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The Profitability of Islamic and Conventional Bank: Case study in Malaysia

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Abstract

This study aims to analyze the profitability in Islamic Banks and Conventional Banks in Malaysia. The study uses the period of the year 2006 to until the year 2011. In methodology, this research using T-Test Model, Regression and Correlation.Meanwhile, data are collected from the Bursa Malaysia and bank website in Malaysia. This study finds that Islamic Banks are more profitable than Conventional Banks whereas Total Loan to Total Asset for Islamic bank is higher than Conventional bank. Based on Regression test, for Conventional Banks, ROE is an influence profitability of Conventional Bank.and for Islamic Banks, ROA and ROE are significant factor that influence profitability. Based on Correlation test, ROE is an influence profitability of Conventional Bank and for Islamic Banks, ROA and ROE are significant relationship with independent variable which is Total Equity to Total Asset.

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Keywords: Profitability, Conventional Banks, Islamic Banks, T-Test, regression, Malaysia

1. Introduction

The world's banking system around the two types of banks. The one is interest-based banking system called as the conventional banking system and the other is an interest-free banking system called as the Islamic banking system. Islamic banks and conventional banks both create competition among themselves to satisfy customers and fulfill their expectations and long term benefits for the economy. The conventional banks and the Islamic banks are differentiated commonly on the basis of their goals, riba and risk sharing practices. The Islamic banking was first introduced in

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Malaysia in 1983. Since more than 50% of the population in Malaysia is made up of Muslims, the Islamic banking system which subscribes to Syariah principles is provided to operate alongside the conventional banking system. This is to provide an alternative to the customers for conducting commercial banking transactions. To regulate Islamic banking, the Islamic Banking Act 1983 was legislated and came into effect on April 7, 1983. There are 17 Islamic banks operating in Malaysia. (Bank Negara Malaysia, 2007).

Among them are fully fledged Islamic banking institutions, namely Bank Islam (M) Bhd, Bank Muamalat (M) Bhd and Bank Kerjasama Rakyat Malaysia Bhd. A few of them are from international Islamic banks e.g. Al Rajhi Bank, Kuwait Finance House and some are divisions of the nine domestic groups operating in Malaysia also offer Islamic banking products and services under the Islamic Banking Scheme (IBS banks).

The banking sector in Malaysia, practiced dual banking system, i.e. conventional and Islamic banking systems. Malaysia has nine major domestic banks and 13 foreign banks in its conventional banking sector. Parallel to the conventional banking sector is the Islamic banking sector. It is reported that, four stands out as market leaders (Malayan Banking, CIMB, Public Bank and RHB Bank) and they have together captured a 70% market share in the conventional market. (Bank Negara Malaysia, 2007). The main focus of this study is to look into whether the performance of Islamic Banks is different from the Conventional Banks with respect to profitability. The first objective is to analyze the profitability in Islamic Banks and Conventional Banks. The second objectiveis to identify the factors that influence the profitability of Islamic Banks and Conventional Banks.

2. Literature review

International Association of Islamic Banks (IAIB) defined the Islamic banking as “the Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic Shariah in the fields of finance and other dealings. Therefore, the point is obviously clear that Islamic banking differentiate from conventional banking in terms and conditions of its mission and objectives and duties toward society. The Islamic bank takes all these duties and responsibilities greater than conventional banks, (Hassan & Adnan, 1998). Conventional banking is fundamentally based on the debtor-creditor relationship between the depositors and the bank on the one hand and between the borrowers and the bank on the other, with interest as the price of credit, that reflect the opportunity cost of money.

Bashir (2000) examined the performance of Islamic Banks in the Middle-Eastern region between 1993 and 1998. To measure profitability, he used Non-Interest Margin (NIM), Before Tax Profit (BTP), Return on Assets (ROA), and Return on Equity (ROE). The results confirm previous findings and show that Islamic Banks’ profitability is positively related to equity and loans. The results also indicate that favorable macroeconomic conditions positively impact profitability.

According to, Hassoune (2002) examined the Islamic bank profitability in an interest rate cycle. This paper states that Islamic banks operate on a profit and loss sharing basis compared to conventional bank's operations which are based on interest. Hassoune also compares ROE and ROA Volatility for both Islamic and conventional banks in three GCC region, Kuwait, Saudi Arabia, and Qatar. He states that since Islamic banking is based on profit and loss sharing, managements have to generate sufficient returns for investors given that they are not willing accept no returns (Hassoune, 2002).

According to Sanullah Ansari and Atiqa Rehman (2010) the performance of first Islamic bank in Pakistan i.e. Meezan bank was compared with a group of 5 conventional banks. The study evaluated the performance in terms of profitability, liquidity, risk, and efficiency for the period of 2003-2007. Twelve financial ratios such as Return on Asset (ROA), Return on Equity (ROE), Loan to Deposit ratio (LDR), Loan to Assets ratio (LAR), Debt to Equity ratio (DER), Asset Utilization (AU), and Income to Expense ratio (IER) were used as variables to assess banking performances. T-test and F-test were used to measure the significance difference of these Performances. The study found that MBL is less profitable, more solvent (less risky), and also less efficient comparing to the average of the 5 Conventional banks. However, there was no significant difference in liquidity between the two sets of bank (Moin, 2008). Islamic bank business development framework is not working efficiently as compared to conventional banks (Farrooq, 2007).

In addition to the studies that had been done, Mahmood (2005), by using banks in Pakistan as a case study, compared the financial performance of Islamic banking against conventional banking. He found that, almost in all ratios, Islamic banks were superior to conventional banks during the four year period, from 2000 to 2004. Similar studies in other Middle East countries were also conducted, as evident in the research of Kader, et al. (2007), where comparative financial performance of Islamic banks and conventional banks in the UAE was also examined. The