

**THE IMPACT OF FINANCIAL INNOVATIONS ON THE
FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN
MALAYSIA**

WONG WEN PENG

UNIVERSITI TEKNIKAL MALAYSIA MELAKA

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SIGNATURE :

NAME OF SUPERVISOR : DR. SITI NORBAYA BINTI YAHAYA

DATE :

SIGNATURE :

NAME OF PANEL : DR. NUSAIBAH BINTI MANSOR

DATE :

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WONG WEN PENG

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DECLARATION OF ORIGINAL WORK

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Signature :

Name : WONG WEN PENG

Date :

DEDICATION

I would like to dedicate the appreciation to beloved parents who supported me from spiritually and financially. A special thanks to my supervisor and panel who guided me through this research and thanks to my friends and respondents that helped and assisted me through the journey of research.

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ABSTRACT

The financial industry has undergone transformation over the past few years. Technological change happens rapidly in financial intermediation due to the advancements of information technology, telecommunication, and mobile technology. The outcomes of the revolution are the financial innovations. However, the effect of financial innovations to the financial performance of commercial banks in Malaysia is still suspicious due to insufficient understanding to the motivation of innovation and precious research been conduct in Malaysia to identify the impact of financial innovations on banks' financial performance. This study aims to identify the impact of financial innovations in Malaysia, which is the most significant financial innovation that influence the financial performance and evaluate the relationship between the financial innovations and the financial performance. This research adopted causal research design and primary data were collected by distributing questionnaires among the employees of different commercial banks in Malaysia. The data accumulated is then analyzed using Statistical Package for Social Science (SPSS).

Keywords: Financial Innovations, Financial performance, commercial banks in Malaysia

ABSTRAK

Industri kewangan telah mengalami perubahan sejak beberapa tahun yang lalu. Perubahan teknologi berlaku secara pantas dalam pengantaraan kewangan disebabkan oleh pencapaian yang maju dalam teknologi maklumat, telekomunikasi, dan teknologi mudah alih. Hasil daripada revolusi adalah inovasi kewangan. Walau bagaimanapun, kesan daripada inovasi kewangan terhadap prestasi kewangan bank perdagangan di Malaysia masih mencurigakan kerana pemahaman yang tidak mencukupi dan terhad penyelidikan berkaitan telah dijalankan di Malaysia untuk mengenal pasti kesan inovasi kewangan terhadap prestasi kewangan bank. Kajian ini bertujuan untuk mengenal pasti kesan inovasi kewangan di Malaysia, yang merupakan inovasi kewangan yang paling penting yang mempengaruhi prestasi kewangan dan menilai hubungan antara inovasi kewangan dan prestasi kewangan. Kajian ini menggunakan reka bentuk penyelidikan kausal dan data primer dikumpul dengan mengagihkan soal selidik di kalangan pekerja-pekerja bank perdagangan yang berbeza di Malaysia. Data terkumpul kemudian dianalisis dengan menggunakan Statistical Package for Social Science (SPSS).

Kata kunci: Inovasi Kewangan, Prestasi kewangan, Bank perdagangan di Malaysia

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LIST OF ABBREVIATIONS

ABBREVIATION	MEANING
ANOVA	Analysis of Variance
ATM	Auto Teller Machine
CFIT	Constraint-induced Financial Innovation Theory
DIT	Diffusion of Innovation Theory
EFT	Electronic Funds Transfer
IB	Internet Banking
ICT	Information Communication Technology
NIM	Net Interest Margin
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
R&D	Research and Development
SPSS	Statistical Package for Social Science

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CHAPTER 1

INTRODUCTION

1.0 Introduction

This chapter consisted of research background, further explanation of some keywords, the recent circumstances in specific industry that relevant to the study. This chapter also included the problem statement, research objective. The significant of study and research scope also constructed in this chapter.

1.1 Research Background

Innovation is vital for organizations nowadays and its extent of important keeps augmented over the time. The innovation is not only about new product development but encompassing the conversion of ideas into useful products, services that satisfy a specific needs and expectation of specific customers. Some organizations believe that innovation can bring them wealth. Innovation play important role in assisting firms to adapt with the environmental changes by adoption of potential innovations. Research also showing that majority of the innovation adoption is due to the need of organizations to cut costs, fulfillment to certain governmental laws and nurture efficiency. Innovations boost the

competitiveness of organizations within the market, the organizations that fail to innovate might substitute by better alternatives.

Innovations can be categorized into product innovations, process innovations, market innovations and financial innovations. Product innovations target to introduce novel products into the market; process innovations aim to enhance the process efficiency; market innovations focus on organizational market expansion. Financial innovations are the novel financial tools that tackle the problems faced by the financial institutions. The utilization of technologies that enable the bank to secure a competitive edge within the competitive financial market. Recently, the rise of microfinance and financial technology.

FinTech companies that offer similar banking service with a brand-new way, have threaten the stable position of the commercial banks, plus the banks also compete fiercely with each other (Schubert, 2015) introduced the top four challenges that the banking facing, which are insufficient profitability, rising of consumer expectation, increasing in competition from FinTech start-ups and regulatory pressure. Insufficient profitability happens because of banks fail to generate return on investment and equity that expected by the shareholders.

The sensible developments of a firm in launching a novel products or implementation of new production procedures is called innovations. Hence, innovation is modification in organization that produce new products and enhancement in service and production in outcomes. If a firm want to stay competitive in a market, the product quality and efficiency in production is crucial for it to improve. In brief, innovation enables new product development and improvement in production.

The innovation is counter challenges driven, which means it is created to encounter problems within an environment. It stables a firm position within a highly competitive market, since the competitors are good in imitating each other or even improve the imitated innovations that have better capabilities than the original innovations. Therefore,

innovation is common goals of every companies if they want to gain competitive advantage in the market.

The necessities to maintain performance and efficiency are vital in leading-edge organizations regardless in product-based business or service-based business. Not only the organization but even the countries need innovation to secure the competitiveness among the others. Therefore, innovation plays important roles among firms and countries in their competition. In this study, innovations not only vital in financial industry but also economy sectors as well. Thus, this research limited the study in financial innovations.

Expectation of consumer become a challenge due to banks fail to deliver the standard of service that consumers desire, especially the advancement of technology. FinTech companies also disrupting the traditional banking due to their flexibility in provide financial service and provide of better alternatives than what banks offer. Regulatory from the governments also pressure the banks to spend their budget in building operational systems that compatible with the regulations.

The financial service sector is not excluded from the innovation competition. The financial industry has undergone transformation over the past few years. Technological change happens rapidly in financial intermediation due to the advancements of information technology, telecommunication, and mobile technology. The outcomes of the revolution are the new financial products, cost reduction, risk reduction and better performance.

This research concerns on financial innovations which occurring rapidly in a large scale that driven by the technological advancement. Financial innovations were adopted to reduce or even eliminate the challenges in financial service sectors. Basically, financial innovations enhance the financial institutions and the whole financial market. Financial innovations are motivated by the advancement in telecommunication technologies. Therefore, financial innovations allow financial institution such as commercial bank to sustain in the financial market by improving the financial performance of the bank. The

competition is aggressive in the banking sector. Commercial banks have to compete with existing banks and other financial firms as well. Therefore, being innovative is unavoidable for a bank to grab a niche from the banking industry.

1.2 Research Problem

Despite the rapid transformation that the financial innovations contribute to the financial service sectors. However, the effect of financial innovations to the financial performance of commercial banks is still suspicious due to insufficient understanding to the motivation of innovation and precious research been conduct in Malaysia to identify the impact of financial innovations on banks' financial performance. In Kenya, numerous researches had been conducted to study the relationship between financial innovations and the banks financial performance. Although the importance of financial innovation to the bank performance in service is undeniable, the impact on bank profitability is remained misunderstood. Some researches argued that the positive outcomes of innovations are only in the growth of bank but not essential on the profitability and productivity. There is also research debated that only the large organizations will be beneficial from the innovations. Researchers discussed that the findings cannot be generalized as most of the researches only applicable on those selected banks. Conversely, research concluded that the innovations enhance financial performance of small banks in United States of America (USA) by appealing more consumers to those small banks. Research described that the financial innovations as the booster of economy in the financial service sectors.

Same situation is highlighted in Malaysia banking sectors. (The Star, 2018) reported that banks in Malaysia also experiencing transformation due to the increase of competition and technology disruption. However, banks are encountering with the problems of fraud and scams. The incident of WannaCry ransomware had led to rising of awareness toward the important of data security. Compromising on data protection will

make the banking sectors lost in trust and integrity. Nevertheless, bank competitors are vigorously seeking initiatives to improve their technological capability to meet consumer expectations. Failure to keep up with the customer expectation will put a business into danger position including banking service sector. Commercial banks in Malaysia also facing the pressure in customer attraction and retention. The initiatives of improving the marketing strategy and enhancing innovations should be taken. The banks also need to compliant their function and culture within their operation. High costs will be incurred due to the accountability that the banks have to responsible for the handling of financial crimes and terrorism financing.

1.3 Research Question

- i. What are the impacts of financial innovations on the financial performance of commercial banks in Malaysia?
- ii. What is the most significant financial innovations that influence the financial performance of commercial banks in Malaysia?
- iii. What are the relationships between financial innovation and the financial performance of commercial banks in Malaysia?

1.4 Research Objectives

The research objectives that developed based on the research questions are:

- i. To investigate the impact of financial innovations on the financial performance of commercial banks in Malaysia.
- ii. To identify the most significant financial innovations that influence the financial performance of commercial banks in Malaysia.

- iii. To assess the relationship between financial innovation and the financial performance of commercial banks in Malaysia.

1.5 Significant of Study

The researcher believes that this study is relevant to the following stakeholders: Firstly, the researchers and scholars can acquire information from this study, especially those who want to study about the impact of innovations toward financial performance in Malaysia. The discussions and arguments of this study will be referred by the researchers for their further research. Findings of this study may be a reference and guidance for them to continue the research of common interest.

The findings may also useful for financial institutions, especially the commercial banks that want to search for supportive initiatives and information about the financial innovations and their effect on financial performance. The relationship between the financial innovations and financial performance might be significant for commercial banks in making decision in investment of these financial innovations. At least, this study contributes a guidance for the top management in banks to enhance their performance through financial innovations.

This research also can contribute suggestions for government of Malaysia in searching for the potential innovations that can support the development of financial services industry and improve the financial evaluation and inclusion. This study also enables the policy makers such as Bank Negara Malaysia (BNM) can also use the information in this study to set rules controlling the internet banking, electronic funds transfer and mobile banking.

1.6 Scope of Study

This study investigated 26 licensed commercial banks that governed under Bank Negara Malaysia (BNM). The data were collected from the published financial reports and statements from BNM and respective commercial banks in Malaysia. This study will only consider the financial innovations of internet banking, electronic funds transfer and mobile banking. The financial performance of commercial banks was evaluated based on Return on Assets (ROA). The primary data will be gathered among the employees from commercial banks in Malaysia.

1.7 Limitation of Study

This study only examined the financial innovations in banking industry, which does not include the other financial institutions. Due to time and resource constraint, this research will only cover a part of the financial innovations which are internet banking, mobile banking and electronic funds transfer only.

1.8 Summary of the Chapter

This chapter presented the study on the impact of financial innovations on financial performance of commercial banks in Malaysia. The definition and means of financial innovations have been outlined as the enhancement for new financial products and process. The problem statement in commercial banks in Malaysia has also been highlighted.

CHAPTER 2

LITERATURE REVIEW

2.0 Introduction

This chapter revises critically on the related literature from the previous researches which is pertinent to this study. The relevant theoretical review will be identified and explained. Besides that, theories and models used by the researchers in the same study field will be related to the study within this chapter.

2.1 Financial Innovations

Chen (2018) defined financial innovations as the advancement of financial instruments and payment systems that apply in lending and borrowing of funds. This definition is even updated to incorporate the technology that help in managing risk, credit and equity generation. Financial innovations enable banks to increase credit for borrower and raise equity capital in a less cost way. financial innovations are described as the enhancement of financial products, or different ways in deliver financial services or new king of financial services.