Conventional Banking and Islamic Banking: Do the Different Philosophies Lead to Different Financial Outcomes?

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ABSTRACT

Islamic Banking (IB) is a contemporary segment of banking and finance that has become increasingly significant in many Muslim countries. Malaysia is one of the countries that has adopted a dual banking system. Conventional Banks (CBs) borrow money from depositors at a low interest rate and lend them to borrowers at a high interest rate. In contrast, interest is forbidden in Islam and therefore Islamic banks enter into profit-sharing arrangements with both depositors and borrowers. This study seeks to determine whether differing banking arrangements based on different philosophies lead to different outcomes. Several previous studies have compared the profitability, liquidity and risk performance of the two banking systems, but few studies have focused on revenue distribution between the two types of banking systems. Secondary data from the annual reports of 10 banks with both conventional and Islamic banking windows for five years was used. We used financial ratios to process the data, such as profit return to depositors' ratio, net profit ratio, risk ratio and so on. The independent sample test was used to analyse these ratios. Our findings indicate that depositors get higher returns from Islamic banking than from conventional banking. In contrast, conventional banks appear to have a higher taxation cost, operating cost and net profit margin. In the area of profitability and risk performance, conventional banks perform better, while Islamic banks are more liquid.

Keywords: Islamic Banking, Conventional Bank, Financial Outcomes

INTRODUCTION

Islamic banking (IB) has seen rapid growth in the last few years, more than doubling between 2009 and 2014 (https://www.islamicfinance.com/2014/12/size-islamic-finance-market-vs-conventional-finance/). Islamic banks, in contrast to conventional banks, operate on a Profit-Loss-Sharing (PLS) principle,

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that is based on the principle of Islamic law, also known as the Shariah, since Islamic law forbids interest (Abdullah, Sidek, & Adnan, 2012).

The conventional bank borrows money at a lower interest from customers and loans them to borrowers at a high interest rate (Santos, 2000). The major financial objective of the conventional banking system is to achieve maximization of the shareholder's wealth through interest differential. Although interest is not used in banking transactions, Islamic banks have products and services that are similar to conventional banks, i.e., saving and deposit accounts, loan, credit card and other financial products. All these products and services must abide with the Shariah (Abdullah, Sidek, & Adnan, 2012). The Islamic bank uses the pre-determined profit sharing contract for depositors and borrowers instead of the pre-determined interest rate used by the conventional bank (Zaher & Hassan, 2001). Several recent studies have, however, raised the questions concerning "How 'Islamic' is Islamic Banking" (El Gamal, 2006; Khan 2010; Kuran, 2004). One way of answering the above question is to determine if different banking practices based on different philosophies lead to different financial outcomes.

Several previous studies have compared the profitability, liquidity and risk performance of the two banking systems (Samad, 2004; Rashwan, 2010; Hasan & Dridi, 2010; Ryu, Piao & Nam, 2012), but few studies have focused on whether different philosophies lead to different revenue distribution outcomes. Malaysia is one country that has implemented a dual banking system. The most significant income of conventional banks is interest income, which is different from profit sharing which is the basis of Islamic banking. Consequently, financial ratios are used to determine if different philosophies lead to different revenue distribution outcomes.

The rest of the paper is organized as follows: Section Two provides an overview of the main features of Islamic banking, highlighting the key differences with conventional banking. Section Three identifies the methodology and sample of the two groups of banks. Section Four identifies the main findings of the study. This is followed by a discussion of the findings and conclusion in Section Five.

LITERATURE REVIEW

Islamic banking has developed as a major alternative to conventional banking in many countries around the world, particularly in countries with a Muslim majority population. The combined balance sheets of Islamic banks grew from $150 billion in 1990 to about $1 trillion in 2010, with more than 300 Shariah-compliant institutions operating in 80 countries (Cevik & Charap, 2011). Islamic

banking emerged due to the general guidelines in the Qur'an and the hadıth as to what are and are not permissible forms of economic activity according to Islam. The Qur'an bans *riba* (usually translated as 'interest' or 'usury' but also with the literal meaning of 'excess' or 'increase' [see, e.g., Ayub, 2002, p. xxxi]) and also requires all practising Muslims to avoid financial transactions that involve excessive *ghar¯ar* (uncertainty, i.e., where the outcome is uncertain), *maysir* (outright gambling) and *har¯am* (religiously forbidden) products.

Engaging in trade is encouraged but, ideally, profits must be the result of assuming a proportionate share of the risk involved in the transaction by taking an equity stake in it; profits must not be earned 'risk-free' by making a collateralized loan. This was summarized by a publication of the Islamic Research and Training Institute of the Islamic Development Bank as follows:

The most important feature of Islamic banking is that it promotes risk sharing between the provider of funds (investor) on the one hand and both the financial intermediary (the bank) and the user of funds (the entrepreneur) on the other hand. In conventional banking, all this risk is borne in principle by the entrepreneur (Iqbal *et al.,* 1998).

Money is generally held to have zero opportunity cost (Ayub, 2002) and therefore there is supposed to be no compensation for its use; however, when combined with other resources, money becomes capital and so deserves 'fair' compensation. In short, "In Islam, one does not lend to make money and one does not borrow to finance business" (El Gamal, 2000).

From a more practical perspective, El Hawary *et al.,* (2004) defines IB as a system that adheres to the following four principles:

1. Risk sharing: the terms of financial transactions need to reflect a symmetrical risk/return distribution among each participant to the transaction,
2. Materiality: all financial transactions must have "material finality", i.e., be directly linked to a real underlying economic transaction; thus, options and most other derivatives are banned,
3. No exploitation: neither party to the transaction should be exploited,
4. No financing of sinful activities: transactions cannot be used to produce goods banned by the Qur'an (e.g., alcohol, pork products, gambling, etc.).

The difference between conventional banking and Islamic banking can be summed up as the former is largely debt-based, and allows for risk transfer, while the latter is asset-based, and centres on risk sharing (Table 1).

Table 1: Risk Sharing and Risk Transfer

Islamic Banking (IB) Risk Sharing	Conventional Banking (CB) Risk Transfer
Sources of funds: Investors (profit sharing investment account (PSIA) holders) share the risk and return with bank. The return on PSIA is not guaranteed and depends on the bank's performance.	Sources of funds: Depositors transfer the risk to the bank, which guarantees a pre-specified return.
Uses of funds: IBs share the risk in *Mudharabah* and *Musharakah* contracts and conduct sales contracts in most other contracts.	Uses of funds: Borrowers are required to pay interest independent of the return on their project. CBs transfer the risk through securitization or credit default swaps. Financing is debt-based.

From the above table, one can observe that the crux of IB is Islamic banks as predominantly "risk-taking institutions committed to long-term productive investment on a partnership or equity basis" (Mills & Presley, 1999) since profit-and-loss-sharing (PLS) (i.e., equity participation) "is at the core of Islamic Banking" (Zaher & Hassan, 2001). "Thus Islamic banks are supposed to act as venture capital providers, investing in worthy firms and financing promising ideas in exchange for a share of the profits, rather than lending on the basis of cash-flow and collateral, and forcing firms into liquidation to recover loans that had gone bad through no fault of the borrower" (Khan, 2010). This form of financing is frequently referred to as Shariah-based products and the main forms are *Mudharabah* (a 'sleeping' partner contributes capital and other expertise/knowledge) and *Musharakah* (the financier takes a direct stake in the venture) (Khan, 2010) (Table, 2).

However, equity participation is not the sole means of Islamic financing available. Islamic banking may be done on the basis of something other than equity participation. There are actually two types of Islamic banking and finance (IBF): profit and loss sharing (PLS) and non-profit and loss sharing (non-PLS) (Obaidullah, 2005). PLS, as the name suggests, is participatory (direct equity stake or a partnership), or the financier may choose to be non-participatory and not take an equity stake. Virtually every IBF advocate

Table 2: Shariah-Based and Shariah-Compliant Products

Shariah-Based	Shariah-Compliant
Musharaka	*Murabaha*
Mudaraba	*Bai Muajjal*
	Ijara
	Bai Salam
	Istasna
	Qard al Hasana

argues that equity participation is the desirable alternative and non-participatory finance, sometimes referred to as 'trade-based financing modes,' is acceptable only as an interim measure or for situations where participatory finance is clearly unsuitable, such as very small or personal consumption loans (Usmani, 2002; Ayub, 2002; Sundarajan & Errico, 2002; Zaher & Hassan, 2001). This form of financing is frequently referred to as Shariah-compliant products and the main forms include *Murabaha* ('mark-up' or cost-plus sale), *ijara* (lease), *bay' salam/ istisna* (deferred delivery), *bai muajjal* (deferred payment), *jo'alah* (service fee), and *qard al hasana* (charity/beneficence loan) (Khan, 2010) (Table, 2).

Chong and Liu (2009) show that only 0.5% of Islamic financial institutions utilize PLS products in Islamic business transactions. The dominance of non-PLS transactions like *Murabaha* and *Ijara* in Islamic banking has led to questions concerning "How 'Islamic' is Islamic Banking" Khan (2010) and supported the critics of IBF (El Gamal, 2006; Kuran, 2004).

This study does not seek to answer that question but rather identify whether conventional and Islamic banking based on different philosophies, lead to different financial outcomes between Islamic banking and conventional banking. Several previous studies have compared the profitability, liquidity and risk performance of the two banking systems but few studies have focused on whether different philosophies lead to different revenue distribution outcomes. For example, Ryu, Piao and Nam (2012) found that Malaysia's IBs have lower risks and better profitability than CBs. In contrast, Samad (2004), found no significant difference in the liquidity and profitability between CBs and IBs. Hasan and Dridi (2010) examined the IBs and CBs during the recent global crisis by looking at the impact of the crisis on profitability, credit and asset growth, and external ratings in a group of countries where the two types of banks have significant market share. The findings suggest that IBs were affected differently than CBs. Factors related to the business model of IBs helped limit the adverse impact on profitability in 2008, while weaknesses in risk management practices in some IBs led to a larger decline in profitability in 2009 compared to CBs.

The revenue depicted in the income statement of both conventional and Islamic banks are allocated to five parties. These include profit return to depositors, taxation cost, net profit return to shareholders, banking operating cost and allowance for the impairment loan. But the appellations for the sharing of revenues to these five parties in the income statements of the two banking systems are different. In order to figure them out better, they are illustrated in Table, 3.

Table 3: Revenue Distribution in the Two Banking Systems

Revenue Distribution	Conventional Banking	Islamic Banking
Profit Return to Depositors	Interest Expense	Income Derived from Investment of Depositors' Funds
Taxation Cost	Taxation	Taxation and Zakat
Banking Operating Cost	Other Operating Expense	Other Operating Expense
Allowance for Impairment Loans	Allowance for Impairment Loans	Allowance for Impairment Loans
Net Profit Return to Shareholders	Net profit for the Financial Year	Net Profit for the Financial Year

To observe whether different philosophies lead to different outcomes, the following research hypotheses were tested:

H1, There is a significant difference in the profit return to depositors between conventional banking and Islamic banking.

H2, There is a significant difference in the taxation cost between conventional banking and Islamic banking.

H3, There is a significant difference in the net profit return to shareholders between conventional banking and Islamic banking.

H4, There is a significant difference in the banking operating cost between conventional banking and Islamic banking.

H5, There is a significant difference in the profitability performance between conventional banking and Islamic banking.

H6, There is a significant difference in the liquidity performance between conventional banking and Islamic banking.

H7, There is a significant difference in the risk performance between conventional banking and Islamic banking.

RESEARCH METHODOLOGY

A quantitative approach was applied in this study where secondary data was collected and analysed using SPSS. All data used in this study were obtained from selected samples of full-fledged Islamic banks and conventional banks in Malaysia. The required data came from the annual reports of selected banks. These included the income statements, and statements of financial position found in the annual reports of 2010 to 2014.

In Malaysia, some banks operate with an Islamic window and a Non-Islamic window (conventional bank), while others are either purely conventional banks or purely Islamic banks. For this study, only banks with both a conventional and an Islamic window were chosen for better comparability. There are a total of 11 banks in Malaysia with both a conventional and

Table 4: Selected Banks

Conventional Bank Groups	Islamic Bank Groups
Affin Bank	Affin Islamic Bank
Alliance Bank	Alliance Islamic Bank
AmBank	AmIslamic Bank
CIMB Bank	CIMB Islamic Bank
Hong Leong Bank	Hong Leong Islamic Bank
HSBC Bank Malaysia Berhad	HSBC Amanah Malaysia Berhad
OCBC Bank Malaysia Berhad	OCBC Al-Amin Bank Berhad
Public Bank	Public Islamic Bank
RHB Bank	RHB Islamic Bank
Standard Chartered Bank Malaysia Berhad	Standard Chartered Saadiq Berhad

Source: Bank Negara Malaysia, 2015

Table 5: Formulae for Financial Ratios

Ratio	Conventional Banking	Islamic Banking
H1: Profit return to depositors (Interest (*riba*) ratio)	Interest expense / Interest income	Income attributable to depositors / Income derived from investment of depositors' funds
H2: Taxation cost (Taxation ratio)	Taxation / (Interest income + Other operating income)	(Taxation + Zakat) / Total attributable income
	Taxation/ Profit before taxation	(Taxation + Zakat) / Profit before taxation
H3: Net profit return to shareholders (Net profit ratio)	Net profit for the financial year / (Interest income + Other operating income)	Net profit for the financial year / Total attributable income
H4: Banking operating cost (Other operating expense ratio)	**Overheads / (Interest income+ Other operating income)**	Other operating expense / Total attributable income
Profitability Performance (Pre-Tax Profit on Assets Ratio, Pre-Tax Profit on Shareholders Ratio)	Pre-Tax Profit / Total Assets Average.	
	Tax Profit / Shareholders' Funds	
Liquidity performance (Total Deposits to Total Assets Ratio)	Pre-Tax Profit / Total Assets Average	
Risk performance (Net Impaired Loans Ratio)	Net Impaired Loans / Net Total Loans Average	

an Islamic window, of which 10 were selected for this study (**Table 4**). One bank was omitted because the data was not complete.

Table 5 above describes the formulae for the financial ratios computed.

Table 6: Descriptive Analysis for All Ratios

Group Statistics

	Groups (Banks)	N	Mean	Std. Deviation	Std. Error Mean
Interest(Riba) Ratio	Islamic	50	.546369798	.1641109584	.0232087943
	conventional	50	.488260932	.0571931841	.0080883377
Tax on Income Ratio	Islamic	50	.062378971	.0218031495	.0030834310
	conventional	50	.084881637	.0153239625	.0021671356
Tax on Pre-tax profit Ratio	Islamic	50	.250866822	.0470523405	.0066542058
	conventional	50	.239000141	.0202344972	.0028615900
Net Profit on Income Ratio	Islamic	50	.186744985	.0624622698	.0088334989
	conventional	50	.270362875	.0438029137	.0061946675
Expense on Income Ratio	Islamic	50	.272291732	.0882776994	.0124843520
	conventional	50	.317525699	.0703046230	.0099425751
Pre-tax profit on Assests Ratio	Islamic	50	.010966866	.0043909655	.0006209763
	conventional	50	.015424422	.0025661101	.0003629028
Pre-tax profit on Shareholds' Ratio	Islamic	50	.154278285	.0661340920	.0093527730
	conventional	50	.197128565	.0410573947	.0058063924
Total Desposit on Assets Ratio	Islamic	50	.886856033	.0335477267	.0047443650
	conventional	50	.837208249	.0506764601	.0071667337
Net Impaired Ratio	Islamic	46	.007298784	.0054860113	.0008088682
	conventional	44	.003515369	.0026130647	.0003939343

FINDINGS

SPSS was utilized to run the result of the output as the objective for this study was to compare the outcome of Islamic banks and conventional banks in Malaysia from the year 2010 to 2014. To make the Levene's test for equality of variances and independent sample t-test (2-tailed), we chose a significance level of (α= 0.05) for equality of variances.

Table 6 summarizes the descriptive statistics calculated for the nine financial ratios. The sample size for the Net Impaired Loans ratio is less than 50, because some of the data for Net Impaired Loans was negative.

Table 7 summarizes the results of the independent sample test conducted using Levene's test for equality of variances, and t-test for equality of means.

Table 7: Independent Sample Test for Group Mean Difference

	Levene's Test for Equality of Variances		t-Test for Equality of Means		
	F	Sig.	t	df	Sig. (2-tailed) "P-Value"
Interest *(riba)* Ratio	19.351	0.000	2.364	60.730	0.021
Tax on Income Ratio	1.412	0.238	-5.971	98	0.000
Tax on Pre-tax Profit Ratio	3.061	0.083	1.638	98	0.105*

Continued from Table 7

Net Profit on Income Ratio	3.317	0.072	-7.750	98	0.000
Expenses on Income Ratio	2.489	0.118	-2.834	98	0.006
Pre-tax Profits on Assets Ratio	5.825	0.018	-6.198	78.9	0.000
Pre-tax Profit on Shareholders Ratio	6.575	0.012	-3.892	81.88	0.000
Total Deposits on Assets Ratio	4.679	0.033	5.776	98	0.000
Net Impaired Loans Ratio	15.361	0.000	4.205	65.049	0.000

Indicates the P-value is not significant

From the above results one can observe that the only ratio with no significant difference is the Tax on Pre-tax Profit Ratio. In summary, all the null hypothesis can be rejected. The above findings highlight that the philosophical differences between conventional banking and Islamic banking lead to significant differences in financial outcomes and distribution of revenues to different stakeholders.

Table 6 highlights the means of each ratio for both the conventional banks and the Islamic banks. The mean of Interest (*riba*) Ratio in the Islamic banks is 0.5464, which is bigger than the 0.4883 of the conventional banks. So, this means the Islamic banks share more of their profits with their depositors than the conventional banks. Compared to the low interest saving account in the conventional banks, the Profit-and-Loss Sharing (PLS) paradigm in the Islamic banks is more favourable to depositors.

Similarly, the mean of Tax on Income Ratio of the Islamic banks is 0.6238, which is smaller than the 0.8489 in the conventional banks. The mean of Tax on Pre-tax Profit Ratio of the Islamic banks is 0.2509 is, however larger than the 0.2390 in the conventional banks. Unlike the difference in Tax on Income Ratio which is significant, the difference in Tax on Pre-tax profit ratio is not significant. The mean of expense on income ratio of the Islamic banks is 0.2723 which is smaller than the 0.3175 in the conventional banks, meaning that compared to the conventional banks, other operating expense in the Islamic banks consume a smaller part of total revenue.

Tables 6 and 7 also highlight significant differences in Net Profit on Income Ratio, with the Islamic banks showing a smaller percentage (18%) in comparison to that of 27% for the conventional banks. The higher Net Profit on Income Ratio of the conventional banks is also reflected in the higher Pre-Tax Profit on Assets Ratio of the conventional banks (15%) in comparison to the Islamic banks

(10%) and also in the higher Pre-Tax Profit on Shareholders' Funds Ratio of the conventional banks (19%) in comparison to the Islamic banks (15%). This difference could be attributed to the higher percentage paid to depositors in the Islamic banks. In summary, Islamic banks appear to pay a bigger portion of their revenue to depositors, while having a better control of operating cost and taxation cost.

The statistics also indicate that liquidity of the Islamic banks is better (0.8869) in comparison to the conventional banks (0.8372), The Impaired Loan Ratio of the Islamic banks (0.0073) is however higher than that of the conventional banks (0.0035). The findings indicate that conventional banks probably have better risk management practices.

DISCUSSION AND CONCLUSION

As highlighted in the introduction and the literature review, the dominance of non-PLS banking transactions have raised questions concerning "How 'Islamic' is Islamic Banking?" This study sought to determine if different banking practices based on different philosophies lead to different financial outcomes. The findings strongly suggest that different banking practices based on different philosophies do indeed lead to different financial outcomes, as all the seven hypothesis tested indicate significant differences in all the financial outcomes.

The reasons for the significant differences are however difficult to explain. For example, why is Tax on Income Ratio lower for Islamic banks? The other interesting finding is the higher return to depositors of the Islamic banking windows in comparison to the depositors of the conventional banking windows and the lower returns to Islamic banking window shareholders. This probably occurs because the depositors of the Islamic banking windows and the conventional banking windows are different, but the shareholders of both banking windows are the same, and their returns is an aggregate of the total returns from both the Islamic and the conventional banking window, i.e., conventional banking window depositors are subsidizing Islamic banking window depositors. Similarly, it is also difficult to explain why the Expense to Income Ratio of Islamic banks is lower although Islamic banking transactions are much more complicated. One possible reason is the misallocation of expenses to the two windows. Similarly, why is the Net Impaired Loans Ratio higher for Islamic banks?

The study probably has raised as many questions as it has answered and also highlighted the difficulties in measuring the performance or financial outcomes of conventional banking versus Islamic banking when the two are operated by the same parent bank and are frequently in the same branch ■

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