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Research paper

Financial liberalization and foreign bank entry on bank performance

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Abstract

Financial sector liberalization had announced by Central Bank of Malaysia in 2009 with the expectation to increase a resilient, diversified and efficient financial sector. Moreover, financial liberalization is intended to increase competitiveness between local and foreign financial institutions in ensuring that overall financial stability and soundness is preserved. The main objective of this study is to measure the effectiveness of financial liberalization implemented by Central Bank of Malaysia in 2009. In particular, this study would like to investigate whether the financial liberalization and the type of bank, size of the bank, liquidity, leverage and bank status explained the Malaysia banking performance. The sample use in this study are all the listed banks totaling 477 yearly-sample data collected from Bankscope. This study suggests that local bank performance is better in the post-financial liberalization period. This result is similar even after applying the trimming method to reduce the outliers' bias. The study also suggest that conventional banks performances are better than Islamic banks regardless whether it is local or foreign ownership. Hence, it can be concluded that, the bank performance is better for local banks in the post-financial liberalization period and suggests that the financial liberalization by Central Bank of Malaysia to stabilize the financial market and increase local bank performance has been effective in achieving its aim.

Keywords: *Bank Performance; Financial Liberalization; Post-Liberalization; Islamic Bank; Conventional Bank; Bank Status; Leverage; Liquidity; Local Bank; Foreign Bank.*

1. Introduction

The Malaysian financial system has long been home to foreign-owned banking institutions, with foreign banks being pioneers in the development of the Malaysian financial system more than a hundred years ago. The oldest bank in Malaysia was a foreign bank that was established to meet the financial requirements of the early European traders. Other major foreign banks followed suit as the strong prospects for growth in trade drew keen interest in establishing presence in Malaysia. Since then, foreign banks have become key players with a significant contribution to the Malaysian economy. Today, foreign banks account for approximately 27% of market share in the assets of the banking sector. Several foreign banks with a sizeable presence in Malaysia have also acknowledged Malaysia's growth potential and connectivity with other economies, and have positioned Malaysia as a priority market within the Asia-Pacific region (BNM, 2012).

A key expectation from increased liberalization is that strong and well-managed foreign banks will contribute to the orderly growth and development of the Malaysian financial sector. According to BNM (2012), the liberalization is intended to grasp all the opportunities that would give benefits and add to the development of the Malaysian financial sector and the economy as a whole, while ensuring that overall financial stability and soundness is preserved. It also aims to strengthen Malaysia's position as an international Islamic financial hub especially in the area of Islamic Finance.

This paper aims to prove a systematic study of how foreign bank presence has affected domestic banking market in Malaysia. Since financial liberalization is intended to increase competitiveness between local and foreign financial institutions in ensuring that overall financial stability and soundness is preserved, financial liberalization in 2009 suggests potential research in measuring the effectiveness of the measures taken. Hence, It can be hypothesized that, if financial liberalization is effective, local banks performance are better or at least the same level with foreign banks in the post-financial liberalization period. This study contributes to the financial liberalization literature in Malaysia.

The objectives of this study encompasses to determine the effectiveness of Financial Liberalization implemented by Bank Negara Malaysia on April 2009 and second to investigate what are the factors that have an impact on the Malaysian Bank Performance.

2. Literature review

Financial liberalization has been introduced by the related body in making the market to be more efficient, especially the financial institutions that are banks are expected to be more efficient in their operations. In a fully liberalized environment, bank performance and efficiency is enhanced. The following research paper focuses on financial liberalization in Malaysia, and the consequences of the implementation on several issues that is Islamic bank performance, bank portfolio allocation to borrowers and banks' intermediation spreads. Elryah (2014) research provides empirical evidence concerning the impacts of liberalization and reforms on Islamic bank's performance in Malaysia. The research use panel regressions model to investigate the relationship between the Islamic banks performance and financial liberalization and reforms with return on assets and equity. The findings indicate that financial liberalization and openness, assets, profitability, return on assets and inflation have statistically positive impacts on Islamic

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banks performances. Degryse et al. (2012) paper explores how foreign bank entry determines credit allocation in emerging markets. It investigates the impact of the mode of foreign entry (Greenfield or takeover) on banks' portfolio allocation to borrowers with different degrees of informational transparency, as well as by maturities and currencies. Yee and Tan (2009) study tries to determine whether financial liberalization in Malaysia was able to promote a competitive environment that could boost the efficiency of banks in terms of reduction in intermediation spreads. Mohamed Ariff (1996) study measures the effects of international factors on domestic financial markets from financial liberalization in Indonesia, Malaysia, Singapore and Thailand.

All these papers discuss the financial liberalization in Malaysia before 2009, however, none of the paper discuss on the financial liberalization announced in April 2009 and its effect on bank performance. Hence, it is the intention of this research to discover the impact of 2009 financial liberalization implemented by Bank Negara Malaysia (BNM) on the bank performance.

Bank Performance Literature

Farag, Mallin and Ow-Yong (2014) examine the relationship between corporate social responsibility (CSR) and financial performance in Islamic banks. The paper analyzes the CSR disclosure index shows that Islamic banks engage across the range of social activities, both as individual banks and as countries. The empirical analysis highlights a positive association between CSR disclosure and financial performance. Dali and Zhang (2014) constructs a model of the performance of Chinese (Mainland) owned banks operating in Hong Kong compare to Hong Kong owned banks and foreign owned banks. Using net interest margin, non-interest expense, impaired loans ratio, equity multiplier and ownership structure, the study found that Chinese owned banks recorded increased performance in terms of net interest margin and equity multiplier but decreased with respect to non-interest expense and impaired loans ratio. However, when compared to foreign banks and local banks (Hong Kong owned banks), the study found that in general, Chinese (Mainland) banks tend to perform poorly across a number of key banking performance indicators. Ding, Wu and Chang (2013) studies the dynamic changes in bank performance before and after government intervention due to the global financial crisis in 2007. Using data from five countries, the empirical results indicate that, on average, the bank performance in terms of solvency, credit risk and profitability improves after government intervention.

Hypotheses Development on Bank Performance in the Post-Financial Liberalization Period

This section develops the foundations and the argument to support the hypotheses on the effect of financial liberalization on Malaysia bank performance.

a) Bank Performance, Financial Liberalization and Type of Bank

Fries and Taci (2005) in Fathi (2010), argue that the presence of foreign banks, which are generally more efficient than domestic banks, can ensure the transfer of banking expertise and technology required to improve efficiency of banks in the host country and also as one of an effective way to support the consolidation of balance sheets of domestic banks inefficiency. Foreign banks can contribute to improve the infrastructure of the financial system by encouraging the introduction of techniques developed in auditing, accounting, risk management, credit control and monitoring. From the macroeconomic side, the presence of foreign banks can improve banking regulations and ensure stable financing of economic activity for host countries. It could be considered as a mean for diversifying risk in the event of an economic downturn. However, Fathi (2010) argue that further work on the contrary tend to highlight the adverse effects of foreign bank entry on the economy in general and on local banks in particular. Based on the results of empirical studies, these researches demonstrate that increased competition following the entry of foreign banks, considered as more efficient than domestic banks, may cause harmful effects (Cao & Shi 2000; Kaminsky and Reinhart, 1999; Rojas-Suarez (1998) in Fathi 2010.

Given the results of the empirical studies, Malaysia financial liberalization in 2009 suggests potential research in measuring the effectiveness of the measures taken. Hence, it can be hypothesized that, if financial liberalization is effective, local banks performance are better or at least the same level with foreign banks in the post-financial liberalization period.

H_1: Local banks performances are better than foreign banks in the post-financial liberalization period.

b) On the effect of bank size, bank liquidity, bank leverage and bank status to Bank Performance.

i) Bank Performance and Size of the Bank

Several studies have found a positive relationship between sizes of the firm play a significant role in determining the performance of the firm. Park and Park (2014) study the effect of financial liberalization on the lending behaviour of banks and non-bank financial institutions (NBFIs) before and after the1997 Asian financial crisis. Findings show that small and medium firms (SMEs) are benefited more from financial liberalization than large firms where the financial liberalization has led banks and NBFIs to allocate more of their loans to SMEs with good performance histories. However, the paper does not find similar effects of financial liberalization on efficiency at large firms. Demirgüç-Kunt and Huizinga (2012) results shed light on whether large bank size is desirable. In practice, bank managers have taken the decisions that have led to the considerable growth of banks around the world in the last two decades or so. Bank managers can benefit from size, as their status and pay may be positively affected by bank size.

H_2: There is a positive relationship between bank performance and size of the bank.

ii) Bank Performance and Liquidity

According to Abdelaziz, Mouldi and Helmi (2011), liquidity variable is used to inform about the level of financial intensity for each bank, and it also makes it possible to evaluate the function of intermediation banking (collection of deposits and distribution of credit). Indeed, liquidity variable allows deciding the level of funds for the banks. There are several literatures that use liquidity as a proxy in measuring the bank financial risk. Demirgüç-Kunt and Huizinga's (2012) study use liquidity as a proxy for bank's risk. The argument is, the higher the liquidity that the bank has, the lower risk of bank failure. Hence, this lead's to better bank performance. The study suggests for an international sample of banks, banks with large absolute size tend to be more profitable as indicated by the return on assets, however with higher bank risk. The result suggests that the liquidity variable has a negative relationship with profitability. Therefore, it can be hypothesized that there is a relationship between liquidity and bank performance.

H_3: There is a negative relationship between bank performance and liquidity.

iii) Bank Performance and Leverage

Chen (2013) investigates the relationship between leverage ratios and bank share performance for Japanese banks during the period of financial crisis in the late 1990s. The results suggest that market leverage before the crisis has statistically and economically significant predictive power for the bank performance during the crisis. Moreover, the study also finds that banks with lower market leverage ratios were affected more adversely by the failure announcements of large financial institutions during the crisis. This evidenced is also supported by ECB (2010c) indicating that the key drivers of bank performance are earnings, efficiency, risk-taking and leverage with the positive and negative argument. Leverage might improve results in the upswing in the way it functions as a multiplier, but, conversely, it can also make it more likely for a bank to fail, due to rate, unexpected losses. In line with these literatures, this study would suggest the following hypothesis between leverage and bank performance.

H_4: There is a negative relationship between bank performance and leverage.

iv) Bank Performance and Bank Status

Hazzi and AL Kilani (2013) examine the financial performance for both of Islamic and traditional banks in Malaysia to know whether or not there are significant differences between such

banks with respect to profitability, liquidity and risk performance. The study find that the traditional banks are more profitable than Islamic banks, while the latter is more liquid and less risky, especially with respect to the risk-weighted capital ratio, than the traditional banks. In line with these literatures, this study would suggest the following hypothesis between bank performance and bank status.

H_5: Conventional banks performances are better than Islamic banks.

3. Methodology

The sample selection strategy, data sources and variable of the study

The sampling criterion for this study is to include all the listed banks in Malaysia from year 2000 to 2013. All banks data were collected from Bankscope database. The total yearly sample data are 477. The financial liberalization period was the one announced by CBM (Central Bank Malaysia) on 27 April 2009 (BNM, 2009). Year before 2009 is used as a pre-liberalization period, while, year 2010 onwards is used as post-liberalization period. The year 2009 is excluded from the sample because this is the liberalization introduction period, hence, it is recognized as possibly capable of influencing the results. Based on the justification made in constructing hypotheses, a model indicating the effectiveness of financial liberalization is develops with five controlling variables that are hypothesizing to have an effect on the bank performance which are types, size, liquidity, leverage, and bank status. The definitions of the variables are as follows:

Regression Model:

Bank Performance (PERF) = $\alpha_o + \alpha_1$ lib*local + $\alpha_2$size + $\alpha_3$liquidity + $\alpha_4$leverage + $\alpha_5$status

Where;

Bank performance (PERF) = return on assets (ROA) and return on equity (ROE); ROA= profit/total assets ; ROE = profit/total equity

Financial liberalization (lib) = dummy variable (year 2009 onwards=1, and 0 otherwise)

Type of bank (Local vs foreign bank) = dummy variable (local=1, foreign=0)

Size of the Bank (size) = total assets (TA)

Liquidity of the bank (liq) = Liquid assets to total deposits and funds (LA/TDepf)

Bank Status (status) = dummy variable (conventional 1, Islamic =0)

Leverage (lev) = total debt (TD)

4. Results and discussion

4.1. Descriptive statistics

Foreign bank showed a good profit compared to the local, as is revealed roa and roe. Additionally, foreign bank maintained higher liquid assets to deposits and funds (latdnf) than local banks. The mean difference between local and foreign bank on loan assets to total deposits and funds (latdnf) is very wide, where foreign bank's latdfn is two times higher than local latdfn. However, foreign banks maintained lower total assets and total debt as compared to local bank. These findings provide some support for the view that the overall financial conditions and performances of foreign bank branches tend to be stronger than those of local banks.

Analysis on the effects of the financial liberalization and five control variables on Malaysia bank performance are observed in Table 3. Model (1) and (4) shows, the interaction between financial liberalization and types of banks, local or foreign, (lib*local) is the primary interest of this analysis, has a significant positive coefficient. The roa and roe is regressed against the interaction, lib*local. The results confirm that both roa and roe proxies for the performance of local and foreign banks' appear to be dependent on financial liberalization. The interaction coefficient is positive indicating local banks performances are better from foreign banks in the post-financial liberalization period. However, these results change when the control variables is added into the model. Models (2), (3) and (4) support model (1) results, has a significant positive coefficients. However, for model (5) and (6), it does not has a positive significant coefficients. Overall, it can be concluded that financial liberalization play an important role in determining banks performance.

Bank Performance (PERF) = $\alpha_o + \alpha_1$ lib*local + α_2 size + α_3 liquidity + α_4 status + $\alpha_5$leverage

Table 3: Regression on ROA with Financial Liberalization and Control Variables

	(1)	(2)	(3)	(4)	(5)	(6)
var	roa	roa	roa	roe	roe	roe
lib*local	0.301 ***	0.426 **	0.344 *	5.716 ***	7.570	7.669
	(0.11)	(0.184)	(0.19)	(1.97)	(5.40)	(5.42)
size		-0.0468			1.290	
		(0.121)			(0.93)	
liq		-0.013	-0.0127		-0.0238	-0.0214
		(0.008)	(0.008)		(0.02)	(0.02)
status		1.161 ***	1.114 ***		12.28 *	12.29 *(
		(0.329)	(0.325)		(7.34)	7.362)
leverage			0.008			1.195
			(0.116)			(0.85)
Constant	0.765 ***	0.926	0.427	9.446 ***	-11.15	-10.20 *
	(0.11)	(1.259)	(1.190)	(1.85)	(7.031)	(5.920)
Tot	424	423	423	424	423	423
R^2	0.003	0.219	0.218	0.003	0.037	0.038

The data that used in this regression are samples available after deleted year 2009 to eliminate year liberalization bias and is regressed using robust standard error to eliminate heteroscedasticity biased.

Robust standard errors in parentheses *** $p<0.01$, ** $p<0.05$, * $p<0.1$.

In particular, the control variables in the regression that are size, liquidity and leverage representing bank characteristics are also not significant for model (2), (3), (5) and (6). The size variables has a conflicting sign in models (2) and (5). Model (2) has a negative sign, while model (5) has a positive sign. Leverage has a negative sign for all models (2), (3), (5) and (6) which is consistent with hypothesis 2, H_2. As for liquidity, the variable has the same negative sign for all the models. Nonetheless, for types of the bank variable, (conventional or Islamic - status) it has a positive significant coefficient, as expected. This result suggests that conventional bank performs better than Islamic bank, following Hazzi and AL Kilani (2013).

5. Conclusion

The evidence reported in this study includes the impact of financial liberalization by Bank Negara Malaysia in year 2009 with the objective of establishing a more stable financial market. First, although different proxy is used to represent bank performance, the results from the regression are similar. The first hypothesis is supported, that is, local bank performance is better in the post-financial liberalization period. Second, the results also suggest supporting the second hypothesis, H_5, that is conventional banks

performances are better than Islamic banks regardless whether it is local or foreign ownership. This result is in line with the study by Hazzi and AL Kilani (2013).

Hence, it can be concluded that, the bank performance is better for local banks in the post-financial liberalization. Summarizing, the evidence presented in this section suggests that the financial liberalization in 2009 by Bank Negara Malaysia to stabilize the financial market and increase local bank performance has been effective in achieving its aim.

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