The Impact of Financial Risks on The Performance of Islamic Banks in Malaysia

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ABSTRACT

The purpose of this study is to analyze the impact of financial on the performance of Islamic Banks in Malaysia. This study covers most of Islamic banking institutions in Malaysia which operated during period of 2008 to 2014. By using a panel data series, the data for 15 Islamic banks are taken from the Bank Scope database. There are several factors that have significantly affect on Islamic banks performance. One of them is financial risk. Financial risks that used in this study are credit risk, liquidity risk, operational risk, and capital risk. Overall result, the study finds significant relationship between capital risk, operational risk and financial performance. But there is no relationship between credit risk and liquidity risk towards performance of Islamic banks in Malaysia.

Keywords: Financial Risk, Islamic Banks, Performance.

1.0 INTRODUCTION

1.1 Background of the Study

Islamic banking is the banking systems that free from interest which is there is no fixed level of profit. Risk sharing between investor, bank and user of fund become important characteristics. This component is not in other banking system. Besides, Islamic banking system is the bank which run according through Islamic laws which states about procedures for accurate operational of Islamic system based on outlined by decisions in the Quran (Holy
book of Islam) and words from Prophet (which are referred as Sunnah). The principles and Islam takes care as a whole of human well-being is one of ethical principles of Islam social behavior (Uddin, 2003). As a Muslim, they required not too involved in forbidden activities in order to create social values.

In 1983, the first Islamic bank was established in Malaysia. Malaysia has emerged as a country with established financial institutions that use Islamic banking system. Muda and Jalil (2007) stated that Islamic financial system has managed to gain popularity when it was competitive in the industry as Islamic financial products. Meanwhile in 2000, 18% per annum growing at average for Islamic banking sector in Malaysia in terms of assets but 20% of the total banking markets share by 2010 continue to challenge by Malaysia government (Z. A. Aziz, 2006).

Islamic bank exist in all parts of the world and are looked upon as a variable alternative system which has many things to offer. It was initially to fulfill the needs of Muslims, Islamic bank has now gained universal acceptance. Malaysia becomes the first country to implement dual banking system where Islamic banking system operates side by side with conventional banking system under Islamic banking scheme (IBS). Malaysian model is recognized by many Islamic countries as model of the future and many countries have shown interest. There is several Muslim countries came to Malaysia to study how dual banking works.

Islamic banking has grown rapidly in Malaysia recently. There are now total 16 Islamic banks in Malaysia. Besides, Malaysia has also placed a strong emphasis on human capital development alongside the development of the Islamic financial industry to ensure the availability of Islamic finance talent. All of these value propositions have transformed Malaysia into one of the most developed Islamic banking markets in the world.

The Islamic banks have stable growth rates in Malaysia. Even though the banking and financial sector has been involved in the financial crisis in 2008, Islamic banks have shown an increase in the rate of growth when it is in high demand in Islamic banking services. This is because the financial sector and Islamic banking is becoming increasingly popular in emerging markets after helping some financial institutions avoid the worst of the economic meltdown (Yap, Chan and Bermet, 2012). However, every financial institution has the risks that can effect to the performance of the business. The risks may have an impact towards the achievement of objective of the Islamic banks.

1.2 Problem Statement

The banking industry is booming globally. Each bank in the world will try to improve the overall profitability of the performance, where the performance is measured in terms of a better position in the world's financial institutions. In 2008, there has been a decline in the financial institutions and business in United States and it has caused the other countries were also affected. This situation also led to financial institutions, particularly the banking sector suffered heavy losses in business or go bankrupt. However, Islamic banking institutions are less adversely affected like a conventional banking (SP Parashar, 2010). This is because the Islamic banking institutions have followed different policies, laws, and also different ways to manage the business in the banking sector.
According to Alzorqan (2014), the bank's performance is different for each bank and it is influenced by factors such as basic management of banks and the markets they served which determine their exposure to risk. Based on the previous study, it indicates that there are various types of risks faced by banks such as credit risk, operational risk, interest rate risk, market risk and foreign exchange risk. For Islamic banking, this study will help identify the factors that have an impact on the profitability of banks.

Although there are many studies have been done on measured the Islamic banks performance globally, there is still little analysis done on the studies especially in Malaysia. It has caused of the availability of data. According S. Wasiuzzaman and H. Tarmizi (2010), because of the Islamic banks in Malaysia have just started to publish annual reports on their Islamic banking segment; it may take time to conduct a depth analysis for the study due to insufficient of data. Therefore, by the available data, this study can conduct to identify the strong factors that influence the performance of Islamic banks in Malaysia.

Therefore, this study is going to examine the impact of factors such as credit risk, operational risk, liquidity risk and capital risk towards the performance of Islamic banks in Malaysia.

2.0 LITERATURE REVIEW

In this era, throughout the country have set up Islamic banking. Islamic banking is a banking system that has viable as conventional banking, where it offers a lot of things that complies with Islamic law. The original purpose of the establishment of Islamic banks is to offer products that can meet the needs of Muslims. However, Islamic banking is also accepted by non-Muslims. According to Ahmad (2004) and Muhamad. A and Azmi Omar. M (2012), Islamic banking has grown over the past two decades throughout the country. The growth rate of Islamic banks recorded a high in terms of number and size. In the next decade, the Islamic bank is forecast to monopolize more than half of total deposits in Islamic countries.

2.1 Performance of Islamic Banks

According to Simpson and Kohers (2002), return on assets (ROA) is a ratio that is often used to measure the financial performance of the banking industry. This ratio is used to indicate the ability of management gain in business investment. In additions, return on equity (ROE) is also closely associated in the banking industry. Both of these ratios are that the best indicators to be used because these ratios have the same function as the performance indicators in terms of the direction of movement of financial performance. But these ratios are totally difference in interpreted analysis and magnitude (Simpson and Kohers, 2002). However, most of the previous studies used the financial ratios as a tool to measure the performance of Islamic banks (Kader et al., 2007; Kumbrai et al., 2010; Misra and Apa, 2013; Ibrahim et al., 2014). In the related previous study, MA Hossain and MM Ullah (2016) investigated the comparison of Islamic banks performance in Pakistan and Bangladesh. The study has conducted during 2009 to 2013 by using the financial ratios such as profitability ratio, liquidity ratio, marketability ratio and solvency ratio to measure the Islamic banks performance. From the findings, they stated that the result is a significant difference in profitability between these banks. The Pakistani Islamic banks have shown a good performance compare with the Bangladeshi Islamic banks in the capital, solvency and
liquidity ratio. But performances of Bangladeshi Islamic banks are doing better than performance of Pakistani Islamic banks in risk and capital adequacy ratio and profitability ratio.

Zaman and Irfan (2014) examined the Islamic banks performance and efficiency in South Asian Countries by using the financial ratios. The sample of study consists of four countries which are Iran, Bangladesh, Brunei and Pakistan and the data were collected from period 2004 until 2011. From this study, the finding shown that the Islamic banks is high efficient and positive impact towards return on assets ratios, followed by return on equity ratio and net profit ratio of banks. However, they also found that the result is negative impact on the profitability of the Islamic banks.

Samar Saud (2011) examined the Islamic banks performance in Saudi from period 2005 until 2009. He used the panel data regression analysis and financial ratios as an indicator to measure the banks performance. Saudi banks have been selected in this study and from the results; he stated that the performance of Saudi banks are good and stable in banking industry. However, the size of Saudi banks has a negative relationship with banks performance. In addition, Srairi (2009) and Chong and Sufian (2008) also found the same results.

2.2 Credit Risk

Under Islamic law, Islamic banks are not allowed to conduct business transactions based debt instruments. In addition, one of the reasons the credit risk is higher than conventional bank is a practical use for credit risk management techniques are limited. Therefore, it used to reduce the credit risk or any speculative methods including credit default swaps, options and futures. Besides, Islamic banks have an obligation to indemnify the full financing of the borrower if there is a case of negligence borrower. Thus, Islamic banks are more risky than conventional banks (Errico and Sundararajan, 2002; Bourkhis and Nabi, 2013).

Habib Ahmed (2001) stated that the most important financial risk on measured the banks performance is the credit risk. According to Akhtar, Ahmed, and Usman (2011), stated the credit risk is more affected by debt equity ratios, bank size and capital adequacy. They investigated the risk management practices towards Islamic banks in Pakistan. From the finding, it has shown the positive and statistically significant relationship with the credit risk. Nawaz and Munir (2012) found that credit risk management effected on the banks’ profitability. It will be able to maximize its investment revenue in debtors and this improves and promotes its financial standing and performance therefore a good credit policy decision is positively related to high financial performance.

Boahene, Dasah and Agyei (2012) examined the relationship between credit risk and banks’ profitability. They found a positive relationship between credit risk and bank profitability. Meanwhile, they recommended that management should be cautious in setting up a credit policy that might not negatively affect profitability. However there are several researchers who found that credit risk has negative relationship toward performance of banks. Athanasoglou, Delis and Staikouras (2005) stated the credit risk which is expected to have a negative relationship with the bank's profits. Besides, Hosna Manzura and Juanjuan (2009) find that non-performing loans is most variable that effect on
profitability if compared with the capital adequacy ratio. The effect of credit risk was not the same for all the banks.

Olawale Luqman Samuel (2014) examines the relationship between credit risk and performance of commercial banks in Nigeria. It shows that there is negative and significant relationship between credit risk and performance of commercial banks.  
**H1: There is a relationship between credit risk and Islamic bank’s performance.**

### 2.3 Operational Risk

The Basel Committee recognizes that operational risk is a term that has a variety of meanings and therefore, for internal purposes, banks are permitted to adopt their own definitions of operational risk, provided that the minimum elements in the Committee’s definition are included.

Lee (1999) and Dai (2004) examined banks’ operational performance and determined the influential factors: efficiency, profitability, capital adequacy, liquidity, management capabilities, and growth potential. Yousfi (2014) examines the relationship between risk and financial performance in Jordanian Islamic banks. They also found the significant and negative relationship between operational and performance of Islamic banks.

Miyakoshi and Tsukuda (2004) determined that a bank’s regional location has a significant effect on its operational efficiency and that a company’s employee education and training can enhance its operational performance. Thus, the operational risks are likely to be more significant for Islamic banks due to their specific contractual features (Greuning and Iqbal, 2008; Iqbal and Mirakhor, 2007).

Abdul Aziz Al-Rashidi and Omar Baakeel (2012) identify relationship between operational risk effects on financial development in Saudi companies. They found that there is positive relationship towards financial development. Moreover, studies that conducted from Festus M Epetimehin and Obafemi Fatoki (2015) operational risk effects on financial development and growth in Nigeria. They also found the same results.  
**H2: There is a relationship between operational and Islamic bank’s performance.**

### 2.4 Liquidity Risk

Liquidity risk is the risk that occurs when inability of the bank to meet short term financial demand. This is because due to the inability of asset to convert into cash. According to Ghannadian and Goswami (2004), the implementation of an Islamic bank and how Islamic banking schemes deal with liquidity support in the process of money creation from side to side the contribution transaction account and found that invest the funds on the basis of profit and loss is an attractive destination for banks for developing countries. We can see that performance of Islamic bank is important to attract investor in order to develop their countries.

Bourke (1989) and Sufian and Habibullah (2010) studies found there is a positive result between the level of liquidity and profitability with the proxy of liquid assets to total assets.
and loans to total assets. It demonstrates the higher liquidity of a bank can give higher profitability of the bank.

Based on Haron and Azmi (2004) and Wasiuzzaman and Tarmizi (2010) and opinion, they found that a positive and significant relationship of liquidity and profitability. It said that opposite signs of the Islamic banks with conventional banks due to the profit and loss sharing basis.

According to Chen and Laio (2011), they found that the relationship between liquidity and return is positive and significant result. It means that when the liquidity of bank increasing, the profitability also increases. However, a study that is conducted on Indonesia’s bank denies the result with a negative sign and significant relationship (Izhar and Asutay, 2007). Noraini (2012) and Yousfi (2014) examine liquidity risk between financial performance based on ROA and ROE. They also found that there is negative relationship between liquidity risk and financial performance of Islamic banks.

H3: There is a relationship between liquidity risk and Islamic bank’s performance.

2.5 Capital Risk

Bank capital can be defined as the fund attributed to the proprietors as available in the balance sheet (Nwankwo, 1991). It often considered as a cushion that helps banks absorb their losses and thus avoid failure in the long run (M Helmy, 2012)

According to Abreu and Mendes (2002), they found a positive relationship between capital and profitability. From the study, lower expected bankruptcy costs will occur when they planned a well-capitalized bank and it will show profit later. On the other hand, a study from Bashir (2000) a measure of capital by using the equity to total asset ratio for Islamic bank also found the same results.

According to Asikhia Olalekan and Sokefun Adeyinka (2013) examine the effect of capital adequacy on profitability banks in Nigeria. From the findings for the primary data analysis revealed that there is non-significant relationship but the secondary data analysis showed a positive and significant relationship between capital adequacy and profitability of bank. In the determination of profitability, capital adequacy plays as a key role. Olson and Zoubi (2011) also stated that the relationship between capital adequacy and profitability of banks are significant and positive relationships.

Nikoo S.F. (2015) identifies the impact of capital structure on banking performance in Tehran. The results show that there is significant and positive relationship between capital and performance of banks.

Meanwhile, Al-Tamimi, Miniaoui, and Elkelis (2015) surveyed relationship between financial risk and performance of Islamic banks of Gulf Cooperation Council. Therefore, found that there is significant negative between capital risk and Islamic banking performances.

H4: There is a relationship between capital risk and Islamic bank’s performance.
2.6 Conclusion

These studies have used four independent variables which consist of credit risk, operational risk, liquidity risk and capital risk. Each variable is believed could give an impact positively or negatively on performance of Islamic banks in Malaysia. Based on the previous studies, the impact of Islamic banks performance influenced by several factors has been recorded and stated in this chapter. By reviewing the previous studies, current study assessor are updated with miscellaneous information and result that help in completing this study.

3.0 METHODOLOGY

This study is about factor affecting Islamic bank’s performance in Malaysia. We include five years data from 2008 until 2014 and use the data from annual report of 16 Islamic banks in Malaysia and industry data from Bank Negara Malaysia to calculate the ratio. All the data represent dependent and independent variables. This data can be used to investigate the relationship between the selected independent variables (credit risk, operational risk, capital risk and liquidity risk) and the Islamic bank’s performance in Malaysia.

3.1 Data Analysis

Based on this study, multiple regression is been using since there are many variables that need to be tested with the dependent variable. E-Views software is going to be used in the analysis and processing the data.

In this chapter explains about the data collection that used and collects all the possible researcher opinion about this study. Second is theoretical framework which explains about independent variable and dependent variable. Third, making a hypothesis statement for selected variable and making possible equation for selected variable. Lastly, list the possible test that will be used for panel data in this study.

4.0 EMPIRICAL RESULTS

In this chapter, the empirical result of the entire test conducted will be explained. There are five sections that will explain in a different focused area. This performed with the stated objective of finding the relationship between dependent and independent variables. The finding and analysis of the study were run through research using Microsoft Excel and E-views 9 statistical tools. At the end of the chapter, a summary findings and results obtained will be present.

A few tests had been run in Unit Root Test; Levin, Lin, Chin (LLC) Test, Hadri Test, Descriptive analysis, Redundant Likelihood Ratio Test, Hausman Test, Panel Regression Random Effect Model, Normality Test, and Multicollinearity Test.

Overall, the results showed that there are two independent variables that has significant relationship towards performance of Islamic banks in Malaysia. The independent variables that have significant relationship are Capital Risk (LCAR) and Operational Risk (LOPR) has significant relationship towards performance of Islamic banks in Malaysia proven from Panel
regression random effect. Meanwhile, other two variables which are Credit Risk (LCRR) and Liquidity Risk (LLIR) showed no significant relationship to performance of Islamic banks.

5.0 RECOMMENDATIONS AND CONCLUSIONS

In this study, it contains results of the study between independent variable and dependent variable once finish run diagnostic test. Thus, in this chapter consists of two sections which are section 5.1 discussion of findings for this study. Section 5.2 will discuss about recommendation from the results and for future research.

5.1 Discussion Findings

Main objective for this study is to examine the impacts of financial risks towards performance of Islamic banks in Malaysia. The financial risks consists capital risk, credit risk, liquidity risk, and operational risk. The analysis of the findings consists of two dependent variables which are ROA and ROE. The finding in this study will answer the research objective.

Based on the results, it shows that there is insignificant relationship between credit risk and performance of Islamic banks based on ROA and ROE. Objective 1 can be answered which is to identify the relationship between Credit Risk and performance of Islamic banks in Malaysia. It is not similar from the finding that have been done by Yousfi (2014) found that there is significant between credit risk and performance of Islamic banks.

For operational risk, the result shows that there is a significant relationship between operational risk and performance of Islamic banks based on ROA and ROE. It can answer the following objective which is objective 2 stated that to identify the relationship between operational risk and performance of Islamic banks in Malaysia. Based on the previous research from Al-Tamimi, Miniaoui, and Elkelis (2015) found similar results that there is negative relationship between operational risk and performance of Islamic banks.

For liquidity risk results, it shows that there is insignificant relationship between liquidity risk and performance of Islamic banks. It can answer objective 3 which to examine the relationship between liquidity risk and performance of Islamic banks based on ROA and ROE. It is not similar from previous research Noraini (2012) found that there is significant relationship between liquidity risk and performance of Islamic banks.

Lastly is capital risk. It shows that there is a significant relationship between capital risk and performance of Islamic banks based on ROA. It is similar finding from the previous research. Based on previous research, Asikhia Olalekan and Sokefun Adeyinka (2013) show positive and significant relationship between capital and profitability banks in Nigeria. Meanwhile, there is insignificant relationship between capital risk and ROE. It is not similar from Nikoo (2015) found that there is positive but significant between capital structure and banking performance.
In conclusion, objective 2 and 4 was answer based on the finding that found in this study. It can be concluded that there is no relationship between credit risk and liquidity risk towards performance of Islamic banks based on the model and findings in this study.

5.2 Recommendations

As recommendation, it seems there are opportunities to other students to further study on the relationship between the financial risk and Islamic bank performance. From the finding, we found that there are some recommendations for future studies in order to obtain more precise findings.

The first recommendation is conduct the study related with the comparison of the performance of Islamic and Conventional banks in Malaysia. The future study should use the financial risks as the independent variable, to examine the impact of the financial risks towards the performance of both banks. By this study, the researcher could identify the similarities and differences between these banks.

Besides that, it recommended that to add other variables such as gross domestic product, inflation, non-profit loans to get better result in future study. By adding the new variables, the researcher could find the other variables that significant relationship with the Islamic banks performance in Malaysia.

However, it is also recommended that other method should be used in next research rather than panel data regressions. For example, the future study used the time series analysis as the method to measure the performance of Islamic banks in Malaysia. It is because to give the robust result and will give the deep explanation of the relationship between financial risks and Islamic banks performance.
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