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Islamic Banking in Malaysia: The Changing Landscape

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Abstract: *The banking industry in Malaysia is dominated by conventional banks, with Islamic banks accounting for roughly one-fifth. In addition, the Islamic banking sector is overwhelmingly in the hands of conventional banks, thanks to their Islamic subsidiaries which outnumber the 'wholesome' Islamic banks whose market share of the Islamic banking business is on the decline. In this equation, the Islamic subsidiaries of conventional banks have an upper hand, as they can ride on the coattails of their parents – which gives them a competitive edge - while the stand-alone domestic Islamic banks and foreign-owned full-fledged Islamic banks have to fend for themselves. The Islamic subsidiaries of conventional parents are in the driver's seat actively leading the industry, while the wholesome Islamic banks have apparently taken the backseat, which may not augur well for the future of Islamic banking that is currently stuck in the initial stage of product differentiation. It is likely that the Islamic subsidiaries of conventional banks will continue to 'Islamise' their conventional products, with wholesome Islamic banks passively following suit, rendering the transition from Shari'ah-compliant products to Shari'ah-based products somewhat elusive.*

Keywords: conventional banks, Islamic subsidiaries of conventional parents, wholesome Islamic banks, *Shari'a*h-compliant products, *Shari'ah* based products
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1. Introduction

The story of Islamic banking in Malaysia began with the establishment of Bank Islam Malaysia Berhad (BIMB) in 1983, with Lembaga Tabung Haji playing a pivotal role as the major shareholder. Currently, Tabung Haji owns 55.2 percent of BIMB Holdings which owns 100 percent of Bank Islam. The BIMB has expanded from four branches in the first year of its establishment to 142 branches at present.[1] During the first 10 years, the bank showed impressive growth in terms of deposits, financing and profits, thanks mainly to its monopoly status and the absence of competition (the bank's lacklustre performance in later years was blamed for its lack of innovation). To provide the much-needed competition, Bank Negara Malaysia (BNM), the central bank, allowed conventional banks to operate Islamic "windows" under the

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Interest-free Banking Scheme in 1993. Initially, the three largest local conventional banks in the country, namely Bank Bumiputra Malaysia Berhad (BBMB), Malayan Banking (Maybank) and United Malayan Banking Corporation (UMBC) were given licence to operate Islamic windows. By end-1993, there were 21 conventional banks with Islamic windows.

The Islamic windows of the conventional banks, due to their extensive network, were able to reach most parts of the country, a feat that BIMB with a small branch network could not accomplish. The conventional banks have done a great service to Islamic banking in the country through their Islamic windows, promoting Islamic banking and Islamic financial products. However, there were fears that deposits and investment incomes through Islamic windows may get mixed up with other deposits and interest incomes in the "common kitchen", which would defeat the purpose. There were also nagging concerns that the products offered through the Islamic windows could be no more than "interest-free", for there is much more to Islamic banking than the absence of interest (*riba*). All these led the central bank in 2002 to invite the conventional banks, both local and foreign owned, to convert their Islamic windows to Islamic subsidiaries.[2]

The Islamic subsidiaries of conventional banks came under the Islamic Banking Act of 1983, quite unlike the Islamic windows which were governed by the Banking and Financial Institutions Act (BAFIA) of 1989. The eight domestic conventional banks that have established Islamic banking subsidiaries are RHB Bank, Hong Leong Bank, Maybank, CIMB Bank, Public Bank, Affin Bank, Alliance Bank and Am Bank. The three foreign-owned conventional banks with Islamic banking subsidiaries are HSBC, Standard Chartered and OCBC. Their Islamic subsidiaries are known as Amanah, Saadiq and Al-Amin respectively. In addition, there are three foreign-owned full-fledged or wholesome Islamic banks[3], namely Al-Rajhi Banking & Investment Corporation, Asian Finance Bank Berhad and Kuwait Finance House, competing with local wholesome Islamic banks, namely Bank Islam, Bank Muamalat and Bank Rakyat. Since all of them are subject to a common stringent *Shari'ah* oversight, the perception now is that Islamic products offered by the Islamic subsidiaries of conventional banks are *Shari'ah*-compliant like their stand-alone/wholesome Islamic counterparts. Besides, the question of "common kitchen" does not arise anymore, given the firewall separating the conventional parent from its Islamic subsidiary.

This article attempts to study the landscape changes in the Islamic banking industry in Malaysia and their implications for the future of the industry. More specifically, the paper examines the impact of Islamic banking on the market share of conventional banking and the latter's response, and then analyses the competition between the Islamic subsidiaries of conventional banks, on the one hand, and the full-fledged/wholesome Islamic banks, on the other.

2. Conventional vs Islamic Banking

Malaysia plays an iconic role in Islamic banking, having been a pioneer and a front-runner in the global arena. The country has come a long way since the establishment of its first Islamic bank in 1983. There are now six wholesome Islamic banks, local and foreign, and 11 Islamic subsidiary banks owned by conventional banks, local and foreign, all co-existing with 21 conventional banks.

Islamic banking operations are based on *Shari'ah* principles which define the nature and character of the deposits mobilised and financing provided. Islam prohibits interest (*riba*) and permits trade (*tijara*). Accordingly, in Islamic banking, profits are derived from the contract of trade (*al-bai'*), unlike conventional banks where profits are from interest-bearing loans. In Islam, it is business risk taking, and not financial risk taking, that forms the basis for profits. The *al-bai'* principle is represented by exchange of money with an underlying asset, whereas a contract of interest-bearing loan involves an exchange of money for greater returns (Ariff & Rosly, 2011).

Profit, in Islam, is all about risk taking (*ghorm*), effort (*kasb*) and responsibility (*daman*). The *Shari'ah* objective (*Maqasid al-Shari'ah*) plays a critical role in determining the legality of Islamic transactions, as it insists that all transactions must have positive impact on general welfare of the concerned party. Seen in this context, there is much more to Islamic banking than the prohibition of *riba*. Other prohibitions include ambiguity (*gharar*), gambling (*maisir*), and bribery (*rishwa*). All transactions must be transparent, based on mutual consent with offer and acceptance (*ijab* and *qabul*) free from duress (*ikroh*).

In short, real sector connectivity and risk sharing distinguish Islamic banking from conventional banking. In Islamic banking, all financial transactions must relate to the real economy with no space for 'financialisation' or financing for the sake of financing. In Islamic paradigm, the financial sector is inextricably linked to the real sector of the economy which means that the financial sector would not exist on its own. In other words, the financial sector primarily functions as the facilitator of the real sector.

While Islamic banks have demonstrated that they are indeed different from their conventional counterparts, there are tensions between the theory and practices of Islamic banking. This may be attributed to the perception that the Islamic products are no different from the conventional ones, going not only by the strong resemblance between the two but also by the prices charged for the products. According to the Law of One Price, two products bearing the same risk profile must assume the same pricing.

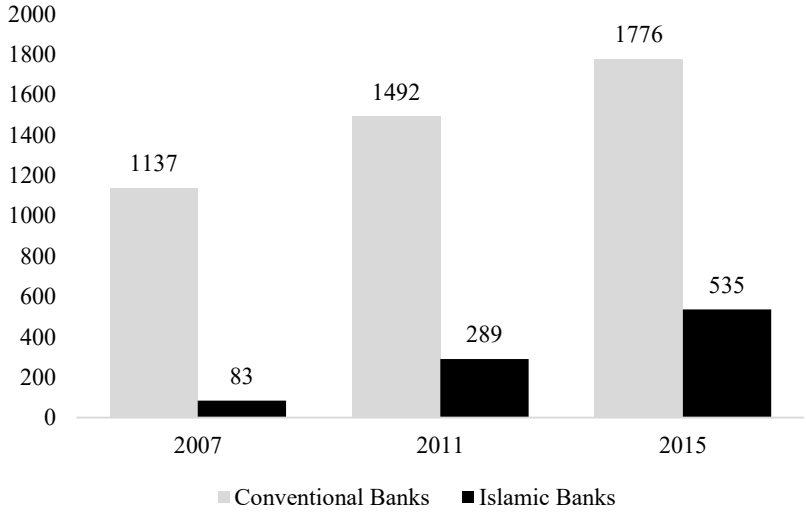
The crux of the problem is that Islamic bank products are modelled after their conventional counterparts. For every conventional product, there is a

corresponding Islamic substitute with *Shari'ah* compliance. Islamic banks offer 'differentiated' products by simply adopting conventional risk and return profile, subject to *Shari'ah* constraints. Thus, the products offered by Islamic banks, in the first stage of their evolution, are very similar but not identical to that of conventional banks.

It was envisaged that Islamic banks, as they evolve and enter the second stage, would move away from 'differentiated' (*Shari'ah*-compliant) to distinctly 'different' or 'dissimilar' (*Shari'ah*-based) products that will have no bearings on the current conventional products. The third stage is a visionary one that would unveil innovative 'home grown' products based on research and development (R&D). To embrace this mature stage, Islamic banks will have to leap into a new development trajectory, with risk and reward sharing modes of financing in sync with the lofty Islamic ideals.

The emergence of Islamic banking has not thwarted the expansion of conventional banks in Malaysia. Figure 1 shows that, in terms of assets, conventional banking has continued to grow, unperturbed by the impressive advances made by Islamic banking over the years. Understandably, Islamic banking as a newcomer pales in comparison with its conventional counterpart.

Figure 1: Asset size: Conventional vs Islamic banks



Conventional banks continue to play a predominant role in the Malaysian economy, despite losing some market share to Islamic banks. The share of conventional banking in total deposits has declined from 92.5 percent in 2007 to 76.9 percent in 2015, while its share of total financing has also fallen

from 93.4 percent to 72.9 percent between 2007 and 2015, as shown in Table 1. The decline is striking also in terms of assets, as the conventional banking total share of the industry has shrunk from 93.2 percent in 2007 to 76.9 percent in 2015 (Table 1).

Table 1: Percentage market share of Conventional and Islamic banking

Year	Assets		Deposits		Loans/Financing	
	Conventional	*Islamic*	*Conventional*	*Islamic*	*Conventional*	*Islamic*
2007	93.13	6.87	92.46	7.54	93.35	6.65
2008	87.22	12.78	86.67	13.33	86.48	13.52
2009	85.32	14.68	85.79	14.21	84.59	15.41
2010	84.30	15.70	84.56	15.44	83.07	16.93
2011	83.77	16.23	82.46	17.54	81.33	18.67
2012	80.46	19.54	80.41	19.59	77.99	22.01
2013	78.56	21.44	77.20	22.80	76.75	23.25
2014	78.00	22.00	75.56	24.44	74.77	25.23
2015	76.85	23.15	75.87	24.13	72.88	27.12

Source: Computations based on data derived from the annual reports of individual banks.

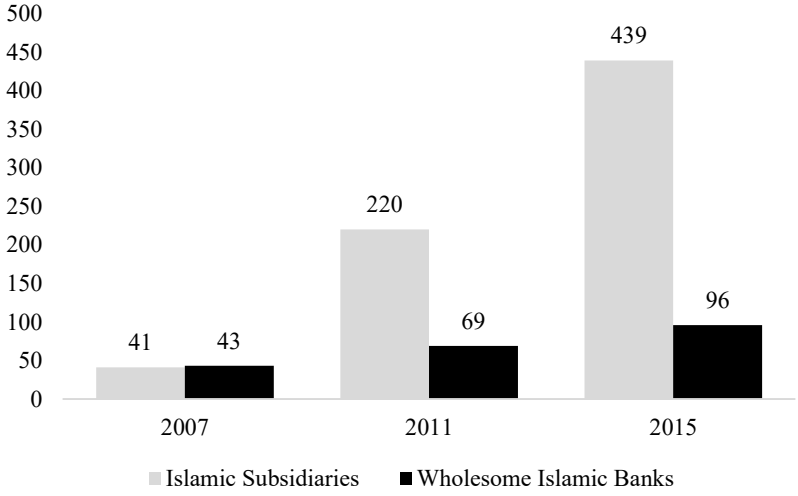
Although conventional banks have lost considerable market share to Islamic banking in the country, the former have responded to the challenge constructively by setting up Islamic windows and subsequently converting these Islamic windows into Islamic subsidiaries.

3. Islamic Subsidiaries vs Wholesome Islamic Banks

Technically speaking, there is no difference between Islamic subsidiaries and wholesome Islamic banks operating in Malaysia, as all of them are subject to the same set of oversight and regulations, so much so that the products offered by all of them meet the stringent *Shari'ah* requirements imposed by the Shari'ah Advisory Council at BNM. The only difference between the two is that the Islamic subsidiaries have conventional parents, both domestic (e.g. Maybank) and foreign (e.g. HSBC), whereas the wholesome Islamic banks are either stand-alone domestic banks (e.g. Bank Muamalat) or subsidiaries of foreign Islamic parents (e.g. Kuwait Finance House).

The advent of Islamic subsidiary banking in 2002 has made a huge dent in the profile of wholesome Islamic banking in Malaysia. The latter was leading and the former was lagging until 2007, after which the lead/lag relationship was reversed. Figure 2 shows that the wholesome Islamic banking asset size, which was marginally larger in 2007, was subsequently dwarfed by the remarkable advances made by the Islamic subsidiary banking.

Figure 2: Asset size: Islamic subsidiaries vs wholesome Islamic banks



The Islamic subsidiaries of conventional banks have taken up much of the slack of their parents, as the subsidiaries' share of the Islamic banking industry assets has grown from 48.7 percent in 2007 to 82.1 percent in 2015, as shown in Table 2. What is more, the Islamic subsidiaries' share of deposits has risen from 46.7 percent in 2007 to 81.1 percent in 2015, while their share of Islamic financing has grown from 51.1 percent to 84.3 percent during the same period (Table 2).

Table 2: Islamic Banking Business: Percentage Share of Islamic Subsidiaries and Wholesome Islamic Banks

Year	Assets		Deposits		Financing	
	Islamic subs	***Wholesome***	***Islamic subs***	***Wholesome***	***Islamic subs***	***Wholesome***
2007	48.74	51.26	46.72	53.28	51.12	48.88
2008	68.28	31.72	67.20	32.80	73.09	26.91
2009	69.64	30.36	66.95	33.05	76.21	23.79
2010	71.99	28.01	70.00	30.00	78.73	21.27
2011	76.04	23.96	75.40	24.60	82.21	17.79
2012	78.02	21.98	77.17	22.87	83.06	16.94
2013	80.28	19.72	80.00	20.00	83.39	16.61
2014	81.17	18.83	82.50	17.50	85.12	14.88
2015	82.06	17.94	81.10	17.90	84.26	15.64

Source: Computations based on data derived from the annual reports of individual banks.

The share of Islamic subsidiaries of conventional banks in *total* bank deposits has risen sharply from 3.7 percent in 2007 to 19.7 percent in 2015, while that of wholesome Islamic banks has stagnated at 4.3 percent in 2007 and 2015, although it has doubled in absolute terms. Likewise, the wholesome Islamic banks' share in *total* bank financing / loans has risen only incrementally from 3.3 percent to 4.2 percent between 2007 and 2015, while that of the Islamic subsidiaries of conventional banks has jumped from 3.4 percent to 22.8 percent during the same period.

Evidently, the wholesome Islamic banks are not on par with the Islamic subsidiaries of conventional banks. Their share of total Islamic deposits has fallen from 53.3 percent to 17.9 percent between 2007 and 2015, while their share of Islamic financing has also declined from 48.9 percent to 15.6 percent. In terms of total Islamic banking assets, the share of wholesome Islamic banks has fallen from 51.3 percent in 2007 to 17.9 percent in 2015.

4. Implications

The impressive performance of Islamic subsidiaries of conventional banks has catapulted them into the forefront of Islamic banking business in Malaysia. It is remarkable that the Islamic subsidiaries, which were way behind the wholesome banks in the initial stages, could overtake the latter from 2008 onward, leapfrogging to the commanding heights that they now occupy.

It is obvious that the Islamic subsidiaries of conventional banks are not competing with their parents. They are, in fact, competing with the wholesome Islamic banks, both local and foreign, a competition in which they clearly have an upper hand. The advantages are now staked visibly in favour of these Islamic subsidiaries. Without a doubt, the Islamic subsidiaries have the support of their strong parents, on whose coattails they can ride comfortably. The extensive branch networks of their parents are a boon to these subsidiaries as they can share the parents' premises and facilities, which is not the case for the stand-alone wholesome Islamic banks.

No doubt the wholesome foreign Islamic banks also have the support of their Islamic parents abroad, but they lack the kind of logistic and institutional infrastructure enjoyed by the Islamic subsidiaries of conventional parents. In other words, the Islamic subsidiaries of conventional banks have benefited much from the implicit subsidies and other types of support provided by their conventional parents, quite unlike the wholesome Islamic banks.

We can hypothesise that these advantages would render Islamic subsidiaries more efficient than their wholesome Islamic counterparts[4] as the subsidiaries do not bear the full operating cost, thanks to implicit subsidies from their parents.[5]

With conventional banks having such an overwhelming stronghold as stakeholders in the Islamic banking industry, the chances their Islamic subsidiaries will continue to copy their parents' products with *Shari'ah* compliance. The wholesome Islamic banks, which compete with conventional banks and their Islamic subsidiaries, are likely to simply follow suit. While there may be nothing wrong or objectionable about all this from the *Shari'ah* point of view, the ensuing fixation on *Shari'ah* compliance is likely to scuttle the industry's commitments to climb up the value-added chain. This means that Islamic banks may stay focused on or remain preoccupied with producing '*Shari'ah*-compliant' products instead of venturing into the world of '*Shari'ah*-based' products.

However, we must hasten to add, the products of Islamic subsidiaries of conventional banks are no less 'Islamic' than that of wholesome Islamic banks, as all of them strictly adhere to the stringent *Shari'ah* requirements and they are all subject to regulations and oversights. Nonetheless, the question is: are Islamic banks owned by conventional banks are as zealous or passionate about Islamic principles as the wholesome Islamic banks? It is a moot question who would take the lead in propelling the Islamic banking industry to the next level: the former or the latter? They can do it together only if they are equally zealous. If not, the onus will fall squarely on wholesome Islamic banks, but the pertinent question is whether they can call the shots when they are outnumbered and overshadowed by the subsidiaries of conventional banks.

That said, we must not lose sight of the contributions conventional banks have made to the development of Islamic banking industry. In the mid-eighties, when the outreach of Bank Islam Malaysia was limited by its small branch network, the conventional banks' Islamic windows were able to take the Islamic banking facility to every nook and corner of the country, thanks to their extensive branch networks. The conventional banks' interest in Islamic banking, for whatever reasons, was then a boon to the then fledging Islamic banking industry in terms of horizontal expansion. Going forward, one may wonder if the strong involvement of conventional banks in the Islamic banking industry would constrain its advancement vertically. Put another way, the concern here is not about horizontal expansion but about vertical progression.

5. Some Concerns

As mentioned earlier, real sector connectivity and risk sharing are the hallmarks of Islamic banking. The current Islamic banking products are mirror images of conventional products, with *Shari'ah* compliance being the main differentiator. While real sector connectivity is manifest in all these products, there is much controversy over *tawarruq munazam*, a substitute for

the conventional personal loan facility, as its real sector connectivity is dubious, where commodities are bought and sold on the spot, not for profit but for the sole purpose of securing a bank loan.

There is very little risk-sharing activity currently in the Islamic banking fraternity as the players have been acting to minimise risks. Contrary to the notion that risk sharing forms the bedrock of Islamic finance, *musharakah* (profit and loss sharing) plays an extremely insignificant role in the portfolio of Islamic banks. The problem lies on both supply and demand sides. On the supply side, Islamic banks are wary of high risks associated with the *musharakah* mode, while clients on the demand side find *musharakah* a costlier option as the cost of equity capital is much higher than that of borrowed capital, and hence, the preference for bank loans. Therefore, only high-risk firms with questionable credentials would seek *musharakah* arrangements and hence, the high premium associated with such systematic risks.

Islamic banks are facing an identity crisis. The term 'lenders' and 'financiers' are used interchangeably, although there is a difference: all lenders are financiers, but not all financiers are lenders. Islamic banks do not 'lend' but do provide 'financing'. All this begs the question: if Islamic banks are not 'lenders', need they identify themselves as 'banks' in the first place? Viewed in this perspective, the term 'Islamic bank' is arguably a misnomer, if not an oxymoron. By associating with the banking (i.e. lending) business, Islamic banks unwittingly now share the same mindset as conventional banks.

The above identity or association has led unfortunately to some unintended consequences. The perception that Islamic banks are not very different from conventional banks stems from the fact that (a) Islamic bank products closely resemble conventional bank products, (b) Islamic banks follow conventional bank benchmarks in product pricing and (c) Islamic banks behave like conventional banks with hardly any risk sharing. Notwithstanding the confusion all this may have caused among the clientele, Islamic banks in reality are very different from conventional banks. To be sure, Islamic banking is synonymous with *halal* banking. As in the case of *halal* meat – where the product looks the same, tastes the same and costs the same as standard meat – the products of Islamic banks resemble that of conventional banks in some ways, but there is a big difference: one is *halal* and the other is not.

The Islamic banking clientele may be classified, based on casual empiricism, into four categories: the loyalists, the sceptics, the pragmatists and the opportunists. The Loyalist accepts Islamic bank products with no questions or qualms. The Sceptic has doubts about the purity of some Islamic bank products but is willing to tag along, assuming that things will improve over time. The Pragmatist is unsure of the purity of Islamic bank products

but willing to give the benefit of the doubt on the ground that sin, if any, would fall on the financier and not the customer. The Opportunist is either indifferent or agnostic, subscribing to the view that *riba* refers to usury and not bank interest, and would switch freely from one to the other depending on costs and returns.

One would expect that there will be more and more 'loyalists' and fewer and fewer 'sceptics' as Islamic banks transcend to the next level and beyond. The fact that Islamic banking is stuck in the first stage of product differentiation for four decades may suggest that Islamic banks are either complacent or caught in what may be dubbed as the '*Shari'ah* compliance trap'. To break out of this impasse, Islamic banks should first cease to be under the shadow of conventional banking, which means that they must set their own standards, norms, best practices and benchmarks.

Anecdotal evidence suggests that wholesome Islamic banks are competing with conventional banks rather than among themselves. This 'head-on competition' with conventional banks may have led these Islamic banks to concentrate on Islamic substitutes (with *Shari'ah* compliance) for conventional products and follow the conventional benchmarks in product pricing. Thus, it is unsurprising that the returns on deposits and financing costs of Islamic banks are strikingly similar to that of conventional banks.

The 'head-on competition' strategy would enable Islamic banks to target wider audiences, comprising both Muslim and non-Muslim, while it forces them to be on par with conventional banks in terms of ease of access, product mix and competitive pricing. This option, however, places Islamic banks at a huge scale disadvantage vis-a-vis their conventional counterparts in terms of economies of scale and scope and at the risk of being boxed into the '*Shari'ah* compliance' mode and mould for ever.

In contrast, the 'niche market' strategy would take Islamic banks closer to meeting specific Islamic needs by targeting primarily customers who care about *Shari'ah* rulings. The focus of Islamic banks would then be predominantly on the Muslim clientele, meeting their basic banking needs and venturing into sophisticated areas, such as asset development and wealth management. The niche market approach can still be inclusive enough to appeal to non-Muslims who appreciate the ethical content. To be sure, Islamic banking is not meant for Muslims only but for all, regardless of their religious orientations.

The niche market strategy implies that Islamic banks will compete less and less with conventional banks and more and more among themselves. This reorientation will compel them to come up with innovative *Shari'ah*-based products that would meet customer needs at competitive prices, empowering them to distance themselves from conventional banking.

If Islamic banks can sell a better product, there is no reason why they should not charge a higher price for it, as the customers would not mind

paying a bit more for a better product; what more if these banks can sell better products at lower prices. We will not be able to see the best of Islamic finance unless and until Islamic banks are able to leapfrog from a compliance mode to an innovative one.

At the same time, if they can cut costs through efficiency gains, they should also be able to share these gains with their clients in the form of better returns and lower costs. It is conceivable there may come a time when there will be Islamic banks with specialisations, such as Murabaha Banks, Mudarabah Banks, Musharakah Banks. These Islamic banks may well create a 'new' market of their own without having to compete head-on with their conventional counterparts. Under this scenario, competition with conventional banks, to say the least, would be indirect, not head-on.

6. Conclusion

Evidently, the Islamic subsidiaries of conventional banks in Malaysia have taken the thunder away from the Islamic banking pioneers who have long been in the Islamic banking business. One might argue that there is really nothing wrong with all that, especially since the financial products of the Islamic subsidiaries are just as Islamic as that of the wholesome Islamic banks, with none of the salient Islamic principles being compromised.

It took several centuries for conventional banking to evolve into what it is today. Islamic banking has a long way to go before it can reach its pinnacle. For now, even after four decades, Islamic banking is still at the initial stage of product differentiation. All indications are that Islamic banks are likely to remain stuck in this infant stage for a much longer period than previously thought, given the current trends in the banking industry.

The banking industry is currently dominated by conventional banks, with Islamic banks accounting for roughly one-fifth. Islamic banks established as subsidiaries of conventional banks outnumber wholesome Islamic banks. Clearly, there has been no level playing field in the dual banking system. Conventional banks could do what Islamic banks could (by default, through their Islamic subsidiaries or windows), while Islamic banks understandably cannot do what conventional banks can (by design). For instance, it is unimaginable for a wholesome Islamic bank to own conventional subsidiaries or windows.

The Islamic subsidiaries of conventional banks are firmly in the driver's seat, with wholesome Islamic banks taking the back seat – which may not augur well for the future of Islamic banking. The chances are that the Islamic subsidiaries of conventional banks would continue to 'Islamise' their conventional products, with wholesome Islamic banks following suit passively. Islamic banking is unlikely to move to the next tier so long as the

wholesome Islamic banks are unable or unwilling to play the leadership role in steering the industry towards new frontiers.

Notes

1. For a detailed analysis of the expansion and performance of Bank Islam Malaysia, see Zainal-Abidin (2016).
2. For a discussion on the role of conventional banks in the Islamic banking business in Malaysia through windows and subsidiaries, see Mohamad, Muhamad Sori & Mohd Rashid (2016).
3. For a comparison of the performance of foreign-owned wholesome Islamic banks with that of foreign-owned Islamic subsidiaries in Malaysia, see Rosly (2016).
4. Several empirical studies confirm that conventional banks are generally more efficient than their Islamic counterparts: e.g. Banker & Natarajan (2008), Beck, Demirguc-Kunt, Merrouche (2013), and Othman & Mersni (2014). A plausible explanation for this is that Islamic banks face more risks than the conventional banks, not to mention the add-on cost of Shari'ah compliance. However, thus far, there is no empirical evidence of efficiency comparisons between Islamic subsidiaries and wholesome Islamic banks in the literature.
5. There are no studies comparing the efficiency of conventional parents with their Islamic subsidiaries. A recent research, using the Data Envelopment Analysis (DEA) technique, has found that Islamic subsidiaries in Malaysia are indeed more efficient than not only the wholesome Islamic banks but also their conventional parents (Ariff & Shawtari, 2017).

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