

## Factors Considered By Islamic Banks When Designing Islamic Banking Products/Services. Case Study of Selected Islamic Banks in Malaysia.

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**Abstract: Purpose** - The purpose of this paper is to reveal in detail the findings of a study of factors considered by Islamic banks when designing products and services for businesses and individual customers. This study attempted the reveal of the predominance of the Islamic rule of transactions over all other factors considered when designing Islamic banking products. The study further examined whether these factors vary between different Islamic banks so as to facilitate the application of the findings in different countries with Islamic banking initiative.

**Design/methodology/approach** - This paper adopted questionnaire as a reliable tool for data collection from the Islamic banking customers using convenient sampling.

**Findings** - The findings of the study suggested that Islamic banks prioritize the Shariah component and the legal/regulatory requirement of the country (Malaysia) when designing Islamic banking products. Most of the Islamic banks have separate Islamic segments which are small franchises within the banks, and some banks have conventional products that shields the Islamic products. The level of awareness of Islamic products is still minimal as compared to that of Conventional products. All the banks considered for the study prioritized the Shariah principle and Central bank regulation in designing Islamic Banking Products.

**Research Limitations/implications** - This paper contributed to the understanding of the important elements considered in designing Islamic banking products. The outcome of this research indicated that Islamic banks focus on these four factors/variables of the study and that the products are usually designed for any customer willing to comply with all the terms including the Shariah requirement. The Shariah component is usually a challenge for most businesses especially those prohibited by the Shariah law.

**Originality/Value** - The paper identified Islamic banking factors using selected Malaysian Islamic banks as benchmark. This study also discovered approaches in the Islamic banking system to enable adoption into countries that are new to the Islamic banking principle like Ghana and other countries with major conventional principles.

**Key terms:** Islamic banking products, Shariah law.

**Paper type** - Research Paper

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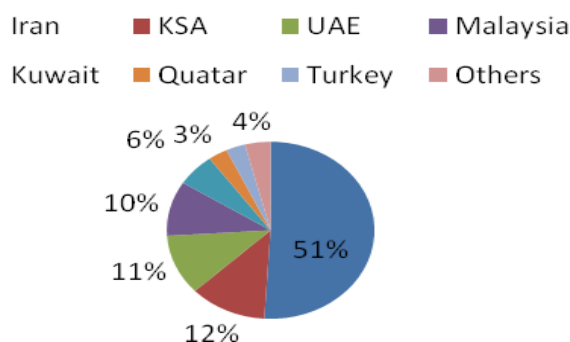
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### I. Background Introduction

Islamic banking started in the early 1960s and it is based on the Shariah principle, also called the Fiqh al-Muamalat (Islamic rules of transactions) (Man, 1988). The primary principle of Islamic banking is prohibition of interest (riba), profit and loss sharing and the other concepts of Islam such safekeeping (Wadiah), joint venture (Musharakah), cost plus (Murabahah), and leasing (Ijarah). According to the laws of Islam, certain businesses are considered unlawful (haraani) and these may include alcohol, pork, pornography etc. (Siddiqui, 2008).

The growing sector of Islamic banking increased as a result of the increasing purchasing power of Moslem communities across the world at large, and this created a niche market which banks and other financial institutions identified and exploited profitably in order to remain competitive (Alam, 2012). Examples of these financial institutions in Malaysia are Maybank, Alliance Islamic Bank Malaysia, Bank Islam, Affin Islamic, RHB Islamic, Hong Leong Islamic Bank and many others. This study will make references to CIMB Islamic Malaysia.

Islamic banking industry growth in the worldwide financial market reached \$1.4 trillion US dollars by January 2014. The Standard and Poor(S&P) estimates predicted this figure is likely to increase substantially and the records of June, 2017 shows approximately USD 1.9 trillion in 2016 (World Bank and Islamic Development Bank Group, 2016) indicating that this industry will continue to grow as predicted.



**Figure: 1.0** Gulf countries participation in Global Islamic banking (World Bank and Islamic Development Bank Group, 2016)

This research paper will try to unravel the factors that Islamic banks consider when designing banking products or services keeping in mind the principles and concepts of Shariah. This study also seeks to reveal the predominance of the Islamic rule of transactions over all other factors considered when designing Islamic banking products. It further examines whether these factors vary between different Islamic banks in different countries.

## II. Statement Of The Problem

Even though divergent views have been expressed by most researchers on whether Islamic banks practice only Islam rule of transaction, or a hybrid financial system where Islamic banking products are mixed with conventional products, there appears to be a limited knowledge as to whether Islamic banks survive basically by practicing the principles of Shariah in business or whether they consider only Islamic concepts when designing their products and services (Salem, 2019). This problem is partly attributed to the challenge of collecting these information from the Islamic banks as most of these information are not made public.

These developments notwithstanding, we may ask; to what extent is Islamic rule considered when designing Islamic Products and services? What other factors are considered by Islamic banks when designing their products and services? Are these considerations the same across all Islamic banks in different regions that practice Islamic banking? This study seeks to unravel these issues by addressing the following questions:

1. To what extent is the Shariah law considered when designing an Islamic banking product?
2. What is the Legal/regulatory requirement for Islamic banks with regards to the design of Islamic banking products?
3. To what extent is the Islamic principle of prohibition of halal businesses considered when designing banking products for businesses?
4. Are Islamic banking products designed only for Islamic businesses and does demography factors of Islamic banks influence the design of Islamic banking products?

The significance of this is to gather and exploit data on the factors that are considered by Islamic Banks when designing banking products. This study will help researchers, Islamic banking customers, and banking institutions understand the complexities involved when designing Islamic banking products by Islamic banks. This study will further illustrate whether all Islamic banks consider the same factors or the factors are bank or country specific. Moreover, this research is hoped to create the awareness and increase the participation of non Muslim banking customers purchasing products/services of Islamic banks. Invaluably, this research would serve as a comprehensive guide for further research.

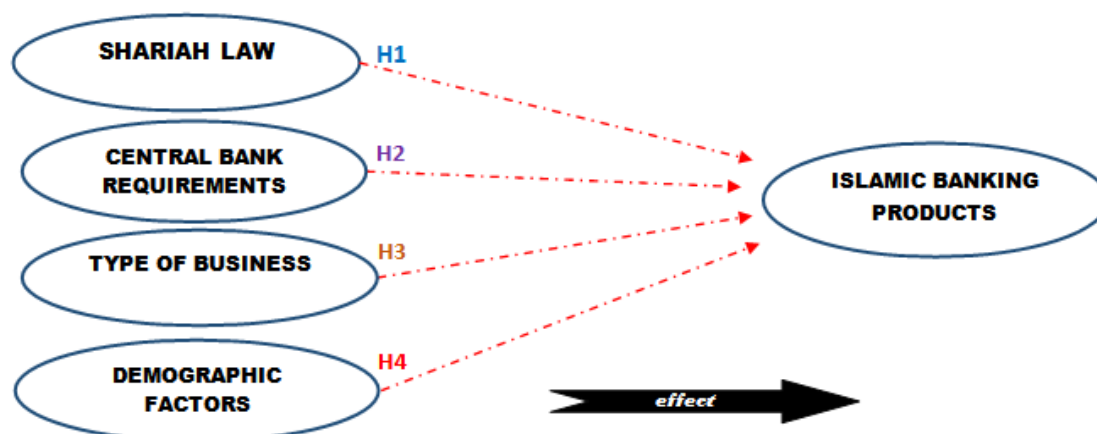
## III. Objectives

1. To determine the extent to which the Islamic principle of transaction is complied with when designing Islamic banking products.
2. To evaluate how the Central Bank requirements affect the Islamic banks when designing banking products for customers.
3. To determine whether Islamic banks consider the type of business of the customers when designing Islamic banking products.
4. To ascertain whether the demographic factors of Islamic banks are considered when designing Islamic banking products.

### **Theoretical Concept**

The current study extends previous studies by adopting research framework based on the principles of “Shariah” and “riba” (Javadin, et al., 2015; Gudarzi & Dastan, 2013). This study identifies three additional

variables namely “Central bank requirements”, “type of business”, “demographic factors”. This model will be tested on the respondents of selected Islamic banks in Malaysia. This model is summarized below:



**Figure 1.2** Research Framework.

## IV. Literature Review

### 2.1 Shariah Principle

The commercial banks operate on interest bearing transactions while Islamic banks operate based on the requirement of Shariah as stated in the Holy Quran, which is explained to maintain the purity of all transactions. Shariah also requires the segregation of Islamic funds from Non Islamic funds. For instance, CIMB’s Islamic banking products such as FSMI2, NEF2 are designed according to the basic principles of Shariah (Abdullah & Rahman, 2015). This was also recognized in previous literatures by Haniffa & Hudaib (2007). There are four basic Shariah principles that govern transactions in Islam (Suleiman, 2001). There will be no interest (riba) on transactions; there shall be no transactions that are speculative (Gharar) such as gambling; there should be no production of prohibited goods and services (Haram); and all persons must support the Islamic tax system (Zakat) (Yusniza & Azian, 2013).

### Profit and loss sharing (Mudharabah)

The principle of Mudharabah is a contractual agreement between a financial institution that mobilizes funds, an entrepreneur who provides expertise, and human resource that utilizes the funds for business (El-Gamal, 2006). The profit of the business is shared based on a pre determined ratio while the loss is suffered by all parties equally. This is a financial risk according to Shariah because the bank loses its funds but it is justified when the bank claims part of the profit. This principle is the fundamental principle in Islamic banking (Abdullah & Rahman, 2015).

### Safekeeping (Wadia)

With Wadia, the customer and the bank enter into a contractual agreement where the bank keeps and acts as a trustee of the amount deposited. The bank, while acting as a trustee utilizes the deposit for its business, but gives an assurance to refund the entire amount of deposit upon the demand of the depositor. Islamic banks offer instruments that are in line with the religious belief and culture of Muslim societies and they mainly depend on the depositors’ money as a major source of funds (Aggarwal & Yousef, 2000). The banks usually reward their customers with hibah (a gift) for using the funds at its discretion and frequency however there is no guarantee payment of gift to the depositors (Abu Bakar, 2007).

### Joint venture (Musharakah)

Musharakah principle applies where two or more persons/businesses enter into an agreement to combine their resources together and share rights, liabilities and profits from operations. This principle often applies to investment projects, letters of credit, and the acquisition of properties. From the interviews conducted, while the investment of each partner may not be the same, they each retain equal right to participation and management in the business, however no fixed amount can be settled for any of the participants. This principle has been unanimously agreed on by Muslim scholars according to (Bank Negara Malaysia, 2011). The principle has been applied to by CIMB in the design of products such as NED 2, FSMI 2 and other products.

**Cost plus (Murabahah).**

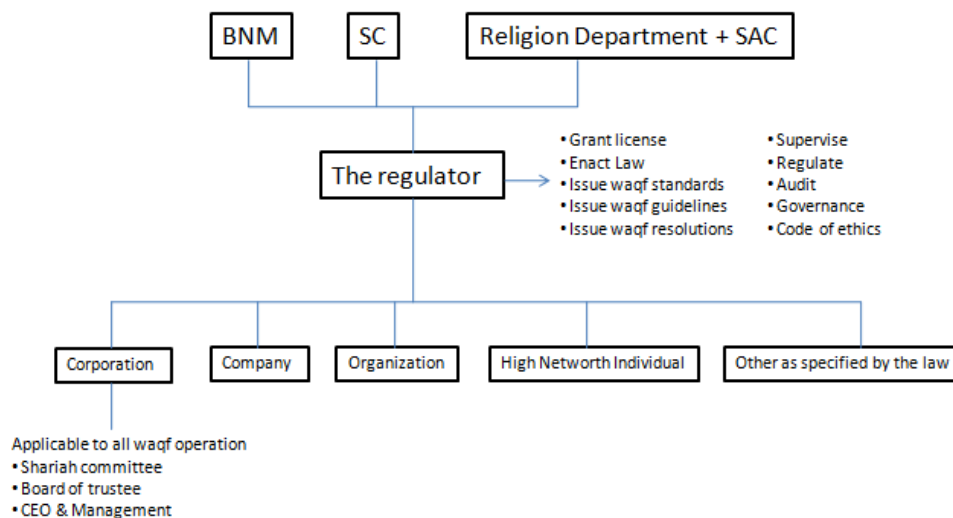
This principle applies to an agreement by two parties on a set price and profit margin for the sale of goods. This application of the Shariah is commonly used in the design of Islamic mortgage contracts. In such contracts, the bank does not loan the money to the buyers but instead, purchase the property from the seller, and then re-sell it to the buyer at a profit (Amanah Islamic Bank , 2013). The bank then allows the customer to pay back in installments. With CIMB mortgages, collateral is required as a protection for the bank. This is justified because there are no penalty requirements for late payments by the buyers.

**Leasing (Ijarah)**

This concept allows the bank to provide the customer with the assets/equipment such as a plant, office automation, or motor vehicle for a definite period and price. This contract is similar to conventional leasing agreements. These concepts are adhered to by Islamic banks when designing products. According to Che-Ha, et al., (2016), the Shariah law states that conventional banking system creates a system of unequal distribution of capital, and this issue is what the zakat (Islamic tax), one of the five pillars in Islam (mentioned over 30 times in the Quran), intends to solve. This was supported in the literature of Farook, et al., (2011). From this review, it can be concluded that CIMB applies the basic Islamic principles of transaction when designing its banking products. The application of the Islamic financing principles of Mudharabah, Wadia, Murabahah, Musharakah and Ijara is an important role of Islamic banks in mobilizing the direct resources toward attaining competitiveness in the market. In addition these principles are basic and fundamental to Islamic banking, economics and finance (El-Gamal, 2006).

These principles are the major guidelines provided by the Shariah law on transactions considered by all businesses that consider following the Islamic rule of transactions (Aggarwal & Yousef, 2000). Some banks prioritize some principles over others depending on the nature of the business transaction either, leasing, joint venture, or others.

**2.2 Legal/regulatory requirement**



**Figure2.0** Regulatory Framework (Adopted from World Bank and Islamic Development Bank Group, 2016)

**Bank Negara Malaysia (BNM) and the Security Commission (SC)**

The Central Bank of Malaysia also known as Bank Negara Malaysia (BNM) and the Security Commission (SC) are the regulators of all the registered financial institution in Malaysia. These regulators both ensure the institutions comply and adhere to the laws, acts and guidelines of Malaysia (Bank Negara Malaysia , 2011). Islamic banks are also subject to these regulations. The Central bank imposes control mechanism to monitor all Islamic Financial Institutions (IFI) due to several complications of the Shariah compliance requirements. All new products for Islamic banking institutions must adhere to the Shariah as stated by the guidelines of the BNM (Hong Leong Bank, 2011). Currently all IFIs are regulated by BNM under the purview of the Islamic Banking and Takaful Division (Bank Negara Malaysia , 2011).

**Shariah Advisory Council (SAC) of BNM**

The BNM established a Shariah Advisory Council (SAC) in May 1997 as the highest Shariah authority in Islamic finance in Malaysia (Kabiru, 2014). The SAC has full authority to determine the nature of operations

of the banking businesses, takaful businesses and Islamic financial business. SAC members appointed by the financial institution must first of all be recognized by BNM. This is to ensure that the members appointed are qualified to advice on the compliance of Shariah law in the design of Islamic banking product. This role was reinforced in the 2009 Central Bank of Malaysia Act (CBMA). The SAC's authority supersedes over any other regulatory authority should there be an issue contradictory to Shariah body or committee's recommendations. The court and arbitrators are also required to make reference to the rulings of the SAC for any proceedings relating to Islamic financial business and such rulings are also binding (Bank Negara Malaysia , 2011). These therefore affect the design of Islamic banking products as the bank must consider meeting all these requirements when designing banking products.

### **2.3 Type of Business**

Islamic banks consider the types of businesses when designing products and services. This is because, different businesses require different amount of capital, and hence different financing products (Alam, 2012). Islamic products are classified under different Islamic contracts such as Mudharabah, murabahah etc, and these contracts have different rates, margin of advance, financing tenure, scope and benefits. The bigger the size of the business, the more funds it will require and the more risk the bank takes in terms of product offering, as a result of the no interest charge requirement by the Shariah principle. These events necessitate the bank to consider the type of business it is designing the products for as different businesses have different business risks (Hasan, 2011; Alam, 2012).

Personal businesses are small businesses usually sole proprietorships. The basic rule is that for the business to be approved it must satisfy the Shariah rule on non harani business thus the business must not be prohibited by Islam and must also meet the standards set by the Shariah Advisory Committee. The clients of Islamic bank operate as partners to the bank (Abu Bakar, 2007); as a result of the profit as loss sharing principles.

Due to the nature of and regulations of Islamic banks, most IBP are designed for SMEs and partnerships which focus on profit and loss sharing which is fundamental in Shariah law and this is presumed to be best business for Islamic Banking Institutions. This also justifies that for a product to be approved for a customer; the type of business is taken into account and assessed to determine its eligibility. It can also be concluded that individual institutions and corporations who deposit money into Islamic banks do so under Shariah compliant agreements.

### **2.4 Demography of businesses**

Most Islamic bank hardly mentioned whether they consider the demography of customers when designing products. The demographic units considered include location, age, region, and employee count groups, type of industry or sector. This may paramount when designing Islamic banking product. This is because the requirement of different business in different industries differs from one another; also the number of employees as well as the other demographic factors differs with different businesses (Ramdhony, 2013).

The demographic factors may be important for customization of the Islamic banking products (Fada & Wabekwa, 2012). Islamic banks also competes with other Islamic banks and when competition intensifies, the bank can influence its performance by designing products to suit customers' needs. Therefore, considering the different demography of customers of Islamic banks in the design of Islamic products is of paramount importance for banks (Rashid, et al., 2012). Attitudes, behaviour, beliefs are different among people in different regions of Malaysia, the way of life of one region is different from another region. The cultural belief system is another important consideration in business and this differences must be identified when marketing Islamic products to the different customers (Javadin, et al., 2015). The place of origin of a person also shapes a person's believe system, for a bank to remain competitive , it considers these changes when designing product and marketing strategies (Hidayat & Al-Bawardi, 2012). These demography factors also help boost employee perception of the bank and hence the products positioning. Farook, et al., (2011) indicated the importance of personal factors such as the employee count groups in the adoption process. The employee groups such as labor unions are influential in affecting the banks activities hence good brand image must be created. The bank considers these changes when designing banking products for these different groups in order to remain competitive (Fada & Wabekwa, 2012).

Every industry or sector has its own practices that influences the decision of businesses in terms of product offering. The Islamic banking sector is an increasing sector with increasing competition and diversity of service development. This pressures the Islamic banks to become increasingly responsive to the market considerations in terms of segmentation, targeting and positioning. CIMB's management uses market strategies, infrastructure, information technology and their ability to innovate and differentiate to compete in the industry (Malaysian Accounting Standards Board-MASB, 2010). The bank keeps up to date information about the events

within the industry in order to shape its products and services to suit the industry that is supported by the Islamic laws.

Based on the review of literature above, the study came up with the following hypotheses;

*H1 Islamic principle of transaction has an influence when designing Islamic banking products;*

*H1a Islamic banks prioritize the Islamic principle of transaction over profit making strategies;*

*H2 Central Bank requirements affect the Islamic banks when designing banking products for customers.*

*H3 The type of business of the customers has an influence in the design of Islamic banking products by Islamic banks.*

*H4 Demographic factors of Islamic banks are considered when designing Islamic banking products.*

## V. Methodology

### **Sample:**

This chapter describes the research methodology adopted for the study. A comprehensive list of Muslim and non-Muslim bank customers is not available for the study. Such a list would require the banks to reveal their staff and customers' list and contact details. Such a list could not be obtained from the banks due to confidentiality reasons. Hence, the study adopts a non-probability sampling method using a convenience sampling method. The operation of the research was limited to customers and Staff of 10 Islamic Banks in Selangor, Malaysia. This is because it is important to undertake the research within the immediate environment of the researcher enable cut down on cost and saved time (Creswell, 1999).

### **Data Collection and Research Instrument**

The primary data for the research is gathered by means of a self-administered questionnaire, which were hand delivered to available respondents and through email to elicit voluntary participation (Creswell, 1999). The questionnaire consisted of four parts: Part 1 seeks information on the influence of Shariah law. Part 2 is formulated to gather the respondents' perceptions about how the regulatory framework influences the design of Islamic banking products. Part 3 collected information about the influence of the type of business and Part 4 gathered information of the how demography of bank and business influence the design of Islamic banking products. Other information was obtained from published articles of other researchers of similar studies online. The population of the study comprised of Muslim and non-Muslim mid-level staff and customers of over 5 years at the Islamic banks. The criteria that is set for the selection of the respondents is that they should be adults (18 years old and above) who use and understand the services offered by the Islamic banks (Aggarwal & Yousef, 2000).

## VI. Data Analysis

A pilot study was first carried out in which the questionnaire was pre-tested on a small study sample ( $n = 20$ ) consisting of 5 non-Muslim customers. Based on the preliminary feedbacks received, the study questionnaire was finalized, adjusted and implemented with some minor changes in the sequence and wording of the questions.

A total of 150 questionnaires are distributed to the Muslim and non-Muslim mid-level staff and the customers. The survey data collection process was not smooth as expected since many respondents had little time on their schedule to complete the questionnaire. Completed questionnaires were later screened for errors, incomplete or missing responses. Questionnaires that had more than 50% of the questions left unanswered or incorrectly answered were abandoned as invalid and excluded from the process of data analysis. After the final screening process, 120 responses were effectively considered complete and valid for data analysis. This represents a response rate of 80%, which is considered to be good in view of the time and cost constraints (Sekaran & Bougie, 2010). SPSS version 16.0 was used to analyze the data. A number of statistical analyses were performed. The current study used factor analysis in order to identify the factors that qualified for further data analysis. Cronbach's alpha was also used to test for reliability of the research instrument. The Appendix provides the full list of questionnaire items.

**Factor analysis:** The rationale of employing this statistical tool is due to the fact that this technique can help the researchers to reduce a large number of items to some smaller number by showing which variables belong together and which seem to indicate the same thing. The analysis is also important in confirming the construct validity of the scales using the principal component analysis.

**Cronbach's alpha:** The study also used Cronbach's alpha test in order to assess the reliability of the scales employed in this study. The Cronbach's  $\alpha$  values for all dimensions ranged from 0.891 to 0.962, exceeding the minimum of 0.6 (Hair, et al., 2003), thus the constructs measured were deemed reliable. Consequently, items which have values higher than 0.6 are retained for further analysis.

*Correlation analysis* was employed to test the relationships between the variables. More importantly, regression analysis was used to examine the relationship between the independent variables and the dependent variable.

## **VII. Results**

**Correlation:** The correlations of the major variables used in the study indicates that Shariah principle, Legal/regulatory requirement and type of business are positively correlated with the design of Islamic banking products ( $p < 0.01$ ). This means that all Islamic banks considered in the study have strong consideration for the Shariah principle and the Central bank or legal regulation of the country when designing Islamic banking products. The correlation for demography of the Islamic bank is negative, which indicates that that variable is not considered when designing Islamic banking products.

**Hypotheses testing and discussion of result:** Results indicates that three constructs; Shariah principle Legal/regulatory requirement and type of business are positively related to the design of Islamic banking Products. Shariah principle is positively related to the design of IBP at the 1 percent significance level ( $p$ -value  $\frac{1}{4}$  0.000,  $t$   $\frac{1}{4}$  8.322). Similarly, legal/regulatory requirement and type of business constructs are also positively related to the design of IBP but at the 5 percent significance level ( $p$ -value  $\frac{1}{4}$  0.035,  $t$   $\frac{1}{4}$  2.133), and ( $p$ -value  $\frac{1}{4}$  0.034,  $t$   $\frac{1}{4}$  2.133) respectively. Consequently, H1, H2 and H3 are supported. These findings are consistent with previous studies (Alemu, 2012; Hidayat & Al-Bawardi, 2012; Farook, et al., 2011; Abdullah & Rahman, 2015). These findings provide evidence of the appropriateness of the constructs Shariah principle, regulatory framework and type of business in the context of the design of Islamic Banking Products. Demography/location of the Islamic bank is found to be negatively related to the design of Islamic Banking Products but not significant ( $p$ -value  $\frac{1}{4}$  0.754,  $t$   $\frac{1}{4}$  20.314). Hence, H3 is rejected. This means that Islamic banks rarely consider the location or demography of the intended customers when designing Islamic Banking Products.

The findings also show that most banks have Islamic banking segment which uses Islamic financial system based on the Shariah principle, the results also show the Islamic banks prioritize some Shariah laws over others. The IBP are not designed for only Muslims but those customers who meet the requirement of the Shariah principle. The Islamic banks must publicize more information on Islamic banking products to increase awareness that these products are not designed solely for Muslim customers. Also every Islamic franchise has a Shariah Advisory Unit responsible for ensuring that Islamic Banking Products comply with the Shariah principles. They also ensure compliance to the Central bank's requirements of the country.

In short, the findings suggest that Islamic banks need to design their Islamic Banking products by taking into consideration the principles of Shariah, the country's legal or regulatory requirement, and the type of their clients' business.

## **VIII. Conclusion**

This research paper identified the factors considered by Islamic banks when designing Islamic banking products. Islamic Banking has gotten well known with a proven track record since its introduction to society. The growing number of assets and asset management under the classification "Islamic" is evidence of the level of acceptance by the market.

To compete on a leveled playing field with other financial institutions, Islamic banks would need to be competitive and this means producing and having more innovative products that meet the demands of the individuals and businesses. The Islamic products developed must comply not only with Shariah requirements but also with the country's legislation, Shariah Advisory Committee guidelines and ethical requirements. Since Islam promotes fairness, justice and transparency, banks should observe these ideals as well.

## **IX. Recommendation**

There should be a medium available for the public to be informed on banking products and services and their features as this has not been clearly stated anywhere in some of the Islamic banks under the study. Consumers must be given some variation in their banking products in order for them to understand and appreciate the specialty of every Islamic banking product in the Islamic banks and other banks with Islamic products. Since Islamic banking products are not designed solely for the Islamic banking customers, the image and advertisement must be created clearly to avoid misinterpretation by non-Muslims, as most of the non-Muslims having businesses meeting the requirement of the Shariah may have interest in patronizing the Islamic banking products.

## **X. Recommendation For Further Studies**

The challenge of the Islamic banking system is that variations in products, which have the same contract is subjected to different interpretation by the Shariah advisors, therefore there could be further studies

carried out on the why adoption of Islamic banking products in terms of patronage is slower compared to the conventional products. Also, further studies can be carried out to investigate why most of the Islamic banks have the resistance to disclose information of Islamic banking factors to the public.

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