

CHAPTER TWO : AN OVERVIEW OF THE BANKING INDUSTRY IN MALAYSIA AND BANKING RISKS

2.1 Introduction

The banking is one of the important sector in any country. It acts as a machine to move the economy. Both government, companies and households use banking sector with the varying motives. In particular, government used banks to carryout out its monetary activities, corporate organizations (companies) use banking facilities to manage their need for funds while households use banking sector for saving/investing their funds and to secure a personal loan. In the first section, this chapter discusses an overview of the banking industry in Malaysia. Under these section, various subtopics are explained which includes comparison between Islamic and Conventional banks with regards to the governing laws and contracts employed (i.e. Ijara, Murabaha, Tawarruq, Qard, Msharakah Mutanaqisah). In the second section, an overview of the banking risks is discussed which includes Credit risk, Market risk, Liquidity risk and Operational risk.

2.2 An Overview of Banking Industry in Malaysia and Banking Risks.

The main banking businesses that BNM licensed and regulated in Malaysia are Islamic banking, investment banking, commercial banking, and money brokering. The Malaysian financial system structure has grown through rationalization and consolidation to become less fragmented. The Asian financial crisis of 1997 induces the Malaysian government to set up measures that regulate the banking system strictly. Malaysian Central Bank, i.e. Bank Negara Malaysia (BNM), implemented the process for merger and acquisition of all the local banking institutions in Malaysia to become ten anchor banks. The process was completed in 2002. In order to ensure that local

banks compete with international banks, the Malaysian government motivates banks to implement the mergers further. Currently, the number of conventional commercial banks in Malaysia stood at 25.

The Malaysian International Islamic Financial Center (MIFC) was launched in August 2006. The main aims and objectives is to promote Islamic finance in Malaysia to be the international Islamic finance hub. Several incentives are developed to create an environment that is conducive to practice Islamic finance businesses. To further promotes advance Malaysia as a center for an international Islamic finance, the promotional activities of MIFC have increasingly focused on the participation of foreigners in the Islamic financial system of Malaysia from the European established financial centers, Middles East and Asia. To date, there are seventeen (17) Islamic banks conducting business in Malaysia. Malaysian government allows foreign banks to have 100% participation in these banks' equity.

Malaysia lowered its economic growth forecast for 2019 and pledged to keep monetary policy accommodative as global risk weight on the trade-reliant economy. Gross domestic product is expected to increase by 4.3 percent to 4.8 percent in 2019, with trade tensions and low commodity prices among the most significant factors. The international reserves of Bank Negara Malaysia increased to USD103.5 billion as of April 2019. The reserves level has taken into account the quarterly adjustment for foreign exchange revaluation changes. The reserves position is sufficient to finance 7.7 months of retained imports and is 1.0-times total short-term external debt. It should be noted that the BNM reduced the SRR from 3.5% to 3.00 effective from 16 November 2019. This policy is believed to increase the overall banks' liquidity in Malaysia (BNM press release, 2019).

Table 2. 1 : List of the Islamic Commercial banks in Malaysia (2017)¹

No	Banks
1	Bank Islam Malaysia Berhad
2	Bank Muamalat Malaysia Berhad
3	RHB Islamic Bank Berhad
4	CIMB Islamic Bank Berhad
5	Kuwait Finance House (Malaysia) Berhad
6	Hong Leong Islamic Banking Berhad
7	Al Rajhi Banking & Investment- Corporation (Malaysia) Berhad
8	Affin Islamic Bank Berhad
9	EONCAP Islamic Bank Berhad
10	AmIslamic Bank Berhad
11	Asian Finance Bank Berhad
12	Alliance Islamic Bank Berhad
13	Maybank Islamic Berhad
14	Public Islamic Bank Berhad
15	HSBC Amanah Malaysia Berhad
16	Standard Chartered Saadiq Berhad
17	OCBC Al-Amin Bank Berhad

Table 2. 2 : List of Conventional Commercial banks in Malaysia (2017)²

No	Banks
1	Affin Bank
2	Alliance Bank
3	RHB Bank Berhad
4	CIMB Bank Berhad
5	Bank of China (Malaysia) Berhad
6	Hong Leong Banking Berhad
7	Industrial and Commercial Bank of China (Malaysia) Berhad
8	AmBank (M) Berhad
9	Bank of Nova Scotia Berhad
10	Bangkok Bank Berhad
11	Bank of Nova Scotia Berhad
12	JP Morgan Chase Bank Berhad
13	Maybank Berhad
14	Public Bank Berhad
15	HSBC Bank Malaysia Berhad
16	Standard Chartered Berhad
17	OCBC Bank Berhad
18	India International Bank (Malaysia) Bhd
19	Citibank Berhad
20	Deutsche Bank (Malaysia) Bhd
21	Mizuho Bank (Malaysia) Berhad
22	Royal Bank of Scotland Berhad
23	United Overseas Bank (Malaysia) Bhd

¹ Data Elicited from Fitch Connect Database from 2000-2016² Data Elicited from Fitch Connect Database from 2000-2016

2.3 Comparison Between Islamic and Conventional Banks.

Laws:

Islamic banking base its operations according to the principles of Shariah. The objectives of the Shariah were clarified by Islamic jurists such as Imam al-Ghazali amongst others as: faith; life; intellect; lineage; and, property (Kamali, 2008) and was then applied in various contexts of a Muslims' life including issues relating to human relations (mu'amalat). Other studies have concluded that the operations of Islamic banks promote the realisation of an Islamic financial system that is drawn from Islamic law (see for example Iqbal 1997; Zaher & Hassan 2001). Among others, Shariah permits Islamic banks to operate business based on four principles: (1) risk-sharing or concept of equality; (2) materiality or economic value; (3) no exploitation whereby neither party nor the transaction should be exploited and (4), no financing of activities that are banned by the Quran (e.g., alcohol, pork products, etc.). Additionally, Shariah forbids Islamic banks in business dealing with elements of riba (interest), gharar (speculative trading) and maysir (gambling) as such activities lead to the conditions that may facilitate economic exploitation and unlawful profit (Naughton & Naughton 2000; Lewis 2007; Hassan & Lewis 2007; and Hossain 2009). Conventional banks, on the other hand, operate on human-made laws. Their primary motivation is profits, and sometimes it takes the intervention of governments to regulate unethical trading.

2.3 Shariah Contracts in Islamic Banks

Every bank manages its liability and asset side separately, in conventional banks both asset and liability sides are governed by loan transactions. However, in Islamic banks both liability (deposits and investments) and asset (financing) side of

bank are governed through separate Shariah contracts. Islamic bank uses numerous Shariah contracts for deposits, investments and financings. For deposits, Islamic banks are using *qard* and *tawarruq* contracts and for investments, the contracts used are *wakalah* and *mudarabah*. On the other hand, for the financings, Islamic banks mostly use *tawarruq*, *murabahah*, *ijarah* and *musharakah mutanaqisah* contracts.

Qard:

Qard is a contract of lending of money by a lender in this case, the customers of Islamic banks to a borrower (Islamic banks) where the latter is bound to repay an equivalent replacement amount to the lender. This contract is applicable for deposits in Islamic banks.

Wakalah:

Wakalah refers to a contract in which a party (*muwakkil*) authorizes another party as the agent (*wakil*) to perform a particular task, in matters that may be delegated, either voluntarily or with imposition of a fee. This contract is used for investments as the customer will appoint the Islamic bank as an agent to manage the funds and Islamic banks will receive fee.

Mudarabah:

Mudarabah is a partnership in profit in which one partner provides capital (*rabbul mal*) and the other provides labour and business expertise (*mudarib*). There will be agreed profit-sharing ratio between *rabbul mal* and *mudarib*. Under a *mudarabah*, any profit generated from the capital is shared while financial losses are borne by the *rabbul mal*.

Mudarabah is the Shariah contract used for investment accounts in Islamic banks.

Tawarruq:

Tawarruq consists of two sale and purchase contracts for commodity. The first involves the sale of a commodity by a seller to a purchaser on a deferred basis (*murabahah*

contract). Subsequently, the purchaser of the first sale will sell the same commodity to a third party on a cash and spot basis. This *tawarruq* can be used for both deposits and financings in Islamic banks. Generally, commodities such as gold, silver, barley, salt, wheat and dates are not allowed in *tawarruq* transactions. The common commodities used are crude palm oil in Bursa Suq Al Sila in Malaysia and metal in London Metal Exchange.

Murabahah:

Murabahah, also referred to as cost-plus financing, is the Shariah contract used by Islamic banks for financing structure in which the seller and buyer agree to the cost and markup of an asset. The asset traded in a *murabahah* contract should be recognized by the Shariah, valuable, identifiable, deliverable and already in existence and owned by the seller. The ownership of the asset must be effectively transferred from the seller to the purchaser.

Ijarah:

Ijarah is an alternative to conventional lease contract. Islam has allowed *ijarah* contract to fulfill the different needs of the people. Sometimes, people want to use and take benefits from an asset, but they are not able to own the asset or might not be interested to own it due to various reasons. The contract of *ijarah* give them a luxury to get the right of use without taking the ownership of an asset.. In other words, *ijarah* is a sale of usufruct or service in return for compensation. The subject matter of the *ijarah* is the usufruct of an asset or the service that is rendered by an employee. Although, *ijarah* is a sale of usufruct or service, but it is different from normal sale. It is because, in *ijarah* (lease) contract, only the possession and usufruct of an asset if transferred to the lessee, while the ownership remains with the lessor. Unlike the sale contract, whereas both

ownership and usufruct are transferred from the seller to the buyer. *Ijarah* contract is used for the financing structure in Islamic banks.

Musharakah Mutanaqisah:

Musharakah refers to a joint enterprise which is formed for conducting business, all partners to this enterprise share profit as per agreed ratio and loss is shared up to the ratio of contribution. However, the type of *musharakah* used in Islamic banks as part of the financings structure is *musharakah mutanaqisah*. *Musharakah mutanaqisah* is a contract of partnership between the two parties (customers and Islamic banks), where one party (in this case, the customer) gradually buys the whole parts of the property. The transaction starts with the formation of partnership, after which buying and selling of the equity take place between the two partners. It is therefore necessary that this buying and selling agreement must be independent of the partnership contract. *Musharakah mutanaqisah* can be applied in home financing products. Based on the joint-ownership, the Islamic bank and the customer contribute their respective shares of the capital required to acquire the property according to a pre-determined ratio agreed to between them at the beginning of the contract. The Islamic bank then leases the property (*ijarah* contract) to the customer who undertakes to incrementally acquire the full ownership of the property from the Islamic bank over an agreed period.

2.4 Banking Risk

Major risks for banks include credit, operational, market, and liquidity risk. Since banks are exposed to a variety of risks, they have well-constructed risk management infrastructures and are required to follow government regulations. Regulators, such as the Bank Negara Malaysia (BNM), set the regulations to counteract risks and protect depositors.

2.4.1 Why Do the Risks for Banks Matter?

Due to the large size of some banks, over exposure to risk can cause bank failure and impact millions of people. By understanding the risks posed to banks, governments can set better regulations to encourage prudent management and decision-making. The ability of a bank to manage risk also affects investors' decisions. Even if a bank can generate large revenues, lack of risk management can lower profits due to losses on loans. Value investors are more likely to invest in a bank that is able to provide profits and is not at an excessive risk of losing money.

2.4.2 Credit Risk

Credit risk is the biggest risk for banks. It occurs when borrowers or counterparties fail to meet contractual obligations. An example is when borrowers default on a principal or interest payment of a loan. Defaults can occur on mortgages, credit cards, and fixed income securities. Failure to meet obligational contracts can also occur in areas such as derivatives and guarantees provided. While banks cannot be fully protected from credit risk due to the nature of their business model, they can lower their exposure in several ways. Since deterioration in an industry or issuer is often unpredictable, banks lower their exposure through diversification. By doing so, during a credit downturn, banks are less likely to be overexposed to a category with large losses. To lower their risk exposure, they can loan money to people with good credit histories, transact with high-quality counterparties, or own collateral to back up the loans.

2.4.3 Operational Risk

Operational risk is the risk of loss due to errors, interruptions, or damages caused by people, systems, or processes. The operational type of risk is low for simple business operations such as retail banking and asset management, and higher for operations such as sales and trading. Losses that occur due to human error include internal fraud or mistakes made during transactions. An example is when a teller accidentally gives an extra \$50 bill to a customer. On a larger scale, fraud can occur through breaching a bank's cybersecurity. It allows hackers to steal customer information and money from the bank and blackmail the institutions for additional money. In such a situation, banks lose capital and trust from customers. Damage to the bank's reputation can make it more difficult to attract deposits or business in the future. For Islamic banks, Shariah non-compliance risk is part of the operational risk. Shariah non-compliance risk is the risk of loss that arises from the failure of the Islamic banks to comply with the Shariah rules and principles determined by the Shariah Board or the relevant body in the jurisdiction in which Islamic banks operate (Islamic Financial Services Board).

2.4.4 Market Risk

Market risk mostly occurs from a bank's activities in capital markets. It is due to the unpredictability of equity markets, commodity prices, interest rates, and credit spreads. Banks are more exposed if they are heavily involved in investing in capital markets or sales and trading. Commodity prices also play a role because a bank may be invested in companies that produce commodities. As the value of the commodity changes, so does the value of the company and the value of the investment. Changes in commodity prices are caused by supply and demand shifts that are often hard to predict. So, to decrease

market risk, diversification of investments is important. Other ways banks reduce their investment include hedging their investments with other, inversely related investments.

2.4.5 Liquidity Risk

Liquidity risk refers to the ability of a bank to access cash to meet funding obligations. Obligations include allowing customers to take out their deposits. The inability to provide cash in a timely manner to customers can result in a snowball effect. If a bank delays providing cash for a few of their customer for a day, other depositors may rush to take out their deposits as they lose confidence in the bank. This further lowers the bank's ability to provide funds and leads to a bank run. Reasons that banks face liquidity problems include over-reliance on short-term sources of funds, having a balance sheet concentrated in illiquid assets, and loss of confidence in the bank on the part of customers. Mismanagement of asset-liability duration can also cause funding difficulties. This occurs when a bank has many short-term liabilities and not enough short-term assets. Short-term liabilities are customer deposits or short-term guaranteed investment contracts (GICs) that the bank needs to pay out to customers. If all or most of a bank's assets are tied up in long-term loans or investments, the bank may face a mismatch in asset-liability duration. Regulations exist to lessen liquidity problems. They include a requirement for banks to hold enough liquid assets to survive for a period of time even without the inflow of outside funds.

2.5 Summary of the Chapter

Commercial banks in Malaysia plays a vital role in the economy for two reasons; (i), they act as a significant financial intermediation source and (ii), the bulk of the country's money stock is represented by their checkable deposit liabilities. At the end of 2019, there were 42 commercial banks in Malaysia including 16 Islamic banks. The main

differences between Islamic and conventional banks as explained above is with regards to the laws they follow, the concept of money recognition, profit and loss sharing aspects, and their relationship with the financial institutions. Islamic banks must comply with the Islamic sharia in all its dealings while conventional banks are not required to do so. Due to the nature of the banking business, various risks existed which includes, credit, operational, market and liquidity risk. Such risks could not be avoided in totality; however, a certain mitigation procedure have been developed over time by regulators and the banks management.

