THE DETERMINANTS OF BANK EFFICIENCY IN MALAYSIA: CONVENTIONAL VS ISLAMIC

NURUL NABILA BINTI AMRAN
2013938793

BACHELOR OF BUSINESS ADMINISTRATION
(HONS) FINANCE
FACULTY OF BUSINESS MANAGEMENT
UNIVERSITI TEKNOLOGI MARA
SEGAMAT, JOHOR.

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ABSTRACT

This study explores the area of bank efficiency where efficiency has been constantly said to be the leading cause of bank failure. Sometimes bank are not performing well and not efficient in their performance due to some reasons such as non-performing loan, size of the bank as well as poor management. By referring to Berg, Forsund, and Jansen (1992), when non-performing loan exist in business of the bank, it will lead to bank inefficiency. Another reason that may lead to inefficient of bank is size of the bank itself. As refer to El Moussawi and Obeid (2011), some large banks are inefficiency is probably resulted from an inadequate size measure even though they have attained their optimal size. Another reason is poor management. Kwan and Eisenbeis (1994), Hughes and Moon (1995) and Resti (1995) found that banks with poor senior management may have problems in monitoring both their costs and their loan customers. The objective of this paper is to identify the determinants affecting conventional and Islamic banks' efficiency in Malaysia. As for the dependent variable, this study used bank efficiency to indicate outcome of the change brought in the independent variables. Meanwhile, the independent variables that affect the bank efficiency are bank size, liquidity and operational cost. The data is selected from five conventional banks and three Islamic banks. The period begins from 2006 until 2015 on yearly bases, pooled for 10 years. The data can be obtained from Bank Scope, Data Stream and Annual Report.

Table of Contents

CHAPTER 1: INTRODUCTION

1.1 Background of Study

Banking system in Malaysia comprises commercial banks, Islamic banks and investment bank. The banking institution is the major mobiliser of funds and also the main source of financing, which supports economic activities in Malaysia. Currently, Malaysian banking industry has been separate into two main sections which are conventional banking and Islamic banking. In an attempt to profit from the big growing of Islamic banking, many banks have created a separate entity or subsidiary under their wing so that they may focus primarily on this growing market (Ismail, Majid, & Rahim, 2013).

Conventional banking is based on purely financial model where banks mainly borrow from depositors and lend to individuals or enterprises. In this system, conventional banks make profit through the dissimilar rates of interest by borrowing and lending of money. However, one of the weaknesses of conventional banking is that it is prohibited from trading in the shareholding due to borrowing concern (Shahid, Rehman, Niazi, & Raoof, 2010).

Islamic banking is following Shariah law. Their main principles are to manage business following to the share of profit and loss and forbid interest earning and rewarding. Despite looking new or seeing as the modern trend, actually Islamic finance is old as the religion itself. This is because all the principle that has been use in Islamic