IMPACTS OF LIQUIDITY RATIOS ON PROFITABILITY OF COMMERCIAL BANK IN MALAYSIA

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DEC 2012

ABSTRACT

The present study aims to reveal the relationship between liquidity and profitability so that every bank has to maintain this relationship while conducting day to day operation. There are two objectives for the study that will give some guidelines in order to do the research effectively which is to examine the relationship that exists between liquidity ratios with profitability and also to determine which variables have the strongest relationship toward profitability. The study will be done on current ratio, liquid ratio, and loans to assets ratio towards return on assets. For this purpose, seven commercial banks in Malaysia had been chosen

There was show this model have heteroscedasticity problem and had been cured using PGLS regression. The result show that there are significant impact of only current ratio and liquid ratio towards return on assets while loans to assets ratio was insignificant impacts towards return on assets. The results also answer the objective for this study which is to determine the relationship between independent variable with the dependent variable. It also shows that liquid ratio is the independent variable has the strongest relationship toward profitability.

CHAPTER ONE: INTRODUCTION

1.0 Introduction

Profitability and liquidity are of important issues that management of each commercial unit should take studying and thinking about them in to account as their most important duties. According to Bitterback (2002), he believes that liquidity has more importance because companies with low profitability or even without profitability can serve economy more than companies without liquidity.

Liquidity management is very important for every organization that means to pay current obligations on business. There are methods that can be used to measure liquidity and it usually calculated by using liquidity ratios. Liquidity ratios are used for liquidity management in every organization in the form of current ratio, liquid ratio and loans to assets ratio and it's greatly affecting on profitability of organization. The liquidity versus profitability principle state there is a trade-off between liquidity and profitability, gaining more of one ordinarily means giving up some of the other.

Usually, banks face two major issues regarding liquidity. Firstly, banks are responsible for managing liquidity creation and secondly responsible for managing liquidity risk. Bank's assets and liabilities play a central role in their balancing of liquidity creation and liquidity risk. Banks rely on both assets and liabilities as sources of liquidity. These two elements of a bank's liquidity are intertwined. The effective management of liquidity allows a bank to fund increases in its assets and to meet obligations as they come due. An asset's liquidity can be used to describe how quickly, easily, and costly it is to convert that asset into cash (Berger & Bouwman, 2008). Operating cash flows generate by assets will affect continuing bank liquidity. Banks with fewer current assets will having problem in continuing their operations while if the current assets are too much, it shows the return on investment is not in perfect condition. (Horne and Wachowicz, 2000). A bank's liabilities include all the banks sources of funds. Banks have three main sources of funds consist of deposit accounts, borrowed funds, and long term funds

Furthermore, liquidity creation helps banks stay liquid, it especially for banks when other forms of financing become difficult. Managing liquidity creation is to ensure the banks own liquidity so that the bank can continue to serve its function. According to financial intermediation theory, the creation of liquidity is a key reason why banks exist. Banks create liquidity on the balance sheet by financing relatively illiquid assets such as business loans with relatively liquid liabilities such as transactions deposits.

While, liquidity risk is a probability that a company will not be able to pay its short term obligations as they come due. The most familiar region of risk that involve with bank is liquidity risk. This can be seen today from the continuing effects of what started in 2007. According to Brunnermeier and Yogo (2009), there are a number of the other risks faced by banks such as credit risk, operational risk, and interest rate risk, which may culminate in the form of liquidity risk. Diamond and Rajan (2005) said when banks face increasing liquidity risk, many times in the face of financial crisis or turmoil, they also face a downturn in new business. This may cause the failure of a given bank or even the entire banking system due to contagion effect. If this matter is not handled properly, this can, in turn, affect the banks operations and profitability. According to Acharya, Shin, & Yorulmazer (2009), the balancing act for banks between liquidity risk and creation can also be a strategic decision instead of one solely to meet demands and prevent the bank from failing.

The banks and government are now having deep insight into the liquidity position of banks. A failure in liquidity management may result in a bank becoming unable to meet its obligations. This scenario if played-out, could easily cause a bank to fail and lead the bank to face serious financial problems. Arif and Anees (2012).

1.1 Problem Statement

Liquidity ratios measure a business ability to meet the payment obligations by comparing the assets with the liabilities. If the coverage of the latter by the former is insufficient, it indicates that the business might face difficulties in meeting its immediate financial obligations. This can, in turn, affect the company's business operations and profitability. There has been a great deal of study on this issue due to the financial crisis that began in 2007 and is still affecting the economy today. At the beginning of the financial market crisis in 2007, many banks had adequate capital levels but they still at the end experiencing serious difficulties when it came to liquidity management. Problem with bank liquidity management is that when bank makes mistake, the effect is drastic towards profitability. The experiences of banks in several advanced economies in confronting liquidity stress during the current financial market turmoil have revealed the increasingly problem of liquidity risk. The banks sector should understand or to think to give more priority on liquidity management.