

# Comparative Study Islamic Banking and Conventional Banking of Rural Banking in Riau Province

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## Comparative Study Islamic Banking and Conventional Banking of Rural Banking in Riau Province

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### Abstract

*One of the unique banking in Indonesia is the rural banks (RB) (bank perkereditan rakyat, BPR). One form of microfinance institutions (MFIs) for poverty reduction is a rural bank. RB as one of the banking institutions has an important role in supporting the economy of Indonesia. The purpose of this study is to comparing the performance of RB which has Islamic system with RB which conventional system. The population and sample consists of 26 RB in Riau province. The period of this study is from 2012 to 2015. Data are taken from the bank's annual reports. This study using panel data and using pooled Ordinary Least Squares (OLS) and random effect. The results indicate that the dummy variable ownership and systems of banks, total assets, equity and the cost impact on the rural banks performance. While the region dummy variable is not significant to the performance of rural banks. We find that the Islamic banking of rural banks in Riau province perform better than the Conventional banking system. This suggests that the conventional systems due to the bank is not burdened with payment of the deposit fee is fixed, relatively more honest customer honesty in the payment of loans and revenue Islamic bank financing is greater than the various forms of financing offered to customers.*

**Keyword** : Islamic banking and Conventional banking and rural banks

### 1. Research background

These two types of banks can be found in most countries in the world. There are private owned banks and government owned banks, but the uniqueness of Indonesian banking system is that there is another owned banks category, which is called the rural banks (bank perkereditan rakyat, BPR). One form of microfinance institutions (MFIs) for poverty reduction is a Rural Bank or hereinafter referred to as RB. RB as one of the banking institutions has an important role in supporting the economy of Indonesia. One role of RB is difficult to help people who have access to bank lending public funds so that people do not need to borrow money from moneylenders. RB also participate in supporting the development of Small and Medium Enterprises

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(SMEs) in Indonesia, which became one of the largest business sectors in Indonesia, is assisting the government in job creation. BPR role here is to help the development of SMEs through lending capital raised from public funds; RB should improve their business performance. With good financial performance, the public confidence in the RB as financial institutions collector and distributor of funds will also be higher. RB in Indonesia exist in every district. RB has two systems, namely Islamic banking and conventional banking. Hence this study will try to identify whether the bank system pattern will affect the bank performance. Do they perform better than Islamic banking and conventional banking?. These are the questions that the study wishes to answer.

3 Both islamic banks and conventional banks are financial intermediation that helps to transfer the funds from investors, depositors or savers to borrowers. Regular Conventional Banks cannot be involved in venture transactions or merchandizing transactions, which is allowed in Islamic banks. But there are merchant banks who are allowed to do merchandizing. The main difference between islamic banks and conventional banks are practice of interest rate and speculative transactions, investment in alcohol, in tobacco and in pig made products are prohibited in accordance with Islamic principles. Generally, conventional banking Principles are manmade, whereas in islamic banks principles and rules are based on *Syariah* who set up the principles, simply to say transactions of Islamic banks are based on profit and loss sharing. As we are aware of, that interest rate for Conventional Banks is main source of earnings. As a proof, interest is forbidden in not only Islam and in Christianity as well. Likewise, as it is being stated in Quran chapter 3,verse 130 " O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful." And another proof in Quran chapter 2, verse 275 is "Allah has permitted trade and has forbidden interest. Unlike Islamic Banks, the conventional banks are not allowed to purchase commodities with the aim of reselling them, in other words it is forbidden for them to buy capital assets or fixed assets such as: building, tracks, cars, machineries with the purpose to resell them with mark up unless they do not use for their own.

In previous literature, a lot of work is done on determining the factors which influence the bank performance in Indonesia. But a little work is done on of RB, especially the comparison between the performances of RB that have Islamic banking and conventional banking in Riau Province. So, the main purpose of this study is to fill this gap by comparing the performance of RB that have Islamic banking and conventional banking and determining which factors have significant influence on bank performance of banking sector of RB during the period of 2012-2015.

## 2. Literature Review

The extent of literature on Islamic banking divided into theoretical and empirical dimension. The earliest works dealing with the potential of Islamic banking include Mannan (1968), Ahmad (1987), Saeed (1996) and Iqbal and Mirakhor (1999). These authors discussed a wide range of institutional issues including concepts and principles that are subject to interpretation. Due to the rapid growth in Islamic banking in these recent decades, it calls for opportunities for the academics to conduct study in analyzing its' financial performance using financial ratios. Some previous studies investigated performance of Islamic Banks and compare it with conventional banks performance (Samad, 1999; Samad and Hassan, 2000; Iqbal, 2001; Rosly and Bakar, 2003; Samad, 2004; Kader et. al, 2007; Widagdo and Ika; 2007; Beck et al., 2010; Jaffar and Manarvi, 2011; Ansari and Rehman, 2011; Wahidudin at al., 2012; Merchant, 2012; Zeitun, 2012; Babatunde and Olaitan, 2013)

Babatunde and Olaitan (2013) Comparing conventional and Islamic banks and controlling for all other factors, the studies find few significant differences in business orientation and performance in the areas of liquidity, profitability, risk and solvency and efficiency. The conventional banks are more profitable in addition to being better able to influenceively and timely meet up with financial obligations. However, Islamic banks are less exposed to liquidity risk and appear to be more cost-influenceive while the conventional banks depend more on external sources for funding.

Beck et al. (2010). Examining Islamic banks in 21 countries. The studied find Islamic banks perform better than conventional banks measured by ROA well during the global economic crisis and beyond the crisis. The results Usman and Khan (2012) show that Islamic banks have high growth rate and profitability than the conventional banks. Moreover the Islamic banks have high liquidity power than conventional banks.

Jaffar & Manarvi (2011) evaluated the performance of Islamic and conventional banks through Capital, Assets, Management, Earnings and Liability (CAMEL) test during the period of 2005 to 2009. The sample of their research are 5 Islamic banks and 5 conventional banks. The study found that Islamic banks performed better and having high liquidity than the conventional banks, moreover it is realized that conventional banks have pioneer in the management and having a good earning ability.

Iqbal (2001) evaluated the performance of Islamic banks through trend analysis and ratios analysis during the period from 1990 to 1998 and it is found that Islamic banks performed well than the conventional banks.

Study Wahidudin at al. (2012) analyze the determinants of profitability in Islamic banks will be compared to conventional banks in Association of Southeast Asian Nations (ASEAN) countries. The study found that profitability will look at different banking characteristics such as Short term fund management, Source management, capitalization, liquidity, size and Macro- economic conditions.

The study Merchant (2012) found out that after crisis Islamic bank increased their loan loss reserves, while conventional banks increased their loan loss reserves and equity to total assets. During the four year period of 2008 – 2011, Islamic banks possessed adequate capital structure but have lower Return on Assets Average (ROAA) and poor management efficiency. Asset quality and liquidity for both the modes of banking system have not any significant difference.

Zeitun (2012) directed a study on the Gulf Cooperation Council (GCC) for a period of 2002 – 2009, to assess the factors that affect financial performance the Islamic bank and conventional banks. The study included a sample of 38 conventional banks, and 13 Islamic banks. The factors that were studied were foreign ownership, bank specific variable and macroeconomic variables. Some interesting results were found. Cost to income ratio and performance of the banks held a negative correlation for Islamic and conventional banks. Equity was found out to be important factor in maximizing the profitability of Islamic banks. The size of the banks supported the economies of scale utilizing the ROE for Islamic banks. GDP was found to be positively related, while inflation negatively related to the banks performance.

Ansari and Rehman (2011) conducted a study on the performance analysis of Islamic and conventional banks in Pakistan for the period of 2006 -2009. By utilizing 18 different financial ratios which represented profitability, liquidity, risk and solvency, capital adequacy, deployment ratio and operational efficiency, the study found that in comparison to conventional banks, Islamic banks were highly liquid and less efficient. The study also found out that Islamic banks were less risky than conventional banks.

Dietrich and Wanzenried (2009) using qualitative variables to indicate the location of the differences between regions in the Swiss bank that is included in the observations. The results showed that banks in some areas have better performance. This study modifies the variable location to be the difference between urban and rural regions, to look at the possibility of differences in the characteristics contained as a result of differences in the operational area.

Large banks will profit from economies of scale. Thus, the cost can be reduced when compared to small banks. At the same time, large banks may also have operations in various ways. By then, the bank can take higher risk and gave of return is higher. This research will positively affect the bank's performance. Mamatzakis and Remoundos (2003), Alexiou and Sofoklis (2009), Sufian (2010), Barry et al. (2011) find that total assets have a positive effect on ROA and ROE. Meanwhile Sufian and Majid (2010), Barry et al. (2011) and Javaid et al. (2011) indicate where the amount of the asset has a negative correlation to ROA.

The study Berger and Bonaccorsi (2006), Mashharawi and Al-zu'bi (2009), Barry et al. (2011), Hoffmann (2011) and Gul et al. (2011) found that the ratio of equity have negative influence on ROE. This suggests that the cost of the agency consistent with the theory that the increased use of debt to increase ROE. Meanwhile Mashharawi

and Al-Zu'bi (2009), Alex <sup>2</sup> and Sofoklis (2009), Sufian (2010), Davydenko (2010), Sufian and Majid (2010), Barry et al. (2011), Javaid et al. (2011), Ramadan (2011), Riewasathirathorn <sup>2</sup> et al. (2011) and Sufian and Habibullah (2012) found that the ratio of equity have a positive influence on ROA. This shows the high equity ratio to increase banks' ability to overcome the loss of assets, including loans, increase the income of the bankruptcy cost reduction, higher gain if do offer some product expansion in profitable bank. High equity can reduce the amount of outside capital requirement which is higher than the cost of equity capital to be able to reduce bank profits.

The findings Beck et al. (2005), Mashharawi and Al-zu'bi (2009) and Mirzaei et al. (2011) found that the ratio of operating costs to total assets has a negative influence on ROA and ROE. Meanwhile Kosmidou et al. (2007) showed that the ratio of operating costs to total assets has no influence on ROA.

### 3. Research Methods

The population and sample <sup>2</sup> consists of 26 rural banks. The period <sup>2</sup> this study is from 2012 to 2015. The data are taken from banks' annual reports. In this study using panel data and using pooled ordinary least square (OLS) and random effect analysis. To test following model is estimated:

$$ROA_{it} \text{ dan } ROE_{it} = \beta_0 + \beta_1 * D_{SYARIAH}_{it} + \beta_2 * D_{OWN}_{it} + \beta_3 * D_{REG}_{it} + \beta_4 * ASSET_{it} + \beta_5 * COST_{it} + \beta_6 * EQUITY_{it} + e_{it}$$

where

$ROA_{it}$  : Return on assets of bank  $i$  in period  $t$ ,

$ROE_{it}$  : Return on equity of bank  $i$  in period  $t$ ,

$D_{SYARIAH}_{it}$  : A dummy variable that takes on a value of one if Islamic banking of RB <sup>2</sup> in period  $t$ , zero otherwise,

$D_{OWN}_{it}$  : Dummy variable taking the value 1 for government ownership and 0 for otherwise bank.

$D_{REG}_{it}$  : A dummy variable that takes on a value of one if RB located in the district  $i$  in period  $t$ , zero otherwise,

$ASSET_{it}$  : natural logarithm of total assets

$COST_{it}$  : operating costs to total assets.

$EQUITY_{it}$  : total equity to total assets.

$e_{it}$  : error term of bank  $i$  in period  $t$ .

### 4. Result and Discussion

The pooled regression results without adjusting standard errors for heteroscedasticity. To ensure that there is no problem of multicollinearity, variance inflation factor (VIF) are estimated and since the results show that the VIF are below 10.

Table 1. The Result Regression analysis  
Dependent Variable: ROA

| Variable          | OLS without standard errors |          | OLS with robust standard errors |          | Random Effect |          |
|-------------------|-----------------------------|----------|---------------------------------|----------|---------------|----------|
|                   | Coef.                       | p-value  | Coef.                           | p-value  | Coef.         | p-value  |
| Constan           | 11.766                      | 0.187    | 11.766                          | 0.168    | 4.383         | 0.704    |
| D_SYARIAH         | 9.775                       | 0.000*** | 9.775                           | 0.000*** | 9.571         | 0.000*** |
| D_DOWN            | -1.754                      | 0.078*   | -1.754                          | 0.013**  | -2.051        | 0.162    |
| D_REG             | -1.203                      | 0.116    | -1.203                          | 0.153    | -0.794        | 0.474    |
| ASSET             | -0.279                      | 0.576    | -0.279                          | 0.560    | 0.081         | 0.903    |
| COST              | -66.167                     | 0.000*** | -66.167                         | 0.000*** | -62.252       | 0.000*** |
| EQUITY            | 21.566                      | 0.000*** | 21.566                          | 0.000*** | 25.028        | 0.000*** |
| R-squared         | 0.838                       |          | 0.838                           |          | 0.835         |          |
| AdjustedRsquared  | 0.828                       |          | -                               |          | -             |          |
| Prob > F          | 0.000                       |          | 0.000                           |          | -             |          |
| Numberobservation | 104                         |          | 104                             |          | 104           |          |

\*, \*\* and \*\*\* denote significance at the 10%, 5% and 1% level, respectively, p-value in parentheses

Table 2. The Result Regression analysis  
Dependent Variable: ROE

| Variable           | OLS without standard errors |          | OLS with robust standard errors |          | Random Effect |          |
|--------------------|-----------------------------|----------|---------------------------------|----------|---------------|----------|
|                    | Coef.                       | p-value  | Coef.                           | p-value  | Coef.         | p-value  |
| Constan            | -294.020                    | 0.183    | -294.020                        | 0.183    | -403.404      | 0.047**  |
| D_SYARIAH          | 98.323                      | 0.000*** | 98.323                          | 0.000*** | 99.873        | 0.002*** |
| D_DOWN             | -32.200                     | 0.023**  | -32.200                         | 0.025**  | -37.960       | 0.107    |
| D_REG              | -1.321                      | 0.874    | -1.321                          | 0.874    | 5.972         | 0.740    |
| ASSET              | 18.514                      | 0.122    | 18.514                          | 0.122    | 23.742        | 0.038**  |
| COST               | -460.769                    | 0.000*** | -460.769                        | 0.000*** | -422.545      | 0.000*** |
| EQUITY             | 258.750                     | 0.031**  | 258.750                         | 0.014**  | 333.540       | 0.000*** |
| R-squared          | 0.598                       |          | 0.4738                          |          | 0.587         |          |
| Adjusted R-squared | 0.567                       |          | -                               |          | -             |          |
| Prob > F           | 0.000                       |          | 0.000                           |          | -             |          |
| Number observation | 104                         |          | 104                             |          | 104           |          |

\*, \*\* and \*\*\* denote significance at the 10%, 5% and 1% level, respectively, p-value in parentheses

Based on the the result regression analysis indicates that the variable ownership by the Government RB negative effect on ROA and ROE. It shows the performance of rural banks owned by the Government of the lower value of privately owned rural banks. Dummy variable *syariah* positive effect on ROA and ROE. It shows that performance-based *syariah* better than conventional of RB. Total assets positive effect on ROE. COST variable negative effect on ROA and ROE. Equity variable positive effect on ROA and ROE. While the dummy variable region does not affect the ROA and ROE.

The results of data analysis showed that the BR Islamic system better than conventional systems. This shows that the Islamic system is more profitable than conventional systems. Islamic banks more profitable systems due unencumbered bank deposit fee payments are fixed, relatively more honest customer honesty in the payment of loans and profit Islamic bank financing is greater than the various forms of financing offered to customers. The results support from the research conducted by Beck et al. (2010) and Ansari and Rehmad (2010). Their results show the bank performance with the Islamic system has a better than conventional bank system.



The result of data processing shows that the private ownership of rural banks by better than government-owned banks. This is caused by three factors, the first of coordination and weak supervision by the local government so that the management can abuse of office for his owned profit. Second, the incentives to management can not improve its performance while the actions and sanctions are very low. Third, the frequent political interest in the position and still have a bureaucratic system hinder the progress of the bank. Results of research conducted with Reaz (2005), Berger et al. (2005), Omran (2007), Micco et al. (2007), Iannotta et al. (2007), Fu and Heffernan (2008), and Cornett et al. (2010) found that the ownership structure of private bank have positive influence or significance toward bank performance, from that research can be shown that the private bank is better than government bank.

The results of COST variable negative effect on ROA and ROE. This shows that the banks that have high productivity and efficiency will always keep operating lower costs. By using electronic technologies such as ATM and money transfer can be a reason for lower costs. This can lower salary costs (capital may reimburse employees of the bank). The results of the study conducted with Beck et al. (2005), and Al-Zu'bi Mashharawi (2009) and Mirzaei et al. (2011) found that the ratio of operating expenses divided by total assets have a negative impact on ROA and ROE.

Variable EQUITY positive effect on ROA and ROE. This indicates that the high equity ratio can improve the ability of banks to cope with the loss of assets including loans, increase the income of the reduction in bankruptcy, earn higher profits if expanding the product offer of some banks is profitable. Number of high equity can reduce the need for outside capital where higher capital costs compared to equity so as to reduce bank profits. The results are consistent with research by Garcia-Herrero et al. (2009), Alexiou and Sofoklis (2009), Sufian (2010), Davydenko (2010), Sufian and Majid (2010), Barry et al. (2011), Javaid et al. (2011), Ramadan (2011), Riewsthirathorn et al. (2011) and Sufian and Habibullah (2012).

Dummy variable REG not significant to ROA and ROE. This is caused by the same bank operational system for all banks everywhere so RB on the provincial capital is no different performance by RB being the district.

## **5. Conclusion**

In this study, we examine the performance of rural banks in Riau province from 2012 to 2015. The results indicate that the dummy variable ownership and systems of banks, total assets, equity and the cost impact on the rural banks performance. While

the region dummy variable is not significant to the performance of rural banks. We find that the Islamic banking of rural banks in Riau province perform better than the Conventional banking system. This suggests that the conventional systems due to the bank is not burdened with payment of the deposit fee is fixed, relatively more honest customer honesty in the payment of loans and revenue Islamic bank financing is greater than the various forms of financing offered to customers. Meanwhile, there are three factors causing the performance of RB is lower than the government-owned RB is the first privately owned by the local government coordination and weak supervision so that management can abuse of office for his own profit. Second, the incentives for management can not improve its performance while the actions and sanctions are very low. Third, the frequent political interest in the position and still have a bureaucratic system hinder the progress of the bank. For their next study by adding variables and add RB sample areas to other provinces.

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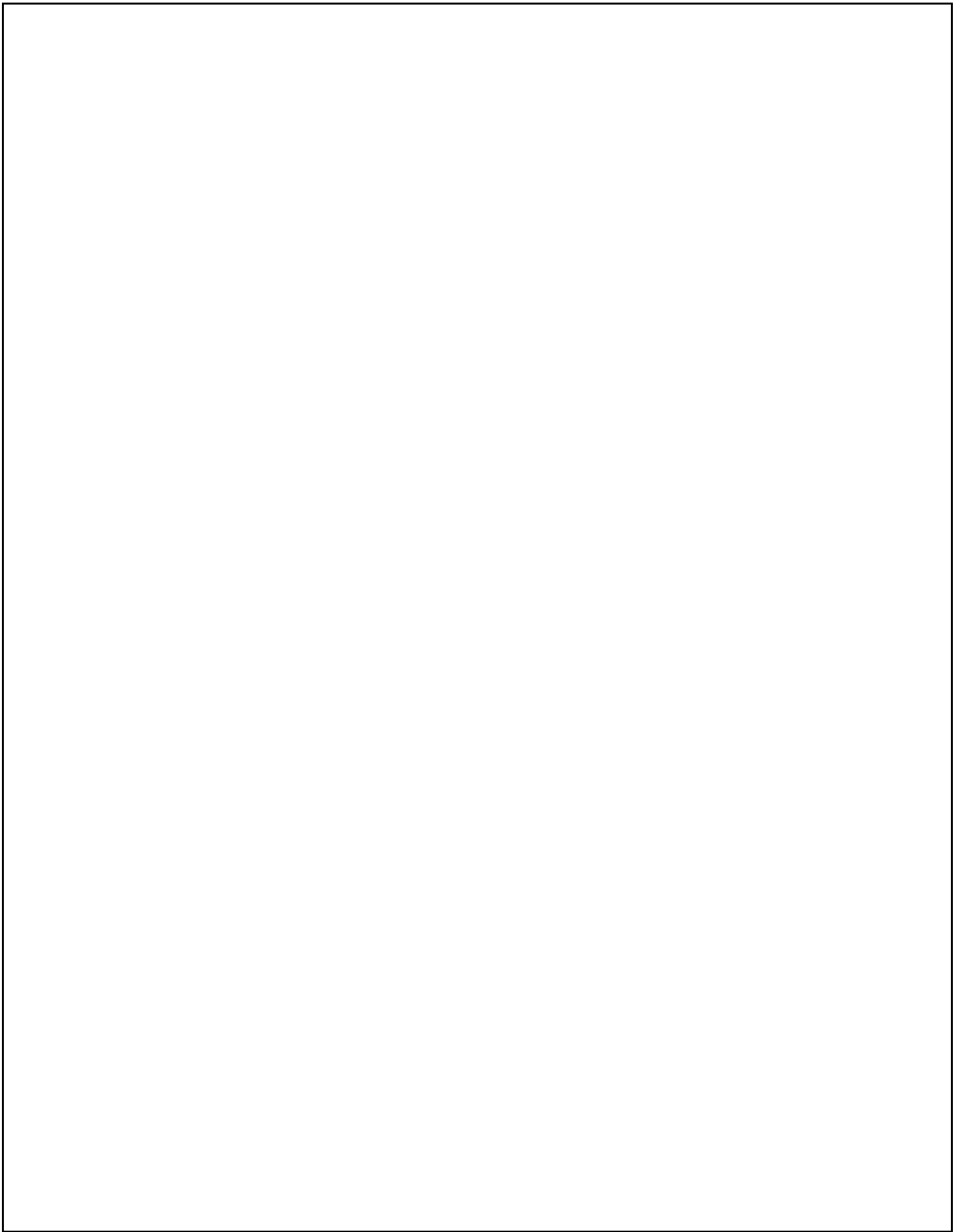
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