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يونيورسيتي إسلام انتارابغسا ملسيا

THE EFFICIENCY OF ISLAMIC AND CONVENTIONAL COMMERCIAL BANKS IN MALAYSIA: AN ANALYSIS OF CORPORATE GOVERNANCE DETERMINANTS

BY

SURAYA BINTI AHMAD

A dissertation submitted in partial fulfilment of the requirements for degree of Master of Science (Accounting)

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ABSTRACT

The study examines the relative efficiency of the Islamic commercial banks (ICBs) and conventional commercial banks (CCBs) in Malaysia. Using the Data Envelopment Analysis (DEA), the study measures and compares the level of efficiency of the ICBs and CCBs from the year 2003 to 2007. In addition, this study explores the corporate governance factors that may influence the efficiency of the domestic commercial banks. There are ten local commercial banks selected, which comprise of eight CCBs and two ICBs. Three-stage analysis is adopted, where the first step involves the DEA to measure the relative efficiency of the selected banks in intermediating inputs into outputs. The study adopts the standard constant return to scale (CRS) and variable return to scale (VRS) models that involve the calculation of the technical efficiency (TE), pure technical efficiency (PTE) and scale efficiency (SE). The inputs selected are labor, capital and total deposits. Meanwhile, the outputs are including loans and advances, and total income. The second step of analysis involves the evaluation of the difference in the average efficiency score of the ICBs and CCBs using the Mann-Whitney *U* test. It is found that the CCBs outperformed ICBs in all efficiency measures, thus indicates that the CCBs may be more efficient than the ICBs. The corporate governance determinants are grouped into two models, Model 1 (includes the size of the board of directors, the proportion of the independent directors on board, the separation of the CEO and chairman position, the frequency of board meeting) and Model 2 (includes the size of the nomination committee, the size of the remuneration committee, the size of the risk management committee and the size of the audit committee). The result shows that Model 1 and 2 are significantly associated with the TE and SE score. In fact, under Model 1, the size of the size of the board of directors and the proportion of the independent directors on board are significantly affecting the TE and SE of the domestic commercial banks. Meanwhile, under Model 2, the size of the remuneration committee is the significant determinants that influences the TE and SE score. In addition, the SE score is also significantly being influenced by the size of the nomination committee.

ملخص البحث

تبحث الدراسة إلى النفاذ للعلاقة بين المصارف الإسلامية التجارية ICBs والمصارف التجارية العادية CCBs في ماليزيا. تقيس الدراسة وتقارن بين فعّالية مستوى ICBs وبين مستوى CCBs من العام 2003م إلى 2007م مستخدمة تحليل المعلومات الشامل DEA. وكذلك، تفحص العوامل المتحدة المحكومة التى قد تؤثر على فعّالية المصارف التجارية المحلية ، من حلال ثمانية مصارف CCBs، ومصرفين ICBs. سيكون التحليل على ثلاث مراحل: الأولى: استخدم فيها تحليل المعلومات الشامل DEA لقياس مدى فعالية المصارف المختارة للعينة في تحويل المدخلات إلى المخرجات. كما استخدم نموذج افتراض ثبات نسبة العوائد (بزيادة عوامل الإنتاج) CRS ومتغير نسبة العوائد VRS وفيهما الحساب الفنيات الكفاية TE، وفنيات الكفاية الصافية PTE، وأيضا مقياس الكفاية. والمدخلات المختارة هي العمال ورأس المال ومجموج الودائع. أما المخرجات فهي القروض والسلفيات ومجموع الإيرادات. تختص المرحلة الثانية بالتثمين في إختلاف الفعالية العمومية على ICBs وCCBs مستخدمة اختبار مان- ويتني. اتضح من خلالها أن CCBs أكثر اختصاصا من ICBs لكل من الكفايات. العوامل المتحدة المحكومة فرقتين ومنهما، فرقة الأولى (فيها كبر مجلس الإدارة، وكمية من مجلس الإدارة المستقل، وإنفصال مدير المؤسسة عدى الرئيسى، وتردد ملتقى للمجلس) وفرقة الثانى (فيها كبر لجنة ترشيح، والتعويض، وإدارة المخاطرة، وتدقيق الحسابات. وتبين النتائج أن فرقة الأولى وفرقة الثانى كلاهما تؤثرت بعدد TE وSE . وفضلا عن هذا، كبر مجلس الإدارة وكمية من مجلس الإدارة المستقل أيضا تؤثرت TE وSE لمصارف التجارية المحلية. وتحت فرقة الثانى، كبر لجنة التعويض هي العوامل البينة التى تؤثرت بعدد TE وSE . عدد SE أيضا تؤثرت بكبر لجنة ترشيح.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it confirms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

……..
Abdul Rahim Abdul Rahman
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

…….
M. Shabri Abd. Majid
Examiner

This dissertation was submitted to the Department of Accounting and is accepted as partial fulfilment of the requirements for the degree of Master of Science (Accounting).

……..
Nazli Anum Mohd Ghazali
Head, Department of Accounting

This dissertation was submitted to the Kulliyyah of Economics and Management Sciences and is accepted as partial fulfilment of the requirements for the degree of Master of Science (Accounting).

……..
Khaliq Ahmad
Dean, Kulliyyah of Economics and Management Sciences

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 degrees at IIUM or other institutions.

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To my parents Haji Ahmad bin Hassan and Hajjah Semek@Asmah binti Daud, siblings and beloved friend.

Allāh burdens not a person beyond his scope. He gets reward for that (good) which he has earned, and he is punished for that (evil) which he has earned. "Our Lord! Punish us not if we forget or fall into error, our Lord! Lay not on us a burden like that which You did lay on those before us (Jews and Christians); our Lord! Put not on us a burden greater than we have strength to bear. Pardon us and grant us Forgiveness. Have mercy on us. You are our Maulā (Patron, Supporter and Protector, etc.) and give us victory over the disbelieving people (Surah Al-Baqarah, verse 286).

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institution
AE	Allocative Efficiency
ALBB	Alliance Bank Berhad
AFBB	Affin Bank Berhad
AMBB	AmBank (M) Berhad
BAFIA	Banking and Financial Institutions Act 1989
BIMB	Bank Islam Malaysia Berhad
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
CB(s)	Conventional Bank(s)
CCB(s)	Conventional Commercial Bank(s)
CIMB	CIMB Bank Berhad
CRS	Constant Return to Scale
DEA	Data Envelopment Analysis
DMU(s)	Decision Making Unit(s)
EON	EON Bank Berhad
e.g.	*(exempligrantia)*: for example
et al.	*(et alia)*: and others
etc.	*(et cetera)*: and others
FBM	Frequency of the Board Meetings
FSMP	Financial Sector Master Plan
HLBB	Hong Leone Bank Berhad
i.e.	*(id est)*: that is
IBA	Islamic Banking Act 1983
IB(s)	Islamic Bank(s)
IBU	Islamic Banking Unit
ICB(s)	Islamic Commercial Bank(s)
IFSB	Islamic Financial Service Board
IAHs	Investment Account Holders
MBB	Malayan Banking Berhad
MCCG	Malaysia Code on Corporate Governance
MPI	Malmquist Total Factor Productivity Index
OE	Overall Efficiency
PBB	Public Bank Berhad
PIDB	Proportion of Independent Directors on Board
PTE	Pure Technical Efficiency
RHB	RHB Bank Berhad
SAC	Size of the Audit Committee
SBD	Size of the Board of Directors
SCCP	Separation of the CEO and Chairman Position
SE	Scale Efficiency
SNC	Size of the Nomination Committee
SRC	Size of the Remuneration Committee

SRMC	Size of the Risk Management Committee
TE	Technical Efficiency
VRS	Variable Return to Scale

CHAPTER ONE

INTRODUCTION

1.0 INTRODUCTION

This chapter explains the importance of efficiency as an approach in measuring the performance of banks in Malaysia. This chapter firstly discusses the background and motivation of the study. Subsequently, this chapter discusses the research objectives and structure of the study.

1.1 PROBLEM STATEMENT AND MOTIVATION OF THE STUDY

The financial service sector is the most significant economic sector in the world. The financial sector assembles savings and allocates credits that enable the firms and households to cope with the economic uncertainty through collecting, hedging, sharing and pricing risk (Harker and Zenios, 2000). The contributions of the financial sector are channeling the funds from the ultimate borrowers and improving the quality and quantity of the real investment. This increases the income per capita, while raising the society's standard of living (Harker and Zenios, 2000).

The financial service sector accounted for almost 5% of the gross domestic products (GDP) in the US, 5.5% in Germany, 3.5% in Italy, 9% in Japan and 6.5% in Singapore (Harker and Zenios, 2000). These percentages are increasing annually, as the financial system becomes more diversified. In fact, the Malaysian financial industry accounted for 10.7% of the Malaysian GDP in 2007 (BNM, 2008). These figures proved that the financial sector is one of the contributors towards of the growth of the country.

Thus, Bank Negara Malaysia (BNM) played a major role to ensure the stable performance of the Malaysian financial institutions. One of the initiatives made by the BNM is the pronouncement of the Financial Sector Master Plan (FSMP) in 2001. Under the FSMP (2001), the BNM recommended a program that extends from the period of eight to ten years. This recommendation aimed at improving the efficiency, innovation, flexibility, resilience and dynamism of the banking institutions, by paying extra attention on the domestic banking institutions.

In fact, in order to develop a core of strong domestic banking institutions that is able to provide the broad range of high quality products and services to the economy and that is efficient and cost effective, the FSMP (2001) suggested the development of the industry-wide benchmark and measurement to strengthen the corporate governance. However, there is no specific industry-wide benchmark and measurement provided by the BNM.

The motivation of examining the efficiency, governance and performance of the banking institutions is made possible by their dominant market share that is essential in facilitating the economic growth (BNM, 2001). As the financial sector is becoming more diversified, more foreign institutions enter the domestic market. This leads to higher competition in the market. In order to ensure the survival of the domestic banking institutions, the banks must improve their efficiency and effectiveness to be at least equivalent to the world-class players (BNM, 2001).

The emphasis on the importance of improving the domestic banking institutions' efficiency has also motivated this study. The focus of this study is mainly on the efficiency of the Islamic commercial banks (ICBs) and conventional commercial banks (CCBs). This is due to the fact that the commercial banks are the main contributors of the pre-tax profit in the banking institutions. In addition, the

number of the commercial banks covers more than 50% of the total of banking institutions in Malaysia (BNM, 2009).

Although there are a number of literatures on the Malaysian banks' efficiency, only a few attempted to focus on the efficiency of the ICBs and CCBs. Several studies only focused on the conventional banks (CBs) such as Krishnasamy, Alfieya Hanuum and Perumal (2003), Fadzlan (2004; 2005; 2007) and Fadzlan and Suraya (2005). On the other hand, Abdus Samad (1999), Saiful Azhar and Mohd Afandi (2003), Mohd Azmi, Abdul Rahim, Rosylin, M. Shabri and Mohd Eskandar Shah (2006), Hamim Syahrum, Naziruddin and Syed Musa (2007; 2008) and Nor Aiza (2007) focused on the Islamic banks (IBs). Due to lack of researches that compares the efficiency of the ICBs and CCBs, this study attempts to fill the gaps identified in the literature.

It is found that only two literatures studied the impact of the corporate governance factors on the efficiency measures. However, the researches only investigated the impact of several corporate governance determinants (i.e. the board size, the proportion of the independent directors on board and the frequency of the board meetings). Nevertheless, this study includes several other corporate governance determinants, which are identified and quantifiable from the Guidelines on Corporate Governance for Licensed Institutions (2005), the Guidelines on Corporate Governance for Licensed Islamic Institutions (amended 2007) and the Malaysian Code on Corporate Governance (amended 2007).

In addition, this study takes into consideration the suggestion by Coelli, Rao, O'Donnell and Battese (2005) to broaden the study on the efficiency measure by investigating the impact of the quality characteristics on the performance. In the literature, it was found that there was lack of studies that examined the factors which led to the differences in the level of efficiency. For example, the study by Nor Aiza

(2007) and Hamim Syahrum et al. (2007) examined the influences of the bank's specific characteristics on the efficiency. However, none of the studies considered the corporate governance determinants as one of the factors that may influence the efficiency level of the Malaysian banks.

In order to administer the management's activities efficiently, an organization should have good corporate governance. Good corporate governance may reduce the principle agent problem by ensuring the accountability of the respective individual in the organization. In addition, Frei, Harker and Hunter (2000) argued that the management integrates people, technology and process in order to decide which goods and services should be produced. Therefore, it is expected that by having a good corporate governance mechanism, the management may make decision for the best interest of the bank, which may lead to a better performance in the banking sector.

In addition, by studying the impact of the corporate governance on the efficiency of bank, the management may benefit to improve their efficiency and thereby improve their performance. Besides, strong enforcement by the BNM on good corporate governance indicates that the BNM concerned on the way the banks are being managed. Thus, this study attempts to fill the gaps in the literatures and at the same time contributes in understanding the impact of corporate governance on the efficiency of the banks.

1.2 OBJECTIVES OF THE STUDY

This study is aimed to examine the impact of the corporate governance on the bank's efficiency. This study contributes to the management of the ICBs and CCBs, and the regulators in understanding what drives or factors influencing the performance of the

best-practice (frontier) banks and the improvement needed for the worst-practice banks. Therefore, the research objectives (RO) of this study are as follows:

RO_1: To measure and compare the level of efficiency of the ICBs and CCBs in Malaysia; and

RO_2: To explore the corporate governance factors that may influence the efficiency of the commercial banks in Malaysia.

In order to achieve the RO_1, firstly this study measures the relative efficiency of two ICBs and eight CCBs for the year 2003 to 2007. The relative efficiency is measured using the Data Envelopment Analysis (DEA); a non-parametric technique that computes a relative ratio of outputs to each unit of inputs (Avkiran, 1999). Later, the efficiency score is compared according to the type of the commercial banks in order to evaluate whether there is a difference of the mean score for both types of commercial banks. The research questions linked to RO_1 are as follows:

RQ_1: What is the level of efficiency of the commercial banks in Malaysia?

RQ_2: Is there a difference in the level of efficiency of the ICBs and CCBs?

Meanwhile, the RO_2 focuses on the evaluation whether there is significant impact of the selected corporate governance determinants on the efficiency score. This will be analyzed using the multiple-regression analysis. Several corporate governance determinants are extracted from the Guidelines on Corporate Governance for Licensed Institutions (2005), the Guidelines on Corporate Governance for Licensed Islamic Institutions (amended 2007) and the Malaysian Code on Corporate Governance (amended 2007).

These determinants are: (i) the size of the board of directors; (ii) the proportion of the independent directors on board; (iii) the separation of the CEO and Chairman position; (iv) the frequency of the board meetings; (v) the size of the nomination

committee; (vi) the size of the remuneration committee; (vii) the size of the audit committee; and (viii) the size of the risk management committee. Therefore, the research questions derived to answer the RO_2 are:

RQ_3: Is there a relationship between the size of the board of directors and the Malaysian commercial banks' efficiency?

RQ_4: Is there a relationship between the proportion of the independent directors on board and the Malaysian commercial banks' efficiency?

RQ_5: Is there a relationship between the separation of the CEO and Chairman position and the Malaysian commercial banks' efficiency?

RQ_6: Is there a relationship between the frequency of the board meetings and the Malaysian commercial banks' efficiency?

RQ_7: Is there a relationship between the size of the nomination committee and the Malaysian commercial banks' efficiency?

RQ_8: Is there a relationship between the size of the remuneration committee and the Malaysian commercial banks' efficiency?

RQ_9: Is there a relationship between the size of the audit committee and the Malaysian commercial banks' efficiency?

RQ_{10}: Is there a relationship between the size of the risk management committee and the Malaysian commercial banks' efficiency?

1.3 STRUCTURE OF THE STUDY

The study comprises of six chapters. This chapter is the introductory part of the study, explains the background and motivations of the study, the research objectives and the research questions.

In Chapter Two, the chapter explains the theory and practice of the Islamic banking. This includes the discussions on the philosophy and principles of the Islamic banking, and its development worldwide and specifically in Malaysia. In addition, this chapter also discusses the corporate governance issues for the IBs in Malaysia.

Chapter Three reviews the literature on the performance measurement, while focusing on the efficiency as the focus of the study. The methods used in measuring efficiency are explained in this chapter. Finally, it reviews the literature and identifies gaps in the study on the bank's efficiency.

The emphasis of Chapter Four is on the research methodology. This chapter discusses the research objectives and questions, and presents the research design. This includes the sample selection, research method, data collection procedure and data analysis.

In Chapter Five, the results are presented in three parts. Firstly, the findings on the efficiency of individual and categories of commercial banks are presented. Secondly, the chapter summarizes the findings on the difference of mean score for the ICBs and CCBs. Subsequently, the results of the impact of the corporate governance determinants are also presented.

Finally, Chapter Six discusses the findings, the limitations and contributions of the study. The chapter also provides some recommendations for the future research in the area of the bank's efficiency and corporate governance.