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Determining Factors of Customers' Preferences: A Case of Deposit Products in Islamic Banking

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Abstract

Islamic banking and finance are areas that have attracted attention, especially after the recent global financial crisis. While the existing literature highlights a significant shift in consumers' behaviour with regard to bank selection, it does not investigate the motives behind such moves. Understanding customers' preferences to deposit their money into Islamic banks are crucial for banks operating in such a highly competitive industry. Having a good understanding of the real motives behind customers' preferences will help banks to understand customers better. Besides, improving the bank's liquidity issues, it contributes to the growth of the country's economy. Thus, this paper explores the findings from a qualitative data through a face to face interview on factors influencing customers' preferences for deposit products in Islamic banks. These results will eventually be used for developing a survey questionnaire for future empirical research. The face-to-face interview revealed that sharia compliance, returns, confidence and trust, security, transparency, flexibility of withdrawal scheme were among the determining factors that influence customers' preferences in making decisions. Safety and security, the human touch and zakat (alms) were the additional elements found to be missing from the literature. Future empirical research would include these elements as items in building up the survey instrument.

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Keywords: Islamic banking; sharia compliance; customer preference; profit sharing; guaranteed custody; deposit

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1. Introduction

The finance and Banking sector plays a crucial role in the economy. As intermediaries between depositors and borrowers, it contributes to the economic growth by offering various products and services. Banks generate profits through interest from loans by charging higher rates than the cost of paying interest to depositors. Deposits remain a primary source of bank financing (Khir, Gupta, & Shanmugam, 2008). The interest is used by banks to determine the amount of returns in attracting depositors to pledge their money in the banks. Customers deposit their money in the banks due to returns and risks. Most people accept that there is a positive relationship between risk and return. In investment, customers always seek for high returns with minimal risks. However, this is not necessarily a reality. Investments that generate high returns typically have a higher risk.

The emergence of Islamic banking in a time of financial crisis in 2008 is evident worldwide. Previously, Islamic banking was known among the Muslim majority countries. After the financial crisis, many Islamic banks were institutionalized all over the world (Foster, 1983; Waemustafa, 2013). The world began to recognize Islamic banking as an alternative solution to the crisis that struck the financial industry (Ayub, 2007; Vandore, 2008). For instance, some leading commercial banks in the West started to offer products similar to Sharia-compliant products offer in Islamic banking (Haron & Ahmad, 2000). The impact of the financial turmoil has raised a question and left riddles unanswered. We witnessed the fragility of conventional banks and the consistency of Islamic banks in facing the financial crisis. During the period, traditional banks recorded a loss of US4.26 billion while Islamic banks were less affected and recorded a profit of US$4.74 billion (Fam, Waller, & Erdogan, 2004). The world has seen the sudden shift of customers' behavior and perception towards Islamic banking. Customers begin to lose their faith in the current financial system (Al-Duri, 1986a). More interestingly, in Malaysia, the record shows an average annual deposit growth of 32% (USD$40 billion in 2008 to USD$100 billion in 2012). On the contrary, the share of conventional banking in total deposits has dropped from 92.5% in 2007 to 80.4% in 2012 (Ariff, 2014).

Despite the existence of relatively high risk in *mudarabah* (profit sharing) and no guaranteed returns under *wadiah* (guaranteed custody) contract, yet, customers continue to deposit their money in Islamic banking. These go in contradiction to the patrons motive of pledging their money in the first place, and are oppose to the fundamental principle of maximizing profit and avoiding the high risk. Perception of risks and returns being a primary force that drives customers' preferences no longer has binding, and its theories are incapable of explaining the unexpected change in customers' behavior. Customers' preferences have gone beyond risks and returns factor (Beal, Goyen, & Phillips, 2005; Fama & French, 2007; Fisher & Statman, 1997). What are the factors that influence customers' preferences to deposit their money in Islamic banking? What are the most critical factors perceived by customers that motivate them to pledge their money in Islamic banking? Understanding why customers prefer to deposit their money into Islamic banks is crucial for banks operating in such a highly competitive industry. Having a good understanding of the real motives behind customers' preferences will help banks in understanding customers better. As such, there is a need to formulate new client strategies to meet the rising expectations and demands. Specifically, improve in cash mobilization could help to solve liquidity issues in Islamic banks and at the same time contribute to the growth of the country's economy. Therefore, this paper is an attempt to explore factors that influence customers' preferences to deposit their money in Islamic banking. Besides, this paper also aims to identify the critical factors perceived as the most crucial driving forces that influence the customers' decision.

2. Literature review

2.1. *Islamic banking concept*

According to Malaysian Islamic Banking Act 1983, Islamic bank refers to "any company that carries on Islamic banking business and holds a valid license. All the offices and branches in Malaysia of such a bank shall be deemed to be one bank". The concept of Islamic banking has been narrated quite differently by many scholars. Rammal and Zurbruegg (2006), Bello (2007) and W. Ahmad (2008) explain Islamic banking as the banking system that follow the Islamic jurisprudence (Sharia law) and *muamalat* (business transaction). WhileDar and Presley (2000) postulates that the dissimilarity lies in the profit sharing and is in compliance with sharia. Research carried out by Honohan (2001) includes a strict sense of recklessness or uncertainty (*gharar*), exploitation of ignorance (*jahl*) and gambling