FINANCIAL PERFORMANCE ISLAMIC BANKING UNIT IN INDONESIA: A COMPARATIVE STUDY PRIVATE BANKS AND REGIONAL DEVELOPMENT BANKS

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Hamdi Agustin*

***Abstract**: One of the unique banking in Indonesia is a Regional Development Banks (RDB), which is a districts government-owned bank. Indonesia banks have Islamic banking units, where the status usually in division and business unit of the Bank's parent (conventional). But there are no funds will be mixed with the conventional, because they have a different system of financial records between sharia units and conventional units. The purpose of this study is to comparing the performance of RDB and private banks which has Islamic banking units. The population and sample consists of 24 Islamic business units Regional Development Banks (RDB) and private owned banks. From the 24 banks, only 18 banks were selected to be the sample. The banks are 7 private banks and 11 regional development banks. The period of this study is from 2010 to 2014. Data are taken from the bank's annual reports. This study using panel data and using pooled Ordinary Least Squares (OLS), random effect and fixed effect analysis. The results showed that RDB of Islamic banking units is better than Islamic business unit of private banks; this suggests that due to several factors. First, lending only to employees of the local government where government employees are very difficult to stop. Because of they are difficult to be dismissed; the probability that they are unable to repay loans is very low despite the unstable economic situation. Second, since RDB provide services only to an area only, so it has special knowledge about the area. This simplifies the RDB to assess loan applications from customers and identify viable loans. Third, the performance of RDB supervised by local governments This study also shows that DIBU, DEPOSIT, LDR, CAR and NPL plays a significant factor in explaining the performance of Islamic banking unit in Indonesia banks.*

***Keyword:** Financial Performance, Islamic Banking Unit, Regional Development Banks and Private Banks*

1. INTRODUCTION

Islamic bank as to conventional banks is for-profit organizations. However, bank Islam prohibits usury or business activity that is not in accordance with Islamic principles.

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The fundamental difference Islamic banks and conventional banks are both of institutions and businesses that relied on the principle of the capitalist economy, so the advantage is simply translated into the level and aspect of sheer material and reward results with the system of interest, while the Islamic bank is a banking principles which are based on Islamic values, thus favoring not only profit, but the spiritual benefits such as social and obtain the blessing of Allah SWT.

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 government owned banks category, which is called the community development banks. Community development banks in Indonesia exist in every district. They are monetary organizations operated on a local basis. In terms of coverage, their coverage is much smaller than the private and the publicly owned banks. RDB categorized as focused bank, i.e. the bank with regional focus. RDB has two systems, namely Islamic banking unit and conventional banking. Hence this study will try to identify whether the bank system pattern will affect the bank performance.

Regional development banks and private owned banks have Islamic business units where the statuses of the Bank's parent (conventional) level usually division, department, group, business unit, or even a product. But there are no funds will be mixed with the conventional, because the recording. Even though the transaction is done in a conventional parent bank counter, bank records in the system is also different and reporting to the Bank Indonesia is also different, so in principle the funds received from Islamic banks will not be mixed with conventional banks. Operational of Islamic banks are still not in accordance with Islamic sharia real. This can impact negatively for Muslims. In this case, Muslims had they own opinion that the system of Islamic banks is equal to the conventional system.

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 RDB, especially the comparison between the performances of RDB and private owned banks and that have sharia units and determining which factors have significant influence on bank performance of banking sector during the period of 2010-2014.

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; Roslyand 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).

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 is manmade, whereas in Islamic banks principles and rules are based on Sharia 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 markup unless they do not use for their own.

Several studies have documented that the state-owned banks have lower assets, higher costs and lower quality assets compared with private banks (Berger *et al.*, 2004; Micco *et al.*, 2004; Berger *et al.*, 2005). Additionally, Cornett *et al.* (2010) states that the bank holds government to lower profits have small capital and high-risk loans so as to reduce the bank's performance. They found that during the financial crisis, government banks have performed better than private banks in terms of cash flow, capital base and loan quality. After the financial crisis, private banks have performed better than government bank in terms of capital adequacy ratio, asset quality and management efficiency.

Micco *et al.* (2007) studied the relationship between bank ownership and bank profits in 179 countries. They found that state-owned banks have a negative impact on developing countries and has no influence on the industrial countries. State-owned banks in developing countries tend to have lower earnings margins and higher overhead costs than privately owned banks. They did not find evidence of a difference between the performance of government banks and domestic in industrialized countries. Flamini *et al.* (2009) studied 389 banks in Africa for the period 1998 to 2006 and found that state-owned banks have a negative effect on ROA. Bank-owned bank suffered a loss of bank management inefficient compared to privately owned banks. Fu and Heffernan (2009) investigate bank in China for the period 1985-2002. The results showed that the private bank is more profitable than the bank because the government has a growth advantage and higher efficiency of the government bank, despite having a market share which is smaller than the state banks.

Iannotta *et al.* (2007) studied three forms of bank ownership privately owned banks, joint venture banks and state-owned bank with a sample of 181 banks in 15 European countries for the period 1999-2004. Bank performance is measured using gross profit. The results showed that state-owned banks have lower profitability of private banks because the government has a shortage of bank capital, low deposit, the amount of lending to small and high liquidity levels of government so that the bank cannot operate optimally. Yu and Neus (2009) and Dietrich and Wanzenried (2009) also found that private banks earn higher returns compared to government banks in Germany and Switzerland respectively. The results of this study with Reaz (2005) who found the bank the government has return on assets is lower than the private banks in Bangladesh.

Berger *et al.* (2005) using data Argentina for the period 1990 to 1999 and found that state-owned banks have a weak profit before privatization. After privatization performance of these banks has increased. Omran (2007) investigated 12 banks in Egypt for the period 1996-1999. At that time, many state-owned bankswere privatized. The results showed private banks have profitability and efficiency of banks that have a mix of majority ownership by the government. This contrast with the findings Althanasoglou *et al.* (2008) who found a private bank in Egypt have lower performance due to mergers and acquisitions undertaken by these banks. Meanwhile, Chantapong (2005) found no effect of bank ownership on ROA and ROE in Indonesia and Thailand.

3. DATA AND METHODS

The population and sample consists of 24 Islamic business units Regional Development Banks (RDB) and private owned banks. In the 24 banks, only 18 banks were selected to be the sample. The banks are 7 private banks and 11 regional development banks. The period of this study is from 2010 to 2014. The data are taken from banks' annual reports. In this study, method using panel data and using pooled ordinary least square (OLS), random effect and fixed effect analysis. To test if Islamic Banking Unit influences performance of banks, the following model is estimated:

$$ROA_{it} = \beta_0 + \beta_1{*}DIBU_{it} + \beta_2{*}DEPOSIT_{it} + \beta_3{*}LDR_{it} + \beta_4{*}CAR_{it} + \beta_5{*}NPL_{it} + \beta_6{*}SIZE_{it} + e_{it}$$

Where:

ROAit	:	Return on assets of bank i in period t,
DIBUit	:	A dummy variable that takes on a value of one if Islamic banking unit of RDBi in period t, zero otherwise,
DEPOSITit	:	natural logarithm of total deposit.
LDRit	:	total loans to deposit ratio.
CARit	:	capital equation ratio.

NPLit	:	non-performing loans.
SIZEit	:	natural logarithm of total assets
eit	:	error term of bank i in period t.

4. RESULTS AND DISCUSSION

Based on Table 1 shows the ROA, DEPOSIT, LDR and SIZE differ significantly where DEPOSIT, LDR and private banks SIZE more higher than RDB. However, ROA of RDB is higherthan private banks. It shows the RDB have higher returns than private banks. It is caused by RDB know their respective regions so that loans can provide optimal benefits because they concentrated on their respective areas. To ensure that there is no problem of multico-linearity, variance inflation factors (VIF) are estimated and since the results show that the VIF are below 10.

Table 1
Comparisons of Mean of Selected Variables BetweenDifferent Systems of Banks

Ratios	*Means all bank (%)*	*Means (%)*	*p-Value (2 tailed)*
ROA	3.0428		0.000***
RDB	3.4516		
Private banks	2.4003		
DEPOSIT	15.1432		0.000***
RDB	13.3313		
Private banks	17.9904		
LDR	87.7088		0.003**
RDB	85.1033		
Private banks	91.7286		
CAR	17.0148		0.169
RDB	17.4346		
Private banks	16.3671		
NPL	1.1786		0.207
RDB	1.0802		
Private banks	1.3331		
SIZE	15.9375		0.000***
RDB	14.4453		
Private banks	18.2823		

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

Table 2 presents the pooled regression results without adjusting standard errors andwith robust standard errors for heteroscedasticity. When we test for heteroscedasticity using Breusch-Pagan test, we find that we can reject the null hypothesis of equal variances. Thus, a better estimation model should account for heteroscedasticity. The results ofdata processing using the pooled regression results indicate standard errors with out adjusting variable DIBU, LDR, CAR and NPLROA significantly influence the results, while the pooled regression with robustst and ardmethod is no different, only an additional variable DEPOSIT significantly to ROA.

Table 2
Regression Without Adjusting and with Robust Standard ErrorsDependent Variable: ROA

Variable	*OLS without standard errors*		*OLS with robust standard errors*	
	Coef.	*p-value*	*Coef.*	*p-value*
Constan	-1.445673	0.341	-1.445673	0.278
DIBU	1.049996	0.005***	1.049996	0.052*
DEPOSIT	-.0497795	0.408	-.0497795	0.073*
LDR	.0297095	0.010***	.0297095	0.010***
CAR	.0839541	0.017**	.0839541	0.094*
NPL	-.331598	0.012**	-.331598	0.041**
SIZE	.0593074	0.603	.0593074	0.461
R-squared	0.3385		0.3385	
Adjusted R-squared	0.2907		-	
Prob> F	0.0000		0.0000	
Number observation	90		80	

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

DIBU has a positive effect on ROA.Theory agency noted that the company managed by managers who do not have a stake in the firm will lead to a conflict of interest between managers and shareholders. However the results of this study found that even a bank manager had no interest in the bank, they still manage the bank very well. This may be due to several factors. First, lending only to employees of the local government where government employees are very difficult to stop. Because they are difficult to be dismissed, the probability that they are unable to repay loans is very low despite the unstable economic situation. Second, since RDB provide services only to an area only, so it has special knowledge about the area. This simplifies the RDB to assess loan applications from customers and identify viable loans. Third, the performance of RDB supervised by local governments, weakness bank manager showed the inability of local governments to identify a competent manager. This in turn will give a negative impact on the ability of local governments. This finding is contrast with Reaz (2005), Beck *et al.* (2005), Berger *et al.* (2005), Omran (2007), Micco *et al.* (2007), Iannotta *et al.* (2007), Fu and Heffernan (2008), Yu and Neus (2009) and Flamini *et al.* (2009) in which studies have found that private banks have better profit compared with a bank controlled by the government. The results of this study also differs with Hadad *et al.* (2003), Fernandez *et al.* (2005) and Chantapong (2005) who found the bank's ownership structure has not affect the bank's profitability.

DEPOSIT has a negative effecton ROA. It shows the Third Party Fund (DPK) burden on banks to pay the profit sharing ratio compared to owners of capital the bank receives the funds. This finding is contrast with Sudiyat no, Bambang (2010) and Hasan, Ghufran (2014). LDR has a positive effect on ROA. Loan to deposit ratio concerns the ability of a bank to anticipate changes in funding sources. This could have serious consequences on a bank's capacity to meet its obligations when they fall due. Effective liquidity management seeks to ensure that, even under adverse conditions, a bank will have access to the funds necessary to fulfill customer needs, maturing liabilities and capital requirements for operational purposes. The principal source of liquidity in the Indonesian banking industry is the large deposit base and, to a lesser extent, interbank borrowings. In recent years, almost all major Indonesian banks have exhibited excess liquidity as funds withdrawn from the Indonesia stock exchange were channeled into various types of deposits accounts. The result of study is related to Steinherr and Huveneers (1994), Haron, Sudin, (2004) and Alexius, C., & Sofoklis, V. (2009).

CAR has a positive effect on ROA. This suggests that bank shave greater equity better prepared for the changes in economic conditions. Large bank capital could reduce the cost of bank ruptcy and allow banks to makeloans at a lower cost. In addition a large bank capital allows the bank to take the opportunity while the economy is in good conditions where, for example, the bank may increase the amount of the loan and this will increase profits for the good economic conditions are likely customers are able topay their debts. The result is consistent with previous research study conducted by Demirguc-Kuntand Huizinga (2000), Pasioras and Kosmidou (2007), Iannotta *et al.* (2007), A than as oglou *et al.* (2008), Sufian (2010), Davydenko (2010), Sastrosuwi to and Suzuki (2012), Ramadan (2011) and Sufian and Habibullah (2012).

NPL has a negative effect on ROA. The loan loss is the most important determinant of bank profitability, and which can be defined as the possibility of losing all or part of the interest, loan asset or both. Theoretically, the increase in the Company's exposure to credit risk adversely affects the profitability of the company, and in order to improve profitability, the company shall act to reduce its exposure to credit risk through more effective credit risk management and control. This shows that loan-loss can reduce bank profits so that the lower the value of ROA**.** The result of study shows related to study of Mamatzakis and Remoundos (2003). Berger and Bonaccorsi (2006), Al-Hashimi A. (2007). Athanasoglou *et al.* (2008) Alexius and Sofoklis (2009) and Chen and Lion (2011), Ramadan, I. Z. (2011).

SIZE has not effect on ROA. This finding is contrast with Bashir (2003), Hassan dan Bashir (2005), Pasiouras dan Kosmidou (2007), Flamini *et al.* (2009), Naceur dan Goaied (2008) dan Riewsathirathorn *et al.* (2011) founda positive effect on ROA.

Mean while the results of data processing using methods and Fixed Effect Random Effectare not different from the pooled regression method without adjusting results with robust standard errors and standard. The results of data processing by using Random Effect DIBU are only significant variable to ROA. While, results using the Fixed Effect variable DEPOSIT, LDR and CAR significantly to ROA.

Table 3
Regression with Random Effect and Fixed Effect Dependent Variable: ROA

Variable	*Random Effect*		*Fixed Effect*	
	Coef.	*p-value*	*Coef.*	*p-value*
Constan	1.104753	0.632	25.5613	0.000
DIBU	1.264121	0.061*	dropped	dropped
DEPOSIT	-.0610296	0.571	-1.733227	0.000***
LDR	.0126098	0.270	.0203875	0.053*
CAR	-.0325879	0.417	-.0894288	0.022**
NPL	-.0999921	0.477	.1996541	0.135
SIZE	.1041152	0.582	.2030526	0.428
R-squared	0.2289		0.0153	
Adjusted R-squared	-		-	
Prob> chi2	0.3500		0.0000	
Number observation	90		90	

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

5. CONCLUSION

In this study, we examine the performance of Islamic banking unit in Indonesia from 2010 to 2014. Our study uncovers interesting results; find that the Islamic banking unit of community development banks performs better than the Islamic banking unit of private banks. This suggests that due to several factors. First, lending only to employees of the local government where government employees are very difficult to stop. Because they are difficult to be dismissed, the probability that they are unable to repay loans is very low despite the unstable economic situation. Second, since RDB provide services only to an area only, so it has special knowledge about the area. This simplifies the RDB to assess loan applications from customers and identify viable loans. Third, the performance of RDB supervised by local governments This study also shows that DIBU, DEPOSIT, LDR, CAR and NPL plays a significant factor in explaining the performance of Islamic banking unit in Indonesia banks.

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