THE MALAYSIAN ISLAMIC BANKING SECTOR VIEWED THROUGH SYSTEMS THEORY

BY

RIASAT AMIN IMON

A thesis submitted in fulfilment of the requirement for the degree of Doctor of Philosophy (Economics)

Kulliyyah of Economics and Management Sciences
International Islamic University Malaysia

AUGUST 2018

ABSTRACT

The main objective of this research is to understand how the Malaysian Islamic commercial banking system (MICBS) has been developing. There are two main concerns of MICBS that this research addresses. The first is the declining performance of the MICBS. The second concern is how the MICBS has developed according to conventional standards despite constant criticism of its reliance on short-term, debt-based modes of finance. The main argument of this thesis is that both these problems arise because of the restricted scope of economic methodology. To remedy this problem, this research uses Systems Theory to broaden the analysis of MICBS. Applying this economic systems methodology to the MICBS reveals that the development of the MICBS depends on the interaction between the internal incentives (the corporate governance framework) and external incentives (the *Shariah* governance framework) within the MICBS. Ultimately, the internal incentives overpower the external ones, which leads to the MICBS emulating the conventional banking system. The systems methodology is also used to identify non-mainstream conventional banking models that may serve as an alternative guide that would bring MICBS closer to its original founding values. Specifically, this research proposes that the German Banking System (GBS) would allow the MICBS to develop according to some its original values, especially in terms of real sector contribution and development. However, future research should investigate other alternative banking systems in terms of their ability to aid MICBS-development. Overall, this research reveals the importance of methodology in the development of the MICBS. The systems level analysis of the MICBS proves that there are other alternative models that can help MICBS develop in a way that is more consistent with its values.

خلاصة البحث

إن الباعث لإجراء هذا البحث يكمن في مسار التطور الجاري للبنوك الإسلامية التجارية في ماليزيا، فهذا البحث يركز على محورين أساسيين في هذا السياق: المحور الاول والملاحظ حديثا هو انحدار مستوى الأداء لتلك البنوك، والمحور الثاني هو كيفية تطور تلك البنوك بناء على معايير التقييم في البنوك التقليدية رغم الانتقاد المستمر لاعتمادها في التمويل على أدوات الدين قصيرة الاجل، يتركز النقاش في هذه الأطروحة لإثبات إن السبب في كلتا المشكلتين مصدره محدودية نطاق وطبيعة مناهج البحث في الاقتصاد، ويطرح البحث استعمال نظرية الأنظمة لتوسيع نطاق التحليل والتصدي لهذه المشكلة، حيث تقوم منهجية هذه النظرية (نظرية الأنظمة الاقتصادية) في سياق تطور البنوك الإسلامية التجارية في ماليزيا على التفاعل بين المحفزات الداخلية (إطار حوكمة الشركات) والمحفزات الخارجية (إطار الحوكمة الشرعية)، حيث تتغلب المحفزات الداخلية على المحفزات الخارجية مما يؤدي إلى مجاراة ومحاكاة البنوك الإسلامية لنظيرتها التقليدية، هذه المنهجية أيضا تم استعمالها للتعرف على أنظمة أخرى للبنوك التقليدية من حيث صلاحيتها لتكون بديلا لقيادة البنوك الإسلامية التجارية في ماليزيا نحو القيم الأصيلة التي بنيت عليها، ويقترح الباحث النظام المصرفي الألماني كبديل يسمح بتطور البنوك الإسلامية التجارية بناء على قيمها الأصيلة خصوصا فيما يتعلق بارتباطها بالقطاع الاقتصادي الحقيقي والتنمية، كما يوصي الباحث بالقيام بدراسات أخرى في المستقبل للبحث عن أنظمة مصرفية بديلة تسهم في تطور البنوك الإسلامية التجارية في ماليزيا، وبشكل عام يكشف هذا البحث أهمية المنهجية في دراسة تطور البنوك الإسلامية التجارية وإمكانية إيجاد بدائل لنماذج يمكن أن تخدمها في تطور يتسق مع القيم الأصيلة التي بنيت عليها

APPROVAL PAGE

The thesis of Riasat Amin Imon has been approved by the following:

Mohamed Aslam Bin Mohamed Haneef
Supervisor

Mustafa Omar Mohammed
Co-Supervisor

Maya Puspa Rahman
Internal Examiner

Ma'bid Ali Al-Jarhi
External Examiner

Md Yousuf Ali
Chairman

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Riasat Amin Imon

Signature .... Date ....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

DECLARATION OF COPYRIGHT AND AFFIRMATION OF FAIR USE OF UNPUBLISHED RESEARCH

THE MALAYSIAN ISLAMIC BANKING SECTOR VIEWED THROUGH SYSTEMS THEORY

I declare that the copyright holders of this dissertation are jointly owned by the student and IIUM.

No part of this unpublished research may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission of the copyright holder except as provided below

1. Any material contained in or derived from this unpublished research may be used by others in their writing with due acknowledgement.

2. IIUM or its library will have the right to make and transmit copies (print or electronic) for institutional and academic purposes.

3. The IIUM library will have the right to make, store in a retrieved system and supply copies of this unpublished research if requested by other universities and research libraries.

By signing this form, I acknowledged that I have read and understand the IIUM Intellectual Property Right and Commercialization policy.

Affirmed by Riasat Amin Imon

……..……………………..	………………………..
Signature	Date

ACKNOWLEDGEMENTS

Nothing is, without His Permission, and the eighty two thousand eight hundred and odd words that adorn these three hundred and thirty seven pages, is no exception to this fact. Were it not for His Infinite Mercy and Blessings, this dissertation could have easily lost its purpose. It is only You my Lord, Who Has Granted me each and every conceivable support to endure, including the people around me, whose countless sacrifices are the driving force behind the biggest ideas to the minutest of punctuation marks in this thesis; people to whom I must now turn and thank profusely.

To my dearest parents, I am forever indebted to you for your hardship and sacrifices. Your unpretentious, unconditional love and concern throughout my life, even at the cost of your own health, has always been as genuine as it has been hidden from plain sight. But like the quiet, unrelenting flow of water that shapes the most stubborn of bedrock, you have chiselled me into my best form. I am truly grateful to you for everything you have done and still do. I must also thank my sisters whose advice and help has always been instrumental to my wellbeing. To my parents-in-law who have readily accepted me as their own, I owe my gratitude for not only endearingly offering me their counsel, but for their determined and meaningful intervention when they thought it best for me.

To my respected supervisor, Professor Dr. Mohamed Aslam Haneef, for whom I have the utmost regard, I am extremely fortunate to have you as my mentor. Where others judged me, you defended me and where others saw flaws, you saw potential. Thank you for your trust in my abilities, your unselfish flexibility and your constant guidance. It made all the difference in my attitude and ability to persevere. To my co-supervisor, Associate Professor Dr. Mustafa Omar Mohammed, thank you for giving me the liberty to consult you at any given time, and for giving my thesis more pointed purpose. Your advice in all matters spiritual will also always be very close to me.

There are so many others whose support is crucial to the realization of this dissertation, including Professor Dr. Rokiah Alavi and Dr. Ibrahim Nuhu Tahir, as well as all my lecturers from the Kulliyyah of Economics. The department has always given me the benefit of the doubt for which I am immensely grateful. To my dearest friends who have always been there like Muhammad Abdul Latif, Danial Rahman, Haroon Shawkat Ali and Muneeb Bin Yusuf, I am deeply indebted to each and every one of you for your constant support and care. I could not have asked for dearer friends.

Finally, the person most deserving of my gratitude is my beloved wife, Sarah, who has sacrificed just about everything to see this thesis through. This achievement is hers as much as it is mine. Sarah, your belief in me and your willingness to stand by me through the bitter and the worst is as admirable as it is astounding. You have given, and given. And given. Your resilience and determination is nothing short of stellar and you have left me in absolute awe. My love, I am truly blessed to have been chosen by you, and I will always feel indebted and grateful to you. Thank you from my heart of hearts.

TABLE OF CONTENTS

PART II: CHAPTER THREE

LIST OF TABLES

LIST OF DIAGRAMS

LIST OF ABBREVIATIONS

3PBS – 3 Pillar Banking System

ABM – Agent-Based Model

BIMB – Bank Islam Malaysia Berhad

BNM – Bank Negara Malaysia

CCB/s – Conventional Commercial Bank/s

CFS – Conventional Financial System/Sector

CGF – Corporate Governance Framework

DCR – Displacement Commercial Risk

ESWA – Economic Systems Worldview Attribution

IBF – Islamic Banking and Finance

IBS – Islamic Banking Scheme

ICB/s – Islamic Commercial Bank/s

ICBS – Islamic Commercial Banking System

IE – Islamic Economics

IFS – Islamic Financial System/Sector

IFSA – Islamic Financial Services Act

IIMM – Islamic Interbank Money Market

FFIB – Full Fledged Islamic Bank

GBS – German Banking System

GST – General Systems Theory

GTM – Game Theory Model

MCCBS – Malaysian Conventional Commercial Banking System

MICBS – Malaysian Islamic Commercial Banking System

PAM – Purposeful Activity Model

PLS – Profit and Loss Sharing

RD/s – Root Definition/s

RRR – Rate of Return Risk

SAC – *Shariah* Advisory Council

SC – *Shariah Committee*

SCE – Structural-Change Exclusion

SICB/s – Subsidiary Islamic Commercial Bank/s

SNR – *Shariah* Noncompliance Risk

SSM – Soft Systems Methodology

TMT – Too Many Theories

WIB – Window-based Islamic Bank

WICB – Window-based ICBs

CHAPTER ONE

INTRODUCTION

1.0 MALAYSIAN ISLAMIC COMMERCIAL BANKING SYSTEM (MICBS)

The earliest Islamic commercial banks (ICBs) can be traced back to the early 1950s in Pakistan, and 1960s in Malaysia's Tabung Haji initiative and Egypt's rural Mith Ghamr project in 1963. Each of these pioneering initiatives were founded on Islamic edicts such as interest prohibition and values such as mutually beneficial (profit or risk-sharing) contracts. After a half-century worth of growth and development, contemporary Islamic banking has matured into a $1.8 trillion[1] global industry, and even spans countries with Muslim minority populations such as the UK, France and the US. It is clear that Islamic commercial banks (ICBs) are a permanent fixture of modern, contemporary, Islamic financial systems.

However, the nature and quality of this unprecedented growth is equally important. Since its inception, there have also been concerns regarding the development of the Malaysian Islamic Commercial Banking System (MICBS). These concerns originate from the founding goals of Malaysian Islamic commercial banks (MICBs). In the context of this research, a concern in the MICBS is defined as trepidation that results from the MICBS falling short of any of its key aims. This research identifies two such aims that the author considers central to the concerns arising within the MICBS. The first is the aim that the MICBS becomes the global hub for Islamic banking. The importance of this particular goal is reflected by its inclusion in the Financial Sector Master Plan (FSMP). The FSMP is a blueprint designed by the Malaysian federal

[1] Global Islamic Financial Report 2012,

monetary authority, Bank Negara (BNM), of the Malaysian financial sector. The concern arises out of recent performance data, which indicates that the MICBS may be falling short of its goal to corner the global Islamic financial market. Domestic statistics, according to EY's well known annual publication, the World Islamic Banking Competitiveness Report (Ernst and Young, 2016); show that the growth rate of the MICBS fell from 1.6% in 2011 to 0.6% in 2014. The report refers to the decline as a possible stabilizing point of the MICBS[2], which clearly does not reflect its global mandate.

The same report states the median asset-growth rate (or CAGR) as 7% (for the four years up to 2014). However, this rate has been declining since 2011. Whereas the growth rate was above the 20% mark in that year, it had constantly declined to its lowest point (4%) by the end of the study-period (2014). These statistics clearly hint at some form of slowdown or saturation. The report concludes that the MICBS "… needs to diversify its sources of income by substantially enhancing its low risk, fee-based income streams to address its under-performance in terms of its ROE" (Ernst and Young, 2016:50). The phrase "low risk, fee-based income streams" refers to the MICBS' main source of revenue, and it calls for these sources to be substantially enhanced. Phrases such as these along with "under-performance" connotes the idea that the MICBS will not move forward in its present form, but should alter its practices in some way to carry on progressing. The publication also reports the market share at 21.3%, whereas Saudi Arabia has breached the 50% milestone. It is clear why these trends are a cause for concern.

[2] Stabilization is suggested in the context of the current market penetration strategies of the MICBS (which may change in future)

The second major concern regarding the development of the MICBS relates to its focus and reliance on debt-based financial activities. As previously stated, each concern takes root in a founding ideal. In this case, the original concept of ICB was envisioned to be a financial system that would not only be interest-free, but would also maintain close ties to the real sector by emphasizing risk-sharing mechanisms (equity-based transactions) and avoiding risk-transfer activities (debt-financing). This way, ICB would be able to differentiate itself from conventional practices, and offer alternative services that are just to both parties of a financial contract. Reality has painted a different picture unfortunately. According to BNM's latest health-report on the Malaysian Banking sector, the Financial Stability and Payment Systems Report 2016 (Bank Negara Malaysia, 2017) maintains equity financing at 12.2% of total ICB deposits. As such, equity financing has never gained the prominence it was expected to over the forty-plus years of MICBS development.

Its reliance on retail financing has raised another related concern: that the MICBS has not only abandoned its founding objective, but has done so in order to follow the conventional banking sector. This has been mentioned by the prominent voices of the academia and research such as Ariff (2014) and Mirakhor (2010). There are other more long term, systemic, social costs of facilitating and extending the debt-base of a country, such as, exposing future generations to financial vulnerability through debt-contracts.

The fact that the MICBS has not achieved either of these cornerstone objectives over the last forty years indicates towards the possibility of a deeper, underlying problem within its developmental framework. Notwithstanding the issue of MICBS' growth and its fixation on retail financing, it may still be argued that these issues do not warrant an inquiry into the developmental nature of MICBS. However, there are other important justifications for this research, such as, the corporate social responsibility (CSR) of banks. This is an important criterion since economic institutions, in accordance with the Islamic value system, are required to contribute positively towards society. Unfortunately, research indicates that though CSR is viewed as a necessary component of MICBS by practitioners (Wan Jusoh and Ibrahim, 2017) as well as other stakeholders (Dusuki, 2005), the MICBS is still found to be wanting in terms of its social contribution (Nor and Hashim, 2015). In fact, Nor and Hashim (2015) also find that practitioners themselves believe that a formal CSR framework is necessary for effective disbursement of social duties—but is also found to be non-existent. Thus, MICBS does not fulfill its social responsibilities and nor has it been able to structurally ./develop a framework over the last four decades of its existence. This also points towards a possible structural developmental problem within MICBS.

The main purpose of this introductory chapter is to investigate these developmental concerns so that a workable hypothesis about the developmental problem/s of the MICBS, can be determined. In other words, the aim of this introductory chapter is to attempt to answer the question: What is the root cause of ICB not being able to achieve its developmental goals or aims?

1.1 A NARRATIVE OF THE MICBS PROBLEM

The nature of this study necessitates an unorthodox structure because the exact nature of the problem of the MICBS is not agreed upon. In such scenarios, the problem needs to be traced to its source so that it can be better understood. The narrative process used here allows this. It entails the identification of the apparent problem, then the "tracing" of this problem by understanding its context, then characterizing or contextualizing it according to its context. Once the context of the problem is understood, the root problem can then be rationalized and hypothesized. Finally, the framework for testing the hypothesis can be determined. Diagram 1.1 depicts this process.

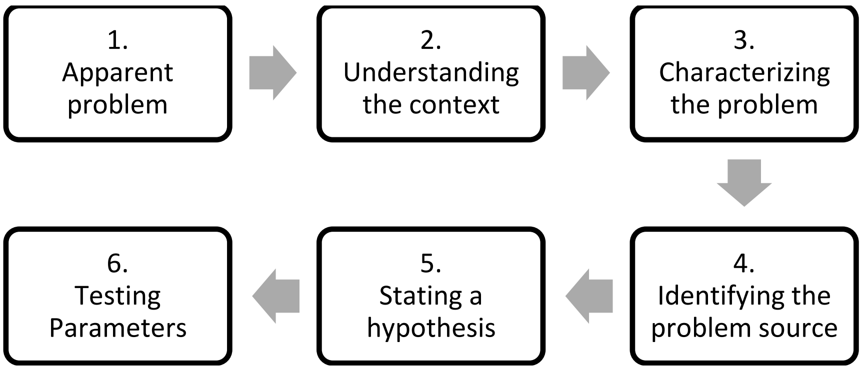

Diagram 1.1: A Narrative Approach for Problem-Identification

As seen above, the narrative approach is more meticulous about the background and context of the problem. It not only facilitates the tracing and characterization of problems, but also expedites transparency in the process, so that observers may vet the process and weigh in where necessary. Logically, this means that the transparency afforded by the narrative approach in the problem selection process leads to a problem identification and selection process of higher quality.

The main drawback of a narrative approach is that it adds length to the introductory chapter (as can be seen by the additional stages in the diagram), which is counterintuitive to the notion of "summarizing the research problem and its parameters". However, the benefits of transparency (meticulousness) clearly outweigh the costs (duration). It can even be argued that this is a necessary step in research where the characterization and contextualization of the research problem is critical, as is the case here.

1.1.1 The Apparent Problem: Two Groups of MICBS Critics

In order to understand the apparent problem of the MICBS, there is a need to understand two groups of critics who are central to the development of the MICBS. The first group who are concerned about the recent performance shortcomings in the MICBS are referred to as "mainstreamists", while the second group who are concerned about a deviation from ICB norms, are labeled as "structuralists".

1.1.1.1 Mainstreamists: Conventional Emulation

"Mainstreamists" are so named to reflect their leanings towards conventional, mainstream banking practices. In general, adherents believe the best way to develop the MICBS is to use bank strategies and frameworks that have been developed by the already mature, conventional, mainstream banking system, so long as these do not contradict *Shariah* compliance regulations. Mainstream banking is commonly referred to as the US banking model (the US banking system was the first to move from the classical or universal banking model to the present-day commercial banks), or the Anglo-Saxon banking model (as a reference to the common banking system used by English speaking countries including the US, Canada, the UK, New Zealand and Australia). Mainstreamists support development within the present framework of the

MICBS[3], but want it to improve by overcoming some of its deficiencies as a fledgling industry that hold it back. They are generally critical of issues that prevent the MICBS from effectively competing against their conventional counterparts. Thus, mainstreamists, for example, would support financial engineering and product development that follows conventional banking trends. This has led to the accusation that the MICBS is mimicking the Malaysian conventional commercial banking system (MCCBS). However, mainstreamists view the targeting of the same markets as the MCCBS as healthy, competitive behavior that will allow the MICBS to further develop. As such, it is fine for the MICBS to emulate the MCCBS in their designs so long as the current *Shariah*-compliance mechanisms are in place to safeguard Islamic ethical values (Bakar, 2016).

The guiding principles of mainstreamists are best understood through two very prominent practitioners in the MICBS. The first person, Dato' Dr. Abdul Halim bin Haji Ismail, has earned the title of the Father of the MICBS, because of his role in its establishment and development (Dusuki, 2007). The 2014 Islamic Finance Royal Award winner was the former Managing Director of Bank Islam Malaysia Berhad from 1983 – 1994, who pioneered the core design of the organizational framework of the Malaysian Islamic commercial bank (MICB), including its operating procedures. In addition, Ismail has been a member of the *Shariah* Advisory Council (SAC) of the Malaysian central bank (BNM) from 1997 – 2013). Despite critics citing the core model of the MICBS as one of the key-reasons for MICBS gravitating towards CCB-like practices, Ismail has firmly maintained that the key point of demarcation between the MICBS and MCCBS, lies in the former's contracts being in line with *Shariah*-

[3] Present form refers to the current practices and design of the Malaysian ICB framework also known as the contemporary Malaysian Islamic banking framework.