

# HOW ISLAMIC BANKS SET FINANCING CHARGES: A SURVEY OF PEOPLE'S PERCEPTION IN MALAYSIA

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## ABSTRACT

A number of recent studies find evidence that there is no significant difference between Islamic and conventional deposit rates. It was conjectured that this may be due to an increasing dependence of Islamic banks on fixed rate products as opposed to profit-loss sharing products. Some authors go to the extent of arguing that Islamic banks are more interest-dependent than interest-free. In an effort to provide a rational explanation to this issue, we surveyed public opinion on factors that are deemed important in determining Islamic bank rates. A 3-page survey instrument was developed based on information obtained from interviews with bankers and survey of literature. Convenience sampling or the snowball survey method was used. Based on 401 usable responses, our results indicated that the most important factors considered in determining Islamic financing rate were "credit risk" and "cost of funds". Other factors of importance include "operating costs", "cost of capital" and "market interest rate". Interestingly, the influence of conventional rates was not considered to be very important. Given that these factors are likely to be similar to those driving conventional rates, the reason why Islamic rates are closely related to conventional rates is becoming clearer.

**Keywords:** Financing rates, *ijarah* financing, *murabahah* financing, Islamic banks

## INTRODUCTION

Of late, several studies are beginning to question whether Islamic banks in Malaysia are indeed Islamic in the true sense of the word. This question arises based on several studies that find that there is no significant difference between Islamic bank rates and conventional bank rates. In fact, the findings of previous studies may be summarized into two major findings. First, in general, Islamic rates are not significantly different from conventional rates. Second, Islamic rates are significantly influenced by conventional rates (see for example, Chong & Liu, 2009; Khan, 2010; Cevik & Charap, 2011). These findings have led some authors to question whether Islamic banks are indeed interest-free or interest-dependent (Chong & Liu, 2009; Cevik & Charap, 2011). These are indeed controversial findings because they challenge the conventional belief that Islamic bank products are supposed to be profit sharing as opposed to being based on interest rates. A rational explanation of the reality is urgently required to dispel the belief that Islamic banks are merely copycats of conventional banks.

In Malaysia, Islamic banking products are usually developed based on adoption and adaptation. First, the conventional bank products are adopted based on the needs and demands of the public. Then, syariah experts are brought in to make an adaptation

of the product so that it complies with syariah ruling. The adaptation usually comes in the form of removing the interest element from the transaction as well as putting in the necessary contractual element to make it syariah-compliant. However, the fact remains that Islamic banks are offering their products to all customers regardless of their religious faith, not just to the Muslim segment of the population. This means that whatever the premise of their pricing might be, they are just a player in the banking industry and have to compete head-on with conventional banks.

Many of the previous studies on Islamic banking focus on comparative analysis of Islamic rates versus conventional rates. To conduct these studies, only prime deposit rates and average deposit rates are used since these are publicly available. Therefore, analyses are generally confined to these rates and the behaviour of individual banks may have been lost in the average. In an effort to provide a different perspective to this issue, this study surveys public opinion concerning their perception of the factors that are deemed important in determining the financing rates of Islamic banks. This study fills an obvious gap in trying to seek answers as to why Islamic rates are found to be closely following the conventional rates. The specific objectives are two fold: (i) to understand how Islamic banks determine product prices and (ii) to determine factors that are taken into consideration in the price setting. In addition this study also seek to identify factors that are deemed important in influencing the price setting of Islamic bank products from the viewpoints of various interest groups.

Our study specifically focuses on two of the most popular Islamic financing contracts –

*ijarah* and *murabahah*. The questions to be answered by this study are as follows: How do Islamic banks go about setting their financing rates? What are the important factors influencing Islamic banks' financing rates in general? What are the factors influencing Islamic leasing rates in *ijarah* financing? What are the factors influencing financing rates via *murabahah* contracts? The respondents of this survey were divided into two broad categories: bank staff and non-bank staff (or the public). The results of this study provide a new perspective concerning the provocative observations of some authors in respect of the roles and performance of Islamic banks in a dual-banking setting.

This study contributes to the existing literature in two respects. First, our focus is on financing rate. This represents a departure from previous studies that use deposit rates because of the unavailability of financing rates when the studies were conducted. Second, the study surveys public opinion, which is very rarely done. The survey was conducted in two stages. First, we interviewed bank officers in order to obtain first-hand information on their pricing policies. The information from these interviews was used to help construct the survey questionnaire. The interview was followed by a questionnaire survey on people's opinion on the Islamic financing rates.

### **Factors Influencing Bank Rates**

Gambacorta (2008) states the analysis of the banks' interest setting has been largely neglected by existing literature. The majority of the previous studies focus on the determinants of bank margins (e.g., Ho & Saunders, 1981; Maudos & Fernández de Guevara, 2004; Carbo-Valverde & Fernandez, 2007). According to Santomero (1984),

literature that studies banks' interest rate setting behaviour generally assumes that banks operate under oligopolistic market conditions. A bank does not act as a price-taker but sets its loan rates taking into account various factors such as the demand for loans, available deposits and credit-worthiness of the borrower. In lending money to customers, banks act as pure intermediaries between lenders and borrowers. The following section reviews the main factors that influence banks' financing/lending rates.

### *Real Gross Domestic Product*

The supply and demand for loanable funds theory suggests that the interest rate on loans depends positively on real gross domestic product (GDP) and inflation. High GDP growth conditions increase the number of projects becoming profitable, and hence, increase the demand for credit, which allows banks to charge higher lending rates (Kashyap et al., 1993). On the other hand, better economic conditions would increase the income (deposits), and therefore, reduce the incentive for banks to set higher deposit rates. Gambacorta (2008) uses Italian bank data to examine how banks set interest rates. Consistent with the theory, he finds that deposit rates are negatively related to real GDP while lending rates are positively influenced by GDP.

### *Operating Costs*

In reality, banks have to cover their costs, which are a function of deposits taken and loans granted. The costs incurred by banks (e.g. for screening, monitoring, branching costs, etc.) are expected to have a positive effect on the interest rates on loans and a negative effect on deposit rates. A positive relation between operating expenses and

interest rates has been supported by Gambacorta (2008), Maudos & Solis (2009), and Entrop et al. (2015). They find that banks with high operating costs pass these on to their clients by setting higher rates of interest on credits and lower rates of interest on deposits.

In practice, banks incur administrative costs that are included when costing loan products. When processing loan applications, there are standard operating processes that need to be followed, which include verification of data, processing of the application, credit analysis, meetings and decision making. According to Wruuck (2013), operating costs include the working hours spent on consultations and the cost of internal coordination and decision making processes for lending; hence, low costs translate into lower rates. Maudos & Fernandez de Guevara (2004) argue that even in the absence of competitive pressures and any kind of risks, banks will have to cover their operating costs, which are a function of the deposits taken and the loans granted. The higher the operating costs, the higher the loan price will be.

### *Default Risk*

When banks give loans, there is always a possibility that the borrower will default. This risk has to be taken into account in determining the loan prices, and hence, banks will obtain relevant personal information about the borrower in order to assess the price of risk; this is usually done before loan decision is made. The information includes employment, income, other debt obligations, living costs and liabilities and existing loan obligations. Most banks also look at the borrower's credit rating. The credit score may be used to gauge the probability of default. A good credit rating means a lower

probability of default, which will translate into a low cost of borrowing, and vice versa. A borrower is likely to have a positive credit rating if he/she has a good history of repayment on previous loans. Banks will demand a higher loan price for higher credit risks. However, high credit risks may be mitigated by commensurate collateral.

Angbazo (1997) undertook a study of 286 US commercial banks between 1989 and 1993, and finds that loan risk and interest rate risk are positively associated with lending rates. Similarly, Gambacorta (2008) states that banks that invest in riskier projects will have a higher required rate of return in order to compensate for the higher percentage of bad loans. These results support the view that lending rates are directly associated with loan default risk.

### *Interest Rate Risk*

Maudos & Fernández de Guevara (2004) view that banks are risk-averse agents that take deposits and grant loans, both of which arrive randomly, with the probability of arrival depending on the margin the bank charges and the elasticity of the demand for loans/supply of deposits. The random character of deposit supplies and loan demands exposes them to interest rate risk. Angbazo (1997) finds that banks with higher interest rate risk exposure are positively associated with higher rates. Saunders & Schumacher (2000) find that bank interest rates are significantly influenced by the interest rate volatility. The results of Gambacorta (2008) also indicate that both bank deposit and lending rates are positively correlated with the market interest rate volatility.

### *Bank Capital Channel*

The bank capital channel is based on the fact that bank assets typically have a longer

maturity than liabilities (Van den Heuvel, 2002). During an increase in market interest rates, a smaller fraction of loans can be re-negotiated with respect to deposits, as loans are mainly long-term, while deposits are typically short-term. Banks therefore incur a cost due to the maturity mismatch that reduces profits and capital accumulation. If bank capital is relatively low and it is too costly to obtain new capital or an interbank loan, banks will reduce lending (otherwise they fail to meet regulatory capital requirements) and widen their interest rate spread. This leads to an increase in the lending rates and a decrease in deposit rates. The results of Gambacorta (2008) indicate that the maturity mismatch between bank assets and liabilities has a positive effect on lending rates and a negative effect on deposit rates.

### *Cost of Funds*

Sathye et al. (2003) and Deans & Stewart (2012) state that there are a number of factors that influence bank lending rates. The most important is the cost of funds. Banks procure funds from savers and lend to deficit units. When the bank borrows funds from the savers (depositors), it has to pay interest. This is the financial cost of procuring funds and is always factored into the pricing of all loans. Therefore, banks with higher funding costs are expected to recover this cost by setting higher lending rate.

### *Competition*

Ho & Saunders (1981) view banks as risk-averse intermediaries between lenders and borrowers. In this process, banks are exposed to competitive pressures, which determine their loan prices. Customers will evaluate the price by comparing the financial products of many banks.

Banks need to know the interest rates that competitors are charging and use the information to establish their own prices when offering similar banking products. McShane & Sharpe (1985) find that market interest rates have a significant impact on banks' prices.

### **Pricing Setting Method**

As mentioned in the previous section, price is a very important part of a bank's revenue. If a financial product is not given the correct price, this may affect the bank's revenue and may lead to failure of the financial product. This section discusses various methods used by banks to determine the price of a loan or the financing/lending rate.

#### ***Cost-plus Pricing Model***

Under the cost-plus structure, banks will first determine the cost of lending and then will add a profit margin to the cost to arrive at the loan price. This model assumes that loan prices consist of four components:

- (i) the funding costs incurred to raise funds, regardless of whether funds are obtained through customer deposits or money markets;
- (ii) the operating costs of servicing the loan, which include the loan application and payment processing, and bank's staff salaries and other expenses related to the loan;
- (iii) a risk premium to compensate the bank for the degree of default risk inherent in the loan request; and
- (iv) a profit margin that provides the bank with an adequate return on its capital.

In Islamic transactions, in the cost plus pricing or mark-up sale, it is required that the bank's cost and the mark-up are disclosed to the borrower. Cost plus pricing contracts have been widely used

by Islamic banks as a mode of financing in various financing operations, such as home financing, motor vehicle financing, personal financing and trade financing. For Islamic banks, the lending rate includes the cost of funds or cost of deposits, cost of resources: i.e., salaries and other overhead costs, type of risk taken by the Islamic banking, and a statutory profit margin (Rosly, 2010). This pricing model is also used by conventional banks. In conventional bank loans, the contractual interest rate is the sum of the:

- (1) interest rate of deposits,
- (2) overheads,
- (3) credit or default risk, and
- (4) profit margin.

#### ***Price Leadership Model***

The price leadership model refers to the existence of one dominant bank that takes a leading role in establishing the lending interest rate, while the small banks simply follow the rates thus set (Diette, 2000). This usually happens when the products are not highly differentiated and there is enough demand for each of the competitors to remain profitable in the business.

In practice, competition affects a bank's targeted profit margin on loans. In today's banking environment, intense competition for both loans and deposits among financial institutions has significantly narrowed the profit margins of banks, which in turn, has driven more banks to use the price leadership model in establishing the loan prices. The major banks establish the prime rates charged to the most creditworthy customers on short-term loans. The prime rates are then used as a benchmark by other banks with appropriate adjustments for many other types of loan. However, to maintain an adequate return in the price-leadership

model, banks need to keep the funding and operating costs and the risk premium as competitive as possible.

In Malaysia, Islamic banks constitute around a quarter of the market share of the country's banking industry. In terms of asset size, Islamic banks are in general much smaller than conventional banks. In this situation, Islamic banks may be "forced" by the market to simply follow conventional rates in order to remain competitive.

### *Risk-based Pricing Model*

This is a pricing model in which banks determine their lending rates based on the degree of risk of the customer. Generally, a credit-scoring system is used to evaluate the creditworthiness of potential borrowers. Various type of information about borrowers becomes input into the system. This information includes the credit history of the borrower, various financial information/ratios, and the current level of borrowing and years of experience in the industry. The output of credit scoring is a single number that measures the likely future loan performance of the borrower (Feldman, 1997). Banks can use the credit scores in an automated process that approve or reject loan application. The credit scoring is a tool for setting an appropriate default premium when determining the rate of interest charged to a borrower. This is known as the risk-based pricing model. Banks that use risk-based pricing can offer competitive prices to customers with good credit scores and increase the risk premiums accordingly for those with lower credit scores. Ultimately those with scores below certain level will be rejected.

In practice it is very likely that Islamic banks and its conventional counterparts used all

the three pricing models simultaneously. In the first instance banks have to ensure that their rates cover the operating costs of the loan to remain profitable. Secondly, banks have to be mindful of the default risk of the customers and have to charge a certain risk premium to compensate for the risk to protect themselves against losses due to loan default. Thirdly, banks who are not leaders of the industry will have no alternative but to benchmark their rates against the industry leader in order to remain competitive.

## METHODOLOGY

The objective of this study is to try to explain the factors that are considered important for Islamic banks in determining the price for their financial products through a survey. The survey was carried out in two stages. The first stage was face-to-face interviews and discussion with Islamic bank officers. The objective of this stage was to obtain first-hand information about the determination of bank rates and other related issues. The information obtained in this stage was used to design the survey questionnaire employed in the second stage. The second stage was an open survey using Likert-scale questions that are designed to obtain more structured information concerning the factors determining Islamic bank lending rates.

To carry out the face-to-face interviews, e-mails were sent to the banks requesting an appointment. Five out of sixteen banks agreed to be interviewed. These interviews were carried out in early 2015. We were grateful to the participating banks and their officers who patiently discussed and explained to us how their rates were determined and what factors were important

in setting the rates. The interview sessions were attended by at least two research team members and at least two bank officers. In one of the banks we visited, the interview was attended by the Deputy CEO and three other senior officers. All interviews were held on the bank premises, usually in one of their meeting rooms. The sessions typically lasted between 1 to 3 hours, depending on the enthusiasm of the bank officers to discuss the issues. Although the interviews were unstructured and free-flowing, we made sure that our pre-prepared questions were asked.

The second stage was a questionnaire survey on the perceptions of the respondents on factors determining Islamic bank rates. The survey questions were developed based on the first stage face-to-face interviews with bank officers and the literature review. Our questionnaire was divided into two parts. The first part was designed to gather information about the respondent's personal, demographic and the use of Islamic banking products. The second part of the survey contained Likert-scale statements on various factors that might be important in determining bank financing rates. Although there are quite a number of financing products offered by Islamic banks, we chose to focus on the ones that are most popular: *ijarah* and *murabahah*.<sup>1</sup> The respondents were asked to indicate their level of agreement or disagreement on a five-point Likert scale, ranging from 'strongly disagree' to 'strongly-agree' with each of the individual statements pre-

sented in the survey. A pilot test was conducted to ensure the clarity and validity of the questions before the questions were finalized.

The survey was conducted over a three-month period in the middle of 2015. Convenience sampling (the snowball method) was used to collect data. The survey questionnaires were distributed to friends and colleagues, who in turn, distributed them to their friends and colleagues. The survey questionnaires were also distributed through e-mails and online survey as well as self-administered questionnaires distributed by hand to bank employees and customers. A total of 435 questionnaires were returned, of which 401 were usable for analysis.

## RESULTS AND DISCUSSION

### *Interview Results*

The questions asked during the interviews are designed to obtain information regarding the key factors bank takes into consideration when determining financing rates and also regarding methods of determining the rates. The respondents were in general very cooperative and tried their best to explain their pricing practices. Basically the factors involved were both qualitative and quantitative and it seems that all factors mentioned were given equal weightage in their pricing consideration. Taking all the interviewees' responses into account, important factors that seem to have the greatest

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<sup>1</sup> Islamic financing products can be grouped under two types of contract: (i) trade-based contracts, such as *ijarah* (leasing) and *murabahah* (mark-up or cost plus); and (ii) partnership-based contracts, such as *mudharabah* and *musharakah*. However, in practice, the majority of the Islamic banks financing products are trade-based (Chong and Liu, 2009; and Khan, 2010), while partnership-based financing are very minimally used. Based on this observation, we decided to focus on the two most popularly used trade-based financing products that is *ijarah* and *murabahah*.

influence in determining the financing rates can be summarized as follows:

1. **Cost of Funds.** These costs comprise the cost of acquiring funds and the opportunity cost of the funds. The cost of funds refers to the costs incurred by the bank to raise funds to lend to customers. The sources of funds include customer deposits and money market borrowing. In addition, banks are required to withhold a certain percentage of their liabilities as Statutory Reserve Requirement (SRR), as stipulated by the Central Bank. The SRR is one method used by the Central Bank to regulate money supply in the economy. To banks, this represents an opportunity cost as they are not able to lend the money from the reserve. Some interviewees also indicated that a bank's cost of capital was also taken into account in deciding the base financing rate.
2. **Operating Costs.** The total costs of operating the bank must also be considered. This includes the costs for marketing, research and development, salaries, depreciation, utilities and other overheads. The list looks like it encompasses all expenditure of a bank's operation typically found in their income statements. It is not exactly clear how total expenses influence the financing rate, but our guess is that it reflects a bank's efficiency in running its operation. We can venture to say that more efficient banks can afford to charge borrowers lower rates. In addition, the banks also consider loan processing and loan maintenance costs. Loan processing is the process of checking the applicants' particulars, capacity to borrow and credit record. Loan maintenance is
3. **Credit Risk.** Another important factor influencing financing rates is credit risk. Credit risk refers to the possibility that the borrower will default on the loan. Default may be in the form of late payment or non-payment, in which case banks need to incur additional costs in an effort to collect payment. Banks usually estimate a credit scoring system of customers to determine the rates to be charged. A customer with high credit risk would be charged higher rates.
4. **Loan Liquidity.** Financing rates are also dependent on the assets purchased by the loan. House loans are less liquid compared to car loans in that the latter is usually short-term and the asset is easier to dispose of in the market. Car loans are therefore seen to have less liquidity risk than home loans and should carry a lower financing rate.
5. **Competition.** An Islamic bank has to compete with conventional banks as well as other Islamic banks. As Islamic banks, their main business is financing business or the purchase of assets in a way that is consistent with Islamic rules. Syariah rules aside, these are also functions of conventional banks that operate side-by-side with Islamic banks in a dual-banking environment. As of 2015, Malaysian Islamic banking represents less than a quarter of the entire banking system in the country. Because of their relatively small size, their pricing is often based on the "follow the leader" rule, which means that they closely follow the lending rates of conventional banks in order for them to remain

competitive in the market. They are also usually engaged in non-price competition, such as product differentiation and customer service.

6. **Other factors.** In addition to the above list, a few banks also mentioned other factors that they usually consider in setting financing rates. These are collateral, loan size relative to asset value and customer loyalty. In terms of relative loan size, a smaller loan size relative to the value of assets would be less likely for the customer to default, hence less risky and should carry a lower rate. Customer loyalty is measured by the number of other services of the bank used by the same customer. A lower rate may be extended based on loyalty in order to keep customers in the bank.

## Questionnaire Survey Results

### Demographic profile

The first part of the questionnaire asks respondents for basic information relating to their demographic profile. The results are shown in **Table 1**. Out of 401 respondents, about 74 percent were users of Islamic banking products and about 26 percent were non-users. The respondents consisted of 13.5 percent staff of Islamic banks, 17.2 percent staff of conventional banks and 69.3 percent non-bank staff. Of those working in a bank, more than half have more than 5 years' experience in the bank. Almost all (99.3%) respondents have gone through tertiary education. With respect to religion, about 60 percent of the respondents were Muslim and 40 percent were non-Muslim. The most common Islamic banking products used by respondents were savings account (65.8%), car financing (38.2%) and home financing (31.7%).

**Table 1:**  
**Respondents' demographic profile (N=401)**

	Item	Frequency	Percentage (%)
Q1	Current user of an Islamic banking product		
	Yes	297	74.1
	No	104	25.9
Q2	Currently a staff of a banking institution		
	A staff of an Islamic bank	54	13.5
	A staff of a conventional bank	69	17.2
	Not a bank staff	278	69.3
Q3	For bank staff, number of years working in a bank (N=123)		
	Less than 1 year	9	7.3
	1 to 5 years	49	39.8
	More than 5 years	65	52.9
Q4	Religion		
	Muslim	239	59.6
	Non-Muslim	162	40.4
Q5	Education		
	College/University	398	99.3
	Non-college	3	0.7
Q6	Which of the following Islamic banking product you use? (can choose more than one product)		
	Saving account	264	65.8
	Car financing	153	38.2
	Home financing	127	31.7
	Current account	19	4.7
	Investment account	35	8.7
	Credit card	6	1.5
	Land financing	1	0.3
	Never a customer of Islamic bank	97	24.2

## Factors Determining Financing Rate

In Section 2 Part 1 of the survey, eight factors that are deemed important in determining the financing rate of Islamic banks are provided and respondents were asked to indicate their level of agreement or disagreement on a 5-point scale, where 1 = strongly disagree, 2 = disagree, 3 = no opinion, 4 = agree, and 5 = strongly agree. This part of the survey asks for respondents' perception on the financing rate in general without reference to any particular financing product. **Table 2** presents the results of the survey. The first column shows the mean score for all of the respondents, the second and third columns compare the mean scores for the subgroups "bank staff" and "non-bank staff". The next two columns compare the scores of Islamic bank staff versus conventional bank staff, followed by users versus non-users of Islamic banks, and, lastly, Muslim versus non-Muslim respondents. As column 1 of **Table 2** shows, among the eight factors listed, the respondents indicated that there were three most important factors (mean score greater than 4.0) determining the financing rate; these factors are: "credit risk", "cost of funds" and "operating costs". These three factors were also mentioned as being the top three by the bank officers in our focus group interviews. The next important factors were "market interest rates", "cost of capital" and "conventional bank rates", each with average scores greater than 3.0. Apparently, respondents generally disagreed that "loan amount" and "loan tenure" are important in determining the financing rates.

Columns 2 and 3 of the **Table 2** compare the responses of the respondents who were working in a bank and those who were not bank staff. Amazingly, both

groups show exactly the same ranking of the factors. The Spearman rank correlation between the two groups is reported at the bottom of the table and it is not surprising to note that the correlation is greatly significant. Columns 4 and 5 compare the scores and rankings of Islamic bank staff versus conventional bank staff. It can be seen that there was a slight difference in the ranking of the top five factors, but the bottom 3 were similar. The rank correlation between the two groups is also significant. Columns 6 and 7 compare the scores and rankings of user versus non-user of Islamic banking products; the rankings are similar except for a small rearrangement of the middle three factors. The last two columns compare the scores and rankings of Muslim versus non-Muslim respondents; the rankings are also practically the same.

We would like to make an additional observation for columns 4 and 5. These two columns report the scores given by bank staff, who were divided into those working in Islamic banks and those working in conventional banks. Compared to other subsamples, these two groups should be given more weight in view of their familiarity with the issue at hand. We observe that Islamic bank staff placed greater importance to "cost of funds" and "cost of capital" compared to conventional bank staff. The scores for "cost of funds" were 4.778 and 4.464 for Islamic and conventional bank staff, respectively; while for "cost of capital" the scores were 4.222 and 3.783 respectively. We rationalize these results as follows: Islamic banks, in general, have limited ability to raise funds. They are behind conventional banks in their ability to attract deposits and they also have limited access to the money market due to the limitations of shariah-compliant instruments. Thus, the cost of

funds is of utmost importance in price setting for Islamic banks compared to conventional banks.

Our results that “credit risk”, “cost of fund”, and “operating cost” were the most essential factors for determining financing rates seem to suggest that respondents believed that Islamic banks are acting as intermediaries between lenders and borrowers; they are not lenders per se’. As intermediaries the costs and risks are passed to borrowers in the form of financing rates. Overall our findings are consistent with the focus group interview results and also with the previous empirical findings of Ho & Saunders (1981) and Maudos & Fernandez de Guevara (2004), who find that loan prices are influenced by risks, costs, and competitive pressures.

### *Ijarah Financing*

This part of the questionnaire contains a list of ten questions that are related to the determination of *ijarah* financing. *Ijarah* refers to a contract made between a bank and a customer whereby the bank purchases an asset and leases the asset to the customer for a scheduled payment for a specific period of time. Usually, the ownership of the asset will be transferred to the customer at the end of the lease period.

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*Ijarah* refers to a contract made between a bank and a customer whereby the bank purchases an asset and leases the asset to the customer for a scheduled payment for a specific period of time.

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In this survey, we are interested in identifying the factors that are deemed important in determining the lease rate.

**Table 3** presents the results. The table shows that, in general, our respondents felt that the most important factors influencing *ijarah* rate were the “credit risk of the customer”, “cost of funds” and “bank’s operating costs”. Clearly, these are the exact same factors mentioned in **Table 2**. Other important factors influencing *ijarah* financing included: “competition with Islamic banks”, “base financing rate”, “market interest rate” and “liquidity of the asset”. Factors that were not important include “value of collateral”, “lease tenure” and “value of asset”. It was also observed that, in general, the subsample responses are in agreement with the whole sample, except for some minor differences in the ranking of some of the factors. Our results are consistent with the empirical evidence of Angbazo (1997), Maudos & Fernández de Guevara (2004) and Maudos & Solis (2009) who in general, find similar factors having impact of banks’ lending rates.

Looking closer at columns 4 and 5, as we did in **Table 2**, we find that the order of importance of Islamic bank staff was as follows: operating costs, base financing rate, credit risk and cost of funds; while the order for the conventional bank staff was as follows: cost of funds, credit risk, operating costs and competition. Three out of the four top factors were common between the two groups with the exception that Islamic bank respondents mentioned base financing rate as the second most important factor, which reflects their preoccupation with the cost of funds.

Table 2:

## Factors determining financing rate in general

	All respondents (N=401)		Bank Staff (N=123)		Non-bank staff (N=278)		Respondent is a bank staff of				Islamic banking products				Respondent's religion			
							Islamic bank (N=54)		Conventional bank (N=69)		Users (N=297)		Non-users (N=204)		Muslim (N=239)		Non-Muslim (N=162)	
	Mean	Rank	Mean	Rank	Mean	Rank	Mean	Rank	Mean	Rank	Mean	Rank	Mean	Rank	Mean	Rank	Mean	Rank
	1		2		3		4		5		6		7		8		9	
Credit Risk	4.514	1	4.610	1	4.471	1	4.630	2	4.594	1	4.508	1	4.529	1	4.552	1	4.457	1
Cost of funds	4.387	2	4.602	2	4.291	2	4.778	1	4.464	2	4.428	2	4.269	2	4.431	2	4.432	2
Operating costs	4.062	3	4.268	3	3.971	3	4.463	3	4.116	4	4.071	3	4.039	3	4.092	3	4.019	4
Market interest rate	3.858	4	4.171	4	3.719	4	4.056	5	4.261	3	3.845	5	3.894	4	3.661	5	4.148	3
Cost of capital	3.776	5	3.976	5	3.687	5	4.222	4	3.783	5	3.906	4	3.404	6	3.720	4	3.585	5
Conventional bank rates	3.406	6	3.577	6	3.331	6	3.593	6	3.565	6	3.354	6	3.558	5	3.293	6	3.574	6
Loan amount	2.963	7	2.813	7	3.028	7	2.870	7	2.768	7	2.970	7	2.942	7	2.661	7	3.407	7
Loan tenure	2.643	8	2.585	8	2.669	8	2.563	8	2.580	8	2.583	8	2.817	8	2.310	8	3.136	8

Notes: The table shows the mean scores for each statement. Mean scores are calculated from a scale of 1 to 5, 1 being strongly disagree and 5 being strongly agree. Results for Spearman rank order correlation:

Between respondents of bank staff and non-bank staff (column 2 and 3):  $r = 0.974, p = 0.000$ .

Between respondents of Islamic bank staff and conventional bank staff (column 4 and 5):  $r = 0.905, p = 0.002$ .

Between respondents of Islamic bank users and non-users (column 6 and 7):  $r = 0.952, p = 0.000$ .

Between Muslim and non-Muslim respondents (column 8 and 9):  $r = 0.930, p = 0.002$ .

**Table 3:**

**Factors determining *ijarah* financing rate**

	All respondents (N=401)	Bank Staff (N=123)	Non-bank staff (N=278)	Respondent is a bank staff of		Islamic banking products		Respondent's religion	
				Islamic bank (N=54)	Conventional bank (N=69)	Users (N=297)	Non-users (N=204)	Muslim (N=239)	Non-Muslim (N=162)
<i>Ijarah</i> financing rate depends on:									
	1	2	3	4	5	6	7	8	9
Credit risk of the borrower	4.030	4.033	4.025	3.907	4.130	3.993	4.125	3.958	4.130
Costs of fund	3.952	4.106	3.881	3.852	4.304	3.993	3.827	3.946	3.966
The operating costs	3.808	3.943	3.737	4.129	3.797	3.798	3.808	3.782	3.827
Comparison with other Islamic banks	3.773	3.781	3.766	3.833	3.739	3.731	3.885	3.757	3.790
Bank's Base Financing Rate	3.530	3.602	3.514	3.926	3.348	3.586	3.414	3.435	3.698
The current market interest rate	3.500	3.642	3.439	3.815	3.507	3.444	3.664	3.484	3.531
The marketability the asset	3.134	3.211	3.112	3.333	3.116	3.118	3.212	3.084	3.228
The value of the collateral	2.967	3.016	2.960	3.130	2.928	3.020	2.856	2.816	3.216
The length of the lease period	2.386	2.537	2.356	2.630	2.464	2.428	2.365	2.121	2.840
The value of the asset	2.116	1.992	2.198	1.944	2.029	2.168	2.039	1.967	2.383

### *Murabahah Financing*

In this part of the questionnaire, we list eleven factors deemed important in determining the *murabahah* financing rate and respondents are asked to indicate the extent of their agreement or disagreement to the factors. *Murabahah* is a sale contract, whereby the bank sells the asset to the customer at cost plus a mark-up. In this contract the mark-up represents the bank profits. The customer then agrees to make a regular periodic payment until the purchase price is fully paid. The results of the survey are shown in **Table 4**.

As can be seen in **Table 4**, the most important factors in determining the mark-up price was “customer’s risk”, “cost of funds”, “interbank Islamic money market rate” and “competition”. Customer’s risk and cost of funds were two important factors found in the previous section, while the money market rate and competition were new factors in *murabahah* financing. This means that Islamic banks used the money market rate as a benchmark for their profit margin and also the prices of other Islamic banks in order not to price themselves out of the market. Other factors that received some agreement from the respondents included the bank’s operating costs, Kuala Lumpur interbank offer rate, conventional bank interest rate, liquidity of the asset and the value of the asset. Factors that were not related included the payback duration and customer loyalty. Again, as found in the previous sections, the ranking of the factors are in general agreement among all the subsamples.

Upon closer examination of the responses provided by the staff of the Islamic banks

and conventional banks, we find that the top five factors for both groups were the same, but differ only in the ranking of these factors.

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*Murabahah is a sale contract, whereby the bank sells the asset to the customer at cost plus a mark-up. In this contract the mark-up represents the bank profits. The customer then agrees to make a regular periodic payment until the purchase price is fully paid.*

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Islamic bank staff placed credit risk, cost of funds and operating costs as the top three factors, while conventional bank staff placed risk, competition and cost of funds as their top three factors. These rankings may indicate that Islamic bank staffs are more concerned about their operating costs as their banks are relatively smaller in size compared to conventional banks.

**Table 4:**

**Factors determining *murabahah* financing rate**

	All respondents (N=401)	Bank Staff (N=123)	Non-bank staff (N=278)	Respondent is a bank staff of		Islamic banking products		Respondent's religion	
				Islamic bank (N=54)	Conventional bank (N=69)	Users (N=297)	Non-users (N=204)	Muslim (N=239)	Non-Muslim (N=162)
<i>Murabahah</i> financing rate depends on:	1	2	3	4	5	6	7	8	9
Customer's credit risk is very important	4.169	4.293	4.017	4.444	4.174	4.168	4.192	4.142	4.222
Cost of funds	3.998	4.187	3.917	4.241	4.145	3.983	4.048	3.958	4.062
Islamic Interbank money market rate	3.955	4.024	3.907	3.870	4.145	3.929	3.981	4.034	3.809
Competitor's price	3.927	4.065	3.860	3.944	4.159	3.865	4.087	3.979	3.839
Operating costs	3.788	4.024	3.683	4.093	3.971	3.828	3.673	3.749	3.846
The Kuala Lumpur interbank offered rate	3.657	3.756	3.608	3.630	3.855	3.606	3.789	3.674	3.623
Conventional bank rates	3.528	3.691	3.442	3.648	3.725	3.475	3.644	3.456	3.611
Marketability of the assets	3.157	3.349	3.094	3.389	3.319	3.172	3.173	3.109	3.265
Value of the contract	3.136	3.252	3.101	3.426	3.116	3.192	3.019	3.100	3.216
The instalment duration	2.303	2.268	2.342	2.185	2.333	2.290	2.404	2.113	2.623
Customer loyalty	2.326	2.923	2.363	1.870	2.623	2.269	2.548	2.121	2.667

## CONCLUSION

This study aims to identify the factors that Islamic banks consider in making the pricing decision of their financing products and to understand their price setting method. There are two components in this study. We first interviewed the bankers of Islamic banks in a group discussion regarding the pricing of their products, to find out their pricing policies and factors that they took into consideration in the price determination. The second component was a survey to obtain public opinion concerning the factors they considered important for price determination in Islamic banks.

From the interviews, it is clear that there are several common factors that Islamic banks take into account in the determination of the financing rates. These include the cost of funds, cost of capital, and the operating costs. The borrower characteristics that influence risk are also found to be important in setting the price. This is followed by market factors, such as market interest rate, competitor price and interbank rates. It is also found that the pricing policies of Islamic banks include cost-plus, risk-based and follow-the-leader. Being a minority player, Islamic banks have to apply these policies simultaneously in order to remain competitive in the market.

The survey results are broadly consistent with the interview results. In summary, the respondents agree that the main factors in price setting decisions are related to lending risk, cost of funds, cost of capital and operating costs. The survey results also indicate that the duration of the loan and the amount borrowed are unimportant factors for price setting. Our survey results on *ijarah* and *murabahah* financing indicate that, more or less, similar factors influencing the financing rates. The most important factors for determining *ijarah* and *murabahah* financing are credit risk, costs of fund, operating costs, followed by money market rate. We can conclude from the interviews and survey results that the price setting decisions are made based on both quantitative and qualitative inputs. To the extent that similar factors are also used by conventional banks in setting their lending rates, this study provides some form of rationalization on the similarity between the Islamic and conventional rates found by previous studies.

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