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About

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INSIGHT Journal focuses on social science and humanities research. The main aim of INSIGHT Journal is to provide an intellectual forum for the publication and dissemination of original work that contributes to the understanding of the main and related disciplines of the following areas: Accounting, Business Management, Law, Information Management, Administrative Science and Policy Studies, Language Studies, Islamic Studies and Education.

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FOREWORD BY DEPUTY RECTOR OF RESEARCH, INDUSTRIAL LINKAGES & ALUMNI

Since 2018, the INSIGHT JOURNAL (IJ) from Universiti Teknologi MARA Cawangan Johor has come up with several biennial publications. Volume 1 and 2 debuted in 2018, followed by Volume 3 this year as well as Volume 4 with 19 published papers due to the great response from authors both in and out of UiTM. Through Insight Journal, lecturers have the ability to publish their research articles and opportunity to share their academic findings. Insight Journal is indexed in MyJurnal MCC and is now an international refereed journal with many international reviewers from prestigious universities appointed as its editorial review board members.

This volume 5 as well as volume 6 (which will be published in 2020) are special issues for the 6th International Accounting and Business Conference (IABC) 2019 held at Indonesia Banking School, Jakarta. The conference was jointly organized by the Universiti Teknologi MARA Cawangan Johor and the Indonesia Banking School Jakarta. Hence, the volumes focus mainly on the accounting and business research papers compiled from this conference, which was considered a huge success as over 66 full papers were presented.

Lastly, I would like to thank the Rector of UiTM Johor, Associate Professor Dr. Ahmad Naqiyuddin Bakar for his distinctive support, IJ Managing Editor for this issue Dr. Noriah Ismail, IJ Assistant Managing Editor, Fazdillah Md Kassim well as all the reviewers and editors who have contributed in the publication of this special issue.

Thank you.

ASSOCIATE PROF. DR. SAUNAH ZAINON
Deputy Rector of Research, Industrial Linkages & Alumni
Editor-in-Chief for INSIGHT Journal
Universiti Teknologi MARA Cawangan Johor

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The Impact of Malaysian Ringgit Fluctuation towards Profitability of Islamic Banks in Malaysia

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Abstract

Profitability of a bank mostly relies on its financial performance as the ability to leverage operational, investment decisions and strategies to achieve a business financial constancy. This study is devoted to examine the selected Malaysian Ringgit factors that bring impact to the profitability of local Islamic banks in Malaysia. A set of data were obtained from each bank's financial statement and the World Bank data from year 2007 until 2016. Return on assets has been used as a dependent variable while debt to equity ratio, capital adequacy ratio, exchange rate and interest rate serve as an independent variable. The findings show that three independent variables give positive significant relationship and will be discussed further throughout the paper. For that purpose, policymakers should focus on these three variables for standardizing the economic environment to all local Islamic banks operating in this country.

Keywords: Bank's profitability, Ringgit fluctuation*,* Debt to equity ratio, Capital adequacy, Exchange rate, Interest rate.

1. Introduction

Malaysia is well-known for its highly progressive and attractive Islamic financial sector as it has grown substantially by demonstrating a high level of profitability and is less affected by the global economic downturn (Muhamad & Yameen 2013). Islamic financial system aims to create an environment where Muslims could involve in financial and banking activities without any uncertainty that is against the religion (Parviz, 2009). In Malaysia, Islamic banking system was fully established with the Enactment of Islamic Banking Act 1983. Aligned with that, Bank Islam Malaysia Berhad was set up and regulated by Bank Negara Malaysia under the Islamic Banking Act 1983 as the first Malaysian Islamic bank. Other than that, commercial banks, merchant banks and finance companies are also allowed to offer Islamic banking products and services under the Islamic Banking Scheme. Currently, there are over 300 Islamic financial institutions across 75 countries around the world.

In different international currency markets and volatile exchange rates, most international trades are operated by major foreign currencies such as US Dollar, Japanese Yen, and others. In Malaysia, Bank Negara Malaysia is the sole authority in issuing the national currency known as Ringgit Malaysia which was officially published in 1967. However, when the Asian financial crisis took place in 1997, the Malaysian Ringgit became a victim when both the pre-crisis and crisis periods led to volatile stock prices and ringgit exchange rates over the years (Zubair, 2002).

Due to this tragedy, Bank Negara Malaysia decided to set the ringgit value at RM3.80 against the US dollar. After the crisis, Ringgit Malaysia was pegged to almost seven years before it started to lower its value to RM4.0025 against the lowest dollar in 17 years. Therefore, this study aims to assess the impact of Ringgit Malaysia's fluctuations on the profits of local Islamic banks in Malaysia by measuring its debt to equity, capital adequacy, exchange rate (RM / US dollar) and interest rates. Measuring the profitability in terms of return on assets (ROA) is done by using banks specific variables.

2. Literature Review

Previous studies conducted by Hassan and Bashir (2003) discussed Return on Assets (ROA) and Return on Equity (ROE) as the overall performance measures of Islamic banking. They point out that asset returns can reflect the management's ability to use bank financial and investment resources to generate profits. Another study by Elizabeth (2015), examined the positive impact of currency fluctuations on financial performance of commercial banks in Kenya by using asset returns as dependent variables. Debt to equity ratio was used to analyze the financial position of the bank, thus affecting the performance of the bank. Leong, Liew, Mah, Tan and Yew (2013) found that the debt equity ratio has a significant relationship with the profitability of the bank. On debt to equity results, it was agreed upon by Husni (2011) who saw a significant positive and significant relationship between profit and debt to the equity ratio. Meanwhile, the results of the study conducted by Yogendrajah and Thanabalasingam (2011) are contradictory as profit margins and debt to equity are positive but not insignificant.

The capital adequacy ratio is a valuable tool for assessing the security and soundness of the bank. Some researchers point out that a bank with a high capital ratio or more equity capital indicates more bank security and is the advantage of gaining higher profits (Vong & Chan, 2009). A study on the effects of foreign exchange fluctuations and commercial bank profits in Nigeria was done by Amenawo, Hodo and Emmanuel (2016). The study focused on the relative impact on bank profits by using four features of the bank as an independent variable comprising bank size, bank divestment, non-performing loans and capital adequacy ratios. Ahmad (2017) also found that the results of the study show that the capital ratio, other operating income, GDP for each capital, bank size and concentration and oil prices have affected the Islamic bank positively. A lot of research conducted for commercial banks also leads to positive relationships with asset returns, indicating that the increase in bank capital adequacy will lead to an increase in return on assets (Stephen et al., 2014; Pasiouras & Kosmidou, 2007). In the previous studies, the exchange rate as a determinant of Islamic bank capability had a significant impact on its performance compared to conventional banking systems. Given the currency market to determine the exchange rate, there are some transactions that take place in conventional markets that are not suitable for Islamic trading systems which include swap, futures, options and forward contracts. The profitability of Islamic banks is not directly affected by the exchange rate but variations in the prices of the goods affect the business efficiency and profitability.

Yang and Zeng (2014) defined it as "the exchange rate measures the relative price of non-tradable goods in terms of tradable goods". In a study conducted by Nahar and Sarker (2016), exchange rates negatively affect the ability of Islamic bank financing. It is also supported by Elizabeth (2015) who claimed that a negative correlation exists between exchange rate fluctuation and the profitability measured by asset ratio returns. The negative outcomes also show inconsistence with a study conducted by Javaid and Alalawi (2017) which revealed that the exchange rate along with other macroeconomic variables is significant in determining the profitability of Saudi Arabian banks. However, a study by Iriani and Yuliadi (2015) contradicts the findings and found that the impact of macrovariables on non-performance financing of Islamic banks in Indonesia shows that exchange rate has a positive impact the nonperforming financing. Likewise, Habib and Islam (2017) also found that Islamic banks' stock market were significantly influenced due to interest and exchange rate in India. It is also supported by Carolyn and Daniel (2016) where exchange rate fluctuations positively and significantly affect the bank's performance in Nigeria. Further research results agree with the findings that exchange rates have a positive significant effect towards the return on assets.

High inflation rates are generally linked to high interest rates on loans, and therefore higher revenues. When interest rates increase, deposits are more attractive while investments are less, and bank pays more to their saving accounts. On the other hand, high interest rates will impede borrowings as consumers will have to pay a high monthly fee. As a result, loan defaults increase and it directly affects the profitability of the bank.

For Islamic banks, it does not charge fixed rate on their deposits or loan transactions, so inflation may be a factor in the cause's variations on bank's ability. Hence, the higher the interest rate, the higher bank profitability through lower capital and lending, then inflation is expected to have a positive impact on bank's profits. Referring to a study done in Nigeria by Obamuyi (2013), bank lending rates directly affect the bank's income and expenses, and net revenue affects profitability. Research found that interest rates have a positive impact that would affect the return on assets.

3. Results and Discussion

The research approach is to observe the impact of Ringgit Malaysia's fluctuation on local Islamic banks in Malaysia, covering a 10-year period from 2007 to 2016 using secondary data. To determine the most significant variables, this study has resulted in a financial ratio of profitability ratio, efficiency ratio, liquidity ratio, bank size and tax. In analyzing all data, STATA software has been used as a sampling technique to run multiple regression analysis (multicollinearity). Annual data were collected from the financial statements and annual reports of 10 banks as well as Bank Negara Malaysia. Up to 100 observations were used for this investigation. The correlation between dependent and independent variables was also tested to determine the relationship between each variable. In this study also, causal study was selected to measure the effect of the effects upon changes in the incident. It involved one or more of the factors that are the cause of the problems.

The research covered four independent variables that reflect the size of the bank's profits on local Islamic banks in Malaysia. Variables focus on debt to equity ratio, capital adequacy ratio, exchange rate, and interest rate.

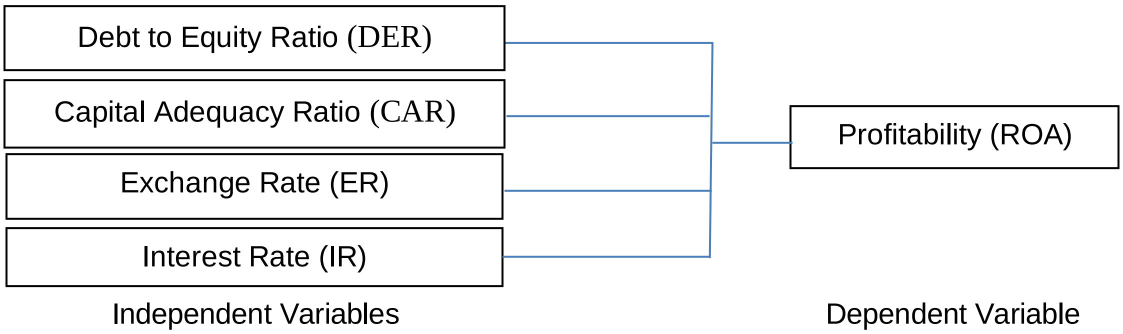

Figure 1 Research Framework

Table 1 Descriptive Statistics

Variables	Mean	Sd Deviation	Min	Max
Profitability	1.869059	0.9652378	0	3.82280
Debt to equity ratio	12.02789	6.403012	0	30.3759
Capital adequacy ratio	13.25462	7.0668690	0	60.8100
Exchange rates	3.41454	0.3418696	3.06	4.1483
Interest rates	3.03000	0.9780779	0	4.2700

Table 2 Correlation Statistics

	Profitability	Debt to equity ratio	Capital adequacy ratio	Exchange rates	Interest rates
Profitability	1.000000				
Debt to eq ratio	0.3870	1.000000			
Cap adq ratio	0.5321	0.3224	1.000000		
Exch rates	-0.0776	-0.0075	0.0478	1.000000	
Interest rates	0.6116	0.4914	0.5874	0.0223	1.000000

To analyze the results of the study, first it is useful to comment on some preliminary features of the data. Table 1 shows descriptive statistics for the profitability and the four variables used in the model. The mean of all other independent variables is positive. The mean of capital adequacy ratio is the largest (13.25) and varies greatly across variables (max = 60.81 and min = 3.06).

Table 2 shows the correlation among variables. The findings indicate that only exchange rates give negative relationship with profitability by -0.0776, while the other independent variables have positive relationship with profitability by 0.3870, 0.5321, and 0.6116. Overall, the correlation statistic result brings no multicollinearity problem in obtaining the data because the value is 1.42 which is not more than 5 between independent variables.

Table 3 Regression Analysis

Source	SS	df	MS
Model	40.3328808	4	10.0832202
Residual	51.9038305	95	.54635611
Total	92.2367113	99	.931683952

Number of obs	=	100
F(4, 95)	=	18.46
Prob > F	=	0.0000
R-squared	=	0.4373
Adj R-squared	=	0.4136
Root MSE	=	.73916

roa	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
der	.0150533	.0133404	1.13	0.262	-.0114308	.0415373
car	.0360652	.0130173	2.77	0.007	.0102226	.0619077
er	-.2784264	.2176133	-1.28	0.204	-.7104434	.1535906
ir	.4041926	.1021253	3.96	0.000	.2014484	.6069369
_cons	.9359641	.7775484	1.20	0.232	-.6076647	2.479593

This section shows the regression analysis of Islamic bank's profitability and its variables. The model shows the relationship between dependent variable and independent variables. The result illustrates that the dependent variable has significant relationship with the independent variables at p-value 0.0000 which is less than 0.00 level of significance. The R-squared valued 0.4373 or 43.73% of the variable changes means return on assets can be explained by all independent variables while another 56.27% is unexplained. Adjusted R-squared equals to 0.4136 means 41.36% of the variation in return on assets can be explained by the variation of independent variables. Out of four independent variables, two variables are significant. Capital adequacy ratio and interest rates show a significant indicator at 0.01 level of significance and has positive relationship with the dependent variable.

Debt to equity ratio shows 1.50533% increase in return on assets which leads to positive but insignificant relationship. The result is also similar to Yogendrajah and Thanabalasingam (2011) who indicated that profitability is not strongly positive with the capital structure measured by the debt to equity ratio. This is because using more debt will lead to increase in required rate of return and it will give negative impact towards the probability of the firms. However, the result conflicts with the studies by Leong et.al. (2013) and Husni (2011) who stated that there is significant relationship between debt to equity ratio and the return on assets. Both findings show that loan loss provision is heavily dependent on the bank's performance. Increase in loan loss will lead to the increase debt to equity ratio, thus indirectly may affect the bank's profitability.

For capital adequacy ratio, it shows 3.360652% increase in return on assets which is found to be similar with Pasiouras and Kosmidou (2007) and Stephen et al. (2014). The result for exchange rate gives insignificant relationship with the bank's profitability where it decreases by 27.84264% and this is supported by Elizabeth (2015). Fluctuation of the exchange rate has negatively influenced the economy by making the cost of living more expensive. For instance, the banks are exposed to the exchange risk since the country or the bank itself heavily relies on the import activities. However, this is contrary to other studies done by Carolyn and Daniel (2016) who stated that the fluctuating and volatility of exchange rate may contribute to the growth of profitability banks. This happens when many imports are bought and paid by the locals using the dollars instead of Malaysian

Ringgit. When the Malaysian Ringgit is weakening against the dollar, the banks are making an arbitrage profit. Besides, interest rate gives positive significant relationship with the return on assets increased by 40.41926%. This finding is similar to Obamuyi (2013) that the higher the interest rate will benefit the banks in term of higher profit.

Table 4 Random Effect Result

```
Random-effects GLS regression                   Number of obs      =       100
Group variable: code                            Number of groups   =        10

R-sq:  within  = 0.5083                         Obs per group: min =        10
between = 0.2845                                               avg =      10.0
overall = 0.4011                                               max =        10

Random effects u_i ~ Gaussian                   Wald chi2(4)       =     85.13
corr(u_i, X)       = 0 (assumed)                Prob > chi2        =    0.0000

------------------------------------------------------------------------------
         roa |      Coef.   Std. Err.      z    P>|z|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
         der |   .0433484   .0115646     3.75   0.000     .0206822    .0660145
         car |   .0311148   .0105273     2.96   0.003     .0104817    .0517479
          er |   -.258925   .1673665    -1.55   0.122    -.5869573    .0691072
          ir |   .2373688   .0826228     2.87   0.004      .075431    .3993066
       _cons |   1.100137   .6123508     1.80   0.072     -.100048    2.300323
-------------+----------------------------------------------------------------
     sigma_u |  .32453677
     sigma_e |  .52695878
         rho |  .27499075   (fraction of variance due to u_i)
------------------------------------------------------------------------------
```

From the above result, the overall R-squared value is 0.4011 which indicates that 40.11% of the total variation in the level return on assets for local Islamic banks in Malaysia occurs because of the variation in debt to equity ratio (DER), capital adequacy ratio (CAR), exchange rate (ER) and interest rate (IR). The remaining 59.89% might be due to the randomness or other variables.

4. Conclusions

The aim of this study is to examine the impact of Malaysia Ringgit fluctuations on the profitability of local Islamic banks in Malaysia by measuring its debt to equity, capital adequacy, exchange rate (RM/ US dollar) and interest rate. Measuring the profitability in terms of return on assets (ROA) was done by using banks specific variables during the period of 10 years starting from 2007 until 2016 by applying the panel data (random effect model).

Firstly, the study concludes that the debt to equity has a positive but insignificant impact to the return on assets of the local Islamic banks. This indicates that using more debt will lead to increased rate of return of the banks and it will give negative impact towards the profitability of the banks. The debt to equity ratio indicates how much the firm or banks are using its assets relative to the amount represented in shareholder’s equity.

Secondly, there is a positive and significant relationship between capital adequacy ratio and the bank’s profitability. The capital adequacy is a minimum capital required by a banking institution to ensure that the bank has enough capital on account to meet obligations and absorb any unexpected losses. A rise of capital adequacy ratio results in reduction of bank profitability and vice versa.

Thirdly, the study concludes that the exchange rate has a negative and insignificant relationship with the profitability of local Islamic banks in Malaysia. Moreover, the Ringgit Malaysia exchange rate against the US dollar was observed during the period of study. As the value of Ringgit Malaysia decreases against US dollar, it will lead to negative and significant impacts towards the return on assets of local Islamic banks in Malaysia.

Finally, the results of this study suggest a positive significant relationship between interest rate and the return on assets of the local Islamic banks in Malaysia. This indicates that the interest rate has influenced the profitability of the banks in positive impact. A rise of interest rate will cause the banks to earn more income or profit.

The proceeding empirical analysis allows us to shed some light on the relationship between bank characteristics as well as industry and macroeconomic indicators, and profitability of Islamic banks in Malaysia. From the research findings, recommendations can be given with regards to policy and practice in banking sector. As a matter of policy implications, there is a need to draw several proposals at the bank level which shows that size of the bank has a significant impact on the performance of Islamic banks. Consequently, Islamic banks in Malaysia should focus more on expanding the banks to achieve full benefits of economies of scale. For policymaker, they should standardize the economic environment to all local Islamic banks operating in this country. In addition, the regulator also has an important role to ensure and to safeguard the value of domestic currency as well as the needs to implement efficient monetary and fiscal policies as to help any deficit balance of payment caused by the strong currency fluctuation. Islamic banks should also focus on predicting forthcoming inflation in the country. The capability of the banks to forecast future inflation helps banks to determine its interest rate above the inflation. However, when considering that Islamic finance does not deal with interest rates, it could be assumed that forecasting and predicting the inflation rate could help the bank in making decisions with regards to the rate of profit sharing, loan quantity and asset quality.

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