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The Determinants of Malaysia Islamic Financial Development

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Abstract

The purpose of this study is to examine the determinant of Malaysia Islamic Financial Market Development. This study has been conducted using secondary data from multiples types of data source that include Bank Negara Malaysia (BNM) data bank, World Development Indicator (WDI) and World Governance Indicator (WGI). Data retrieved was an annual data from 1984 to 2016 and the quantitative tools that been used is multiple regression analysis. The result from this study found out that, trade openness (TO) and rules of law (RL) was significantly and positively contributed to the development of Islamic financial market development of Malaysia. The coefficient correlations of these two variables were same with direction of the constructed hypothesis. On the other hand, Gross Domestic Product (GDP), Financial Openness (FO), Political Stability and Absence of Violence (PSAV), and Regulatory Quality (RQ) were not able to influence Islamic financial development. It is believe that, there would be other determinants that might have significant impact in Islamic financial market development that not included in this study. Limited data availability on Islamic financial market has become one of the main constraints in this study. In addition, there also no stand alone data on institutional quality of Islamic finance conduct that available to be used. This study contributed to narrow down the focus on mechanism that able to improve Malaysia Islamic financial market in the future. It is because, the more financial development taking place, the more progress in economic growth would be.

Key-word: - Islamic Financial, Financial Market, Bank Negara.

1.0 INTRODUCTION

On May 1997, Shariah Advisory Council (SAC) that has the highest authority on Islamic finance in Malaysia has been introduced by Bank Negara Malaysia. As referring to Ismail & Tohirin (2010), the main focus of SAC is to supervise, regulate and ascertain the Islamic law that related to Islamic finance practices. SAC also act an advisor for Bank Negara Malaysia regarding *shariah* matters and checked Islamic product compatibility especially on *Takaful* (insurance) and banking. According to Bank Negara Malaysia Act 2009, SAC has been given a sole authority in matters of Islamic banking, finance and *takaful*. Whereby, all the contradict issues on Islamic matter in Malaysia, SAC shall be prevail.

1.1 Development of Malaysia Islamic Finance Market

Bank Negara Malaysia (BNM) also play its role in promoting Islamic finance to the outside world by issuing a licensed to 10 highly committed Islamic bank in 2006. (International Herald Tribune, 2007; Khan & Bhatti, 2008). In addition, according him, Malaysia government also give an incentive in term of tax exemption from 2007-2016 for *Takaful* industry as an encouragement to promote economic growth to the country. Due to this, it has boosted the performance of Malaysia Islamic finance to another level. In fact, in 2004, Malaysia Islamic securities able to captured 42% and 25% of total outstanding private debts securities and bond respectively. This is due to the *sukuk* (Islamic Bonds) that been introduced in 2001. (Al-Salem, 2009).

It's not stop there, in 2005, the International Centre for Education in Islamic Finance (INCEIF) has been established with the aims to produce new expert and professional in Islamic finance. It is believe that, by enhancing on human capital development, it will able to support other institutions and initiatives for the future development. (Malaysia International Islamic Financial Centre (MIFC), 2013). It has been proven by looking at the report from Islamic International Rating Agency (IIRA) (2010), saying that, Malaysia has the strongest capital market in the world. And Bursa Malaysia is one of the most resilient markets during the global financial crisis in 2007-2010 and in fact able to generate growth during this critical period.

1.1.1 Limitation faced by Malaysia Islamic Finance Market

Although Malaysia have a positive progress in term of their Islamic financial system, but they also facing a critics and conflicts from others especially their competitors. Based on Khan *et al*. (2008), Malaysia faced huge critics especially from Middle East countries that claim, Malaysia Islamic financial system is too liberal in conducting the interpretation of *shariah* principle into Malaysia practice. They also argued that, Malaysia Islamic financial system does not have enough satisfactory support and involvement especially from general public of Malaysia its own.

Besides that, Malaysia also had been claim regarding the ambiguity issues in their financial reporting. It is due to constructive obligation of return smoothing where, Malaysia supervision authority does not permitted the holder of Profit-Sharing Investment Account (PSIA) to bear a loss of their capital. (Kaouther, Jean-Laurent & Lotfi, 2011). Due to this, the reliability and transparency of their financial reporting has been question by public and investors. This issues become more serious when Malaysia started to allowed the conventional banks and financial institutions to provide Islamic products through Islamic windows services.

1.2 Problem Statement

The crisis in 1997 and 2008 become the most critical years for all country over the world especially in term their financial performance. Not to forget, some of the countries been declared bankrupt as a result of debt burden that push them into a lower ground. Although most of the country was affected and still reeling from this sub-prime wave, but in contrast, most of the countries from Organisation of Islamic Conference (OIC) was not badly affected. (Rahim & Zakaria, 2013). Contradict to this, some of the countries become the most resilient market and able to construct a positive growth in their capital market. All of this resilient market mostly comes from Islamic Capital Market.

Malaysia is one of the countries that able to survive during this financial crash. In fact, it also adopts this financial system almost on the same year and using universal rules of *shariah* like other countries such as Saudi Arabia, Egypt and Qatar. But looking to the OIC Equity Market table from IIRA (2010), Malaysia under Bursa Malaysia Berhad was leading among the OIC member country and was claimed to be most developed, mature and transparent financial system. In addition, for the market capital, Malaysia was rank on the second place and let the other countries far behind. Although, most of the countries has make a positive growth and progression in their Islamic financial market, but what are the mechanism that distinctive Malaysia performance with others? Would it due to differences in Gross Domestic Product (GDP), quality of institutions, government policy, school of taught, population and etc?

By taking economic institutions quality as a major concern, this factor is believed to have a significant influence on the performance of the Islamic financial market of Malaysia. Looking at Acemoglu, Johnson, Robinson, & Thaicharoen (2003), institutions includes bureaucracy policy, rules of law, enforcement of property rights, corruptions illegality, and political stability. This can causes the volatility of the market in respect to certain interest group of people. Therefore, the transparency of the financial system itself plays an important role in order to direct its own direction in the future.

1.3 Research Objectives

This study conducted with two aims which is generally to give an overview and build up an understanding of Islamic finance. And specifically, to examine the determinants of Islamic Financial Market Development of Malaysia.

2.0 LITERATURE REVIEW

2.1. Definition of Islamic Finance

Based on definition of Islamic finance by Azrul (2010), Islamic finance is define as in contrast to conventional finance, involves the provision of financial products and services by institutions offering Islamic financial services (IFS) for s*hariah* approved underlying transactions and economic activities, based on contracts that comply with *shariah* laws. *Shariah*, the basis for finance that meets the religious requirements of Muslims in line with their *'aqidah*, is the factor that distinguishes Islamic finance from conventional finance.

2.2 Variables of Financial Development

Gross Domestic Product per capita was positively and significantly a constants measure toward the level of financial development. (Badi, Panicos & Siong Hook,2009). In addition, according to Rajan and Zingales (2003), the Trade Openness and Financial Openness is significant measures on the contribution of financial developments. Moreover, Badi *et al.* (2009) also added that, the financial development can also be measured by looking at the institutional quality. This institutional quality that been includes are referred to Political Stability, Rule of Law and Regulatory Quality.

2.3 Principles of Islamic Finance

The basic elements of Islamic finance include profit and risk sharing, transparency and full disclosure, good governance, value-based innovation and principles of justice. (Mohd Zain, Ishak, Abdul Khadir & Adul Latif, 2011). These will implicitly provide checks and balances to the current system. It also been supported by, Kyeong, Shu, & Doowoo (2012) where the Islamic finance principles includes four main things which is prohibited *riba*, gharar, investments that violate the rules of *shariah* or known as *haram* and promotes profit and loss sharing.

2.4 Islamic Finance Products

Since *riba* is strictly prohibited in Islamic finance, there are few acceptable solutions has been put into practice as an alternative to replace the fixed interest return from conventional system. It was done by introduced the variables rates of return based on economic return from investment that has been made. This solution has been transform into several form of products that been practice in Islamic finance which is included *Mudaraba, Musharakah*, *Murabaha, Ijara* and *sukuk*.

2.5 Institutional & Its Function

2.5.1 Education, Research & Training Centre

Education is a crucial mechanism in enhancing the knowledge and the important of Islamic financial system. According to Belouafi, Belabes, & Daoudi (2012), the effectiveness of a country in strengthening their education system for Islamic finance depend on two factors which is education attractiveness and competitiveness. For the education attractiveness, it's about the ability of a country in order to attract the higher education courses to be invested in their territory. It is because, each of the country is competing each other to became the hub or centre for Islamic Finance education internationally. As for education competitiveness, it mainly about the ability of a country to penetrate the educational space outside it country.

2.5.2 Central Bank

Central Bank play an important roles in ensure the smoothness of the operation of all financial institutions under it supervision whether conventional or Islamic system. Liquidity is an indicator that been practices by Central Bank in order to measure the availability of money. Focusing on Primary liquidity that consist of free reserve (voluntary and involuntary), Central Bank used it as a precautionary for bank reserve and precautionary balance. It meant to control the overall money availability by both financial systems separately especially when the cash flow drained out from Central Bank.

2.5.3 Shariah Governance Body

On May 1997, Bank Negara Malaysia has established Shariah Advisory Council (SAC) that has the highest *shariah* authority on Islamic finance in Malaysia. According to Ismail *et al*. (2010), the main objective of SAC is to supervise, regulate and ascertainment of Islamic law that is related to the Islamic finance business and operation. In addition, it also acts as an advisor for the Bank Negara on the *shariah* matters and checked the compatibility of Islamic product especially on *Takaful* (insurance) and banking.

2.6 Other Contributions of Islamic Finance

2.6.1 Crisis Solution

The Islamic practice has added an essence to the economic stability by prohibit the adoption of riba, speculation and unfair transaction in the economic. As referring to Dewi & Ferdian (2010), prohibition of riba in Islamic finance practices would be solution for the financial crisis. It is because, conventional financial system have created a basis for the global financial crisis. As per claims by Chapra (2008), lack of monitoring and supervision in conventional financial system on market activities has created a disciplinary issue. In addition, there also uncontrollable lending and huge leverage contributed to the crisis. This financial crisis has solved the confusion on management and concept that circulated at every level of institutions, organization and product level as well. Therefore, by according to Ahmed (2009), if all the institutions followed the principles that has been underlines by the Islamic finance practices, it would prevented current global crisis from happening again in the future.

3.0 RESEARCH DESIGN AND METHODOLOGY

There are many methods that been use for the data analysis. However, previous researchers had used multiple regression analysis, first differences method, normality test, serial correlation test, and multicollinearity test.

3.1 Sample and Population

The sample for this paper is drawn from the annual data set of World Development Indicators through World Bank. Specifically, the sample included was Malaysia GDP per capita and trade openness data. For the GDP per capita, it is based on 2000 U.S.D constant price annual data. And for the trade openness, it is generated from the summing up of export and import of goods and services of Malaysia. For the data on financial openness, it is obtained from Lane & Milesi- Ferretti (2007), whereby it defined financial openness in term of GDP that has been transformed from country foreign asset and liabilities. By looking at this data, it is useful to measure the capital account openness of Malaysia. Lastly, for the data on the institutions and governance, it is obtained from World Governance Indicator (WGI). It is include all the interested independent variables which are political stability and absence of violence, government effectiveness, rules of law, and lastly regulatory quality. It also has been used by other previous researchers (Kaufmann, Kraay, & Mastruzzi, 2008).

3.2 Hypothesis

***H_1:** There is a positive relationship between trade openness and Islamic Financial Market Development for Malaysia.*
***H_2:** There is a positive relationship between rules of law with Islamic Financial Market Development for Malaysia.*

4.0 RESULTS AND DISCUSSION

4.1 Model: IFMD = β0 + β1GDP + β2TO + β3FO + β4PSAV + β6RL + β7RQ + ε

Variables	Coefficient	T-statistic
Constant	2.690	1.313
Gross Domestic Product	-0.180	-1.316
Trade Openness	0.913	3.875 ***
Financial Openness	0.180	0.681
Political Stability and Absence of Violence	-0.090	-1.030
Rules of Law	0.322	2.128 **
Regulatory Quality	0.306	1.562
R-Squared	0.639	
Adjusted R- squared	0.541	
F-statistic	6.504	
Prob (F-statistic)	0.000	
Breusch-Godfrey Serial Correlation LM tests	0.161	

Table: 4.1.1 (a) – Result of Multiple Regression Analysis & Serial Correlation LM Test

Based on the serial correlation LM test, there is no serial correlation exist in this model since the p-value is greater than 0.05. Then, the estimated results of OLS can be accepted as a final result. Based on this result, it shows that Trade Openness (TO) was significant at 1% with t-statistic of (3.875), and Rules of Law (RL) was significant at 5% with t-statistic of (2.128). TO with coefficient of 0.913 portrayed that, an increase in TO by 1%, Islamic Banking Asset will increase by 0.913%. Similarly, RL with coefficient of 0.322 meant that, an increase by 1% of RL will causes the Islamic Banking Asset to rise by 0.322%.

This result was aligned previous study by Law (2009), whereby there is positive impact from trade openness on financial development of a country. In addition, James (2008), said that, trade openness remove the trading barrier that in return promote a positive capital inflow to the nation. Through this capital inflow, more financial innovation and product can be created for better development. Rules of law also found to be supported by previous study. Rules of law is said to be important element in deciding the failure or success of a financial reforms. (Law & Habibullah, 2009). Unfortunately, Gross Domestic Product (GDP), Financial Openness (FO), Political Stability and Absence of Violence (PSAV), and Regulatory Quality (RQ) were not statistically significant at 5%. F-statistic is significant at 1% with adjusted R-squared of 0.541. Adjusted R-squared meant that, 54.1% of dependent variables were explained by independent variables.

4.1.1.3 Normality test;

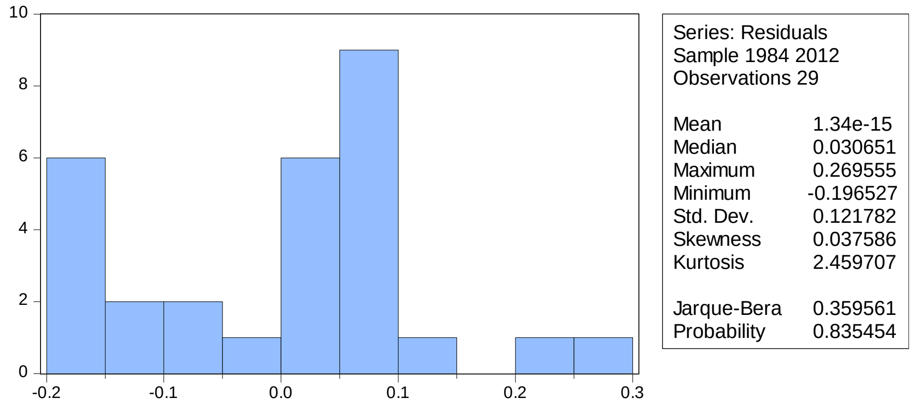

Table: 4.1.1 (c) – Result of Normality test

Normality test is done in order to see whether the data is normally distributed or not. According to this test, this data is normally distributed because the p-value is more than 0.05

4.1.1.4 Multicollinearity Test;

After estimating the model, 4 variables is not significant. Then it might have multicollinearity in the model. Multicollinearity arises when there is high correlation between two independent variables. It causes the significant variables become insignificant by increase the standard error. If standard error increases, the t-value will decrease and hence p-value will high. Then, particular variables become insignificant but in reality it was not.

	LGDP	LTO	LFO	LPSAV	LRL	LRQ
LGDP	1.000000	0.761009	0.876342	0.353115	-0.15769	0.474360
LTO	0.761009	1.000000	0.633064	0.566964	-0.31132	0.218674
LFO	0.876342	0.633064	1.000000	0.368860	0.019221	0.562482
LPSAV	0.353115	0.566964	0.368860	1.000000	0.031242	0.391248
LRL	-0.15769	-0.31132	0.019221	0.031242	1.000000	0.207385
LRQ	0.474360	0.218674	0.562482	0.391248	0.207385	1.000000

Table: 4.1.1 (d) – Result of Correlation Matrix

Variables	**Coefficient**	**T-statistic**
Constant	1.895	1.139
Gross Domestic Product	-0.115	-1.187
Trade Openness	0.915	3.930 ***
Political Stability and Absence of Violence	-0.089	-1.026
Rules of Law	0.347	2.387 **
Regulatory Quality	0.337	1.795
R-Squared	0.632	
Adjusted R- squared	0.552	
F-statistic	7.896	
Prob (F-statistic)	0.000	

Table: 4.1.1 (e) – Result of Multicollinearity test after drop FO

After run the correlation coefficient for all independent variables, its shows that, GDP and FO is highly correlated with 0.876%. Looking at the p-value, FO has high value than GDP, therefore it is decided that to drop FO from equation. Unfortunately, dropping FO from equation does not change the number of independent variables to become significant. Then we come to conclusion that, this model does not have multicollinearity problem because, based on the guideline, in order to have good model, most of the independent variables must be significant. (Williams, 2015).

5.0 CONCLUSION

Based on the result, TO and RL have significantly and positively relationship with development of Islamic financial market. The positive relationship is consistent with the hypothesis direction, and the significant associated with the financial development of Islamic finance has made the result strong enough to support hypothesis 1 and hypothesis 2. The positive relationship indicates that the more trade openness of a country, the more financial development will be. Similarly, with a well performed of enforcement of the rules and law in the Islamic finance, the more development in this sector will be.

This result is supported by the previous study by James (2008) and Anwar & Sun (2011), where the trade openness has make a significant contribution to the financial development of Malaysia through increasing pattern of foreign investment. On the other hand, rules of law also consistent with result from other researchers, whereby, legal institutions play an important role in contributed to the financial development system. (Ayadi, Arbak, Naceur & Groen, 2013). Then, it is believe that, trade openness and rules of law were two important mechanisms in contributing to Islamic financial development.

The other four variables namely, GDP, FO, PSAV, and RQ were found to be insignificant to the Islamic finance development. The coefficient of GDP is found to be negatively related, which meant the growth of nation will drop the Islamic finance development. It was different from the magnitude of hypothesis 1, where it should be positively related. It also contradicted with the literature where, according Anwar *et al*. (2011), positive relationship of bi-directional can be existed between the financial development and economic development.

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