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## External and Internal Determinants of Islamic Bank's Financial Performance in Malaysia

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### Abstract

The Organisation of Islamic Countries was established by the Islamic Development Bank in the 1970s. Subsequently, Islamic finance has started to grow rapidly. Such growth contributed to the development of Malaysia's Islamic financial sector where the number of Islamic banks increased from two to fifteen by 2011. Despite good performance, the banks faced various challenges that could affect their commendable achievement. This study seeks to identify internal and external factors of the Malaysian Islamic bank's financial performance. Data were collected from the published annual report data for 10 years. All fifteen Islamic banks were selected. The financial performance was measured by Return on Assets. Capital Adequacy, Bank Size, Growth Domestic Product, and Inflation Rate were the investigated factors. Other sources of data were the statistical bulletin and Data Stream. A descriptive and regression analysis were used. This study finds three factors are having significant relations with the Islamic bank's financial performance. To improve financial performance, Malaysian Islamic banks can focus on bank size because the bigger the bank size, the bank is financially stronger. However, they should be tactful when designing any strategy involving capital adequacy as this study suggests it is negatively related to the bank's financial performance.

**Keywords:** Islamic Bank, Financial Performance, Return on Asset, Capital Adequacy, Regression

### Introduction

The banking industry is very essential to a nation's economic development, and the stability and soundness of the financial system appear to have a brunt on the state of the whole economy (Rahman, 2018). A financial system of banking that follows Shariah law requires both parties, the bank, and the depositors to share mutual risk and profits. In addition, Islamic banks must uphold the integrity of their commercial transactions by avoiding non-shariah activities such as riba (interest), maisir (gambling), and speculative trading (gharar).

Since the establishment of the Organisation of Islamic Countries (OIC) by the Islamic Development Bank in the 1970s, Islamic finance has grown rapidly. Subsequently, the growth contributed to the development of Malaysia's Islamic financial sector since 1983, where the

number of Islamic banks increases from two to sixteen between 2001 to 2011 (Bank Negara Malaysia, 2021). Later, two Islamic banks merged and the number of operating Islamic banks became fifteen. Accelerating at approximately 20 percent annual growth rate, Islamic finance is reported to be the fastest thriving sector of the global financial industry (House, 2013). Furthermore, Malaysia's Islamic finance industry is among the most attractive and progressive Islamic banking sector in the world.

However, the strong increase in inflationary pressures, particularly in the United States, has encouraged a few central banks to raise interest rates at a more rapid rate, which may result in tighter global financial conditions. Consequently, increases in commodity and food prices, as well as labour shortages, could hinder Malaysia's growth potential. In September 2022, Malaysia's annual inflation rate fell to 4.5 percent from 4.7 percent in the previous month. This rate was less than a market forecast of 4.6 percent but very unlikely to decrease further. Economic growth can affect the performance of Islamic banks by influencing the demand and supply of financial services and the macroeconomic environment and stability. A higher economic growth rate can boost the profitability and growth of Islamic banks by creating more opportunities and market for them. On the other hand, a higher inflation rate could adversely affect local financial sector, including the Islamic finance by eroding the value of money and purchasing power. Furthermore, higher inflation rates negatively affect the real returns and financial transaction costs. Both factors are beyond the bank's control. It is very difficult to factor in these variables in assessing the profitability prospect for the Islamic banks. Hence, it is important to examine how inflation rates and economic growth rates are affecting Islamic bank performance, so that the Islamic banks and their stakeholders can make better prediction of the Islamic banks' financial prospects.

Over the past three decades, Malaysian Islamic banking sector has grown quickly, with average annual asset growth of 15 percent since 2000 and an increase of 20 percent in 2010 (Kunhibava, 2012). Furthermore, it continues to make significant progress as of 2013 with a total asset of RM 426.16 billion or almost 13 percent of all Islamic banking total assets worldwide, trailing only by Iran and Saudi Arabia respectively (Leow, 2014). Compared to the conventional banking industry, factors that influence the growth or decline in profitability of Islamic banks in Malaysia have only been the subject of a small number of studies. Therefore, this research intends to contribute to the discussion and analysis of the performance factors of Islamic banks in Malaysia, focusing not only internal factors in the administration and management of the Islamic banks, but also external factors such as macroeconomic conditions.

Malaysia is a home to a range of Islamic banks and Islamic window operations offered by conventional banks. The key objective of this study is to investigate factors that influence the performance of Malaysian Islamic banks. It examined the impact of capital adequacy, bank size, gross domestic product, and inflation on the performance of all 15 Islamic banks listed with the Bank Negara Malaysia. These Islamic banks have been identified as the top-performing banks in Malaysia on the Bank Negara Malaysia website. However, the banking industry faces many challenges as the business landscape and technology are changing rapidly. The banks must improve their knowledge related to the business and profitability drivers. The future of a bank depends on how they handle these drivers and business agility. Understanding both internal and external factors help them to assess the strengths and weaknesses of Islamic banking in Malaysia. Ensuring the sustainability of Islamic banks is paramount for greater financial inclusion for the communities. Islamic banking promotes social justice, equity, and welfare for all stakeholders because it is a form of financial

intermediation that is based on the principles of Shariah, which prohibits interest, speculation, gambling, and any unethical activities. Hence, Islamic banks play a vital role to the equitable economic growth and development of a country such as Malaysia.

In the nutshell, these factors reflect current circumstances faced by the Islamic banks, which are crucial in predicting Islamic bank performance. By understanding the factors that are important to Islamic bank performance, the bank management and those involved in decision-making, policy formation, and future researchers can get better insights of how the bank performance are affected. It contributes by providing contemporary empirical evidence on how these factors affect the performance of Islamic banks in Malaysia. The banking business is an economy's backbone, providing vital funding and supporting economic processes (Dawood, 2014). Updating knowledge about what variables affect the Islamic bank performance is essential in designing financial strategies to promote the bank sustainability. Findings from this study are valuable for regulators too as they reveal key relevant factors to formulate strategies and actions to sustain the banking system's soundness and progress in an ever-changing economy.

### **Literature Review**

Based on Act 276 of the Islamic Banking Act 1983 under Malaysian legislation, Islamic banking is defined as any corporation that runs an Islamic bank, regardless of whether the account is savings, investment, current or any type of deposit account. As a profit-making entity, any Islamic bank strives to maximise value to its shareholders. This is usually measured by its profitability level. Prior studies on factors that influence the profitability level of banks cover two important areas; measures of profitability and contributing factors.

In relation to the first area, previous literature indicates that there are two common methods for determining a bank's profitability: Return on Assets (ROA) and Return on Equity (ROE). The ROA is a metric that is considered more appropriate to assess the profitability of banks (Rivard, 1997). Since the ROA measures profitability in relation to total assets, many studies use ROA as a proxy for financial performance of an entity. A return on assets (ROA) represents a company's potential to earn returns on every dollar invested in an asset (Hadi, 2014). It sheds light on how effectively management utilises its resources to generate profits. Assets are defined as both current and non-current assets. In other words, the ROA shows how effective the bank's management in utilising existing resources to generate profit (Bashir, 2003). Hence, the ROA was chosen as a dependent variable in this study to illustrate how much money the banks made on each Malaysian Ringgit worth of their assets.

For the second area, existing studies suggest several factors that influence profitability level of a financial entity. Several major factors revealed by previous studies are the capital adequacy ratio (CAR), the bank size, the gross domestic product (GDP) and the inflation rate. The capital adequacy ratio (CAR), is also known as the capital-to-risk weighted assets ratio. It is a metric used to assess a bank's financial stability (CRAR). This ratio indicates a degree of depositors' protection and the efficiency and dependability of the bank's financial processes. It is a ratio that reflects how much of the bank's risky assets, such as credit, marketable securities, and payments in other banks, is financed by the bank's own capital funds in addition to debt funding. The CAR depicts a safety valve to ensure that depositor funds are secure while fostering the stability and efficacy of the banking system (Almazari, 2017).

A bank size is likely to determine the influence of economies of scale in the banking sector. Many studies used a bank size as a determinant of bank profitability. The total assets of a bank is frequently used as a proxy for its size. A previous study defines the meaning of bank

size as the ratio that represents banks' ownership of the assets (Khosrow, 2018). Furthermore, a company size is defined as total value of an organisation's assets (Pandey, 2004).

The nation's gross domestic product (GDP) per capita is an external factor that can affect a bank performance. During a good economy, individuals tend to have more money and are likely to deposit it in a bank or an investment account, which increases the bank's lending activity and brings the bank more profits (Vong, 2009). In addition, the inflation may sway banks' real rates of return on assets and has a big impact on their profitability too. Oner (2010) defined inflation as the rate of price increases over a specific time period.

These are some of the probable factors that can affect the performance of Islamic banks. However, different studies use different measures and methods to evaluate the performance of Islamic banks, such as return on equity (ROE), net profit margin, total assets turnover, etc. This study decided to use common measures as suggested by existing literature.

The following diagram illustrates the conceptual framework for this study.

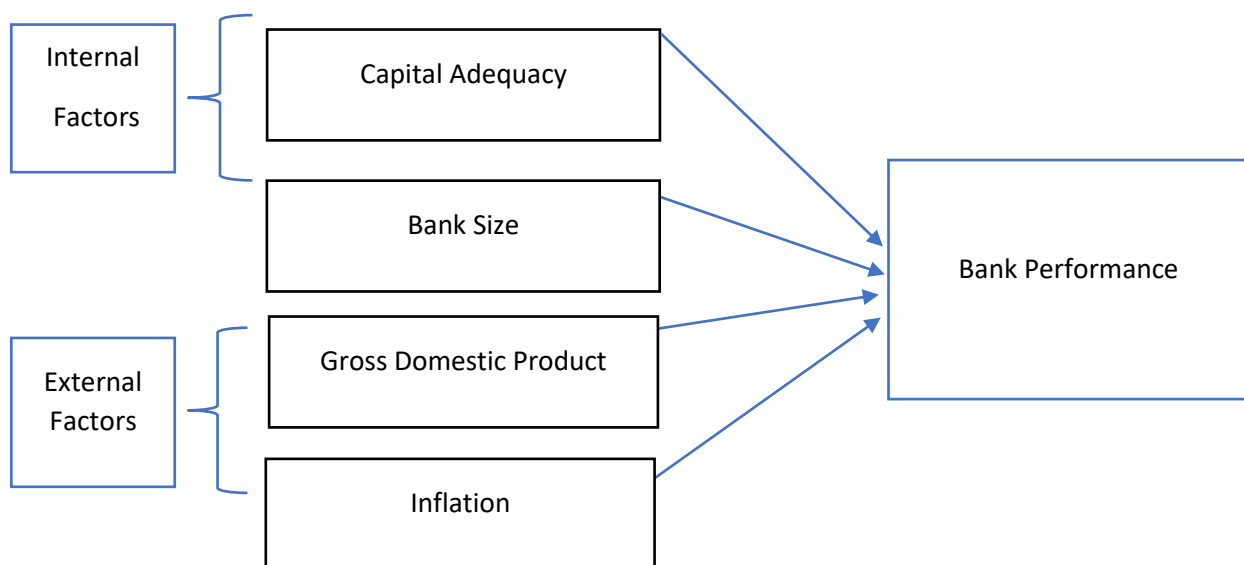


Figure 1: A conceptual framework for the determinants of Malaysian Islamic bank's performance

This paper attempted to determine how capital adequacy, bank size, gross domestic product and inflation were related to the Malaysian Islamic bank's performance. There were four specific hypotheses. The research hypotheses were as follows,

H<sub>1</sub>: There is a significant relationship between capital adequacy and return on assets of Islamic Banks in Malaysia.

H<sub>2</sub>: There is a significant relationship between bank size and return on assets of Islamic Banks in Malaysia.

H<sub>3</sub>: There is a significant relationship between gross domestic product and return on assets of Islamic Banks in Malaysia.

H<sub>4</sub>: There is a significant relationship between inflation and return on assets of Islamic Banks in Malaysia.

**Research Methodology and Method**

*Population and Sampling Method*

According to (Sekaran, 2010) the definition of "population" refers to the entire group of people, events, or things of interest that the researcher wishes to investigate and make inferences. This study selected the whole population of the Islamic banks in Malaysia. For the purpose of this investigation, data for internal factors were collected from 15 published Islamic banks annual reports as per listed in the Central Bank of Malaysia’s List of Licensed Banking Institutions in Malaysia (Bank Negara Malaysia, 2021), while for external factors, the data were derived from the Data stream. The period of study was 10 years; 2012 to 2021. Therefore, this study used 150 firm-year observations in total.

*Data collection and analysis*

Data is collected from the published annual reports and online data services. The unit of analysis is the entity that is being analysed in the study, the Malaysian Islamic bank. The definition and measurement of variables were as provided by Table 1 below.

Table 1

*Definition and Measurement for the Dependent and Independent Variables.*

Variable	Acronym	Formula
Return On Asset	ROA	Net Profit / (Beginning Total Assets + End Total Assets)/2)
Capital Adequacy	CA	Includes Tier1 items consist of equity and reserves and Tier2 items. The annual changes in CAP of bank j defined as: $\Delta CAP C j t, = - APj t CAPj t, -1$ = (Tier 1 capital + Tier 2 capital) ÷ Risk-weighted assets.
Bank Size	BS	Log model of total assets to normalise the data
Gross Domestic Product	GDP	The health in the economic activities and output were measured by GDP growth rate
Inflation	IF	Increases in the overall price level for goods and services.

The SPSS was used to analyse the data, specifically in undertaking the descriptive and linear regression analysis. Furthermore, it was also used to test the appropriateness of the data for the regression such as the descriptive and normality test, and identifying any multicollinearity and autocorrelation issues.

*The regression model was,*

$$Y (ROA) = \alpha + \beta_1 X_1 (CA) + \beta_2 X_2 (LogBS) + \beta_3 X_3 (GDP) + \beta_4 X_4 (IF) + \epsilon$$

*where,*

Y was the Return on Asset

$\alpha$  was Constant number of equations

$\beta$  was correlation coefficients

$X_1$  was Capital Adequacy

$X_2$  was Log Bank Size

$X_3$  was Growth Domestic Product

$X_4$  was Inflation

$\epsilon$  was the random error

**Discussion on Results and Findings**

The descriptive statistics in the data Table 2 provide a brief summary of the observations that was drawn from the data analysis.

Table 2  
*Descriptive Statistics*

	ROA	CAR	LogBS	GDP	IF
MEAN	63.4468	17.8934	10.3658	3.8230	1.7863
MEDIAN	70.6280	16.4823	10.3456	4.7684	2.0973
MAXIMUM	152.3265	39.1139	11.4181	6.0067	3.8712
MINIMUM	-91.2577	11.7309	9.4488	-5.6470	-1.1387
VARIANCE	1663.358	21.628	0.168	10.650	1.772
STD DEV	40.7843	4.6506	0.4104	3.2634	1.3313

The mean for ROA was 63.4 %, indicating that Malaysian Islamic Banks performed by achieving more than 50% returns on their total assets during the study period. Overall, they were showing high efficiency in assets utilization. In addition, the average capital adequacy ratio was 17.8%, and it was low which indicated that the Islamic bank might not have enough capital to cover the risk associated with its assets (Agbeja, 2015). However, this average capital adequacy ratio meets the minimum capital adequacy ratio required by the Bank Negara Malaysia for the Islamic banks, which is at 8% (Bank Negara Malaysia, 2021). Next, the bank size was measured by the natural logarithm value of total assets of RM 1,012,837,224.71. The average bank size shows that majority of the Malaysian Islamic banks are of slightly above one billion.

For the two external factors, the average GDP and was 3.8 and 1.7 respectively. The average GDP reflects the average value created by the Malaysian economy and the average inflation rate during the study period is lower than the average inflation rate from 1973 to 2023. Inflation can affect the performance of Islamic banks by diminishing the purchasing power and value of money and real returns and costs of financial transactions. The low average rate of inflation during the study period is favourable to the banking industry in general. The Islamic banks can benefit from the low inflation rate too.

Table 3  
*Skewness and Kurtosis Tests*

	ROA	CAR	LogBS	GDP	IF
SKEWNESS	-0.75	1.79	0.38	-2.42	-6.57
KURTOSIS	1.18	4.14	-0.96	4.44	0.21
SUM	9517.01	2684.01	1554.86	574.44	267.95
OBSERVATION	150	150	150	150	150

Table 3 show that data for several variables were negatively skewed with the leptokurtic distribution, sharper than a normal distribution. They also had many observations concentrated near the mean with thicker tails. However, based on results from other tests such as the Kolmogorov-Smirnov and Shapiro-Wilk indicated that the data was acceptable for the linear regression.

To test the hypotheses, the regression model was run using the SPSS. Table 4 summarises results from the regression model.

Table 4

*Results from the linear regression*

	Constant	CAR	LogBS	GDP	IF
Unstandardised coefficients, $\beta$	-216.079	-3.276	32.314	2.801	-4.220
Std Error	77.722	.630	7.052	1.363	3.278
T statistics	-2.780	-5.200	4.582	2.055	-1.287
Probability	.006	<.001**	<.001**	.042*	.200

\*5% significant level

\*\*1% significant level

As this study attempts to examine how two external and internal factors are related to the Malaysian Islamic bank performance, Table 4 shows two factors, both internal factors, the capital adequacy ratio and the bank size are significantly related to the bank performance at 1% significant level. However, the direction of relation is different between the two internal factors. The capital adequacy ratio is inversely related to the bank performance. If the capital adequacy ratio decreases by 3.276 percent, the bank performance would increase by 1 percent. A capital adequacy ratio is critical to ensure that banks have enough cushion to absorb losses before they become insolvent. This result suggests that too much capital might not be a good business strategy to increase profits.

On the other hand, the bank size is positively and significantly related to the bank performance. The theory of economies of scale explains the positive relationship between bank size and production efficiency, as larger banks can provide more financial products and services at lower costs. High ownership of assets contributes to the bank's competitive advantage that makes it more attractive to the public.

The gross domestic product is positively related to the bank performance but the relation is only significant at 5% significant level. As the country is showing increases in value created by the economy, the Islamic bank benefits from the prosperous economic condition. The public demand higher financial products and services to facilitate their spending activities.

### Conclusion and Limitations

This study provides some empirical evidence on factors that can affect the Malaysian Islamic banks. It finds two internal factors, namely the capital adequacy ratio and the bank size and one external factor, i.e., the gross domestic product, are significantly related to the bank performance. The financial sector is very competitive. It continues to change due to unavoidable factors such as technological advancement and changing in consumer behaviour. Therefore, it is very important for the managers of financial institution such as the Islamic banks to continue updating their knowledge of what factors are significantly related to their performance.

As a matter for the policy implication, to spur the Islamic bank growth in Malaysia, the government via its central bank and agencies can focus on the bank size to achieve maximum benefits of larger economic scale. In addition, Malaysia must actively promote an innovative and inclusive Islamic financial system during major international events and forums for knowledge exchange and bigger potential financial markets.

There are several limitations in this study. The results are confined to the selected independent variables. Future researchers can include other factors to gather comprehensive view of factors that can have potential effects on the Islamic bank performance. In addition, there are various ways to measure the variables and different approach to test the variables.



Future researchers can also use other regression models. It is important to consider the context, scope and limitations of this study when interpreting the results.

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