UNIVERSITI PUTRA MALAYSIA

# A STUDY ON CUSTOMERS AWARENESS OF ISLAMIC BANKING SCHEME: HONG LEONG FINANCE BHD

ROZAIN BIN DAUD

GSM 1999 28

# A STUDY ON CUSTOMERS AWARENESS OF ISLAMIC BANKING SCHEME : HONG LEONG FINANCE BHD

ROZAIN BIN DAUD

FACULTY OF ECONOMICS AND MANAGEMENT
UNIVERSITY PUTRA MALAYSIA
SERDANG, SELANGOR
1999

# A STUDY ON CUSTOMERS AWARENESS

# OF ISLAMIC BANKING SCHEME :

# HONG LEONG FINANCE BHD


**ROZAIN BIN DAUD**
**GSO 1394**


***Master of Business Administration***

A project paper submitted to
The Faculty of Economics and Management
in partial fulfillment of the requirement for the
Master of Business Administration


**FACULTY OF ECONOMICS AND MANAGEMENT**
**UNIVERSITY PUTRA MALAYSIA**
**SERDANG, SELANGOR**

**1999**

*Specially dedicated to my wife, Misah and my childrens, Firdaus, Faiz, Fahmi, Farhan, Fatinah, Faris and my mother and family members...*

#### *ACKNOWLEDGMENTS*

*I would like to express my sincere gratitude and thankful to my supervisor, Dr. Mohamad Ali bin Abdul Hamid for his invaluable guidance, comments, suggestions throughout the preparation of this project paper.*

*I also wish to express thankful to the branch managers who had given cooperation in getting respondents for this survey. Special thanks also goes to Zulkarnain Muhamad Sori for his guidance during data processing analysis and materials for the study.*

*I also wish to express my heartfelt appreciation and inexpressible debt to my wife, Misah*
*and my childrens, Firdaus, Faiz, Fahmi, Farhan, Fatinah and Faris for their patience and support during the years of my study. It also goes to my dearest mother and family members who had given all the support and prayers that I needed.*

*Rozain Daud*
*September/October 1999*

# *ABSTRACT*

## A STUDY ON CUSTOMERS AWARENESS OF ISLAMIC BANKING SCHEME: HONG LEONG FINANCE BHD

In Malaysia, Bank Islam Malaysia Bhd is the first Islamic bank in this country and it is still the only one Islamic bank. Realizing the need of the Muslims to transact in an interest-free environment and allowable under the syari'ah, the government through its banking system regulatory arm, Bank Negara Malaysia had allowed the conventional banks to have Islamic banking services parallel to the conventional system. The system so far has proceeded effectively and have gained tremendous response from the public, Muslims and non-Muslims.

This study is aimed at identifying the awareness among the customers of Hong Leong Finance Bhd as to the factors that encouraged them to have an Islamic banking account, and also to those that have not opened an Islamic banking facility, the reasons for them not opening one. The study revealed that the main factors that influence them are the 1) profit sharing concept 2) It's free of Riba' or interest 3) It has both loans and deposits services 4) the profit sharing rate is fair. Besides, it is also available to all and they are aware that only certain financial institutions offers Islamic banking scheme. Factors that influence the customers not opening the accounts are 1) the products were not attractive 2) not much variety of products 3)not much publicity/promotions. The secondary factor is that they are satisfied with the conventional banking.

# TABLE OF CONTENTS

## CHAPTER FIVE : RESULTS AND ANALYSIS

## LIST OF TABLES

# LIST OF APPENDICES

# CHAPTER ONE

# INTRODUCTION

## 1.1 History and Development of Islamic Banking

One of the basic changes envisaged in the wake of the Islamic transformation of a modern economy is the replacement of institution of interest by institutions whose statutes, rules and procedures expressly state their commitment to the principles of Islamic shari'ah[1]. To conform with the principles of Islamic law, many Islamic countries have sought to revive Islamic financial practices in what is becoming known as 'Islamic banking'. 'Islamic banking' is the conduct of banking operations in accordance with Islamic teachings (Ahmad, 1994). This banking is essentially based on principles of profit- and loss-sharing which allows for conformity to Islamic ethical principles.

The establishment of Islamic bank and the emergence of interest-free transactions in the banking system and has created an opportunity for the Muslims to safely engaged in their banking transactions in a legitimate way. The main principles of Islamic banking activities comprise of prohibition of interest in all forms of transaction, undertaking business and trade activities on the basis of fair and legitimate profit,

[1]Shari`ah is a comprehensive principle of the total way of life Denny (1985), shari`ah comprises all that might be positively called law and occupies the central place in the Islamic system of final authority

giving zakat (alms tax), prohibition of monopoly, and cooperation for the benefit of society and development of all 'halal'[2] aspects of business that are not prohibited by Islam (Khan, 1983).

The history of Islamic banking activities can be traced back to the birth of Islam. Unlike the conventional banks which continued to progress over time, the Islamic banking concepts which were pioneered in the early years of Islam failed to expand into a complete banking system. Homoud (1985) suggest that the dark ages of the European Continent was a cause for the backwardness, not only in the European but also in Islamic countries, leading to the severance of link with all forms of Islamic banking practice which had existed in earlier times.

The late 19th and early 20th century is widely known as the beginning of an era of Islamic resurgence (Sudin Haron & Bala Shanmugam, 1997). As the Islamic banking concepts awareness took place within many Islamic communities especially at the end of the 1960s and in the early 1970s, Islamic banks emerged from within. The growth of Islamic banking during the last two decades has been extremely impressive and there is little doubt that, with the large customer base, Islamic banking are not merely a passing phenomenon (Wilson, 1990).

Currently in Arab and Muslim countries, a new banking system on Islamic economics principle is rapidly developing. Attempts at establishing such banks have been going on for over 30 years; the first having started in Egypt in the early sixties in

[2] Licit as oppose to illicit or 'haram'

the village of Mit-Ghamr. It proved quite successful but was then closed down apparently for political reasons. Nevertheless, the venture laid the seeds of modern profit-sharing banking system. Soon afterwards, more banks were opened, the first being the Islamic Development Bank (an intergovernmental bank), set up in 1975.

Some of the Islamic banks are the Dubai Islamic bank (1975), Kuwait Finance House (1977), Faisal Islamic Bank of Egypt (1977), Faisal Islamic Bank of Sudan (1973), Jordan Islamic Bank (1978), Bahrain Islamic Bank (1975), Islamic Banking System, Luxembourg (1980), Islamic Bank of Malaysia (1983) and Islamic Bank of Mauritania (1983).

Malaysia is the only country with the best government support for Islamic banking. It means a measured quality support by the finance and banking authorities of the country using the full force of the various ministries and the central bank and promoting the profit-and-loss sharing Islamic banking as a viable alternative to the riba-based conventional banking (Business Times, 7 May 1993).

Islam prohibits riba', which is commonly known as interest in all kinds of loan. In the conventional banking system where lending is concerned, interest is a fixed payment in addition to the principal sum that is required to be repaid by the borrower to the bank. It is normally worked out on the basis of fixed rate. The depositors of the banks also gets interest on their deposits which is normally at a lower rate as compared to lending.

## 1.2 The Malaysian Banking System

### 1.2.1 Commercial Banks

Banking in Malaysia is more than 100 years old and the first commercial bank to be established in the country was a branch of the Chartered Mercantile Bank of India, London and China in Penang in 1859 (Johnson Pang, 1991). In the early days, commercial banks were commonly known as "exchange banks" as their business was predominantly confined to financing of external trade by way of overdraft, packing credits, various forms of trade bills and foreign exchange transactions. Since then, the evolution of the banking and financial system has been profound, especially in the 1970's with the rapid expansion of the local banks and their branch network. As of 31st December, 1998 there are 38 commercial banks 10 merchant banks and 39 finance companies.

### 1.2.2 Islamic Banking

Practically all existing Islamic banks were established and operated where the system of interest persist. Islamization of the banking system has been phased to avoid any abrupt changes which might cause unpredictable disarray in the economy (Zakariya Man, 1988). According to this approach, Islamization of the banking sector is to be implemented by first establishing a model Islamic bank side by side with the existing interest-based banks. It is hoped through time, the superiority of the Islamic banking model will cause the practice of interest-based banking to be phased out without any adverse effect on the economy.

The progress of Islamic banking in Malaysia is not peculiar and it co-exist with the conventional banks. Islamic banking system in Malaysia is considered to be more progressive compared to the systems of other Muslim countries. It's history began when the Bank Islam Malaysia Berhad (BIMB) was established in 1983 and now it is complemented by the Islamic financial market, Islamic windows, and the Islamic stock market. It has been the model for Islamic banks in Indonesia and Brunei. It is to note that the establishment of BIMB marked the commitment of the Malaysian government to introduce Islamic banking in Malaysia, the present government, however, does not have any intentions of Islamization of the entire financial system. It is the long term objective of the Central Bank of Malaysia to create an Islamic banking system parallel to the conventional system.

### 1.2.3 Interest-Free Banking Scheme

In the process of increasing the number of players in the Islamic financial services, the Central Bank has introduced a scheme known as 'Skim Perbankan Tanpa Faedah' or the 'Interest-Free Banking Scheme' (IFBS). Under this scheme often known as the 'Islamic windows' , all commercial banks, merchant banks and finance companies are given an opportunity to introduce Islamic banking products and services. It began in 1993 and as at end of 1995, 44 financial institutions participated in the IFBS comprising of 23 commercial banks, 18 finance companies and 3 merchant banks. Total deposits mobilized under the scheme as at end 1995 amounted to RM2.1 billion while total financing extended amounted to RM1.4 billion.

### 1.2.4 Characteristics of the Interest-Free Banking Scheme (IFBS)

There are two main characteristics that must exist before IFBS is allowed to operate in a financial institution;

1. Separation of IFBS management fund from the management of fund of the conventional banking.
2. Monitoring of shari'a adviser over institution.

#### 1.2.4.1 Separation of IFBS Management Fund

The reason is to determine IFBS financial stand and profit distribution to the customers (saver/investor) through accumulations of deposits such as "al-wadiah"[3] current and saving account, and "al-mudharabah"[4] investment account.

The agreement based upon al-wadiah's principle or trust is the agreement between the owner and the trustee. The wealth must be able

[3] Refers to goods or deposits which have been deposited with another person, who is not the owner, for safe keeping.

[4] Refers to an agreement made between a party, who provides the capital and another party (entrepreneur), to enable the entrepreneur to carry out business projects, which will be on a profit-sharing basis according to predetermined ratios agreed upon earlier.

to be returned to the owner when requested. Both parties cannot name any payment conditions unless with the willingness and sincerity of both parties.

In the management of al-wadiah current and saving account, the customer is the property's owner while the bank is entrusted to care for the property. In order to maintain it's competitiveness as a commercial institution, a bank will authoritatively give part of it's profit to the customer in the form of 'hibah'[5] or prize money. However, the bank is not obligated to allocate a larger portion to the customers' saving.

Based on the mudharabah principle, the parties involved are the investors and the entrepreneur that agree to do business together. Investors contribute their wealth while the entrepreneurs make use of their skills. Profit division from the business will be agreed based on the contracts fixed. The Mudharabah General Investment Account operates with it's principle of profit sharing where a customer act as an investor and the bank as the entrepreneur. Profit gained from the distribution of minimum ratio agreed between the investor and the bank.

**1.2.4.2 Monitoring of Shari'ah Adviser**

Negotiations with expert shari'ah advisers is one of the key that holds the IFBS operation. They are individuals with credentials and capable of

[5] A gift from the bank as a token of appreciation for patronizing the bank.

monitoring the dynamic operations of Islamic banking. Among the roles played by the Shari'a adviser are to provide consultation services, assuring purity of fund and fair profit partitions among bank clients.

## 1.3 Objectives of Islamic Banking

The existence of Islamic banks is to promote, foster and develop the banking services and products based on the Islamic principles. Thus, Islamic banking was primarily designed to cater for the banking and financial requirements of Muslims in the country who perceive the conventional banking system as being inadequate or inappropriate to their needs (Investor Digest, 1993). In the Islamic countries, the aims of the Islamic bank are at realizing the following;

1. Attracting and collecting funds and mobilizing resources available in the Islamic nation together with consolidating such resources through the development if individuals' saving awareness,

2. Directing funds to the investment activities that serve the objectives of the economic and social development in the Islamic nation, and,

3. Carrying out banking activities and services in accordance with Islamic jurisprudence free from usury and exploitation, and in such a way as to solve the problem of shot-term financing.

In Malaysia, the objective of Islamic bank is to establish and operate a banking institution that adheres in its practices to the principles, rules and regulations laid down by the religion (Halim, 1983). The central pillar of the Islamic banking system is that financing can only be on an interest-free basis. Therefore, IBS operations and investment policies are based on non-interest related techniques which take into consideration the underlying transactions;

1. Islamic bank must not receive or pay interest in any form,
2. Islam considers money as a means to satisfy needs,
3. Money cannot be rented for the sake of making more money, and,
4. Financial commitments are determined by the underlying transactions (Khan, 1986)

However, the shari'ah supervisory council of Bank Negara Malaysia (the Central Bank) has ruled that Islam does not bar out shares from being held by non-Muslims (Investor Digest, 1993) and is available to everyone, Muslims and non-Muslims.

## 1.4 Shari'ah principles in Islamic Banking

The shari'ah principles are adopted in Islamic banking or interest-free banking, and the widely used principles can be generally classified into four categories as below:

i. Profit and loss sharing,

   a. Mudharabah

   b. Musharakah

ii. Fees or charges based,

a. Murabahah

b. Ijara

iii. Free service,

a. Qard Hassan

iv. Ancillary principles,

a. Wadiah

A brief explanation of the principles are as follows:

### 1.4.1 Mudharabah

Mudharabah means 'Profit and Loss sharing (PLS)' or 'trust finance'. This is basically an agreement between at least two parties, one being a lender or sometimes known as an investor and an entrepreneur also known as an agent-manager. In the agreement, the investor agrees to finance or entrust money to the entrepreneur who is to trade in an agreed manner and then return to the investor the principal and pre-agreed proportion of profits and keep for himself the remainder. The distribution of profit between the two parties must necessarily be on a proportional basis and cannot be on a lump sum or a guaranteed amount. In the case of loss as a result of circumstances beyond the control of the entrepreneur, the investor will bear all the financial risks and the entrepreneur loses the time and his efforts only. In banking practice, this is a case of 100-percent financing. It is a prerequisite that such a contract must categorically spell out the proportions of profit that will accrue to both the provider of capital and the entrepreneur. It is also contractual in such a contract that the provider of capital shall not interfere in the management of the venture (Chapra, 1992).

The main function of the mudharabah bank is to invest funds on the principle of mudharabah i.e. by advancing money to enterprises for investment in industry, commerce and agriculture with the object of profit-sharing (Rahman, 1979).

### 1.4.2 Musyarakah

This concept is more or less the equivalent of partnership in western concept In Islamic banking, musyarakah means "participating financing". Under musyarakah, both the provider of capital and the entrepreneur contribute to the capital of the joint venture. Both could participate in the management of the project. The ratio of the distribution of profit should be clearly spelt out; but the distribution need not necessarily coincide with the proportionate shares of the project. This is also a concept of profit and loss sharing (Banker's Journal Malaysia, 1983).

### 1.4.3 Murabahah

This concept transforms lending activity into a sale-and-purchase transaction. It thus defines the process as a cost-plus or mark-up sale agreement. The provider of capital basically buys the goods that the borrower wishes to acquire and