conventional banks by using the identified variables explained in the section 3.2. It is assumed that the accounting systems in Islamic banks and conventional banks have been standardized.

3.4. Sources of Data

Sources of data used in this paper are based on the annual report of each selected banks. The period of analysis is from 2002 until 2005.

3.5. Limitation of the Paper

This paper is focused on the analysis of financing rate of both Islamic banks and conventional banks. The paper‟s analysis is limited to the variables mentioned in the formula. Other factors, either economic or non-economic, are not discussed deeply in the paper.

4. Findings and Analysis

4.1. Selection of Islamic banks and Conventional banks

The table 2 below shows the data of total assets, total deposits and total financings of Islamic banks (full pledge) as at end 2005.

Table 2: Islamic Banks' (Full Fledge) Assets, Deposits and Financings as at end 2005

Bank	Asset		Deposits		Financing	
	2005	2004	2005	2004	2005	2004
Affin Bank	3,648,672	3,158,467	2,038,344	2,287,365	1,624,148	1,261,328
AmIslamic Bank	9,055,784	8,041,389	3,579,449	3,099,575	7,547,192	6,885,832
Bank Islam	15,848,906	12,958,514	13,483,171	11,268,901	10,350,738	7,985,959
Bank Muamalat	10,269,647	8,070,831	9,373,971	7,455,010	4,154,021	2,887,415
CIMB		640,357		197,416		
EON		3,935,118		2,617,550		3,455,549
HongLeong	5,816,399	1,396,770	4,889,360	885,759	3,481,226	645,416
Kuwait	515,175		128,792		1,875	
RHB	7,623,666	6,213,078	6,605,894	4,961,238	3,400,411	3,754,579

Source: Annual Report of each individual bank

From the table above, it can be observed that the top three of Islamic banks (full pledge) in terms of asset, deposits, and financings are Bank Islam, Bank Muamalat and AmIslamic Bank. Therefore, these banks will be selected to represent the Islamic banks operating in Malaysia.

Meanwhile, the table 3 below shows the data of total assets, total deposits, and total financings of commercial banks as at end 2005. The Islamic windows which operate under commercial banks are also included in the table.

Table 3: Conventional Banks' Assets, Deposits and Financings as at end 2005 RM ('000)

Bank	Asset		Deposits		Financing	
	2005	2004	2005	2004	2005	2004
ABN AMRO Bank Berhad	4,082,900	3,349,136	1,730,594	1,995,576	473,374	465,264
Affin Bank Berhad	23,691,492	16,917,944	17,842,071	12,952,948	19,252,950	11,512,912
Alliance Bank Malaysia Berhad	2,155,060	2,002,710	15,521,300	14,539,100	13,964,300	12,424,100
AmBank (M) Berhad	61,884,980	60,362,458	34,447,340	33,017,293	44,164,278	42,419,201
EON Bank Berhad		33593155		22643530		24828012
Hong Leong Bank Berhad	57,675,075	36,778,941	39,990,690	26,123,219	26,832,852	16,598,398
HSBC Bank Malaysia Berhad		33,495,898		26,556,293		19,765,414
Malayan Banking Berhad	175,434,713	143,551,149	118,275,713	96,868,877	122,794,854	93,492,595

Islamic window of Malayan Banking Berhad	21,918,101	17,056,547	15,044,703	9,957,356	17,065,565	12,761,980
OCBC Bank (Malaysia) Berhad		27,596,725		16,962,910		20,045,744
Islamic windows of OCBC Bank		1,576,225		1,098,541		887,547
Public Bank Berhad	107,364,902	88,932,718	82,205,182	68,265,639	65,716,481	54,898,009
Islamic window	8,045,900	6,629,706	6,093,087	3,491,355	7,350,507	6,312,532
of Public bank						
Southern Bank Berhad		23,826,521		14,172,425		15,839,657

Source: Annual Report of each individual bank

The top three commercial banks representing conventional side based on the table above are Malayan Banking Berhad (known as MayBank), Public Bank Berhad, and AmBank (M) Berhad. It is also interesting to note that Islamic window which operates under Malayan Banking Berhad has greater total assets, deposits and financings compared to all full pledge Islamic banks.

Hence, this Islamic window will also be included in the comparison between Islamic banks and conventional banks.

4.2. Comparative Analysis of Financing Rates

This section tries to analyze the financing rates of Islamic banks and that of conventional banks. Since the BBA (Bay Bithaman Ajil) scheme is widely used by Islamic banks including Islamic windows operating under commercial banks, and even occupies first rank of financing mode, the formula that determines the BBA rate will be taken into consideration. This formula is similar to the formula used in the conventional banks. Thus, all independent variables as mentioned in the third section will be compared and elaborated individually.

Before we analyze further, it is important to observe the data showing that the financing rates given by Islamic banks are higher than financing rates of conventional banks. Table 4 perceives this picture.

Table 4: Effective Profit / Interest Rates

List of Banks	Effective Profit/Interest Rate (%)			
	2005	2004	2003	2002
AmIslamic Bank (Full Fledge-2005)	7.97	5.40 – 8.61		
Bank Islam Malaysia Berhad	6.95	6.63		
Bank Muamalat Malaysia Berhad	6.6	6.3		
Malayan Banking Berhad	6.33	6.89	6.89	7.51
Islamic window of Malayan Banking Berhad	7.25	8.31	8.12	7.27
AmBank (M) Berhad	7.47	6.40 – 9.05	7.20 - 9.05	
Public Bank Berhad	6.11	6.47	6.4	6.75

Sources: Annual Report of each individual bank

Generally all Islamic banks including Islamic window have higher rates of financing. In the year 2005, for instance, their average financing rate is 7.19 %. If we look at the conventional banks, their average financing rates for the same year is 6.64 %.

This data shows that Islamic banks offer higher rates of financing compared to the conventional ones. In this section, we will elaborate the factors or variables that give significant contribution towards these higher financing rates.

a. Cost of (Islamic) Deposits

The table 5 below shows the percentage of cost of deposits of all selected Islamic banks and conventional commercial banks including their Islamic windows.

Table 5: Cost of (Islamic) Deposits of Islamic and Conventional Banks

List of Banks	Cost of Deposits (%)			
	2005	2004	2003*	2002*
AmIslamic Bank (Full Fledge-2005)	2.81	2.68	N/A	N/A
Bank Islam Malaysia Berhad	1.98	1.94	N/A	N/A
Bank Muamalat Malaysia Berhad	2.1	2.3	N/A	N/A
Malayan Banking Berhad	2.1	2.36	2.36	2.88
Islamic windows of Malayan Banking Berhad	2.73	2.68	2.63	3
AmBank (M) Berhad	2.96	2.70 – 3.44	2.90 – 3.44	N/A
Public Bank Berhad	2.73	2.67	2.71	3

Source: Annual Report of each individual bank

*Data is not available for full pledge Islamic banks

It can be observed that in all cases, the cost of deposits tend to increase from year to year, except in the cases of Bank Muamalat and Malayan Banking Berhad. They show a decreasing trend from 2.3 % (2004) to 2.1 % (2005) in Bank Muamalat case and from 2.36 % (2004) to 2.1 % (2005) in Malayan Banking case. If we take the average of cost of deposits in 2004, then all Islamic banks added by one Islamic window will have average deposits cost of 2.4 %. Similarly, by the same calculation method, the average deposits cost of conventional banks in the same year is equal to 2.58 % - 2.82 %. In the year 2005 the average deposits cost of Islamic banks including the Islamic window equals 2.41 %. Likewise, for the case of conventional banks, their average deposits cost is equal with 2.60 %.

All results show that the cost of Islamic deposits is less than the cost of conventional deposits. This also can be interpreted that the return on deposits paid by Islamic banks is less than the return on deposits paid by conventional banks.

Overheads Expenses – Capital Ratio

Regarding overhead/capital ratio, the table 6 below gives clear picture of comparison between full pledge Islamic banks (including one Islamic window) and conventional banks.

Table 6: Overhead/Capital ratio of Islamic banks and Conventional banks

List of Banks	Overhead/Capital			
	2005	2004	2003	2002
AmIslamic Bank (Full Fledge-2005)	0.04	0.09	0.03	0.06
Bank Islam Malaysia Berhad	0.39	0.18	0.16	0.16
Bank Muamalat Malaysia Berhad	0.27	0.28	N/A	N/A
Malayan Banking Berhad	0.14	0.14	0.13	0.12
Islamic window of Malayan Banking Berhad	0.01	0.02	0.02	0.02
AmBank (M) Berhad	0.29	0.24	0.19	0.17
Public Bank Berhad	0.11	0.10	0.15	0.16

Source: Annual Report of each individual bank (authors‟ calculation)

An Islamic Bank has the lowest overheads per capital ratio compared to other Islamic banks, though it is still less than the ratio of Islamic window of Malayan Banking Berhad. On the other hand, Public Bank has the lowest overheads per capital ratio for the last two years in the family of conventional banks. Generally, in the year 2004 the average overheads per capital ratio for Islamic banks and Islamic window from the figure above is 0.14, while for the conventional banks their average ratio is equal with 0.16. If Islamic window is excluded, then the average ratio for full pledge Islamic banks will be 0.18. It can also be analyzed that this Islamic widow is backed by Malayan Banking Berhad which is the largest bank in Malaysia. The average ratio of Islamic banks and Islamic window has increased from 0.14 to 0.18 in the year 2005. If the Islamic window is not included, then the average ratio will be 0.23. Furthermore, the average ratio for conventional banks in the same year is 0.18. It shows that in 2005, the Islamic banks are less efficient than the conventional ones.

b. Default Premium

The magnitude of default premium may actually vary from one bank to another bank, even from one financing to other financings. The way a bank does to determine this premium depends upon the character and capability of the borrowers. If they are trustable personalities then the bank may charge lesser default premium.

Another important indicator that often used by the bank is NPL (Non-Performing Loan) or NPF (Non-Performing Financing). The former is related with conventional banks while the latter is related with the Islamic ones. Since Islam does not recognize loan other than *qard hasan* (non-interest loan), the use of word "financing" is more preferable. The NPL / NPF reflect the past experience that a bank has. Through this experience, the bank can predict the magnitude of default premium according to the prevailing circumstances.

Below is the table showing the percentage of NPL of conventional banks and NPF of Islamic banks including Islamic window.

Table 7: NPL / NPF of Conventional banks / Islamic banks

List of Banks	NPL/NPF							
	2005		2004		2003		2002	
	Gross (%)	Net (%)	Gross (%)	Net (%)	Gross (%)	Net (%)	Gross (%)	Net (%)
AmIslamic Bank (Full Pledge-2005)	9.97	4.94	16.47	13.08	10.98	6.1	15.87	12.12
Bank Islam Malaysia Berhad	21.54	16.07	15.62	10.1	15.48	9.9	14.83	10.78
Bank Muamalat Malaysia Berhad	6.78	4.2	9.44	4.9				
Malayan Banking Berhad	4.68	4.83	5.75	6	11.19	5.99	12.35	6.87
Islamic window of Malayan Banking Berhad	5.94	5.82	5.76	5.79	6.83		6.04	
AmBank (M) Berhad	20.60	13.84	24.25	17.91	18.92	11.46	25.37	15.42
Public Bank Berhad	1.96	1.74	2.56	2.17	2.80	1.94	4.23	2.41

Source: Annual Report of each individual bank

From the table above, the AmIslamic Bank is seems successfully to reducing its gross NPF from 16.47 % in 2004 to 9.97 % in 2005. However, this success story is not followed by the Bank Islam Malaysia Berhad. Its NPF drastically increases from 15.62 % in 2004 to 21.54 % in 2005. Bank Muamalat, at the same time, is able to reduce its NPF from 9.44 % to 6.78 %. If we look at the conventional banks, then all of them are able to reduce their NPL. Public Bank, for example, is able to lower its NPL from 2.56 % to 1.96 % in the year 2005.

Overall, in the year 2005 the NPF of Islamic banks is 11.06 % while the NPL of conventional banks is 9.08 %. It means that the Islamic banks, as the result, have more default premium than the conventional ones since the possibility of bearing default financing is higher. In other words, they also have more bad debtors than the conventional banks.

Hence, the higher financing rates of Islamic banks are caused mainly by higher default premium and overheads per capital ratio. Universal banking concept can be proposed to be the solution for having lower financing rates. In this concept, Islamic banks are allowed to manage various businesses, such as investing its fund in different sectors, arranging re-insurance business, etc. This can be done by two ways: either they perform it by themselves or by forming subsidiaries. However, the cost of establishing subsidiaries is not cheap. The government, particularly the Bank Negara Malaysia as the sole monetary authority, should back this idea by amending Banking and Financial Institutions Act (BAFIA) 1989.

5. Conclusion

This paper is aimed to analyze the factors that create higher rates of financing of Islamic banks compared to their conventional counterpart. Bank Islam Malaysia Berhad, bank Muamalat and AmIslamic Bank are chosen to represent the Islamic banks, while

on the conventional side, Malayan Banking Berhad, Public Bank and AmBank (M) Berhad are selected. The data shows that in the year 2005, for example, the average financing rates offered by Islamic banks in Malaysia is equal with 7.19 % while on the other side, conventional banks offer 6.64 % rates averagely. A number of variables have been observed in order to explain this fact. In terms of cost of deposits, conventional banks have higher deposits cost as compared to the Islamic ones. It means that the conventional banks give higher return on deposits to their depositors. Furthermore, in terms of overheads per capital ratio, all Islamic banks including Islamic window of Malayan Banking Berhad have lower ratio in 2004 compared to their conventional counterparts. However, in 2005, they have higher ratio than the conventional banks. It is also interesting to note that the lower ratio that the Islamic banks have in 2004 was contributed significantly by Islamic window of Malayan Banking Berhad which is backed by the largest bank in Malaysia. If this window is excluded, then in both 2004 and 2005, the Islamic banks have higher ratio. In terms of default premium, it can be concluded that Islamic banks pay higher default premium since their NPF is higher than the NPL of conventional ones. Islamic banks face more bad debtors.

Generally, the factors that contribute significantly towards higher financing rates of Islamic bank are default premium and overheads per capital ratio. Universal banking system can be adopted as a solution to overcome this higher financing rate. Islamic banks should also diversify their assets. Through this method, it is expected that Islamic banks can run with larger capital base so that operating expenditure can be minimized.

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