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Research Article

DRIVERS' GROWTH OF ISLAMIC BANKING INDUSTRY: LESSON FROM MALAYSIA

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Abstract

Numerous studies focus on the Islamic banking performance, banks' growth. There are, however, very little is known about the drivers' growth of Islamic banking. The paper attempted to fill this gap. To achieve the objectives of the study, we considered government financial strategies for Islamic banking in Malaysia (Master Plan financial services 2000-2010 and Blueprint financial sector plan 2011-2020), reviews various scholarly writings on the development of Islamic banking industry, and the strategic plans of selected banks. In this context, we explored the drivers' growth Islamic banking industry in Malaysia for the period 2002-2012. The findings of the study revealed that the government strategies, high skilled banker's human resources, financial stability, foreign banks, innovative products, awareness of the customers and quality of the financial and regulatory reforms were main drivers' growth of Islamic banking in Malaysia.

Keywords: Banking Growth; Islamic Banking; Islamic Law; Regulatory Reforms; Malaysia.

Introduction

An important question in Islamic banking is what is the main drivers' growth of the Islamic banking industry with international financial regulations? In the literature, the main focus has been to analyze the relationship between Islamic banking and economic growth (Furgani and Mulyany, 2009), the efficiency of Islamic banking Industry (Sufian, 2007) or the impact of financial liberalization, reforms may influence the performance of Islamic banking in Malaysia (Elryah, 2014). However, these issues have received far less attention in the context of growth banking industry. In particular, no previous study has made an attempt to relate the growth of Islamic banking to government strategic and regulatory reforms.

In the recent world Islamic Banking Competitiveness report 2013–14 expected rapid-growth markets for QISMUT — Qatar, Indonesia, Saudi Arabia, Malaysia, UAE and Turkey — are six RGMs that, together with Bahrain, are important to the future internationalization of the Islamic banking industry by 2018 will represent GDP of US$4.8t, a mostly young population of around 419m, trade flows of US$3.6t and banking assets of US$6t (Islamic Financial services Board, 2013). Thus, Malaysia implemented the concept of Islamic banking in 1983 with the first Islamic bank called Bank Islam. The growth of the Islamic banking Industry was more rapid when the government in 1996 opened the opportunity for foreign Islamic banks. By early 2000, most of the local commercial banks had implemented the sharia law as a window of their Islamic banking products (Wasiuzzaman and Tarmizi, 2010).

Islamic banking activity consistent with Islamic law (Sharia) has become a material part of the global financial services industry, growing rapidly in both size and stature. The Malaysian Islamic assets rose 15 percent to 389.3 billion ringgit (USD$123billion), strengthening the country's position as the global hub for Shari'ah-compliant financing (Bank Negara Malaysia BNM, 2012)

In several recent studies, the causal relationship between Islamic banking growth and strategy and regulatory reforms has been invested, for instance, (Iqbal 2010) tried to model the challenges facing Islamic financial industry growth. The author argues that at the present pace of growth and weak infrastructure, the industry will face challenges in achieving sustainable growth.

Islamic banking is a recent phenomenon as compared to conventional banking which operates for more than a century. Islamic banking operates on risk sharing concept instead of interest (Riba) in conventional banking. Islamic banks due to its significant growth in assets all over the world have proved their existence in non-Muslim countries by opening Islamic banking branches / windows to cater the growing demand for its products and services (Olson, D., & Zoubi, T. A. 2008).By the same reasoning, (Khan *et al.*, 2012) focused on growth of Islamic banking in Pakistan in terms of its Deposits, Investments, Assets and Owners' Equity for the period from 2004 to 2009. They implement t-test to determine the growth rates of Islamic and Conventional banks. They concluded that the growth rates in investments and owners' equity were insignificant.

In this work, we discuss the problem of impact of government policies on Islamic banking growth, the question is then whether the government policies will be sufficiently strong to cause the growth of Islamic banking? The purpose of this study is to identify and investigates the main drivers of Islamic banking growth in Malaysia. The analysis methodology consists in specifying an econometric model which explains the relationship between the drivers' growth of Islamic banking and Malaysia's government policies.

Research Questions

In this study, we will deal with these questions: What is the main drivers' growth of the Islamic banking industry? Will Islamic banks continue to be as successful as it's started? Or will international financial regulations destroy its market share? Whether the government policies will be sufficiently strong to cause the growth of Islamic banking? How was the Islamic banking industry adapted to the new International financial regulations it operates in?

Hypotheses of the Study

H01: The greater regulatory improvement by government, the higher bank's growth.

H02: The diverse and quality of Islamic innovation products, the higher bank's growth.

H03: High level management efficiency, the higher growth will be the Islamic banks achieve.

H04: The improvement of investment environment, the higher banks' growth.

H05: The foreign banks entrance, the better bank's growth.

Islamic Banking Industry in Malaysia

Malaysian government in 1963 established Tabung Haji (the Pilgrims Management and Fund Board) to provide a systematic mobilization of funds from Muslims to assist them perform pilgrimage in Makkah as well as to participate in investment opportunities. Thus, the Malaysian government introduced a well-coordinated and systematic process of implementing the Islamic financial system; the process can be divided into four phases. The first phase is considered as the period of familiarization (1983-1992), when the government established the first Islamic bank in the country namely (Bank Islam Malaysia Berhad).

The second phase, from 1993-2003 aimed to create more conducive environment for competition in banking sector. Thus, the banks was given time to capture a larger market share. During that phase, it to awareness the Muslim people about the benefit of Islamic banking system. During that period, the government authorities (BNM) under "Islamic Banking Scheme (IBS) allowed conventional banks to offer Islamic banking services (Islamic Windows).

The third phase 2004 -2010 the period of financial liberalization (BNM, 2004). In that period, the Malaysian government invited foreign Islamic banks especially those working in GCC to operate and set up business in foreign currency. During that period, the government launched the Malaysian International Islamic financial Centre project. The BNM approved for the setting up of an International Currency Business Units (ICBU) within the Islamic financial institutions. It also for Labuan offshore Islamic banks and the divisions of the offshore banks are granted approval to establish operational offices anywhere in Malaysia.

The fourth phase that commenced from 2011, the BNM launched a ten-year Financial Sector Blueprint focuses on further strengthening the role of the financial sector to facilitate the transition toward a high value-added, high-income economy, and suggests a need for the private sector to take the lead. Thus, the Malaysian government implemented the regulatory reforms to enhance the performance of Islamic banks and to boost the market share for Islamic banking from 20% to 40% by 2020.The next section briefly reviews previous works related to this topic. We will then introduce our methodology and its results, and conclude by drawing some policy implications.

Theoretical Framework

In Malaysia, the Islamic banking has growing rapidly during and after global financial crisis in 2008. Thus, the Malaysian government has provided legal platform for the industry to grow, Malaysia invited foreign Islamic banks to set up business by foreign currency and contribute Islamic banking growth, there are 16 Islamic banks wiring in Malaysia (Elryah, 2014).

Empirical and theoretical analysis in (Iqbal and Munawar, 2001) show that the profit ratio of Islamic banks compare favourably with international standards, it should be noted that conventional banks depositors are guaranteed their principal amounts and hence bear less risk than Islamic banks depositors. Therefore, the depositors of Islamic banks would genuinely expect a higher rate of return to compensate for extra risk. The literature shows that the performance and profitability of Islamic banks are far better than selected conventional banks. The study also found that Islamic banks are comparatively much better than conventional banks in terms of assets, deposits, financing, investments, efficiency, and quality of services and recovery of loans (Awan, 2009).

In his paper, (Siddiqui 2008) finds a significant role of International banks around the world also reorganized its products structure from normal deposits to Derivatives, Hedging and Investments in order to avail profit opportunities. On the other hand, the Non-Muslims are also interested in Islamic banking products and considered it to be commercially as discussed in Brooks (1999).

While there is a large amount of empirical literature that examines Islamic Banking performance and profitability in Malaysia, few empirical studies investigate the Drivers of Islamic Banking Growth. In addition, the theoretical analysis of Furgani and Mulyany (2009) examined the dynamic interactions between Islamic banking and economic growth of Malaysia, they found that there is evidence to support demand following hypothesis of GDP and Islamic bank, where increase in GDP causes Islamic banking to develop not vice versa.

However, there are only a few studies that examine the Islamic Banking Growth (Khan *et al.*, 2012) examined the growth of Islamic banking in Pakistan in terms of total deposits, total investments; total assets and total equity of both Islamic and conventional banking during 2004 – 2009, they used chain base method. They found growth rate of deposits and assets were statistically significant, whereas growth rate in investments and owners' equity were found statistically insignificant.

There are many scholar measured the Islamic banking performance, (Ghayad, 2008; Olson and Zoubi, 2008). However, these previous studies focus on the efficiency of Islamic banking industry, distinguish between Islamic and conventional banks and corporate governance and the global performance of Islamic banks. This paper contributes to existing literature in several ways; we focus on drivers of Islamic banking growth by analyzing the strategic planning of Islamic banking and finance of Malaysia for the period 2002-2012.

Although, there are rich literatures on Islamic banking, efficiency, financial liberalization, reforms, competitiveness, performance and profitability, but no study has focused on the drivers' growth of this industry. Briefly, it is believed that there is a gap in the literature, which refers to a lack of research focusing particularly on the drivers of Islamic banking growth and development. In next section, we try cover relatively this gap at least for the selected Islamic banking in Malaysia by conducting theoretical analysis.

Data and Methodology

To explore the drivers' growth of Islamic banking industry, we review various scholarly writings on the development of Islamic banking industry, review of relevant data on banking growth, author's personal experience and association with the industry including involvement in the development of the proposed driver's growth of Islamic banking in Malaysia.

The author will investigate the Islamic banking strategies guided by the financial sector Master Plan 2000-2010, Blueprint Financial Plan 2011-2020, and consider the questionnaire for high ranking and top decision makers in Islamic banks and BNM (the Central bank). The surveying is to answer the following inquiries:

1- The strength of the Islamic banking growth based on products innovation, financial infrastructure, liquidity, management efficiency, and ownership.
2- The weakness faced the Islamic banking, based on total factor productivity, leverage, capitalization, commitment policy initiatives, regulatory improvement.
3- The opportunities that exist in the business environment that the Islamic banks could take advantage, based on, investment environment, return on assets of bank, and equity on return.
4- The threats and challenges, balance development, competitiveness of the industry compatibility political commitment. That the banks are not under control.

The information obtained was used to examine the drivers' growth of Islamic banking industry in Malaysia.

Analysis and Discussion

In this section we examine a case and give a conclusion for the case based on the related drivers' growth and regulations as well as strategies of the Bank Negara Malaysia.

Liberalization of Islamic Banks

Malaysian government continues to invite the foreign Islamic institutions to set up international business of Islamic banking in Malaysia to conduct business of foreign currency. Currently, there are 5 foreign Islamic banks working in Malaysia continue to enhance the banking stability.

Malaysia government developed strong Islamic banking and finance to face any future crises and challenges and implemented financial liberalization policy in order to integrate the Islamic banking and finance, and it was emerged as one of the leading a hub of Islamic banking and finance in Islamic countries. Thus, Malaysian Islamic banking has been on a progressive upward trend, recording an average annual growth of 49% in terms of assets over the period 1995-1999.

In 2000 the Islamic banking sector continued to register a strong asset growth of 30% to RM47.1 billion whilst deposits and financing increased to RM35.9 billion and RM20.9 billion, respectively. In terms of banks' performances, the share market Islamic banking assets reached 6.9% of the banking system by the end of 2000, while it reached 26% in 2012. We summarized the information obtained from interviews and secondary data concerning the main drivers' growth of Islamic banking Industry in Malaysia in the following:

1. The growth of the Islamic financial landscape based on instruments that can compete.

2. The Islamic banking is becoming vast expanding network branches.
3. The legal system recognized for international Islamic finance transactions.
4. Innovative and sophisticated Islamic banking products and services.
5. Strengthening of the Investment environment.
6. Establishing socio-economic justice and promoting employment and stability.
7. Islamic banking becoming a material part of global financial services and the regulatory and supervisory framework for international Islamic finance
8. Promoting trade and increasing the size of the global Islamic finance industry.
9. Excellence in customer focus, operational transformation and expanding international.
10. The significant demand for sukuk has been spurred by the high levels of surplus savings and reserves in Asia.
11. Strong legal and regulatory framework that provides a sound foundation.
12. Cross border collaborations are absolutely critical for the sustained and inclusive growth of Islamic finance.
13. Promote greater linkages and cross border flows of Islamic finance transactions to support investment, financing and trading activities between ASEAN and the GCC.
14. Huge amount of businesses and foreign companies.

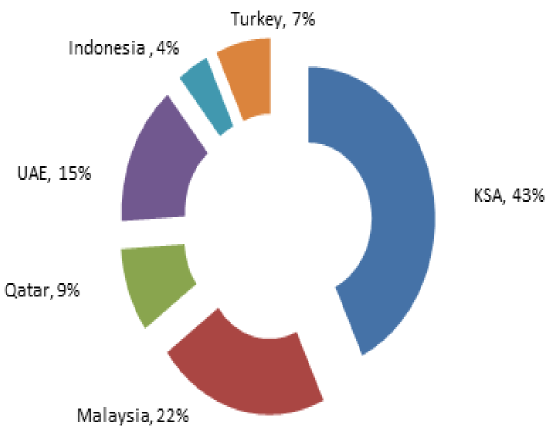

Fig. 1: Islamic Banking Assets with rapid-growth Markets 2012. [Source: Constructed by Author Using data from World Islamic Banking Competitiveness Report (2013—14)]

The figure above (Fig. 1) demonstrates the comparison the Islamic banking growth in Malaysia and some Golf Cooperation Council countries (GCC). The Islamic banking assets' growth in these countries were slowed down during the period followed the global financial crises except Kuwait and Malaysia which were showed it is highest growth 22% and 21% respectively.

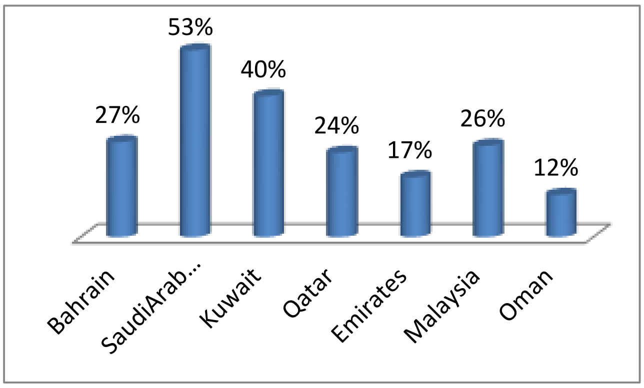

Fig. 2: Islamic Banking Market Shares as the end of 2012. [Source: Constructed by Author Using data from World Islamic Banking Competitiveness Report 2013-14]

Fig. 2 shows that such recent increase in the market shares of Islamic banking in the GCC and Malaysia. Saudi Arabia has ranked number one on the list with highest market share of 53%, Bahrain has ranked number two with a market share of 27 %, while Malaysia has ranked third among the group 26%. Thus, Malaysian authorities intend to reach 40% market share of Islamic banking by 2020 (Aziz 2009-2012).

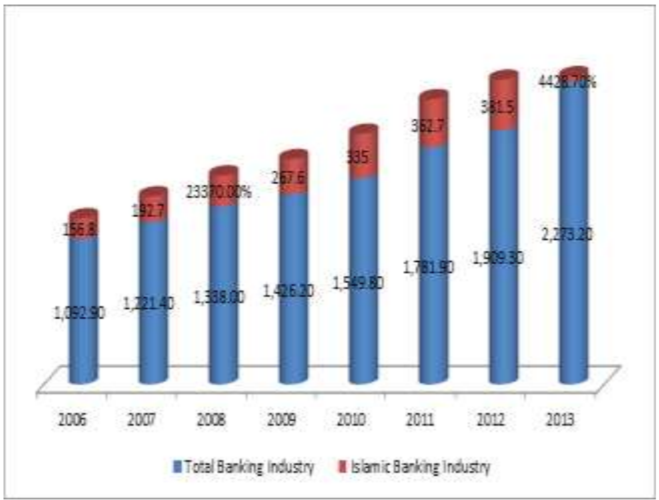

Fig. 3: Islamic banking assets vs. total Industry [Source: BNM, 2014.]

The Fig. 3 shows that the assets of Islamic banking increased from RM233.7 bn in 2008 to RM381.5 bn in 2013, while the total industry was increased from RM1.338 bn and RM1.909.3bn for the same period. It also shows the Compound Annual Growth Rate CAGR of 19.5% is higher than total banking industry. According to BNM the Islamic banking assets in Malaysia totalled RM434 bn at end-May 2014, representing 21% of total banking-system assets versus 16% at end-2009.

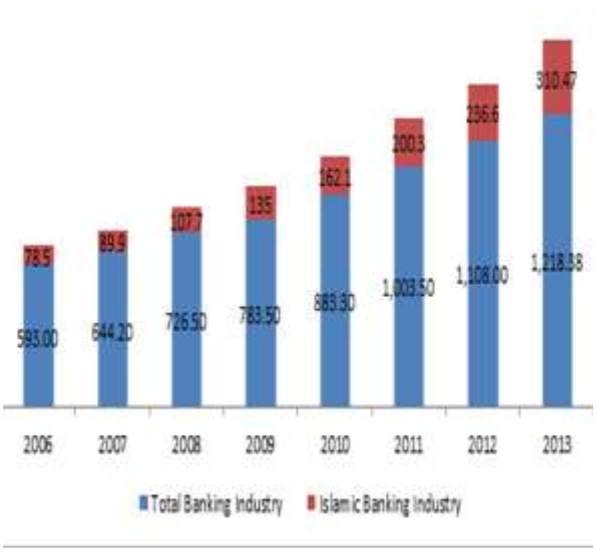

Fig. 4: Islamic banking financing vs. total industry [Source: BNM, bank Islam 2014.]

The Fig. 4 illustrates the differences in total industry and Islamic banking financing levels. The financing of the total banking industry for 2008 and 2013 by RM726.5 bn and 1.218.38, respectively, while the Islamic banking financing growth was increased from RM107.7 bn to RM310.47 bn for the same period with 18.1% higher than total banking financing growth.

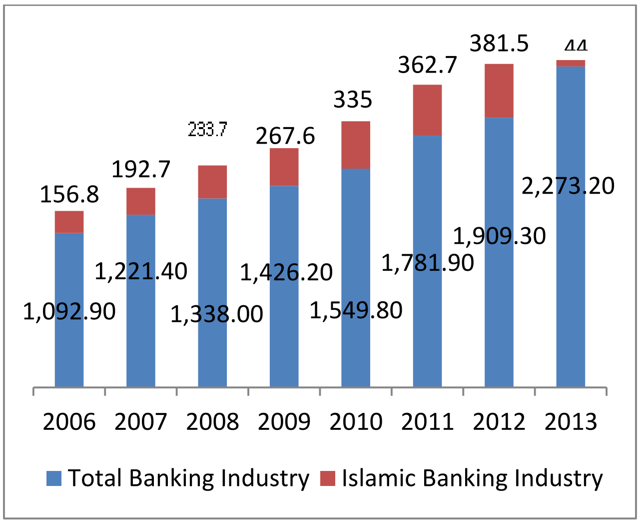

Fig. 5: Islamic banking deposits vs. total industry. [Source: BNM, bank Islam Berhad 2014.]

The figure above (Fig. 5) demonstrates the differences between Islamic and total banking industry deposits. Islamic banking is growing higher than total industry during the period 2010, 2011 and 2012

As the competition becoming stronger, Malaysian Islamic banks adopted a more sophisticated to satisfy the current and future customers' needs. It believed one of the drivers' growth of the industry, blueprint plan will increase the efficiency and sustain the growth of Islamic banks. The government strategy is to covet the market share of Islamic banks to 40% by 2020 from the current market share 25%.

Islamic Banking Products

With increasing to Islamic innovative products (more than 100), Malaysia have opportunity to strengthen Islamic Banking and finance started working closely with Arab regulators, especially those of Bahrain, the United Arab Emirates, the International Monetary Fund (IMF), the Islamic Development Bank (IDB) and the Basel committee, the Islamic Financial Services Board(IFSB) issued a draft in 2005 on Basel 2 rules for Islamic institutions, the infrastructure, capacity building and human resources development, domestic players with global centre of fund flows linkages, ambition to be the international Islamic financial hub, set-up a billion dollar Islamic Finance institution. Thus, Islamic banking industry in Malaysia has opportunity to continue to grow further. The future opportunities can presented are as follows:

1. Ambition to be the international Islamic financial hub
2. Islamic finance has been accepted by both Muslims and non-Muslims due to continuous awareness program and customer experience.
3. Innovative products are the key factor to push Islamic banking to a higher level.
4. Wider variety of products and services, there is also expectation of shift from the conventional banking to the Islamic banking".
5. Create partnerships between Malaysian and global banks, particularly those in the Middle East.
6. Conventional banks continue to launch Islamic windows.

With regard to the first hypothesis, the results show that the clarity of legal and regulatory initiated by Malaysian government has been enhanced the higher bank's growth. Thus, the BNM introduced the Islamic financial services Act (2013) to provide greater regulatory clarity and to distinguish deposits made for savings and those made for investment which is causing significant to retail portfolios, Development Financial Institutions Act DFIA (2002), and Government Funding Act 2005.

With regard to the second hypothesis, the diverse and quality of Islamic innovation products have believed one of the main drivers' growth of Islamic banking industry in Malaysia. Currently, there are 17 Islamic banks, 10 Islamic windows, 6 DFIs offering Islamic banking, 6 International Islamic Banks, 14 International Currency Business Unit suffering more than 100 Islamic products in Malaysia.

With regard to the third hypothesis, Malaysia has intended to develop the Islamic banking industry. Thus, the BNM planned the industry to reach 40% market share of banking sector by 2020. Therefore, the competition amongst market participants will promote the Islamic banking growth. Therefore, it is expected to that the high level management in Islamic banking will contribute the higher growth.

With regard to the fourth hypothesis, the business environment in Malaysia is one of the drivers' growth of economic development in general and Islamic banking industry in particular. In this context, the Islamic banks experiences growth during and after global financial crisis in 2007-2008. Thus, the business environment in Malaysia helped Islamic banking industry to grow and to become the third largest international hubs for Islamic finance around the globe.

With regard to the fifth hypothesis, there are many foreign financial institutions working in Malaysia, the ongoing financial liberalization and reforms will create opportunities for partnerships between Malaysian and Middle Eastern banks, which may become a key driver for growth of Islamic banking in Malaysia.

Conclusion

In conclusion, while Malaysian Islamic banking continues to have a positive growth in some ways, serious questions is asked conventional regulators about will Islamic banks continue to be as successful as it's started? Or will international financial regulations destroy its market share? And whether the government policies will be sufficiently strong to cause the growth of Islamic banking?

The hypotheses were created to find that the government strategies, management efficiency, quality of Islamic innovation products, improvement of investment environment, foreign banks entrance, and greater regulatory improvement by government and better reforms lead to a higher banks' growth.

To test these hypotheses, we analyzed the strategic of financial system, the recent reforms, and financial services Master, financial sector blueprint, and selected banks strategies plans during 2002-2012. We also used theoretical methods to explore the effects of these policies on Islamic banking growth.

On findings concluded macroeconomic growth will drive the growth of Islamic banking leading to further growth of sharia-compliant banking.

Our key results indicate that there are many conventional banks converted their operations to become Shariah compliant which will enhance the growth of Islamic banking. To conclude, we can say that our results arising from our method showed a significant effect of the government policies, high skilled banker's human resources, financial stability, foreign banks, innovative products, awareness of the customers and quality of the financial and regulatory reforms are the main drivers of Islamic banking growth in Malaysia.

Finally, we generally recommended to the bankers have to improve the uniformity between Sharia's views and transparency regarding the application of sharia, places a huge burden on the marketing of Islamic financial services. Also one of the big challenges that Malaysian Islamic banks have been faced is contracts drawn up may not be recognized in Middle Eastern states. Islamic bankers use alternative structures to deliver products with similar benefits to their conventional counterparts, the Malaysian government introduce reforms to Islamic banking to grow up to reach 40% of market share by the end of 2020.

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