EFFECT OF CREDIT CRUNCH ON BANKING INDUSTRY IN MALAYSIA

By Anita Neelakandan

ABSTRACT

The financial market turmoil in 2007 and 2008 has crept into the world economy leading to a credit crunch. Most studies have focused on the impact on lending activities, capital adequacy and bank supervision. However this study attempts to focus on the effect of credit crunch on the Malaysian Banking Industry in respect to **risk of bank failure** following the collapse of Bear Stearns, Lehman Brothers, and Washington Mutual.

This is crucial as money and credit markets are important sources of capital for banks. In a credit crunch where risk premiums have reached abnormally high levels in both markets, it will become more expensive and difficult for banks to obtain credit may lead to an unstable financial system. Large losses and write-downs requires banks to restore capital adequacy levels by raising new equity or by reducing debt which would result in reduced loan portfolio by adopting tighter credit standards. Unstable financial system will lead to bank failure.

This study adopts Estrella's model in utilizing two simple primary capital ratios i.e. leverage ratio and ratio of capital to gross revenue as predictors of bank failures in the short term (1-2 years). The sample comprises 7 local conventional banks, 7 foreign conventional banks and 7 Islamic banks in Malaysia.

The study also includes secondary ratios i.e ratios on Return on assets ratio and return on equity ratio to relate the ratios' volatility of earnings and rate of earnings to shareholders as a reflection of the global financial crisis.

The data collected is from secondary data published in the respective annual reports from 2006 to 2009. The mean, medium and standard deviation is computed using excel statistics.

Based on the findings above, Islamic banks in terms of leverage ratio and gross revenue ratio, Islamic banks are adequately capitalized and gross revenue ratio is more stable. This indicates low levels of risks leading to bank failure which is not impacted by the global financial crisis. Islamic banks displayed stability in returns on assets and return on equity.

Local conventional banks recorded a higher capital adequacy than Islamic banks. Local conventional banks also maintained higher gross revenue ratios than Islamic Banks. However, standard deviation for both ratios rose drastically displaying high levels of volatility arising from the risk impacted by the global financial crisis.

Foreign Conventional banks show highest capital adequacy compared to local conventional banks only. Foreign conventional banks gross revenue were riskier revenues compared to local conventional and Islamic banks. Return on assets ratio for Foreign Conventional Banks' indicated less riskier returns compared to local conventional banks indicating lower level of risk of bank failure. Return on equity ratio of Foreign Conventional banks displaying increasing levels of risk of bank failure impacted by the global financial crisis.

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