

**EFFICIENCY OF COMMERCIAL BANKS IN MALAYSIA USING
VAIC METHOD**



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JUNE 2012

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5. Report

5.1 Proposed Executive Summary

ICT has not been much considered as an important variable for intellectual capital measurement in previous studies. According to the Organization for Economic Co-operation and Development (1996), ICT is best regarded as the facilitator of knowledge creation in innovative societies. In the knowledge based economy, ICT is not only considered as a driver for change but as a tool for releasing the creative potential and knowledge embodied in people. A study of banks in UK found that Information Technology (IT) has a significant impact on intellectual capital performance (VAIC) (El-Bannany, 2008). Prior to the globalization and liberalization era, the commercial banks in Malaysia were facing stiff competition in terms of providing a variety of products and services, especially when Bank Negara opened up the financial sector to qualified foreign banks in its effort to drive domestic banks to better performance, efficiency, and innovation. Besides that, banks have been able to better serve their customers with the advance of ICT, by the usage of smart cards, ATMs, mobile banking, electronic banking, telephone banking, twenty four hour service, the overall quality of services, expanded portfolios of products and services, and better customer relationship management with the use of advanced tools and variety of products. Therefore, ICT has not only provided infinite banking opportunities to expand product and services beyond reach, but also heightens the competitions and risks faced by banks in the financial system (Voon-Chong et al, 2010). This study basically seeks to investigate to what extent the commercial banks are efficient in terms of value creation efficiency and to see whether there is a relationship between the Value Added Intellectual Coefficient (VAIC) and financial performance. Hence, this study will include ICT efficiency as another component in the VAIC method.

5.2 Enhanced Executive Summary

This thesis evaluates the intellectual capital efficiency of commercial banks in Malaysia and aims to investigate whether the intellectual capital components have an impact on the financial performance of the commercial banks as well as to identify the intellectual capital components that drive the financial indicators of the commercial banks. The VAIC method used in the measurement of IC by Pulic

(2001) is adopted and consists of the sum of human capital, structural capital and capital employed efficiencies. Nonetheless, this study has incorporated an additional component which is ICT efficiency as an important component for evaluating the intellectual capital efficiency of banks. This study is significant to the implementation of Financial Sector Master Plan (FSMP) by the banking institutions to enhance the level of operating efficiency and allow greater strategic focus on business operation in enhancing competition and innovation. This study will help the bankers to see how strong they are in intellectual capital efficiency compared to the foreign banks. The adoption of ICT in commercial banks has brought about many changes in the banking industry which had enhanced competitive pressures in the banking industry. Foreign banks in Malaysia are more innovative and move forward faster than domestic banks because they are able to leverage on the research and development initiative, expertise and off-the-shelf products, or introduce new systems that already have been tested by parent banks. As a result, foreign banks were more capable of identifying and reacting to changes in the market much faster than most domestic banking institutions. They were also able to open new distribution channels that operate beyond the traditional delivery methods for financial services. Therefore this study adds ICT in VAIC in order to study how efficient are the banks in terms of ICT efficiency. Data on calculating the VAIC are taken from 2001 until 2008 of 22 banks which collecting in their annual reports. The results of 22 observations showed that banks have relatively higher ICT efficiency than human capital, structural capital and capital employed efficiencies. Foreign banks are found to be more efficient during the years 2001 to 2006 and 2008, whilst domestic banks were better than foreign banks during the year 2007. Overall, domestic banks have improved and are highly competitive in the banking industry. In multiple regression model, by using panel least square method, the findings also revealed that capital employed efficiency was considered highly by the commercial banks for improving the financial performance of the banks. This implies that physical capital remains as a prominent factor in sustaining and boosting the banks' financial performance whilst human capital efficiency is considered highly by the commercial banks for increasing the profitability and the return on equity only. In addition, structural capital efficiency was proved to have a significant impact in raising the financial performance of the commercial banks, whilst ICT efficiency was considered by the commercial banks in improving the return on equity. This result is useful for the bankers and practitioners in decision making of both operational and strategic opportunities and for implementation of skill building

measures such as on the ability to discern trends and developments in ICT which was based on the FSMP (2001). In conclusion, the intellectual capital efficiency has proved to have increasing the financial performance of the commercial banks in Malaysia.

5.3 Introduction

The traditional ways of accounting measurements are normally used as the main financial performance indicators to measure the current position of a company for decision making and formulating strategies. However, this is no longer an adequate measurement tool in a knowledge-based economy (Roos, 1998; Chareonsuk, 2008). According to Roos (1998), the traditional accounting measurements are inadequate for strategic decision making. He suggested that the traditional accounting measures must be complemented to show the potential value created all the way through in an organization and intellectual capital generally represents the critical resource in the potential value creation process. Even though physical capital is vital for business operation, intellectual capital also plays a pivotal role to indicate corporate financial performance (Chan, 2009). More often, prior to the knowledge and globalization era, the business management style has changed in response to global competition where businesses operate in the world of intangibles and intellectual capital, identified as a set of intangibles (resources, capabilities and competence) that drives the organizational performance and value creation process (Bontis, 1998).

Knowledge is involved in creating value in an organization, which is manifested as intellectual capital that includes human capital, structural capital, intellectual assets and intellectual property (Seetharaman, 2004; Bontis, 1998). Many previous studies have focused on defining practical and reliable models to measure intellectual capital (Mavridis, 2004) as a driver for increasing a firm's value and competitive advantage. However, the most suitable measure of a firms' intellectual capital is still uncertain since every model has its own advantages and disadvantages. According to Mavridis (2004), intellectual capital measurements are divided into two groups. The first group focuses on the costs or expenses (process oriented) and the second group focuses on the profit or investment return (value oriented).