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Examination of Profitability between Islamic Banks and Conventional Banks in Bangladesh: A Comparative Study

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Abstract

The aim of this research work is to compares the profitability of Islamic banks to conventional banks in Bangladesh. It considers reasons behind the difference in profitability. Profitability ratios: return on assets and return on equity is used to find out the superiority in terms of profitability between the two types of banks. The study includes 2nd Generation banks and annual reports for the year 2009-2011is used. The results of the study indicate that conventional banking is more profitable in Bangladesh. Adoption of certain business policies and modes of operation are the reasons behind the difference in terms of profitability as found through personal interviews conducted on bank executives from both spheres.

Keywords: Islamic banks, conventional banks, profitability, Bangladesh

JEL Classification: G20, G21

1. Introduction

The Islamic Banking industry has recently grown tremendously and has expanded widely reaching several international financial centers, reflecting an increasing interest in Shariah-compliant products and services. Given this growing interest, several international market institutions have launched Shariah-compliant indices (e.g. "Dow Jones" in the US and "FTSE" in the UK). According to the Saudi Arabian Monetary Agency (SAMA), the assets held by Islamic Financial Institutions amount to more than $822 Billion by end of 2009. By the end of 2010, they are expected to exceed $1 Trillion. There are more than 430 Islamic Financial Institutions operating in more than 75 countries. Moreover, about 191 conventional banks have opened Islamic windows. In addition, the total assets of Islamic investment funds amount to $ 27 billion by the end of 2009.

Islamic banking is in operation in Bangladesh from the year 1983. There are 30 private commercial banks out of which only 7 banks are operating on the principles laid by the Islamic Shariah and other 23 banks are conventional (interest based) banks. The growth of Islamic banking is worth observing. Moreover, the shifting of conventional banks such as Exim Bank Ltd, Social Investment Bank Ltd and First Security Bank Ltd to fully fledged.

Islamic banks and the others opening Islamic banking wing is indicating that there is business opportunity worth taking. The competitiveness of Islamic banks with the conventional bank gives the initiative to compare the profitability between these two extreme systems of banking. The purpose of this paper is to investigate which type of banking is more profitable and what are the possible reasons for superiority for the particular type.

2. Problem Statement

Although there are studies that investigated the differences in terms of profitability, liquidity, risk solvency, efficiency between the two types of banking in other parts of the world but there is no such study conducted in Bangladesh as per my findings. The Islamic banking industry has a substantial stake in the overall banking industry in Bangladesh and its conventional counterparts are doing their best by opening Islamic banking wings and some even converting them to fully fledged Islamic banks to have a share of the business opportunity. But, the question that needs to answer is which type of banking is more profitable and what are its underlying causes.

Bangladesh has witnessed three generations of banks coming into operation. There are six more banks being given license recently. It is important for all the stakeholders of all banks to know which type of banking is profitable and what are the underlying causes for the difference in performance.

3. Review of Literature

Comparative Studies Investigating Performance of Different Types of Banking

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 the performance of Islamic banks during certain period (Sarker, 1999; Arief, 1989; Wibowo & Saptutyningsih, 2004) while the others studied the performance of Islamic Banks and compare it with conventional banks performance (Samad, 1999; Samad & Hassan, 2000; Rosly & Bakar, 2003; Samad, 2004; Kader et al., 2007; Widagdo & Ika, 2007). Samad (2004) examined on the financial performance of interest free Islamic banking against interest-based conventional bank in Bahrain. Comparison analysis was made in terms of their liquidity, risk and credit risk and profitability during the period of 1992-2001 (post Gulf war period). The result showed that there is no significant difference between Islamic banks and conventional banks with respect of its' profitability and liquidity. However, the study finds that there exist significant differences in credit performance.

ROA and ROE for Assessing Bank Profitability

Mamatzakis and Remoundos (2003) examined the determinants of the performance of Greek commercial banks from 1989 to 2000. They measured the profitability of the commercial banks using the ratios of return on assets (ROA) and return on equity (ROE).

Business Policy and Profitability

Mamatzakis and Remoundos (2003) considered internal factors, like management policy decisions and external factors, like economic environment to explain the profitability of the banks. The results suggested that the variables related to management decisions assert a major impact on the profitability of Greek commercial banks.

4. Research Questions

This study proposes to investigate the following research questions:

1. Is there any difference between profitability of Islamic banks to conventional banks in Bangladesh?

2. Is the difference in profitability due to business policies adopted by the different systems of banking in Bangladesh?

5. Hypotheses

The hypotheses derived from the research questions are:

1. Conventional banks are more profitable than Islamic banks in Bangladesh.

2. The difference in profitability is due to the difference in business policies adopted by the two types of banking in Bangladesh.

6. Research Methodology

To measure financial performance of bank, this study employed 2 financial ratios that adopted from Samad and Hassan (2000).

The present study will investigate the profitability between Islamic banks and conventional banks using profitability ratios. The profitability ratios are used to assess the capability of company to generate earnings as compared to its expenses and other relevant costs incurred during certain period of time. This study uses following ratios for measuring profitability of bank.

a. Return on Asset (ROA) = profit after tax/total asset. It shows how a bank can convert its asset into net earnings. The higher value of this ratio indicates higher capability of firm. This ratio provides indicator for evaluating the managerial efficiency (Samad, 1999; Samad & Hassan, 2000; Samad, 2004; Kader et al., 2007)

b. Return on Equity (ROE) = profit after tax/equity capital. This ratio indicates how bank can generate profit with the money shareholders have invested. The higher value of this ratio shows higher financial performance. Like ROA, this ratio is also an indicator for managerial efficiency.

For the later part, in order to find out adoption of certain kind of business policies is the reason behind the difference in profitability, personal interview of bank executives will be conducted using open ended structured questions.

7. Data Set

Annual reports for the year 2009, 2010 and 2011 of the 15 2nd generation banks enlisted private commercial bank in the Dhaka Stock Exchange (DSE) will be used to calculate ROA and ROE. The banks are selected depending on the period of achieving banking license. This is done to make the analysis more realistic as the banks in a certain group have the opportunity to enjoy market exposure equal to its counterparts.

8. Empirical Result and Discussion

This section provides the findings of this study that are presented in figures and tables. Further analyses in light of the significant result are discussed in detail in this section. Table 1 outlines the financial performance comparison between Islamic banks and conventional banks in the period 2009-2011in terms of 'Return on Assets (ROA)' whereas; Table 2 shows the comparison in terms of 'Return on Equity (ROE)'.

Table 1. Return on Assets comparison (Appendix-1)

Name of Bank		ROA	
Islamic Banks	**2009**	**2010**	**2011**
Al-Arafah Islami Bank Limited	1.77%	2.65%	2.06%
Export Import Bank of Bangladesh Limited	2.02%	3.06%	1.56%
First Security Islami Bank Limited	0.68%	0.86%	0.64%
Social Islami Bank Limited	1.08%	1.17%	1.23%
Standard Deviation(for three years)		***0.77%***	
Conventional Banks	**2009**	**2010**	**2011**
Dhaka Bank Limited	1.23%	1.86%	2.14%
Eastern Bank Limited	2.08%	3.05%	2.17%
Mercantile Bank Limited	2.51%	1.64%	1.51%

Mutual Trust Bank Limited	1.55%	1.72%	0.53%
National Credit & Commerce Bank Limited	2.61%	2.84%	2.16%
One Bank Limited	1.61%	3.21%	1.88%
Premier Bank Limited	2.30%	2.60%	0.68%
Prime Bank Limited	2.26%	2.35%	1.85%
Southeast Bank Limited	1.66%	2.10%	1.21%
Standard Bank Limited	1.56%	2.06%	1.73%
Trust Bank Limited	1.13%	2.22%	1.21%
Standard Deviation(for three years)	0.61%		

2nd Generation conventional banks have higher mean ROA of 1.91% with standard deviation of 0.61% compared to Islamic banks mean ROA of 1.56% and standard deviation of 0.77%.

Table 2. Return on Equity comparison (Appendix-2)

Name of Bank	2nd Generation ROE		
Islamic Banks	2009	2010	2011
Al-Arafah Islami Bank Limited	24.10%	20.01%	18.34%
Export Import Bank of Bangladesh Limited	25.10%	27.77%	13.94%
First Security Islami Bank Limited	11.41%	13.99%	12.75%
Social Islami Bank Limited	12.14%	15.26%	11.03%
Mean (for three years)	***17.15%***		
Standard Deviation(for three years)	***5.82%***		
Conventional Banks	2009	2010	2011
Dhaka Bank Limited	19.32%	25.52%	24.13%
Eastern Bank Limited	17.26%	20.51%	17.49%
Mercantile Bank Limited	38.70%	19.84%	18.04%
Mutual Trust Bank Limited	22.27%	22.57%	8.40%
National Credit & Commerce Bank Limited	18.38%	25.35%	19.25%
One Bank Limited	23.68%	38.80%	20.61%
Premier Bank Limited	23.47%	28.23%	7.66%
Prime Bank Limited	23.93%	20.85%	19.25%
Southeast Bank Limited	16.51%	16.12%	9.87%
Standard Bank Limited	18.10%	24.34%	18.87%
Trust Bank Limited	16.27%	25.66%	15.92%
Mean (for three years)	***20.76%***		
Standard Deviation(for three years)	***6.63%***		

2nd Generation conventional banks have higher mean ROE of 20.76% with standard deviation of 6.63% compared to Islamic banks mean ROE of 17.15% and standard deviation of 5.82%.

Hence, hypothesis 1 can be accepted that conventional banks are more profitable than Islamic banks in Bangladesh.

Expert opinion for testing Hypothesis 2

T. Barua (personal communication, August 13, 2012) does not accept that conventional banks enjoy extra support from policies from its regulator the central bank.

However, she acknowledges the fact of difference in mode of operation as one of the differentials of profitability. She also acclaims that conventional banks have the opportunity to engage investments which is not possible for Islamic banks. And, having a diversified portfolio increases profitability of conventional banks.

A. Rahman (personal communication, August 13, 2012) accepts that mode of operation and business policy adopted by Islamic banks is making this type of banking less profitable. He argued that Islamic banks because of its Shariah compliance can not involve in call money business. Another example that he placed forward was that Islamic banks can not finance import of alcohol based drinks for 5 star hotels but it is possible for conventional banks. He also added that fund diversion which is a culture among Bangladeshi business persons is difficult in Islamic banks because of its procedures, thus these people prefer conventional banks. The lack of understanding of investment modes of Islamic banks by potential clients is a major issue making Islamic banks less profitable than conventional banks.

H. Islam (personal communication, August 13, 2012) shared the same views as by A. Rahman (personal communication, August 13, 2012). He added that clients consider the two types of banking as the same and do not understand the difference in operations and business policies.

From the expert opinions there is substantial evidence that the difference in business policies between the two types of banking is a reason for conventional banks being more profitable. Therefore, hypothesis 2 is accepted that the difference in profitability is due to the difference in business policies adopted by the two types of banking in Bangladesh.

9. Conclusion

This study examined the profitability of Islamic banks against the conventional banks in Bangladesh. Financial performance measures were expressed in terms of return on assets and return on equity. To make the study more robust, 2nd Generations banks were studied in the evaluation for the years from 2009-2011. Of the result, despite the remarkable growth in the number of total Islamic banks and Islamic units in Bangladesh, the result of this study has shown that, Islamic banks are more profitable than conventional banks.

The result of this study implies that even though Bangladesh is among the biggest Muslim community country in the world, the awareness of consuming Shariah compliance products and services are still low. This finding is consistent with previous study (Widagdo & Ika, 2007).

Although Islamic banking has gone through tremendous growth in the past few decades in Bangladesh and in the rest of the world, but it is still at its infancy compared to the existence of conventional banking. Raising awareness and explaining the modes of operations to existing and potential clients can increase profitability and overall competitiveness of Islamic banks.

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Appendixes

Appendix-1: Return on Assets Calculation.

The formula to calculate return on assets is:

$$ROA = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

Name of Bank	**2009**			**2010**			**2011**		
Islamic banks	Profit after tax	Total Assets	ROA	Profit after tax	Total Assets	ROA	Profit after tax	Total Assets	ROA
Al-Arafah Islami Bank Limited (AAIBL)	858,987,708	48,515,787,384	1.77%	1,959,046,882	74,005,006,188	2.65%	2,198,751,489	106,768,180,918	2.06%
Export Import Bank of Bangladesh Limited (EXIM)	1,682,990,615	83,319,897,893	2.02%	3,456,063,638	113,047,466,849	3.06%	2,017,715,667	129,709,816,841	1.56%
First Security Islami Bank (FSIBL)	326,837,749	47,978,552,952	0.68%	548,600,731	63,619,797,799	0.86%	579,939,082	91,012,899,089	0.64%
Social Islami Bank Limited (SIBL)	431,522,723	39,980,819,472	1.08%	640,104,563	54,665,814,961	1.17%	1,032,461,861	83,961,647,464	1.23%
Mean					1.56%				
Standard Deviation					0.77%				
Conventional Banks									
Dhaka Bank	959,372,816	77,767,413,094	1.23%	1,678,976,188	90,139,480,260	1.86%	2,242,648,272	105,037,213,825	2.14%

Limited									
Eastern Bank Limited	1,454,541,675	69,870,738,519	2.08%	2,514,201,697	82,530,978,439	3.05%	2,552,428,701	117,564,320,732	2.17%
Mercantile Bank Limited	1,662,776,869	66,166,515,602	2.51%	1,425,338,409	87,140,109,470	1.64%	1,755,727,337	116,655,283,665	1.51%
Mutual Trust Bank Limited	820,605,298	52,774,766,068	1.55%	988,362,060	57,529,205,095	1.72%	404,222,699	76,331,366,189	0.53%
National Credit & Commerce Bank Ltd	1,719,502,296	65,937,491,463	2.61%	2,371,678,769	83,554,177,553	2.84%	2,236,973,518	103,683,731,860	2.16%
One Bank Limited	726,700,936	45,163,169,144	1.61%	1,887,450,749	58,736,282,671	3.21%	1,271,757,611	67,640,780,157	1.88%
Premier Bank Limited	1,088,317,560	47,343,235,844	2.30%	1,772,018,163	68,240,347,651	2.60%	510,898,838	74,951,106,927	0.68%
Prime Bank Ltd	2,823,473,302	124,984,702,326	2.26%	3,640,602,007	155,222,005,259	2.35%	3,717,005,596	200,995,680,436	1.85%
Southeast Bank Limited	1,870,185,240	112,676,984,924	1.66%	2,763,933,028	131,784,270,526	2.10%	1,912,188,670	158,078,590,323	1.21%
Standard Bank Limited	764,249,513	49,000,899,514	1.56%	1,369,069,153	66,596,011,627	2.06%	1,296,508,644	74,953,060,139	1.73%
Trust Bank Limited	610,905,838	54,206,648,607	1.13%	1,294,438,303	58,360,673,800	2.22%	933,436,636	77,036,027,453	1.21%
Mean					1.91%				
Standard Deviation					0.61%				

Source: Taken from the primary data

Appendix -2: Return on Equity Calculation

The formula to calculate return on equity is:

$$ROE = \frac{Net\ Income}{Avg\ Stockholder's\ Equity}$$

Name of Bank	2009			2010			2011		
Islamic banks	Profit after tax	Equity Capital	ROE	Profit after tax	Equity Capital	ROE	Profit after tax	Equity Capital	ROE
Al-Arafah Islami Bank Limited (AAIBL)	858,987,708	3,564,728,466	24.10%	1,959,046,882	9,790,357,834	20.01%	2,198,751,489	11,989,109,322	18.34%
Export Import Bank of Bangladesh Limited (EXIM)	1,682,990,615	6,706,106,914	25.10%	3,456,063,638	12,446,729,033	27.77%	2,017,715,667	14,469,482,767	13.94%
First Security Islami Bank (FSIBL)	326,837,749	2,865,410,755	11.41%	548,600,731	3,920,011,486	13.99%	579,939,082	4,548,950,568	12.75%
Social Islami Bank Limited (SIBL)	431,522,723	3,555,754,821	12.14%	640,104,563	4,195,859,384	15.26%	1,032,461,861	9,358,334,353	11.03%
Mean					17.15%				
Standard Deviation					5.82%				
Conventional Banks									
Dhaka Bank Limited	959,372,816	4,965,681,970	19.32%	1,678,976,188	6,579,729,388	25.52%	2,242,648,272	9,293,796,879	24.13%
Eastern Bank Limited	1,454,541,675	8,429,152,418	17.26%	2,514,201,697	12,257,444,389	20.51%	2,552,428,701	14,592,202,592	17.49%
Mercantile Bank	1,662,776,869	4,296,251,741	38.70%	1,425,338,409	7,185,685,263	19.84%	1,755,727,337	9,730,888,265	18.04%

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Limited									
Mutual Trust Bank Limited	820,605,298	3,684,509,112	22.27%	988,362,060	4,378,809,286	22.57%	404,222,699	4,814,929,200	8.40%
National Credit & Commerce Bank Ltd	1,719,502,296	9,357,109,383	18.38%	2,371,678,769	9,357,109,383	25.35%	2,236,973,518	11,621,812,802	19.25%
One Bank Limited	726,700,936	3,068,565,231	23.68%	1,887,450,749	4,864,285,099	38.80%	1,271,757,611	6,171,169,693	20.61%
Premier Bank Limited	1,088,317,560	4,638,044,157	23.47%	1,772,018,163	6,277,115,732	28.23%	510,898,838	6,673,405,999	7.66%
Prime Bank Ltd	2,823,473,302	11,796,677,214	23.93%	3,640,602,007	17,464,292,325	20.85%	3,717,005,596	19,306,395,169	19.25%
Southeast Bank Limited	1,870,185,240	11,329,177,287	16.51%	2,763,933,028	17,145,997,491	16.12%	1,912,188,670	19,376,301,509	9.87%
Standard Bank Limited	764,249,513	4,221,723,852	18.10%	1,369,069,153	5,625,055,862	24.34%	1,296,508,644	6,870,527,272	18.87%
Trust Bank Limited	610,905,838	3,754,866,056	16.27%	1,294,438,303	5,045,020,636	25.66%	933,436,636	5,863,651,545	15.92%
Mean					20.76%				
Standard Deviation					6.63%				

Source: Taken from the primary data.