

**COMPARATIVE STUDY ON INTERNAL AND EXTERNAL  
DETERMINANTS OF NON-PERFORMING LOANS OF ISLAMIC BANKS IN  
MALAYSIA**

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## **ABSTRACT**

This research paper is purposely conducted to identify the determinants of non-performing financing of Islamic banks in Malaysia using internal and external variables. Internal variables selected in this study are loan growth, loans to deposit ratio, banks' size and financing contract. While the external factors are GDP annual growth, inflation, interest rate and unemployment rate. This study employs a panel data method using 16 Islamic banks in Malaysia with studies period from 2008 to 2014. This study used secondary data sources and all the variables used are regressed using Ordinary Least Square method in Eviews software. In general, the result found that internal variables are more dominants in determining the NPF of Islamic banks in Malaysia. Based on empirical findings, it is found that loan growth and financing contract are the internal variables that significant in determining the NPF while inflation and unemployment rate are the external factors that significant in determining the NPF of Islamic banks in Malaysia.

## CHAPTER ONE

### INTRODUCTION

Banking industry is vital to the economy development of ones' country as it act as a financial intermediary between surplus unit and deficit unit. Over the last three decades, Malaysia has succeeded in developing a vibrant Islamic banking industry through the establishment of Islamic Banking Act in 1983 (Siew Chun Hong, 2015). This development has led to the growth of Islamic bank in Malaysia and become an importance global financial development.

According to (Ling, 2009), Malaysia's approach toward Islamic banking is unique whereby a dual banking system was introduced where conventional banks can operate as Islamic banks as well. In March 1993, the Interest-free Banking Scheme (IFBS) was launched by Bank Negara Malaysia (BNM) which allowed conventional banking to operate and offer Islamic products. Later in 1998, the IBFS was changed to Islamic Banking Scheme (IBS).

Initially, the first financial institution that offered Islamic products and services is Malaysian Pilgrims Fund Board (Lembaga Tabung Haji Malaysia) which is a saving institution that was established in 1963 for Muslims to perform their Hajj (pilgrimage to Mecca) costs. Later in 1983, the first Islamic banks in Malaysia which is Bank Islam Malaysia Berhad began their operations. With the introduction of IFBS by BNM, several conventional banks have shown their interest to operate in dual banking system which includes Malayan Banking Berhad and Bank Bumiputra Malaysia Berhad (now known as CIMB Bank Berhad).