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Risk-return analysis of Islamic banks' investment deposits and shareholders' fund

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Abstract

Purpose – The purpose of this paper is to study the differences or variance in the yields of Islamic and conventional bank deposits and capital, respectively, in view of their contractual differences, namely the former which is based on equity and the latter on debt.
Design/methodology/approach – The paper uses a financial ratio approach.
Findings – It was found that deposit yields in conventional banks were lower than return on equity (ROE), which truly reflect the contractual differences between fixed deposit and bank's capital. Also, it was found that Islamic banks' deposit yield and ROEs do not reflect their risk-taking properties, as their variances were found to be smaller.
Research limitations/implications – The paper adds to the literature on risk-return relationship in Islamic capital theory, which currently lacks theoretical studies.
Practical implications – The paper shows that increasing the level of risk taking in *mudarabah* investment account could increase its expected returns.
Originality/value – Since both shareholders' capital and *mudarabah* investment accounts constitute risk capital, variance in yields should be proportional to risk. The paper is the first attempt to explore and compare yields from Islamic bank capital and *mudarabah* deposits.

Keywords Islam, Banking, Yield, Debt capital, Financial risk
Paper type Research paper

1. Introduction

Islamic banks have been construed as financial intermediaries that mobilise resources in the direction of projects approved by the Islamic Law (the *Shariah*), using Islamic financing instruments (Siddiqi, 1983). As the operations of Islamic banks are based on strict *Shariah* guidelines, it is well acknowledged as explained by Masood (1995) that the purpose of *Shariah* is to protect the interest of the public (*maslahah al-ammah*), one of which is the protection of property (*al-mal*). In the protection of property, the Quran prohibits *riba* and enjoins trade and commercial activities (*al-bay'*). It also condemns acquiring wealth through the game of chance (*maisir*) and other illicit businesses that are prone to manipulate the public by way of introducing ambiguities (*gharar*) in contractual relationships.

One of the cornerstones of Islamic banking is the prohibition of *riba* and the application of trading and commerce (*al-bay'*). This commandment is expected to generate equitable relationship between the banking firms and their customers, such that the wealth (*al-mal*) of shareholders and depositors, who inject capital and deposits respectively into Islamic banks, increases in proportion to the risk that they assume in the business. This paper intends to show that the case is not true for Islamic banks in Malaysia. It examines the factors that could have caused the dichotomy between the low returns on *mudarabah* deposits and higher returns on shareholders' fund, although both operate on profit–loss sharing principle.

Managerial Finance
Vol. 34 No. 10, 2008
pp. 695-707

0307-4358
DOI 10.1108/03074350810891010

2. Principle of risk in Islam

Man generally believes that the future is uncertain and worries that exposure to uncertainties will lead to loss and personal injury. The exposure to such uncertainties constitutes risk that is defined by Elgari (2003) based on the Arabic word *mutakharah*, as the situation that involves the probability of deviation from the path that leads to the expected or usual result. This is somewhat similar to the definition espoused by proponents of conventional finance, i.e. risk is the volatility or SD of net cash flows of the firm (Shelagh, 1996).

However, uncertainties concerning future events can also imply a positive thing when the outcome is a windfall. Hence, taking risks can lead to profits, as well as losses. On the other hand, since only God knows what lies ahead of man, risk and uncertainties should be faced with adequate planning, such that all efforts to confront it are pursued without inflicting harm and injury to the society.

The study of risk in modern economics and finance was made famous by Knight (1921) in his work on risk, uncertainty and profit. Another celebrated work on risk is by Markowitz (1952) who studied effects of asset risk, correlation and diversification on expected investment portfolio returns. In a nutshell, he said that no additional expected return can be gained without increasing the risk of the portfolio. To that extent, Islam and modern finance is in congruence with the values attached to risk and return. However, Islamic finance disagrees with the risk-free rate associated with interest rates on loans, as well as equities. Toutounchian (2003) argued that when all projects compete with each other on the basis of their internal rate of return, there is no need to bring any exogenous factor, such as interest rate to intervene the market mechanism in determining the opportunity cost of capital for all projects.

As explained by Walter (1993), the banking business is a business of managing risks. Within the modern financial landscape, for more than 20 years, the Islamic banks' core business has relied a great deal on installment-based financing. Among all contracts, *murabahah* is the most commonly used method of financing by Islamic banks (Kuran, 1995). The risk exposure to these transactions is predominantly associated with credit or default risk. When Islamic banks further encroach into non-banking territory, such as joint-venture financing by means of *mudarabah* and *musharakah*, the major risks it faces are market and agency risk. Likewise, the application of *ijarah* contracts should largely expose the lessors to operational and payment risk. Further on, exposure to delivery risk are one of the top concerns in *salam* and *istisna'* financing.

The juristic principle of "*al-ghunm bil-ghurm*" is often the most quoted source of Islamic values about risk (*ghurm*). Interestingly, the mentioning of risk (*ghurm*) in Islamic law is always accompanied with the possibility of gains. In general, *al-ghunm bil ghurm* means that "one is entitled to a gain if one agrees to bear the responsibility for the loss". In the *Mejelle* (Tyler *et al.*, 2004, translation), the Arabic translation of the legal maxim is "the detriment is as a return for the benefit". In other words, when one is willing to face a risk (i.e. potential loss), he expects to make some gains when the loss does not occur.

When Islam enjoins trade and commerce (i.e. *al-bay'*), it lays out a risk-return principle based on moral values. In trading, the merchant faces potential losses, since he does not know what exactly the market has prepared for him. Although he can make estimates and projections about market behaviour based on past events, his exposure to uncertainties is an overriding concern. Under uncertainties, there is no guarantee that he can make profits. But in Islam, man believes that it is God who

determines the outcome of events. Man is not capable of determining the future path of his actions. Uncertainties concerning the future thus warrant him to take every precaution to minimise the losses that may occur.

3. Behaviour towards risks

In connection to behaviour towards risks, individuals can be categorised into two groups, i.e. the risk taker and the risk averse. According to Arzu *et al.* (2005), risk takers are willing to accept higher risks for higher returns, whereas risk averse individuals accept lower level of risks for lower returns. On the other hand, In Islam, behaviour towards risks has many dimensions. Individuals who wish to see their money intact and preserved can do so by putting them in *wadiah yad dhamanah* financial instruments. They can even keep cash under the pillow but doing so will leave their money depleted by way of *zakat* and inflation (Saud, 1980). *Zakat* serves as a penalty to those who choose to keep idle balances for more than a year. In this way, people who want to avoid potential losses on their assets should know the unwarranted cost of doing so. Avoiding risk in Islam is allowed with a condition that no contractual income is given away on the placement made with the Islamic bank. In fact, one may have to pay fees on the service rendered by the bank to protect their idle balances from theft and destruction caused by say, natural calamities.

In general, Islam's attitude towards risk-taking behaviour is a positive one. When an individual plans to invest his money and expects to earn returns from the investment, he is not allowed to avoid potential losses from uncertainties of future cash flows of the investment. This means that he can neither expect to receive capital protection nor fixed returns from the investment. He must allow the capital to depreciate or appreciate along with the market movements and is prohibited from transferring the risk to someone else.

4. Extreme behaviour towards risks

Riba is prohibited by God in the following verse: "Those who devour *riba* will not stand except as stands one whom the evil one by his touch has driven to madness. That is because they say: Trade is like *riba*. But Allah hath permitted trade and forbidden *riba*. Those who, after receiving directions from their Lord, desist shall be pardoned, for the past their case is for Allah to judge. But those who repeat (the offence) are companions of the fire. They will abide therein forever." (Qur'an, 2:275). Since Islam is a religion that cherishes moderation and prohibits excesses, it is critical to note that the prohibition of *riba* is allied to an extreme behaviour against risk in wealth creation. Likewise, the prohibition of gambling signifies Islam's rejection of extreme behaviour of risk taking. These two extreme behaviour towards risks are explained below.

4.1. Risk avoidance in interest-bearing loans

Collateral is a widespread feature found in many loan contracts (Christian, 2007). According to Elsas and Krahnen (2002), the argument for the use of collateral is to create a strong relationship to the lender, which will become especially beneficial for a borrower in the case of financial distress. Under prudent loan management, a loan is free from default risk when it is fully collateralised. In this sense, the interest income is acquired by the lender without potential losses, since there is no uncertainty about loan recovery when the borrower fails to pay up.

This is an extreme side of a financing contract, where the borrower bears the risk of bankruptcy, whereas the lender takes no risk at all. The lender is a risk avoider since he

rejects taking risks with an expectation to gain in granting the loan. He desires to make money from the loan but refuses to face uncertainties of non-repayment.

4.2. Excessive risk in game of chance

In an act of gambling, winning and losing are driven by pure chance alone. The outcome of gambling is neither influenced by knowledge nor skills of the bettors. In this sense, taking part in gambling exposes gamblers to huge potential losses. People who gamble embrace risk in the most excessive way. They are willing to lose their bets in exchange for a disproportionately huge prize that is impossible to win. As a game of chance, gambling often makes people behave irrationally since their decision is predominantly driven by false illusions of winning big. This extreme behaviour of risk taking is prohibited in Islam in view of the outcome which is aleotary in nature. However, Islam allows extreme risk taking behaviour when the outcome is non-aleotary but based on insightful market research and sound business planning. For example, investment in the venture capital sector is extremely risky. It is common knowledge that out of every ten venture projects, only one is in the money. Failures in venture capital are often caused by market volatilities and lack of monitoring on the investee company.

5. Risks in Islamic banks' shareholders' fund

Capital is the fund contributed by the owners of a banking firm. Bank owners contribute part of their wealth to banking firms in a hope to acquire a competitive return on their invested funds. David *et al.* (2004) opined that for financial institutions, the primary function of capital is to cover unexpected credit and market risks losses, because risk of such losses inevitably accompanies a bank's core business of lending money and making markets. These funds are however subjected to many risks that may erode the value of the funds but may also increase its value when the banking firm performs very well. A financial institution's success requires that it be able to identify, assess, monitor and manage these risks in a sound and sophisticated way (David *et al.*, 2004).

Capital in an Islamic bank works the same way. It is generally mobilised through a *musharakah* agreement, where capital owners place their funds at risk in the pursuit of profits. For example, the value of share capital in the form of common stocks is exposed to market volatilities. Their value will increase or decrease based on the banking firm's performance.

The nature of risks faced by capital owners in an Islamic bank varies in accordance to the types of financial instruments it uses, the people it hires to manage the bank and its degree of transparency. These are examined in the following.

5.1. Risks in Islamic banking

In relation to modern banking, risk management is about attitude towards risk and the pay off associated with it, and strategies in dealing with them. As an operational issue, risk management is about the identification and classification of banking risks, and methods and procedures to measure, monitor and control them. (Angelopoulos and Mourdoukoutas, 2001). In contrast to conventional banks, Islamic banks face greater difficulties in recognising and handling risks due to greater complexities arising from the nature of specific risks and the profit–loss sharing concept of Islamic financing (Sundararajan and Errico, 2002; Vernardos, 2005).

Islamic banking firms use various forms of Islamic finance contracts to fulfill customers' need for financing facilities. Each of these products has its own unique risks that expose the bank to potential losses in return for expected returns. The risks associated with each single product can be further broken down into major and non-major risks. Major risks mean the risks that dominate the product in use. The major risks faced by Islamic banking products are given in Table I.

Some of the risks faced by the shareholders of Islamic banks can be minimised and even eliminated, while some cannot. For example, the credit risk attached to *murabahah* can be minimised by tightening up credit valuation or it can simply be eliminated by not offering the facility at all. Unsystematic risks, such as credit risk as evident in *murabahah* financing can use available risk mitigation strategies such as high down-payments, higher collaterals and stringent credit enhancers. On the contrary, market risk in *musharakah* and *mudarabah* products can neither be avoided nor transferred to a third party by way of undertakings, recourse and claims.

5.2. Capital risk in banking

The risk exposure of Islamic banking products examined above can affect the financial performance of an Islamic bank. For example, when the bank makes an excessive amount of *murabahah* financing, which results in large amounts of non-performing financing (NPF), provision for bad and doubtful debts will be set aside to reflect the strong probability of uncollectible loss to the bank. When losses are reported after adjustment to both general and specific provisions, the value of the shareholders' capital will depreciate. For an Islamic bank to stay in business, fresh capital injection is in order. In Table II, the exceedingly high NPF (i.e. caused by the profit-interest rate gap), has caused the bank to put high provisions for bad debts. Although it has

Product based on	Major risks	Risk classification
Murabahah	Credit risk	Unsystematic
Musharakah	Market and agency risk	Systematic
Mudarabah	Market and agency risk	Systematic
Ijarah thumma al-bay'	Credit risk	Unsystematic
Ijara wa iktina	Operational and payment risk	Unsystematic
Salam	Delivery risk	Systematic
Istisna'	Delivery risk	Systematic
Bay' al-enah	Credit risk	Unsystematic
Tawarruq	Credit risk	Unsystematic
Commodity murabahah	Credit risk	Unsystematic

Table I. Major risks faced by Islamic banking products

Asset–liability structure (assume SRR=10 per cent)	
Asset	Liability
Statutory reserves $40m	Deposits $4000m
Financing $3,600m	Capital $400m
*NPF $200m	Capital after loss $100m
Profit $100 m	Capital depreciation $100m
General Loss Provision $200m	
Loss $100m	

Table II. Islamic banking: net loss and capital

reported $100 million in gross profits, the net profit after the provision for NPF is negative. Subsequently, the shareholders' capital will decline by $100 million. Usually, when no fresh capital injection is forthcoming, the bank may have to cease its operations.

Table II shows that a reported loss of $100 million will cause capital to depreciate by the same amount. However, the above model assumes that all losses from financial activities are carried only by the shareholders and as such, does not adversely affect the size of investment deposits. In this way, the risk in using Islamic financial instruments opens the bank to potential losses in its share capital. This capital risk is the risk that the shareholders must accept to carry, in return for profits. The higher the risk that they are expected to take, the greater the amount of returns that they expect to make from the investment. Table III below shows the return on equity (ROE) for all FDIC banks in the USA between 1992 and 1995. As a comparison, the ROE for Malaysian banks between 1999 and 2005 is also provided is Table IV.

Return of equity is the rate of return flowing to the stockholders. It is the net benefit that the shareholders receive from investing their capital in the bank and risking their capital in the hope of earning a decent profit. By placing their capital at risk, the shareholders deserves to earn profits, which are also determined by bank management efficiency, which include efficiencies in tax management, expense control, asset and fund management.

Year	ROE (%)
2005	12.68
2004	13.27
2003	15.04
2002	14.11
2000	13.53
1998	13.51
1996	13.31
1994	13.33
1992	12.21
Average	13.44

Source: Rose and Hudgins (2008, p. 172)

Table III.
Return on equity – FDIC Banks in the USA (1992-2005)

Year	ROE (%)
2005	16.9
2004	16.3
2003	15.3
2002	16.3
2001	13.4
2000	20.4
1999	9.8
Average	15.49

Source: Central Bank of Malaysia's, Annual Reports (1999-2005)

Table IV.
Banking Sector's ROE – Malaysia (1999-2005)

The positive ROE for conventional banks however does not mean that the shareholders received a stream of permissible (*halal*) income since the financing operations implicates interest as *riba*. Although the bank's exposure to risk is readily evident, the major risk it holds is credit risk, which is often mitigated by stringent risk management. Risk exposure to credit risk is often put to a minimum by prudent lending and well-disciplined collection policy. In this manner, the ROE is reflective of the bank's attitude towards risk, which is credit risk. The shareholders are willing to lose their capital from bad loans in return for profits generated from debt financing services. In addition to that, the bank's exposure to other unsystematic risks, such as interest rate risk, foreign exchange risk, liquidity risk and operational risk also exposes it to potential losses. However, these additional risks are tied up to the loans taken up by the bank's customers. They are risks associated with debt financing and not financing involving profit sharing or purchases of assets, such as land and properties.

On average, banks in the USA and Malaysia earned 13.44 and 15.49 cents, respectively, from every dollar of investment in the loan market. In other words, the ROE of 13.44/15.49 is the return from investing in the loan market, where the demand and supply of deposits and loans are based on fixed income and capital protection contract. In terms of the returns to fixed depositors, Tables V and VI show the six months and one year return on fixed deposits for Malaysian and US banks, respectively.

The return on interest-based deposits is expected to be lower than ROE, as the former is risk-free, in the sense that the bank guarantees depositors a fixed return, as well as capital preservation. The fact that depositors are not willing to carry any risk of investment in their respective fixed deposit accounts helps explain why returns on deposits are always lower than ROE, as shown in Tables VII and VIII.

Cerficates of deposits	Yield (%)
Six months	4.59
One year	4.83

Source: www.bankrate.com, January 2007

Table V.
Yield on certificates of deposits – USA

Fixed deposits	Yield (%)
Six months	3.34
One year	3.67

Source: Central Bank of Malaysia Monthly Statistical Bulletin, January 2007

Table VI.
Yield on fixed deposits – Malaysia

Variable	Financial contract	Yield (%)
One year ROE	Equity	13.44
One year CD	Debt	4.83
		Variance = 8.61

Table VII.
Yields on one year Certificate of Deposits and Shareholders' Fund – USA

Based on Tables VII and VIII, the gap of 8.61 and 11.82 per cent between one year ROE and deposit yield of US and Malaysian banks, respectively, show that a risk premium actually exists to reward risk taking behaviour of the bank's shareholders, in contrast with the risk avoidance behaviour of depositors. The bank's shareholders are willing to risk their capital while the depositors are not willing to do so. The inverse risk-return principle is working well in the conventional banking system.

6. Risk to mudarabah depositors

The public in general place their money in banks for two main purposes, namely for fulfilling transactional and investment needs. To fulfill the transactional objective, Islamic banks offer facilities such as *wadiah yad dhamanah* deposit, which provides safekeeping with guarantee services. In using this product, depositors no longer supply funds to earn a fixed income. Instead, they place deposits for protection. *Wadiah yad dhamanah* means safekeeping with guarantee. *Wadiah yad dhamanah* depositors allow the Islamic bank to invest the depositors' money in return for deposit protection that they got for free. Since the custodian service is given without a price, the Islamic bank holds no legal obligation to pay depositors a fixed return and may do so only on voluntary basis. In this manner, the bank holds prerogative on profit distribution policy in the form of gift (*hibah*).

The same is not true for Islamic fixed deposits, often known as *mudarabah* investment deposits. In this partnership structure, no guarantee is given to capital preservation and fixed income, as it runs under equity principle. It is a risky product as the underlying contract is based on profit–loss sharing system. Profits are acquired only when the investments are performing, while capital may depreciate or even diminish if the investment ends in losses.

The *mudarabah* investment deposits constitute the bulk of total deposits (TD) in Malaysia. In Table IX, almost all of the Islamic banking institutions concerned secure more than 50 per cent of their TD in *mudarabah*, the highest being EONCap Islamic

Table VIII.
Yields on one year Fixed Deposits and Shareholders' Fund – Malaysia

Variable	Financial contract	Yield (%)
One year ROE	Equity	15.49
One year FD	Debt	3.67
		Variance = 11.82

Table IX.
Mudarabah and non-*Mudarabah* deposits – Malaysia (2005)

Islamic bank	*Mudharabah* deposits (MD)	Non-*Mudharabah* deposits	Total deposits (TD)	(MD/TD) ×100 (%)
1. Bank Islam Malaysia Berhad	8,376,629,000	5,106,542,000	13,483,171,000	62.13
2. Hong Leong Islamic Bank Berhad	3,929,304,000	1,348,236,000	5,277,540,000	74.45
3. RHB Islamic Bank Berhad	3,778,185,000	1,733,460,000	5,511,645,000	*68.55*
4. Maybank Berhad	5,281,273,000	9,763,430,000	15,044,703,000	*35.10*
5. Bank Muamalat Malaysia Berhad	5,146,334,000	4,227,637,000	9,373,971,000	*54.90*
6. EONCap Islamic Bank Berhad	2,839,268,000	700,347,000	3,539,615,000	*80.21*

Note: RHB – Rashid Hussein Berhad (founder of the bank)
Source: Annual Reports, 2006

Bank Berhad. Returns on Islamic deposits are however flexible in nature since residuals is based on performance rather than contracted upfront as evident in all interest-bearing deposit. Although these *mudarabah* rates are quoted using the rates declared in the previous months, they are not fixed upfront and serve as an indicative rate of return on *mudarabah* deposits (ROMD).

The *mudarabah* contract operates along profit–loss sharing principles while fixed deposits are based on the contract of debt. As an equity product, a *mudarabah* deposit offers no capital protection and legal claims against any form of returns. To make up for the risk exposure of the product, *mudarabah* depositors are expected to receive higher returns relative to that of fixed depositors who avoided risk.

7. Risk and reward under profit–loss sharing principle: rate of ROMD and ROE

In an Islamic bank, the contract between the bank and the *mudarabah* depositors involve equity participation. In the case of depositors, they act as capital providers (*rabb al mal*) in a *mudarabah* contract with the Islamic bank, where the Islamic bank is the entrepreneur (*mudarib)*, i.e. the party that manages the venture. In a *mudarabah* contract, profit will be distributed according to a pre-determined profit-sharing ratio. However, in the event of losses, the losses shall be borne solely by the *rabb al mal*. In the case of loss out of negligence in managing the funds, the *mudarib* is required to cover the loss.

As the relationship between the *mudarabah* depositors and the Islamic bank a capital provider–entrepreneur relationship that entails profit–loss sharing, the evaluation of an Islamic bank's performance is important to the *mudarabah* depositors. This is due to the nature of the contract, in which the performance of the Islamic bank will determine the quantum of profits to be distributed to all *mudarabah* depositors. In the competitive global financial system, an Islamic bank's performance provides signal to depositors and shareholders alike, whether to invest or withdraw their funds from the bank.

One way of measuring an Islamic bank's performance and managerial efficiency is by analysing its ROE. ROE (profit after tax/equity capital) is the net earnings per dollar of the Islamic bank's equity capital. As such, a high ROE indicates a high degree of managerial efficiency.

Table X shows that for the year 2005, the ROE of six Islamic banking institutions averages at 7.27 per cent, the highest and the lowest being 13.37 and 4.44 per cent, respectively.

Islamic bank	Profit after taxation and *zakat* (RM)	Share capital (RM)	ROE (%)
1. Bank Islam Malaysia Berhad	−507,807,000	730,181,000	NA
2. Hong Leong Islamic Bank Berhad	23,194,000	521,937,000	4.44
3. RHB Islamic Bank Berhad	41,484,000	565,154,000	7.34
4. Maybank Berhad	241,607,000	1,806,571,000	13.37
5. Bank Muamalat Malaysia Berhad	32,328,000	523,683,000	6.17
6. EONCap Islamic Bank Berhad	20,686,000	410,747,000	5.04

Note: RHB – Rashid Hussein Berhad (founder of the bank)
Source: Annual Reports, 2006

Table X.
Return on equity of six Islamic banking institutions

Profits are created from all financing activities conducted by the Islamic bank as a *mudarib*. But as a *mudarib*, the Islamic bank is also required by law to support the deposits it mobilises from the public, which is defined by regulatory capital of 8 per cent, as required by Basel 1. In this way, the proportion of *mudarabah* deposits to the share capital as shown in Table XI seems to show that the *mudarabah* model actually does not hold well in the current Islamic banking environment. In fact, the bank who serves as a *mudarib* actually holds capital, in which it is less than the TD that the bank mobilises from the public. As shown in Table X, the share of *mudarabah* deposits is higher than the share capital, the highest being 1147.20 per cent or 11.47 times. On average, the *mudarabah* deposits are 7.56 times higher than the share capital.

The performance of the *mudarib*, i.e. the Islamic banking firm is measured in two forms. The first one reflects her relationship with the depositors, which is measured by the ROMD. The other measurement refers to the ROE. ROE actually implies that the shareholders agreed to run the Islamic banking business on a *mudarabah* basis with the bank's *mudarabah* depositors and on custodian basis with the *wadiah yad dhamanah* depositors. In the former, the Islamic bank shares the risks with the depositors while in the latter, the bank guarantees the deposits and therefore abandons any form of profit–loss sharing arrangement with the *wadiah yad dhamanah* depositors.

In 2005, the variance between the ROE and ROMD of six Islamic banking institutions as mentioned above reveals that the ROE is higher than the ROMD, the highest being 9.82, as recorded by Maybank, the largest Islamic banking institution in Malaysia. On average, the variance between ROE and ROMD is 3.69 (see Table XII).

Islamic bank	*Mudharabah* deposits	*Mudharabah* deposits/share capital (%)
1. Bank Islam Malaysia Berhad	8,376,629,000	1147.20
2. Hong Leong Islamic Bank Berhad	3,929,304,000	752.83
3. RHB Islamic Bank Berhad	3,778,185,000	668.52
4. Maybank Berhad	5,281,273,000	292.34
5. Bank Muamalat Malaysia Berhad	5,146,334,000	982.72
6. EONCap Islamic Bank Berhad	2,839,268,000	691.24

Note: RHB – Rashid Hussein Berhad (founder of the bank)
Source: Annual Reports, 2006

Table XI.
Ratio of *mudarabah* deposits to shareholders' capital

Islamic bank	ROE (%)	12 month ROMD (%)	Variance (ROE–ROMD)
1. Bank Islam Malaysia Berhad	NA	2.71	NA
2. Hong Leong Islamic Bank Berhad	4.44	3.80	0.64
3. RHB Islamic Bank Berhad	7.34	3.42	3.92
4. Maybank Berhad	13.37	3.55	9.82
5. Bank Muamalat Malaysia Berhad	6.17	3.40	2.77
6. EONCap Islamic Bank Berhad	5.04	3.73	1.31

Note: RHB – Rashid Hussein Berhad (founder of the bank)
Source: Annual Reports, 2006

Table XII.
Return on *mudarabah* deposits and shareholders' fund

8. Profit distribution to the *mudarabah* depositors and shareholders

With the liberalisation of the financial sector in Malaysia, Islamic banking institutions have to offer competitive rates of return at acceptable risk levels. As shown in the analysis conducted above, the *mudarabah* deposits leveraged by the Islamic banking institutions are significantly higher than the capital provided by the shareholders, i.e. 7.56 times higher, on average. In view of the larger proportion of TD to bank's capital, are returns acquired by the depositors and shareholders reflect fairness and are proportionate to the risks that each party faces? (see Figure 1)

There are two possible reasons as to why the ROMD is considerably lower than the return on shareholders' capital (ROE). These are explained as follows:

(1) The Islamic bank's capital absorbs all systematic and unsystematic risks. Although in theory, *mudarabah* deposits carry significant amount of market risk as defined by the principles of *mudarabah*, this risk is in reality not operationally recognised by Islamic banking regulators. For example, *mudarabah* and *musharakah* financial products are allotted huge risk-weights up to 400 per cent by the Islamic Financial Service HB Board. In view of such a degree of risk taken by the bank's capital and practically none by *mudarabah* deposits, it is not surprising to see that *mudarabah* deposits command a similar earning capacity to their conventional counterpart (Figure 2).

(2) Investments in *murabahah* and other credit-related instruments carry small margins. In this way, only large volumes of transactions can secure larger earnings and net profits. The smaller ROEs of Islamic banks relative to

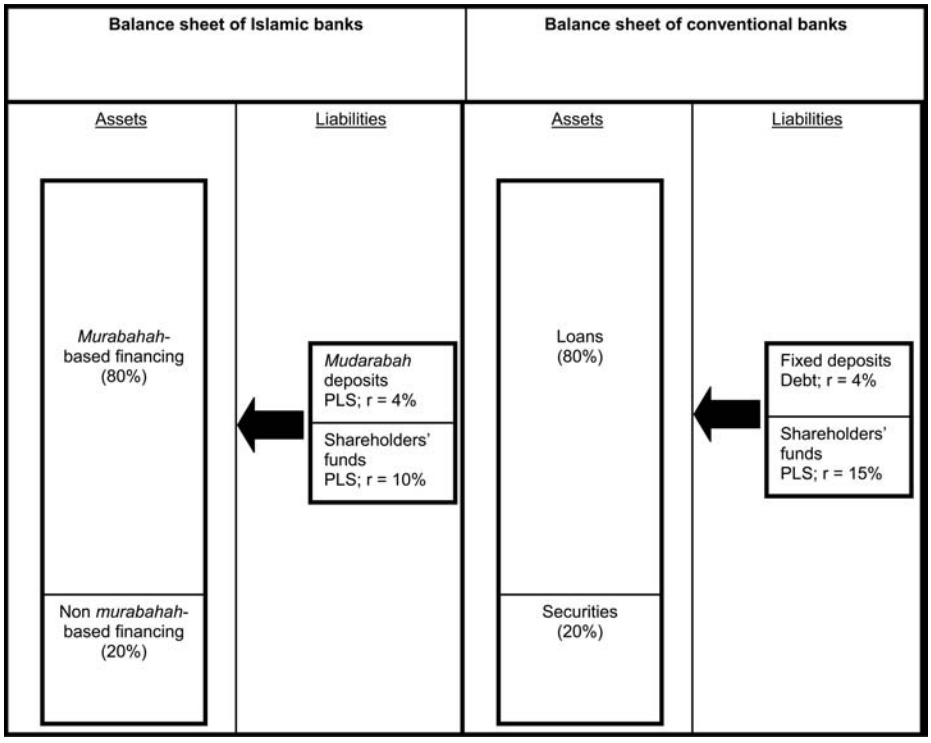

Figure 1.
ROD and ROE

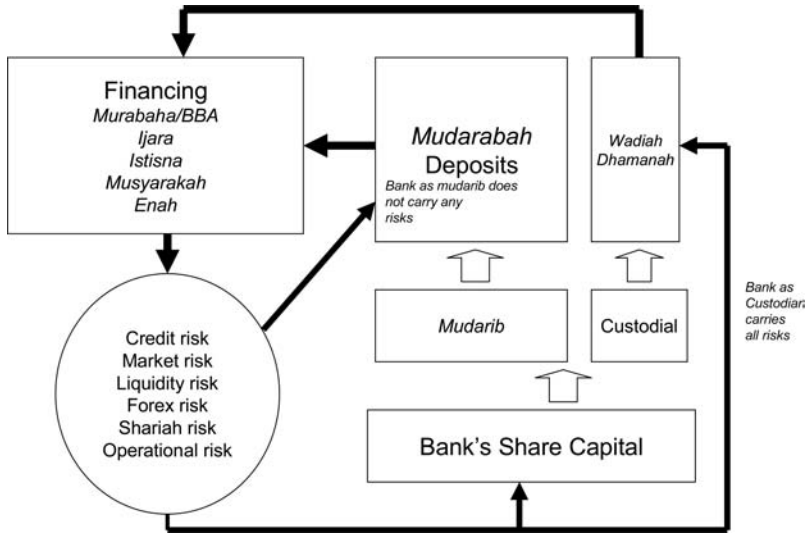

Figure 2.
Distribution of risks among bank's shareholders and depositors

conventional banks shows that this is true. This consequently generates lower ROMD relative to interest income earned on fixed deposits.

9. Conclusion

Although it is believed that Islamic banking runs on profit-sharing basis with depositors, it is evident that this equity principle has yet to be operationalised and reflected in the ROMD and return of bank capital (ROE). The large discrepancy between ROMD and ROE in Islamic banking seems to imply that *mudarabah* deposits have been treated in a similar fashion to fixed deposits, where banking risks are entirely borne by the bank's capital. For this reason, Islamic banking may not be able to find its competitive edge in profit-sharing or commercial ventures as stipulated by the Quran under the pretext of *al-bay'*. It is well understood that the current risk appetite of bank stakeholders may not warrant the wholesale application of *mudarabah* in deposit mobilisation for fear of sudden withdrawals and bank runs, as a result of losses suffered by *mudarabah* depositors.

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January 2007, available at: www.bankrate.com

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