AN EMPIRICAL ANALYSIS OF FINANCIAL STABILITY OF ISLAMIC BANKS: A CASE OF MALAYSIA

BY

ODEDUNTAN AKEEM KOLAWOLE

A dissertation submitted in fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance

Institute of Islamic Banking and Finance
International Islamic University Malaysia

APRIL 2014

ABSTRACT

Financial stability of a bank is its ability to withstand any financial shocks or stress which might be due to liquidity risk, excessive leverage, nonperforming loans, etc. The present study explores the indulgence of most Islamic banks in Malaysia on financing in the form of debt-based financial products with a view to analysing its impacts on the financial stability of those banks. Relevant data were collected from the annual reports of sixteen (16) Islamic banks in Malaysia within the time-frame of 2008 to 2012. The study adopts Z-score analysis as a proxy to assess financial stability of Islamic banks while Liquidity ratio, Nonperforming financing as well as Credit risk ratio were used as a proxy to measure the debt-based model. Partial Least Squares (PLS) was used to analyse the relationship between the dependent variable (financial stability) and the independent variables (debt-based model). The outcome of the study shows that there is a negative relationship between Non Performing Financing (NPF) and financial stability on one hand and between credit risk and financial stability on the other. Liquidity however shows a positive and significant relationship with financial stability. In a nutshell, the study finds that Islamic banks are financially stable but grant excessive financing while the total assets invested on financing are on the increase year by year. Hence, this result reveals an impending financial crisis for Islamic banks if its financing mechanism is not revisited.

خلاصة البحث

الاستقرار المالي للبنك هو قدرته على تحمل المخاطر والصدمات المالية التي قد يكون سببها راجعا إلى مخاطر في السيولة اوالإفراط في الاستدانة اوالقروض المتعثرة، الخ. في هذه الدراسة يستكشف الباحث تساهل معظم البنوك الإسلامية في ماليزيا و تركيزها على التمويلات التي تقدمها في شكل ديون من ضمن منتجاتها المالية ، وذلك بهدف تحليل وفهم آثار هذه الطريقة على الاستقرار المالي لتلك البنوك. في هذه الدراسة تم جمع البيانات ذات الصلة من التقارير السنوية لستة عشر (16) البنوك الإسلامية في ماليزيا ضمن الإطار الزمني من عام 2008 إلى عام 2012. اعتمد في تحليل نتائج هذه الدراسة الى مقياس (ز-) كبديل لتقييم الاستقرار المالي للمصارف الإسلامية بينما تم استخدام كل من نسبة السيولة ، والتمويلات المتعثرة ، وكذلك لقياس نسبة مخاطر الائتمان بمثابة وكيل لقياس النموذج القائم على الديون. في حين تم استخدام المربعات الجزئية (PLS) لتحليل العلاقة بين المتغير التابع لـ(الاستقرار المالي) والمتغيرات المستقلة التي تمثل (النموذج القائم على الديون). توصلت الدراسة الى أن هناك علاقة سلبية بين التمويلات المتعثرة والاستقرار المالي من طرف وبين مخاطر الائتمان والاستقرار المالي من طرف آخر. بينما استنتجت الدراسة وجود علاقة إيجابية وهامة ما بين السيولة وبين الاستقرار المالي. باختصار، وجدت الدراسة في نتائجها أن المصارف الإسلامية هي مستقرة ماليا على وجه العموم ولكنها تمنح التمويل المفرط يزيد في حين أن إجمالي الأصول المستثمرة في التمويل تزيد عاما بعد عام ، وهذا يكشف احتمالية وقوع أزمة مالية وشيكة للبنوك الإسلامية إذا لم يتم إعادة النظر في الطرق و الآليات التي تقوم عليها تمويلات هذه البنوك.   .

APPROVAL PAGE

I certify that I have supervised and read this study. In my opinion, the study conforms with acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Islamic Banking and Finance

…………………………………..
Abideen Adewale Adeyemi
Supervisor

I certify that I have supervised and read this study. In my opinion, the study conforms with acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Islamic Banking and Finance

………………………………..
Ahamed Kameel B. Mydin Meera
Examiner

This dissertation was submitted to the institute of Islamic Banking and Finance and is acceptable as a fulfilment of the requirements for the degree of Master of Islamic Banking and Finance

………………………………..
Ahamed Kameel B. Mydin Meera
Dean,
Institute of Islamic Banking and Finance

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degree at IIUM or other institutions.

Akeem Kolawole Odeduntan

Signature…………………………………. Date ……………………..

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

DECLARATION OF COPYRIGHT AND AFFIRMATION OF FAIR USE OF UNPUBLISHED RESEARCH

AN EMPIRICAL ANALYSIS OF FINANCIAL STABILITY OF ISLAMIC BANKS: A CASE OF MALAYSIA

No part of this unpublished research may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission of the copyright holder except as provided below.

1. Any material contained in or derived from this unpublished research may only be used by others writing with due acknowledgement.

2. IIUM or the library will have the right to make and transmit copies (print or electronic) for institutional and academic purposes.

3. The IIUM library will have the right to make, store in a retrieval system and supply copies of the unpublished research if requested by other universities and research libraries.

Affirmed by Akeem Kolawole Odeduntan.

………………………… ……………………
Signature Date

This study is dedicated to all scholars, writers, researchers, authors and publishers who devote their time to minimise if not obliterate Riba (interest) and its effects in the global financial system through their scholarship, publications, studies and lectures

ACKNOWLEDGEMENTS

My gratitude goes to Almighty Allah who has favoured me with yet another stride in my academic endeavour. Truly, I have no doubt whatsoever in my mind that Allah rewards effort. May His choicest peace, benevolence, blessing and mercy continue to be showered on the soul of the seal of prophets, Muhammad *Ibn* Abdullah (SAW), his household, his companions and the entirety of the *Ummah.*

My profound commendations and appreciations go to my indefatigable supervisor and mentor who in spite of his busy schedule painstakingly went through my work. His input in the course of this work can never be over emphasized. I thank you so meticulously, Dr Abideen Adewale Adeyemi for your tutelage from inception till the last moment. May Almighty Allah reward you abundantly and grant you success in your endeavour.

I appreciate my lecturers in the Institute of Islamic Banking and Finance International Islamic University Malaysia for a job well done. Thank you so much Prof. Aslam, Prof Engku Rabiah, Associate Prof Rosni, Associate Prof Younus, Dr Mustapha Umar, Dr Umar Idris, Mr Mustapha Hamat (P-Mus), Haji Ali, Dr Sheila and many others. I would like to acknowledge the thought-provoking contribution made by Associate Prof. Syed Musa (Masters Coordinator, IIIBF) during my thesis proposal presentation. Also, I wish to acknowledge and appreciate my friends and colleagues at the Institute the names of whom are too numerous to mention. Besides, I express my thanks to the entirety of the management of the International Islamic University Malaysia for granting me concession during my financial predicament.

Furthermore, may I seize this golden opportunity to appreciate my parents, Mr and Mrs Odeduntan. My thanks to them is immeasurable for they had done within their capability all that parents owe to their children. I hold you in high esteem and invoke Allah to prolong your lives so that you can reap the fruit of your labour right from the surface of the earth.

My sincere appreciation also goes to my wife, Saidah Abike Faderera who has been supportive all this while. I really thank her for her patience. May Allah preserve you for me and grant us together with our offspring peaceful, harmonious and prosperous lives filled with piety and excellent character. I must not as well hesitate to appreciate my lovely child, Khalid Olakunle for his wishes all the time. I pray to Allah to grant you long life and prosperity. My gratitude is also extended to my siblings, Hafiz (Abu Abdullah), Kafayat (Iya Basit), Idayat (Iyawo), Sahid and the last baby of the house, Tawakalt.

In the same vein, I wish to extend my profound appreciation to the management and staff of Ahmed Zakari and Co. (chartered accountants) for according me the opportunity to gain professional experience during my stay in their firm as an intern. I am particularly thankful to Mr Ismaila Zakari, FCA (Managing partner) and

Mr Tajudeen Oni, FCA (Partner) for their support and words of encouragement. May your firm continue to wax from strength to strength.

Besides, I thank all those who have contributed in what form or the other to the success of my program. I am sincerely grateful to the following for their financial and moral support: Engr. Faheed Olajide (Abu Hamzah); My mum, Mrs Fatimah Odeduntan; My Dad, Mr Kilani Odeduntan; My wife, Mrs Saidat Odeduntan; Mr Arikeuyo (Baba Kafaya); Mr Modupe Kadri (MAK); Hon. Jide Jimoh; Mr Ismail Afenifere; Mr Quwam Balogun; Mr Miftah Tijani; Mr Sahid Tijani; My brother, Mr Hafeez Odeduntan; Alhaja Shakirat Balogun (my mother in-law); Dr Imran Adeleke; Alhaj Qasim Badrudeen; Mr AbdulMajeed Oladokun; Engr. Kaamil Kalejaiye; Alhaja Mrs Modinat Akintunde; Alhaja Mrs Rukayat Olatunde-Ibrahim; Mr AbdulFatah Ismail; Mr Ishaq Yakin; Alhaj Sabiu AbdulQuadr; Mr Sahid Mustapha; Mr Ibrahim Adeigbe; Mr Qasim Bakare (No shaking); Brother Muhammad AbdulKareem (colleague and friend at IIIBF); Brother Muhammad Sahid; Mr Mutalib Shekoni (Phd student at IIIBF); Mr Mohamed Charif (President, IIBF students' society); Mr Mumin Adebisi; Alhaj Masud Ajala; Mr Binyamin Ajayi (Baba Pupa); Mrs Muhibat (lecturer, Crescent University and Phd student at USIM); Dr Ganiyat Adeshina-Uthman (lecturer, NOUN); Alhaj Abdul Wahid Shittu (Shaykh) and the Muslim Students' Society of Nigeria, Lagos State Area Unit.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

COMMON ABBREVIATIONS

BBA: Bai' BithamanAjil (this means deferred payment sales)

e.g (exempligratia): for example

etc (et cetera): and so forth

et. al (et alia): and others

GDP: Gross Domestic Product

IBF: Islamic Banking and Finance

n.d: no date

no. /nos: number/numbers

n.p: no place, no publisher

NPF: Non Performing Financing (for Islamic banks)

NPL: Non Performing Loan (for conventional banks)

PLS: Partial Least Square

SEM: Structural Equation Model

vol.: Volume

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

According to the financial development report (2012) of the world economic forum, the global real sector accounts for only about a quarter of the world's Gross Domestic Product (GDP). The remaining three quarter is accounted for by the financial sector. This situation has not only caused over concentration on financial activities but has also gingered financial crisis that the whole world is still battling with (Fapohunda, 2012; Asa'ad and Imane, 2012). Although, the world has faced a number of financial crises since the first quarter of the last century, it climaxed in 2006 with subprime mortgage that kicked off in the US and spread sporadically to the entire world in 2007/2008.

This scenario gives a vivid picture of multifaceted crisis that envelops the world particularly as it is evident in the high rate of poverty, injustice, ecological destruction and a host of others (Fapohunda, 2012). The current financial system has been alleged to have played a significant role in the increasing inequality in the distribution of income and wealth (Fapohunda, 2012; ICKE, 2011). It has been structured in such a manner to transfer wealth from the poor to the rich and from developing or emerging economy to the developed ones. This is facilitated by the excessive use of structured debt, securitisation and usury (Interest).

Interest has played a devastating role in the overall global economic meltdown. In a statement credited to Lord Josiah Stamp, former director, Bank of England during a speech delivered in 1927 at the University of Texas, who said:

> The modern banking system manufactures money out of nothing. The process is perhaps the most outstanding piece of sleight of hand that was ever invented... If you wish to be slaves to the Bankers, and pay the costs of your own slavery, then let the bank create money

To corroborate the above assertion Chief Olusegun Obasanjo (former President of Federal Republic of Nigeria) was said to have remarked at the G8 Summit, Okinawa, 2000 thus:

> All that we had borrowed up to 1985 or 1986 was around $5 billion and we had paid about $16 billion yet we are still being told that we owe about $28 billion. That $28 billion came about because of the injustice in the foreign creditors' rate. If you ask me: 'what is the worst thing in the world?' I will say it is compound interest

No wonder why Furqani (2011) argued that the conventional system is unstable because of fragile foundation upon which it was built which has led to bubble growth and a steady stream of attendant crisis.

One of the basic lessons that we can draw from the global financial meltdown is the need to take into cognizance the systemic financial risk as well as the need to design mechanisms of maintaining financial stability. Financial stability has been described by many people as a concept that is difficult to define. The Central Bank of Malaysia defines financial stability as a state of sound and efficient financial system to withstand adverse economic cycles and shocks thereby preventing inordinate disruptions to the intermediation process and maintaining confidence in the financial system.

In accordance with European Central Bank (2012), there are three conditions associated with financial stability. They are:

1. The financial system should possess the wherewithal to be able to transfer the resources efficiently and smoothly from savers to investors
2. Financial peril has to be gauged and priced accurately and must also be relatively well managed
3. The financial system should be in such a manner that it can comfortably absorb financial and real economic shocks.

It is interesting to note that a French economist, who won the 1998 Nobel Prize, Maurice Allias once predicted the inevitability of the current global financial meltdown and warned against its consequences. He therefore proposed two basic components which include regulating interest rate to zero percent and amending the tax rate to about 2 percent. Coincidentally, his proposal sees eye-to-eye with the Islamic concept of banking and finance. Islam advocates an interest-free economic system and imposes Zakat at the rate of two and half percent on the wealthy faithful.

By way of definition, Islamic banking system is a system of banking that complies with the principles and guidelines of Shariah. According to the Bank Negara Malaysia (Central Bank of Malaysia), Islamic banking is defined as:

> Asystem of banking that complies with Islamic law also known as Shariah law. The underlying principles that govern Islamic banking are mutual risk and profit sharing between parties, the assurance of fairness for all and that transactions are based on an underlying business activity or asset

It has a range of objectives which is often described in Islamic terminology as *Maqasid Shariah.* Muhammad and Shakhboz (2009) quoted Hassan and Lewis (2007) that the essential socio-economic goals of Islam include economic comfort coupled with full employment, high economic growth, socioeconomic fairness and equitable distribution of income and wealth. Furthermore, other goals in this perspective, they maintained, include the stability in the value of money as well as the mobilization and investment of savings in order to enhance economic development in such a manner that all the parties involved participate in the return (profit sharing).

Islamic banking has been declared by many to be booming at a remarkable rate. Many Muslim and non-Muslim countries have set up banking system in line with the provisions of Shariah. England, Singapore, United States of America and South Africa are living examples of some Muslim minorities' places that patronize Islamic banking. It is noteworthy that even at the point when global financial crisis was worrisome especially in 2008; European Finance House and Gatehouse Bank are two Islamic banks that were still opened.

The World Islamic Banking Competitiveness report released on Monday 4th March, 2013, by Ernst and Young had it that global Islamic finance, that is, assets invested in Shariah compliant products, is expected to reach 1.8 trillion US dollars, up to 38.5 percent year on year. However, it should be recalled that at the end of 2011, the global Islamic finance asset had already hit 1.3 trillion US dollars representing a 150 percent increase over the previous five years.

Arguably, it is crystal clear that the growth of Islamic finance has been very impressive. The reasons for this growth, according to Derbel, Bouuraoui and Dammak (2010) were attributable to the rise of Muslim population who are really desirous of Shariah compliant financial products as well as efficiency and laudable performance of Islamic banks. Some other reasons according to the study had it that Islamic banking is a system based on high ethical value which does not condone speculation and prohibits illicit investment activities such as interest, speculation, alcohol, gambling, pork and prostitution but only permits investments in tangible assets.

Meanwhile, several studies have shown various views about stability of Islamic banks. Some views held that Islamic banks are stable based on the fact that they do not transact on riba-based, Gharar and Maysir contacts. In the same token, Ali (2012) opined that operating a bank in the profit and loss approach as obtained in the Islamic banking increases the viability of the structure. This is because it encourages such banks to diversify their investments to minimize risk and increase profit. Furthermore, according to IMF survey (2010), it was observed that the growth of credit and asset of Islamic banks during the global financial crises doubled that of conventional.

The study attributed high solvency of Islamic banks to the fact that most of the banks were used to lending a high percentage of their portfolio to the consumer sector. Moreover, the fact that Islamic banks rely heavily on retail deposits and financed real estate, private equity and equities make them resilient to financial instability. Following this, Islamic banks are not as exposed to risks as the non-Islamic counterparts.

In contrast, some authors have maintained that Islamic banks are financially unstable. They blame the cause of this on liquidity risk, operational risk and legal risk (Derbel, et al, 2010). Derbel et al (2010) showed that the ban on interest could lead to underdevelopment sources of fund which poses an obstacle to Islamic banks in terms of liquid management. Besides, the persistent inability to standardize products and lack of harmonization of Islamic principles owing to the different interpretations of the schools of thought may contribute in no small measure to operational and legal risk.

Meanwhile, the current practice of Islamic Banking Finance has not brought about the desired objective. At this juncture, it should be reiterated that the practice of Islamic finance has been skewed to debt financing as opposed to equity. In other words, the principle of risk sharing where profits and losses are shared based on pre-determined ratios or as agreed by the partners are less favoured by the practitioners. Besides, a number of challenges still stir Islamic finance in the face. The intricacy of Islamic financing contract, narrow default penalties as well as moral hazard incentives associated with profit and loss sharing contracts may pose some challenges to the operation of Islamic banks.

Apart from this, operational limitations on investment and risk management activities are some of the factors that could pose threat to Islamic banks and make them less stable than their conventional peers. As if that is not enough, the unhealthy rivalry and competition with the western banking system may force some Islamic banks to pattern their pricing behaviour along with conventional thereby making them to be hyper-sensitive to interest rate changes.

1.2 STATEMENT OF PROBLEM

Islamic banking products are generally categorised into three main parts namely: the equity based, the fee based and the debt based otherwise called the debt financing. A cursory look into the current operational modality of Islamic Banking and Finance (IBF) will reveal that it has not still freed itself from the dominant framework of debt-based finance. Furqani (2011) held that Islamic finance is still viewed as serving the same conventional economic goals and interest. In actual practice, however, most banks channel their advertisement towards home financing, car financing and the likes through various products such as Murabaha, BBA, Bay' Inah and the recent Musharaka Mutanaqisah (Diminishing Partnership). They adopt this debt financing model for reasons they feel are productive for the growth of the sector. Their reasons among others are higher profit rate and less risky nature of these products.

Thus, with the level patronage surrounding the debt coupled with the low rate of investment strategy of depositors fund, it is projected that the banks may not be able to meet the needs of customers in no time due to high demand. Therefore, sooner than envisaged the Islamic banking and financial institutions may also experience the financial instability as it is currently obtainable in the conventional banking and financial industry.

Furthermore, the possibility of default by customers whether wittingly or otherwise and the leniency of the Sharia principles on the defaulters may suggest some impending financial instability for Islamic banks. This argument conforms to the outcome of a study conducted by Siddiqi (2006) who maintained that Islamic economists disagreed with the increasing dominance of debt financing in Islamic financial system. He assert that the greater the role of debt the less the capability of the system to absorb real shocks. Hence, the present study is conducted to analyse the current financing contracts of Islamic banks with a view to evaluating their soundness and liquidity to withstand any economic cycles or shocks.

1.3 OBJECTIVES OF THE STUDY

The main objective of this study is to assess the financial stability of Islamic banks in Malaysia. The following specific objectives are also pursued:

1. To investigate what factors explain the financial stability of Islamic banks in Malaysia
2. To assess the relative strength of each factor in explaining the financial stability of Islamic banks in Malaysia
3. To proffer suggestions based on the research findings

1.4 RESEARCH QUESTIONS

This research answers the following questions:

1. What factors explain the financial stability of Islamic banks in Malaysia
2. What is the relative strength of each factor in explaining the financial stability of Islamic banks in Malaysia

1.5 SIGNIFICANCE OF THE STUDY

It is pertinent to say that in previous studies effort was channelled towards a comparative analysis between Islamic banks and conventional banks. In other words, little or no attention has been paid to analysing financial stability in a particular financial system or economy. The present study bridges this gap by examining financial stability with respect to prevalent financing contracts by Islamic banks in Malaysia.

Besides, the study aims at sensitizing the practitioners to be wary of the excessive use of debt financing. In other words, it introduces to the practitioners the risks and danger associated with the debt-based financing model. This will in no small measure prepare them ahead towards any impending crises or risks that might be associated with such. It will also help them to design mechanism for preventing bankruptcy or collapse of the banks.

The study will also be beneficial to the management in that they will strive towards seeing to the day-to-day running of the banks. Customers particularly the borrowers and investors will benefit from this study in a manner that it will remind them to always seek the pleasure of Allah through their sustenance. This will be accomplished by patronizing Islamic banks even if the return on their earnings is not as competitive as obtainable in the conventional. Their concerns will be promoting Islamic principles and being contented with whatever they have.

The outcome of the study will also be advantageous to the regulatory bodies (or policy makers) as more frame work to protect the banks as well as the customers will have to be promulgated. The regulatory body such as

Central bank should make a concerted effort to identify system-wide risks and take appropriate action to ensure financial stability of Islamic banks. That is, the roles of Central bank in monitoring and regulating financial stability cannot be over emphasized. This is essential so that the image of the Islamic banks will be protected.

1.6 SCOPE AND LIMITATION OF THE STUDY

The study focuses on the financial stability of Islamic banks with particular attention on their NPL, credit and liquidity. This is imperative to study at this crucial time when it has been observed that most banks in Malaysia tend to favour debt-based financing model over other available models. Based on the available data on bank scope related to annual report of Islamic banks, the researcher only considers the period covering 2008 to 2012. This is because the data available could only be found for these banks in the stated period. This research does not consider the efficiency of Islamic banks as well as their capital adequacy and asset/liability management. All the risks exposed to Islamic banks by virtue of their operational principles are not covered in this study.

Besides, the country in focus in this study is Malaysia and the reason for this choice is not far-fetched. A cursory look into countries operating Islamic banks will reveal that Malaysia happens to be one of the largest hubs for Islamic finance. This is evident in its establishment of many banks that are Shariah-compliant coupled with the establishment of many institutional bodies such as International Certified Education in Islamic Finance (INCEIF), Islamic Banking and Finance Institute Malaysia (IBFIM) and