Performance Efficiencies of Domestic and Foreign Islamic Banks in Malaysia

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ABSTRACT
This study examines the performance efficiencies of full-fledged Islamic banks in Malaysia for the period from 2006 to 2011. The Malaysian Islamic banking industry has grown tremendously in terms of assets, deposits and total financing over the study period. Data Envelopment Analysis (DEA) is employed in this study to measure the cost efficiency as well as the technical efficiency and its decompositions. The results show that, on average the main contributor of cost efficiency for Islamic domestic and foreign banks in Malaysia is allocative efficiency. In addition, the results find that foreign Islamic banks are more efficient than domestic banks with respect to pure technical efficiency and allocative efficiency.

INTRODUCTION

Islamic banking has been one of the fastest-growing sectors across the global banking industry. The global Islamic banking assets and assets under management have reached USD750 bn and are expected to hit USD1 trillion in 2010 (Mckinsey, 2007). However, the International Monetary Fund (IMF) postulates that with total assets of Islamic banking at USD250 bn, they will reach USD1 trillion by 2016 (Bloomberg, 2009). There are over 300 Islamic financial institutions worldwide across 75 countries and the world's 100 largest Islamic banks target an annual asset growth rate of 26.7% while the global Islamic finance industry is experiencing an average growth of 15-20% annually (McKinsey, 2007). Ernst and Young (2011) in a report entitled 'World Islamic Banking Competitiveness Report 2011-2012' outlined that the global Islamic banking assets will reach USD1.1 trillion by 2012, an increase of 33% from USD826 bn in 2010. They added that Malaysia will contribute about 13% (USD38 bn) towards the Islamic banking asset growth worldwide. This phenomenon has been the result of Malaysia's long track record of over 30 years to build successful domestic Islamic banking. As at December 2011, Malaysia's total Islamic banking assets had reached RM335 bn with an average growth rate of 16.07% over the period from 2002 to 2011 (Bank Negara Malaysia, 2012).

The establishment of the first Islamic bank, the Dubai Islamic Bank, in 1975 was initiated by a group of Muslim businessmen under a special law that allowed it to engage in business while accepting deposits. Since then, most of the formations of Islamic banks worldwide were private initiated. However, the establishment of Islamic banking in Malaysia was different from Islamic banking in the Gulf and the rest of the world (Samad, Gardner and Cook, 2005). This was because the first Islamic bank in Malaysia, Bank Islam Malaysia Berhad (BIMB) was government initiated. The establishment of BIMB in July 1983 under the Islamic Banking Act 1983 marked a new era in Malaysian Islamic banking. A decade later, the government introduced the 'Interest-Free Banking Scheme'. The scheme made Malaysia among the first nations in the world to allow a full-fledged Islamic banking institution (Islamic bank) to operate side-by-side with the conventional banks. The conventional banks are allowed to offer Islamic banking products or services to customers under a scheme known as the Islamic window.

The scheme was introduced to promote Islamic banking to be a more efficient and effective mode in increasing the number of institutions offering Islamic banking services at the lowest cost in the shortest time (Bank Negara Malaysia, 1994). The growing interest to offer Islamic products is due to the banks' desire to offer Islamic services to the large Muslim population and the banks were also motivated to tap the increasing interest of international investors who were attracted to *Shariah*-compliant products (Sole, 2007). In March 1993, 21 Islamic financial products were offered by three banks. However in July 1993, the scheme was extended to all conventional banks. In October 1999, the second full-fledged Islamic bank, Bank Muamalat Malaysia Berhad (BMMB) was established.