

**DETERMINANTS OF CREDIT RISK IN MALAYSIAN
ISLAMIC BANKS**

SITI NORSAKINAH BT SH AHMAD TAJUDDIN

UNIVERSITI KEBANGSAAN MALAYSIA

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**MASTER'S PROJECT IN PARTIAL FULFILMENT OF THE
REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS
ADMINISTRATION**

**GRADUATE SCHOOL OF BUSINESS
UNIVERSITI KEBANGSAAN MALAYSIA
BANGI**

2009

ACKNOWLEDGEMENTS

All praise is to Allah. We praise Him, seek His help, and ask for His forgiveness. Praise and blessings of Allah be upon His Messenger, Prophet Muhammad. Many thanks to Allah, the most Merciful, and the most Gracious, for all the remarkable bounties He has granted me to successfully finish my study.

Consequently, my deep appreciation and sincere thanks go to my helpful supervisor, Dr. Shuhaila binti Saadiah and Dr. Mohamad bin Abdul Hamid, to have led in such fashion as my work. I am thankful to them for their expert advice, encouragement, patience, stimulating discussions, suggestions, supervision, reference and supporting me to finish this work. May your kindness will be rewarded here and hereafter. May Allah bless both of you. Insha-Allah.

My obligations also go to the academic and administrative staffs of the Graduate School of Business UTM. My special thanks go to Prof. Madya Dr. Allah Marlin Abdul Dahir for her encouragement and other USM staffs as well as the lecturers and support during the preparation of this paper. Not to forget staffs in Government departments for their cooperation in giving the data during my research work. My sincere thanks also go to my beloved Malaysia.

DECLARATION

I hereby declare that the work in this project is my own except for quotations and summaries which have been duly acknowledged.

20 March 2009

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Consequently, my deep appreciation and sincere thanks go to my helpful supervisors, Dr Shahida bt Shahimi and Dr Mohamad bin Abdul Hamid, to have left as much freedom in my work; I am thankful to them for their expert advice, encouragement, guidance, stimulating discussions, suggestions, supervision, patience and supporting me to finish this work. Hope your kindness will be rewarded here and hereafter. May Allah bless both of you, Insya-Allah.

My obligations also go to the entire academic and administrative staffs of the Graduate School of Business UKM and in particular to Prof. Madya Dr. Aliah Hanim Mohd Salleh for her encouragement during the course and other UKM staffs as well for the assistance and support during the preparation of this paper. Not to forget staffs in Economics department for their cooperation in giving facilities during my discussion with my supervisors. My special thanks also go to Universiti Malaysia Terengganu especially to my head department, Dr. Mohd. Zulkifli bin Mokhtar for his support and encouragement during the preparation of this paper.

My heartfelt gratitude also goes to all my friends especially Khaizie, Yuli, Fitriya, Mariam, Nani, Wahida and Azah for their continuous encouragement, cooperation, and help.

Last but definitely not least, I would like to dedicate this study to my parents, brothers and sisters whose precious advice and moral support enabled me to persist on fulfilling this research.

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ABSTRACT

Credit risk is the oldest form of risk in the financial markets and has been receiving great attention mainly in the banking institutions. According to the Basel Committee on Banking Supervision (2000), credit risk continues to be the leading source of problems in banking institutions all over the world. In the context of Malaysia, Central Bank of Malaysia (2001) had announced that credit risk continues to remain the largest source of risk for banking institutions in Malaysia due to the fact that a banking institution's financing portfolio is typically the largest asset and the major source of revenue. Financing default will cause cash flow problems and affect banks' liquidity, which then reduce the banks' profitability. Therefore, credit risk mitigation and management is very crucial. It is assumed that the more rigorous risk mitigation and management attached in banks' management, the lower the credit risk, hence the higher profit received by banks. The aim of this study is to examine determinants of credit risk in Malaysian Islamic banks. The study makes use of panel least squares and generalized least squares regression methods based on an unbalanced panel data of 96 observations from 15 Islamic banks for the period of 1999 to 2007. Twelve variables representing internal determinants are tested empirically using panel data estimation. This study reveals that financing extended to risky sectors, ratio of debt over asset, leverage, financing and bank size determine credit risk in Malaysian Islamic banks significantly. Islamic banks have tendency to targeting risky financing since these financing usually promised higher return to the banks. Islamic banks also have higher level of risk particularly in recession period since they employ more debt. Indeed, higher debt ratios imply that the lower the cushion against banks' losses in the event of liquidation. Both findings confirm that moral hazard encourages high risk-taking behaviour by Islamic banks. However, banks make high consumption of tier-1 capital compared to tier-2 capital in order to insulate them from risk. This implies that capital plays an important role and indicates the safety and soundness of Islamic banks. High level of financing activities resulting in banks to have high level of credit risk since borrowers tend to default on their financing. Since Islamic banks' financing are in the form of profit and loss basis, their financing-profitability relation depends on the economic conditions. Hence, high default rates during economic depression reduce the banks profit in financing portfolio. Larger banks have lower level of credit risk since they have better opportunities to diversify compared to smaller banks. Possible implications are addressed based on the findings to enhance risk management culture in Islamic banking institutions.

ABSTRAK

Risiko kredit merupakan salah satu risiko utama dalam pasaran kewangan dan sering diberikan perhatian yang serius terutamanya di institusi perbankan. Menurut *Basel Committee on Banking Supervision* (2000), risiko kredit merupakan penyumbang masalah utama kepada institusi kewangan di seluruh dunia. Risiko kredit telah dikenalpasti sebagai penyumbang terbesar risiko yang dihadapi oleh institusi perbankan di Malaysia (Bank Negara Malaysia 2001). Hal ini disebabkan oleh portfolio pembiayaan merupakan komponen aset terbesar yang memberikan pulangan yang tinggi kepada sesebuah bank. Kemungkiran di kalangan peminjam akan menjejaskan aliran tunai dan memberi kesan terhadap kecairan bank yang akhirnya membawa kepada pengurangan keuntungan. Oleh yang demikian, adalah penting bagi sesebuah bank untuk meminimumkan risiko kemungkiran atau risiko kredit ini. Keuntungan bank dapat ditingkatkan sekiranya pihak pengurusan bank memberi perhatian yang serius dalam usaha meminimumkan risiko kemungkiran. Justeru, kajian ini dijalankan untuk mengenal pasti penentu risiko kredit bank Islam di Malaysia. Bagi mencapai objektif kajian, sebanyak 96 cerapan data panel tak terimbang yang meliputi 15 buah bank Islam, bank skim perbankan Islam dan subsidiari bank Islam bagi tempoh 1999 hingga 2007 digunakan dalam proses penganggaran. Sebanyak dua belas pemboleh ubah dalaman bank diuji secara empirikal menggunakan kaedah penganggaran data panel berdasarkan kaedah kuasa dua terkecil biasa dan kuasa dua terkecil teritlak. Hasil kajian menunjukkan bahawa peningkatan pembiayaan terhadap sektor berisiko, darjah hutang terhadap aset, leveraj, pembiayaan dan saiz bank menyumbang kepada peningkatan risiko kredit. Bank Islam mempunyai kecenderungan untuk menawarkan pembiayaan terhadap sektor berisiko bagi memperoleh kadar pulangan yang tinggi. Bank Islam juga memiliki risiko yang tinggi terutama ketika kelembapan ekonomi disebabkan kecenderungan bank mengambil hutang berlebihan. Bank yang mempunyai nisbah hutang yang tinggi menandakan bahawa bank sukar menyerap kerugian terutamanya dalam mengatasi masalah kecairan yang dihadapi. Kajian ini membuktikan bahawa *moral hazard* menggalakkan bank Islam cenderung untuk mengambil risiko. Walaubagaimanapun, bank menggunakan modal kumpulan-1 lebih tinggi berbanding modal kumpulan-2 bagi menyerap risiko. Ini menunjukkan bahawa modal memainkan peranan yang penting dan menggambarkan ketelusan dan keteguhan bank Islam. Peningkatan penawaran dalam aktiviti pembiayaan menyebabkan kepada peningkatan risiko kredit. Aktiviti pembiayaan perbankan Islam adalah berasaskan kepada perkongsian untung dan rugi, maka keuntungan daripada aktiviti pembiayaan bergantung kepada keadaan ekonomi. Kadar kemungkiran yang tinggi ketika kelembapan ekonomi akan menyebabkan keuntungan yang disumbangkan oleh portfolio pembiayaan berkurangan. Bank yang mempunyai jumlah aset yang besar mempunyai risiko kredit yang rendah disebabkan bank mampu menawarkan pelbagai produk dan perkhidmatan dengan risiko dan aliran pendapatan yang pelbagai. Beberapa implikasi penting dicadangkan dalam kajian ini bagi menggalakkan budaya pengurusan risiko di kalangan perbankan Islam.