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The effect of financial liberalization towards financial stability of Islamic banks in Malaysia

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Abstract

Financial liberalization will affect the stability of the financial system due to excessive risk. Liberalization effort in Islamic banks players raises the issues of the ability of how Islamic banks can survive in the financial liberalization regime. Financial liberalization induced competition and thus impact on financial stability due to excessive risk taking. Malaysia is operating in dual financial system, the effect of mediating roles of competition and interest rate between financial liberalization is expected to be vary at some extend due to shariah constraint. This paper aims to analyze the effect financial liberalization and financial stability. Structural equation model – Partial least square (PLS-SEM) is used to analyze the research model with a comprehensive data set covering the Islamic banks over 1994 -2017. The empirical results denote a significant negative impact of financial liberalization on Islamic banks' financial stability in Malaysia. Lastly, it can be concluded that this study has an implication for policymakers and the banking industry

Key Words: Banking, Financial Liberalization, Financial Stability, Islamic Banks, PLS-SEM
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1. INTRODUCTION

Under financial liberalization regime, the financial stability can be achieved via financial development that will facilitate economic growth. However, with financial liberalization it will have an impact on financial stability especially on Islamic banks. Financial liberalization also has been identified as source of financial instability and lead to financial crisis (Hamdaoui, 2017) this is because with more integrated system due to financial liberalization not only the return will increase but the risk will also be increase because it will affect the bank behavior to take risk by giving more financing to the customer. The mechanism of the financial liberalization is via competition and deregulation of interest rate. Therefore, banks need to adjust the lending and deposits rate due to deregulation to get the highest net interest margin. This exposure is when there is a mismatch of asset and liabilities due to financing duration with the adjustment of the interest rate. Therefore, the bank is in a vulnerable position to become more fragile and expose to financial crisis. According to Shehzad and Haan (2008), Daniel and jones (2007), the factor contributing to the banking crisis is financial liberalization. Gruben, Koo, and Moore (2003) concluded that the financial liberalization regime banks are likely to become insolvent. However, there are two contracting views regarding financial liberalization. Even financial liberalization is linked to financial instability, and it will also help strengthen financial and economic growth (Ranciere, Tornell, & Westermann, 2006). In a dual financial system, Islamic banks also play an essential role in the financial system's stability.

The factors affecting banking stability and its effect on financial system stability would differ with types of banks. Therefore, understanding the banks' stability is crucial because the failure of the banking sector will impact the economic system (Llewellyn, 2007; Milne, 2009). The effect of on financial stability will also have different impacts when operating in a dual financial system. The issue arises is whether Islamic banks are financially stable than the counterparts? Boumediene and Caby (2009) Islamic banks can absorb to the negative shocks due to risk sharing principle. However, this argument has to be empirically analyzed to assess the factor that leads to financial instability in Islamic banks (Lassoued, 2018). It is being argued that the islamic banks should be stable because of risk sharing contract that can act as financial buffer.

The impact of financial liberalization on Islamic banks' stability versus conventional banks is an issue to be further researched. The principles of Islamic shariah law and the contract's transparency make Islamic and conventional banks' operation different in terms of asset-liability structure and product offering (Ashraf, Rizwan and L'Huillier, 2016). The assets liability structure of a bank will determine the risk taking. For example, for Islamic banks, the concept of risk sharing is used for their assets and liabilities activities. Under PLS the credit risk from the banks can be shifted to the investment holders rather than the debt holder. The negative shock on the asset's sides can be pass through to the investment depositors using the concept of risk sharing where the depositors will share the risk with the bank (Čihák and Hesse, 2010). However, the exposure will be on how the Islamic banks can absorb the shock from the interest rate movement by deregulating the interest rate. With the development of Malaysian Islamic banks, Islamic banks need to play their role in contributing to the financial system's overall stability. Therefore, there is a need to undertake this research to examine these stability issues in Islamic banks.

2. LITERATURE REVIEW

Crokett (1997) discusses the financial stability is when there is an absence of financial instability. According to Kindleberger, 1978, in the early literature, cyclical excess is the reason for financial instability. Therefore due to the demand, the financial assets' prices increase in value, thus encouraging speculators to take advantage by financing the additional purchases on margin. Henceforth, when these assets are overvalued, the prices will suddenly increase, resulting in adverse effects on the financial system. Schwartz (1987) observed that financial is due to the mistake in monetary policy that generates financial distress, particularly disruption of the money supply. According to Ionescu (2013) financial liberalization aims to eliminate inefficiencies through 1) the banking activities liberalization, by removing the interest rate threshold and ceiling on bank deposits and loans, 2) relaxation of restrictions on non-banking financial intermediation activities, to increase competition; 3) the creation of new markets; 4) the progressive privatization of the state banks.

The effects of financial liberalization can exacerbate the behavioral mechanisms that lead to financial instability. Financial stability ought to be stable when there is no disturbance in the economy that can lead to financial crisis. Such an event can lead to exposure to the individual banks where they need to adjust their asset and liability management to remain competitive in the market due to the interest rate adjustment. Contagion is another cause why the financial industry is exposed to systemic instability because it is presumed to be vulnerable to failure contagion across institutions (Crokett, 1997). Contagion is usually thought to be more likely in the financial industry than elsewhere due to the complex structure and integrated financial system.

Financial liberalization aims to eliminate government interference in the financial system. Financial liberalization is the primary determinant of banking crises (Demirgüç-Kunt and Detragiache, 1999; Kaminsky and Reinhart, 1999). In theory, financial liberalization is anticipated to improve bank efficiency (Berger and Humprey, 1997). Gluzmann and Guzman (2017) showed that financial liberalization is positively associated with increased crises. Financial liberalization and financial growth positively impact financial instability, while economic growth has a negative effect on financial instability (Batuo, Mlambo, & Asongu, 2018). Ding, Wu and Chang (2013) on the bank performance before and after government intervention due to the global financial crisis in 2007. However, the empirical results signify that, in terms of solvency, credit risk and profitability improve after government intervention. Claessens, et al. (2001) empirically show that foreign bank entry due to financial liberalization reduces income, profits, and costs of domestic banks. However, empirical evidence conducted by Lee, Sapriza and Wu (2016) found that there is a significant negative relationship between financial liberalization with the probability of both a systemic banking crisis and the currency crisis. They studied 39 countries and demonstrated that financial liberalization reduces the likelihood of financial crises. Al-Ajlouni (2008) examined the ability of Islamic banks to benefit from financial globalization. The result shows that financial globalization will have adverse effects on Islamic banks' profit margin. Hence, financial liberalization will have an impact on financial stability for Islamic and conventional banks. The empirical obtained results are debated. Some researchers show that financial liberalization has a positive effect on stability. Whereas other empirical findings consider that liberalization has a negative effect on bank stability, determining a decrease of this measure. Others believe that financial liberalization leads to the destruction of the financial system. Thus, it can be hypothesized that:

H1 = Financial liberalization has significant effect on financial stability for the Islamic banks

3. RESEARCH METHODOLOGY

This study adopts secondary data in a quantitative approach in analyzing the financial stability in Malaysia. The secondary data is collected from Bankscope database of Bureau van Dijk's and FitchConnect. This study uses annual data from the year 1996 to 2017. This study's sampling criterion includes all banks, including Islamic in Malaysia, from 1996 to 2017. Structural equation model – Partial least square (SEM –PLS) method being employed. The dependent variables of the study are financial stability measured by insolvency risk (Zscore) and bank performance measured by return on assets (ROA) and return equity (ROE). While Financial liberalization can be defined as the financial freedom given to the banks by the government due to deregulation to improve efficiency. Therefore, this study will use the financial freedom index (Beck, Demirguc¸-Kunt and Levine, 2016)

4. ANALYSIS OF RESULTS

4.1 Measurement Model

Table 1 presents the measurement models' results (formative construct) for Islamic and conventional banks in Malaysia. PLS-SEM is the preferred approach when the structural model is having formative constructs structural model (Hair et al., 2019). Formative measurements are to be assessed based on the following: convergent validity, indicator collinearity, statistical significance, and relevance of the indicator weights (Hair et al., 2017.).

The variance inflation factor (VIF) is to evaluate the collinearity of the formative indicators. VIF values of above 5 indicate critical collinearity issues among the latent variables of formatively measured constructs. When the model is based on secondary data, a variable measuring a similar concept would be used (Houston, 2004). In table 1, all formative construct fulfilled VIF threshold for Islamic banks. Table 2 the VIF ROA and ROEA for conventional banks are above the threshold of 0.70. Hair et al. (2017) suggest that the correlation of the formatively measured construct with the single-item construct should be 0.70 or higher.

As shown in Table 1, the ROAE for Islamic banks is not significant. The ROAE for conventional banks also not significant as per table 2. Even one item is not significant than ROAA, but it is acceptable because the ROAA is part of the component to calculate the financial stability. The results from the bootstrapping must indicate that the outer weight from each formative indicator is significant. If the indicator is not significant, it can still be retained based on content validity (Hair et al., 2017). On the other hand, researchers can omit the formative indicators when the outer loading is <0.5 and not significant (Hair et al.,2017)

Table 1: Convergent validity, indicator collinearity and statistical significance for Islamic banks

CONSTRUCT	ITEM	CONVERGENT VALIDITY	WEIGHTS	VIF	T-VALUE WEIGHTS	SIG
FINANCIAL STABILITY	ROAA	0.805	-0.316	1.241	1.273	0.204
	ROAE		0.069	1.244	0.320	0.749
	ZSCORE		0.975	1.011	16.461	0.000

4.2 Structural Model

Table 2 shows the financial stability perspective as the endogenous construct, financial liberalization for Islamic banks (β=-0.124, t=3.475, p<. 01) shows negative and significance with financial stability. As a result, hypothesis HI is supported. Meaning here for Islamic banks the higher the financial liberalization index ie is liberalizing the system or less government intervention the stability reduces.

Table 2: Path Coefficient and Hypotheses testing

Hypothesis	Relationship	Std Beta	T-value	P-values	LL	UL	Supported
H1 (islamic banks)	Financial liberalization -> Financial Stability	-0.124	3.475	0.000	-0.189	-0.100	YES

5. CONCLUSION AND DISCUSSION

Hypothesis 1 investigates the direct result of liberalization of the financial sector on financial stability on Islamic banks. The present study's motivation to examine the effect of financial liberalization on financial stability is to respond to the previous literature (Cook, Hababou & Roberts, 2005; Daniel & Jones, 2007; Ghosh, 2016). The results indicated that the relationship between financial liberalization and Islamic banks' stability was found to be statistically significant. The findings from the current research imply that relationship between financial liberalization and reforms were found is to be significant to Islamic banks' stability in Malaysia. From this study, financial liberalization impacts Islamic banks' stability, which means that for Islamic banks to liberalize the system more, it is fragile or leads to financial stability. Ideally, financial liberalization could enhance financial stability and economic growth, but in the case of Islamic banks in Malaysia, the result shows a significant negative impact.

For Islamic banks, bank regulation is necessary to contribute to the financial security and the efficiency or stability of banks (Alam, 2013). This can be shown in the analysis where the direct effect of financial liberalization and financial stability is negatively significant. Islamic banks have said to be mimic conventional banks (Nosheen and Rashid, 2020). With the government's interference, Islamic banks need to safeguard its stability and thus enjoy their advantage. This can avoid the Islamic banks having exposure to insolvency due to the Islamic banks are bound the shariah requirements. Therefore, the regulation can ensure that Islamic banks can manage maturity mismatch due to financial liberalization deregulation. Malaysia is the Islamic financial hub; thus, Islamic banks' growth can be achieved with adequate regulation and infrastructure.

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