

**EXAMINING THE RELATIONSHIP BETWEEN FOREIGN  
ISLAMIC BANK ENTRY, ASSET QUALITY AND LIQUIDITY  
WITH PERFORMANCE OF DOMESTIC ISLAMIC BANKS IN  
MALAYSIA**

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UNIVERSITI UTARA MALAYSIA**

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**Thesis Submitted to  
Othman Yeop Abdullah Graduate School of Business,  
Universiti Utara Malaysia,  
in Partial Fulfilment of the Requirement for the Master of Sciences (Banking)**

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I hereby declare that the project paper is based on my original work except quotations and citations that have been duly acknowledged. I also declare it has not been previously or concurrently submitted for any other Master's programme at Universiti Utara Malaysia or other institutions.

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## **ABSTRAK**

Kajian ini mengkaji hubungan antara kemasukan bank asing, kualiti aset dan kecairan dengan prestasi bank Islam domestik di Malaysia. The analisis empirikal kajian adalah terhad kepada bank-bank Islam di Malaysia dalam tempoh 2008-2013. Objektif utama kajian ini adalah untuk menentukan kesan kemasukan bank Islam asing kepada bank-bank Islam domestik di Malaysia. Kajian ini menggunakan nisbah kewangan bank dengan mengeluarkan komponen dari Model CAMEL, iaitu; Kualiti aset, dan kecairan. Hasil kajian menunjukkan bahawa kemasukan bank Islam asing mempunyai kesan negatif terhadap prestasi bank-bank Islam domestik menggunakan ROE sebagai pengukur tetapi tidak memberi kesan apabila ROA digunakan sebagai ukuran prestasi. Ini bermakna bahawa bank-bank Islam asing mengurangkan prestasi bank-bank Islam domestik. Selain itu, kualiti aset dan kualiti kecairan tidak mempunyai kesan yang besar ke atas prestasi bank-bank Islam domestik.

Kata kunci: Kemasukkan bank Islam asing, Kualiti aset, Kecairan, ROA, ROE.

## **ABSTRACT**

This study examines the relationship between foreign bank entry, asset quality and liquidity with performance of domestic Islamic banks in Malaysia. The empirical analysis of the study is restricted to Islamic banks in Malaysia within the period of 2008-2013. The main objective was to determine the effects of foreign Islamic bank entry on domestic Islamic banks in Malaysia. The study used financial ratios of banks by extracting components of CAMELS Model, namely; Asset quality, and Liquidity. The result shows that foreign Islamic bank entry has negative effects on the domestic Islamic banks performance using ROE as a measure but has no effect when ROA was used as a measure of performance. This means that foreign Islamic banks reduce domestic Islamic banks performance. In addition, asset quality and liquidity quality had no significant effect on domestic Islamic banks performance.

Keyword: Foreign bank entry, asset quality, liquidity, ROA, ROE.

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## **LIST OF ABBREVIATIONS**

PERF- Performance

BNM- Bank Negara Malaysia

FIE- Foreign Islamic entry

AQ- Asset quality

LIQ- Liquidity

ROA- Return on Assets

ROE- Return on Equity

## **CHAPTER ONE**

### **BACKGROUND OF THE STUDY**

#### **1.0 Introduction**

This chapter begins with explanations on the Malaysian financial system, foreign Islamic bank entry and liberalization on foreign banks entry. This is followed by the explanation on the problem statement, the research questions and research objectives, the significance of the study and finally the organization of the study.

#### **1.1 Malaysian Financial System**

The foundation of any financial system is made up of banks because they assume a crucial role in contributing and developing the economy. A study conducted by Hassan, Sanchez, and Yu (2011) established that the effectiveness of financial intermediation can affect the growth of the economy and also bank inadequacies can bring about crises which have negative effects on the economy. In other words, banks are essential in financing economic activities and contribute to the soundness of the financial system. Every country is concerned in creating a strong and solid banking system, which allows the organizational framework to ensure a proper expansion and development of financial relations in the economy. A stable banking system helps to provide efficiency in unforeseen circumstances and also brings about incentives and reliable financial information for all participants. However, the bad performance of the banking industry in any nation would have a disastrous effect on the economy.

The banking system in Malaysia started with the establishment of the Central Bank which is also known as Bank Negara Malaysia (BNM) under the Central Bank of Malaya Ordinance 1958, on January 26, 1959. The main concern of the Central Bank since the early 1960s was to establish an oriented Malaysian banking system. This led to the extension of the domestic banking system and reorientation of operations of the foreign banks with the aim of catering and meeting domestic needs (Mahadzir, 2004). Presently, the Malaysian banking industry constitutes of the Investment banks, commercial banks, foreign banks, Islamic banks, and other financial institutions. These institutions constitute the main institutional source of credit to the economic sector. According to BNM, as at December 2014, there are 27 commercial banks in Malaysia, among which 8 are local banks, and 19 are foreign-owned banks, 16 Islamic banks, which consist of 10 local banks, and 6 foreign-owned banks, 13 investment banks and other financial institutions (BNM, 2013).

Malaysia has succeeded in introducing a dual banking system and has become known as among the first set of nations to have a full-fledged Islamic banking system performing alongside with the conventional banking system. The conventional banks and Islamic banks perform identical functions for example, accepting of deposits, running of retail banking services, giving out of loans and advances, and financial guarantees. While Islamic banks and conventional banks perform similar functions, their modes of operation are distinct. The conventional banks operates on pre-fixed interest whilst Islamic banks are based on the profit and loss sharing (PLS) principle and interest-free method of financing in performing their business as intermediaries (Ariff & Rosly, 2011).



Islamic banking is defined as a system of banking which is based on Islamic law (Shari'ah) principles and standards and it is also guided by Islamic laws (Rosnia, Norhazlina & Wahab, 2011). Islamic law forbids usury, payment and collection of interest, which is commonly referred to as riba. Islamic law generally disallows transaction in financial risk (which is usually understood as gambling). Mohamad, Hassan, and Bader, (2008) noted that conventional banks gains profits by drawing deposit from the depositors at a low interest rate, and resell these funds to the borrowers at a higher interest rate, based on its competitive advantage at collecting information and underwriting risk. Consequently, conventional banks earn profits from the spread between the interest rate gotten from borrowers and the interest rate paid to depositors. In contrary, the Islamic banks under the name of Islamic PLS, the relationship between borrower, lender and intermediary are established in financial trust and partnership. The relevance of the interest-free banking services in Islamic banking has brought about a pioneering environment amidst practitioners to which the substitution of interest is expected. Dar, (2003) established that there are four types of financing which can be used to substitute interest; sale-based, rent-based, investment-based, and service-based. As at end of November 2013 the Islamic banking assets in Malaysia are over USD132 billion and the Islamic banking market share increased from 7.8% in 2007 to 20.7% in 2013 (BNM, 2013).

The Islamic financial sector is represented by 16 Islamic banks, 8 takaful companies an Islamic money market, and a broad range of financial products.

## **1.2 Foreign Islamic Bank Entry and liberalization on Foreign Banks entry**

In recent times, there has been a great increase in trading in goods and financial services internationally. To expedite such trade, many banking institutions have also become multinational. Banks have expanded globally by setting up foreign subsidiaries and branches or by acquiring established foreign banks. The internationalization of the banking sector has been propelled by the liberalization of financial markets worldwide. Developing and developed countries alike now to a greater extent permit foreign-owned banks and allow foreign entry on a national treatment basis (Claessens, Demirgüç-Kunt, & Huizinga, 2001).

Foreign bank entry is defined as a process by which foreign banks begins operations in a host country mainly by establishing a branch or a subsidiary. According to Tschoegl, (2003) the present degree of integration across banking sectors around the globe can only be compared to what was operative eve of World War I. The author pointed out two different strategies that foreign banks may adopt to enter a country; (i) they enter as traditional operation and (ii) innovators. This traditional operation involves setting up branches and subsidiaries. Their activities is just to offer regular international banking services such as finance trades, provide foreign exchange transactions and also make trade payments, while as an innovator, the foreign banks enter to other countries to seek better investment opportunity and market prospects. Several studies like Focarelli and Pozzolo (2001) and Claessens, Demirgüç-Kunt, and Huizinga (2000) identified factors that compel a bank to go multinational. According to Claessens, Demirgüç-Kunt, and Huizinga (2000), foreign banks are enticed to markets with low taxes and higher per capita income and also profitable investment opportunities in the host countries. Focarelli and Pozzolo, (2001) found that foreign banks prefer to make investments in countries with lesser regulatory

limitations on banking activities. Further, Barth, Caprio, and Levine, (2004) produced a cross-country proof that tightened restrictions on entry into banking sector (whether foreign or domestic banks) are identified with increased net interest margins and overhead costs. These factors implies that the degree of economic integration between a foreign bank's home country and the host country which it enters, the market prospects obtainable in the host country, and entry limitations and other regulations (including tax treatment) have all affected the timing and pattern of foreign entry.

The banking sector's liberalization opens up domestic markets for foreign banks and also encourages tremendous growth of international trade in financial services. The banking liberalization will enhance the effectiveness of the banks, improve the allocation of credits, encourage savings and, thereby leading to a higher economic growth (Beju & Ciupac-Ulici, 2012). Malaysia has joined a number of countries in liberalizing their economy in order to enjoy the benefits that comes with it by changing a number of regulations. Malaysia adopted a gradualist approach in liberalizing the financial sector. This gradual and progressive approach allows the country to tap into fully the benefits of financial sector liberalization and also gives the banks the capacity and ability to absorb these changes without affecting the overall stability of the country's banking industry(BNM, 1999).

In 1966, foreign banks were prevented from opening additional branches in Malaysia; however, the ban was lifted about forty years later (BNM, 2005). The Malaysian Government has always had the desire to develop the country as the hub, capital or centre point of Islamic banking worldwide. To meet this objective, the government has taken measures, which amongst others involves liberalizing the

Malaysian Islamic banking sector which led to the introduction of foreign Islamic banks into the Malaysian banking market in September, 2003. The strategy is to create more competition, to tap new growth and development opportunities, and also to increase the performance of the Malaysian Islamic banking industry as a whole (Fadzlan Sufian, 2010). The Malaysian Government's dedication to this is proved by the issuing of licenses to three foreign banks from the Middle East, which are, Al-Baraka Islamic Bank, Al-Rajhi Banking and Investment Corporation and Kuwait Finance House, to operate as full-fledged Islamic banks in the country in September, 2003 (Sufian, & Haron, 2008).

Following this, Kuwait Finance House which is the first fully fledged foreign Islamic bank, started operations in August, 2005 while Al-Rajhi Bank and Qatar Islamic Bank, started operations in 2006 and early 2007, respectively. Under the Islamic Banking Act (1983), the new foreign Islamic banks are permitted to perform a broad range of Islamic banking business in Malaysia. The new foreign Islamic banks are required to meet the minimum paid-up capital of RM10 million and will have to pay an annual license fee of RM50, 000. Malaysia's Islamic banking industry has grown tremendously since the establishment of Bank Islam Malaysia Berhad (BIMB) as the first fully fledged Islamic bank in the country 31 years ago (Mokhtar, Abdullah, & Al-Habshi, 2006). BIMB was the only Islamic bank that were in operations for 10 years since July 1983 before the government permitted other conventional banks to provide Islamic banking services with the use of their available infrastructure and branches (BNM, 1994 & 1999). The number of Islamic banks in the country increased because the government permitted the conventional banks to provide Islamic banking services or "Islamic windows". They did so because it was assumed to be the most efficient and adequate method of expanding the number of

banks which offered Islamic banking services at a lowest cost and in a lesser time (BNM, 1999).

The presence of new foreign players is presumed to have a positive effect on the Islamic banking industry in specific areas such as Islamic product innovation, improvement and development, but the smaller players will endeavour to drive business volumes and build their position in the Islamic banking industry as competition rises (Sufian & Haron, 2008).

### **1.3 Problem Statement**

The entry of foreign owned banks has so many effects on the Malaysian economy. There is far reaching writing and experimental studies dissecting the effect of foreign involvement on domestic financial systems. Supporters of foreign direct investment (FDI) noted that the increase in foreign Islamic banks entry gives rise to competition in the banking sector thereby bringing about the reduction of expenses, increase in the quality of banking services offered, and also helps for more competent banking methods (Claessens & Jansen, 2000; Claessens *et al.*, 2001; Lensink & Hermes, 2004).

Foreign banks entry can also have effects on the domestic bank market and on the customers. Goldberg, Dages, and Kinney, (2000) argue that there would be a reduction in the stability of credit available to domestic banks when there is an increased foreign banks presence. This is so because foreign banks helps capital outflows through close ties to international financial markets than domestic banks. In addition, Dages *et al.*, (2000) also argued that foreign banks picks the most effective and productive market segments, leaving less competitive domestic banks with worse

ratings, which leads to an increase in the riskiness of domestic banks' portfolios that may result in the failure of domestic banks.

The liberalization of the banking industry allowed for establishment of foreign Islamic banks in Malaysia. Sufian, (2010) noted that this would help the domestic Islamic banks increase their performance and also enable them to compete favourably with their foreign counterpart thereby leading to the growth and development of the Malaysian banking industry.

On the effect of asset quality on bank's performance, Srairi, (2009) argued that if there is an increased exposure to credit risk, banks performance will decrease. In addition, Vong and Hoi,(2009) found that Islamic and conventional bank have negative relationship in their asset quality. However, even though these studies found negative relationship, there is need for this study to be carried out in developing country like Malaysia.

According to Alkassim,(2005) banks' ability to meet its debt obligations is called liquidity. Sufian and Habibullah (2009), among others, found a positive significant relationship between the level of liquidity and bank performance. The authors noted that banks would have a higher performance when its liquidity is high. Haron and Azmi (2004) and Wasiuzzaman and Tarmizi (2009) also supported this findings as the authors found a positive and significant relationship of liquidity and bank performance. Further, there is limited study on the relationship of foreign Islamic bank entry with domestic Islamic bank performance; therefore this study will fill in the gap in these areas.

Despite the fact that studies like Acheampong,(2013), Clarke, Cull, and Martinez Peria, (2001), Denizer, (2000) that examined the effect of foreign Islamic banks entry on the domestic sector are voluminous, to the best of my knowledge, very limited study were done on the Islamic banking sector particularly in Malaysia. Even though, there exist a few studies which have analyzed the performance of the Malaysian Islamic banking sector, (e.g. Mokhtar, Abdullah, & Alhabshi, 2008; Sufian, 2007; Samad, 2004; Samad & Hassan, 1999) these studies were not focused on examining the relationship between foreign Islamic bank entry, asset quality and liquidity on the performance of domestic Islamic banks. Hence, this study endeavours to fill in the gap and add insight to the present studies in a few regards that will be examined. Particularly, this study performance comparison includes foreign Islamic banks as well as the domestic Islamic banks in Malaysia.

#### **1.4 Research Questions**

- a) What is the effect of foreign Islamic bank entry with the performance of domestic Islamic banks in Malaysia?
- b) What is the effect of asset quality with the performance of domestic Islamic banks in Malaysia?
- c) What is the effect of liquidity with the performance of domestic Islamic banks in Malaysia?

#### **1.5 Research Objectives**

- a) To investigate the effects of foreign Islamic bank entry with the performance of domestic Islamic banks in Malaysia.

- b) To examine the effects of asset quality with the performance of domestic Islamic banks in Malaysia.
- c) To determine the effects of liquidity with the performance of domestic Islamic banks in Malaysia.

## **1.6 Significance of the Study**

The importance of this study can't be over emphasized. The study is noteworthy to the stakeholders, for example, the academicians, financial institutions and policy maker. Firstly, this study is of great importance for academicians, as it fills in an essential hole in the existing studies, giving a much better understanding of the domestic Islamic banking industry performance in Malaysia in the midst of competition from an increased foreign banks entry. Apart from academicians, professionals and practioners could also gain from this study, as it examines the true effect of bringing in foreign investors into the local Islamic banking industry in Malaysia. It permits drawing deductions on whether increased foreign banks presence positively or negatively affect the growth of the Islamic banks in Malaysia. The study can, subsequently, be pertinent for the regulatory bodies of Malaysia for refining the approach policy of financial sector regulation, specifically with respect to foreign entry.

The research will give more understanding, whether the current regulatory approach of pulling in foreign investments into the financial sector is proficient and if authorities ought to increase or reduce the entrance of foreign Islamic banks. Also, Islamic banks in Malaysia can also profit from this study, as they would be more ready to face whatever challenge considering conceivable changes in economic situations and market conditions because of foreign Islamic bank entry.



What's more, it would be helpful for foreign Islamic banks proposing to enter the Islamic banking sector in Malaysia to foresee potential changes in the business sector and predicting whether it would at present look appealing to them.

### **1.7 Organization of the Study**

The study is organised into five chapters. Chapter One discusses the background of the study, problem statement, research questions and the research objectives, and also the significance of the study. The literature review was outlined in the Chapter Two. This chapter reviews several literatures and theories which relates to foreign Islamic bank entry on Islamic banks performance in Malaysia. It also covers the prior empirical evidences that are related to the study.

Chapter Three describes the methodology which shows and explains the techniques and methods used in the study. It begins with explanations on the research framework, research design and measurement. Chapter Four, shows the empirical results and discussions on the relationship of foreign Islamic bank entry on the performance of domestic owned Islamic banks. The consistent and differences of the result in comparison with prior empirical evidences are highlighted.

Finally, Chapter Five is a conclusion of the research objectives carried out. This chapter highlights the contributions of the study and also explains limitations that should be noted. Also, suggestions for future research are also presented.

### **1.8 Summary of Chapter**

This chapter explains the overall picture of the study. It gives an explanation of the Malaysian financial system and definition of foreign entry, which is focused on the Malaysian banking sector. This study discusses the liberalization on foreign bank

entry which is focused on the Malaysian banks and identified issues and gaps which leads to problem statement, research objectives, research questions and significance of the study. Then organisation of chapters is presented to explain on how the study is organised.

## CHAPTER TWO

### LITERATURE REVIEW

#### 1 Introduction

This chapter introduces the literature review of the study. It gives a critical review of the contemporary literatures and theories related to the effects of foreign Islamic bank entry. It covers the foundation and empirical evidences that are related to the study.

#### 2.1 Foreign bank entry

Various studies in the contemporary literatures have been able to reveal the effect of foreign banks entry on the domestic banks' performance. However, the empirical findings provide inconsistent results. Studies by Unite and Sullivan,(2003) found that foreign bank entrance in the Philippines urges domestic banks to be more effective, and also concentrate on their operations due to increased risk, and become less reliant on relationship-based banking. Barth *et al.*,(2004); Lensink and Hermes, (2004); Focarelli and Pozzolo, (2001) among others, contends that domestic banking sector gains from foreign banks entry. The studies found that foreign banks entry stimulates cost cutting interest, enhances performance, and also leads to an increase in the different types of products and services offered by the domestic sector. However, studies by Demirgüç-Kunt and Levine, (2008); Claessens and Laeven,(2004) among others, contends that foreign banks entry affects domestic banks negatively because of the severity of the competition.

On economic level, Lensink and Hermes, (2004) contend that the effects of foreign bank entry on domestic bank performance is reliant on the level of economic development of the host country and demonstrate that at lower level of economic expansion, foreign bank presence is largely connected with increased expenses and margins for the domestic banks. However, at a higher level of economic development, the effect is less where foreign bank entry is associated with a fall in expenses or increase in the domestic banks profit margins. Acheampong, (2013) found that foreign bank entry is beneficial to the economy. They argued that foreign bank presence induces improvement in the domestic financial system infrastructure and regulations. These improvements in the domestic bank regulation diminish the odds of systematic bank failures and will also lead to stability and soundness in the financial system of the economy.

The positive effects of foreign bank presence has on domestic banks has been examined by several studies. Debnath and Shankar (2008) in their study of Indian banks for the period of 2001-2005 found that foreign banks were quite more proficient as compared to the domestic banks. Consistent with Debnath and Shankar (2008), Sanjeev (2009) in his study of Indian banks, for the period of 2003 to 2007, found a similar result. They concluded that foreign bank were more efficient when compared to Indian local banks.

Denizer (2000) in his study on the effects of foreign bank presence on domestic banks in Turkey found that there is a reduction in net interest rate margins, returns on assets and overhead costs of domestic bank after foreign banks enter the banking market. These discoveries help supports the idea that foreign banks mounts competitive pressure on the domestic banks in Turkey, notwithstanding the way that

these foreign banks had a market share of just somewhere around 3.5% and 5% during the period of (1970-1997). Dages *et al*, (2000) argued that foreign banks presence may help to enhance the overall stability and soundness of the domestic banking sector by ensuring a steady supply of credit because it is believed that foreign banks have contact to more diverse source of liquidity than the domestic banks.

Further, Chantapong (2005) in a study on the Thailand banking sector proposes that the performance of the foreign banks is greater than their domestic bank counterpart to a large extent. The results demonstrates that despite the fact that the presence of foreign banks increases rivalry and competition in the banking sector, the domestic banks appear to profit from these enhanced managerial, mechanical and technological adjustments and transfer. In a study carried out by Dubauskas and Kowalski ( 2005), the authors argued that foreign banks increased competition in the banking sector and reduced profitability of domestic banks. The results also showed that foreign banks improved the quality of service and improvement in the host country's banking industry, like the development of Internet banking services and introducing more useful risk management techniques. Moreover, foreign banks presence has made domestic banks more dependable, thereby making it easier and less expensive for domestic banks and their customers to borrow from international markets.

Arguments against foreign bank presence are numerous. Dages *et al.*, (2000) established that an increased foreign banks presence will lead to a reduction in the stability of credit available to domestic banks. This is so because foreign banks facilitate capital outflows by establishing closer ties to international financial markets

than domestic banks. Further, the author also noted that foreign banks “cherry pick” the productive and profitable market segment, leaving the less competitive domestic banks to serve other customers with worse ratings, which leads to an increase in the overall riskiness of domestic banks’ portfolios that may cause in the collapse of domestic banks.

Moreover, foreign banks may “cut and run” during financial difficulties or crisis and therefore cannot be seen as a steady source of credits for domestic market (Dages *et al.*, 2000). Sengupta, (2007) in their study found that foreign banks may visage problems in transferring some of the credit valuation methods used in developed markets due to lack of information in developing markets. This may result in the decline of credit available to small and medium-size firms as foreign banks will prefer to take large companies whose information are readily accessible and available.

Claessens *et al.*, (2001) by using a sample of 80 countries found that foreign bank entry brings about the decrease in non-interest income, performance, and general costs of the domestic banks. Similarly, Barajas, Salazar and Steiner (2000) who studied on the Colombian banking system for the period of 1985-1998 demonstrates that foreign bank entry enhance competition in the domestic sector as proven by diminished intermediation spreads. Yet foreign bank entry also comes with an immense decline of reported credit quality among domestic banks. Additionally, administrative expenses of domestic banks increases because of the way these banks need to redesign and upgrade their activities and services due to an aggressive competition pressure. Therefore, foreign bank entry appears to be connected with increased expenses for the domestic banking system of Colombia. Feldstein, (2000)

also found that foreign banks in Korea 'cherry pick' the best credit and leaves the worst for the domestic banks. He contends that foreign banks have a tendency to increase their lending during the good times, but decreases it in terrible times.

Several research works have established that foreign banks have a tendency to be less proficient than domestic banks in host countries in developed countries. Sturm and Williams, (2004) found out that Japanese foreign- owned banks in the U.S. are, on average, less efficient than U.S. banks in their study of the cost and profit efficiencies of the Japanese banks and the domestic banks in the US for the period of 1984 to 1989. They discovered that Japanese banks operating in the US were less cost and profit efficient than their US-owned counterparts. Also, Berger *et al.*, (2000), in their study found that in developed economies, foreign banks had a tendency to have a much lower performance scores in relation to the domestic banks' efficiency performance. In developing and transition economies, however, the trend is quite different. In fact, performance evaluation between foreign and domestic banks demonstrates that foreign banks in transition and developing economies have thrived in capitalizing on their advantages and also shows a higher level of competence than their domestic peers Claessens *et al.*, (2001); Hasan and Marton,(2003) are example of studies who found that foreign banks are slightly more efficient than the domestic ones in India.

Claessens *et al.*, (2001) further reported that in developing countries, foreign banks has the tendency to have high interest margins, increased profits and higher tax payments when compared to domestic banks. However, Fatimah Salwa Abd Hadi and Norma Md Saad ,(2010) in their study of Malaysian banks for the period of

2006-2008 noted that domestic Islamic banks performed better than foreign-Islamic banks.

## **2.2 Asset Quality and Bank Performance**

Asset quality is an assessment of the credit risk identified with an asset (Rose, & Hudgins, 2013). It is also an evaluation of the value of bank assets and is generally based on the leases and loans. It also involves taking cognizant of the probability of the borrower paying back the loans (Debnath & Shankar, 2008). Cebenoyan and Strahan, (2004) argue that banks which are productive (demonstrated by a low cost to income ratio) develop the abilities to manage their assets and in this way would have the capacity to further lend their assets to risky borrowers and also have the finesse to use credit derivatives in order to buy and sell their assets. In a study carried out by Awan (2009) by using indicators such as ratio of provisions to NPLs and ratio of NPLs to deposits, non-performing loans (NPLs), ratio of NPL to advances/financing, found out that the asset quality of Islamic banks are more efficient, effective and productive than conventional banks since Islamic banks have healthier balance sheet and low default rate. Kosmidou, Tanna and Pasiouras (2005) used a proxy of loan loss reserves to gross loans and it showed a positive significance of asset quality on net interest margin; however, loan loss reserves is insignificant on ROA. The authors concluded that high risks may well result in high returns. Among others, Kosmidou *et al.*, (2005) and Sufian and Habibullah, (2009) in their study also found a positive relationship of asset quality in relation to bank performance. Vong and Hoi (2009) also found a positive relationship between asset quality and bank performance. Hefferna and Fu (2008) found a positive and significant coefficient on the loan loss reserve ratio, showing that loan loss provisioning improves Islamic



banks' performance. However, Hassan and Bashir (2003) found no difference in the asset quality of conventional and Islamic and banks but identified that Islamic banks were better capitalized than conventional banks.

Srairi (2009) who made use of loan loss reserve to total assets as measurement observed that a continuous exposure to credit risk is mostly followed with decrease in the performance of banks. Athanasoglou, Delis and Staikouras (2006); Ramadan, Kilani and Kaddumi, (2011); Vong and Hoi, (2009) found an inverse and significant relationship of asset quality and bank performance for Islamic and commercial banks respectively. An inverse relationship demonstrates that an increase in exposure to credit risk may lower the bank's profit. Tanna, Kosmidou and Pasiouras, (2005) and Wasiuzzaman and Tarmizi, (2009) in their studies also used the loan loss reserves to total/gross loans ratio as a proxy to the variable and found a negative relationship between asset quality and bank performance. In a study conducted by Jaffar and Manarvi (2011) of Pakistani banks for a period of 2005-2009 found that asset quality remained the same in Islamic and conventional banks. Belanes, and Hassiki, (2012) in their study of Islamic and conventional banks in MENA countries for the period of 2006–2009 found an insignificant difference between asset quality and banks performance. On the relationship between asset quality and bank performance, Elyor, (2009) found that asset quality and bank performance has a positive relationship on domestic banks with the existence of foreign banks in the market.

### **2.3 Liquidity and Bank Performance**

Liquidity is defined as the capability of a company to exchange its assets into cash. It is also called marketability. It is important to note that assets can be sold without depreciating the price. It is preferable and safer for investors to invest in liquid assets since the investment can be regained anytime and when investors want (Rose, & Hudgins, 2013). Liquidity is one of the internal factors that can be used to evaluate banks' performance. Liquidity helps to establish a percentage of assets that makes up the loan portfolio.

Several researchers such as Alkassim (2005) used a number of proxies on the relationship of liquidity and banks' performance such as total loan to total asset, and total financing to total deposit. He observed that both the Islamic and conventional banks tend to have same liquidity. Sufian and Habibullah (2009) discovered a positive significant relationship between the level of liquidity and banks' performance with the use of liquid assets to total assets and loans to total assets as a measurement of liquidity. The author found that the higher the liquidity of a bank, the higher is its performance. Prior studies on Islamic banks show that the result is mixed and diverse. Studies such as Haron and Azmi (2004) and Wasiuzzaman and Tarmizi (2009) found a significant and positive relationship between liquidity and banks' performance. They contend that conventional banks have the conflicting signs with Islamic banks because of the profit and loss sharing mode. Similarly, Tanna, *et al.*,(2005) found the same result in their studies of the relationship between liquidity and bank performance even when using different measurements for liquidity. Jaffar and Manarvi (2011) in their study of Pakistani banks for the period of 2005-2009 found that Islamic banks performed better than conventional banks.

Samad (2004) compared the performance of Islamic Banks and conventional banks in Bahrain. The result shows an insignificant difference, in terms of bank performance and liquidity. The result is consistent with Kader, Asarpota and Al-Maghaireh (2007) who also found no big difference in terms of profitability and liquidity. Kosmidou *et al.*,(2005) in his study examined the UK commercial banks and found a negative sign of liquidity on net interest margin though this is only significant in the presence of external factors. On the other hand, with the use of liquid assets to total assets and loans to total assets, Alkassim (2005) discovered a significant and inverse relationship of liquidity in relation to bank performance with the argument that low levels of bank liquidity increases banks performance and high levels of liquidity reduces performance of banks. These differences in result from prior studies might be owed to the different of elasticity of demand for loan from each sample. Kosmidou *et al.*,(2005) in their study used the liquid asset to customer and short term funding ratio as a measurement of liquidity and found that there is a negative relationship between liquidity and bank performance. Hassan and Bashir (2003) found that commercial banks are more liquid when compared to Islamic banks while Srairi (2009) in his study also found a negative relationship between the liquidity and bank performance for Islamic banks and argues that this may be due to the surplus of liquid assets that are creating a cost of opportunity. He also emphasized that in order to avoid insolvency, banks more often than not hold liquid assets to meet up unfavourable shocks and so the less liquid the bank, the higher is their performance. This was also confirmed by Akhter, Raza, and Akram (2011) who revealed that the liquid assets to customer deposits and short-term funds ratio was lower for Islamic banks when compared to conventional banks. Izhar, and Asutay, (2007) also found a negative sign and significant relationship. A study by

Idris, Asari, Taufik, Salim, Mustaffa and Jusoff (2011) showed that liquidity does not meet the prerequisite of significance and hence it is not an absolute determinant to affect the performance of Islamic banks in Malaysia. The results found by Acheampong, (2013) on the relationship between liquidity and bank performance indicates a positive relationship of the domestic banks with the existence of foreign banks in the market.

#### **2.4 Summary of Chapter**

This chapter gives a critical review of literatures that are related to the study. it also provides insights on the empirical evidences of various studies on foreign entry, asset quality and liquidity and its relationship on bank performance.

## **CHAPTER THREE**

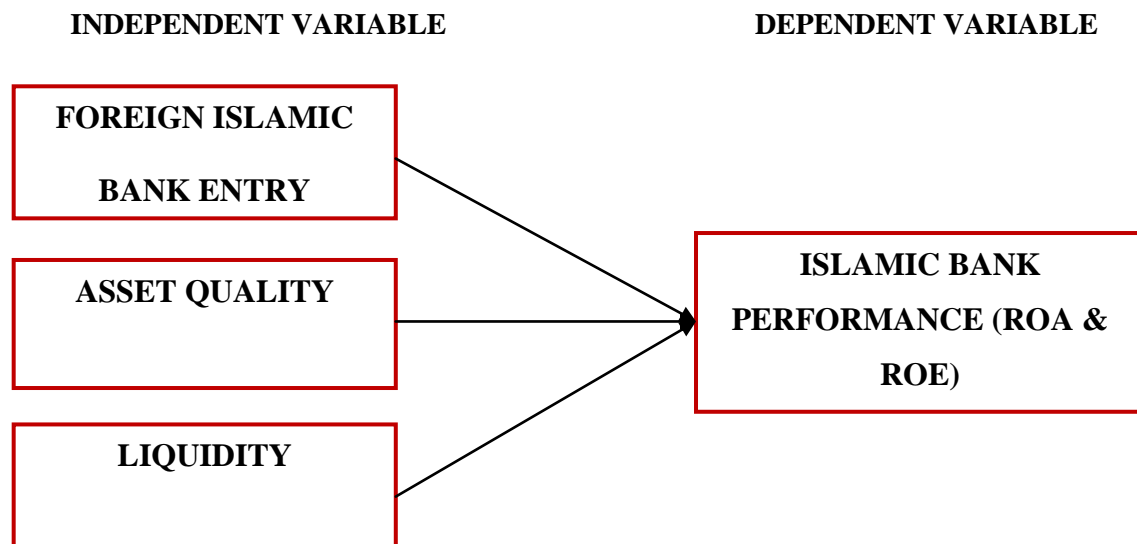
### **METHODOLOGY**

#### **3.0 Introduction**

The method used to conduct this study is described in this chapter. It discusses the research framework which was developed based on the literature review. It also explains the development of hypotheses, the measurement of both the independent and dependent variable of the study, the population and data collection and finally, the analysis of the data.

#### **3.1 Research Framework**

The research framework as shown in figure 3.1 has been developed based on the literature review and research problems. The framework lays emphasis on the effects of foreign Islamic bank entry on the performance of domestic Islamic banks. The Islamic bank's performance which is the dependent variable is measured by Return on Asset (ROA) and Return on Equity (ROE). The independent variables are foreign Islamic bank entry and two CAMELS factors namely; (i) Asset quality, (ii) liquidity. The theoretical framework of this study is shown as in Figure 3.1.



*Figure 3.1*  
*Theoretical framework*

This study is an extension of Acheampong (2013) who studied the effect of foreign bank entry on financial performance of domestic banks in Ghana. However, this study is different from Acheampong, (2013) in the sense that this study is focusing on Islamic banks; the CAMELS factors used in this study are asset quality and liquidity and this study is particularly done on Malaysian Islamic banks. Acheampong, (2013) on the other hand focused on commercial banks in Ghana and used different CAMELS factors, namely capital adequacy and liquidity.

### **3.2 Definition and Measurement of Variables**

#### **3.2.1 Dependent Variables:**

The dependent variable of this study is bank performance. Bank performance refers to how a bank achieves its goal of profit maximization and reduction of risk conditions (Genu & Marcel, 2008) and is measured by using return on equity (ROE) and return on assets (ROA). ROE is one of the most popular measurement for performance and have been extensively used by previous researchers such as

Alkassim, (2005); Haron, and Azmi, (2004); Hassan and Bashir, (2003). ROE helps to indicate the real financial condition of banks (Lin, Zhang, & Zhu, 2009). ROE also measures how a bank utilizes its equity that is the shareholders fund. Hassan and Bashir,(2003) highlight that banks in general utilize financial leverage greatly to improve ROE to competitive levels. A higher ROE means that the bank is utilizing its equity efficiently and higher return to shareholders.

Another dependent variable used is ROA. ROA shows the profit made per dollar of assets and mainly reveals management's capacity to make use of the bank's financial and real investment resources to produce profits (Hassan & Bashir, 2003). For any bank, the ROA depends on the bank's policy decision as well as irrepressible factors relating to the economy and government regulations.

### **3.2.2 Independent Variables:**

The independent variables of this study are foreign bank entry, asset quality and liquidity.

**3.2.2.1 Foreign bank entry:** Foreign bank entry is described as a process by which foreign banks starts offering banking services in a host country (Tschoegl, 2003). Following Acheampong (2013), this study uses dummy as a measurement for foreign Islamic banks presence. If there was a foreign bank entry in a particular year, 1 (one) was assigned; if there was none 0 (zero) would be assigned.

### **3.2.2.2 Asset Quality**

Asset quality is defined as an evaluation of the qualities associated with banks' asset. The loan loss reserve to gross loans (LLR) is used as a measure of asset quality. This ratio is used as a measurement because it shows the amount of total

loan portfolio that has been made available but not written off (Alkassim, 2005). Given a similar charge-off policy, the higher the ratio, the poorer the quality of the loan and this will lead to an increased risk of the loan's portfolio. According to Kosmidou *et al.*, (2005), a poor loan quality could diminish interest revenue and increase bank's provisioning costs. However, with a sound quality loans, a high ratio may possibly indicate a positive relationship between risk and profits, according to the risk-return hypothesis. Golin ,(2001) noted that the challenge for bank management is to decrease the risk of defaulting in loans repayment and to price loans so that proceeds are more adequate to cover up loan losses. This measurement has been used by previous studies such as Heffernan and Fu (2008) and Kosmidou *et al.*, (2005) as a measure of asset quality.

### **3.2.2.3 Liquidity**

Liquidity is described as the ability of a bank to meet up its short-term obligations (Alkassim, 2005). Without the necessary liquidity and funding to meet up with its debt, a bank might fail rapidly, or at least be technically bankrupt. According to Alkassim, (2005) liquidity assumes a fundamental part towards the performance of banks. In general; when the value of the ratio is high, the better it would be for the bank because their margin of safety they possess to cover the debts will also be high. The study uses the ratio of liquid assets to customers and short term funding to measure the relationship between liquidity and performance. By using the liquid assets over customer's short-term funding as a proxy for liquidity, this ratio accounts for deposits run off. This ratio works as a signal to show the extent to which deposit takers can meet the short-term withdrawal without having liquidity problems. This ratio should be high for more liquid banks because it shows, as a percentage, how



short-term funding can be met if there is an unexpected customer withdrawal. This measurement has been extensively used by previous studies such as (Akhter *et al.*, 2011; Alkassim, 2005; Kosmidou *et al.*, 2005) in measuring liquidity. Table 3.1 shows the summary of the variables, the measurement for each variables and previous studies that used the same measurements.

Table 3.1  
*Summary of variables and measurements*

<b>VARIABLES</b>	<b>ACRONYM</b>	<b>MEASUREMENTS</b>	<b>SOURCES</b>
PERFORMANCE	PER	ROE = Net income/ total equity ROA= net income/ total assets	(Lin <i>et al.</i> , 2009), Sufian and Habibullah,(2009) Hassan and Bashir, (2003), (Kosmidou <i>et al.</i> ,2005)
FOREIGN ENTRY	FE	Use of dummy	Acheampong, (2013)
ASSET QUALITY	AQ	Loan loss reserve to gross loans	Heffernan and Fu, (2008) Kosmidou <i>et al.</i> , (2005)
LIQUIDITY	LQ	Liquid asset to customers and short term funding	Kosmidou <i>et al.</i> , (2005) and Akhtar <i>et al.</i> , (2011)

### 3.3 Population and data collection

The Islamic banks in Malaysia as at 2013 consist of 6 foreign banks and 10 domestic banks. As this study examines the relationship between foreign bank entry, asset quality and liquidity with performance of the domestic Islamic banks, only financial data of the domestic Islamic banks are collected. The existence of the foreign Islamic banks in Malaysia is proxied by dummy variable. Hence, in examining the relationship of variables in the research framework, secondary data comprising of financial ratios of the 10 domestic Islamic banks are used. The period of observations of this study is confined to 2008-2013 only. The study period starts at 2008 as this is

the year foreign Islamic banks started their operations in Malaysia as a result of the liberalization policy implemented by the Malaysian government. The list of Islamic banks used in the study is shown in Appendix 1.

Data of this study was obtained from the Bank Negara Malaysia, and Bursa Malaysia, while annual reports of individual banks were obtained from the banks websites. The data was constructed based on the selected balance sheet and income statement items and also notes to the financial statement. Panel data which is a combination of time series and cross sectional data are used in the study. The study covers the entire population of Islamic banks in Malaysia. The Islamic banks are selected as units of analysis because of the dual banking in Malaysia and also less focus given to this type of banks. All the banks in this study are locally incorporated and have commenced operations in Malaysia.

### **3.4 Hypotheses Development**

The hypotheses development of the study is essentially based on Camel framework. According to Camel framework, it is a suitable, simple and basic model to evaluate the financial and managerial assessment of institutions. It is also a type of financial analysis which is mostly used to assess the managerial and financial performance of banks in order to determine the soundness and safety of the banks (Sarker, 2006). The variables asset quality and liquidity were chosen because asset quality helps in the evaluation of measuring the credit risk related with an asset (Rose & Hudgins, 2013). It is an estimation of the quality of bank assets and is normally based on the loans and leases. Liquidity is used to describe all assets that are held in cash or near cash. It is one of the significant components of a viable bank. In fact, liquid assets are

the most salient features of the banking operations and all other financial businesses. As far as banks are concerned, failure to manage their liquid assets effectively could lead to insolvency of the banks (Acheampong, 2013).

### **3.4.1 Foreign Islamic bank entry and domestic Islamic banks performance**

In a study by Chantapong (2005) on the Thailand banking sector revealed that foreign banks perform higher than domestic banks. The results indicates that in as much as foreign banks entry leads to an increased rivalry and competition, domestic banks also profits from this entry in the areas of technological transfer and improvement in banks management. Similarly, Dubauskas *et al.*, (2005) found that presence of foreign banks generally improved competition in the banking sector. The results show that there is an improvement in the banking industry of the host country in terms of developed internet banking service and introduction of other risk management techniques. Moreover, foreign banks entry has made domestic banks more reliable, and also borrowing from international markets has become less expensive both for the domestic banks and their customers. Thus, this study hypothesized the relationship between foreign Islamic bank entry and domestic Islamic bank performance as follows:

#### ***Hypothesis 1***

**H1: There is a positive relationship between foreign Islamic bank entry and domestic Islamic bank's performance**

### **3.4.2 Asset Quality and Domestic Islamic banks performance**

Asset quality which is usually based on the loans and lease is an assessment of the quality of bank assets (Rose, Peter; Hudgins, 2013). Kosmidou, *et al.*, (2005) in his study used a proxy of loan loss reserves to gross loans as a measurement of asset quality and found a positive significance of asset quality on net interest margin.; however, loan loss reserves is found to be insignificant on ROA. The authors concluded that increased risks may result in high returns. In addition, Kosmidou, *et al.*,(2005) and Sufian and Habibullah (2009) in their study also found a positive relationship between asset quality and bank performance. Hence, this study hypothesized the relationship between asset quality and domestic Islamic banks' performance as follows;

#### ***Hypothesis 2***

**H1: There is a positive relationship between asset quality and domestic Islamic bank's performance.**

### **3.4.3 Liquidity and Domestic Islamic banks performance**

Studies by Akhter, Raza, and Akram (2011) established that conventional banks had higher liquidity than the Islamic banks while using the liquid assets to customer deposits and short-term funds ratio as a measurement of liquidity. Further, Kosmidou *et al.*,(2005) in their study also found an inverse sign of liquidity on Islamic banks' performance. Therefore, the relationship between liquidity and domestic Islamic banks' performance is hypothesized as follows;

### *Hypothesis 3*

**H1: There is a negative relationship between liquidity and domestic Islamic bank's performance**

### **3.5 Regression Models**

The regression analysis used for this study is conducted by using GLS (General Least Square) estimation. GLS method is found to be more suitable as it helps to decrease the normality issue in the model. GLS which is an altered model of OLS is more suitable than OLS in the case of a non-normal data (Gujarati, 2004). White's General Heteroscedasticity and AR (1) were conducted to solve heteroscedasticity and also auto-correlation problems respectively. Further, Hausman test result determines the most appropriate model for this study. Thus regression model is as follows;

$$Performance = \beta_0 + \beta_1 AQ_{it} + \beta_2 LQ_{it} + \beta_3 FIBE_{it}D + \varepsilon_{it}$$

Where;

Performance = ROA and ROE

AQ = Asset quality

LQ = Liquidity

FIBE= dummy variable for foreign Islamic bank entry;

E = error term

### **3.6 Diagnostic Tests**

The techniques of data analysis used in this study include regression analysis, panel data test, normality, heteroscedasticity and auto-correlation. Panel data test describes

the analysis on fixed effect model (FEM), random effect model (REM) and Hausman test.

### **3.6.1 Normality**

This is used to describe the scale which the distribution of the sample data correspond to a normal distribution. Normality test is the most basic postulation in multivariate analysis. Residual plots and statistical test are used to verify the normality test of the data based on Kolmogorov-Smirnov test and Skewness and Kurtosis (Hair, 2006).

### **3.6.2 Heteroscedasticity**

In this study, the Breusch-Pagan-Godfrey test was used to detect the existence of heteroscedasticity problem in the model. Gujarati, (2004) noted that Breusch-Pagan-Godfrey is appropriate for large sample test and is not sensitive to the assumption that the distribution  $\mu_i$  are not normally distributed.

### **3.6.3 Auto-correlation**

Auto-correlation is referred to as the correlation between members of the series of observations ordered in time or space (Gujarati, 2004). In detecting the existence of auto- correlation in the model, Lagrange Multiple test is used. Hansen (2009) and Gujarati (2004) shows that Lagrange Multiple test is the most useful test for detecting auto-correlation problem in small and large samples.

### **3.6.4 Panel Data Test**

Panel data test is an analysis used to choose the most appropriate panel data model. According to Gujarati (2003) and Greene (2003) there are two most famous panel data model which are the fixed effects model (FEM) and random effects model (REM). The random effects model (REM) treats intercepts among individual differently than the fixed effect model. The approach shows that the banks included as samples are drawn from a larger universe of such banks and they have a general mean value for the intercept and the individual differences in the intercept values of each bank are revealed in the error term (Gujarati, 2003).

### **3.7 Summary of Chapter**

This chapter describes the variables used for this study. It depicts the theoretical framework, the measurements used for the variables, population and data collection, regression model, hypothesis and finally the diagnostic tests carried out.

## CHAPTER FOUR

### RESULTS AND DISCUSSION

#### 4.0 Introduction

This chapter provides the results and analysis on the relationship between foreign Islamic bank entry, asset quality and liquidity on performance of domestic Islamic banks. It shows the descriptive analysis of the study, the normality test and the panel data analysis result of the study. It also gives a summary of the result of the independent variables to the dependent variables.

#### 4.1 Descriptive Statistics of Variables

Descriptive statistics analysis explains the basic features of the data in the study. The aim of this statistics is to summarize a data set. Table 4.1 present the descriptive results of the variables used in the study on the next page.

Table 4.1  
*Descriptive Statistic Analysis*

	Mean	Median	Maximum	Minimum	Std.dev
ROA	0.0085	0.0079	0.0172	0.0021	0.038
ROE	0.1222	0.1066	0.2934	0.0431	0.0524
FIBE	0.1695	0.0000	1.0000	0.0000	0.3784
AQ	0.0324	0.0231	0.2605	0.0085	0.0366
LQ	0.3016	0.2886	0.9885	0.0321	0.1527

Table 4.1 presents the descriptive results of the variables considered in this study. From this table, the average percentage of return on assets of the overall sample was



0.9% with a maximum value of 1.7%. However the performance of banks from the return on equity presents a different picture with an average value of 12.2% and a maximum value of 29.3%. This showed that bank performance on ROE was much better than the ROA. On average, 17% of the banks are foreign. It also shows that the mean of asset quality in bank's performance is 0.0324 while liquidity is 0.3016.

#### 4.2 Normality Test

Table 4.2 present the result of Kolmogorov-Smirnov which explains the normality distribution of the data on the study. The result is as follows:

Table 4.2  
*Normality Test Result*

##### Tests of Normality

	Kolmogorov-Smirnov <sup>a</sup>			Shapiro-Wilk		
	Statistic	Df	Sig.	Statistic	df	Sig.
ROA	.413	59	.000	.154	59	.000
ROE	.120	59	.002	.877	59	.000

a. Lilliefors Significance Correction

Table 4.2 shows a significant result of Kolmogorov-Simonov test for normality; indicating that the distribution of data is not normal. It is found that the significant values are less than 0.05, hence suggesting violation of normality assumptions of the data. However, as the sample size of the study is considered as large (N= 59), the violation of normality assumption is not a serious problem. Pallant (2007) and Hair *et al.*, (2006) defined large sample as more than 30 observations and contend that the violation of normality assumption for a large data should not be a major problem.

This is so because normality assumption will not affect many of the results obtained in multiple regression analysis and generalizing ability of the result.

### 4.3 Panel Data Analysis

The regression analysis of the study was conducted using the GLS (General Least Square) estimation. GLS method is found to be more appropriate as it helps to reduce the normality problem in the data. GLS is a transformed model of OLS and it is more appropriate than OLS in the case of an abnormal data (Guajarati, 2003). White's General Heteroscedasticity and AR (1) are conducted to solve heteroscedasticity and auto-correlation problems while fixed effects model is used as it is found from the hausman test that this model is the most appropriate model for this study. Table 4.3 shows the regression result of the study. The result is explained based on beta coefficient, significant value and so on.

Table 4.3:

*The relationship between Foreign Islamic bank entry, asset quality and liquidity on domestic Islamic Bank Performance (ROA)*

<b>Variable</b>	<b>Beta Coeffi</b>	<b>t – statistics</b>	<b>p – value</b>
C	0.078	6.7725	0.0000
Foreign	-0.0012	-1.1479	0.2569
Asset	0.013	0.9559	0.3421
Liquidity	0.0016	0.4865	0.6289
R <sup>2</sup>	0.5469		
Adjusted R <sup>2</sup>	0.4287		
Prob (F- statistics)	0.000		
Durbin Watson stat	2.3697		
N	59		

According to Table 4.3, the result indicates that there is no relationship in any of the independent variable and ROA. The adjusted R-squared of the study is 43% (0.4287) implying that the regression model could explain 43% variation in ROA. The result

also found that none of the independent variables is significant in explaining the variations in ROA. This shows that foreign Islamic bank entry, asset quality and liquidity have no effect on Islamic bank's performance.

Table 4.4:

*The relationship between Foreign Islamic bank entry, asset quality and liquidity on domestic Islamic bank performance (ROE)*

<b>Variable</b>	<b>Beta Coeffi</b>	<b>t – statistics</b>	<b>p – value</b>
C	0.1177	6.8254	0.0000
Foreign entry	-0.0326	-2.0861	0.0425
Asset	0.2914	1.4802	0.1456
Liquidity	0.0016	0.0334	0.9735
R <sup>2</sup>	0.4639		
Adjusted R <sup>2</sup>	0.3241		
Prob (F- statistics)	0.0016		
Durbin Watson stat	2.1449		
N	59		

Based from table 4.4, it is found that adjusted R-squared of the model is 32% (0.3241); indicating that the model explains 32% of variations in ROE. The result also found that only foreign Islamic bank entry is significant in explaining the variations in ROE while asset quality and liquidity is found to be insignificant. This shows that foreign Islamic bank entry has an effect on Islamic banks performance while asset quality and liquidity has no effect on Islamic bank's performance.

Further, foreign Islamic bank entry is found to have a negative relationship with ROE. The negative relationship implies that a decrease in foreign Islamic bank entry will increase domestic Islamic bank's performance.

## **4.4 Discussion of Results**

### **4.4.1 Foreign Islamic Bank entry and domestic Islamic bank's performance**

From the result above, it indicates no relationship for foreign bank entry and domestic Islamic banks' performance for ROA while for ROE, there is a negative relationship. The parameter  $\beta_3$  showed a negative relationship between foreign Islamic bank entry with domestic Islamic banks by (-0.0326) value which is contrary as expected. This means that one decrease in foreign Islamic bank entry will increase domestic Islamic banks performance by 3.3% with the economic assumption of other factors remain constant. In addition it is statistically significant at 5% because the p-value of foreign Islamic bank entry is 0.0425. Therefore, the positive hypothesis that hypothesized positive relationship is rejected. This is consistent with studies like Claessens *et al.*, (2001) and Barajas, Salazar and Steiner (2000) who found that foreign bank entry leads to a decrease in profitability, non-interest income, and general costs of the domestic banks. In comparing this study with Fatimah Salwa Abd Hadi and Norma Md Saad ,(2010) in their study of Malaysian banks for the period of 2005-2007 the authors found that domestic Islamic banks performed better than foreign-Islamic banks. This is different from this study results as a negative relationship indicates a reduction in the domestic Islamic banks performance. This shows that foreign Islamic bank affects domestic Islamic banks' performance.

### **4.4.2 Asset quality and domestic Islamic banks performance**

The result on the relationship between asset quality and Islamic bank's performance is found to be statistically insignificant. The results indicate no relationship between asset quality and domestic Islamic banks performance (for both ROA and ROE

measures). This implies that even if there is a reduction or an increase in the asset quality of Islamic banks, it does not have any effect on its performance. Therefore, the null hypothesis is accepted. Even though the result found is contracting the alternate hypothesis which shows that there is a positive relationship, it is still backed by some studies like Belanes, and Hassiki, (2012) who found no relationship between asset quality and bank performance.

#### **4.4.3 Liquidity and domestic Islamic banks performance**

The study found that liquidity has an insignificant relationship with Islamic banks performance. The result also indicates no relationship between liquidity and domestic Islamic banks performance (for both ROA and ROE measures). Further, the result indicated an increase or decrease in liquidity does not have any effect on Islamic banks performance. Thus the hypothesis which stated that the relationship between liquidity and Islamic bank's performance is negative is rejected. This is consistent with Samad, (2004) and Kader *et al.*, (2007) who found no significant difference, in terms of bank performance and liquidity.

#### **4.5 Summary of Hypothesis Testing of Foreign Bank Entry, Asset Quality and Liquidity on Performance of Domestic Islamic Banks**

<b>HYPOTHESES</b>	<b>ROA</b>
H1: There is a positive relationship between foreign Islamic bank entry and domestic Islamic banks' performance	Hypothesis is not supported
H2: There is a positive relationship between asset quality and domestic Islamic banks' performance	Hypothesis is not supported
H3: There is a negative relationship between liquidity and domestic Islamic banks' performance	Hypothesis is not supported

<b>HYPOTHESES</b>	<b>ROE</b>
H1: There is a positive relationship between foreign Islamic bank entry and domestic Islamic banks' performance	Hypothesis is not supported
H2: There is a positive relationship between asset quality and domestic Islamic banks' performance	Hypothesis is not supported
H3: There is a negative relationship between liquidity and domestic Islamic banks' performance	Hypothesis is not supported

#### **4.6 Summary of Chapters**

The findings of this study have been analysed in this chapter. This consist of the summary of descriptive data, normality test, panel data test showing the relationship between the independent and dependent variables and the discussion of the results.

## **CHAPTER FIVE**

### **CONCLUSION AND RECOMMENDATION**

#### **5.0 Introduction**

This chapter summarizes the study in line with the research objectives. It gives an overview of the research process and the conclusion of the research. It also makes suggestion for future research.

#### **5.1 Overview of the Research**

The relationship between foreign Islamic bank entry, asset quality and liquidity on domestic Islamic banks performance in Malaysia is examined in the study. The data used in the study is 16 Islamic banks of which six are foreign Islamic banks while 10 are domestic Islamic banks from Malaysia for the period of 2008-2013. A sample of 6 years annual reports and bank scope from 2008-2013 was gathered which give 59 observation. The study used foreign Islamic bank entry, asset quality and liquidity as independent variables while return on asset and return on equity was used as the dependent variable. The descriptive analysis, normality test, heteroscedasticity test, auto- correlation, regression analysis and panel data test was used for the study in order to analyse the relationship between independent and dependent variable.

The results show that foreign bank entry, asset quality and liquidity have no impact to domestic Islamic banks performance when using ROA as the performance measure. However, foreign bank entry is found to have significant effect to ROE which is another measurement for performance in this study. The entire hypotheses hypothesized were rejected. The plausible reason for the significant results of foreign

bank entry on domestic Islamic banks' performance could be as a result of the liberalization of the economy and also Malaysia is a developing country which has different characteristics than developed countries. Literature review and previous studies were done on developed country that is why the results are different than some of the previous studies such as (Sturm & Williams, 2004).

## **5.2 Contributions of the Study**

### **5.2.1 Body of Knowledge**

The liberalization of the banking sector is an essential element to foreign Islamic bank entry because it will have an effect on domestic Islamic banks performance. This study contributed to the existing literature on the banking industry ranging from the scope in terms of years and the dimension in terms of size of the data. In addition, academic scholars will find this study interesting especially those operating in Islamic banking sector. The reason is for the empirical result which will serve as evidence for the decision, the limitations as well as future research suggested by this study.

### **5.2.2 Policy Maker**

The result of this study will help policy makers in mapping of new regulations on liberalization. The opening up of the Islamic banking sector in Malaysian to foreign banks entry is observed as a vital aspect of the process of getting optimal performance and productivity which is a trend that has already been set in motion in the Islamic banking industry. Also, policymakers will be more prone to find ways to discover how to optimise their resources as well as utilize their resources to the best



of their ability to reduce the rate of wastage during the process of producing either banking products or services.

### **5.2.3 Practitioners**

Due to the liberalization process, increase in foreign banks entry cannot be stopped. For practitioners, the study strongly recommends that the bank practitioners as well as staffs should upgrade their existing services by improving their internet facilities, development and innovation of Islamic banking products. This will in turn help to improve their efficiency in the banking industry.

### **5.3 Limitations**

The study only looked at Islamic banks in Malaysia and not on conventional banks. It also only looked at Malaysian banks do the results do not represent all developing countries.

### **5.4 Suggestion for Future Research**

There are some areas that can be improved upon or considered for future research. The Malaysian financial system is made up of other financial institutions such as Islamic banks, corporate and investment banks. Future research can be targeted to these areas. Future research can also be suggested on more developing countries such as Thailand, Indonesia, and Philippines. This study only used asset quality and liquidity from the CAMELS framework. More information can also be gathered on other variables in the CAMELS framework. The number of years can also be extended and also since the study considered the post entry that is after liberalization, future research can study both the pre-entry and the post-entry period.

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