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Research Article

A Comparative Analysis Of Financial Performance Of Conventional And Islamic Banks In Indonesia

Suskim Riantani[1], Wien Dyahrini[2]

[1,2]Economic and Business Faculty, Widyatama University

[1]suskim.riantani@widyatama.ac.id

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Abstract: This study aims to analyze the differences in financial performance between conventional banks and Islamic banks. Financial performance is measured through capital, asset quality, earnings, and liquidity. The unit of analysis was carried out on conventional banks and Islamic banks during the research period of 2014-2018. This research uses descriptive and comparative methods. The sampling method used was two-stage cluster sampling and purposive sampling. Observations were made on three conventional banks and three Islamic banks. The method of analysis used a mean difference test with the t test statistic at a significance level of 5%. The results showed that there was a significant difference in the capital of conventional banks and Islamic banks, conventional banks had better capital performance than Islamic banks. There is a significant difference between the asset quality of conventional banks and Islamic banks. Conventional banks have better asset quality performance than Islamic banks. There is a significant difference in earnings between conventional banks and Islamic banks. Conventional banks have better earnings performance than Islamic banks. There is a significant difference between the liquidity of conventional banks and Islamic banks. Islamic banks have better liquidity performance than conventional banks.

Keywords: capital, asset quality, earnings, liquidity, conventional bank, Islamic bank

1. Introduction

The development of the financial sector, which is marked by changes in the structure and improvements in banking performance in Indonesia, is expected to bring changes to the national economy. Financial institutions, especially banks have a very important role in the movement of the Indonesian economy. At a time when the state was in the process of economic recovery, banks were generally not able to optimally carry out their main function as financial intermediary institutions. Because when there is a slowdown in economic growth, banks will be very careful in extending credit. The role of banks as financial intermediary institutions will be needed when the country's economy is growing.

Banks as financial intermediary institutions collect funds from the public in the form of deposits and distribute them to the public in the form of credit and other forms (Law No.10 of 1998 Article 1 paragraph (2) concerning Banking). There are two types of banks in Indonesia based on the payment of interest or profit sharing: (1) banks that conduct business conventionally, and (2) banks that conduct business in sharia manner. Conventional banks and Islamic banks have similarities in several ways, especially in terms of the technicality of receiving money, the transfer mechanism, the computer technology used, the general conditions for obtaining financing, financial reports, and so on. The basic differences between the two are related to legal aspects, organizational structure, financed business, work environment, and profit sharing. Conventional banks fully apply the interest system, while Islamic banks apply the profit-sharing system. The contract entered into by a bank as a saver mediator with a borrower is carried out by setting an interest. Whereas in Islamic banks, public funds deposited in the bank are channeled to borrowers for profit. The profit will be shared between the customer and the bank according to the agreed agreement.

To accommodate the Indonesian people who are predominantly Muslim, in 1991 Muamalat Bank was inaugurated which runs operations with Islamic law. Islamic banks in Indonesia are increasing from year to year. Many conventional banks then opened branches operating in sharia. According to the Otoritas Jasa Keuangan (OJK), the performance of Islamic banking continues to grow. This is reflected in the position of Islamic banking assets which were recorded to still grow by 20.65%, financing 14.76% on an annual basis or year on year (yoy) at the end of February 2018.

Islamic banking is also a bank that is resistant to economic crises. When Indonesia experienced the monetary crisis in 1997, conventional banking experienced a very difficult period, even some banks were liquidated, because the deposit interest rate was so high that it reached more than 50%. This resulted in conventional banks unable to distribute loans and experiencing liquidity problems. But at that time, Islamic banks still showed good performance, because Islamic banks were not dependent on interest rate fluctuations. The Indonesian central bank also announced that Islamic banking was not affected by the global crisis in 2008. However, even though the

development of Islamic banks in Indonesia was very fast, banking was still dominated by conventional banking. Total assets, financing and third party funds from Islamic banks are still very small, not more than 5% compared to national banks.

A bank is a company that is engaged in trust, meaning that the bank will get a good reputation if the public can trust it. Therefore, bank management is required to be able to improve the performance and health of the bank. Based on these conditions, this study was conducted with the aim of comparing the financial performance of Islamic banks with conventional banks. Financial performance is measured through capital, asset quality, earnings, and liquidity.

2. Literature review

The Indonesian central bank determines banking financial performance indicators, which can be seen from the aspects of capital, asset quality, earnings, and liquidity. In this study, capital is measured through the capital adequacy ratio (CAR), asset quality through earning asset quality, earnings through return on assets (ROA), and liquidity through loan to deposit ratio (LDR).

Capital is used as a measure of performance, because capital shows the criteria for the adequacy of the bank's capital. Capital is used to determine the adequacy of the Bank in supporting its activities efficiently. Lack of capital is a common symptom experienced by banks in developing countries. This shortage of capital can come from two things, the small amount of capital, and the low quality. The assessment is based on the Capital Adequacy Ratio (CAR) set by the Indonesian Central Bank as the measure used in capital adequacy. Sufficient capital is related to providing own capital needed to cover the risks that may arise from investing in productive assets that contain risk and to finance investment in fixed assets in inventory. The CAR based on the BIS (Bank for International Settlements) standard is 8%. This is one way to calculate whether the existing capital in a bank is adequate or not. The fulfillment of BIS standards for international banking consists of 4% capital originating from shareholder equity, preferred stock, and free reserves. Then 4% of secondary capital comes from subordinate debt, loan loss provisions, hybrid securities and revolution reserves. Banks that do not meet the CAR of 8% are taken into account in assessing the soundness of the bank, will also be subject to sanctions in bank supervision and guidance.

Capital Adequacy Ratio (CAR) is the amount of capital adequacy for a bank to finance all assets that are assessed as potential risks. CAR is a ratio that shows the extent to which all bank assets that contain risk (credit, investment, securities, claims on other banks) are also financed from the bank's own capital funds in addition to obtaining funds from sources outside the bank, such as funds from the public. , loans and others. CAR shows the amount of reserve funds obtained from a comparison of capital and risk-weighted assets. If the CAR value is high, the bank is able to finance operational activities and make a large enough contribution to profitability. Thus, the higher the CAR, the better the bank's ability to bear the risk of any credit or risky earning assets. A decrease in CAR will certainly result in a decline in the ability of banks to extend credit. A low CAR also decreases the ability of a bank to survive when it incurs a loss. In addition, low CAR also results in decreased customer confidence which in turn can reduce bank profitability (Arinta, 2016; Basilgan & Akman, 2019).

Asset Quality measures the likelihood of funds being invested in productive assets (principal including interest) based on certain criteria. In Indonesia, asset quality is assessed based on its collectibility, current, special mention, substandard credit, doubtful credit, or bad credit. The difference in the collectability level is needed to determine the minimum allowance for earning assets write-offs that must be provided by the bank to cover the risk of possible losses. Based on the 1991 pakfeb, banks are required to establish a reserve of at least 1% of all earning assets plus 3% of earning assets classified as substandard, 50% of earning assets classified as doubtful, 100% of earning assets classified as loss. Assessment of the soundness of a bank's earning assets is based on an assessment of the quality of the earning assets against the assets being quantified. And based on two ratios, the comparison of classified earning assets to the total earning assets, as well as a comparison of the allowance for earning assets losses to classified assets (Kurniasari, 2015).

The profitability aspect is the bank's ability to increase profits and the business efficiency it wants to achieve. A healthy bank is a bank that can generate increasing profits. Profitability is measured from the Return on Assets as a measure of the bank's performance in terms of earning. ROA is an indicator of a bank's ability to generate earnings from its assets. Thus, effective asset management will provide a high ROA level. High ROA attracts investors to invest in banks through buying shares. The higher the ROA, the more effective the bank is in using its assets to generate profit after tax. Increasing ROA shows better bank performance (Prastawa, 2016).

Loan to Deposit Ratio is the ratio between loans and third party funds (current accounts, savings, time deposits, and other short-term liabilities). The LDR provides an indication of the amount of third party funds channeled in the form of credit. This LDR is an indicator of medium term bank liquidity. A bank shows liquid, if the bank concerned can pay all its debts, especially savings deposits, current accounts and time deposits when they are collected, and can fulfill all credit applications that are feasible to be financed. The Indonesian central bank determines the soundness level of a bank as follows: an LDR ratio of 110% or more is given a credit value of 0, meaning that the bank's liquidity is considered unhealthy, an LDR ratio below 110% is given a credit value of 100, meaning that the bank's liquidity is considered healthy. Some banking practitioners agree that the safe limit of a bank's loan to deposit ratio is around 80% with a tolerance limit ranging from 85% to 100%. Meanwhile, the central bank of Indonesia sets a limit for LDR of 78 - 92%.

Loan to Deposit Ratio (LDR) or finance to deposit ratio (FDR) in Islamic banks is a traditional measurement that shows time deposits, current accounts, savings, etc. used in fulfilling customer loan requests. The LDR compares the amount of funds disbursed to the public (credit) with the amount of public funds and the capital used. LDR describes a bank's ability to cover third party funds. LDR is a ratio that measures a bank's ability to meet its obligations, namely to extend credit. The assumption is that the bank is able to allocate credit effectively, then the number of non-performing loans will be small and credit risk will decrease. The higher the LDR, the higher the bank's profit. The increase in bank profits, the bank's performance will also increase (Muchlis, 2016).

The hypothesis in this study is that there are significant differences in the financial performance of conventional banks and Islamic banks, both in terms of capital, asset quality, earnings, and liquidity.

3. Research method

The research method uses descriptive and comparative methods, namely to see and compare the financial performance of conventional banks with Islamic banks. Financial performance is seen from four indicators, namely capital, asset quality, earnings, and liquidity. The research was conducted at conventional banks and Islamic banks during the 2014-2018 period. The sampling method used was two-stage cluster sampling and purposive sampling. Through this method, the sample in this study consisted of three conventional banks and three Islamic banks. The test statistic uses the paired t test, which is to test whether there is a difference in financial performance between conventional banks and Islamic banks during the study period.

Financial performance is seen from four indicators, namely capital, asset quality, earnings, and liquidity. Capital is measured through the capital adequacy ratio (CAR), which is the ratio between the amount of capital and the Risk Weighted Assets. Asset quality is measured by earning asset quality, namely the ratio between classified assets and total earning assets. Earnings is measured through return on assets, namely the comparison between profit after tax and total assets. Liquidity is measured through the loan to deposit ratio (LDR) or finance to deposit ratio (FDR) in Islamic banks, which is the ratio between loans and funds plus capital. The test statistic used the t test with a 95% confidence level.

4. Empirical finding and discussion

The following is a comparison of conventional bank CARs with Islamic banks during the study period.

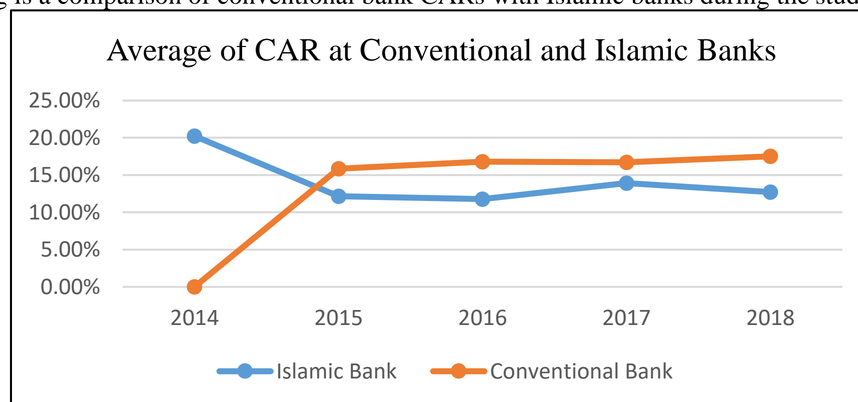

Figure 1. Average of CAR at Conventional Banks and Islamic Banks in 2014-2018

Based on Figure 1, it can be seen that the average CAR of conventional banks shows an increasing trend and is above the average CAR of Islamic banks. Thus, the performance of conventional banks is higher than Islamic

banks. However, the CAR level in each of these bank groups is in the healthy category based on the provisions of the central bank of Indonesia. The average CAR at conventional banks is higher because third party funds and total assets owned are higher than in Islamic banks. These large total assets mean that conventional bank CAR which must be kept for safeguarding funds is also large (Juniardi, 2018).

Asset quality in conventional and Islamic banks shows a downward trend during the study period (shown in Figure 2).

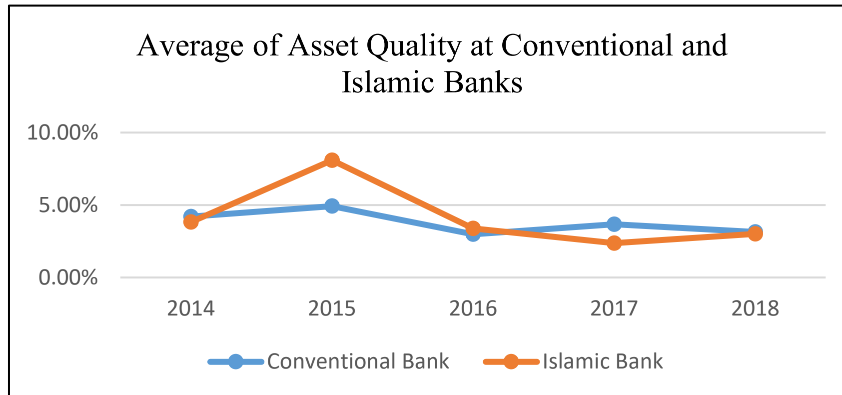

Figure 2. Average of Asset Quality at Conventional and Islamic Banks in 2014-2018

The average asset quality of conventional banks exceeds the average Asset quality of Islamic banks. Thus, the performance of conventional banks is higher than Islamic banks. Nonetheless, the level of Asset quality in each bank group is in the healthy category based on the provisions of the Indonesian central bank. Asset quality assessment is intended to evaluate the condition of bank assets and the adequacy of credit risk management. The high asset quality in conventional banks shows that the credit extended by conventional banks is higher than that of Islamic banks. So that conventional banks must provide sufficient reserves for earning assets to minimize the risk of loss (Hawaldar, 2017).

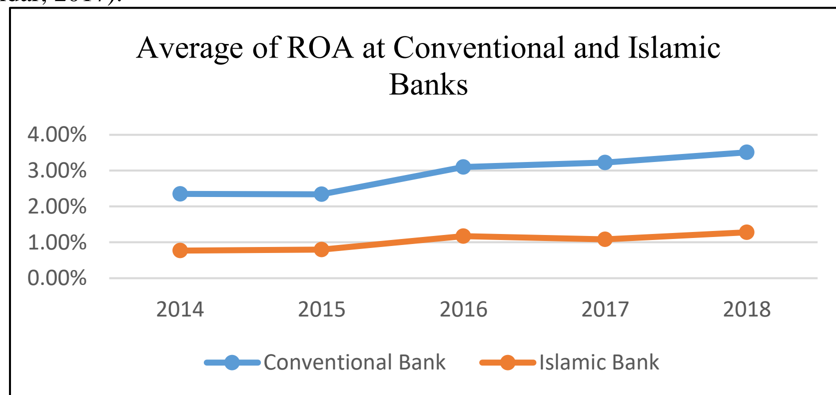

Figure 3. Average of ROA at Conventional Banks and Islamic Banks in 2014-2018

Figure 3 shows the trend of ROA in conventional banks and Islamic banks during the study period. The average ROA of conventional banks is higher than the average ROA of Islamic banks. Thus, the performance of conventional banks is higher than Islamic banks. The high ROA in conventional banks shows the high ability of banks to generate profits from their assets. This logically can be explained that conventional bank funds disbursed in credit are higher than Islamic banks. With an effective level of credit control, the high level of conventional bank funds allocated in this credit can also provide high benefits for banks (Muchlis, 2016).

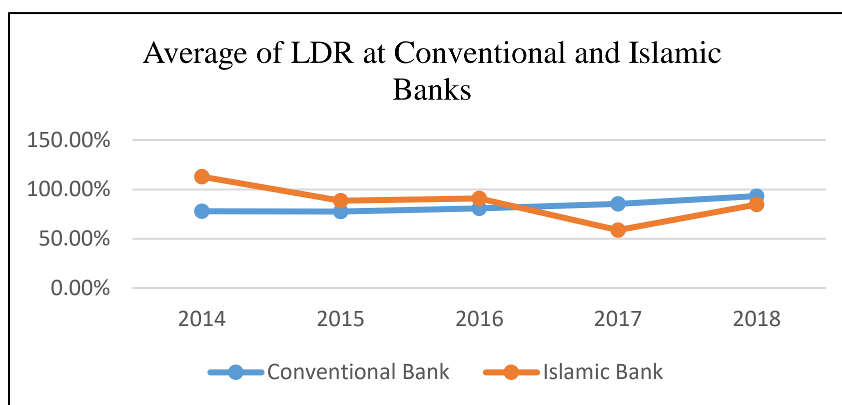

Figure 4. Average of LDR at Conventional Banks and Islamic Banks in 2014-2018

The average LDR (FDR) in Islamic banks as in Figure 4 shows an increasing trend from year to year. The average LDR of Islamic banks is higher than the average LDR of conventional banks. This shows that the performance of Islamic banks is higher than the performance of conventional banks. However, the LDR level has met the bank soundness level requirements set by Bank Central Indonesia. The FDR ratio shows the level of liquidity of Islamic banks where this ratio will determine the level of profit sharing that will be received by customers. The more customer funds that are allocated in the form of financing, the higher the profit sharing rate that the savings customer will receive. On this basis, the regulator does not impose a maximum limit on the liquidity ratio for Islamic banks. Meanwhile, regulators limit the liquidity ratio of conventional banks (Juniardi, 2018).

Table 1 shows the results of hypothesis testing that there is a significant difference in CAR between conventional banks and Islamic banks (P value 0.003). The results of this study are in line with the research of Arinta (2016), Muchlis (2016), Juniardi (2018). The results of the study contradict the results of Yustani (2014) study that the CAR of conventional banks is not different from Islamic banks. There is a significant difference between the asset quality of conventional banks and Islamic banks (P value 0.041). The results of the study are in line with the research of Prastawa (2016), Hawaldar (2017). The results of the study contradict the findings of Kurniasari (2015). There is a significant difference between the ROA of conventional banks and Islamic banks (P value 0.030). The results of this study support the research of Arinta (2016), Yustiani (2014), Muchlis (2016), Juniardi (2018), Khalil (2019). The results of the study are not in line with the findings of Abideen (2019). There is a significant difference between the LDR of conventional banks and Islamic banks (P value 0.018). The results of the study are in accordance with the research of Arinta (2016), Yustani (2014), Muchlis (2016), Prastawa (2016), Khalil (2019). The results of the study contradict the results of research conducted by Wahyuni (2017) which found that the LDR of conventional banks is not significantly different from the FDR of Islamic banks.

Table 1. Hypothesis Testing Results

Var	Sig	Mean Difference	
		Conventional	Islamic
CAR	0.003	16.220	14.170
Asset Quality	0.041	3.780	3.017
ROA	0.030	2.905	1.287
LDR	0.018	82.885	92.284

The findings of the research as a whole indicate that the performance of conventional banks and Islamic banks is significantly different. The performance of conventional banks is better than Islamic banks. It is understandable that although Islamic banks are more resilient to crises and show good development, conventional banks have been operating for a long time. So that when compared in terms of capital, asset quality, and earnings, conventional banks still have higher performance.

5. Conclusion

The results show that there is a significant difference in the capital of conventional banks as measured by the capital adequacy ratio (CAR) with Islamic banks. Conventional banks have better capital (CAR) performance than Islamic banks. There is a significant difference between the asset quality of conventional banks and Islamic banks.

Conventional banks have better asset quality performance than Islamic banks. There is a significant difference in earnings as measured by the return on assets (ROA) of conventional banks and Islamic banks. Conventional banks have better earnings performance than Islamic banks. There is a significant difference in liquidity as measured by the loan to deposit ratio (LDR) of conventional banks and Islamic banks. Islamic banks have better liquidity performance than conventional banks.

Suggestions for further research are to expand the unit of analysis both from the number of banks sampled and the study period. In addition, the variables used to measure performance by adding risk profile and good corporate governance factors, in addition to earnings and capital factors.

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