UNIVERSITI TEKNOLOGI MARA

DETERMINANTS OF BANK FRAGILITY: EVIDENCE FROM MALAYSIAN COMMERCIAL BANKS

NURUL FARHANA MAZLAN

Thesis submitted in fulfillment
of the requirements for the degree of
Master of Science

Faculty of Business Management

November 2014

ABSTRACT

When banks are considered fragile and what trigger them to be fragile? This research attempts to answer those questions by measuring bank fragility and identify probable factors determining bank fragility of the Malaysian commercial banking sector during the period of 1996-2011. Previous studies have employed different methods to measure the bank fragility. Among the methods used are event study, "government intervention" in term of liquidity support to detect bank fragility and some prefers to use indicator such as Non-Performing Loan (NPL) to identify bank systemic risk. This research constructs the Banking Sector Fragility Index (BSFI) to measure fragility of commercial bank during the period studied. The index is then used to identify the determinants of commercial bank fragility. Results of BSFI show that the commercial banking sectors are in fragile condition from 1996 until 2000 and in a highly fragile stage between 1996 and 1998 since the BSFI are less than -0.50. In addition, findings based on the Logit regression analysis infer that the likelihood of Malaysian commercial banks to be fragile is significantly determined by total loans to total assets and interbank rate. While, Pooled Ordinary Least Squares (OLS) proved that bank specific factors and macro-economic factors have relationship with the level of BSFI.

ACKNOWLEDGEMENTS

Alhamdulillah and I would like to express my special thanks, sincere appreciation and thoughtful gratitude to several persons who have provided vital and helpful comments with valuable suggestions, constructive advises, clear guidance, steady support and throughout the course of this study to the success of this research. They are my supervisor Assoc. Prof. Dr Noryati Binti Ahmad, co-supervisor, Dr. Norlida Jaafar, Finance lecturer, Professor Dr. Ismail Ahmad and Professor Dr. Norhana Salamuddin.

I would like to express my gratitude also to Universiti Teknologi MARA, UiTM, Jab. Pembangunan Sumber Manusia, JPbSM UiTM as well as Kementerian Pengajian Tinggi Malaysia. Finaly, this thesis is dedicated to my beloved parent, Mazlan Ibrahim and Arifah Said, my future husband, Aidi, my sisters, Faizzah, Amal, Aini and my supportive friends.

TABLE OF CONTENTS

CHAPTER ONE
INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The banking sector plays an important role as financial intermediary and is a primary source of financing for the domestic economy. Typical function of the banks is to offer loan and deposit products on the market, and caters to the changing liquidity needs of its borrowers (deficit units) and depositors (surplus units). Banks are vital for three reasons namely as an intermediary, liquidity provider and payment servicer. These three reasons make bank different and special from other financial sectors. Yet, banks are similar to the other business firms that aim for huge profits. However, the banking sector is exposed to high business risk as they are easily susceptible to global political and economic uncertainties. Theories discussed asymmetric information, bank run, adverse selection and moral hazard as the most common reasons that led to the increase in riskiness of bank fragility within this sector.

The effects of financial globalization (cross border financial integration), liberalization and rapid technology advancement complete the banking sector to be more diversified. Despite of having benefits and promoting the development of financial system at the same time it is confronted with complex challenges and issues. While in the Malaysian case, financial liberalisation has the desired effect of stabilising the economy. However, it tends to exert upward pressure on the exchange market variable. Lim (2009) and Noy (2005) suggest that liberalization can lead to financial instability either due to insufficient regulation of the financial sector or erosion of previously granted monopolies of existing banks. Eventually, these banks will be disrupted and become fragile. Therefore, the survival of domestic banking institutions will depend on their ability to improve their performance and efficiency. Besides that, to be competitive with their foreign counterpart, further developments and innovations are required. These developments and innovations are part of liberalization and will result to an increase in loan supply as well as banking deposit. Similar to Lim (2009) and Noy (2005), Sami and Bechir (2009) also claim liberalization that is associated with deregulation may increase banking sector fragility