Financial Performance of Malaysian Founder Islamic Banks Versus Conventional Banks

Rosnia Masruki, Norhazlina Ibrahim, Elmirina Osman and Hishamuddin Abdul Wahab

This paper analyses and measures the performance of two Islamic Banks (Bank Islam and Bank Muamalat) as they deemed to be the pioneer and spearhead of the Islamic banking system in Malaysia. Both banks are then benchmarked against the conventional banks' performance over 5 years (2004-2008). When comparing Islamic banks profitability and liquidity against conventional banks, we found that Islamic banks are less profitable but have better liquidity than conventional banks. The higher profitability of conventional banks is due to the higher net financing and better asset quality that they have. In term of credit risk, we found that the conventional banks encountered high credit risk since their LDR much higher than Islamic banks. Future studies should expand this line of study to examine the best strategy that Islamic Banks can implement in order to attract more non-Muslims borrowers to apply financing from Islamic Banks even though Islamic Banks charging higher profit mark-up.

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1. Introduction

Islamic finance industry in Malaysia has been in existence for more than 30 years. The enactment of the Islamic Banking Act 1983 enabled the country's first Islamic Bank to be established. Malaysia's long track record of building a successful domestic Islamic financial industry of over 30 years gives the country a solid foundation that adds to the richness, diversity and maturity of the financial system. Presently, Malaysia's Islamic banking assets reached USD65.6 billion with an average growth rate of 18-20% annually. As at end-2009, the Islamic financial sector was represented by 17 Islamic banks, 22 commercial banking institutions, an Islamic money market, 8 takaful companies and a broad range of financial products.

The modes of operations between Islamic banks and conventional banks are different. The conventional banking operates on pre-fixed interest whilst Islamic banks based on profit sharing. The modes of operations are different. Islamic banking refers to a system of banking or banking activity that is consistent with Islamic law (Shari’ah) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called riba. Generally, Islamic law also prohibits trading in financial risk (which is seen as a form of gambling). The obvious different is the conventional banking operates on pre-fixed interest whilst Islamic banks based on profit sharing. The conventional banks earn profits by attracting deposits from the depositors at a low interest rate, then reselling those funds to the borrowers at higher

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3 Taken from http://www.bnm.gov.my/microsites/financial/0204_ib_takaful.htm#ib
interest rate, based on its competitive advantage at gathering information and underwriting risk. Therefore, conventional banks make profits from the spread between the interest rate received from borrowers and the interest rate paid to depositors (Mohamad, Hassan & Bader 2008).

The growth of Islamic banks and their performance are also being questioned. Can we say that Islamic banks are doing well compared to the conventional banks? Some argued that it is wrong to compared Islamic banks and conventional banks, when they have been in existence for decades. In this regard, conventional banks enjoy several advantages over Islamic banks. For example, conventional banks have very long history and experience, accept interest which is a major source of bank revenues, do not share loss with clients and ask for guaranteed collaterals in most transactions, enjoy very huge capital, spread widely, have much more developed technologies, can enter Islamic banking market (e.g. Citibank, Bank of America, Deutche Bank, ABN, AMRO, USB, HSBC, and ANZ Grindlays) and proved to benefit from theoretical and empirical research (Mohamad, Hassan & Bader 2008).

According to Samad (2004), many are skeptical about Islamic banks’ performance as newcomers to the market. There are several reasons for this. First, Islamic banks are non-conventional financial institution. Interest as the main income in conventional banks is completely prohibited under Islamic banking. Second, Islamic banks are required to follow two rules, firstly the conventional business laws (man-made law) and also the Islamic laws. The conventional banks are freely to enter any transactions as they like.

It is interesting to look at the current performance of Islamic banks and compared it to the conventional. Are they still far away from the long established conventional bank? This study examines how far the gap between conventional and Islamic banks. Another area worth examine is the determinants of the performance of Islamic banks and conventional banks. This triggers the current study to compare Islamic banks performance with conventional banks.

2. Literature Review

The efficiency of the banking system has been one of the hot issues in financial environment. Since their products and services are of an intangible nature, it is hard to measure their efficiency and competitiveness of financial institutions. Many researchers have attempted to measure the productivity and efficiency of the banking industry using outputs, costs, efficiency and performance. Bank’s performance able to provides signal to depositor and investors whether to invest or to withdraw funds from the bank and whether to buy or sell the bank’s securities. In addition, regulators also need to know the bank’s performance for regulation purposes. On the other hand, the bank’s manager needs to know how well the bank has performed towards its objective or goal by looking at the bank’s performance. However, how can we measure bank’s performance? There are many ways to measure bank’s performance for example using financial ratios and advanced statistical method such as Stochastic Frontier Approach (SFA) and Data Envelopment Analysis (DEA).
The existing literature in this area can be classified into two areas of study. Studies concerning Malaysia specifically have adopted two approaches. The first area of study is investigating the performance of Islamic banks over a certain time frame, and then testing whether they exhibit improving performance (Samad & Hassan, 1999). The second approach, the most popular one is comparing the performance of Islamic banking operations with conventional ones both at a point in time and using time-series analysis.

**Figure 1: The Classification of Studies Done in Determining Performance of Islamic Banks**

All of these studies adopted several methods in assessing the bank performance, which could be further broken down to parametric and non-parametric analysis. The easiest and popular method in assessing the performance of Islamic banks is using financial ratios (e.g.; Samad & Hassan, 1999; Iqbal, 2001; Hassan & Bashir, 2003; Rosly & Abu Bakar, 2003; Haron, 2004; Samad, 2004; Olson & Zoubi, 2008).

The other area of study look into the banks’ efficiency and use more complicated analysis called stochastic frontier approaches (SFA) – a parametric approach rather than financial ratios (Mohamad, Hassan & Bader 2008). Others have adopted a non-parametric analysis using Data Envelopment Analysis (DEA) (Bader et al. 2008; Suffian, 2006 and 2007).

**3. Research Methodology**

The main objective of this study is to compare performance between selected Islamic banks with conventional banks. For achieving the above objective, first, the two bank’s financial performances were analyzed based on their audited financial statements for the last five years (2004 - 2008), which includes five main areas of concern, a) profitability; b) liquidity; c) risk and solvency; and (d) efficiency. T-test is performed to examine any significant differences between these 2 banks. Then we do a comparative analysis between these two banks with the conventional banks. Finally, we presented the result findings and proposed suggestions to each bank’s management to improve performance.
4. Results and Discussions

4.1 Comparative Performance between Selected Islamic Banks\(^1\) and Conventional Bank

Table 1 presents comparative performance indicators of the two selected Islamic Banks\(^{ii}\) against Conventional banks\(^{iii}\). Table 1 also summarizes the time averages of some important ratios. Definitions for all ratios are given in the Appendix 1. The value of each ratio represents the average over the period 2004-2008. In order to see how Islamic banks performed in comparison with the conventional banks over 5 years, we use 11 financial ratios for bank’s performance on the following four financial ratios: (a) profitability; (b) liquidity; (c) risk and solvency; and (d) efficiency.

4.2 Profitability Ratios

The ROAA for Islamic banks is -0.7% while for conventional is 1.0%. This indicates that conventional banks have a healthy return on assets compared to Islamic banks. For every ringgit of asset, the conventional banks able to generate return of 1% of the asset. On the other hand, the Islamic banks making a loss of 0.7%, this is due to the losses incurred by Bank Islam in FYE 2005 and FYE 2006 (as mentioned previously) and Bank Muamalat in FYE 2004. For Bank Muamalat, in FYE 2004, the Bank incurred a net loss of RM26.3 million, mainly attributed to the higher loss provision amounted to RM76.6 million, which is an increase of 121 percent from its previous financial year.\(^{iv}\)(Refer Appendix 4 for Bank Muamalat’s accounting policy on Allowance for Bad and Doubtful Financing)

In terms of the Return on Average Equity (ROAE), that is the amount of profit the banks generate with the money shareholders have invested, the Islamic Banks recorded a lower ROAE than conventional at the average of 0.70% compared to conventional banks at the average of 13.7%.

The higher ROAA and ROAE of conventional banks are due to the higher net financing and better asset quality that they have. Their Net Loans/Total Assets ratio is higher at 57.1% than Islamic banks (45.2%) which denote higher total assets are tied to net loans; and their Impaired Loans/Gross Loan is lower at 6.4% against Islamic banks at 8.1%.

Thus, based on the higher ROAA and ROAE ratios of the conventional banks compared to Islamic Banks, we can conclude that conventional banks are more profitable than Islamic Banks. In terms of statistical differences, from the p-values of the ROAA(0.1225) and ROAE(0.04) ratios, only the ROAE is significant at 5% significance level.

4.3 Liquidity Ratios

From Table 1, the five years’ average of bank assets tied into loans\(^v\) ratio for Islamic banks stood at 45.2% which is lower than conventional banks (57.1%). This means that Islamic banks are more liquid than conventional banks.
The ratio of deposit run off for Islamic banks is 45.1% which is better compared to conventional banks (30.4%). This shows that Islamic banks have larger margin of safety to cover its short-term debts than conventional banks.

Also, from Table 1, we can see that the FDR\textsuperscript{VI} for Islamic banks (49.2%) is lower than conventional banks (68.1%) by 18.9%, this indicates that Islamic banks are more liquid than conventional banks.

Thus, looking at the above ratios, we could say that Islamic banks seem to have better liquidity ratios in comparison to conventional banks. This finding is contradict with Alkassim (2005) and Bashir (2003) which found that conventional banks have better liquidity ratios than Islamic banks. According to Haron (2004) Islamic banks experienced excess liquidity given the lack of Islamic financial instruments in the market for the Islamic bank to invest. Besides, the lower assets tied to net loans of Islamic banks compared to conventional banks which resulted in higher liquidity may due to the stringent financing policy i.e. must complied with 

Shari’ah unlike the conventional banks. Also, from the p-values of the above ratios for the Islamic and conventional banks i.e. 0.0061 for Net Loans/Tot Assets, 0.0001 for Net Loans/Dep & ST Funding and 0.008 for Liquid Assets/Dep & ST Funding, there are statistical differences for both banks at the 5% significance level.

4.4 Risk and Solvency

For financing to deposit ratio (FDR) from Table 1, the p-value (0.0001253) for net financing over deposit and short term fund vividly portrays that there’s significant difference of FDR between average of Islamic Banks (IB) and average of conventional Banks (CB) at 5% significance level.

From Figure 14, the conspicuous difference can be captured by large difference where 49.2% generated by IB and 68.1% FDR for CB. This result connotes that CB is much more susceptible towards credit risk and insolvency. The rationale behind this result can be justified by the market segment of banking in Malaysia. The base of conventional bank is much larger and stronger than Islamic banks. The CB managed to establish confidence among their depositors. The behavior of demands for loans is higher to CB than its counterparts which subsequently cause the excessive credit creation problem (Hasan, 2008). This high FDR becomes worst during economic downturn where the depositors panic of losing their savings and try to evacuate all their savings which also know as ‘bank run’ event. This finding parallels with findings by Linbo & Sherrill (2004) and Samad & Hassan (1999) that conclude the conventional banks more is vulnerable to credit risk.

Next, we will mull over the ratio of shareholder’s equity over liabilities. For E/L, as demonstrated in Figure 2, we can see that there’s significant difference of E/L between CB and IB with 8.4% and 5.3% accordingly. This finding has been supported by small p-value which is 0.027. Even though the E/L is less than one for both CB and IB, the higher value of E/L for CB delineates that CB can provide better equity buffer against claim on liabilities compared with IB. The same pattern also portrayed for equity over
short term funding (ESTF). The CB documents 9% of ESTF while the IB illustrates 5.5%. This large disparity shows that the equity owner’s fund for CB is better protecting the depositors fund. So, we can say that the CB is better than IB when it comes to the protection provided by shareholder’s equity to compensate the depositor’s funds.

Now, we will have closer investigations on how the IB and CB use their equity funds to supports the bank’s assets sides. First is ETA (equity to total assets). From t-test, the ETA for IB and CB is statistically difference (p-value= 0.036) where 7.6% belongs to CB and 5% for IB (as in Figure 2). Both ETAs shown to be less than 10% which implies that the IB and CB rely on large proportion of liabilities instead of equity to support their assets. The high ETA for CB explicates that the equity’s fund for CB can better support the total asset than IB. Antithetically, for the ENF, both types of banks are statistically not difference (p-value= 0.45). From Figure 2, the ENF for CB is higher with 13.2% while the counterpart generates 11.8%. This finding illustrates that during the impairment period of loans (financing), the equity funds for CB can cover their net loans assets by 13.2% while the IB can do the same job with lower capacity of 11.8%.

**Figure 2: Comparison between Average of Islamic Banks (BIMB and BM) and Conventional Banks with regards of Risk and Solvency ratios.**

So far, from the closer inspections of risk and solvency ratios on 5 indicators (FDR, E/L, EST, ETA and ENF) to Islamic banks (IB) and conventional banks (CB), from Figure 2, we can say both banks still exposed to the credit risk and susceptible towards insolvency. From FDR perspective, we can say that Islamic banks are better than conventional banks in controlling their insolvency risk where less than 50% of deposits and short term funding of IB used for credit creation. From the E/L and EST perspective, the conventional banks still becomes champion in providing better equity protection towards liabilities than Islamic banks. The high E/L and ESTF provides better confidence among the depositors and creditors to put their savings and investments. From ETA and ENL angle, we can summarize that the conventional banks can accommodates better equity cushion to support any changes in their asset position as demonstrated by high value of ETA and ENF relative with Islamic banks. The high ETA and ENL provide better buffer for protecting the assets, minimizing the volume of credit
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default and reduces the capital reliance over liabilities. From our view, in order to minimizing the credit risk withstands by Islamic banks, bank can control their credit creation. Besides that, the IB should boost level of equity to reduce the over reliance towards liabilities and provides higher equity buffer.

4.5 Efficiency

From Table 1, from Net financing Income Margin (NFIM) angle, we can ponder that the average NFIM for Islamic Bank outweighed its counterparts by 1.2 % (4% for IB and 2.8% for CB) as showed in Figure 2.

This result illustrates that the IB basically demands for higher net profit rate margin than interest margin commanded by conventional banks. The p-value (0.0321) confirms the substantial disparity.

Figure 3: Comparison between Average of Islamic Banks (BIMB and BM) and Conventional Banks with regards of Efficiency ratios.

From Figure 3, as expected, the same pattern also demonstrated by net financing revenue over asset (NFRA) as the IB required higher profit rate of 3% while the 2.2% belongs to conventional one. Both NFRA rates is statistically significant with 0.0009 of p-value. The higher NFIM and NFRA caused by higher mandates for profit rate revenues relative to the average asset.

Why Islamic bank mandates for higher profit rate revenues? The embryonic Islamic bank segment in the banking industry in Malaysia is not a concrete justification to explain the disparity since that the BIMB has started since 1983 and they have got ample time to strengthen their position in the sectors. One of the feasible reasons to explain the high NFIM lies on the wave of competition with conventional banks. Since that most of Islamic bank using two tier mudarabah system, they facing displaced commercial risk with conventional banks in respects of competition in providing higher return to depositors. As Bank Islam promise higher return to the depositors, they tend to increase the profit markup on their assets side (financing contract)\textsuperscript{vii}. Another reason that justifies the high NFIM for IB is that implementation of profit and loss sharing principle in their operations. In equity investment financing contract (such mudharabah
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and musyarakah), the Islamic banks act as rabb-ul mal and during the sluggish performance of the project, they have to bear huge pecuniary losses. This condition makes Islamic banks to mandates higher profit rate which indirectly elevates NFIM and NFRA.

Can we conclude that Islamic banks are much more efficient in regards with higher NFIM and NFRA? As explained in prior section, the higher margin is better. Our findings is parallel with Hassan (2005) who claimed that Islamic banks are more profit efficient than conventional counterparts. As NFIM and NFRA measures relative of average assets, we can say that Islamic banks profit efficient than conventional banks and favors the liability side of Islamic banks (higher profit rate return to depositors and creditors). But on asset side, the borrower has to pay more to compensate higher profit margin rate but with cheaper funding.
### Table 1: Financial Ratios (Islamic Banks vs. Conventional Banks)

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<td>Loan Loss Res / Gross Loans</td>
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<td>Total Capital Ratio</td>
<td>11.3</td>
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<td>Equity / Tot Assets</td>
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<td>7.6</td>
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<td>Equity / Net Loans</td>
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<td>13.2</td>
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<td>Non Int Exp / Avg Assets</td>
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<td>Return On Avg Equity (ROAE)</td>
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<td>Recurring Earning Power</td>
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<td><strong>Liquidity</strong></td>
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<tr>
<td>Interbank Ratio</td>
<td>392.9</td>
<td>29.5</td>
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<tr>
<td>Net Loans / Tot Assets</td>
<td>45.2</td>
<td>57.1</td>
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<td>Net Loans / Dep &amp; ST Funding</td>
<td>49.2</td>
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<td>30.4</td>
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<td>Liquid Assets / Tot Dep &amp; Bor</td>
<td>44.7</td>
<td>28.5</td>
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</table>

### 5. Conclusion

So far, we have done descriptive and ratio analyses to meet the objective of our study. The cornerstone objective of our study is to compare two founders of Islamic bank’s
performance (Bank Islam and Bank Muamalat) and compared it with benchmark of conventional bank.

From the findings on profitability and liquidity, Bank Muamalat is more profitable and liquid than Bank Islam although statistically they are insignificantly different. The higher profitability of Bank Muamalat owed to the increased in financing and higher asset quality i.e. the financing quality compared to Bank Islam. Bank Islam’s financing/loan also expanding from FYE 2004-2008 however the quality of the financing is lower which can be depicted by higher NPF which in turn attract higher unearned income and loan loss impairment. The higher unearned income and loss impairment which will be charged to expenses and resulted in lower profitability.

In terms of liquidity between Bank Islam and Bank Muamalat, the more liquidity of Bank Muamalat owed to the lesser total assets that are tied to net financing or loans and more liquid assets available for meeting deposit and short term funding demands compared to Bank Islam.

Besides, in comparing Islamic banks profitability and liquidity against conventional banks, we found that Islamic banks are less profitable but have better liquidity than conventional banks. The statistical differences between the two groups of banks in terms of profitability and liquidity ratios are also significant at 5% significance level except for the ROAA ratio. The higher profitability of conventional banks is due to the higher net financing and better asset quality that they have.

The findings of the excess liquidity of Islamic banks may be owed to the current problem faced by Islamic banks i.e. lack of Islamic financial instruments specifically for long term investments in the markets to dispose their surplus liquid funds and also, its suggest the likelihood that funds deposited by customers are lying idle as liquid assets which resulted with little or no income to the Islamic banks (Haron, 2004). Also, the higher liquidity of Islamic banks may due to the limited financing that the Islamic banks can provide compared conventional banks i.e the financing must be Shari’ah compliant.

From risk and solvency perspective, even though there is no statistical difference between Bank Muamalat and Bank Islam (FDR, ESTF, ENF and ETA), we can make some comparison here. Bank Muamalat is less risky than Bank Islam as demonstrated by strong equity cushion to cover liability, short term funding and assets (higher E/L, ESTF and ETA) compared with Bank Islam. The colossal financing to deposit ratio (FDR) also makes BIMB more susceptible towards credit risk and insolvency risk than Bank Muamalat. If we are looking on average Islamic banks against mainstream banks, there’s significance difference in FDR, ESTF and ETA. We found that the conventional encountered high credit risk since their FDR much higher than Islamic banks. But when it comes to the equity buffer, the conventional banks provides better shield than Islamic banks (IB) as demonstrated by high E/L, ESTF and ETA against IB.

For efficiency measure, there’s significance difference for NFIM and NFRA between BIMB and Bank Muamalat. We found that BIMB is much more profit efficient than BM in sense that they managed to earn higher profit rate (NFRA) and profit margin (NFIM)
relative to average assets. For rivals between Islamic banks and conventional banks, we found significant difference where Islamic banks become the champion with higher NFIM and NIRA. The higher profit margin might be benefits most to the liability counterparties (creditors and depositors) as they gained high profit return. On contrary, the borrower need to bear high profit mark-up from Islamic banks as to compensate with risk of default in settlement since that Islamic bank responsible to absorb all pecuniary losses on the financing contract. The good news for borrower for BIMB is that they gain cheaper fund as result of less financing expenses.

We admit that we cannot make ultimate conclusion on the outcomes from five years analysis. But perhaps, we managed to get some basic information or trend on the nature of performance for Islamic banks in Malaysia and open gates for future exploration.

5.1 Recommendations for Future Research

The interesting findings within this study have open wide path for future study. Several recommendations and extension on future study that have not been addressed within this study presented are What is the best strategy that Islamic Banks can implement in order to attract more non-Muslims borrowers to apply financing from Islamic Banks even though Islamic Banks charging higher profit mark-up? What’s the optimal level for loan to deposit ratio (LDR) that can boost firm performance? How can banks manage their large insolvency risk by having large credit creation (high LDR).

Endnotes

i In this case Islamic Banks only include Bank Islam and Bank Muamalat.
 ii Islamic Banks comprises of Bank Islam Malaysia Berhad and Bank Muamalat
 iv During the financial year, the Bank made an additional provis ion of RM17.4 million relating to non-performing financings which have been in default and remain uncollectible for a period of more than 4 years. An additional 50% provision is made for financings which have been in default for more than 4 years but less than 6 years as the collateral value is discounted by a further 50%. In addition, a full provision is made for financings which have been in default for more than 6 years as no value is assigned to their collateral.
 v Represented by Net Loans / Tot Assets in Table 5
 vi Ratio of credit to deposit denoted by Net Loans/Dep & ST Funding
 vii See Archer and Abdel Karim (2007)
 viii For comparison, it’s understood that the loans refer to conventional bank while for Islamic bank offering financing. To make the term for comparison simple, we will stay with term ‘loans’ as generated by Bankscope.
 ix For Islamic bank (IB), NFIM (net financing revenue margin)
 x For Islamic bank (IB), NFRA (net financing revenue / asset)
References


