

## CHAPTER ONE

### INTRODUCTION TO THE RESEARCH

#### 1.1 Introduction

Banks serve as engines and key supporters of the economic growth of a country. Hence, the poor performance of banks negatively affects the whole economy. To avoid such effect, financial reforms have focused on the efficiency of the banking sector. Athanasoglou *et al.* (2008) indicate that a profitable banking sector is highly capable of withstanding negative shocks and stabilizing the financial system. Therefore, the determinants of bank profitability have received much attention from the academic field and the financial markets. Studying the profitability of banks is essential to overcome the major challenges that are faced by the banking sector and the risks that are associated with crises, openness, and globalization.

#### 1.2 The Research Problem

The liberalization of the Islamic banking industry and the global financial crisis has elicited research on the determinants of the profitability of Malaysian Islamic banks.

The liberalization of the Islamic banking industry aims to develop Malaysia into a hub for international Islamic financial activities. This liberalization has greatly changed the structure of the Islamic banking system, which has driven foreign Islamic banks into Malaysia to operate side-by-side with their domestic counterparts. As a result, Malaysian Islamic banks operate in a highly competitive local industry. The success of foreign Islamic banks can also help enhance the reputation of Malaysia as an international center for Islamic financial activities. Tables (1.3) and (1.4) clearly show that foreign Islamic banks suffer from low returns, which threatens their survival in the industry. A significant variance is also found in the profit rates of foreign and domestic Islamic banks in Malaysia, in which domestic Islamic banks have achieved high profit rates whereas foreign Islamic banks have achieved low to negative profit rates.

**Table 1.1 Return on equity of Malaysian domestic Islamic banks (2008, 2009, and 2010)**

Names of banks	2008	2009	2010
Bank Islam Malaysia Berhad	0.0053	0.0285	0.0541
Bank Muamalat Malaysia Berhad	0.0135	0.0196	0.0211
RHB Islamic Bank Berhad	0.0339	0.0473	0.0157
Hong Leong Islamic Banking Berhad	0.0239	0.0318	0.0211
CIMB Islamic Bank Berhad	0.0261	0.0369	0.0703
AmIslamic Bank Berhad	0.0360	0.0514	0.0188
Affin Islamic Bank Berhad	0.0327	0.0083	0.0235
EONCAP Islamic Bank Berhad	0.0301	0.0047	0.0163
Alliance Islamic Bank Berhad	0.0270	0.0556	0.0420
Maybank Islamic Berhad	0.0417	0.0444	0.0422
Public Islamic Bank Berhad	0.0483	0.0676	0.0597

**Table 1.2 Return on equity of Malaysian foreign Islamic banks (2008, 2009, and 2010)**

Names of banks	2008	2009	2010
Kuwait Finance House (Malaysia) Berhad	0.0055	-0.0155	-0.0043
Al Rajhi Banking (Malaysia) Berhad	-0.0192	0.0133	0.0337
Asian Finance Bank Berhad	-0.0154	0.0049	-0.0543
HSBC Amanah Malaysia Berhad	0.0191	0.0282	0.0317
Standard Chartered Saadiq Berhad	0.0153	-0.0022	0.0267
OCBC Al-Amin Bank Berhad	-0.0086	0.0765	0.0088

The liberalization of the Islamic banking system can negatively affect the efficiency of Malaysian Islamic banks as they operate in a highly competitive industry. These banks must balance their profitability with their efficiency. Tables (1.3) and (1.4) clearly show that domestic Islamic banks are, on average, more efficient than foreign Islamic banks. The performance of a bank depends on the opportunities and threats that it faces, both of which originate from the external and internal environments of the bank. Therefore, the influencing factors of the efficiency of banks must also be investigated to help improve their performance.

**Table 1.3 Technical efficiency of Malaysian domestic Islamic banks (2008, 2009, and 2010)**

Names of banks	2008	2009	2010
Bank Islam Malaysia Berhad	0.66531	0.86171	0.92914
Bank Muamalat Malaysia Berhad	0.65446	0.70930	0.72637
RHB Islamic Bank Berhad	0.86342	0.76637	0.90626
Hong Leong Islamic Banking Berhad	0.81632	0.76972	0.90719
CIMB Islamic Bank Berhad	0.62623	0.78215	0.72048
AmIslamic Bank Berhad	0.92648	0.87797	0.87779
Affin Islamic Bank Berhad	0.59473	0.65967	0.65440
EONCAP Islamic Bank Berhad	0.78933	0.74620	0.83232
Alliance Islamic Bank Berhad	0.93422	0.86630	0.95466
Maybank Islamic Berhad	1.00000	1.00000	1.00000
Public Islamic Bank Berhad	0.87647	0.70863	0.79675

**Table 1.4 Technical efficiency of Malaysian foreign Islamic banks (2008, 2009, and 2010)**

Names of banks	2008	2009	2010
Kuwait Finance House (Malaysia) Berhad	0.92181	0.88337	0.84580
Al Rajhi Banking (Malaysia) Berhad	0.70020	0.81205	0.81679
Asian Finance Bank Berhad	0.20463	0.42619	0.52275
HSBC Amanah Malaysia Berhad	0.83057	0.83705	0.81770
Standard Chartered Saadiq Berhad	0.29671	0.47185	0.79911
OCBC Al-Amin Bank Berhad	0.90427	0.68924	0.89085

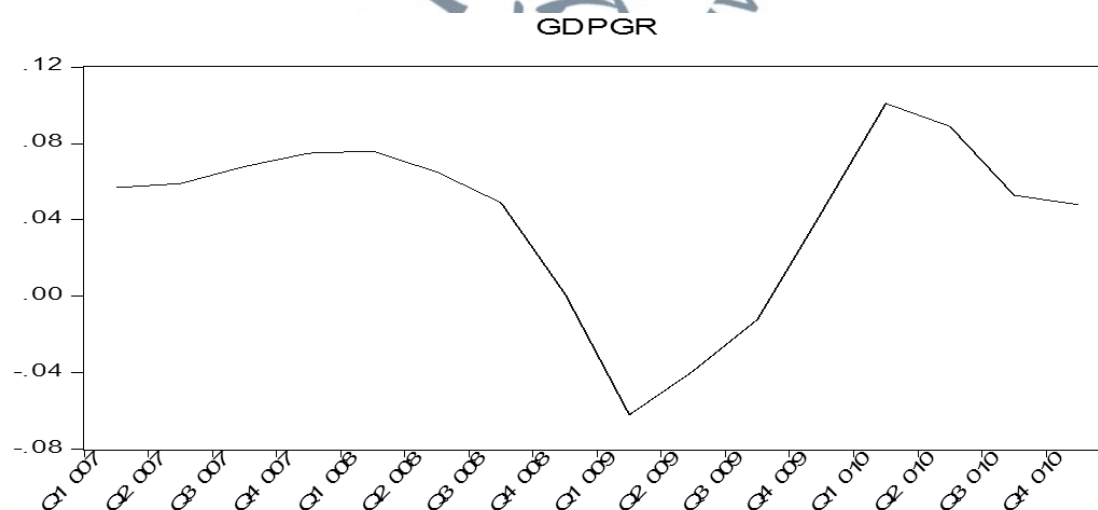
Previous studies have indicated certain differences in the profitability or efficiency of banks that operate within the same market. Sufian (2006) finds that the efficiency of foreign Islamic banks is lower as compared to their domestic counterparts in Malaysia from 2001 to 2004. Tahir *et al.* (2010) observe that from 2000 to 2006, Malaysian domestic commercial banks are relatively more efficient than foreign banks. Differences in the structure, characteristics, and the internal and external influencing factors of foreign and domestic banks can also lead to variations in their performance (Elyor, 2009). The performance of these banks can be analyzed to confirm if such difference exists and to identify what causes such difference. This analysis can help

devise methods on improving the performance of the Malaysian Islamic banks and can assist in developing a regulatory framework for the entry of foreign Islamic banks into the country.

The 2008 global financial crisis has changed the way Islamic banks operate in Malaysia. The performance of banks can also be affected by the changes in their environmental and economic conditions (Muda, 1993). Therefore, an economic shock can result in a sub-optimal performance of a bank. However, Ahmad and Noor (2011) confirm that the 2008 global financial crisis is negatively related to the profitability of 78 Islamic banks in 25 countries.

In 1998, the gross domestic product (GDP) growth of Malaysia was curtailed by the Asian financial crisis that originated from Thailand. In the last quarter of 2008, the economic shock caused by the global financial crisis was felt in Malaysia as its exports, industrial outputs, investments, and consumer sentiments have all declined. As a result, the GDP growth of Malaysia in the fourth quarter of 2008 was significantly lower at 0.1% as compared to the 5.9% GDP growth in the preceding three quarters (Bank Negara Malaysia Annual Report, 2008).

**Figure (1.1) GDP growth in Malaysia from q1 2007 to q4 2010.**



Source: Department of Statistics, Malaysia

The GDP growth in Malaysia contributes to the development of its banking sector. Consistent GDP growth during a particular period enables business units to respond to

the demand for goods and services. Economic cycles that result from the lending and borrowing activities show the contributions of real GDP to the development of the banking sector (Yu and Gan, 2010). As domestic economic activities slow down, the overall loan applications in the country begins to decline. Loan applications have stalled for both the business and household sectors. Therefore, Malaysian financial institutions are severely affected by the financial crisis (Khoon and Mah-Hui, 2010).

This study aims to shed light on the importance of internal and external determinants of the profitability of Malaysian Islamic banks. Studying the profitability of these banks is important to strengthen their risk management, to enable the Islamic banking system, to absorb financial shocks, and to improve their survivability in competitive markets. This study also suggests some policies that can protect and develop the Islamic banking industry and improve the profitability of these banks.

### **1.3 The Research Questions**

The study seeks to answer the following questions:

- 1- What are the determinants of the profitability of Malaysian Islamic banks?
- 2- Are these Malaysian Islamic banks affected by the 2008 global financial crisis in terms of their profitability?
- 3- Can significant differences be found in the determinants of profitability between domestic and foreign Islamic banks in Malaysia?
- 4- Can the profitability variables determine the efficiency of these Malaysian Islamic banks?

### **1.4 The Research Objectives**

This study seeks to fulfill the following objectives:

- 1- To identify the variables that affect the profitability of Malaysian Islamic banks.

- 2- To examine the effect of the 2008 global financial crisis on the profitability of Malaysian Islamic banks.
- 3- To identify the differences between domestic and foreign Islamic banks in Malaysia in terms of the determinants of their profitability.
- 4- To investigate if the efficiency of Malaysian Islamic banks is determined by the profitability variables.

### **1.5 The Research Motivation and Contribution**

The importance of bank profitability at the micro and the macro levels has attracted the attention of researchers, academics, bank managers, and bank regulatory authorities. Many studies on the determinants of the profitability of banks have been published over the recent years. However, only a few of these studies have focused on the performance of Islamic banks, particularly during the 2008 global financial crisis. The widespread effect of such crisis necessitates the investigation of its effect on the Malaysian Islamic banking sector. Identifying the determinants of the profitability of Malaysian Islamic banks can strengthen the risk management of these banks and help protect and develop the Islamic banking industry as a whole to cushion the financial shock. This study also investigates the influence of the type of the Islamic bank on its profitability.

In conclusion, the liberalization of the banking industry and the global financial crisis challenges the Malaysian Islamic banks by rapidly changing their environment, which subsequently affects their profitability and efficiency. These effects motivate this study to investigate the determinants of the profitability of and the effects of the global financial crisis to the Malaysian Islamic banks.

This study aims to contribute to the extant literature by examining the effects of the global financial crisis on the profitability of Malaysian Islamic banks. Moreover, this study fills the research gap by identifying the differences between domestic and foreign Islamic banks in Malaysia in terms of the determinants of their profitability.

This study fills another research gap by investigating if the efficiency of Malaysian Islamic banks is determined by the profitability variables. This study offers meaningful suggestions for decision makers in devising strategies to improve the performance and efficiency of Malaysian Islamic banks.

## 1.6 The Research Organization

The study is divided into six chapters and the overview of each chapter is as follows:

**Chapter One: Introduction to the Research** - This chapter discusses the research problem, research questions, research objectives and research motivation and contribution.

**Chapter Two: An Overview of Islamic Banking in Malaysia** - This chapter introduces an overview for why Islamic banking, definition of Islamic banking, history and development of Islamic banking in Malaysia, Islamic banking financing modes in Malaysia.

**Chapter Three: Literature Review** – This chapter discusses the theoretical literature on bank's profitability, the measure of bank Profitability, previous studies on determinants of Islamic banks' profitability, previous studies on the determinants of Islamic and commercial banks' profitability, previous studies on determinants of conventional banks' profitability, previous studies related to the impact of financial crises on banks performance, previous studies on profitability and efficiency differences between domestic and foreign banks, previous studies on the relationship between bank profitability and efficiency, previous studies on banks' efficiency and summary of the previous studies.

**Chapter Four: Research Methodology** - This chapter describes the research method adopted in this study. It explains the sample of the study, sources of data, software used, variables of study, measure of the variables, estimation model and method of study, data analysis structure (pooled and panel data), regression analysis.

**Chapter Five: Results and Discussion** - This chapter discusses the findings of the determinants of Islamic bank's profitability using the return on assets and return on equity as dependent variable, tests the differences and provides the findings in light of the determinants of profitability between domestic and foreign Islamic banks and also discusses the findings with regards to the determinants of Islamic banks' efficiency in Malaysia.

**Chapter Six: Summary and Conclusions** - This chapter summarizes the study and provides the conclusion for the research objectives. Also, this chapter states the implications of the study, limitation of the study and recommendations for future research.