

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

EZEMA CHIKAODILI JUDITH

**MASTER OF SCIENCE (BANKING)
UNIVERSITI UTARA MALAYSIA**

JANUARY, 2015

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

BY

EZEMA CHIKAODILI JUDITH

815744

**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)**

DECLARATION

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.

EZEMA CHIKAODILI JUDITH

815744

Othman Yeop Abdullah

Graduate School of Business

Universiti Utara Malaysia

06010 Sintok

Kedah Darul Aman

PERMISSION TO USE

In presenting this dissertation in partial fulfilment of the requirements for a postgraduate degree from Universiti Utara Malaysia, I agree that the University Library may make it freely available for inspection. I further agree that permission for copying of this dissertation in any manner, in whole or in part, for scholarly purpose may be granted by my supervisor or, in his absence by the Dean of Othman Yeop Abdullah Graduate School of Business. It is understood that any copying or publication or use of this dissertation or part thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition will be given to me and to Universiti Utara Malaysia for any scholarly use which may be made of any material from my dissertation.

Any request for permission to copy or make other use of the materials in this dissertation, in whole or in part should be addressed to:

Dean

Othman Yeop Abdullah Graduate School of Business

Universiti Utara Malaysia

06010 UUM Sintok

Kedah Darul Aman, Malaysia

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.

ACKNOWLEDGEMENT

My thanks go to Almighty God for his love and mercies towards me during the duration of my study and for a successful completion. To my supervisor, Dr. Nora Azureen Bt Abdul Rahman whose untiring efforts, constructive comments, suggestions, kindness and encouragement made this work possible. To my dear husband, for his unending love, great support, encouragement, prayers throughout the duration of my study. To my lovely daughter: for her patience, smiles and laughter in encouraging mummy. To my parents: for their love, prayers and encouragement. To my siblings, my roomy, Mama K, Dr. Hajiya Rabi'u, Dr. Nasiru, Hauwa, Dr Adejoh and his wife (Mrs.Gloria) and all those who contributed to the success of this work may God bless you all.

TABLE OF CONTENTS

TITLE PAGE.....	i
DECLARATION.....	ii
PERMISSION TO USE.....	iii
ABSTRAK.....	iv
ABSTRACT.....	v
ACKNOWLEDGEMENT.....	vi
LIST OF TABLES.....	x
LIST OF FIGURES.....	xi
ABBREVIATIONS.....	xii

CHAPTER ONE: BACKGROUND OF STUDY

1.0 Introduction.....	1
1.1 Malaysian Financial System.....	1
1.2 Foreign Islamic Banks Entry and Liberalization on Foreign banks Entry.....	4
1.3 Problem Statement.....	7
1.4 Research Questions.....	9
1.5 Research Objectives.....	9
1.6 Significance of the Study.....	10
1.7 Organisation of the Study.....	11
1.8 Summary of Chapter.....	11

CHAPTER TWO: LITERATURE REVIEW

2.0 Introduction.....	13
2.1 Foreign Islamic Bank Entry.....	13
2.2 Asset Quality and Bank Performance.....	18
2.3 Liquidity and Bank Performance.....	19
2.4 Summary of Chapter.....	22

CHAPTER THREE: RESEARCH METHODOLOGY

3.0 Introduction.....	23
3.1 Research Framework.....	23
3.2 Definition and Measurement of Variables.....	24
3.2.1 Dependent Variables.....	24
3.2.2 Independent Variables.....	25
3.2.2.1 Foreign Bank Entry.....	25
3.2.2.2 Asset Quality.....	25
3.2.2.3 Liquidity.....	26
3.3 Population and Data collection.....	27
3.4 Hypotheses Development.....	28
3.4.1 Foreign Islamic Bank entry and Domestic Islamic banks Performance.....	29
3.4.2 Asset Quality and Domestic Islamic Banks Performance.....	29
3.4.3 Liquidity and Domestic Islamic Banks Performance.....	30
3.5 Regression Models.....	31
3.6 Diagnostic Tests	31

3.6.1 Normality.....	32
3.6.2 Heteroscedasticity.....	32
3.6.3 Auto-correlation.....	32
3.6.5 Panel Data Test.....	32

CHAPTER FOUR: RESULTS AND DISCUSSIONS

4.0 Introduction.....	34
4.1 Descriptive Statistics.....	34
4.2 Normality test.....	35
4.3 Panel Data Analysis.....	36
4.4 Discussion of results.....	39
4.4.1 Foreign Islamic Bank Entry and Domestic Islamic Bank Performance.....	38
4.4.2 Asset quality and Domestic Islamic Bank Performance.....	38
4.4.3 Liquidity and Domestic Islamic Bank Performance.....	39
4.5 Summary of Hypothesis Testing of Foreign Bank Entry, Asset Quality and Liquidity with performance of domestic Islamic banks in Malaysia.....	39
4.6 Summary of Chapter.....	40

CHAPTER FIVE: CONCLUSION AND RECOMMENDATION

5.0 Introduction.....	41
5.1 Overview of the Research Process.....	41
5.3 Contribution.....	42
5.3.1 Body of Knowledge.....	42

5.3.2 Policy Maker.....	42
5.3.3 Practitioners.....	43
5.4 Limitations.....	43
5.5 Suggestion for Future Research.....	43
REFERENCES.....	44
APPENDIX.....	49

LIST OF TABLES

Table 3.1: Summary of Variables and Measurements	28
Table 4.1: Descriptive Statistical Analysis	34
Table 4.2: Normality Test Result	34
Table 4.3: The Relationship between Foreign Islamic Bank Entry, Asset quality, and Liquidity on Domestic Islamic Banks Performance (ROA)	36
Table 4.4: The Relationship between Foreign Islamic Bank Entry, Asset Quality, and Liquidity on Domestic Islamic Banks Performance (ROE)	37
Table 4.5: Summary of Hypotheses Testing of Foreign Bank Entry, Asset Quality and Liquidity on the performance of Domestic Islamic Banks	39

LIST OF FIGURES

Figure 3.1 : Theoretical framework	27
------------------------------------	----

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 contents of
the thesis is for
internal user
only

References

- Acheampong, N. K. (2013). The effects of foreign bank entry on financial performance of domestic-owned banks in Ghana. *The International Journal of Business and Finance Research*, 7, 93–104.
- Akhter, W., Raza, A., & Akram, M. (2011). Efficiency and performance of Islamic banking : The case of Pakistan, 2(2), 54–70.
- Alkassim, F. A. (2005). The profitability of Islamic and conventional banking in the GCC countries : A comparative study By, 13(1), 5–30.
- Ariff, M., & Rosly, S. A. (2011). Islamic banking in Malaysia: Unchartered waters. *Asian Economic Policy Review*, 6, 301–319. doi:10.1111/j.1748-3131.2011.01208.x
- Athanasoglou, P. P., Delis, M. D., & Staikouras, C. K. (2006). Determinants of bank profitability in the South Eastern European region. *Bank of Greece Working Paper*, 2, 1–31. Retrieved from <http://mpira.ub.uni-muenchen.de/10274/>
- Awan, A. G. (2009). Comparison of Islamic and conventional banking in Pakistan. *Proceedings 2nd CBRC, Lahore, Pakistan*, 1–36.
- Bank Negara Malaysia, K. L. (1994). Money and banking in Malaysia.
- Barth, J. R., Caprio, G., & Levine, R. (2004). Bank regulation and supervision: What works best? *Journal of Financial Intermediation*, 13, 205–248. doi:10.1016/j.jfi.2003.06.002
- Beju, D. G., & Ciupac-Ulici, M.-L. (2012). The impact of financial liberalization on banking system. *Procedia Economics and Finance*, 3, 792–799. doi:10.1016/S2212-5671(12)00232-8
- Belanes, A., & Hassiki, S. (2012). Efficiency in Islamic and conventional banks: a comparative analysis in the MENA region. *Bank.Mark. Invest.*, 120, 36–49.
- BNM. (1999). *Central Bank of Malaysia. 1999. The central bank and the financial system in Malaysia: A decade of change 1989-1999 (Bank Negara Malaysia, Kuala Lumpur) Pages.* (First., p. (Kuala Lumpur) Pages). Bank Negara Malaysia.
- BNM. (2005). *Annual report*. Bank Negara Malaysia.
- BNM. (2013). *Annual Banking Statistics*.
- Cebenoyan, A. S., & Strahan, P. E. (2004). Risk management, capital structure and lending at banks. *Journal of Banking and Finance*, 28, 19–43. doi:10.1016/S0378-4266(02)00391-6
- Chantapong, S. (2005). Comparative Study of Domestic and Foreign Bank Performance in Thailand: The Regression Analysis Economic Change and Restructuring, 38(1), 63–83.
- Claessens, S., Demirgüç-Kunt, A., & Huizinga, H. (2000). *The role of foreign banks in domestic banking systems” in Claessens, S. and Marion Jansen, (eds.) The internationalization of financial services: Issues and Lessons for developing countries, Boston, Mass. Kluwer Academic Press.*
- Claessens, S., Demirgüç-Kunt, A., & Huizinga, H. (2001). How does foreign entry affect domestic banking markets? *Journal of Banking and Finance*, 25, 891–911. doi:10.1016/S0378-4266(00)00102-3
- Claessens, S., & Jansen, M. (2000). *The internationalization of financial services : Issues and Lessons for Developing Countries. World Trade.* Retrieved from <http://scholar.google.com/scholar?hl=en&btnG=Search&q=intitle:The+Internati>

onalization+of+Financial+Services:+issues+and+lessons+for+developing+coun
tries#0

- Claessens, S., & Laeven, L. (2004). What drives bank competition? Some international evidence. *Journal of Money, Credit and Banking*, 36, 563–583. doi:10.2307/3838954
- Clarke, G. R. G., Cull, R., & Martinez Peria, M. S. (2001). Does Foreign Bank penetration reduce access to credit in developing countries? Evidence from asking borrowers. *World Bank Policy Research Working Paper*. doi:10.2139/ssrn.285767
- Dar, H. (2003). *Handbook of International Banking*, Edward Elgar, (p. chapter 8).
- Debnath, R. M., & Shankar, R. (2008). Measuring performance of Indian banks: An application Data Envelopment Analysis. *International Journal of Business Performance Management*, 10, 57–85. doi:10.1504/ijbpm.2008.015921
- Demirgüç-Kunt, A. & Levine, R. (2008). Finance , financial sector policies , and long-run growth. *The World Bank Development Research Group*, 4469. doi:10.1596/1813-9450-4469
- Denizer, C. (2000). “Foreign bank entry in Turkey's banking sector, 1980-1997”, in: S. Claessens and M. Jansen (eds.), *The Internationalization of Financial Services: Issues and Lessons for Developing Countries*. Dordrecht and Boston, Kluwer Academic Press.
- Derviz, A., & Podpiera, J. (2008). Predicting bank CAMELS and ratings:The case of Czech Republic. *Emerging Market Finance and Trade*, 44(1), 117–130.
- Dubauskas G., Kowalski T., V. V. (2005). Role of foreign banking institutions in the European Union’s new financial markets. *Ekonomika*, 70, 7–21.
- Fadzlan Sufian. (2010). Does foreign presence foster Islamic banks’ performance? Empirical evidence from Malaysia. *Journal of Islamic Accounting and Business Research*, 1(2), 128–147.
- Fatimah Salwa Abd Hadi, & Norma Md Saad. (2010). An analysis on the efficiency of the Malaysian Islamic banking industry: domestic vs. foreign. *Review of Islamic Economics*, 14, 27–47.
- Feldstein, M. (ed. . (2000). Discussion summary version of May 17, 2001, financial policies economic and financial crises in emerging markets economies,NBERConference, Woodstock, Vermont, October 19-21, 2000 ,.
- Focarelli, D., & Pozzolo, A. F. (2001). The patterns of cross-border bank mergers and shareholdings in OECD countries. *Journal of Banking and Finance*, 25, 2305–2337. doi:10.1016/S0378-4266(01)00192-3
- Genu Alexandru Caruntu & Marcel LaurentiuRomanescu. (2008). The assessment of banking performances- Indicators of Performance in Bank Area. *MPRA Paper*, (11600), <http://mpa.ub.uni-muenchen.de/11600/>.
- Goldberg, L., Dages, B. G., & Kinney, D. (2000). Foreign and domestic bank participation in emerging markets: Lessons from Mexico and Argentina. *National Bureau of Economic Research*. Retrieved from <http://www.nber.org/papers/w7714>
- Golin J. (2001). *The Bank Credit Analysis Handbook: A Guide for Analysts, Bankers and Investors*. John Wiley & Sons (Asia) Pre Ltd.
- Gujarati & Greene. (2003). *Handbook of Research Methods in Public Administration*. (K. Y. edited by Gerald J. Miller, Ed.) (Second Edi., p. 992).
- Gujarati, D. N. (2004). *Basic Econometrics*. *Basic Econometrics* (Vol. 4., p. 1002). doi:10.1057/9780230226203.0425

- Hair, J. . (2006). *Multivariate Data Analysis* (6th ed.). Upper Saddle River, NJ [etc.] : Pearson Prentice Hall.
- Hansen, B. E. (2009). *Econometrics. Working Paper*. Retrieved from <http://www.ssc.wisc.edu/~bhansen/econometrics/>
- Haron, S, & Azmi, W. N. W. (2004). Profitability determinants of Islamic banks: A co integration approach. *Creating dynamic leaders*.
- Hasan, I., & Marton, K. (2003). Development and efficiency of the banking sector in a transitional economy: Hungarian experience. *Journal of Banking and Finance*, 27, 2249–2271. doi:10.1016/S0378-4266(02)00328-X
- Hassan, M. K., & Bashir, A. H. (2003). Determinants of Islamic banking profitability. *ERF Paper*, 2–31. doi:102003034
- Hassan, M. K., Sanchez, B., & Yu, J.-S. (2011). Financial development and economic growth: New evidence from panel data. *The Quarterly Review of Economics and Finance*. doi:10.1016/j.qref.2010.09.001
- Heffernan, S. & Fu, M. (2008). “The determinants of bank performance in China”, working paper, City University, London, 25 August.
- Idris, A. R., Asari, F. F. A. H, Taufik, N. A. A., Salim, N. J., Mustaffa, R., & Jusoff, K. (2011). Determinants of Islamic banking institutions’ profitability in Malaysia: *World Applied Sciences Journal (Special Issue on Bolstering Economic Sustainability)*, 12.
- Izhar, H, & Asutay, M. (2007). Estimating the profitability of Islamic bank: Evidence from Bank Muallamat Indonesia. *Review of Islamic Economics*, 11(2), 17–29.
- Kader, J.M Asarpota, A.J. & Al-Maghaireh, A. (2007). “Comparative financial performance of Islamic banks vis-à-vis conventional banks in the UAE” Proceeding on Annual Student Research Symposium and the Chancellor’s Undergraduate Research Award (Online) Available:<http://sra.uaeu.ac.ae/CURA/Proceedings> (May 3.
- Kosmidou, K., Tanna, S., & Pasiouras, F. (2005). Determinants of profitability of domestic UK commercial banks: panel evidence from the period 1995-2002. *Economics, Finance and Accounting- Applied Research Working Paper Series*, 1–27.
- Lensink, R., & Hermes, N. (2004). The short-term effects of foreign bank entry on domestic bank behaviour: Does economic development matter? *Journal of Banking and Finance*, 28, 553–568. doi:10.1016/S0378-4266(02)00393-X
- Levine, R. (1996). (1996). *Financial developments, and economic Growth, in Claude E Barfield (ed.),. International Financial Markets: Harmonization versus Competition*, AEI Press, Washington D.C.
- Lin, X., Zhang, Y., & Zhu, N. (2009). Does bank ownership increase firm value? Evidence from China. *Journal of International Money and Finance*, 28, 720–737. doi:10.1016/j.jimonfin.2008.12.015
- Mahadzir I. (2004). A DEA analysis of bank performance in Malaysia. *Journal Data Envelopment Analysis and performance management*:17-23
- M. Jaffar & I. Manarvi. (2011). Performance comparison of Islamic and conventional banks in Pakistan. *Global Journal of Management and Business Research*, 11(1), Version 1.
- Mohamad, S., Hassan, T. & Bader, M. K. (2008). Efficiency of conventional versus Islamic Banks: International evidence using the Stochastic Frontier Approach (SFA). *Journal of Islamic Economics, Banking and Finance*.

- Mokhtar, H. S. A., Abdullah, N., & Alhabshi, S. M. (2008). Efficiency and competition of Islamic banking in Malaysia. *Humanomics*. doi:10.1108/08288660810851450
- Mokhtar, H. S. A., Abdullah, N., & Al-Habshi, S. M. (2006). Efficiency of Islamic banking in Malaysia: A stochastic frontier approach. *Journal of Economic Cooperation*, 27, 37–70.
- Pallant, J. (2007). *SPSS Survival Manual: A Step by Step Guide to Data Analysis using SPSS for Windows* (3rd ed.). Open University Press, 2007).
- Ramadan, I. Z., Kilani, Q. A., & Kaddumi, T. A. (2011). Determinants of bank profitability- Evidence from Jordan. 180-191. *International Journal of Academic Research*, 180–191.
- Rose, Peter; & Hudgins, S. (2013). *Bank Management & Financial Services* (9th ed., p. 768). McGraw-Hill Higher Education.
- Rosnia Masruki, Norhazlina Ibrahim, E. O. and H., & Wahab, A. (2011). Financial performance of Malaysian founder Islamic banks Versus conventional banks. *Journal of Business and Policy Research*, 6(2), 67–79.
- Samad, A. (2004). Performance of interest-free Islamic banks vis-à-vis interest based conventional banks of Bahrain. *IIUM Journal of Economics & Management*, 12, 15.
- Samad, A., & Hassan, M. K. (1999). The Performance of Malaysian Islamic bank during 1984-1997: An Exploratory Study. *International Journal of Islamic Financial Services*, 1, 1–14.
- Sanjeev, G. M. (2009). Efficiency of Indian public sector banks: An application of data envelopment analysis (DEA) approach. Institute of Chartered Financial Analysts of India (ICFAI). *The ICFAI Journal of Applied Finance*, 15(11), 52–65.
- Sarker, A. A. (2006). CAMELS rating system in the context of Islamic banking: A proposed “S” for shariah framework. *Journal of Islamic Economics, Banking and Finance*, 2, 1–26.
- Sengupta, R. (2007). Foreign entry and bank competition. *Journal of Financial Economics*, 84, 502–528. doi:10.1016/j.jfineco.2006.04.002
- Srairi, S. A. (2009). Factors influencing the profitability of conventional and Islamic commercial banks in GCC countries. *Review of Islamic Economics*, 13, 5–30. doi:10.1007/s11123-009-0161-7
- Sturm, J. E., & Williams, B. (2004). Foreign bank entry, deregulation and bank efficiency: Lessons from the Australian experience. *Journal of Banking and Finance*, 28, 1775–1799. doi:10.1016/j.jbankfin.2003.06.005
- Sufian, F. (2007). The efficiency of Islamic banking industry in Malaysia: Foreign vs domestic banks. *Humanomics*. doi:10.1108/08288660710779399
- Sufian, F., & Habibullah, M. S. (2009). Bank specific and macroeconomic determinants of bank profitability: Empirical evidence from the China banking sector. *Frontiers of Economics in China*, 4, 274–291. doi:10.1007/s11459-009-0016-1
- Sufian, F. & Haron, R. (2008). The sources and determinants of productivity growth in the Malaysian Islamic banking sector: a nonstochastic frontier approach. *International Journal of Accounting and Finance*, 1(2), 193–215.
- Tanna, S., Kosmidou, K. & Pasiouras, F. (2005). “Determinants of profitability of domestic UK commercial banks: panel evidence from the period of 1995-2002”, paper presented at the 37th Annual Money Macro and Finance (MMF) Research Group Conference, Rethymno, Greece, 1-3 September, available at: www.mmf.cerme.it

- Tschoegl, A. E. (2003). Financial Crises & the Presence of Foreign Banks. In *World Bank Conference*.
- Unite, A. A., & Sullivan, M. J. (2003). The effect of foreign entry and ownership structure on the Philippine domestic banking market. *Journal of Banking and Finance*, 27, 2323–2345. doi:10.1016/S0378-4266(02)00330-8
- Vong, P.I.A. & Hoi, S. C. (2009). “Determinants of bank profitability in Macao”,. *Macau Monetary Research Bulletin*, (12), 93–113.
- Wasiuzzaman, S., & Tarmizi, A. (2009). Profitability of Islamic Banks in Malaysia : An Empirical Analysis. *Journal of Islamic Economics, Banking and Finance*, 6, 54–68.