THE RELATIONSHIP BETWEEN RISKS AND EFFICIENCY OF ISLAMIC BANKS IN MALAYSIA

By

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ABSTRACT

Malaysia is a country known as the Islamic financial hub which plays an important role in its economic growth. Given the situation and the development of positive economic growth in Malaysia, Islamic banking needs to improve their performance in terms of efficiency in order to follow the current circumstances. However, Islamic banking is not spared from dealing with certain risks which will impact on their efficiency. Thus, the main objective of this study was to examine the efficiency level of Islamic banks in Malaysia and their relation to credit risk, liquidity risk and operational risk from the period of 2008 to 2013. Twelve Islamic banks were chosen as samples for this study which were taken by the availability of data, through each banks’ annual report from 2008 to 2013. This study was conducted by applying the Data Envelopment Analysis (DEA) and Multiple Regression Analysis to achieve its objectives. The finding shows that Islamic banks in Malaysia exhibited a total of 77.1% of overall efficiency of technical (OTE), 83.1% of Pure Technical Efficiency (PTE) and 92.6% of Scale Efficiency (SE). Despite the global financial crisis that occurred during the middle year of 2007 to the end of 2009 which slightly affected Asian countries such as Malaysia, nevertheless, Islamic banks seem to be more robust during the crisis than conventional banks. This is because of its basic nature which prohibited interest payments (riba) in all transactions. This study shows that credit risk has a negative significant relationship with efficiency of Islamic banks, while liquidity was found to be positive related to efficiency of Islamic banks. This study also found that the size of the bank has positive significant relationship to efficiency. Finding from this study give contribution to the policy makers and regulators as well as to the managers of Islamic banks by providing empirical evidence on the performance of the Islamic banks in Malaysia towards the efficiency level and risks relationship.

Keywords: Efficiency, credit risk, liquidity risk, operational risk, Islamic banks.
ABSTRAK


Kata Kunci: Kecekapan, risiko kredit, risiko kecairan, risiko operasi, Bank-bank Islam.
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ATM</td>
<td>Automated Teller Machines</td>
</tr>
<tr>
<td>BIMB</td>
<td>Bank Islam Malaysia Berhad</td>
</tr>
<tr>
<td>BMMB</td>
<td>Bank Muamalat Malaysia Berhad</td>
</tr>
<tr>
<td>BNM</td>
<td>Bank Negara Malaysia</td>
</tr>
<tr>
<td>CRS</td>
<td>Constant Return to Scale</td>
</tr>
<tr>
<td>DEA</td>
<td>Data Envelopment Analysis</td>
</tr>
<tr>
<td>DFA</td>
<td>Distribution Free Approach</td>
</tr>
<tr>
<td>DMU</td>
<td>Decision Making Unit</td>
</tr>
<tr>
<td>DRS</td>
<td>Decreasing Return to Scale</td>
</tr>
<tr>
<td>IBA</td>
<td>Islamic Banking Act</td>
</tr>
<tr>
<td>IRS</td>
<td>Increasing Return to Scale</td>
</tr>
<tr>
<td>MENA</td>
<td>Middle Eastern and North African</td>
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<tr>
<td>OBS</td>
<td>Off-Balance Sheet</td>
</tr>
<tr>
<td>OTE</td>
<td>Overall Technical Efficiency</td>
</tr>
<tr>
<td>PLS</td>
<td>Profit and Loss Sharing</td>
</tr>
<tr>
<td>PTE</td>
<td>Pure Technical Efficiency</td>
</tr>
<tr>
<td>RM</td>
<td>Malaysian Ringgit</td>
</tr>
<tr>
<td>SE</td>
<td>Scale Efficiency</td>
</tr>
<tr>
<td>SFA</td>
<td>Stochastic Frontier Approach</td>
</tr>
<tr>
<td>TFA</td>
<td>Thick Frontier Approach</td>
</tr>
<tr>
<td>VIF</td>
<td>Variance Inflation Factors</td>
</tr>
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<td>VRS</td>
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CHAPTER ONE
INTRODUCTION

1.0 Introduction

The banking industry is the backbone and major component of the financial system. Thus, it will give impact to the stability of an economy. Any problems and interference that happen in the banking system will give implications for the economic conditions of a country (Akkizidis & Khandelwal, 2008). It means the good economic conditions are resulted from good strategies and good management in handling and controlling any problems that occur around the country.

According to Ayub (2007), the word ‘bank’ is derived from an Italian word ‘banco’ which means shelf or bench. It is used to display coins and for trading money. Therefore, a bank is an institution authorized to take deposits from customers for their financial purposes in expanding their short term and long term finance facilities. He also described that the role of a bank is to keep money which is received from ordinary people, organizations, state or surplus units which is in circulation of economy in a country. Then, the bank will use this pooled money for making advances to others to get a return. The return can be in the form of interests, dividends or others.
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