



UNIVERSITI PUTRA MALAYSIA

**THE FINANCIAL PERFORMANCE OF
ISLAMIC BANK IN MALAYSIA: A COMPARATIVE STUDY**

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GSM 1998 7

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MALAYSIA: A COMPARATIVE STUDY**

**A RESEARCH REPORT SUBMITTED TO THE
FACULTY OF ECONOMICS AND MANAGEMENT
UNIVERSITI PUTRA MALAYSIA**

**IN FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE
OF MASTER OF BUSINESS ADMINISTRATION
A PROGRAM OF COLLABORATION BETWEEN YPM & UPM**

BY

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(1998)

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Acknowledgement

This study would have not been a reality without the constant guidance and supervision of Associate Professor Shamsheer Mohamed, to whom I am greatly indebted. I would also like to acknowledge the support and forbearance of my family, especially my wife and my son, Hassan. My father and mother have definitely been an inspiration throughout my studies and also during my present project. Lastly, I would like to extend my gratitude to all my friends, who were always there to provide a helping hand.

Abstract

This study analyse the performance of the Islamic bank (Bank Islam Malaysia Berhad) and compares it to benchmark bank (Maybank) in the Malaysian banking sector. The study finds that Bank Islam shows all the characteristics of a newly established bank and hence has an inferior performance compared to a well-established bank. An intervening variable identified during the study is that Bank Islam is operations are constrained by the Islamic law.

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CHAPTER ONE

Islamic Banking is necessary and compulsory for any Muslim community, which has the ability and resources to establish an Islamic Bank. Riba consumption is enough and we must put an end to it. Since economic development is necessary for us to exert our influence and to be heard around the world, and economic development is naturally achieved through savings, these savings need an institution to channel, and distribute them the development projects. Banks are the appropriate institutions to perform this function. Unfortunately, the conventional banks charge interests over interests increases which eventually enslaved the debtors. Now they charge a rate which is equal to basic interest (or prime interest) plus interest fluctuations; which means debtor will always pay increasing instalments.

Over the last ten years interest rates have been on the increase. To stabilise the economy and rates and avoid banks' speculations on the economy; there is a need to implement Islamic banking system. One important reason is that Islamic banks have flat rates which discourage the bank to speculate and have rates increased. Because any increase in the rates will decrease the profits on the past contracts which are irreversible for rate adjustments, only the subsequent contracts can assume the increased rates.

1.1 INTRODUCTION

Muslims in Malaysia, like other Muslims elsewhere, had for a long time had a desire to apply Islamic rules and regulations in activities like banking and finance. In early 1970's the Islamic Development Bank was successfully established in Jeddah. The Islamic Bank of Dubai was the first Islamic commercial bank established in 1975. In Malaysia two institutions namely pilgrims' Management and Fund Board and the Muslim Welfare Organisation of Malaysia have initiated efforts to fulfil the desire they were enjoined by other private organisations and individuals. Their efforts and endeavour resulted in the appointment by the honourable prime minister of Malaysia of a National Steering Committee on Islamic Bank on 30th July 1980. The Committee submitted its report on 5th July 1981 which was accepted by the government. The followings are an extract of the recommendations they made :

- A) To establish an Islamic bank, which operates according to the rules and regulations of Shariah.
- B) The Bank should be incorporated as a limited company under the Companies Act 1965.
- C) In order to provide the licensing and supervision of the bank an act styled the Islamic Banking Act 1983 should be legislated and some substantial amendments should be made to existing related Acts.
- D) Bank Negara Malaysia (the central bank) should administer the Islamic Banking Act 1983.
- E) The Bank should set up a Religious Supervisory Council to supervise the compliance of its operations with Shariah Principles.

1.2 THE BANKING LEGISLATION IN MALAYSIA

In Malaysia, the Central Bank of Malaysia Ordinance 1958, provides for the establishment of the Central Bank of Malaysia. The Banking Ordinance 1958 provides for the licensing, and regulation of the business of banking in Malaysia, came into force also on the same date. The Banking Ordinance 1958, was later revised and replaced by the Banking Act 1973. A separate Act called the Borrowing Companies Act 1969, which provides for the licensing and regulation of the business of licensed companies in Malaysia, came into force on May 1969. The Borrowing Companies Act 1969 was later amended and renamed as the Finance Companies Act 1979. The Islamic Banking Act which came into force on April 1983, provides for the licensing and regulation of Islamic banking business¹.

Currently, there are 38 commercial banks, 40 Finance companies and 12 Merchant Banks. Out of the 38 commercial banks, there is one bank which operate on Islamic Banking system i.e. Bank Islam Malaysia Berhad. Besides, there are also 49 other financial institution, which participate in the interest-free banking scheme (IFBS).

¹ Bank Negara Malaysia Organisational Structure (1987), P.2



1.3 ISLAMIC BANKING IN MALAYSIA:

1.3.1 ISLAMIC BANKING OVER THE LAST CENTURY

Islamic Banking is rapidly developing among the Arab and Muslims countries. The emergence of Islamic Banking is relatively new, hardly a decade old compare to conventional banking system which has been existed for more than 200 years in the world. The first Islamic Bank was established in the late 1950s in Pakistan, which charge no interest on its lending. However, this bank was a failure due to lack of supervision. The first Islamic bank in the Middle East was established in 1972 in Egypt. This bank also ran into difficulties despite its initial success.

Since then, other Islamic banks were established in other Islamic countries such as Dubai Islamic Bank (1975), Kuwait Finance Bank of Egypt (1977), Jordan Islamic Bank for Finance and Investment (1979). The move towards the Islamization of the financial system in the above countries has concentrated mainly on establishing Islamic banks that operate in accordance with Islamic Law which advocates, among other things, the prohibition of interest, speculation, and gambling in all economic transaction. The prohibition of the payment and receiving interest in all financial transactions means that Islamic banks cannot have access to debt financing nor can they take part in any investment or lending transaction that would generate a predetermined rate of return ; hence the interest mechanism is substituted by profit and loss sharing (PLS) which mean that in their funding of their operation, Islamic banks have to depend on equity financing. So far, the capital structure of Islamic banks comprise of shareholders' equity and three forms of deposit accounts. These are investment account deposits, Saving account deposits, and current account deposits.

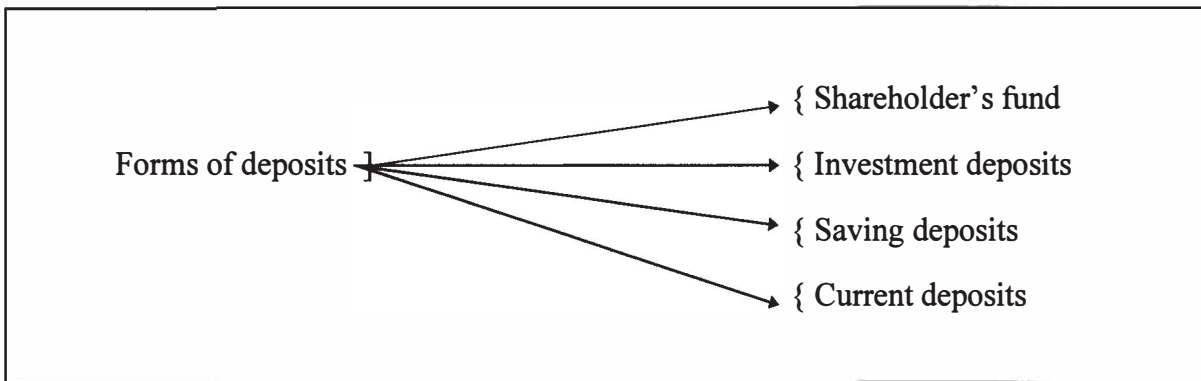


Figure1: Forms of Deposits

In their mobilisation of funds, Islamic banks operate on a system based on profit and loss sharing (PLS) in all financial transaction. Therefore, the basic difference between Islamic banks and conventional bank is that the former functions on an equity based system in which economic agents are not guaranteed a pre-determined rate of return. Rather, the depositor share in the profit made by the bank as well as the losses incurred by it.

1.3.2 DEVELOPMENT OF ISLAMIC BANKING IN MALAYSIA

In Malaysia, Bank Islam Malaysia Berhad (BIMB) was established in 1983. The setting-up of BIMB as the first Islamic bank under the Islamic Banking Act, 1983 was an important milestone in the history of banking in Malaysia. The launching of the interest-free banking scheme in March 1993 is another important landmark event as it provide the foundation towards developing a viable and comprehensive Islamic banking system in Malaysia to run parallel to the conventional banking. The launch on March 4, 1993 on a pilot basis using the three largest domestic banks, namely Malayan Banking Berhad, Bank Bumiputera Berhad and United Malayan Banking Corporation Berhad. The interest-free banking scheme (SPTF-Skim Pembankan Tanpa Faedah) was introduced with the objective of disseminating and promoting

Islamic banking on a wider scope by utilising the existing banking infrastructure, in the conventional institution. Among the main services offered by the Islamic counters are the Bai'Bithaman Ajil (deferred payment sale), Al-Ijarah (leasing), Al-Murabahah (cost-plus), Al-Mudharabah (profit-sharing) and Al-Musyarakah (joint-venture). As the scheme proved popular and had received encouraging support from the public the second phase of the SPTF was launched on August 21, 1993, whereby 10 additional financial institutions joined the scheme. As at December 1993, 20 financial institutions were participating in the SPTF, comprising 10 commercial banks, 8 finance companies and 2 merchant banks, have mobilised deposits amounting to RM 249 million from 45,857 depositors².

The introduction of SPTF in 1993; which was the year of rapid economic growth, provided a boom to banking institutions providing Islamic banking services. The Islamic banking sector showed encouraging progress over the last three years with more players, higher deposits and financing base and broader array of products. In terms of market presence, Islamic banking in Malaysia has successfully garnered the critical mass as SPTF banking facilities are now readily available in the country. As at end -1996, a total of 49 financial institutions participated in the SPTF.

They comprised 25 commercial banks, 21 finance companies and 3 merchant banks³. Bank Islam Malaysia Berhad remained as sole Islamic Bank. Nonetheless the share of Islamic banking in the total financial system is still small. By the end-1996, the proportion of Islamic banking deposits and financing accounted for only 2% and 2.2% respectively of the total deposits and loans of the banking system. The share of deposits and financing from SPTF operations against the system were even smaller, i.e 1% and 1.3% respectively.⁴

² Money & Banking in Malaysia, 35th Anniversary Edition 1959-1994, Bank Negara Malaysia, 1994, p.48

³ Bank Negara Malaysia, Annual report 1996, p.104

⁴ Bank Negara Malaysia, Annual Report 1996, p.103

1.3.3 GROWTH OF ISLAMIC BANKING

The introduction of SPTF (Skim Pembankan Tanpa Faedahdah) in 1993, in the midst of a period of sustained and rapid economic growth, provided a boom to banking institution providing Islamic banking services. The buoyant economy presented a strong platform for banking institutions to accelerate the development of Islamic banking which, in turn assisted banks to be better prepared to meet rising competition by meeting banking needs on Islamic principles.

1.3.4 SOURCES OF FUNDS

As reported in the Bank Negara Annual Report 1996, Islamic banking resources expanded by 63.5% from RM 6.2 billion at end-1995 to RM 10.1 billion at the end of 1996. Deposits remained the primary source of funds, accounting for 71.7% as at end-December 1996. The other major sources comprised shareholder funds and amounts due to other financial institutions. During the year, total deposits mobilised under Islamic banking registered a growth of 47.5% to RM 7.3 billion. The Islamic Bank accounted for a significant portion of total deposits mobilised under Islamic banking, although its share declined from 65.7% at end-95 to 45.2% at end-1996. The banking institution providing SPTF facilities, however, recorded an impressive growth of 85.7% from RM 2.1 billion at end-1995 to RM 3.9 billion at end-1996. In terms of deposit by type, investment deposits continued to constitute the largest portion (59.6%), followed by savings deposits (20.8%) and demand deposits (19.6%). Demand deposits and savings and saving deposits were also experienced notable growth during the year, rising by 50.8% and 58.3% in 1996 compared with 34.7% and 53.7% in 1995 respectively. The increase in investment deposits is prominent in the finance companies and merchant banks, which recorded increases of 150.7% and 510.5% respectively in 1996.

1.3.5 FINANCING

During the year 1993, the growth in total financing extended under Islamic banking continued to remain strong. Financing rose by 75.9% from RM 3.9 billion at end-1995 to RM 6.1 billion end-1996, of which 39.1% emanated from the Islamic bank. The increases of financing through Islamic banking was evident in all sectors of the economy.

During the year, 34.2% of total financing was channelled to the property sector, which comprises construction, real estate and residential housing. Credit to this sector recorded an increase of 103.7% in 1996, compared with 93.1% in 1995. Financing extended to individuals for the purchase of residential properties amounted to RM 984 million, an increase of 117.5% during the year. Financing to real estate, construction and other properties sub-sectors absorbed RM 1.1 million, an increase of 92.8%. The manufacturing sector recorded the second largest share of the total financing extended in 1996. The sector accounted for 15% of the total outstanding financing at the end of 1996 .

2.1 THE CORPORATE MISSION OF THE BANK

The Corporate Mission of the Bank is to seek to operate as a commercial bank functioning on the basis of Islamic principles, providing banking facilities and services to Muslims and the whole population of this country, with viability and capability to sustain itself and grow in the process .

2.2 THE CORPORATE OBJECTIVES OF THE BANK

- 1) To provide its customers with Islamic banking facilities and services of the highest possible quality.
- 2) To attain viability and sufficient level of profitability to sustain growth .
- 3) To develop and foster a competent and innovative management imbued with high standard of integrity and Islamic banking professionalism .
- 4) To develop a motivated work-force inculcated with appropriate work ethics fully committed to the Bank and efficient and courteous service to the customer .
- 5) To constantly strive to protect its shareholders interest.
- 6) To be always conscious of its responsibilities and duties as an Islamic corporate citizen.

2.3 SHAREHOLDERS

The Bank's Memorandum of association has determined that its authorised capital would be RM 500 million divided in 499999999 ordinary shares of RM 1 each and one Special Rights Redeemable share RM1. The initial paid-up capital of the bank was RM 80 million held as follows.

Table 1. Equity-Ownership of Shareholders

Shareholders	Equity held %
Pilgrims' Management and Fund Board	34%
Muslim Welfare Organisation of Malaysia (PERKLM)	18%
State Religious Councils	6%
State Religious Agencies	22%
Federal Agencies	4%
<i>Total</i>	16%
	100 %

The shares are listed on the Kuala Lumpur Stock Exchange Main Board. The Current Paid-up Capital of the Bank is RM 33.450 million and the major shareholders are:

Table 2. Major Shareholders in BIMB.

Pilgrims' Management and Fun Board	26.76%
Al-Baraka Investment and Development Company	9.88%
Majilis Ugama Islam Sabah	5.94%
Lembaga Tabung Angkatan Tentera	4.95%
Jami Company Sendirian Berhad	3.95%
Muslim Welfare Organisation of Malaysia (Pepkim)	3.22%
Majilis Ugama Islam Selangor	3.08%
Majilis Amanah Rakyat a (MARA)	2.97%
Perbadanan Pemasaran FELDA	2.97%
Amin Baitul Mal Johor	2.97%

And Minister of Finance (incorporated) Malaysia holds one special Rights Redeemable Preference share of RM (1).

2.4 BRANCHES

Bank Islam Malaysia Berhad, Widely known as Bank Islam, is entering a new era after 13 years of progress. Bank Islam has grown in size and form and is now ready to take a giant step towards porting a fresh, charismatic and dynamic image. The bank offer to both Muslim and non-Muslims a unified, dedicated and integrated approach maintaining user-friendly and quality service. Currently BIMB has a network of 42 branches and staff strength of 1434 comprising 588 officers of all levels and 846 in clerical and non-clerical grades at the end of the financial year. BIMB is not only promoting Islamic banking products through its own operations but is actively promoting Islamic banking products and services through its own subsidiaries. At present, BIMB has subsidiaries dealing with leasing businesses, nominee services, family and general takaful (Insurance) businesses, trust funds and stockbroking.

2.5 ORGANISATIONAL STRUCTURE

The organisational structure is composed of three Divisions with line functions of Retail Banking, Trade Finance and Treasury and Corporate Banking, and another three Divisions with staff functions of Human Resources Accounts and Legal and Secretarial. The Bank has over 60 branches around the country. Each branch is divided into three Departments: Operations, Finance and Accounts. Each department has a network with its parent division at the head office, The manager of the branch co-ordinates these networks, and takes the responsibilities of the Legal and Secretarial Department with the help of the secretary of the branch. As the structure tells the Bank is divisional with some functional duties delegated to the manager of the branch.

2.6 OPERATIONS DEPARTMENT

It conducts the following activities, which are named as sub-units

- Remittance
- Current Account
- Savings Account
- Investment Account

2.6.1 REMITTANCE AND TRANSFERS DEPARTMENT

It facilitates the transfer of money, or money orders, from one place to another, and also it provides remittance services for overseas transactions. Remittance and transfers are normally completed through three methods, namely Demand Draft Telegraphic transfer and Banker's cheque.

a) Demand Draft. It is mostly for overseas remittances. It operates like this, a customer who wants to remit money to his people or suppliers, comes to the Bank and produces the amount that he wants to transfer, or instructs the Bank to his account (if any) with the bank the account. The bank will levy a charge (rate %) on the amount, No physical cash is transferred, When the Demand Draft is received abroad, the beneficiary will take it to the correspondent bank of the drawer bank. This correspondent bank has the Nostro Account of the drawer bank, which it debited by the amount specified on the Demand Draft. To avoid fraud occurrences, the correspondent bank will keep the updated signatures of all the bank officers of the drawer bank. So that when such documents, like Demand Draft, are received, the signatures on them can be checked against the specimen signatures.

b) Telegraphic Transfer. It is another method of remittance it carries the statements instructions to be executed by the correspondent bank. It is much faster than Demand Draft, Yet still works like Demand Draft.

c) Bank's Cheque. It is often for local use, for example when the bank pays its customers or suppliers; the banker's cheque is processed.

2.6.2 CURRENT ACCOUNT

Bank Islam provides current Account facility for safe custody of cash and easy and convenient access. This facility is provided under the principle of AL-Wadiah. One introducer is required to open this account with an initial deposit of RM 500. A current holder enjoys certain advantages like:

a) the use of cheque book salary crediting facility.

c) standing instructions for payment of nolls and other periodical payments.

e) a monthly account statement.

A charge of RM 10 is levied on a current for every six months. A current account is closed when it becomes inactive. That it has a negative balance .

2.6.3 SAVINGS ACCOUNT

This account is also governed by the principle of Al-Wadiah (safe keeping). The customer puts the money with the bank for purpose of safe keeping. The bank can use the money by seeking permission from the customer. But it is at the discretion of the bank either to give profit to the customer or not. With RM 1 a person can open a saving account. No introducer is required and charges are levied on savings account. Except some large amounts may bear taxes at certain time. Minor persons can open in of the parent or guardians. Firms and business enterprises are not allowed to open savings account. The savings account, unlike current account is automatically closed when it becomes zero in balance.

2.6.4 INVESTMENT ACCOUNT

Bank Islam offers customers an investment account based on the principle of Al - Mudharbah. It has two accounts, general and special. Special Account is negotiated by the manager. For general account the customer can choose to invest for a period of 1, 2, 6, 9, 12, 15, 24, 36, 48, or 60 months. For three months and above the minimum deposit is RM 500, while for one month the investment minimum deposit is RM 5000. The profit ratio, in other words, the distribution of profit is at a ratio of 70% to the investor and 30% to the bank.

2.7 CHEQUES

Cheques are special papers issued by banks: but each bank has its unique and identifiable cheques. Cheques bear instructions by customers to be executed by banks. The instructions are valid / accepted when the cheque is cleared. There are different types of cheque like house, clearing local, outstation cheque etc. House cheques are cheques issued by bank and then is banked on the same bank (the bank's own cheque). Local cheque are cheques issued by the banks and named on another bank within the Klang valley. It takes normally one to three days to clear a local cheque. Outstation cheques are cheques issued by banks south-side Klang valley and