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Determinants of Net Profit Margins in Foreign Islamic Banks: Evidence from Malaysia

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Abstract

This study investigates the determinants of the Net Profit Margins (NPM) of foreign Islamic banks in Malaysia between 2008 and 2022. Using the fixed-effects estimator technique, we find positive and significant effects of risk aversion, overhead cost, total assets, gross domestic product growth, and market share loan on the NPM of foreign Islamic banks. Conversely, higher total weighted risks, capital adequacy ratio, total loan, and inflation are found to negatively impact the NPM. The analysis clearly indicates that both internal and external factors significantly influence the profitability of foreign Islamic banks. This research highlights the critical role of effective management strategies in mitigating risks while ensuring profitability. The findings provide valuable guidance for Islamic banks, policymakers, and regulators in formulating strategies to enhance the performance and sustainability of foreign Islamic banks in Malaysia. These insights can also be leveraged to balance financial stability with long-term profitability in the sector.

Keywords: Islamic Banks, Foreign Islamic Banks, Malaysia, Interest Margin, Profitability

Introduction

Malaysia is one of the countries with the largest Islamic banking industry in the world. The Malaysian government and financial regulators have played a pivotal role in fostering the growth of this sector. One such initiative was the financial liberalization of the Islamic banking sector in 2004, with the issuance of three new Islamic banking licenses under the Islamic Banking Act 1983 (IBA) to Islamic financial institutions from the Middle East (Bank Negara Malaysia, 2006). This move aligns with the Financial Sector Masterplan (FSMP) recommendations to establish Malaysia as a globally recognized Islamic financial hub through the diversification of financial products and the entry of foreign players (Bank Negara Malaysia, 2004).

The entry of foreign Islamic banks, each bringing their unique expertise and strengths, is set to contribute to the expansion of the Islamic banking sector while simultaneously facilitating access to previously untapped markets in Malaysia. Furthermore, their presence is expected to promote healthy competition, a crucial element in driving the industry to higher levels of dynamism. To date, out of a total of sixteen Islamic banks operating in Malaysia, five are foreign institutions; namely, HSBC Amanah Malaysia Berhad, OCBC Al-Amin Bank Berhad, Standard Chartered Saadiq Berhad, Al-Rajhi Banking and Investment Corporation (Malaysia) Berhad, and Kuwait Finance House (Malaysia) Berhad.

These foreign Islamic banks function as intermediaries, facilitating the flow of funds from surplus units (savers) to deficit units (borrowers). As observed by Levine (1997), the development and performance of financial intermediaries are closely linked to a country's economic growth. This is because such intermediation supports the flow of capital within the economy, promoting both individual financial growth and broader economic development. In consequence there is a need for an efficient banking intermediary in the country. In this context, the Net Interest Margin (NIM) is widely used as a proxy to assess the efficiency of financial intermediaries (Dabla-Norris and Floerkemeier, 2007). However, NIM is generally applied to conventional banks, while Net Profit Margin (NPM) is the term used for Islamic banks.

Basically, an excessively high margin may reduce the competitiveness of banks and hinder the efficient allocation of funds between savers and borrowers, potentially restraining investment and economic growth (Khanh and Tra, 2015; Lisnawati and Novianty, 2022). Conversely, a low margin may enhance short-term competitiveness through attracting borrowers, but could undermine financial sustainability, reduce deposit attraction, and restrict the bank's capacity to support long-term economic growth (Sun et al., 2014; Malim & Normalini, 2018). The trend of margins in foreign Islamic banks operating in Malaysia is shown in Figure 1.

Figure 1: Percentage Net Profit Margin (NPM) of Foreign Islamic Banks (2008-2022)

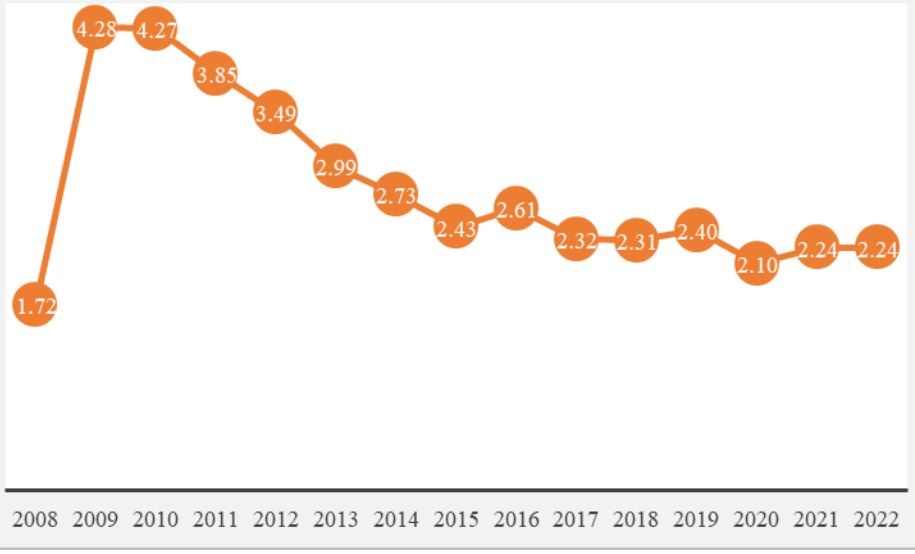

Figure 1 above illustrates the average NPM of foreign Islamic banks in Malaysia from 2008 to 2022. In 2008, the reported NPM was 1.72%. A sharp increase was observed in 2009, with NPM reaching 4.28%, followed by a slight decline in 2010 to 4.27%. However, by 2011 the figure dropped to 3.85%, decreasing further to 3.49% in 2012. The NPM in 2021 and 2022 registered at 2.24%. It should also be highlighted that from 2017 onwards, the NPM appears to have stabilized at a lower level, fluctuating between 2.10% to 2.40%. This suggests that the banks may have adjusted to a lower interest margin environment, or that the economic conditions have compelled them to operate with reduced profitability. This trend also highlights the challenges banks face in maintaining profitability while managing the balance between the rates charged on financing and the rates paid on deposits.

In this context, it is crucial to examine the determinants of NPM for foreign Islamic banks so that bank management can achieve optimal profitability, which in turn supports their sustainability. Furthermore, while numerous studies related to NIM of foreign conventional banks abound, research on the NPM of foreign Islamic banks was rather limited. Although several studies, such as those by Sufian (2006), Kamaruddin et al (2008), Sufian (2010), and Abdul-Majid and Hassan (2011), have examined foreign Islamic banks in the Malaysian banking sector, none have addressed the determinants of profit margins of these banks.

Previous studies on the NPM of Malaysian Islamic banks include Salleh et al (2021), which focused on the determinants of NPM for Islamic banks in Malaysia. Earlier, Salleh et al. (2018) examined the determinants of NPM for subsidiary Islamic banks in Malaysia. This study will thus contribute to the current literature by exploring the determinants of profit margins of foreign Islamic banks in Malaysia. The findings of this study will provide valuable insights for policymakers, industry practitioners, and academics alike. The organisation of this study is as follows. Section 1 reviews the literature related to the interest margins for both conventional and Islamic banks, followed by a review of the literature on foreign banks in Section 2. Section 3 and 4 present the methodology, results, and discussion, respectively, while the last section provides the conclusion.

Foreign Bank and Interest Margins

Demirguc-Kunt and Huizinga (1999), who focused on the banking sectors of 80 countries during the 1988-1995 period, found that in developing countries, foreign banks exceed domestic ones not only in generating higher profits but also in charging higher NIM. However, in industrialized countries, domestic banks were reported to have higher NIM than foreign banks. According to the authors, foreign banks in developing countries have the technological advantages that help them reduce information asymmetry. In Kenya, Tarus *et al* (2012), found that foreign banks tended to reduce NIM due to their greater efficiency, especially between 2000 and 2009. The study observed that foreign banks had a significant concentration in the Kenyan banking sector.

Peria and Mody (2004), focusing on five Latin American countries, found that domestic banks charged higher NIM than foreign banks. Their study differentiated between foreign banks established through the acquisition of domestic banks and de novo foreign banks. The latter, in order to capture a larger market share, tended to charge lower NIM while foreign banks established via acquisition charged higher. In a study by Trinugroho *et al.* (2014),

foreign banks were found to offer the lowest NIM as compared to the state-owned banks and private domestic banks. State-owned banks recorded the highest NIM, followed by private domestic banks. The result applied to the Indonesian banking sector during the 2001-2009 period, following the post-1997 financial crisis.

Claessens *et al* (2001), investigated the impacts of foreign bank presence on the NIM of domestic banks in 80 countries over the same period, 1988-1995. The study revealed that the entry of foreign banks influenced the reduction in NIM of domestic banks, which tended to increase their efficiency and lower overhead costs in response to the foreign competition. In high-income countries, foreign banks were reported to have higher NIM, in contrast to low- and lower-middle-income countries.

Claeys and Vennet (2008), measured the impact of foreign banks through examining the number of foreign banks operating in the country. They discovered that a higher number of foreign banks tends to lead to lower NIM, indicating a spillover effect from the presence of foreign banks. Claeys and Hainz (2006), similarly found a negative impact of foreign banks on NIM, in the Eastern European countries. They attributed this to the risk appetite of foreign banks, which mainly focus on customers with good credit ratings.

Drakos (2003), focused on the Central and Eastern European Countries (CEECs) and the Former Soviet Union countries (FSU) during the period 1993-1999. Both regions have experienced financial reform, and this has led to the reduction in the NIM. The impact of foreign banks on NIM reduction was more significant in CEECs countries, given that the banks have been long-established and were larger in size compared to those in the FSU.

In comparison to other studies, Schwaiger and Liebeg (2008), and Tan (2012), found positive correlations between foreign banks and NIM. Schwaiger and Liebeg (2008) examined NIM between 2000 and 2005 for 11 CEECs and showed a positive relationship between foreign ownership and NIM. Tan (2012) similarly found that foreign ownership had a positive impact on NIM. In addition, Bouzgarrou *et al.* (2018), in their study on 170 French commercial banks between 2000 and 2012, revealed that foreign banks in France charged higher NIMs compared to domestic banks.

Conversely, in Armenia, Dabla-Norris and Floerkemeier (2007) showed no correlation between foreign banks and NIM in the country. Another study by Poghosyan (2010), who examined the CEECs between 1995 and 2006, also yielded non-significant results. The study suggests no significant impact on NIM following foreign bank participation in the host markets, even though there was a substantial increase in the number of foreign banks during that period. Hussain (2014), who studied banking institutions in Pakistan, using time series data and pooled least squares estimates, concluded that foreign ownership had a positive but non-significant impact on NIM.

Methodology

The method of quantitative analysis was employed in this research. Secondary data from financial bank statements, utilized in this study, were sourced from various platforms such as annual reports, FitchConnect database and World Development Indicators (WDI) spanning 15 years from 2008 to 2022. Five foreign Islamic banks were focused on in this

research; namely HSBC Amanah Malaysia Berhad, OCBC Al-Amin Bank Berhad, Standard Chartered Saadiq Berhad, Al-Rajhi Banking and Investment Corporation (Malaysia) Berhad and Kuwait Finance House (Malaysia) Berhad. Table 1 below shows the variable name, variable definition and unit measurement for all variables used in these studies.

Table 1
List of Variables

Variable name	Variables Definition	Unit Measure
Net Profit Margin (NPM)	(Net Financing Income/Total Asset Earning) multiply 100	Percentage
RiskAversion (RA)	(Total Equity/Total Asset) multiply 100	Percentage
OverheadCost (OHC)	(Operating cost/Total Assets) multiply 100	Percentage
TotalLoan (lnLoan)	Logarithm Total Loan	Logarithm value
Market Share Loan (MSL)	Total Loan bank i/ total loan j multiply 100	Percentage
Cap Ratio (CAP)	Tier 1 capital/total risk weight Asset multiply 100	Percentage
Total Weighted Risks (TWR)	Tier 1 + Tier 2 Capital / Capital adequacy ratio multiply 100	Percentage
Total Asset (InTA)	Logarithm Total Asset	Logarithm value
Growth rate (GDPG)	Percentage change of GDP multiple 100	Percentage
Inflation (Inf)	Percentage change of Consumer prices Index multiply 100	Percentage

Model Specification

Many empirical studies on bank interest margin determinants are frequently based on the theoretical framework of the dealership model, introduced by Ho and Saunders (1981) and subsequently extended by Allen (1988), Angbazo (1997), Maudos and Fernandez de Guevara (2004). In this study, we also estimate the dealership model using a fixed effect estimator to account for unobserved heterogeneity at the individual bank level in the case of foreign Islamic banks in Malaysia. The model specification in this paper is adopted from previous studies conducted by Abdeljawad and Bahlaq (2023) and Obeid (2024). The model can be expressed as Equation (1) below:

$$NPM_{it} = \beta 0 + \beta_1 RA_{it} + \beta_2 OHC_{it} + \beta_3 lnloan_{it} + \beta_4 MSL_{it} + \beta_5 Cap_{it} + \beta_6 TWR_{it} + \beta_7 lnTA_{it} + \beta_8 GDPG_{it} + \beta_9 Inf_{it} + \mu_i + \lambda_t + \varepsilon_{it} \quad (1)$$

Where i and t denote the number of banks, i= 1,…..N and time t=1,…,T respectively. The variable NPM_{it} represents the earnings per asset measure in percentage for bank i at time t, RA_{it} represents the percentage of the risk aversion for bank i at time t, OHC_{it} represents the percentage of overhead costs for bank i at time t, $lnLoan_{it}$ represents the logarithm of total loans by bank i at time t, MSL_{it} is percentage of market share of bank i at time t, Cap_{it} is the percentage of the capital ratio of bank i at time t, TWR_{it} represents the percentage of total weighted risk for bank i at time t, and $lnTA_{it}$ refers to the logarithm of total assets of bank i at time t. In addition to Equation (1), β_0 is a constant, β_1… β_9 are unknown parameters to be estimated, μ_i is an individual-specific random effect component differing across of country i,

λ_t is an individual-specific random error component of temporal effects across time t, and ε_{it} is the remainder error term or idiosyncratic random term (Bhaumik, 2015) that fulfil assumption N~(0, σ^2). These assumptions imply that individual error components are neither correlated with each other nor correlated across banks and time series.

Model Selection

For estimation, we employed pooled regression, random effects, and fixed effects models. To determine the most appropriate approach, statistical tests were applied between two techniques. The first technique was the Redundant F-statistic, used to compare the pooled model with the fixed effect model (Chow, 1960), while the second technique employed the Hausman test to differentiate between the random and the fixed effect models (Hausman, 1978). The null hypotheses (Ho) for the redundant test suggests that the pooled model is valid, whereas the alternative hypothesis (H1) posits that the fixed effect model is a more suitable option. The latter is chosen when the test statistic exceeds the critical F-value; conversely however, the pooled model will be considered as being more appropriate.

The second technique conducts tests to choose between the fixed effect model and the random effect model. The null hypothesis (Ho) assumes that both the FEM and REM are consistent, but FEM is inefficient. The alternative hypothesis (H1) posits that FEM is both consistent and efficient, whereas REM is inconsistent. When the Hausman statistic is greater, or the p-value is below 5%, the random effects model is not applicable and is rejected in favour of the fixed effect model. However, if the error terms are correlated and exceed zero, the FEM is not appropriate, since their inferences may be inefficient, and REM is thus a better option to consider. This is because the composite error term consists of two components; the country component (i) and the series and country error component (it), as shown in Equation (1). In consequence, the Generalized Least Squares (GLS) estimator technique is an appropriate strategy for solving the correlation among the composite error terms, yielding a Best Linear Unbiased Estimator (BLUE).

Result and Discussion

Table 2
Variables Descriptive

Variables Name	Mean	Maximum	Minimum	Std. Deviation
NPM	2.798	6.446	0.303	1.086
RA	10.707	23.540	3.770	4.465
OHC	1.624	2.752	0.153	0.535
InLoan	15.589	16.464	14.129	0.530
MSL	2.059	6.505	0.480	1.074
CAP	16.371	41.100	6.560	6.456
TWR	11.310	16.510	7.120	3.538
InTA	16.050	16.914	15.133	0.446
GDPG	4.220	8.700	-5.500	3.380
Inf	2.115	5.400	-1.140	1.532

Table 2 presents the descriptive statistics for all data used in this empirical study on foreign Islamic banks in Malaysia. The mean NPM is 2.798%, with values ranging from 0.303% to 6.446%. The mean risk aversion score is 10.707, ranging from 3.770 to 23.540. TWR

represents an internal risk measure related to the bank's operations or assets with a mean score of 11.310, ranging from 7.120 to 16.510. The mean value of the OHC variable is 1.624 %, ranging from 0.153% to 2.752%. CAP, which measures the bank's capital as a percentage of its risk-weighted assets, has a mean value of 16.371%, ranging from 6.560% to 41.100%. The InTA variable has a mean of 16.050%, ranging from 15.133% to 16.914%. The InTloan variable has a mean score of 15.589, ranging from 14.129 to 16.464. Meanwhile, the MSL mean value is 2.059%, ranging from 0.480% to 6.505%. For macroeconomics indicators, the average Inf rate is 2.115%, with a range from -1.140% to 5.400% while the average GDP growth rate is 4.220%, with values ranging between -5.500% to 8.700%.

Table 3
Correlation

Exogenous Variables	Dependent Variable (NPM)
RA	0.113
OHC	0.302**
InLoan	-0.269**
MSL	0.218*
CAP	-0.023
TWR	-0.382**
InTA	-0.243**
GDPG	0.016
Inf	-0.167

Note: asterisk *, ** is level of significant 10% and 5%

Table 3 presents the results of correlation test between NPM and explanatory variables in this study. The empirical correlations indicate mixed relationships (both positive and negative) across Islamic foreign banks in Malaysia. Initial results suggest that the NPM is positively correlated with variables such as RA, OHC, MSL and GDPG. The RA variable exhibits a positive but weak correlation with NPM and is not statistically significant at the 10% level. In comparison, OHC exhibits a moderate positive correlation with NPM, which is significant at the 5% level, suggesting that higher OHC may impact NPM positively. Similarly, MSL shows positive correlation with NPM and is statistically significant at the 10% level. However, GDPG shows a very weak growth rate and negligible positive correlation with NPM, which was not significant at the 10% level.

Conversely, the results indicate that the NPM is negatively correlated with explanatory variables such as TWR, CAP, InTA, InTloan and Inf. TWR shows a moderate negative correlation with NPM and is statistically significant at the 5% level, indicating that higher TWR is associated with lower NPM. CAP shows a very weak and negligible negative correlation with NPM and is not statistically significant. InTA exhibits a moderate negative correlation with NPM and is statistically significant at the 5% level, indicating that a higher total asset value may negatively impact NPM. InTLoan similarly exhibits a moderate negative correlation with NPM and is also statistically significant at the 5% level, indicating that higher loan levels may negatively impact NPM. Lastly, the Inf variable shows a negative correlation with NPM and is not statistically significant at the 10% level.

Table 4
Results of FEM for NPM Model

Exogenous Variable	Coefficients	Standard Error	Probability
Constant	-5.733	3.980	0.155
RA	0.262**	0.086	0.004
OHC	1.320**	0.240	0.000
InTLoan	-2.496**	0.880	0.006
MSL	0.223**	0.065	0.001
CAP	-0.061*	0.034	0.073
TWR	-0.057**	0.027	0.040
InTA	2.731**	0.885	0.003
GDPG	0.068**	0.026	0.011
Inf	-0.204**	0.062	0.001
	Model Goodness of Fit Criteria		
R^2		0.663	
Adjusted R^2		0.579	
F-Statistic		8.830 [0.000]**	
Number of banks		5	
Number of Observations		75	
Testing Model Selection in Panel Data			
Redundant Fix Effect Test		10.115 [0.000]**	
Hausman Test		17.524 [0.014]**	
Number of banks		5	

Note: The dependent variable is the NPM. Estimation using the Fix effects estimator. asterisk *, ** is level of significant 10% and 5%. Huber-White Sanwish estimator for remedial autocorrelation and heteroskedasticity problem in FEM results.

Table 4 displays the result of the Fixed Effect Model (FEM) estimation, which is deemed more suitable for the data compared to the pooled model or even the random effects model, as indicated by the Redundant F-test (F-value = 10.115; p-value = 0.000) and Hausman test (Chi-square = 17.524; p-value = 0.014), both being significant at the 5% level. The R^2 value of 0.663 shows that approximately 66.3% of the variability in NPM is explained by the independent variables in the FEM, indicating a good fit. The adjusted R^2 value of 0.579 indicates that after considering for the number of predictor variables, this model accounts for 57.9% of the variability in NPM. The significant F-statistic (8.830, p-value = 0.000) suggests that the overall regression model is statistically significant, meaning that at least one coefficient in the model is not equal to zero. We can thus conclude that the FEM is a good fit for the data. The following is an explanation of the main factors that contribute to the NPM of foreign Islamic banks that have been operating in Malaysia.

One of the important factors influencing NPM is RA. The coefficient of this variable has a positive effect and is statistically significant at the 5% level (p-value = 0.004). This finding suggests that, on average, a 1.000% increase in RA is associated with 0.262% increase in NPM, other variables being constant. When a bank operates at a higher level of risk-aversion, it

means that it prefers to function with a higher proportion of equity relative to debt. As such, banks may need to compensate shareholders for higher-risk banking operations with higher NPM. This positive relationship is consistent with past studies by Hutapea and Kasri (2010), Poghosyan (2011), Kumari (2014), Trinugroho et al. (2014) and Salleh (2021) .

OHC is another significant factor influencing NPM. Coefficient results show a positive and highly statistically significant effect on NPM (p-value < 0.001). This finding indicates that a 1.00% increase in OHC is associated with a 1.32% increase in NPM, assuming other variables being constant. Foreign Islamic banks tend to pass overhead costs on to customers through higher NPM. This explains that these banks tend to adjust their pricing strategies in order to accommodate overhead costs while sustaining or enhancing their profitability. Efficient management of operational costs is, therefore, crucial for profitability in the Islamic banking sector. This positive relationship supported findings in previous studies by (Sun et al. 2014; Lee and Isa 2017), Malim and Normalini (2018), Salleh (2021) and Salleh (2018).

By contrast, InTLoan exerts a negative and statistically significant impact on NPM (p-value = 0.006). A one-unit increase in InTLoan is associated with a decrease of 2.496 in NPM, other variables being constant. Previous research by as Kasman et al (2010), Maudos and de Guevara (2004), and Hawtrey and Liang (2008), similarly found a negative correlation between loan size and NPM. However, Afanasieff et al (2002), and Almarzoqi and Naceur (2015), reported contradicting results, indicating that larger loans potentially lead to higher risk exposure and loss. In consequence, risk-averse banks tend to increase their NPM.

Another important factor is MSL, which exerts a positive and statistically significant impact on NPM (p-value = 0.001). This indicates that, on average, a one-unit increase in MSL is associated with a 0.223 increase in NPM, other variables being constant. This positive relationship suggests that as banks increase their share of the loan market, they are able to improve pricing power, and manage interest margins more effectively, thereby boosting profitability. The results highlight the importance of effective market share management in enhancing profitability as previously suggested by (Marinkovic and Radovic, 2014; Maudos and de Guevara, 2004; and Maudos and Solís, 2009).

The results also highlight the impact of CAP, which shows a negative relationship with NPM, with a marginally significant effect (p-value = 0.073) at the 10% significance level. On average, a 1.00% increase in CAP corresponds to a 0.06% decrease in NPM, other variables being constant. This negative impact suggests that when banks increase their larger capital to enhance financial stability and safeguard against potential losses, they face an opportunity cost through underutilizing their capital for investment and lending, thereby reducing overall profitability. This conclusion aligns with those of previous studies by (Sunaryo 2020; and Lisnawati & Amirullah, 2022) who also observed that higher CAP tends to reduce profitability, as it reduces the bank's lending capacity.

TWR demonstrates a negative and statistically significant effect on NPM at the 5% significance level (p-value = 0.040). Specifically, a 1% increase in TWR is associated with an average annual decrease of 0.057% in NPM, assuming all other variables in the model remain constant. An increase in a bank's TWR indicates a greater proportion of riskier assets in its portfolio. In essence, when the TWR increases, NPM tends to decline due to the higher capital

reserves required to cover potential losses, which restricts the banks ability to generate profits. In addition, a higher TWR can impact a bank's cost of capital, as investors and creditors may seek higher returns to offset the increased risk. This demand can exert additional pressure on the NPM. These findings are consistent with Ina Zakiah and Herlina (2024), highlighting the importance of effective risk management strategies that comply with regulatory requirements while also optimizing the bank's asset portfolio to maintain or enhance profitability.

Meanwhile, InTA has a positive and statistically significant effect on NPM (p-value = 0.003). A one-unit increase in InTA is associated with a 2.731 increase in NPM, assuming other variables are constant. Since the results are not negative, it is possible that the economies of scale was not influential. However, it can be suggested that the positive correlation implies that foreign Islamic banks engaging in large-scale transactions may impose higher levels of risk, which consequently results in a higher NPM (Sufian & Hassan, 2012; Tan, 2012). This finding corroborates previous studies by (Sufian and Hasan 2012; Sun et al. 2014; Das 2013; Aboagye et al., 2008; and Salleh, 2018).

The first macroeconomic variable, GDPG, has a positive and statistically significant impact on NPM (p-value = 0.011). On average 1.000 % increase in GDPG is associated with a 0.068 % increase in NPM, other variables being constant. GDP growth signifies an expanding economy, which results in increased business activities. Banks can enhance their profitability by increasing the financing interest rates during periods of economic prosperity since the risk of default is reduced. Healthy economies tend to elevate financing demands, subsequently leading to higher loan rates and interest margins (Claessens et al., 2001; Sufian & Hassan, 2012). The positive relationship is corroborated by the findings of (Trinugroho et al., 2018; Schwaiger 2013; and Sufian and Hasan, 2012).

On the other hand, the second macroeconomic variable, inflation (Inf), has a negative and statistically significant effect on NIM at the 5% significance level (p-value = 0.001). It can be concluded from the result that a 1.000% increase in inflation corresponds with a 0.204% decrease in NPM, with other factors being constant. Inflation induces uncertainty and reduces financing demands in the market. In consequence, Islamic banks tend to lower their NPM in order to stimulate financing demands (Naceur & Kandil, 2009). This finding is in line with those of (Naceur and Kandil 2009; Naceur and Omran 2011; and Ongore and Kusa, 2013).

Conclusion

This paper presents empirical findings on the effects of macroeconomic and bank-specific factors on the NPM of foreign Islamic banks in Malaysia. The study selected a sample of five foreign Islamic banks operating in the country, utilizing data from 2008 to 2022. Results from the fixed-effects model analysis revealed a positive and significant relationship at the 5% significance level between NPM and variables such as RA, OHC, lnTA, MSL, and GDPG. Conversely, the impacts of other variables such as TWR, CAP, Inf, and lnTloan are statistically significant but negatively correlated.

The findings highlight the importance of careful management of capital to maintain a balance between financial stability and profitability. This involves setting capital thresholds that not only comply with regulatory standards but also foster the generation of sustainable

profits. Furthermore, the significant positive impact of MSL on NPM emphasizes the critical role of robust market share strategies in enhancing financial performance within the banking sector.

Ultimately, the positive correlation between GDP growth and NPM underscores the importance for policymakers and business leaders to foster economic conditions that enhance bank profitability and support sustainable growth. Banks must also respond swiftly to inflationary pressures to safeguard their NPM and maintain stability. Thus, these findings underscore significant policy implications for foreign Islamic banks, advising them to incorporate default probabilities accurately into their interest margin calculations. Future research may consider extending the model by incorporating additional explanatory variables, such as other industry-level factors, corporate governance variables, corporate tax and deposit insurance. Although this may not yield immediate insights into existing literature, it offers a promising area for further exploration.

This study makes a significant theoretical contribution by enhancing the understanding of the factors that influence profitability in the Islamic banking sector, particularly for foreign Islamic banks operating in different regulatory and competitive environments. By focusing on NPM determinants specific to foreign Islamic banks, this study enriches and expands the theoretical framework on bank profitability, adapting it to the distinct principles of Islamic finance. Guided by Shariah principles that prohibit interest and emphasize ethical dealings, the study demonstrates the application of established theories of risk, capital management, and operational efficiency within a Shariah-compliant framework. This adaptation broadens the relevance and applicability of these theories to Islamic financial institutions, particularly foreign Islamic banks.

Additionally, this research has important contextual implications for Malaysia, which is currently a global hub for Islamic finance. Foreign Islamic banks in Malaysia operate in a unique environment shaped by both local legislation and competitive dynamics. This study analyzes the main internal and external factors that influence their profitability. The findings offer practical insights for policymakers and industry stakeholders, supporting informed decisions that promote the sustainability and growth of foreign Islamic banks in Malaysia. Furthermore, the findings support the integration of foreign Islamic banks into the Malaysian banking sector to implement policies and strategies to contribute to the financial ecosystem. The research also opens avenues for further studies in comparable markets within Southeast Asia by providing empirical insights specific to Malaysia.

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