BANK SPECIFIC CHARACTERISTICS AND PROFITABILITY OF ISLAMIC AND CONVENTIONAL BANKS IN MALAYSIA

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ABSTRACT

Islamic Banking has become competitive against conventional banking since it is one of the fastest growing institutions nowadays. Therefore, it is reasonable to expect that the performance of both Islamic and conventional banks has become the center of attention particularly in term of their profitability. Hence, the purpose of this study is to investigate the relationship between bank-specific characteristics and profitability of Islamic and conventional in Malaysian banking sector to find the role of internal factors in achieving high profitability from 2008 to 2016. The data is extracted from Fitch Connect database for a nine year period which includes 16 Islamic banks and 22 conventional banks in Malaysia. The findings explained that each variable are justified in the model have statistically significant impacts on Malaysian banks’ profitability. However, the effects are not uniform across profitability measures. Regression findings reveal that bank capital and deposit ratio are significant of bank profitability in Islamic banks. This result implying that high profitability may drive higher capital ratios since profits are a source of capital. The implication shows that a more profitable bank may desire a smaller capital buffer since it knows that it will be able to draw on internal funds to fund expected investment opportunities.

Keywords: Bank Size, Capital, Conventional bank, Deposit, Islamic bank, Liquidity, Profitability

INTRODUCTION

Malaysia has a unique banking system where Islamic and Conventional banks operate side by side...
side and it has appeared as the first country to implement a dual banking system. Islamic banking system was introduced in Malaysia in 1963 with the establishment of Perbadanan Wang Simpanan Bakal-Bakal Haji (PWSBH). PWSBH was introduced in order to give the option for Muslim to save their money to perform Hajj. Later, in 1969, PWSBH merged with Pejabat Urusan Haji and form Lembaga Tabung Haji. The enactment of the Islamic Banking Act 1983 enabled the establishment of the first Malaysian Islamic Bank in 1983 namely Bank Islam Malaysia Berhad (BIMB). Subsequently, the Conventional banks were also allowed to offer the Islamic banking products and services under Islamic Banking Scheme (IBS) but they must separate their Islamic banking funds and activities from the Conventional banking activities to ensure there is no mingling of funds (Borham, 2013).

Conventional banking is based on interest which is against with the Shariah law. Dealing with interest (riba) is strictly prohibited as Allah SWT has mentioned in Quran and has appeared in several revelations. The first revelation is in Surah Al-Rum (39):

“That which you give in usury in order that it may increase on (other) people’s property hath no increase with Allah, but that which you give in charity, seeking Allah’s Countenance, hath increase manifold”.

And the second revelation is in Surah An-Nisaa (161):

“And of their taking usury when they were forbidden it, and of their devouring people’s wealth by false pretences, We have prepared for those of them who disbelieve a painful doom”.

The verses above clearly stated that Islamic banks are prohibited from taking riba (interest). The crux of Islamic banking is that any profit gained by the banks must be interest-free based.

Generally, Islamic bank act as an intermediary and trustee of the deposit placed by the customers similar to the conventional. However, the differences between the Islamic and conventional banks lie on how the profit and loss are shared among the depositors in Islamic banks (Dar and Presley, 2000).

According to Ernst and Young (2016), the asset growth for Islamic banks is higher which is about 4% compared to Conventional which is 1% only in 2014. Besides, Islamic banking market in Malaysia also is still growing and expected to surpass the conventional banking loan growth in near future (The Star Online, 2017). This shows that Islamic Banking has become competitive against conventional banking since it is one of the fastest growing
institutions. Therefore, it is reasonable to expect that the performance of both Islamic and conventional banks has become the center of attention particularly in term of their profitability.

According to Mahmud et al. (2016), bank-specific factors are crucial in determining the profitability of the bank. Besides, Abduh and Idrees (2013) emphasized that bank-specific factors have more ability to influence the bank’s profitability. Lukorito et al. (2014) stated that in order for a bank to survive and remain competitive, they need to understand the internal factors which they can manipulate to their advantage to maximize the profit.

Apart from that, the previous studies only cover the study period from 2000 to 2015. Therefore, this paper seeks to investigate the bank specific factor that mainly impacts on the profitability of Islamic and conventional banks in Malaysia which covers the latest year from 2008 to 2016. On the other hand, the study period was chosen considering the time after the global financial crisis.

This study could provide a comprehensive analysis of profitability determinants of Islamic banks and conventional banks in Malaysia. Unlike most existing study that focuses only on either Islamic or conventional banks, this study emphasizes both aspects. Therefore, this study will contribute to the literature on profitability determinants as well as the performance of Islamic and conventional banks. The result from this study is expected to be useful to the bank management in order to improvise their performance to maximize their profit.

**REVIEW OF THE LITERATURE**

Related to the global financial crisis, Chapra (2008) asserts that during the financial crisis, Islamic banks are slightly affected compared to Conventional banks. Similarly, Amba and Almukharreq (2013) and Mohamed and Salina (2012) from their study found that that Islamic Bank was performed slightly better than Conventional bank during the financial turmoil of 2008. However, Figure 1 denotes that profitability of the Conventional banks increased by 1.13% which is higher than Islamic banks that only increased by 0.77% from 2008 to 2009. However, from 2009 to 2010, Islamic banks profitability increased by 0.43% and the profitability of conventional banks decreased by 1.51%. The trends show inconsistency in the profitability of Islamic and Conventional banks. Therefore, it has attracted the researcher to further investigate the profitability of the Islamic and Conventional banks after the financial crisis period.
Figure 1: Profitability (ROA) for Islamic and Conventional Banks in Malaysia

Sources: Fitch Connect Database

Substantial studies on the profitability of the banks in Malaysia have been done by other researchers such as Aziz (2017); Abduh and Idrees (2013); Haron (1997); Wasiuzzaman and Hanimas (2010); Baharuddin and Azmi (2015); Tafri et al. (2009) and San and Heng (2013). These studies focus only on factors that influence either profitability of Islamic, commercial or Conventional banks. These factors include capital ratio, asset quality, bank age, deposits, operational efficiency, board size, bank size, liquidity, impaired financing, and loan loss provision. Hence, this study attempts to fulfill the gap by examining the factors that influence the profitability of Islamic and conventional banks in Malaysia. Bank specific factors have more ability to give the impact on bank’s profitability.

**Profitability**

Profitability can be defined as the ability of institutions, firm, company or organization to make a profit from their business activities. Profitability is defined by Wiyono and Sari Rahmayuni (2012) as the major source of capital income that measures the corporate performance to express the competitive position of banks in the banking market and quality management. According to Aziz (2017), one of the vital indicators of performance is profitability. Based on the previous study, profitability can be measured by different variable namely Return on Equity (ROE) and Return on Asset (ROA) since these two are the most
often used profitability ratios.

This study uses ROA as the dependent variable. Return on Asset (ROA) refers to the profitability of the firm’s asset after deducting all the taxes and expenses (Van Horne and Wachowicz, 2005). Generally, it measures the operating efficiency based on the generated profits of the firms from its total assets (Kabajeh et al., 2012). According to Hagel et al., (2013), ROA is the most effective financial measures to evaluate the performance of the firm as it shows the company performance comprehensively by looking at both income statement performance and the asset required by the firm to run their business.

The Bank Specific factors are individual bank characteristics which affect the bank’s profitability (Mbella and Magloire, 2017). The determinant factors of bank profitability are capital ratio, bank size, liquidity ratio, and deposit.

Capital ratio refers to the ratio of total equity to total assets which help to determine the number of assets that shareholders have a residual claim (Abduh and Alias, 2014). This is the most standard ratio used to determine the overall financial stability of the banks. It measures the level of leverage used by a bank. In line with the study by San and Heng (2013) who examined the effect of bank-specific factors on the profitability indicates that capital has a positive impact on the profitability of the commercial banks in Malaysia. Supported by Waisuzzaman and Hanimas (2010), who analyzed the effect of bank-specific factors on the profitability of Islamic banks in Malaysia for the period of 2005 to 2008 revealed that capital is significantly related to the profitability of Islamic bank in Malaysia.

Bank size is generally used to capture potential economies in the banking sector. This variable measured as the total asset of the bank. According to Idris et al. (2011), and Ali et al. (2017), stated that bank size is a robust factor that gives a positively impact on the level of profitability in the Islamic banks. In contrast, Aziz (2017) examined the impact of internal factors on the profitability of Islamic banks for the period 2009 to 2015. From the study, bank size was found to have a negative significant relationship with the profitability. This shows that as the bank size increases, it does not necessarily lead to higher profits. Although larger banks have the advantages of more access to additional financing sources, they actually have to face higher risk in dealing with liquidity problems and diversifying products. Meanwhile, San and Heng (2013) study on the profitability of conventional bank in Malaysia found that bank size is positively significant to the profitability.

Liquidity ratio enables to determine a percentage of assets that comprise the loan portfolio. Hassan and Bashir (2003) study on the relationship between internal determinants towards profitability of 39 Islamic banks from 21 countries for the period from 1994 to 2001, found
that liquidity has a negative and significant impact on profitability. This indicates that an increase in liquidity leads to a decreasing in the profitability of Islamic banks. According to Ansari and Rehman (2011) and Suzanna and Ola (2015) who studied a financial performance of Islamic and conventional banks found that liquidity has a positive significant relationship with the profitability of Islamic and conventional banks.

Deposit is considered as bank’s liability. Customers make current, fixed or saving deposits in banks. It is considered as bank liabilities because they must be repaid back to the depositors. Banks invest these deposits in other projects and generate profits on them. Therefore, deposits of the banks are considered as a source of bank funding and it has an impact on the banks’ profit. According to Muhamad et al., (2013) analyzed the determinants of profitability of Islamic bank and the impact of the global financial crisis on the profitability over the period of 2007 to 2010 indicates that deposit ratio has a positive significant impact in determining the profitability of Islamic banks in Malaysia. Besides, Shah and Khan (2017) study the factors affecting conventional banks profitability found that deposit has a positive and significant impact on banks profitability.

Structure Conduct Performance Theory
The theory that has been considered in this paper is Structure Conduct Performance. Basically, the Structure conduct performance (SCP) is proposed by Mason (1939) and later has been modified by Bain (1951). This theory states that when firms have a large percentage of market shares it could increase bank concentration level and fosters competition among firms in the industry. When the market is concentrated in the hands of several firms, the possibility of collusive behavior will be increases. The higher the market concentration ratio the higher the profitability of the firms (Gilbert, 1984). The SCP reveals that the performance of the bank depends on several elements of market concentration, market structure, number and size of the banks, and collusion. Firms will make more profit in the concentrated market rather than in a less concentrated market (Lloyad-William et al, 1994).

Signaling Theory
The signaling hypothesis indicates that asymmetric information allows managers to have better information than outsiders about future cash flows. Therefore, managers expect to signal this information through capital structure decisions. According to the signaling equilibrium, if banks expect to improve their profitability, they should have higher capital, because the capital ratio of bank determines the capacity of a bank to absorb unexpected losses. In theory, an excessively high capital ratio implies that a bank operates conservatively and ignores some potential investment opportunities (Brian et al, 2011).

DATA AND METHODOLOGY

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The data used in the empirical analysis are collected from the annual financial reports of all 16 licensed Islamic banks and 22 selected licensed conventional banks of Malaysia under Bank Negara Malaysia from 2008 to 2016. The annual financial report obtained from Fitch Connect database. This time period was chosen because considering the situation after the global financial crisis.

**Dependent Variable**

The dependent variable for this study is a return on asset (ROA). ROA is used as a proxy to determine bank profitability. ROA measures the ability and efficiency of banks using its assets to generate profit (Manar, 2014). Higher ROA generally shows the greater ability of bank in converting its assets into earnings. This indicates that the higher the ROA, the better the performance of the banks.

**Independent Variables**

As suggested by Anupam and Ganga (2017), Ali et al., (2017), Suzanna and OI (2015), and Ramlan and Adnan (2016), the exact nature of involvement in non-traditional activities at an individual bank may be linked to various bank-specific characteristics as discussed below. There are four bank-specific factors namely bank capital, bank size, liquidity and deposit that will be tested in this paper to examine their impact on the bank’s profitability.

**Capital (CAR)**

Capital (CAR) is used as a proxy to capitalization. CAR is a computation that indicates the financial strength of a company. A higher ratio of CAR refers to the ability of the bank’s current capital to support the further assets growth (Anupam and Ganga, 2017; Wasuizzaman and Hanimas, 2010; and Kamaruddin and Mohd, 2013).

**Bank Size (SIZE)**

Used as a proxy to measure the size of the bank. In the literature, the relationship between size and profitability has been mixed. The size of the banks may affect the profitability of bank positively (Ali et al., 2017; San and Heng, 2013).

**Liquidity (LIQR)**

Liquidity ratios measure the bank capability to fulfill its short-term obligations. It also describes the total amount of debt relative to assets. The higher the ratio means the bank is less liquid (Ansari and Rehman, 2011; and Suzanna and Ola, 2015).

**Deposit (DEPO)**
Deposits ratio is total deposits from banks and other financial institutions as a percentage of total assets. Deposits of the banks are considered the main source of bank funding and hence, it has an impact on the bank’s profitability (Ramlan and Adnan (2016) and Ali et al., (2017).

The collected data is analyzed using descriptive analysis and regression analysis. Meanwhile, correlation analysis is conducted to find if there is the existence of multicollinearity among the variables. The econometrics analysis of unbalanced panel data using EVIEWS 9 program is used to perform the all the tests and to generate the regression results. Using an unbalanced panel data regression to conduct this analysis, the researchers are able to see how relationships between variables change over time. The panel data is useful with observations that span both time and individual factors in a cross section and giving more efficient estimates.

**Multiple Regression Analysis**

According to Hair et al. (2006), multiple regression analysis is defined as a statistical technique used to determine the relationship between independent variables and dependent variable. The coefficient of the individual independent variable is used to predict the tendency of each independent variable. The purpose of this study employs multiple regression analysis is to prove the hypotheses and the control variable. This test helps the researcher to achieve the objective of this study which is to examine the impact of bank-specific factors on the profitability of Islamic and conventional banks.

**Fixed Effect Model**

The researcher employs the Fixed Effect Model (FEM) in multiple regression in determining the relationship between independent variables and dependent variable for this study. According to Sufian (2010), FEM appears to be unbiased and constant evaluations of the coefficients. This model is chosen because it is found to be a most suitable model to be applied in single sampling country. Reyna (2007) assert that FEM is suitable to use in investigating the relationship of predictor and outcome variables within single entity likely as individual, company or country. Besides, Batlagi (2000) and Gelman (2005) stated that FEM is relevant to be employed in specific organization study.
A linear regression is employed in this paper to examine the impact of bank-specific factors on the profitability of Islamic and conventional banks. The regression equation is as follows:

$$\text{ROA}_n = \alpha + \beta_1 \text{CAR}_n + \beta_2 \text{SIZE}_n + \beta_3 \text{LIQR}_n + \beta_4 \text{DEPO}_n + \epsilon_n$$

Where,

- **Dependent variable:** ROA = Profitability
- **Independent variables:**
  - CAR = Capital
  - SIZE = Bank Size
  - LIQR = Liquidity
  - DEPO = Deposit

$\alpha$ = intercept, $\beta$ is regression coefficient, $\epsilon$ is represent of error term.

**FINDINGS AND DISCUSSION**

The comparative analysis between Islamic and Conventional banks and the summary of the results obtained from the multiple regressions of Islamic and Conventional banks in Malaysia are presented in Table 2.

Based on Table 2, the independent variables have a greater impact on ROA of Conventional banks.
banks ($R^2=0.8825$) compared to those Islamic banks ($R^2=0.6062$). In other words, the management of Conventional banks in Malaysia is encouraged to consider the impacts of these variables since they contribute 88.25 percent of their banks’ profitability, particularly SIZE, LIQR and DEPO. The adjusted $R$ square at 54.6% (Islamic banks) and 86.4% (conventional banks) attempts to correct $R$ square to more closely reflect the goodness of suitability of the model in the population.

Table 2: Summary Result of Bank-Specific Factors Impact on Islamic and Conventional Banks Profitability

<table>
<thead>
<tr>
<th>Variable</th>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$\beta$</td>
<td>p-value</td>
</tr>
<tr>
<td>CAR</td>
<td>0.0578</td>
<td>0.0022***</td>
</tr>
<tr>
<td>SIZE</td>
<td>-0.0004</td>
<td>0.9086</td>
</tr>
<tr>
<td>LIQR</td>
<td>0.0013</td>
<td>0.5253</td>
</tr>
<tr>
<td>DEPO</td>
<td>-0.0775</td>
<td>0.0038***</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.6062</td>
<td></td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.5459</td>
<td></td>
</tr>
<tr>
<td>F-Statistics</td>
<td>10.0480</td>
<td></td>
</tr>
<tr>
<td>Sig F-Statistics</td>
<td>0.0000</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>144</td>
<td></td>
</tr>
</tbody>
</table>

Note: *$p<0.10$, **$p<0.05$, ***$p<0.01$ (*abic*).

In contrast, the independent variables collectively only explain 60.62 percent of the variation in profitability of Islamic banks. Although there are two variables (CAR and DEPO) which have a significant impact on profitability (1% respectively), the lower $R^2$ result appears to indicate that there are other factors which are peculiar to Islamic banks that could explain more variation in profitability in Malaysia.

Interesting from the finding, SIZE was found to have a negative relationship with the profitability. This shows that as the bank size increases, it does not necessarily lead to higher profits. Although larger banks have the advantages of more access to additional financing sources, they actually have to face higher risk in dealing with liquidity problems and diversifying products.

Table 2 also shows that two (2) independent variables (CAR and DEPO) have a significant value with the dependent variable (ROA) of Islamic banks. There are two (2) independent variables were found to be not significant with the dependent variables. Therefore, from the
analysis, shows that the most influential determinants of Islamic banks profitability are capital and deposit. The high capital ratio means that the bank protects the depositor. Furthermore, it increases the level of customer loyalty. Banks should manage CAR at the optimum level to ensure that the banks work at the right way. This variable is potentially affect bank’s profitability.

However, three (3) independent variables (SIZE, LIQR and DEPO) have a significant value with the dependent variable (ROA) of Conventional banks. There are one (1) independent variables were found to be not significant with the dependent variables. Therefore, from the analysis, shows that the most influential determinants of Conventional banks profitability are bank size, liquidity and deposit.

The empirical analysis found that LIQR of conventional banks are higher than that of Islamic banks from 2008 to 2016 which indicates higher loans (investments) made by conventional bank.

CONCLUSION

There have been limited studies on the comparative analysis of the profitability between Islamic and Conventional banks particularly in Malaysia. Besides, most of existing study that focuses only on either Islamic or conventional banks, this study emphasizes both aspects. Therefore, this study will contribute to the literature on profitability determinants as well as the performance of Islamic and conventional banks. The result from this study is expected to be useful to the bank management in order to improvise their performance to maximize their profit. Hence, this paper attempts to fulfill the gap by examining the factors that impact the profitability of Islamic and Conventional banks in Malaysia, specifically on the bank-specific factor.

Result from this paper shows, as for the Islamic banks, the bank-specific factor that gives impact on its profitability is the capital ratio and deposit ratio. Where both variables are found to be highly significantly (at level 1%) related to the profitability of the Islamic banks in Malaysia. Meanwhile, as for the Conventional banks, it is found that bank size and liquidity ratio give impact on its profitability. Bank size and liquidity ratio were found to be highly significant (at level 1%) to the profitability compared to the deposit that also found to be significant but at level 5%.

There limitation of this study that needs to be considered. Firstly, this study only examined the bank-specific factors that influence the profitability of the Islamic and conventional banks and do not present the impact of macroeconomic factors towards profitability. Second, the
results established are limited to a number of annual bank transactions recorded each from 2008 to 2016.

Several recommendations for future research to be undertaken are suggested. Firstly, this study only focuses bank-specific factors. Thus, it is suggested for the future researcher to study for both internal and external determinants that might affect the profitability of Islamic and Conventional banks. Second, this study only focuses on the profitability of Islamic and conventional banks in Malaysia. Thus, it is suggested that it might be more attractive if the Malaysian Islamic and conventional bank’s profitability to be compared with a foreign country.

REFERENCES


