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FACTORS INFLUENCING FINANCIAL STABILITY IN ISLAMIC BANKING IN MALAYSIA

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Abstract: *This study examines the relationship between four variables: liquidity risk, credit risk, and bank size. The sample taken was among the Islamic banking system in Malaysia between the bank's financial stability during 2010 – 2018. Data were collected using Eikon Thomson Reuters and analyzed using SPSS. Z-score measures the variables of a bank's s financial stability; liquidity risk is determined by capital to-asset ratio; credit risk is determined by debt to asset ratio; and the natural log of total assets measures bank size. The results show a negative relationship between credit risk and bank size with Islamic banks' financial stability. Bank's financial stability was found to increase when liquidity risk rise. This study attends to contribute to the current literature, mainly on Islamic banking. Moreover, this study provides policymakers insight into drafting guidelines and standards to ensure Islamic banking institutions reach their full potential.*

Keywords: *Liquidity risk, Credit risk, Bank size, Financial Stability, Islamic banking*

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Introduction

Globally, Islamic financial institutions have a positive growth trajectory, as the industry's assets have surpassed the USD 2 trillion mark. According to the Islamic Financial Services Board (IFSB) report in 2018, the industry's growth included three main sectors: banking, capital markets, and takaful, estimated at USD 2.05 trillion in 2017 (Islamic Financial Service Board, 2018). A few factors contribute to Islamic banking's rapid growth (Odeduntan, Adewale & Hamisu, 2016). Firstly, the Muslim population is escalating worldwide and craving to switch from conventional to Islamic banking. Then, the effectiveness and laudable performance of Islamic banking is increasing from year to year. Another factor contributing to Islamic banking is high ethical value and reluctance to provide products or services related to speculation and prohibit illicit investment activities such as interest.

Financial stability is critical because it contributes to economic growth and development (Central Bank Malaysia, 2019). When financial stability exists, the industry can withstand shocks primarily through self-correcting mechanisms, preventing adverse effects from undermining the natural world's economy (Yensu et al., 2021; Yue et al., 2022). A resilient banking system is essential for promoting economic development and reducing the vulnerability of financial institutions to crises (Koskei, 2020). A faulty financial system, in contrast, puts strain on households and businesses, affecting the overall economy by preventing funds from flowing to valuable investments and potentially leading to a liquidity crisis (Ngaira & Miroga, 2018).

Internal and external factors such as macroeconomic, socio-cultural, legal, and political circumstances beyond bank management's control can impact financial stability (Almazari, 2014). However, because of differences in socio-cultural, legal, political circumstances, locational, and economic factors, many researchers' findings in identifying which factors have a significant influence differ. Thus, this research aims to investigate the factors that influenced the bank's financial stability in Islamic banking and to add to the current empirical evidence in the Malaysian context in the following aspects. This study developed the following research questions:

Q1. Does liquidity risk influence the bank's financial stability?
Q2. Does credit risk influence the bank's financial stability?
Q3. Does bank size influence the bank's financial stability?

Literature Review

This study categorized the literature review into three sections to clearly define financial stability and liquidity risk, credit risk and financial stability, and bank size and financial stability. These are discussed further below

Financial Stability

Financial stability is difficult and complex to define due to financial soundness indicators. These indicators include the stock market, political and economic conditions, monetary and regulatory policies, credit and financial leverage, and global financial conditions (Rashid et al., 2017). According to Ghassan & Krichene (2017), financial stability is defined as a financial institution's liquidity, solvability, and positive net worth. In other words, a bank is financially stable if it meets all payments with its owned or borrowed funds. Meanwhile, according to Mabkhot et al. (2022) best way to define financial stability, is to identify the characteristics of financial instability. As a result, the financial stability of banks is defined as the absence of bank instability.

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Financial Stability and Liquidity Risk

Liquidity risk can be defined according to the Islamic Financial Services Board (2018), which is the potential of loss to Islamic Institution Financial Service arising from their inability either to meet their obligations or to fund, will increases in assets as they fall due without incurring unacceptable prices or losses.

Nevine (2017) studied and compared the effectiveness of liquidity risk management in Islamic and conventional banking in Egypt. The study found a positive relationship between loan quality, funding, and liquidity management, while asset quality showed a negative relationship with liquidity management. Based on the result, Conventional Banks have a higher mean than Islamic banking; this indicated that Islamic banking did not widely use liquidity risk management practices in Egypt. Nonetheless, in Malaysia, liquidity risk is vital for financial stability.

A previous study by Khan et al. (2017) in Pakistan investigated the performance differences between Islamic and conventional banks regarding profitability, efficiency, and risk management. The study found that the liquidity management of Islamic banks was better than conventional banks. Also, Islamic banks were less risky and held more cash relative to total assets. It proved the short period for Islamic banks to meet debt obligations, as liquidity problems commonly occurred because of failures in fund management. The researcher also mentioned that maintaining robust liquidity management was challenging in the current global economic scenario, where economic growth was fragile and investors were sensitive.

Another study by Shamas et al. (2017) investigated the moderating role of staff efficiency on the relationship between the bank's specific variables and liquidity risk in the Gulf Cooperation Council (GCC). The study found that bank-specific factors such as profitability were among types of measurement together with return on average asset (ROAA) and return on equity (ROE), capital, non-performing loan (NPLs), and the bank's size, which had significant associations with the bank's liquidity risk. The study also found a moderate impact on policy implications from the bank's management; the bank's management was expected to focus more on staff efficiency. Consistent with Pambuko et al. (2018), the decreased levels of efficiency would lead to the disruption of the operational activities of conventional banks and reduce banking stability.

Research by Muriithi & Waweru (2017) examined the effect of liquidity risk on the financial performance of commercial banks in Kenya. The result found that liquidity risk influenced the financial performance of commercial banks. However, according to Ghassan & Krichene (2017), higher liquidity reserves will lead to better performance in terms of profitability and stability, mainly during the financial crisis. A study by Hlebik & Ghillani (2017) scrutinized and explained to what extent important decisions made by bank managers can influence the capability of an institution. It was about how the institution increased assets and stabilized commitments without impairing cash flow. The researcher suggested that the financial institution increase the required amount of liquid assets, which impacted the risk-based capital ratio and the banks' leverage ratio.

A previous study by Harbi (2017) evaluated the factors affecting banks' liquidity in developed countries. The study found that capital ratio, foreign ownership, credit risk, GDP growth, inflation, monetary policy, and deposit insurance significantly negatively correlate with banks' liquidity. However, off-balance-sheet (OBS) and market capitalization are positively related to

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liquidity and are significant. In contrast, other authors Odeduntan et al. (2016) found that the higher the ratio, the lesser the bank's liquidity risk. This increases the ratio, leading Islamic banks to face liquidity problems.

Financial Stability and Bank Size

Bruha & Kocenda (2018) research assessed the link between banking sector quality and sovereign risk in the European Union (EU). The study found that the size of the banking sector, substituted by scaled total bank assets (TBA), delivered ambiguous results. It only provided limited evidence before the crisis due to a lack of statistical significance. Besides, the industry's size (TBA) was mainly correlated with lower sovereign risk before and after the crisis. However, there were some measures and country-group-related exceptions in which the effect was the opposite.

Other studies by Rashid et al. (2017) found that bank size positively correlates with financial stability. The researchers also mentioned that if Islamic banks have more assets, they tend to have more stability in the financial system. This shows that bank size is influencing the bank's financial stability. Another study by Sharif (2018) discovered the impacts of systematic risk on Islamic bank performance. The finding discovered that there was no statistically significant impact at the significance level for systemic banking risks, specifically capital, liquidity, credit, and operational risks, on the performance of Jordanian Islamic banks due to the financial institution's size.

In contrast, Cai & Zhang (2017) studies mentioned that bank size positively correlates with credit and liquidity risks. The researcher also found that the type of ownership has a positive relationship with credit risk and liquidity risk. Elbadry (2018) also found that bank size significantly negatively impacts liquidity risk. Therefore, the current study utilized bank size to measure financial stability in Islamic banking.

Anginer et al. (2018) analyzed shareholder-friendly corporate governance associated with higher standalone and systemic risk in the banking sector. The data were collected from US banks, non-financial firms, and international banks from 1990 until 2014. The study found that shareholder-friendly corporate governance was associated with greater standalone and systemic risks for financial institutions than non-financial firms. Furthermore, shareholder-friendly corporate governance was associated with greater risk-taking by large banks compared to small banks, consistent with larger banks benefiting from too-big-to-fail guarantees. The researcher also mentioned that in the sample of international banks, the relations between shareholder-friendly governance and bank risks were stronger in countries with generous financial safety nets. This was consistent with the notion that banks tried to shift risk into the financial safety net to increase equity value.

Wahid & Dar (2016) conducted a study to compare the stability of Islamic and conventional banks in Malaysia. The data were collected from 2004 until 2013 using the financial soundness indicator and Z-score index as indicators of the bank's stability. There were 38 financial statements obtained from the website of each bank; 17 Islamic banks and 21 conventional banks. Based on the result, large Islamic banks were less stable than large conventional banks. In contrast, the results revealed that small Islamic banks were more stable than small conventional banks. The results were supported by Chakroun & Gallali (2015), who conducted a study on 136 banks in the Gulf countries and used the Z-score method to measure banking stability. The study found that small Islamic banks tended to be financially more stable than

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small conventional. In contrast, large conventional banks tended to be financially more stable than prominent ones, and small ones were likely to be more stable than large ones. This is consistent in the study of Islamic banking in Malaysia.

Tan (2016) analyzed the impacts of risk and competition on profitability in the Chinese banking industry. The data were collected from state-owned, joint-stock, and city commercial banks over the period starting from the year 2003 until 2011. The researcher used measurements of bank risk and instability inefficiency by calculating the Z-score and ratio of loan loss provision over total loans. The results found that the coefficient of bank size was significant and negative, suggesting there were negative impacts of bank size on return on assets (ROA), net interest margin (NIM), and profit margin (PBT). This finding can be explained by the fact that the smaller banks, such as commercial banks, were easier to manage because the bank managers can concentrate on a smaller number of active businesses, leading to higher profitability. This means that bank size is a factor that influences a bank's profitability. However, the current study used bank size to measure bank financial stability in Malaysia.

Research by Louati & Boujelbene (2015) examined and compared the market power and the efficiency stability of Islamic and conventional banks in MENA zones and South East Asia from 2005 until 2012. The financial data, including income statements and balance sheets, were obtained from the Bank scope database. The researcher used Z-score to measure stability. A decrease in solvency risk indicated the bank was more stable in terms of insolvency risk. The findings showed a significantly negative relationship between high levels of competitiveness and banking fragility. Increased competition in the Islamic banking sector will promote stability in Islamic banking. This result suggests that if the competitiveness were high, it would lead Islamic banks to risk-averse conditions. Besides, the results included that the size and capitalization impacting the Islamic banking competition will influence financial stability. The result found that an increase in the size of Islamic banks can contribute to the strength and stability of the overall banking system. This study coincided with Ozili (2018) in the context of Africa. In conclusion, most studies agreed that bank size influenced the bank's financial stability either positively or negatively.

Financial Stability and Credit Risk

Aldoseri & Worthington (2016) defined credit risk as the potential exposure to risk which occurred when one of the dealing parties made a payment, as in Salam (sale by advance payment for the future delivery) or *Istisna* (contract for manufacture) contract, or with the delivery of assets, as in *Murabahah* (sale on goods with markup) contract, before receipt of funds. The researcher also mentioned that contractual form based on profit sharing, as in *Murabahah* and *Musharakah* (profit and loss sharing), credit risk arose when the business owner or entrepreneur failed to pay the bank its share of profits when due.

Ferhi (2018) study surveyed the credit risk of Islamic and conventional banks and their relationship with the capital from 2005 until 2015. The study found that conventional banks have a higher credit risk than their Islamic counterparts. This was because credit risk significantly affects exposure to financial crises. After all, it could put the bank in distress if not adequately managed. Additionally, an increase in credit risk will lead to a decline in the capital of Islamic and conventional banks. In a nutshell, there was a negative effect of credit risk on the capital in the banking system. Another research by Hachem & Sujud (2018) found that Islamic banks were more understanding, aware, and cautious in their approach than traditional banks. Also, Islamic banks were more efficient in assessing and analyzing credit risk than

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conventional banks. Elbadry (2018) study found that a higher capital adequacy ratio in Saudi banks reduced credit risk.

Researchers named Noman et al. (2018) found that competition promoted financial stability and reduced credit risk in the banking system. Next, research by Ghenimi et al. (2017) investigated the primary sources of banking fragility. The study analyzed the relationship between credit risk and liquidity risk and its impact on the bank's stability. The result confirmed that credit and liquidity risks had no economically meaningful reciprocal contemporaneous or time-lagged relationship. However, both risks influenced the bank's stability, and their interaction contributed to its instability.

Moreover, Cai & Zhang (2017) investigated the link between the Ukrainian banking sector's credit risk and liquidity risk. The findings confirmed that the capital ratio coefficient was positive, and the size coefficient negatively impacted liquidity risk. The results also found a positive and significant impact of credit risk on liquidity risk in Ukrainian banks. Higher credit risk will lead to higher liquidity risk in Ukrainian banks. This finding coincided with Nevine (2017) finding in the context of Egypt. Furthermore, the findings found a positive relationship which was slightly stronger in larger banks and foreign-owned banks.

A study by Saeed & Zahid (2016) investigated the impact of credit risk on the profitability of five big United Kingdom (UK) commercial banks. The study found a positive relationship between credit risk and the bank's profitability. Hachem & Sujud (2018) highlighted that each type of contract from Islamic banks led to credit risk to the bank's financial profitability. The researchers also mentioned that credit risk might threaten conventional and Islamic banks' financial operation and financing. The results also uncovered that the bank size, leverage, and growth were positively interlinked, and the banks achieved profitability after the financial crisis.

Data And Methodology

This study is conducted based on Islamic Banks in Malaysia. It covers the period 2010 to 2018. For this study, we select 16 banks in Malaysia, including ownership from local and foreign Islamic Banking. The population was determined from the websites of the Central Bank of Malaysia; it listed 16 Islamic banks as licensed financial Islamic banks. The number of populations coincided with the period 2010 to 2018. Table 1 presents the number of Islamic banks with data availability in 9 years. Even though the current study has a small sample size consisted of 16 Islamic banks which were not sufficient to conduct the regression test, however, the study can be tested using non-parametric Spearman’s correlation coefficient. This test was used to measure the strength of the relationship between the independent variable and the dependent variable.

Table 1: Sample of Islamic Banks

Description	Number of Islamic Banks
Local Islamic Bank	11
Foreign Islamic Bank	5
List of Licensed Islamic Bank	16

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Definition and Measurement of Variables

Liquidity Risk

This study measured liquidity risk by using the total capital to total assets. Total capital refers to the sum of long-term debt and total shareholder equity. Both items can be found in the bank statement of position. The lower degree of the ratio indicates lower liquidity risk because the increment in a bank's capital will minimize the probability of facing liquidity risk. It is also vital to ensure that the bank's capital absorbs losses that could threaten its solvency. Thus, every bank must hold sufficient capital to mitigate liquidity risk. In this study, the measurement was similar to the previous study by Elbadry (2018) but used different financial data and standards in Malaysia.

Credit Risk

The second independent variable in the current research was credit risk; a ratio of total debt to the total asset will be used. Total debt is included in total liabilities. Both of these items can be found on the bank statement of position. The ratio reflects the degree of credit risk. It indicates that the higher the ratio, the higher the degree of credit risk. According to Ferhi (2018), banks should have appropriate credit risk management to identify, monitor, and control credit risk. This was important to provide foundations to develop prudential supervisory and control mechanisms to manage credit risk. In this current study, the measurement was similar to the previous study by Elbadry (2018).

Bank Size

The third independent variable was the bank size. The measurement was adopted from Elbadry (2018). Consistent with the previous study, the measurement of bank size was considered to the natural log of total assets. It will reflect whether or not large or small Islamic banks influence the bank's financial stability. For further understanding, the measurements and previous studies were summarized as follows:

Table 2: Operationalisation of Variables

Variable	Description	References
Bank's Financial Stability	Z-score was computed from ROA, capital ratio and standard deviation of ROA	Odeduntan et al. (2016)
Liquidity Risk	Liquidity risk was measured by total capital to the total asset ratio	Elbadry (2018)
Credit Risk	Credit risk was measured by total debt to total asset ratio	Elbadry (2018)
Bank Size	Bank size was measured according to the natural log of total assets	Elbadry (2018)

Results and Discussion

Descriptive Analysis

The descriptive analysis of each of the variables is presented in Table 3. The minimum and maximum Liquidity Risk levels were 0.2178 and 18.8267, respectively. The average mean for 144 samples comprised of data from 2010 until 2018 for 12 banks were 8.0977, 91.9017, 34435552, and 11.7436 for Liquidity Risk, Credit Risk, Bank Size, and the bank's financial stability, respectively.

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Table 3: Descriptive Statistics

Variables	Min	Max	Mean	Standard Deviation
Liquidity Risk	0.2178	18.8267	8.0977	2.8320
Credit Risk	81.1733	99.7822	91.9017	2.8287
Bank Size	4071578	226010200	34435552	36670316
Bank's Financial Stability	2.2929	24.6374	11.7436	3.4818
N=144				

Normality Analysis

Since the study has a small sample size; therefore, SPSS was used to discover the distribution of the variables using the number to spot the normality. The normality test was performed using the Skewness and Kurtosis test on liquidity risk, credit risk, bank size, and financial stability. Table 4 displays the summary statistics.

Table 4: Test of Normality

	Skewness	Standard Error	Z-Score	Standard Error	Z-Score
Liquidity Risk	1.664	.202	8.237	4.475	.401
Credit Risk	-1.675	.202	-8.292	4.498	.401
Bank Size	2.879	.202	14.252	10.033	.401
Bank's Financial Stability	2.201	.202			
N=144					

Correlation Coefficient

The correlation between the bank's financial stability and liquidity risk, credit risk, and bank size was tested. Table 5 presents the summary of the result.

Table 5: Spearman's Correlation Coefficient

		Banks Financial Stability	Liquidity Risk	Credit Risk	Bank Size
Bank's financial stability	Spearman's Correlation	1			
	Sig. (2-tailed)				
	N	144			
Liquidity Risk	Spearman's Correlation	.952**	1		
	Sig. (2-tailed)	0.000			
	N	144	144		
Credit Risk	Spearman's Correlation	-.950**	-1**	1	
	Sig. (2-tailed)	0.000	0.000		
	N	144	144	144	
Bank Size	Spearman's Correlation	-.182**	-.255**	.256**	1
	Sig. (2-tailed)	.029	.002	.002	
	N	144	144	144	144

**. correlation is significant at the 0.05 level(2-tailed)

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The results provided the idea that all correlations have significant relationships. The confidence interval does not cross zero (and the significance is lesser than .05), showing a significant positive relationship between liquidity risk and bank financial stability in Islamic banking in Malaysia; as liquidity risk increases, the financial stability also increases. Moreover, the financial crisis has shown that bank failures driven by credit risk in their portfolios will cause a freeze of the marketplace for liquidity Ghenimi et al. (2017). This shows the bank's incapability to fulfil the demand of the depositor.

There is a link between asymmetric information liquidity risk and credit risk and a bank's financial stability. This means a loan default increases this liquidity risk because of the lowered cash inflow and depreciations it triggers. In this regard, banks moved from the risk of withdrawal of deposits or bank runs to a risk of drying up other funding sources, specifically the interbank market. On the other hand, banks were exposed to credit risk due to the information asymmetries in the loan market. Bank failures are common occurrences of liquidity and credit risks (Ghenimi et al., 2017). This indicates that asymmetric information will affect liquidity risk, credit, and bank financial stability. There was a strong, positive correlation between liquidity risk and bank financial stability, which was statistically significant. This finding coincided with the previous study by Muriithi & Waweru (2017) and Rashid et al. (2017).

Results in the table above indicated a strong negative relationship between credit risk and bank financial stability. This suggests that as credit risk increases, financial stability decreases. Moreover, the findings of this research aligned with the implementation of the asymmetric information theory. For example, if the *Musharaka* contract is taken with the wrong partners, the commonly expected profits remain unchanged; however, the expected loss is more significant. The expected loss is assumed to be the result of asymmetric information. This means a negative gross return for the lousy partner will reflect the average net loss for both partners. As a result, when the credit risk increases, it will decrease financial stability. The result was consistent with Noman et al. (2018).

The findings showed a weak correlation and negative relationship between bank size and financial stability. This entails that as bank size increases, financial stability decreases. This finding coincides with the previous research by Wahid & Dar (2016) and Chakroun & Gallali (2015). The results provided the idea that all of the correlations have significant relationships. According to Benamraoui & Alwardat (2018), the asymmetric information theory pertains to the importance of bank size in accessing more information. It reduces the effect of asymmetric information on mudaraba and musharaka contracts. However, the results show that in the context of Malaysia, the larger size banks were less stable than the smaller ones. This indicates that small banks also can access information to borrowers, which enables them to reduce the likelihood of adverse selection and moral hazard (Benamraoui & Alwardat, 2018). From the data in the table, it can be concluded that there were positive and negative correlations between the bank's financial stability and all of the independent variables, including liquidity risk, credit risk, and bank size.

Result Summary

Table 6 summarises the results of the analysis of the objectives of this research. From the results, it can be concluded that the objectives were partially supported in which some independent variables were proven to have a significant effect on the bank’s financial stability.

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Table 6: Summary of Results

Objectives	Remarks
i. To examine the relationship between liquidity risk and the bank's financial stability	Supported
ii. To examine the relationship between credit risk and the bank's financial stability	Supported
iii. To examine the relationship between bank size and the bank's financial stability	Supported

Conclusion and Recommendations

This current study intends to provide evidence-based results on the factors influencing the bank's financial stability in Islamic banking in Malaysia. Due to this fact, the current study relied heavily on a descriptive study in which the relationships between independent and dependent variables were put to the tests accordingly. As mentioned before, the population consisted of 16 Islamic banks in Malaysia. Based on the literature, this study selected three independent variables: liquidity and credit risk. The findings of this study provide some identifications for policymakers and Bank Negara Malaysia regulators in drafting appropriate economic and financial policies. Government interference is required to ensure Islamic banking institutions can sustain and reach their full potential.

Moreover, in the absence of high competition, this indirectly will encourage risk-taking effect on the banking system. However, the risk will shift among Islamic banking if the bank has high competition. Therefore, bank regulators may impose activity restrictions to increase competition and restrict the bank from excessive risk-taking. This is important to mitigate risk for Islamic banking. Other than that, Islamic banking may deposit insurance to promote financial stability and reduce the bank's risk exposure.

Limitations

This study covered nine years from 2010 until 2018, which did not include the year of the financial crisis, which happened in the year 2008 until 2009. Besides, this current study did not focus on the factors influencing the bank's financial stability. More factors also have the same level of influencing power, such as governance, market condition, inflation, and also the regulation of the banks.

Suggestions for Future Research

The study suggested that future studies be done on other factors, such as governance, regulation, and market condition. There is a need for future studies to be carried out over a more extended period starting from the financial crisis in 2008 and continuing the studies until 2023. Doing so would provide more details on Islamic banking and the factors affecting financial stability. It was good to narrow down the study as it can contribute to future research.

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