Factors Contributing to Non-performing Financing: Evidence from Islamic Banks in Malaysia before Pandemic

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ABSTRACT

This study is going to ascertain the contributing factor of non-performing financing in Islamic banks in Malaysia. **Purpose –** This study aims to investigate the specific bank characteristics as well as macroeconomic variables. **Methodology/approach –**Twelve local Islamic banks would be the focus for this study starting from period 2009 until 2018 which are before pandemic. The annual report has been used as the primary source for the financial data. While for the macroeconomics data, DataStream database has been used. Panel data approach was used to investigate the data and all the determining factor from both factors were regressed against non-performing financing. **Findings –** This study found that just two bank-specific characteristics, bank size and capitalization, showed a significant negative link with non-performing financing. While the other variables from macroeconomic factors does not give any important impact on non-performing financing for the Islamic banks in Malaysia.

Keywords: non-performing loans, Islamic banking, bank-specific, macroeconomic, panel data

INTRODUCTION

Non-performing loans (NPL) could be one of the significant influences of the failure of the banking institutions as well as financial disasters. This statement is supported by the study that has been done by Khemraj and Pasha (2009), which stated that there was plentiful evidence that high NPLs led the financial or banking crisis in East Asia and Sub-Saharan African countries. The non-performing loans issue frequently point out as one of the potential risks for the financial instability in Malaysia since, in the 1990s, non-performing loans caused some banks in Asia to bankruptcies during the crisis.

Since the 1997 economic recession, which had a huge impact on several countries, including Malaysia, the notions of NPLs have been actively explored among economist experts. According to Padachi, Polodoo, Seetanah, Sannassee, Seetah, and Padachi (2015), the worldwide financial and economic calamity prompted an increase in NPLs and NPFs. When banks faced an economic or financial crisis, they safeguarded themselves by diversifying their markets or products to avoid losses,

but this resulted in an increase in NPL/NPF levels. The banking industry then got weaker in both domestic and foreign markets, causing a global negative shock to the whole global economy (Padachi et al., 2015). NPLs are also associated with credit risk, which will have an impact on the global economy and the ability of banks to provide credit (Ghosh, 2017).

As a result of the rising rate of nonperforming credit, Banks and other financial institutions are expected to keep up with their credit management. The growing number of non-performing loans from various businesses and individuals has a substantial impact and negative values on financial streams. This same effect will spread throughout the economy, causing the credit crisis to worsen. The researcher has expressed an interest in the reason or reasons that contribute to non-performing loans in this study. There will be appropriate analysis in the examination to create recommendations on remedies to reduce the rate of non-performing loans.

Malaysia's non-performing loans ratio has gradually declined from 9.2% in January 2006 to 1.46% in January 2019. However, the graph seems to start to increase to 1.48% in February 2019, 1.511% in April 2019 and 1.518% in May 2019. It keeps ascending throughout the year until July 2021, it shows that Malaysia Non-Performing Loans Ratio stood at 1.7%. The non-performing loans ratio is calculated by CEIC, which they were provided raw data on Non-Performing Loans and Total Loans by Bank Negara Malaysia.

Because of the increasing trends in non-performing loans provided by the CEIC database, this study will assist managers and policymakers in understanding the cause of non-performing loans by learning about the bank specifics factors and macroeconomics factors affecting non-performing loans in Asian countries, specifically Malaysia. Malaysia has eight commercially licenced banks and twelve Islamic banks. This study emphasises on the factors that may influence NPF in Islamic banks in Malaysia.

LITERATURE REVIEW
The Differences Between Conventional and Islamic Banking
Banks in the commercial (or conventional) sector get their money by borrowing it largely from savers and then lending it out to businesses and individuals. Profit was generated by taking advantage of the spread between borrowing and lending rates. In addition, they offer financial services, such as guarantees and letters of credit. A percentage of their profit is derived from the low-cost money obtained from demand deposits. Commercial banks are not permitted to trade, and their shareholding is tightly restricted to a small percentage of their net worth. However, there are significant issues with bank lending that make it inefficient. Borrowers are typically more knowledgeable about their own businesses than lenders.

An Islamic bank, like other banks, is a financial institution whose principal activity is to collect monies from savers and distribute them to businesses or individuals. Islamic banks operate a system based on Islamic law (also known as Shariah) and directed by Islamic economics. An Islamic bank is a deposit-taking financial organisation whose scope of operations covers all currently known banking activities, with the exception of borrowing and lending growth. Profit-loss sharing and the prohibition on the collection and payment of interest (called Riba') are two fundamental concepts underlying Islamic banking. In general, the conceptual foundation of an Islamic bank is similar to that of conventional banks, in that there are two arms of banking: sources of funds and uses of funds (Zain & Ghazali, 2018).

The summarization of the difference between conventional and Islamic banking shows in Table 1 below.

Table 1. The Difference between Conventional and Islamic Banking

Conventional	Islamic
Pre-determined rate of interest	Free of the use of Riba' (interest)
Debt-based	Asset-based

Risk transfer (lending on interest)	Risk-sharing (profit-loss system)
Money makes money	Money for real-sector development
Based on traditional laws	Based on Shariah principles
Creating a medium of exchange and only aims at maximizing profit	Avoidance of economic activities involving oppression.

Financing

An Islamic loan adheres to the principles of Shariah Law, which are laid out in the Quran, the Hadith, and the Sunnah. Since money is considered a commodity in Islamic loans, the borrower does not have to put up any of their own cash; instead, the bank "buys" the commodity and then "sells" it to the customer at a profit. In other words, the funding provided by an Islamic bank is not in the form of loans but rather the buying and selling of tangible assets like real estate, vehicles, and stocks. In accordance with Islamic law, Islamic banks may not impose interest on their customers and must provide only halal and shariah-compliant goods and services.

METHOD

Variables

The purpose of this empirical study is to investigate the elements that contribute to non-performing financing (NPF). As a result, the researcher includes seven variables, one of which is a dependent variable, and the others are independent variables. The independent variables are classified as bank-specific and macroeconomic causes of non-performing financing. Table 2 displays the descriptions of the variables.

Table 2. Variable Descriptions

Variables	Description	Sources	Expected Sign
Non-Performing Financing (NPF)	Ratio of gross non-performing financing and gross financing	Annual Reports	
Bank Specific Factors			
Bank Size (BNKSZ)	Logarithm of the total assets	Annual Reports	Negative
Capitalization (CAP)	Ratio of equity of the bank to the total assets	Annual Reports	Negative
Net profit-and loss sharing/PLS margin (NPM)	Ratio of net interest income to total assets	Annual Reports	Positive
Macroeconomics Factors			
Real GDP growth rate (GDP)	Output growth	DataStream	Negative
Inflation rate (INF)	Percentage change of the Consumer Price Index (CPI)	DataStream	Positive
Real effective exchange rate (REER)	The value of a currency relative to the weighted average of many foreign currencies, divided by a price deflator or cost index.	UNCTAC	Negative/Positive

Data and Method

110 observations from an unbalanced panel dataset of 12 Malaysian Islamic banks examined between 2009 and 2018 comprise the sample for this study. The majority of bank-specific indicators are derived from annual reports and the FitchConnect database. Meanwhile, the GDP growth rate and inflation rate are obtained from the DataStream database for macroeconomic information. The United Nations Conference on Trade and Development provides data regarding the real effective exchange rate (UNCTAC).

We employ the panel data method to investigate the contributing element of non-performing finance. Panel of data or longitudinal data is a data set that includes both time series and cross-sectional features. Panel data models use a data set with n cross-sectional units (banks), represented by I = 1,2,..., N; (N=10 Islamic banks), observed at each of t=1,2,...,T; (T=10) time points. As a result, the total number of observations in this study is n x T (12 x 10 = 120). However, because there are missing data from the Islamic bank that has been acquired, the number of observations included in this model would be 110.

The fundamental structure of the panel data is specified by the following regression model (Brook, 2008):

$$y_{it} = \alpha + \beta' x_{it} + u_{it} \quad (1)$$

where:

y_{it}= dependent variable

α = intercept term

β = parameters to be estimated on the exploratory variables

x_{it}= observations on the exploratory variables

Either a fixed effects or a random effects model is used for the estimation of panel data. Which models are most appropriate are determined using the Hausman test. The random effects model is utilized based on the results of the Hausman test.

RESULT AND DISCUSSION

Descriptive Statistics

Table 3 shows the fundamental explanatory statistics for the variables. The average, standard deviation, minimum value, and maximum value are all shown. Non-performing financing for Malaysian Islamic banks is 44.25% during the entire testing period, which runs from 2009 to 2018.

Table 3. Descriptive Statistics of Variables

	Mean	Std. Dev.	Min	Max
NPL	0.4425	0.6219	-0.5447	2.5416
BNKSZ	15.6862	0.7680	14.2358	17.7771
CAP	7.1864	1.4529	3.1872	11.3212
NPM	3.6517	1.3399	1.0487	6.4775
GDP	3.4962	1.7979	-3.2856	5.6235
INF	2.2125	0.9795	0.5833	3.8712
REER	4.6522	0.0890	4.5229	4.7484

The association matrix between independent factors was described in Table 4. As demonstrated in Table 4, we can infer that no multicollinearity occurs because all of the independent variables have modest data correlations with one another.

Table 4. Correlation between Independent Variables

	BNKSZ	CAP	NPM	GDP	INF	REER
BNKSZ	1.0000					
CAP	-0.4595	1.0000				
NPM	0.2668	-0.0267	1.0000			
GDP	0.1195	0.1698	0.0743	1.0000		
INF	0.0809	0.0726	-0.0448	0.4805	1.0000	
REER	-0.2659	-0.1661	-0.0340	0.1650	0.1167	1.0000

Empirical Results from Panel Data Analysis

Parameter estimates and t-tests for the random effects model with NPF as the dependent variable are shown in Table 4. Table 4 shows that at the 5% level of significance, a negative correlation between bank size (BNKSZ) and non-performing financing for Islamic banks was discovered. This negative association demonstrates that the larger the bank, the lower the NPF ratio for the bank. In terms of capitalization, when the percentage of capital strength is low, it has a negative impact on loan defaults. Meanwhile, the net interest margin indicates that it has no effect on the NPF. While none of the macroeconomic variables are important.

Table 5. Determinants of Non-performing Financing (NPF)

	Coef.	Std. Err.	z	P>|z|
BNKSZ	-0.5600	0.1355	-4.13	0.000
CAP	-0.1014	0.0513	-1.98	0.048
NPM	-0.0217	0.0638	-0.34	0.733
GDP	-0.0093	0.0287	-0.32	0.747
INF	0.0301	0.0494	-0.61	0.543
REER	0.3153	0.6348	0.50	0.619
Constant	8.6560	7.2987	1.82	0.069

CONCLUSION

In this study, our goal was to identify factors that have the potential to influence Malaysia's Islamic banks' levels of non-performing financing. In order to estimate the data, which spans the years 2009-2018 and consists of financial statements from twelve different banks, the panel regression approach (random effects model) is utilised. It was discovered that bank size (as measured by BNKSZ) and capitalization (as measured by CAP) have a significant negative effect on non-performing financing. In other words, the amount of non-performing financing increases in proportion to the size of the bank as it grows larger. Furthermore, greater capitalization values indicate that banks are well capitalised, which reduces loan defaults and lowers the rate of non-performing lending. On the other hand, macroeconomic determinants appear to have had little impact on non-performing financing for Islamic banks in Malaysia prior to the epidemic.

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