

Islamic Banking Vs Conventional Banking in Malaysia

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ABSTRACT: *The Islamic banking system is a newly developing financial system, which is an effective alternative to the conventional banking system. There is very little awareness of its distinguished structure and services that the Islamic banks offer. While mainly Muslim countries have adopted the Islamic banking system, there exists a dual-banking system in Malaysia where Islamic banking and conventional banking function in a parallel manner. In this study, we have presented the distinguished features of the Islamic banking system and have done a comparative analysis of their financial performance with that of Conventional banks in Malaysia. The comparative analysis is based on key financial ratios that are tested using independent sample t-test and correlational analysis. The key ratios cover the profitability, liquidity and risk coverage aspects of banking.*

KEYWORDS: *Islamic Banks, Conventional Banks, Financial Ratios, Profitability, Risk Coverage, Liquidity.*

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I. INTRODUCTION

All around the world, there are different banking systems in various countries but the most popular and used ones are conventional banking and the Islamic banking. Islamic banking is a finance management system based on the Islamic rules of Shariah. It is based on the Quran and the Hadith, the recorded sayings, and actions of the Prophet Muhammad (PBUH). The bankers ensure their ideas do not deviate from fundamental principles of the Quran. The main concept of Islamic banking is the prohibition on collection of interest and its utilization for the business purposes. Banking in Islam is a saving money framework that depends on the principles of Islamic law, also known as Shariah law, and guided by Islamic financial matters.

Differences between Conventional Banking and Islamic Banking:

Basis of distinction	Conventional Banking	Islamic Banking
Functions and operations	Its functions and operations follow man-made laws and rules.	Its functions and operations follow the Shariah law as mentioned in the Quran.
Charge of Interest	Interest is charged by banks on loans granted to customers.	Riba based loan activities are forbidden under this system.
Variability of Return	Interest income on loans granted to customers is fixed.	Returns in form of profit sharing varies with the profits made by borrowing entities.
Aim	The aim is to make profits without any religious or moral boundaries.	The aim is to make profits with adherence to Islamic laws and principles.
Zakat (Charity)	Ignores the concept of Zakat	Payment of Zakat is a social responsibility duly undertaken by Islamic banks.
Revenue Earning	Revenue is earned in form of fixed interest charges.	Revenue is the profits shared by performing entity in the predetermined proportion.
Loans are granted for all legal activities.	Purpose of borrowing	Various activities related to alcohol, pork, gambling, drugs, etc. are prohibited and hence not funded.

II. LITERATURE REVIEW

- **A study on Islamic banking education and strategy for the new millennium-Malaysian experience.**(Nordin & Mohd, 2001)

After analysis of the paperit was found that some concerns of the banking industry include a vast number of players, broad variety of instruments and interbank market competition. Bank Islam Malaysia Berhad (BIMB) used in-house training, consultancy, seminar and conferences, educational programme to educate the public regarding the services of Islamic banking. The paper also talks about the current scenario of how different banks operate in Malaysia and how the interest free banking scheme (IBS) have been affected by the deflationary force of the crisis in the region since the middle of last year. It also reflects that BIMB is actually having rivals from two other sectors.

- **An Early Warning System for Islamic Banks Performance**(AL-OSAIMY & BAMAKHRAMAH, 2004)

This paper investigates the different ways for predicting the performance of Islamic Banks as an early warning system due to the vital importance of any problem that may face these banks before it emerges and negatively affects their performance and their financial status. Therefore, this system will save on the costs of bad performance or failure to depositors, owners and the economy. Hence, there is an obligation for an early warning system which will help to find out the possible origin of bad performance, identify potential problem banks, ease surveillance of banks as well as curtail its costs and make available proper timing of finding problem banks. Also, in the paper they used a Discriminant Analysis technique to find out the significant characteristics (financial ratios) which differentiates high-performance banks from low-performance ones as this analysis is one of the most used statistical techniques for the prediction of the various levels of performance of business firms.

- **Financial Performance of Islamic and Conventional Banks in Pakistan: A Comparative Study**(Ansari & Rehman, 2011)

The researchers have tried to compare the financial performance of Islamic and Conventional banks to enable depositors, bank managers, regulators, investors and shareholders by giving a true image of financial position of Islamic and Conventional banks in Pakistan. In the paper, they tried to measure as many as financial ratios from various financial statements and annual reports like income statement, balance sheet etc. It measured the financial performance of banks in terms of liquidity, profitability, risk and operational efficiency. Also, they used Independent sample T-test and ANOVA to determine the significance of mean differences of these ratios between and among banks. Therefore, the major aim of paper was to do ratio analysis and understand the financial performance between Islamic Banks and Conventional Banks in Pakistan as it is not only significant for depositors but also for management to advance organization future performance into a better level. Hence the study declared that Islamic banks proved to be less risky, more liquid and operationally efficient than conventional banks.

- **Performance and Risk Analysis of the Islamic Banks: The Case of Bahrain Islamic Bank.** (TUREN, 1996)

In this paper, Seref Turen used Bahrain Islamic Bank as a sample to investigate at micro level the claim that Islamic banking offers high performance and stability. In the paper he evaluated various the risk-return characteristics of the Islamic banks.

Research is conducted through various methods like financial ratio analysis, portfolio analysis and stock analysis. Some ratios indicate that BIB offers a relatively higher return and a lower coefficient of variation than the other commercial banks whereas some analysis shows that BIB's stock is exactly suited for the purpose of portfolio diversification. Hence here the researcher is trying to give partial quantitative answers to the situations of whether the concept of profit sharing in Islamic banking can achieve a better profitability and relatively lesser risk than conventional commercial banks.

- **The profitability of Islamic and conventional banking in the GCC countries: a comparative study**(Alkassam, 2005)

In this paper, the author has used regression models to study important bank characteristics. The impact of bank characteristics on bank profitability has been identified using the Ordinary Least Square method. The study focuses on the sensitivity of internal bank characteristics on profitability indicators. The research on bank profitability has been conducted on GCC Islamic banks, which has been compared to conventional banks.

- **A Comparison of Leverage and Profitability of Islamic and Conventional Bank** (TOUMI, VIVIANI, & BELKACEM, 2011)

The researcher through this paper examines the differences between the Islamic and Conventional banking systems with special focus on the leverage and profitability. A sample of 545 banks (250 Islamic banks and 295 Conventional Banks) from 18 countries for the period 2004-08 is selected for the purpose of the study. With the use of t-test, the differences between both the banking system is found with respect to leverage, profitability ratios and their determinants. It was concluded that there are structural differences regarding the liabilities composition which supports the trade-off theory that states a positive relation between the size and the leverage. On the other hand, there is not a significant difference in the profitability ratios namely Return on Assets and Return on Equity.

III. RESEARCH DESIGN

A. Objectives

- To determine and compare the financial performance of Islamic Banks and Conventional Banks in Malaysia
- To test the profitability performance, liquidity performance and credit risk performance of Islamic banks and Conventional Banks.

B. Scope

The study focuses on four major banks in Malaysia, two of which are representatives of the Islamic Banking system and two of which are part of the Conventional banking system. The banks chosen for this study are:

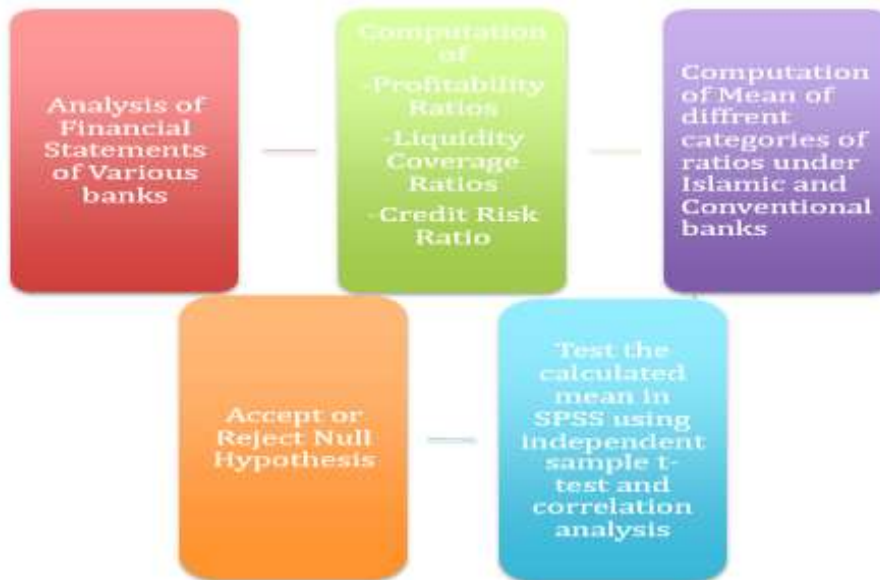
Conventional Banking System	Islamic Banking System
Affin Bank Berhad	CIMB Islamic Berhad
CITI Bank Berhad	RHB Islamic Bank Berhad

The time period chosen for undertaking this study is over a period of 5 years (2013-2017)

The study aims to make a comparison between the conventional and Islamic banking system in Malaysia post amendments made in laws such as The Financial Services Act 2013, Islamic Financial Services Act, Money Services Business Act Etc. which was introduced with the aim of promoting financial stability of Islamic banks.

C. Research Methodology

3.5.1 Financial Ratio Analysis



Secondary data collected from the Annual reports of the different banks is analysed and various categories of ratios are calculated.

Profitability Ratios:

1. Interest Income of loans ratio: $\frac{\text{Interest Income on loans}}{\text{Gross Loan}}$
2. Operating Profit ratio : $\frac{\text{Operating Profit}}{\text{Total Income}}$
3. Operating Expense Ratio : $\frac{\text{Operating Expense}}{\text{Total Revenue}}$
4. Return on Assets : $\frac{\text{Net Profit}}{\text{Total Assets}}$

Liquidity Coverage Ratios:

5. Loans to Deposit Ratio : $\frac{\text{Long Term Loans} + \text{Short Term Loans}}{\text{Total Deposits}}$
6. Cash Deposit Ratio : $\frac{\text{Cash \& Cash Equivalents}}{\text{Deposits}}$

Credit Risk Ratios:

7. Common Equity to Total Assets : $\frac{\text{Total Shareholders Fund}}{\text{Total Assets}}$

$$8. \text{ Total Equity to Net Loans} = \frac{\text{Total Assets}}{\text{Net Loans}} \times \frac{\text{Total Shareholders Fund}}{\text{Net Loans}}$$

The mean of the ratios is calculated separately for Islamic banks and conventional banks and the calculated data is run through SPSS to identify any significant differences in the means of the ratio and to perform correlation analysis.

Statistical tools used:

- Pearson’s Correlation Analysis
- Independent T-Test Analysis

D. Limitations

1. The study is confined only to the country of Malaysia and cannot be used as a sample on a global scale.
2. The analysis done is solely financial and hence an overall view can be distorted.

IV. RESEARCH OBSERVATIONS AND FINDINGS

➤ **Independent Sample T-Test Analysis**

The application of the paired samples t-test helped us to analyse, if there is any significant difference in the mean of the financial ratios between Islamic banks and Conventional Banks. The hypothesis for the same would be as under:

H₀: There is no statistically significant difference in the mean of the financial ratios between Islamic banks and Conventional Banks.

H_A: There is a statistically significant difference in the mean of the financial ratios between Islamic banks and Conventional banks.

Since the financial ratios can be categorized further, the study tests the various categories as well. Hence the null hypothesis can be split into 3:

H₀₁: There is no statistically significant difference in the mean of the profitability ratios between Islamic banks and Conventional Banks.

H₀₂: There is no statistically significant difference in the mean of the liquidity coverage ratios between Islamic banks and Conventional Banks.

H₀₃: There is no statistically significant difference in the mean of the credit risk ratios between Islamic banks and Conventional Banks.

The Independent Samples T Test also popularly known as the two-sample t-test is a statistical. That is used in determining whether there is a statistically significant difference between the means in two unrelated groups. In most cases the Independent Sample T Test is performed with the aim of ascertaining whether the null hypothesis should be rejected or accepted. To perform this function a set significance value is used. This value is usually set at 0.05.

Independent Samples Test for Various Categories of Ratios

With Regard to Profitability Ratios:

H₀₁: There is no statistically significant difference in the mean of the profitability ratios between Islamic banks and Conventional Banks. (If the p value obtained from the test is greater than 0.05)

H₁₁: There is a statistically significant difference in the mean of the profitability ratios between Islamic banks and Conventional Banks. (if the p value obtained from the test is less than 0.05)

Independent Samples Test (Profitability Ratio)

		t-test for Equality of Means						
		t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
							Lower	Upper
Interest_Income_of_Loans	Equal variances assumed	-11.026	2	.008	-.0625205	.0056705	-.0869187	-.0381222
Operating_Profit_Ratio	Equal variances assumed	-1.353	2	.309	-.0736465	.0544400	-.3078831	.1605900
Operating_Expense_Ratio	Equal variances assumed	-3.478	2	.074	-.2946317	.0847016	-.6590731	.0698098
Return_On_Assets_Ratio	Equal variances assumed	-3.514	2	.072	-.0066296	.0018869	-.0147481	.0014888

In the case of profitability ratios, all the ratios have p values higher than 0.05 as illustrated in the table above with the exception of Interest Income on loans. This is because Islamic banking prohibits the collection of interest (Riba) and hence the interest income for Islamic banks is zero. This signifies that the null hypothesis has to be partially accepted because there is no statistically significant difference in the mean values of the profitability ratios (Exception: Interest on loans). This indicates that the financial performance of Islamic banks in terms of profitability, if not on par, is on similar lines with that of conventional banks.

Independent Samples Test (Liquidity Ratio)

		t-test for Equality of Means						
		t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
							Lower	Upper
Cash_Deposit_Ratio	Equal variances assumed	-0.733	2	.540	-.0653246	.0891714	-.4489982	.3183491
Loans_to_deposit_ratio	Equal variances assumed	3.489	2	.073	.1090067	.0312406	-.0254106	.2434240

With Regard to Liquidity Coverage Ratios:

H₀₁: There is no statistically significant difference in the mean of the liquidity coverage ratios between Islamic banks and Conventional Banks. (If the p value obtained from the test is greater than 0.05)

H₁₁: There is a statistically significant difference in the mean of the liquidity coverage ratios between Islamic banks and Conventional Banks. (If the p value obtained from the test is less than 0.05)

In the case of liquidity coverage ratios, all the ratios have p values higher than 0.05 as illustrated in the table above. This signifies that the null hypothesis has to be accepted because there is no statistically significant difference in the mean values of the liquidity coverage ratios. This indicates that the financial performance of Islamic banks in terms of Liquidity of banks, if not on par, is on similar lines with that of conventional banks.

Independent Samples Test (Credit Risk Ratio)

		t-test for Equality of Means						
		t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
							Lower	Upper
Total_equity_to_net_loans	Equal variances assumed	-7.586	2	.017	-.1100041	.0145001	-.1723932	-.0476150
Common_assets_to_equity	Equal variances assumed	-40.022	2	.001	-.0532812	.0013313	-.0590093	-.0475531

With Regard to Credit Risk Ratios:

H₀₁: There is no statistically significant difference in the mean of the credit risk ratios between Islamic banks and Conventional Banks. (If the p value obtained from the test is greater than 0.05)

H₁₁: There is a statistically significant difference in the mean of the credit risk ratios between Islamic banks and Conventional Banks. (If the p value obtained from the test is less than 0.05)

In the case of credit ratios, all the ratios have p values less than 0.05 as illustrated in the table above. This signifies that the null hypothesis has to be rejected and the alternate hypothesis has to be accepted because there is a statistically significant difference in the mean values of the credit risk ratios. This indicates that the financial performance of Islamic banks in terms of credit risk is significantly different from that of its conventional counterparts. The reason for such difference is due to the fact that Islamic banks do not have sufficient Shariah compliant tools for dealing with debt-based contracts when in comparison to its conventional counterpart. Moreover, Islamic banks also face this type of risk in most modes of their financing such as Murabahah, where the very fundamental form of risk occurring in these contracts is credit risk.

➤ **Correlation Analysis**

Correlation is a statistical technique that can show whether and how strongly pairs of variables are related. This type of analysis is used for determining whether a relation exists and then measuring it. The measure of correlation is called as the Coefficient of Correlation.

Correlations (Conventional Banks)

		Operating Profit Ratio	Return on Assets	Loans to Deposit Ratio	Cash Deposit Ratio	Common Equity to Total Assets	Total Equity to Net Loans
Operating Profit Ratio	Pearson Correlation	1	.108	-.941	.415	-.820	-.643
Return on Assets	Pearson Correlation	.108	1	-.287	-.113	.089	.245
Loans to Deposit Ratio	Pearson Correlation	-.941	-.287	1	-.368	.697	.419
Cash Deposit Ratio	Pearson Correlation	.415	-.113	-.368	1	-.835	-.785
Common Equity to Total Assets	Pearson Correlation	-.820	.089	.697	-.835	1	.929
Total Equity to Net Loans	Pearson Correlation	-.643	.245	.419	-.785	.929	1

Correlation analysis can be done to check relationship between two variables. However, correlation can also be used to test for multicollinearity problem i.e. in other words whether independent variables are highly correlated with each other or as is the case here. The analysis of the coefficient of correlation can be done in the following manner.

Correlations (Islamic Banks)

		Operating Profit Ratio	Return on Assets	Loans to Deposit Ratio	Cash Deposit Ratio	Common Equity to Total Assets	Total Equity to Net Loans
Operating Profit Ratio	Pearson Correlation	1	-.324	-.970	-.161	.653	-.311
Return on Assets	Pearson Correlation	-.324	1	.512	-.822	-.091	-.227
Loans to Deposit Ratio	Pearson Correlation	-.970	.512	1	-.077	-.672	.173
Cash Deposit Ratio	Pearson Correlation	-.161	-.822	-.077	1	-.128	.621
Common Equity to Total Assets	Pearson Correlation	.653	-.091	-.672	-.128	1	-.408
Total Equity to Net Loans	Pearson Correlation	-.311	-.227	.173	.621	-.408	1

When the coefficient of correlation of +0.8 or -0.8 indicates a strong correlation between the two variables. An r (coefficient of correlation) of +0.20 or -0.20 indicates a weak correlation between the variables. When the coefficient is 0.00 or close to that value there is no correlation. Hence the analysis can be derived from the above using the given interpretations for various analysis.

In case of conventional banks, the correlation (low, positive) between operating profit and return on assets is 0.108 which shows there is no significance relationship between the two variables. Likewise, there is no significant relationship between cash deposits and return on assets of conventional banks as correlation (low, negative) is only -0.113. On the other hand, operating profit and loans to deposits ratio has a significant correlation (high, negative) of -0.970, and the same implications can be drawn for the relationship between common equity to total assets and operating profit due to the correlation (high, negative) value of -0.820. The relationship between cash deposit and operating profit has correlation (moderate low, positive) of 0.415, while that between loans to deposits and return on assets has a correlation (low, negative) of -0.287. The correlation between common equity to total assets and loans to deposits (moderate high, positive), and total equity to net loans and operating profit (moderate high, negative) are moderate high but with opposite direction implications with correlation values of 0.697 and -0.643 respectively. Loans to deposit and operating profit have a strong correlation (high, negative) of -0.941, while common equity to total assets and return on assets have a very weak correlation (very low, positive) of 0.089. Common equity to total assets and total equity to net loans have a strong correlation (high, positive) of 0.929, while cash deposits and total equity to net loans have a strong correlation (high, negative) of -0.785. With a correlation (low, negative) of -0.368, cash deposits and loans to deposits do not have a significant relationship. For conventional banks, common equity to total assets and cash deposits have a strong correlation (high, negative) of -0.835, while total equity to net loans and return on assets have a correlation (low, positive) of 0.245.

In case of Islamic banks, there is a significant relationship between loans to deposit and operating profit with correlation (high, negative) of -0.970. Whereas the correlation (low, negative) for return on assets and operating profit, and total equity to net loans and return on assets are -0.324 and -0.227 respectively. The relationship between loans to deposits and return on assets has a correlation (moderate, positive) of 0.512, while cash deposits and operating profit have an insignificant relationship with correlation (low, negative) of -0.161. At the same time, Islamic banks have a weak relationship between common equity to total assets and return on assets with correlation (very low, negative) of -0.091, with the same applying for loans to deposit and cash deposits also with correlation (very low, negative) of -0.077. The relationship between common equity to total

assets and operating profit has correlation (moderately high, positive) of 0.653. Loans to deposits and common equity to total assets have a correlation (moderately high, negative) of -0.672, while cash deposits and total equity to net loans have a correlation (moderately high, positive) of 0.621. Cash deposits and common equity to total assets have a weak correlation (low, negative) of -0.128. For Islamic banks, operating profit and total equity to net loans have a correlation (low, positive) of 0.311, while loans to deposits and total equity to net loans have a correlation (low, positive) of 0.173. Return on assets and cash deposits of Islamic banks have a strong correlation (high, negative) of -0.822.

V. CONCLUSION

From the analysis done in Chapter V, it is concluded the null hypothesis is partially accepted I.e. there is no statistically significant difference in the mean of the financial ratios between Islamic banks and Conventional banks.

Financial Ratios	p Value
Interest Income of Loans	0.008
Operating Profit Ratio	0.309
Operating Expense Ratio	0.074
Return on Assets	0.072
Cash Deposit Ratio	0.540
Loans to Deposit Ratio	0.073
Total Equity to Loans	0.017
Common Assets to Equity	0.001

In case of Profitability ratios, as Islamic banking prohibits the collection of interest (Riba), the interest income for Islamic banks is zero. This signifies that the null hypothesis has to be partially accepted because there is no statistically significant difference in the mean values of the profitability ratios (Exception: Interest on loans). This indicates that the financial performance of Islamic banks in terms of profitability, if not on par, is on similar lines with that of conventional banks.

In case of Liquidity ratios, the null hypothesis has to be accepted because there is no statistically significant difference in the mean values of the liquidity coverage ratios. This indicates that the financial performance of Islamic banks in terms of Liquidity of banks, if not on par, is on similar lines with that of conventional banks.

In the case of credit ratios, the null hypothesis has to be rejected and the alternate hypothesis has to be accepted because there is a statistically significant difference in the mean values of the credit risk ratios. This indicates that the financial performance of Islamic banks in terms of credit risk is significantly different from that of its conventional counterparts. The reason for such difference is due to the fact that Islamic banks do not have sufficient Shariah compliant tools for dealing with debt-based contracts when in comparison to its conventional counterpart. Moreover, Islamic banks also face this type of risk in most modes of their financing such as Murabahah, where the very fundamental form of risk occurring in these contracts is credit risk.

The comparative study conducted to examine the financial performance of Islamic Banks and Conventional Banks in Malaysia revealed that the conventional banks in Malaysia are in a better financial position than their Islamic counterparts. It is concluded that Conventional banks are more liquid, less risky and more profitable than Islamic banks.

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