DEPOSIT WITHDRAWAL Behavior in ISLAMIC BANKING

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CONTENT

PREFACE

All praise be to Allah *Subhanahu wa Ta'ala* for guiding us to His way and bestowing upon us wisdoms to understand our duties and rights as human being in this worldly life. May Allah's blessings be upon the Prophet Muhammad *Shalallahu 'alaihi wa Salam* for leading the last generation of human being to Allah's way and through whom Allah has laid the solid foundation for reform.

In spite of the current vagueness in the global financial market, the Islamic banking and finance industry has continued to retain higher performance. International Monetary Fund (IMF) stated that Islamic banking is one of the fastest growing segments in the financial industry with a tracking of 10-15% growth over the past decade, and globally, Islamic banking assets are estimated to grow around 15% a year of $1 trillion by 2016.

In today's competitive environment, customer satisfaction is central to optimal performance and financial returns. Therefore, providing quality service and understanding customers' behavior are the two essential strategies for success and survival. With better understanding of customers' perceptions and behavior, Islamic banks can determine the actions required in meeting the customers' needs and eventually avoid them from withdrawing from Islamic banks.

Maintaining the existing customer is particularly demanding in the era of advanced information and communication technology since it is relatively easy for the customers to gather various information on the options of banking services that are available in the market. Also, the increasing complexity of modern banking has created a greater challenge for the Islamic banks. As competition intensifies, customer's satisfaction on service quality becomes highly critical, thus becoming the deciding factor for the customers whether to stay on or to withdraw from their banks.

This book is intended to enrich the literature of Islamic banking customer behavior especially the deposit withdrawal behavior which leads to withdrawal risk in Islamic banking. There are four independent studies inside the book which are talking the same idea and strengthening each other. Furthermore, this book also demonstrates various quantitative methods which can provide insights for other researchers, postgraduate students and university professors, who are interested to do similar topics. Finally, I only hope this book will benefit the readers from many aspects.

CHAPTER 1

OVERVIEW OF THE BOOK

1. Introduction

Risk management in financial institutions is one of the most important issues, particularly since the world had witnessed the cyclical global financial crises. It is also very important to Islamic banking institutions, which activities are closely related to real economic activities, in preventing bad impacts resulting from unfavorable conditions of real economic/business that may threat banks' performance.

In addition to the traditional risks conventional banks are facing, such as credit, interest, liquidity, and operational risks, Islamic banks are also facing other typical risks relating to their *shariah*-based banking operations such as *shariah* risk, displaced commercial risk and withdrawal risk (Ahmed, 2002). In fact, the failure upon detecting the deposit withdrawal risk in Islamic banks will lead to more severe risks such as liquidity risk. Hence it is necessary to be able to identify factors that affect deposit withdrawal risk.

Deposit withdrawal risk is one of the most important risks to be managed by Islamic banks for some reasons, particularly those operating in dual banking system countries. Those reasons are:

1. Islamic banks operate side by side with the conventional ones, which require them to perform well and be profitable for their depositors.

2. Islamic bank depositors expect Islamic banks to pay competitive returns and provide comprehensive banking services (rational behaviors). During the 1997-1998 and 2007-2008 global financial crisis, especially when conventional banks offered attractive returns, Islamic banks faced a dilemma as the increased interest rate caused rational Islamic banking depositors to have higher rate of return expectations from their Islamic banks. Such dilemma leads to a displaced commercial risk and finally to withdrawal risk.

3. Unlike its conventional counterparts, Islamic banks are bound by Islamic principles that forbid them to take any interest-related incomes. This makes deposits from depositors an important source of funds for the operation and financing of Islamic banks. Therefore, the risk of fund withdrawal is another important aspect that should be well-managed in Islamic banking.

One way to anticipate withdrawal risk is by being able to identify the depositors' withdrawal behavior. This book, therefore, is aimed at analyzing depositors' withdrawal behavior, especially in Malaysian Islamic banking industry. It is particularly focusing on the factors influencing depositors' intention to withdraw their money from Islamic banks in the situation of receiving issue of *shariah* non-compliance products and practices, experiencing lower rate of return, and receiving rumors on banking crisis to occur in the near future. Individual and bank attributes, psychological factors, and macroeconomics variables will be utilized in order to have a good and best fitted model depicting withdrawal behavior of Islamic banks' depositors.

In addition, to get more comprehensive information on depositors' withdrawal behavior, this book is also investigating the main reasons behind the depositors' willingness to initially deposit their money in the Islamic banks. Finally, this book is written as an attempt to propose recommendations for the Islamic banks and policy makers relating to how to identify depositors' withdrawal behavior and thus will be able to mitigate the deposit withdrawal risk. Hence, this book should be among the must-read books for the Islamic bankers, lecturers, students and researchers in the area of Islamic banking.

2. Structure of the Book

How the book is written is actually following the framework provided in Figure 1.1, which is expected to lead the discussion of the book and to provide a better understanding about deposit withdrawal risk through deposit withdrawal behavior of Islamic banking customers. Below is the explanation for the figure.

1. Islamic banks are exposed to risks similar to those of conventional banks. However, there are some risks that are uniquely faced by Islamic banks, such as *shariah* non-compliance risk and displaced commercial risk that may lead some groups of depositors to withdraw their deposit, which means a loss for the bank.

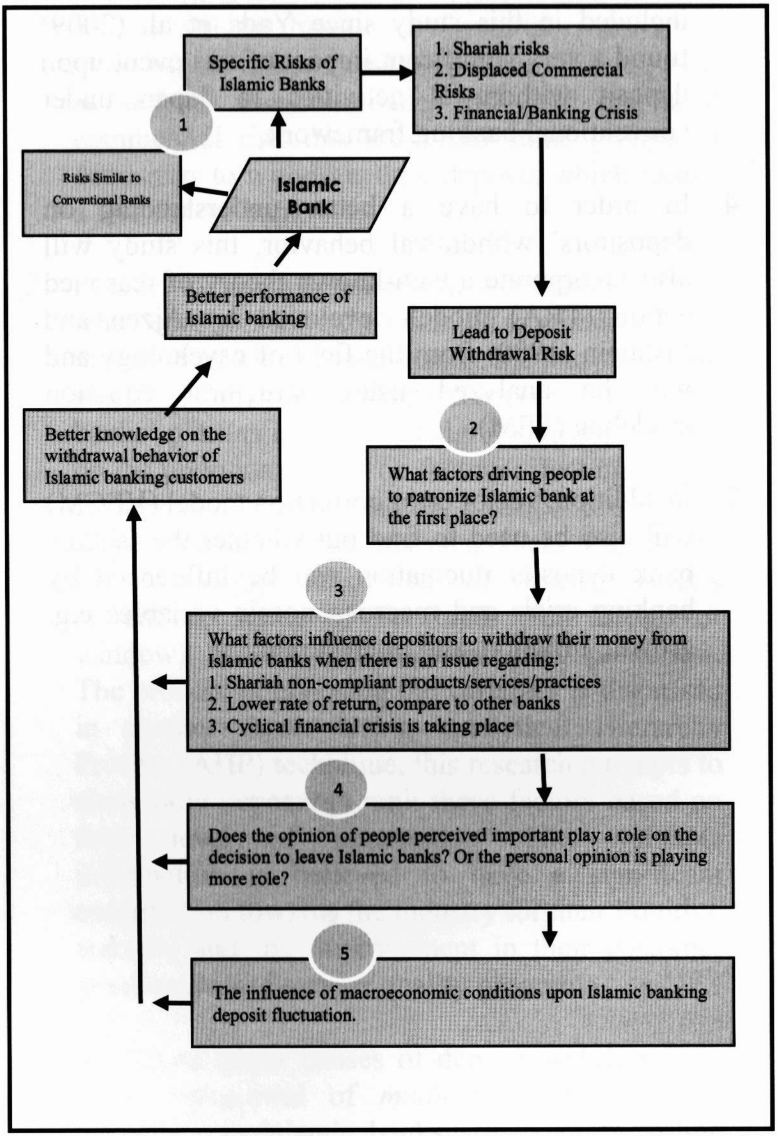
2. In order to have a comprehensive understanding on why depositors have the intention to withdraw their money from their Islamic banks, the knowledge on what make them interested and become the Islamic banks' patrons is playing a significant role. Based on the previous studies on factors affecting people to patronize Islamic banking, 6 factors are chosen to be included in the analysis. These factors are *shariah* compliance, rate of return, bank's reputation, status of the bank (full fledge or window), facilities offered, and staff politeness. The process of choosing the variables is discussed in chapter three. Using Analytical Hierarchy Process (AHP) technique, this research attempts to show how depositors rank these factors based on their level of importance. This valuable information is believed to have a significant contribution towards the industry for their liquidity stability and the improvement in their customer satisfaction and service quality programs.

3. The three major causes of deposit withdrawal or early withdrawal of *mudharabah* deposits by depositors in Islamic banks are issues regarding *shariah* non-compliance (Ahmed, 2003; Abduh, 2011), lower rate of return (Ahmed, 2002).

However, rumor on future banking crisis is also included in this study since Yada et al. (2009) found a very significant impact of this event upon deposit withdrawal activities in Japan under conventional banking framework.

4. In order to have a better understanding on depositors' withdrawal behavior, this study will also incorporate a well-known theory of reasoned action (TRA) model developed by Ajzen and Fishbein (1980) from the field of psychology and will be analyzed using structural equation modeling (SEM).

5. In addition, vector error correction model (VECM) will also be used to find out whether the Islamic bank deposits fluctuation can be influenced by banking crisis and macroeconomic variables e.g. growth, inflation, and interest rate.



Specific Risks of Islamic Banks
1. Shariah risks
2. Displaced Commercial Risks
3. Financial/Banking Crisis
1
Risks Similar to Conventional Banks
Islamic Bank
Better performance of Islamic banking
Lead to Deposit Withdrawal Risk
Better knowledge on the withdrawal behavior of Islamic banking customers
2
What factors driving people to patronize Islamic bank at the first place?
3
What factors influence depositors to withdraw their money from Islamic banks when there is an issue regarding:
1. Shariah non-compliant products/services/practices
2. Lower rate of return, compare to other banks
3. Cyclical financial crisis is taking place
4
Does the opinion of people perceived important play a role on the decision to leave Islamic banks? Or the personal opinion is playing more role?
5
The influence of macroeconomic conditions upon Islamic banking deposit fluctuation.

3. Coverage of the Book

The scope of the discussion in this book is Islamic banking industry in Malaysia. The area has been chosen due to the rapid development of Islamic banking industry in the country. Currently, there are twenty two Islamic banks operate in Kuala Lumpur with both local-owned banks such as Bank Islam Malaysia, Bank Muamalat Malaysia, CIMB Islamic bank, Maybank Islamic, and RHB Islamic bank and foreign-owned banks such as Al Rajhi Banking and Investment Corp. Berhad, OCBC Al-Amin bank and Kuwait Finance House (Malaysia) Berhad.

Furthermore, the scope is also decided due to the variety of the demography and characteristics of Islamic banking customers in Malaysia e.g. religion, age group, socio-economy level, as well as educational level. Therefore, it is expected that the findings provided in this book can represent the true behavior of Islamic banking customers, especially the depositors, with regard to their deposit withdrawal behavior.

The book is organized following the framework in Figure 1.1. However, before reporting all the researches proposed in the framework, Chapter 2 opens the discussion of the book by introducing the readers with the history, basic prohibitions, and products in Islamic banking. Furthermore, Chapter 2 also provides the reader with the rationale of withdrawal behavior of Islamic banking depositors.

Chapter 3 explains the factors influencing the people when they need to decide whether or not to patronize Islamic banking, especially in Malaysia. This chapter is very important in the discussion of withdrawal behavior because mainly, the violation against the factors perceived important by the depositors will lead to withdrawal action.

Chapter 4 and Chapter 5 uncover those who are intended to withdraw from Islamic banking. The former based the analysis upon the respondents' demographic information and the latter based the analysis upon the psychological aspects of theory of reasoned actions.

Chapter 6 utilizes the information from macroeconomic variables to forecast the fluctuation of total deposit in Islamic banking industry and Chapter 7 is to conclude the deposit withdrawal behavior of Islamic banking depositors based on the findings from previous chapters.

CHAPTER 2

A GLIMPSE OF ISLAMIC BANKING

1. Introduction

Over the past few decades, Islamic financial industry has rapidly expanded worldwide. While it is difficult to exactly date back the establishment of the first formal Islamic financial institution in recent history, references are often made to the Mitghamr Egypt Savings Association in 1963 (Iqbal and Mirakhor, 2007a; Ariff, 2005). Though the bank is still active under a new name Nasser Social bank, its objectives are more social than commercial (Gafoor, 1995).

The first private interest-free bank, the Dubai Islamic Bank, was set up in 1975 by a group of Muslim businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt and Sudan. In the same year the Kuwaiti government set up the Kuwait Finance House (Gafoor, 1995).

In 2005, Bloomberg Business week Magazine reported that over 265 Islamic financial institutions might have total combined assets ranging from $250 to $275 billion in more than forty countries. In 2009, Press-TV announced the result of the Asian Banker research that said the world's top 100 Islamic banks managed to increase their assets by 66 percent last year to more than $580 billion as against US$350 billion in 2007, while their rivals were trying to deal with the global financial downturn. Iranian banks are still the predominant Islamic banking players, holding 7 out of the top 10 ranks and 12 of the 100. Meanwhile, Islamic banks in the United Arab Emirates, Malaysia, Saudi Arabia and Kuwait together carve out nearly another 40 percent of total assets, at a time when their conventional rivals were struggling to deal with the global financial crisis. This rapid growth has gained considerable attention in international financial circles where various market participants have recognized promising potentials.

According to the report released by The Banker Magazine, after they conducted a worldwide survey of the development of Islamic financial institutions during 2009, the assets held by Islamic commercial banks and Islamic windows of the conventional banks rose 28.6% from USD639 billion to USD822 billion in 2008 (The Banker, 2010). Whereby, the conventional banking assets posted only 6.8% annual growth within the same period (Arabian-Business, 2010). This is a two digit growth shown by the industry despite the severe impact of the global financial crisis.

2. Historical Background of Islamic Banking

Essentially, Islamic finance was formulated and established as a result of the Islamic revivalism and began with the establishment of Islamic banking (Farooq, 2006). Although Islamic finance modes or contracts was practiced predominantly in the Muslim world throughout the Middle-Ages, Greuning and

Iqbal (2008) mention that an interest in the Islamic mode of banking emerged in several Muslim countries during postcolonial era as part of an effort to revive and strengthen their Islamic identity. It is why, perhaps, Islamic banking and finance could not prosper in the face of hospitality from government authorities like the experience faced by Mitghamr bank which had to be closed for political reasons in the mid of 1967.

However, the Third Islamic Conference of Foreign Ministers, held in Jeddah in 1972, recommended a country-wide establishment of Islamic banks to abolish interest from the financial system. Another important event in the history of Islamic banking development is when there was a change in political climate, particularly in the Middle-Eastern countries, after the energy price rose in 1973-1974, which increased many countries' wealth in the region. These countries, therefore, participated in the social and economic development of Muslim countries through many programs, one of which is the establishment of Islamic banks. Most of the major Islamic banks formed in the 1970s were funded by these countries. Table 2.1 below provides the milestone of Islamic banking and finance in modern era.

Table 2.1. Development of Islamic Banking and Finance in Modern History

Time Period	Development
Pre-1950s	• Barclays Bank opens its Cairo branch to process financial transactions related to construction of the Suez Canal in the 1890s. Islamic scholars challenge the operations of the bank, criticizing it for charging interest. This criticism spreads to other Arab regions and to the Indian subcontinent, where there is a sizeable Muslim community. • The majority of *shariah* scholars declare that interest in its entire forms amount to the prohibited element of riba.
1950s – 1960s	• Initial theoretical work in Islamic economics begins. By 1953, Islamic economists offer the first description of an interest-free bank based on either two-tier *mudharabah* (profit-and-loss sharing contract) or *wakalah* (unrestricted investment account in which the Islamic bank earns a flat fee). • Mitghamr Bank in Egypt and Pilgrimage Fund in Malaysia start operations.
1970s	• The first Islamic commercial bank, Dubai Islamic Bank, opens in 1974. • The Islamic Development Bank (IDB) is established in 1975 • The accumulation of oil revenues and petrodollars increases the demand for *shariah* compliant products.
1980s	• The Islamic Research and Training Institute (IRTI) is established by the IDB in 1981. • Banking systems are converted to an interest-free banking system in the Islamic Republic of Iran, Pakistan and Sudan.

	• Countries like Bahrain and Malaysia promote Islamic banking parallel to the conventional banking system.
1990s	• Attention is paid to the need for accounting standards and a regulatory framework. A self-regulating agency, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) is established in Bahrain. • Islamic insurance (*takaful*) is introduced. • Islamic equity funds are established. • The Dow Jones Islamic Index and the FTSE Index of *Shariah*-compatible stocks are developed.
2000s	• The Islamic Financial Services Board (IFSB) and other similar institutions are established to deal with regulatory, supervisory, and corporate governance issues of the Islamic financial industry. • *Sukuks* (Islamic bonds) are launched. • Islamic mortgages are offered in the United States and United Kingdom.

Sources: Greuning and Iqbal (2008).

The first full-fledged Islamic bank was Dubai Islamic Bank which was established in 1974 and followed by the establishment of Islamic Development Bank (IDB) in 1975. The main purpose of the establishment of IDB is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shariah.

As interest-free financial system began to spread widely to other countries in Middle East and South East Asia, Western analyst quickly challenged the feasibility of a debt and interest-free banking with following propositions (Greuning and Iqbal, 2008):

1. Zero interest would mean infinite demand for loanable funds and zero supply;
2. Zero interest system would be incapable of equilibrating demand for and supply of loanable funds;
3. Zero interest would be no savings, no investment and hence no growth;
4. There could be no monetary policy since instruments for managing liquidity could not exist without a predetermined, fixed rate of interest;
5. Zero interest system would be one-way of capital flight out of the country

To encounter the propositions addressed by Western economist, IDB formed a research institution named Islamic Research and Training Institute (IRTI) in 1981. IRTI has successfully come up with so many evidences that Islamic financial system is not theoretically viable only but also has many desirable characteristics which demonstrated a phenomenal growth in 1990s-2000s (see Table 2.1).

The counter arguments based on researches and modern financial and economic theory are as follows (Greuning and Iqbal, 2008):

1. No Western researchers were able to show satisfactory theory to explain the need for ex-ante positive nominal interest rate;
2. Zero interest is not necessarily zero return on capital;
3. Expected returns is what determines investment and savings;
4. Positive growth is possible in zero interest system;
5. In an open-economy macroeconomic model without an ex-ante fixed interest rate, but with return to investment determined ex post, the assumption of one-way capital flight cannot be justified.

Therefore, Islamic financial system with zero interest is theoretically viable. To date, Islamic financial system continues to grow and the IDB have expanded its members to 56 countries, including Malaysia. By mid 1990s, improvement in practices and several innovative products were introduced in Islamic banking industry. At that time, standardization and good governance were considered necessary. The Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) were then established and have been working to provide standards for the Islamic financial industry.

3. Basic Prohibitions in Islamic Banking Practices

For several decades, conventional banks have been playing an important role of financial intermediation with interest spread as the original sources of income generation. Islamic scholars, as of the inception of conventional banking in Islamic countries, have questioned the validity and necessity of using interest as the soul of conventional financial system. Not only interest, there are at least two more characters in conventional banks' products, services and activities which are gambling and uncertainty.

Riba

The first revelation regarding the prohibition of gambling is in Surah Ar-Rum verse 39 which was revealed 5 years before Hijrah. This verse gives hint for the believers that riba was something undesirable in the eyes of Allah SWT.

The second revelation was happened in early Madani period after Hijrah. In response to provocations of the Jews, Allah SWT recounted their major sins that invited His wrath upon them. However, as in most other cases, these verses indirectly served the purpose of bringin the likes and dislikes of Allah SWT to the notice of the Muslims. These verses are in Surah An-Nisa' verses 160-162.

Riba was formally prohibited for the Muslims in the third revelation which was happened in the month of Shawwal, 3 years after Hijrah, after the Battle of Ohud. These verses are in the Surah 'Ali 'Imran verse 130 to 136.

The fourth revelation of verses talk about the prohibition of riba is shortly after the Surah 'Ali 'Imran. The verses answer the adversaries of Islam who called into question the decree in Surah 'Ali 'Imran by drawing parallels between profits (in trading) and riba. These verses are in the Surah Al-Baqarah verse 275 to 277.

The fifth revelation was happened in the 9^{th} or 10^{th} years after Hijrah, before the farewell pilgrimage (Hajjat-ul-Widaa'). It was recorded that two newly Muslim families, one from Makkah and the other from Thaqeef, quarreled over a ribawi debt contracted before they embrace Islam. The creditors sought exception to the Ahkam in force at the time or, perhaps, immediate settlement of the accounts that the debtors could not afford. The matter was referred to the Prophet SAW and settled by Allah SWT. These verses are in the Surah Al-Baqarah verse 278 to 281.

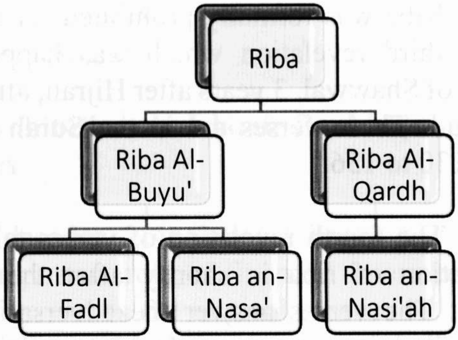


Figure 2.1. Categories of Riba

Riba has been divided into two main categories which are Riba al-Qard and Riba al- Buyu' (see Figure 2.1). Under Riba al-Qard, there is Riba an-Nasi'ah while under Riba al-Buyu', there are Riba al-Fadl and Riba an-Nasa'. Usually Riba al-Qard is highlighted in revelation, Al Quran and known as Riba al-Qur'an. But, Riba al-Bay' is usually stated in hadith of the Prophet Muhammad SAW and also known well as Riba al-Sunnah. Riba al-Qard is directly engaged with the debt while Riba al-Bay' usually involved with sales and transaction.

Riba an-Nasi'ah refers to the time given to the borrower to pay the principal and the time when the additional or the premium will be added. The word of Nasi'ah means to postpone, to wait or to defer. Our Prophet Muhammad SAW once mentioned that "there is no riba except nasi'ah". Riba an-nasi'ah is prohibited by Islam because the creditor got the money without making efforts on it. They just lend the money and wait for the return which is more than the amount borrowed by the debtors. This is clearly discouraged and prohibited in Islam.

Table 2.2. Rules in Riba Al-Buyu'

Exchange	Condition
$Money_1$ + $Money_1$ (gold, silver)	⇨ Equality ⇨ Hand-to-hand (spot)
$Food_1$ + $Food_1$ (dates, wheat, barley, salt)	⇨ Equality ⇨ Hand-to-hand (spot)
$Money_1$ + $Money_2$	⇨ Hand-to-hand
$Food_1$ + $Food_2$	⇨ Hand-to-hand
Money + Food	⇨ No conditions – free trading (free to price the commodity)
Money + Others	⇨ No conditions – free trading
Food + Others	⇨ No conditions – free trading
Others + Others	⇨ No conditions – free trading

Riba al-Buyu' is related to ribawi items and it is divided into two i.e. Riba al-Fadl and Riba an-Nasa'. Riba Al- Fadl is involved in the transactions or exchanges of different quantities of the same commodity or goods simultaneously and Riba an-Nasa' is in existence when the transaction of ribawi items is done not on the spot or hand-to-hand.

The Arabs use certain commodities like wheat, barley, dates and salt (termed as ribawi items) as medium of exchange to purchase other things, and as such they were like money. The basis for the prohibition of riba in the exchange of commodities is based on the hadith of the Prophet on six commodities: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt – like for like, equal for equal, and hand-to-hand (spot); if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand or a spot transaction." [Narrated by Muslim]. Table 2.2 shows the summary of the rules under the aforementioned hadith.

From Table 2.2, we can see that if we want to exchange currency A with currency A, then it should be at the same amount and on the spot. It will be considered involving riba al-Fadl if the amount is different, and involving riba an-Nasa' if the exchange is not done on the spot. The same rule applies for staple foods in the country. However, if the currencies or the staple foods exchanged are different, the requirement is only to be done on the spot, otherwise it will be considered as a loan. The other situations are required no conditions and considered as a free trading.

Gambling

Gambling is any transaction in which a person easily obtaining something without effort and the acquisition of wealth by pure chance. The term al-Maysir has been used in some Quranic verses while the word al-Qimar has been used in certain Hadiths. Both of them have the same meaning and are used to describe gambling. Literally, the word 'maysir' is derived from the root 'yasara' means to become gentle, to draw lots by arrow

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