

**ISLAMIC BANKING IN MALAYSIA: COMPARATIVE PERFORMANCE OF FOREIGN
AND LOCAL IBS BANKS**

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ABSTRACT

This is an empirical study which compares the performance between Islamic windows of the foreign and local conventional banks in Malaysia for the period 2002-2006 by using financial ratio analysis and significant tests to compare the performance in terms of profitability, solvency, liquidity and risks. The main objective of this study is to gauge the comparative performance of the foreign and local IBS banks in Malaysia and the challenges that facing by the local IBS banks. In terms of efficiency, it is found that the local IBS banks on average performed better than the foreign IBS banks in terms of profitability. However, foreign IBS banks are relatively less risky and more solvent than the local IBS banks. On the other hand, the foreign IBS banks are relatively superior in facing liquidity risks as reflected by its lower loan deposits and loan assets ratios. In terms of credit risk, the foreign IBS banks' exposure to credit risk is found to be relatively lower than the local IBS banks. However, the local IBS banks are more risky and more profitable than the foreign IBS banks in terms of earning variability. The finding in this study show that foreign IBS banks performed well when compared to the local IBS banks. This implies that the local IBS banks are facing potential competition from the foreign IBS banks in future.

Key words: Islamic banking; performance; challenges

1. Introduction

Malaysia's approach towards Islamic banking is unique whereby a dual banking system was introduced where Islamic and conventional banks operate side by side. The Interest-free Banking Scheme (IFBS) was launched in March 1993 which allowed the conventional banks to offer Islamic banking products and services. In 1999, the Islamic Banking Scheme (IBS) was established which included the IFBS banks and BIMB. Initially, only the local banks participated in the IBS which included Malayan Banking Berhad, Bank Bumiputra Malaysia Berhad and United Malayan Banking Corporation. These were the large domestic banks in Malaysia that participated in the scheme since the first phase of IBS was launched in March 1993. Subsequently, the scheme attracted participation from the foreign banks when it was found that Islamic banking proved to have a niche in the market.

A competitive environment was created in the country with the increase in the number of players offering Islamic banking services, where each bank tried to capture the customers in the small market. As at the end of July 2007, there were 28 financial institutions offering Islamic banking services in Malaysia. This comprises of 11 full-fledge Islamic banks, 8 commercial banks offering Islamic windows, 4 Islamic investment banks and 5 development financial institutions offering Islamic banking services. The number of Islamic bank branches totaled 1161 at the end of December 2006 whilst IBS counters reached 909. Besides the local banks, it is obvious that the foreign conventional banks are pursuing this market very aggressively. The foreign banks not only introduced their Islamic windows but some have also set up Islamic subsidiaries which offer a wider range of products under the Islamic

Banking Act, 1983. Under this Act, interested parties can apply for a full-fledge Islamic banking licence and operate strictly as an Islamic Bank.

This study is timely to gauge the performance of the foreign and local banks that participated in Islamic banking to measure their relative competitiveness and the challenges that facing by the local IBS banks.

The overall objective of this study is to examine the comparative performance of foreign and local IBS banks in Malaysia in terms of profitability, solvency, liquidity and risks and the challenges that facing by the local IBS banks. The literature review discusses the existing studies elsewhere whilst the section of empirical results highlights the main findings. The paper ends with conclusions and recommendation.

2. Previous Studies

Malaysia it is the only country having an Islamic inter-bank money market and Malaysia also is one of the innovative markets for Islamic banking. In addition, varieties of Islamic banking products have been introduced in Malaysia.

The performance of Islamic banks in Malaysia in term of profitability and exposure to various risks has been analyzed in few studies. Samad and Hassan (1999) evaluated inter-temporal and inter-bank performance of Bank Islam Malaysia Berhad (BIMB) in terms of profitability, liquidity, risk and solvency using financial ratios and significance tests for the period of 1984-1997.

For the inter-bank comparison showed that Islamic banking maintained more liquidity compared to conventional banks. On the other hand, BIMB was found to be less risky and more solvent than conventional banks for the measurement of risk and solvency.

For the inter-temporal results, BIMB was found to be lagging behind when compared with the average conventional bank in the study. However, the study showed that BIMB performed well in terms of its returns on assets (ROA) and return on equity (ROE).

Luqyan (2002) evaluated the performance of Islamic banking operations at three foreign banks in Malaysia namely HSBC, OCBC and Standard Chartered for the period 1996-2000. The performance of the Islamic Banking Scheme (IBS) versus its conventional counterpart at these banks is evaluated by using trend and ratio analysis.

Luqyan found that during and after the crisis the Islamic banking operations at foreign banks have performed well. The return on assets of the foreign banks' IBS was higher than that of their conventional counterparts. On the other hand, the deposits of the three banks' Islamic Banking Scheme (IBS) grew more than 90 per cent on the average and the financing growth was growing more than 100 per cent on the average. This indicated that the Islamic banking operations are more profitable than the conventional ones.

In many ways, however this study is similar to the analyses by Samad and Hassan (1999), Luqyan (2002) but there are differences in this study. Specifically, this study performance comparison involves foreign and local conventional banks. There is lack of study on Islamic banking practiced by conventional banks with Islamic windows due to the reason of most comparison in previous analysis have been done on Islamic banking performance in Malaysia which considered only BIMB and the study on this area is still lacking. This is one of the aspects that this study will try to address, apart from having a detailed comparison performance analysis of foreign and local conventional banks' involvement in Islamic banking in Malaysia.

Last but not least, the empirical nature of this study would contribute to a growing number of empirical researches on Islamic banking.

3. Data and Methodology

In this study, a comparative analysis on the performance of Islamic windows of foreign and local conventional banks will be carried out. The scope of this study covers the period 2002 until 2006. This period is chosen based on data availability and suitability. Three foreign banks are selected in this study namely HSBC Bank Malaysia Berhad, OCBC Bank Malaysia Berhad and Standard Chartered Bank Malaysia Berhad, whilst the sample of local banks include Hong Leong Bank Berhad, Malayan Banking Berhad (Maybank) and Public Bank Berhad. All these banks are selected based on their ranking as the top foreign and local banks in Malaysia (Salahuddin, 2006) to measure their relative competitiveness.

This research would be conducted based on the following:

- (1) Secondary data will be obtained from the annual reports and financial statements of the selected banks and other published data from various sources.
- (2) Financial ratio analysis and significance tests will be used to obtain objective of this study. Inter-bank analysis will be used to analyze the comparative performance of the foreign and local IBS banks in Malaysia. For the inter-bank analysis, ANOVA is used to test the null hypothesis of the equality of means. It is whether the means of the two banking systems under study are significantly different. If the Means Sum Square Between (MSB)/ Means Sum Square Within (MSW) ratio exceed $F_{.05}$, this indicate that the means of the two systems are not equal. The null hypotheses of the equality of means can be rejected. The performance of the banks will be evaluated based on the criteria of profitability, solvency, liquidity, credit risk and earning risk.
 - (i) Profitability Ratios
Profitability is reflected in the earnings of the bank. Return on Equity (ROE) and Return on Assets (ROA) will be used to measure the profitability of the bank. Return on Equity (ROE) is defined as net profit after taxes over total shareholders' funds. The higher the ROE, the higher the profitability of the bank. Return on Assets is defined as net profit after taxes over total assets. ROA measures the efficiency of a bank's management in converting its assets into net earnings.
 - (ii) Solvency Ratios
The important indicator for the solvency of a bank is capital adequacy. Sufficient capital is needed to be maintained by banks to cushion against unexpected losses. If not, the bank will find itself unable to meet the obligations to its depositors and creditors. Two capital adequacy ratios will be used that is the Core Capital Ratio (CCR) and the Risk Weighted Capital Ratio (RWCR). Core Capital Ratio (CCR) is defined as capital base over total assets and Risk Weighted Capital Ratio (RWCR) is defined as capital base over total weighted assets. The calculations for both ratios have been pre-determined. Both ratios can be read off the balance sheets of the financial statement of the banks. Higher capital adequacy ratios indicate that the higher is the cushion the bank has against the risk of becoming insolvent. Equity Multiplier (EM) is used to analyze the solvency of the bank. It is defined as total assets over total equity capital. Banks with high EM are more prone to failure.
 - (iii) Liquidity Ratios
Liquidity refers to the promptness of asset conversion into cash. Liquidity of a bank represents the ability of the bank to meet anticipated demand for its funds from both borrowers and depositors. Liquidity is measured by the Current Ratio, Loan Deposits Ratio (LDR) and Loan Assets Ratio (LAR). Current ratio is defined as the total of cash and short-term funds and deposits and placements with other banks over the total of customer deposits and deposits and placements of other financial institutions with the bank. Current ratio shows the ratio of liquid assets and liquid

liabilities. If the current ratio is high, this indicates that the proportion of liquid assets is higher than liquid liabilities. Hence, this indicates that the bank is in a secure position to meet sudden demands for withdrawals. Loan deposits ratio (LDP) is defined as total loans over total deposits. If the LDP ratio is high, this indicates that the bank is not very liquid and may be unable to respond to demands for withdrawals. This also indicates that the higher the ratio, the higher is the liquidity risk. Loan Assets Ratio (LAR) is defined as total loans over total assets. A bank with a high loan asset ratio indicates that the bank will be unable to dispose of immediately when it needs cash.

(iv) Credit Risk Ratios

Credit risk refers to the profitability that some of the bank's assets, especially its loans, will decline in value and maybe become valueless. This is the largest source of risk for a bank because loans make up the largest portion of the bank's assets. Credit risk is measured by the Ratio of Non-performing Loans to Total Loans (NPLR) and the Ratio of Loan Loss Provision to Total Loans (LLPR). The ratio of Non-performing Loans to Total Loans (NPLR) is defined as net non-performing loans and financing over total loans (less specific provision (SP) and income in suspense (IIS)). The higher the amount of net non-performing loans relative to total loans the higher the risk of default by its borrower. This also indicates that the higher the ratio, the higher is the bank's exposure to credit risk. The ratio of Loan Loss Provision to Total Loans (LLPR) is defined as the general loan loss provision over total loans (less specific provision (SP) and income in suspense (IIS)). This ratio reveals the extent to which a bank is preparing for loan losses. A high ratio indicates that the bank expects a significant portion of its loans to be bad.

(v) Earnings Risk Ratios

Earnings risk refers to the variability in the bank's income over the years. Internal or external factors such as changes in economic conditions may cause earnings to decline unexpectedly. There are three indicators for earnings risk of Islamic banks, namely the standard deviation of the net profit after zakat and taxes (sNI), the standard deviation of ROE (sROE) and the standard deviation of ROA (sROA). The higher the value of these standard deviation, the more risky is the bank's earnings.

4. Result and Discussions

(i) Profitability

The profitability of the foreign and local IBS banks is compared by using the Return on Assets (ROA) and Return on Equity (ROE). The ROA and ROE figures are shown in Table 1 and Table 2.

In terms of profitability of the foreign IBS banks, Table 1 shows that the average ROA ratio of the foreign IBS banks has exhibited a downward trend from 0.020 in 2002 to 0.006 in 2004. However, the average ROA ratio increased to 0.007 in 2005 but decreased again to 0.005 in 2006. On the other hand, as shown in Table 2 the average ROE ratio of the foreign IBS banks has exhibited a downward trend from 0.147 in 2002 to 0.060 in 2003. The average ROE ratio increased to 0.093 in 2004 but dropped further to 0.090 and 0.060 in 2005 and 2006 respectively.

In comparison, the average ROA ratio of the local IBS banks has exhibited an upward trend from 0.007 in 2002 to 0.009 in 2003 as shown in Table.1. However, the average ROA

ratio dropped to 0.007 in 2004 but increased to 0.017 in 2005. In 2006, the ratio only slightly dropped to 0.016. Furthermore, as shown in Table 2 the average ROE ratio of the local IBS banks has exhibited a downward trend from 0.150 in 2002 to 0.110 in 2003. However, the trend increased to 0.183 in 2005 but dropped to 0.160 in 2006.

Table 1: Return on Assets

| Bank | 2002 | 2003 | 2004 | 2005 | 2006 |
|---------------------|--------------|--------------|--------------|--------------|--------------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 0.027 | 0.004 | 0.008 | 0.008 | 0.009 |
| SCB | 0.026 | 0.014 | 0.005 | 0.003 | 0.004 |
| OCBC | 0.007 | 0.004 | 0.006 | 0.009 | 0.003 |
| <i>Average</i> | <i>0.020</i> | <i>0.007</i> | <i>0.006</i> | <i>0.007</i> | <i>0.005</i> |
| <i>Local Bank</i> | | | | | |
| Maybank | 0.008 | 0.006 | 0.004 | 0.011 | 0.020 |
| Public | 0.010 | 0.013 | 0.008 | 0.026 | 0.021 |
| Hong Leong | 0.003 | 0.009 | 0.008 | 0.014 | 0.007 |
| <i>Average</i> | <i>0.007</i> | <i>0.009</i> | <i>0.007</i> | <i>0.017</i> | <i>0.016</i> |

Source: Annual Reports of the banks: various issues.

Table 2: Return on Equity

| Bank | 2002 | 2003 | 2004 | 2005 | 2006 |
|---------------------|--------------|--------------|--------------|--------------|--------------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 0.190 | -0.030 | 0.100 | 0.080 | 0.080 |
| SCB | 0.090 | 0.080 | 0.090 | 0.050 | 0.040 |
| OCBC | 0.160 | 0.130 | 0.090 | 0.140 | 0.060 |
| <i>Average</i> | <i>0.147</i> | <i>0.060</i> | <i>0.093</i> | <i>0.090</i> | <i>0.060</i> |
| <i>Local Bank</i> | | | | | |
| Maybank | 0.150 | 0.120 | 0.110 | 0.200 | 0.270 |
| Public | 0.220 | 0.070 | 0.060 | 0.160 | 0.130 |
| Hong Leong | 0.080 | 0.210 | 0.160 | 0.190 | 0.080 |
| <i>Average</i> | <i>0.15</i> | <i>0.133</i> | <i>0.110</i> | <i>0.183</i> | <i>0.160</i> |

Source: Annual reports of the banks: various issues.

By using inter-bank analysis, the means of ROA and ROE of the foreign IBS banks were recorded 0.0274 and 0.2700 respectively compared to 0.0336 and 0.4420 respectively of the local IBS banks as shown in Table 1.3. In comparison as shown in Table 1.3, the local IBS banks on average performed better than foreign IBS banks in term of profitability. The Anova test confirmed that the difference between the foreign and local IBS banks is statistically significant at 5% level of significance.

Table 3: Profitability Ratios for Foreign and Local IBS Banks (2002-2006)

| Variables | Mean 2002-2006 | | MSB | MSW | F-Test |
|-----------|-------------------|-------------|--------|--------|---------|
| | Foreign Banks | Local Banks | | | |
| ROA | 0.0274 | 0.0336 | 0.0001 | 0.0003 | 0.3443* |
| ROE | 0.2700 | 0.4420 | 0.0740 | 0.0091 | 8.1409* |

Note: Difference in means: *significant at 5% level.

(ii) Solvency

The solvency of the foreign and local IBS banks is compared by using core capital ratio (CCR), risk-weighted capital ratio (RWCR) and the equity multiplier (EM). The CCR, RWCR and EM figures are shown in Table 4, Table 5 and Table 6 respectively.

In terms of solvency, the average core capital ratio of the foreign IBS banks dropped from 70.47 in 2002 to 9.37 in 2004 as shown in Table 4. However, the CCR increased to 12.47 and 13.05 in 2005 and 2006 respectively. On the other hand, the average risk-weighted capital ratio of the foreign IBS banks has shown in a downward trend from 72.19 in 2002 to 13.62 in 2004 as shown in Table 5. However, it increased to 18.45 in 2005 and 20.95 in 2006.

As shown in Table 4, the average core capital ratio of the local IBS banks increased from 10.18 in 2002 to 21.63 in 2003 but decreased to 9.86 in 2004. The ratio increased again after 2004 to 12.46 in 2005 and increased slightly to 12.82 in 2006. Moreover, the average risk-weighted capital ratio of the local IBS banks increased from 11.56 in 2002 to 23.63 in 2003 as shown in Table 5. After 2003, the ratio decreased to 12.14 in 2004. However, it increased again from 14.90 in 2005 to 15.18 in 2006.

Table 4: Core Capital Ratio

| <i>Bank</i> | <i>2002</i> | <i>2003</i> | <i>2004</i> | <i>2005</i> | <i>2006</i> |
|---------------------|--------------|--------------|-------------|--------------|--------------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 14.80 | 13.70 | 8.20 | 13.40 | 14.60 |
| SCB | 181.86 | 92.17 | 10.57 | 15.46 | 17.69 |
| OCBC | 14.74 | 8.81 | 9.34 | 8.57 | 6.87 |
| <i>Average</i> | <i>70.47</i> | <i>38.23</i> | <i>9.37</i> | <i>12.47</i> | <i>13.05</i> |
| <i>Local Bank</i> | | | | | |
| Maybank | 9.00 | 6.76 | 5.37 | 6.62 | 8.07 |
| Public | 12.10 | 45.40 | 13.40 | 19.10 | 17.80 |
| Hong Leong | 9.44 | 12.73 | 10.82 | 11.67 | 12.60 |
| <i>Average</i> | <i>10.18</i> | <i>21.63</i> | <i>9.86</i> | <i>12.46</i> | <i>12.82</i> |

Source: Annual Reports of the banks: various issues.

Table 5: Risk-weighted Capital Ratio

| <i>Bank</i> | <i>2002</i> | <i>2003</i> | <i>2004</i> | <i>2005</i> | <i>2006</i> |
|---------------------|--------------|--------------|--------------|--------------|--------------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 16.40 | 14.50 | 9.20 | 14.60 | 15.90 |
| SCB | 183.92 | 92.96 | 21.13 | 30.92 | 35.37 |
| OCBC | 16.25 | 9.60 | 10.53 | 9.84 | 11.59 |
| <i>Average</i> | <i>72.19</i> | <i>39.02</i> | <i>13.62</i> | <i>18.45</i> | <i>20.95</i> |
| <i>Local Bank</i> | | | | | |
| Maybank | 10.81 | 9.62 | 9.23 | 10.64 | 12.11 |
| Public | 13.70 | 47.20 | 14.80 | 20.80 | 19.40 |
| Hong Leong | 10.18 | 14.08 | 12.38 | 13.26 | 14.04 |
| <i>Average</i> | <i>11.56</i> | <i>23.63</i> | <i>12.14</i> | <i>14.90</i> | <i>15.18</i> |

Source: Annual Reports of the banks: various issues.

As shown in Table 6, the average equity multiplier ratio of the foreign IBS banks has exhibited an upward trend from 11.61 in 2002 to 15.55 in 2004 and dropped further to 13.99 and 13.36 in 2005 and 2006 respectively. In comparison, the average equity multiplier ratio of the local IBS banks has exhibited a downward trend as overall from 22.64 in 2002 to 10.77 in 2006.

Table 6: Equity Multiplier

| Bank | 2002 | 2003 | 2004 | 2005 | 2006 |
|---------------------|--------------|--------------|--------------|--------------|--------------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 7.22 | 8.79 | 13.63 | 10.40 | 9.73 |
| SCB | 3.32 | 6.22 | 18.38 | 16.07 | 9.41 |
| OCBC | 24.28 | 30.49 | 14.64 | 15.50 | 20.93 |
| <i>Average</i> | <i>11.61</i> | <i>15.17</i> | <i>15.55</i> | <i>13.99</i> | <i>13.36</i> |
| <i>Local Bank</i> | | | | | |
| Maybank | 18.34 | 19.88 | 24.39 | 17.76 | 13.93 |
| Public | 22.50 | 5.05 | 7.99 | 6.01 | 6.50 |
| Hong Leong | 27.09 | 22.58 | 19.36 | 13.71 | 11.89 |
| <i>Average</i> | <i>22.64</i> | <i>15.84</i> | <i>17.25</i> | <i>12.49</i> | <i>10.77</i> |

Source: Annual Reports of the banks: various issues.

By using inter-bank analysis in the Anova test, it is found that the foreign IBS banks are relatively less risky and more solvent than the local IBS banks. As shown in Table 7, the means of core capital ratio and risk-weighted capital ratio of the foreign IBS banks were 86.16 and 98.54 respectively compared to 40.18 and 46.45 respectively of the local IBS banks. This indicated that the foreign IBS bank capital adequacy position is relatively more secure. This result is statistically significant at 5% level of significance. Furthermore, it is found that the mean of equity multiplier of the foreign IBS banks was 41.80 compared to 47.40 of the local IBS banks whilst the local IBS banks have higher EM than the foreign IBS banks.

Table 7: Solvency Risk Ratios for Foreign and Local IBS Banks (2002-2006)

| Variables | Mean 2002-2006 | | MSB | MSW | F-Test |
|-----------|-------------------|-------------|---------|---------|---------|
| | Foreign Banks | Local Banks | | | |
| CCR | 86.16 | 40.18 | 5285.40 | 3159.78 | 1.6727* |
| RWCR | 98.54 | 46.45 | 6783.94 | 2697.43 | 2.5150* |
| EM | 41.80 | 47.40 | 78.2320 | 106.887 | 0.7319* |

Note: Difference in means: *significant at 5% level.

(iii) Liquidity

The liquidity of the foreign and local IBS banks is compared by using the current ratio, loan deposits ratio and loan assets ratio. The figures are shown in Table 8, Table 9 and Table 10.

The average current ratio of the foreign IBS banks did not increase steadily as shown in Table 8. The ratio dropped to 0.11 in 2004 after 2003 and increased again to 0.46 in 2005 but dropped again to 0.37 in 2006. This indicated that the bank's liquidity position did not improving steadily over the years. Moreover, the average loan deposits ratio and loan assets

ratio of the foreign IBS banks show downward trends from 2002 to 2003 but increased after 2003 to 2006 as shown in Table 9 and Table 10.

As shown in Table 8, the average current ratio of the local IBS banks in 2002 was 0.31 but the ratio decreased after 2002 from 0.25 in 2003 to 0.18 in 2006. This indicated that the bank's liquidity position did not show any improvement. Furthermore, the average loan deposits ratio of the local IBS banks shows an upward trend from 0.47 in 2002 to 1.23 in 2004 but decreased to 0.98 in 2005 and increased to 1.04 in 2006 as shown in Table 9 whilst the average loan assets ratio shows an upward trend over the years as shown in Table 10.

Table 8: Current Ratio

| <i>Bank</i> | 2002 | 2003 | 2004 | 2005 | 2006 |
|---------------------|--------|------|------|------|------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 0.0005 | 0.02 | 0.22 | 0.33 | 0.30 |
| SCB | 0.17 | 0.66 | 0.06 | 0.85 | 0.38 |
| OCBC | 0.06 | 0.19 | 0.05 | 0.20 | 0.43 |
| <i>Average</i> | 0.08 | 0.29 | 0.11 | 0.46 | 0.37 |
| <i>Local Bank</i> | | | | | |
| Maybank | 0.14 | 0.03 | 0.19 | 0.14 | 0.23 |
| Public | 0.61 | 0.69 | 0.03 | 0.07 | 0.08 |
| Hong Leong | 0.19 | 0.04 | 0.27 | 0.33 | 0.23 |
| <i>Average</i> | 0.31 | 0.25 | 0.16 | 0.18 | 0.18 |

Source: Annual reports of the banks: various issues.

Table 9: Loan Deposits Ratio

| <i>Bank</i> | 2002 | 2003 | 2004 | 2005 | 2006 |
|---------------------|------|------|------|------|------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 4.36 | 1.05 | 0.88 | 0.81 | 0.84 |
| SCB | 0.33 | 0.11 | 0.05 | 0.48 | 0.54 |
| OCBC | 0.23 | 0.22 | 0.79 | 0.71 | 0.62 |
| <i>Average</i> | 1.64 | 0.46 | 0.57 | 0.67 | 0.67 |
| <i>Local Bank</i> | | | | | |
| Maybank | 0.80 | 1.12 | 1.22 | 1.07 | 1.25 |
| Public | 0.36 | 0.57 | 1.77 | 1.18 | 1.17 |
| Hong Leong | 0.24 | 0.32 | 0.71 | 0.70 | 0.69 |
| <i>Average</i> | 0.47 | 0.67 | 1.23 | 0.98 | 1.04 |

Source: Annual Reports of the banks: various issues.

Table 10: Loan Assets Ratio

| <i>Bank</i> | 2002 | 2003 | 2004 | 2005 | 2006 |
|---------------------|------|------|------|------|------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 0.92 | 0.39 | 0.55 | 0.54 | 0.57 |
| SCB | 0.22 | 0.09 | 0.01 | 0.18 | 0.31 |
| OCBC | 0.20 | 0.21 | 0.55 | 0.60 | 0.52 |
| <i>Average</i> | 0.45 | 0.23 | 0.37 | 0.44 | 0.47 |
| <i>Local Bank</i> | | | | | |
| Maybank | 0.68 | 0.79 | 0.71 | 0.73 | 0.72 |
| Public | 0.34 | 0.42 | 0.75 | 0.90 | 0.88 |
| Hong Leong | 0.19 | 0.30 | 0.45 | 0.58 | 0.61 |
| <i>Average</i> | 0.40 | 0.50 | 0.64 | 0.74 | 0.74 |

Source: Annual Reports of the banks: various issues.

In the Anova test for the inter-bank analysis as shown in Table 1.11, the means of loan deposits ratio and loan assets ratio of the foreign IBS banks were 2.4040 and 1.1720 respectively compared to 2.6340 and 1.8100 respectively of the local IBS banks. Since the mean of the foreign IBS banks is lower than that of the local IBS banks for the period in this study, this indicates that the foreign IBS banks are relatively superior in facing liquidity risks as reflected by its lower loan deposits and loan assets ratios. This result is statistically significant at 5% level of significance.

Table 11: Liquidity Risk Ratios for Foreign and Local IBS Banks (2002-2006)

| Variables | Mean 2002-2006 | | MSB | MSW | F-Test |
|---------------------|-------------------|-------------|--------|--------|---------|
| | Foreign Banks | Local Banks | | | |
| Loan Deposits Ratio | 2.4040 | 2.6340 | 0.1323 | 1.4435 | 0.0916* |
| Loan Assets Ratio | 1.1720 | 1.8100 | 1.0177 | 0.1398 | 7.2798* |

Note: Difference in means: *significant at 5% level.

(iv) Credit Risk

The credit risk of the foreign and local IBS banks are compared by using the percentage of general provision to total loans (LLP) and percentage non-performing loans to total loans (NPL). The figures are shown in Table 12 and Table 13.

In terms of credit risk, it is found that the general provision to total loans for the local IBS banks lower than the foreign IBS banks' average in three out of five years as shown in Table 12. This indicated that the local IBS banks' expectations of bad loan recovery were lower compared to the foreign IBS banks.

In addition, the percentage of non-performing loans to total loans for the foreign IBS banks were higher than the local IBS banks' average in 2002 but lower in 2003 until 2006 as shown in Table 13. This indicated that the foreign IBS banks' credit risk were lower than that of the local IBS banks.

Table 12: General Provision to Total Loans

| Bank | 2002 (%) | 2003 (%) | 2004 (%) | 2005 (%) | 2006 (%) |
|---------------------|-------------|-------------|-------------|-------------|-------------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 0.90 | 0.60 | 0.40 | 0.20 | 0.10 |
| SCB | 9.70 | 7.70 | 10.60 | 0.30 | 0.60 |
| OCBC | 1.40 | 1.00 | 0.58 | 0.48 | 0.74 |
| <i>Average</i> | <i>4.00</i> | <i>3.10</i> | <i>3.86</i> | <i>0.33</i> | <i>0.48</i> |
| <i>Local Bank</i> | | | | | |
| Maybank | 4.60 | 5.54 | 5.79 | 5.82 | 5.15 |
| Public | 1.12 | 1.26 | 1.97 | 1.87 | 1.64 |
| Hong Leong | 0.70 | 1.20 | 1.10 | 1.60 | 1.20 |
| <i>Average</i> | <i>2.14</i> | <i>2.67</i> | <i>2.95</i> | <i>3.10</i> | <i>2.66</i> |

Source: Annual Reports of the banks: various issues.

Table 13: Non-performing Loans to Total Loans

| <i>Bank</i> | 2002 (%) | 2003 (%) | 2004 (%) | 2005 (%) | 2006 (%) |
|---------------------|-------------|-------------|-------------|-------------|-------------|
| <i>Foreign Bank</i> | | | | | |
| HSBC | 1.60 | 1.50 | 1.50 | 1.50 | 1.50 |
| SCB | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| OCBC | 2.10 | 1.30 | 1.50 | 1.50 | 1.50 |
| <i>Average</i> | <i>1.73</i> | <i>1.43</i> | <i>1.50</i> | <i>1.50</i> | <i>1.50</i> |
| <i>Local Bank</i> | | | | | |
| Maybank | 1.47 | 2.27 | 3.12 | 3.50 | 3.31 |
| Public | 1.68 | 1.88 | 1.71 | 1.56 | 1.50 |
| Hong Leong | 1.50 | 1.50 | 1.50 | 1.60 | 1.50 |
| <i>Average</i> | <i>1.55</i> | <i>1.88</i> | <i>2.11</i> | <i>2.22</i> | <i>2.10</i> |

Source: Annual Reports of the banks: various issues.

By using inter-bank analysis, the local IBS banks are relatively exposed to greater credit risk as compared to the foreign IBS banks as shown in Table 14. The mean of non-performing loans to total loans for the local IBS banks is a high figure of 5.92 compared to 4.6 for the foreign IBS banks. This result is statistically significant at 5% level of significance by the Anova test.

Table 14: Credit Risk Ratios for Foreign and Local IBS Banks (2002-2006)

| <i>Variables</i> | Mean 2002-2006 | | MSB | MSW | F-Test |
|-------------------------------------|-------------------|-------------|--------|---------|----------|
| | Foreign Banks | Local Banks | | | |
| General Provision to Total Loans | 7.06 | 8.112 | 2.7668 | 15.4050 | 0.1796* |
| Non-performing Loans to Total Loans | 4.6 | 5.92 | 4.356 | 0.3792 | 11.4873* |

Note: Difference in means: *significant at 5% level.

(v) *Earnings Risk*

The earnings risk for the foreign and local IBS banks is measured by using the standard deviation of profit after tax, ROE and ROA, while coefficient of variation (CV) is defined as the ratio of standard deviation to the mean. The result is shown in Table 15 and Table 16.

In terms of earnings risk as shown in Table 16 and Table 17, the CV of profit after tax for the local IBS banks is slightly lower compared to the foreign IBS banks. This indicated that the local IBS banks are more profitable than the foreign IBS banks. This result is statistically significant at 5% level of significance by the Anova test. In contrast, the CV of ROE and ROA for the local IBS banks are higher than the foreign IBS banks. This indicated that the local IBS banks are more risky than the foreign IBS banks. This result of the means of ROE is statistically significant at 5% level of significance by the Anova test. However, the Anova does not suggest the means of ROA are statistically significant at the 5% level of significance.

Table 15: Standard Deviation of Profit after Tax, ROE and ROA: Foreign and Local IBS Banks

| <i>Bank</i> | <i>Standard Deviation of Profit After Tax (2002-2006)</i> | <i>Standard Deviation of ROE (2002-2006)</i> | <i>Standard Deviation of ROA (2002-2006)</i> |
|---------------------|---|--|--|
| <i>Foreign Bank</i> | | | |
| HSBC | 22605 | 0.078 | 0.011 |
| SCB | 2821 | 0.023 | 0.010 |
| OCBC | 5691 | 0.040 | 0.002 |
| <i>Local Bank</i> | | | |
| Maybank | 165750 | 0.066 | 0.006 |
| Public | 92131 | 0.066 | 0.008 |
| Hong Leong | 31477 | 0.061 | 0.004 |

Source: Annual Reports of the banks: various issues.

Table 16: Variability of Profit after Tax, ROE and ROA for Foreign and Local IBS Banks (2002-2006)

| | | Foreign Banks | Local Banks |
|------------------|------|---------------|-------------|
| Profit After Tax | Mean | 10372 | 96453 |
| | S.D | 31117 | 289358 |
| | CV | 3.000 | 2.999 |
| ROE | Mean | 0.047 | 0.064 |
| | S.D | 0.141 | 0.193 |
| | CV | 3.000 | 3.016 |
| ROA | Mean | 0.008 | 0.006 |
| | S.D | 0.023 | 0.018 |
| | CV | 2.875 | 3.000 |

Table 17: Earnings Risk Ratios for Foreign and Local IBS Banks (2002-2006)

| <i>Variables</i> | Mean 2002-2006 | | MSB | MSW | F-Test |
|------------------|-------------------|-------------|---------|--------|---------|
| | Foreign Banks | Local Banks | | | |
| Profit After Tax | 10372 | 96453 | 11.1146 | 2.3178 | 4.7953* |
| ROE | 0.047 | 0.064 | 0.0005 | 0.0004 | 1.1248* |
| ROA | 0.008 | 0.006 | 4.1667 | 0.0000 | 0.2941* |

Note: Difference in means: *significant at 5% level

5. Conclusion and Recommendations

The main objective of this study is to gauge the comparative performance of the foreign and local IBS banks in Malaysia.

This study compares the performance of the foreign and local IBS banks in Malaysia in terms of profitability, liquidity, solvency, credit risk and earnings risk. The period of this study is from 2002-2006. The methods of analysis include financial ratio analysis and significance tests.

The findings in this study on the comparative performance between the foreign and local IBS banks are as follows: In terms of profitability, it is found that the local IBS banks on

average performed better than the foreign IBS banks. However, the foreign IBS banks are relatively less risky and more solvent as represented by their higher capital adequacy ratios as compared to that of the local IBS banks.

On the other hand, the foreign IBS banks' loan deposits and loan assets ratios are lower than that of the local IBS banks which indicated that the foreign IBS banks are relatively superior in facing liquidity risks as reflected by its lower loan deposits and loan assets ratios. However, the local IBS banks' exposure to credit risk is found to be relatively higher, as indicated by its higher non-performing financing ratio.

In terms of earning variability, the CV of profit after taxes for the local IBS banks lower than that of the foreign IBS banks during the period of study. This indicated that the local IBS banks are more profitable than the foreign IBS banks. In contrast, the CV of ROE and ROA for the local IBS banks are relatively higher than that of the foreign IBS banks. This indicated that the local IBS banks are more risky than the foreign IBS banks.

The finding in this study show that foreign IBS banks performed well when compared to the local IBS banks. This implies that the local IBS banks are facing potential competition from the foreign IBS banks in future. To remain competitive with the foreign IBS banks which have the advantage of scale economies, the local IBS banks have to be more aggressive in developing more innovative and attractive Islamic products and services. Although the local IBS banks have bigger deposit volume compared to the foreign IBS banks but the deposit growths in the foreign IBS banks over the period of study were relatively higher than that of the local IBS banks. With the introduction of new products, the local IBS banks can attract more deposits to improve its deposit growth. The local IBS banks should also provide rates of return which are competitive with the returns from the foreign IBS banks in particular and other banks in general to compete in the market.

In addition, the local IBS banks can upgrade their facilities by investing in technology to develop telephone banking and on-line services using proprietary software. By upgrading the banking facilities, a more convenient service can be provided to the clients of the banks such as checking of account balances, making payments transfers between accounts conducted from home or office 24 hours a day and also clients of the bank themselves are able to print off account statements and records of their transactions via the Internet.

Moreover, customers' satisfaction can influence the performance of a bank and determines its success and competitiveness. Hence, local IBS banks need to improve the quality of their services and keep track with changing consumer needs. Moreover, a close relationship between the bank and the client is a need and the local IBS banks can provide a standardized service which nevertheless the client feels is designed for their particular circumstances.

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