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Profitability Determinants of Islamic Private-Owned Banks and Conventional State-Owned Banks in Indonesia

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The aim of this research was to investigate the effect of profitability determinants i.e. capital ratio, loan, size, deposits and credit risk of Islamic private-owned banks and conventional state-owned banks in Indonesia from 2012 to 2017. The population was 11 Islamic private-owned banks and 6 conventional state-owned banks. Based on the criteria of purposive sampling technique, a total sample of 12 banks was obtained (6 Islamic private-owned banks and 6 conventional state-owned banks). A multiple regression analysis was applied. The findings indicated that capital ratio, size, deposits and credit risk did not affect profitability of Islamic private-owned banks but loan positively did. The results also proved that capital ratio, deposits and credit risk did not affect profitability of conventional state-owned banks but size positively did. All profitability determinants of the two kinds of banks had no mean difference except credit risk. Due to the limitations of this research, it is recommended for further research to add other related variables of profitability determinants.

Key words: *Capital ratio, loan, size, deposits, credit risk, profitability, Islamic private-owned banks, conventional state-owned banks.*

Introduction

One of the goals of Islamic and conventional banks is to increase their profitability Zeitun (2012). The fundamental difference in gaining profitability between the two kinds of banks is that Islamic banks use profit and loss sharing on the basis of sharia principles namely musyarakah, mudharabah, ijarah, salam, murabahah, and other schemes. In the meantime, conventional banks are very contradictory where the interest expense on customer's loans is the main profitability.

The profitability of Islamic and conventional banks can be affected by both external and internal determinants. The previous research investigating the impact of external determinants i.e. (inflation rate, bank concentration, government ownership) to profitability were Saeed (2014), Ghazouani and Moussa (2013), Gul et al (2011), Ali et al. (2011), Saona, (2011), Sufian and Chong; (2008), Pasiouras and Kosmidou; (2007), Athanasoglou et al; (2006), Staikouras and Wood; (2004). The results proved that profitability of these two kinds of banks was affected by those external determinants.

Many researchers also conducted their research about the effect of internal determinants in conventional and Islamic banks. However, findings on the internal determinants i.e. (operating efficiency, capital ratio, credit risk, liquidity, loan, size, deposits) were still contradicted. For example, studies by Petria et.al. (2015), Capraru and Ihnatov (2014), Vong and chan (2009), Kosmidou et al. (2008), Bashir (2003) mentioned that profitability were positively influenced by operating efficiency, credit risk, capital ratio, liquidity and loan. Meanwhile, Alharthi (2016) Massod and Ashraf (2012), Smaoui and Salah (2011), Sufian and Abdul Majid (2011), Fu and Heffernan (2010), Miller and Noulas (1997) concluded that operating efficiency, credit risk, capital ratio, liquidity, loan negatively affected profitability. Ben Khediri (2009) investigated the relationship between loan to profitability in Islamic banks in the Middle east. The results stated that loans did not affect profitability.

Size and deposits are also one of the crucial internal determinants of profitability of Islamic and conventional banks. A study by Davydenko (2011), Idris et al. (2011), Goddard et al. (2004) mentioned in their research that a bank's size and deposits had a positive effect on profitability. The different studies were carried out by Mokni and Rachdi (2014), Lee and Hsieh (2013). The results showed that size and deposits had a negative effect on profitability.

The owners of conventional and Islamic banks can be state and private. However, the management of conventional stated-owned banks often gets intervention from the ruling government. Studies by Lee et al. (2013), Tong and Junarsin (2013), Love (2011), Fan et al., (2008), Faccio (2006), Khaja and Mian (2005), Sapienza, (2004) concluded that the government often intervened conventional state-owned banks to provide loans for corporate companies that had political relations with the authorities, force to issue loans that sometimes reach twice as much as they should. This intervention may give a bad effect to profitability of conventional stated-owned banks.

Conventional stated-owned banks in Indonesia are also inseparable from ruling government intervention. This condition occurs because of a conflict of interest. The management of conventional state-owned banks are sometimes government people involved in a particular political party or people who are an extension of the government so that the intervention is possible and in turn will have an effect on the profitability of the banks. A study by Kusdhianto et al. (2013) mentioned that the management decisions of state-owned companies in Indonesia got intervention from those who had power in the government which ultimately affected the profitability of the companies. Indonesian Corruption Watch (ICW) informed that the acts of corruption and financial manipulation are very large in state-owned enterprises (Irawan, 2012).

Most of previous studies only investigated the profitability determinants on conventional or Islamic banks. However, few studies focus on the internal determinants of the profitability of conventional stated-owned banks and Islamic private-owned banks. Furthermore, there have not been previous studies that examined the comparison of internal determinants of profitability between these two kinds of banks which have different schemes in gaining profitability.

Given the differences, results in the previous studies of: (i) the internal determinants effect to profitability of conventional stated-owned banks and Islamic private-owned banks, (ii) an intervention from ruling government to conventional stated-owned banks, and (iii) the different schemes in gaining profitability of the two kinds of banks, there has been no empirical research conducting a comparative internal determinants of profitability between the two kinds of banks especially in Indonesia. Hence, it is necessary to do research to investigate how internal determinants consisting of capital ratios, loan ratios, size, deposits and credit risk affect the profitability of the two kinds of banks in Indonesia. This research also tries to see whether there are mean differences of internal determinants between the two kinds of banks. This study only uses internal determinant variables because these variables are largely determined by bank management, but the decision is likely to be intervened by interested parties outside the bank's management, especially at conventional stated-owned banks.

The contribution of this study to literature is to fill the research gap that there are still differences in the results of the study and clarify how the influence of internal determinants on the profitability of conventional stated-owned banks and Islamic private-owned banks. The originality of this study was to conduct comparative studies to see how the impact of internal determinant on profitability and whether there are mean difference of internal determinants of two kinds of banks which has never been done by previous researchers, especially in Indonesia.

Literature Review and Hypothesis Development

Capital and Profitability

Capital is very essential for banks to increase profitability. Banks which have large capital will be protected from insolvency (Kosmidou; 2008). According to Dietrich and Wanzenried (2011), banks which maintain equity levels relative to their assets will perform well. Angbazo (1997) concluded that banks were funded more favorably than those that were not. Athanasoglou et al. (2008) investigated the impact of the reliability of banks on profitability in Greek banks. The results of the study showed that credit risk and capital ratios had a positive relationship with profitability. Furthermore, banks that have a higher equity to asset ratio usually do not depend on external funding so that cost of capital can be reduced which ultimately contributes a positive effect on bank profitability. Based on previous studies, the hypothesis is:

H1: Capital ratio has a positive effect on the profitability of Islamic private-owned banks and conventional stated-owned banks.

Loans and Profitability

The impact of the number of bank loans on the bank's financial performance is difficult to predict. If the bank has a high loan, this allows the bank to get a higher profit and also increase the risk. Staikouras and Wood (2004), Bashir, (2003), Sufian and Habibullah, (2009) proved that increasing loans will have a positive effect on profitability. Even though loans were the dominant profitability of the bank, there were studies that proved the negative effect of loans on profitability. Hassan and Bashir (2005) proved that an increase in the laons ratio would have a negative effect on profitability because in fact profitability is also influenced by the loan portfolio provided. Most empirical studies prove that loans are important because they have a positive impact on increasing bank profitability. Based on these studies, the hypothesis is:

H2: Loans ratio has a positive effect on the profitability Islamic private-owned banks and conventional stated-owned banks.

Size and Profitability

The role of bank size in maximising profitability is still a matter of controversy in the literature review. Most literature studies proved that size could provide an optimisation of company profitability. Alp et al. (2010), and Dogan (2013) stated that size had a positive and significant relationship to the profitability of a company. This research is also supported by research conducted by Athanasoglou et al. (2008), Pasiouras and Kosmidou (2007), Gul et al. (2011), Saeed (2014). Their results proved that size had a positive and significant influence on profitability. The companies that have a large size will benefit from the existence of an economy of scale. If the size of the company enlarges, it will have market power, reduce risk and the economies of scale will encourage efficiency and easy access to markets. According to the hypothesis of relative efficiency (Clarke et al., 1984), banks that have a large size are more efficient and more profitable compared to banks with small size. The hypothesis of this research is:

H3: Size has a positive effect on the profitability of Islamic private-owned banks and conventional stated-owned banks

Deposits and Profitability

The more deposits the bank gets, the more the loan can be distributed to customers and increase profits. Lee and Hsieh (2013) stated that additional bank deposits can increase profits while low deposits may have a negative impact on their profitability. Therefore, customer deposits are positively related to bank profitability. However, the inability of banks to release loan money can reduce the level of profitability because interest must be paid to depositors. Deposits are expected to affect positively banking performance. If the deposit grows higher, it will be able to expand the bank's business and consequently generate more profits. The impact of deposit growth on profitability depends on several factors, namely: the ability of banks to transform deposits into productive income assets, bank operational efficiency and higher credit quality. The hypothesis of this research is:

H4: Deposits has a positive effect on the profitability of Islamic private-owned banks and conventional stated-owned banks.

Credit Risk and Profitability

Credit risk has the potential to have an impact not only on banks as creditors but also shareholders, managers, suppliers, customers, financial communities, governments, competitors and regulators. The quality of the loan portfolio is used as a proxy for credit risk, which is determined by the loan loss / total assets losses. High non-repayment allowances from loans, as measured by provisions for loan losses, reflect a decrease in credit quality. In the long run, the decline in credit quality can have a negative effect on profitability because the actual depreciation costs from default tend to be higher. Furthermore, the allowance for credit losses is an indicator of the quality of bank assets. A higher ratio indicates a decrease in credit quality and can cause a decrease in profitability because bad credit is expected to reduce profitability. The negative impact of loan loss reserves on banks will show a decline in loan quality, increasing provisioning costs. Thus, the loan loss against the total loan ratio has a negative relationship with the profitability of the bank. Miller and Noulas (1997) found a negative relationship between credit risk and bank profitability and they argued that such correlations signify greater risks related to loans. Then a higher loan inventory level can raise bank concerns. Changes in credit risk may reflect changes in the health of the bank's loan portfolio (Cooper et al., 2003), which can affect the performance of the institution. Decrease in company profitability is caused by variations in credit risk. Athanasoglou et al. (2008) stated that banks set a number of specific standards for the level of provisions for lending adopted by the national banking system. The hypothesis of this research is:

H5: Credit risk has a negative effect on the profitability of Islamic private-owned banks and conventional stated-owned banks.

This research aims to investigate the influence of internal determinants i.e. (capital ratios, loan ratios, size, deposits and credit risk) on profitability in Islamic private-owned banks and conventional state-owned banks in Indonesia. The The population was 11 Islamic private-owned banks and 6 conventional state-owned banks. Purposive sampling technique was applied. The criteria of sampling as follows:

1. Islamic private-owned banks and conventional stated-owned banks in Indonesia.
2. These two kinds of banks Islamic private-owned banks and conventional stated-owned banks in Indonesia that provide complete annual financial reports from 2012-2017.

Based on the criteria of purposive sampling technique, a total sample of 12 banks was obtained (6 Islamic private-owned banks and 6 conventional state-owned banks). The data used in this study is secondary data obtained from the official website of the Indonesian stock exchange and the web of Islamic banks in Indonesia. Variables, measurement of variables and scales are in table 1 below:

Table 1: Variables, Measurement of Variables and Scales.

Variables	**Measurement**	**Scales**
Profitability	Earning after tax/ *Total Asset*	Ratio
Capital ratio	Equity / Total Asset	Ratio
Loans	Net Loans / Total Asset	Ratio
Size	Log total assets	Ratio
Deposits	Total deposits / Total Assets	Ratio
Credit risk	loan losses / total assets.	Ratio

A multiple regression analysis was employed to determine the influence of capital ratios, loan ratios, size, deposits and credit risk on profitability. The regression equation model in the study is as follows:

Model 1: Regression Equation

$$Y1 = \alpha 1 + \beta 1\ X1 + \beta 2\ X2 + \beta 3\ X3 + \beta 4\ X4 + \beta\ 5X5 + e1$$

Information:

Y1 = Profitability i.e. (Return on assets / ROA) of Islamic private-owned Banks

α1= Constant of Islamic private-owned banks

β1, β2, β3, β4, β5 = The coefficient of capital ratio, loans, size, deposits and cedit risk of Islamic private-owned banks.

X1. X2., X3., X4., X5. = capital ratio, loans size, deposits and cedit risk of private-owned Islamic bank

e1= error

Model 2 : Regression Equations

$$Y2 = \alpha 2 + \beta 6\ X6 + \beta 7\ X7 + \beta 8X8 + \beta 9X9 + \beta 10X10 + e2$$

Information:

Y2 = Profitability (Return on assets / ROA) of state-owned conventional banks.

α2 = Constant of state-owned conventional banks.

B6, β7 β8, β9, β10 = The coefficient of the capital ratio, loans, size, deposits and cedit risk of conventional state-owned bank.
X6. X7 X8 X9, X10 = capital ratio, loans,size, deposits and cedit conventional risk of conventional state-owned banks.
e2 = Error

Research Findings and Discussions

Table 2 and Table 3 mention the descriptive statistics of Islamic private-owned banks and conventional state-owned banks. The average profitability, capital ratio, loans, size, deposits, and credit risk of Islamic private-owned banks are 0.065, 0.136, 0.365, 10.53, 0.216 and 0.05 respectively. Meanwhile, the average profitability, capital ratio, loans, size, deposits, and credit risk of Islamic banks of conventional private-owned banks are 1.92, .134, .646, 10.58, .2161 and .050 respectively.

Table 2: Descriptive Statistics of Islamic Private-Owned Banks

	N	Minimum	Maximum	Mean	Std. Deviation
Profitability	36	.01	.48	.0650	.10574
Capital ratio	36	.01	.46	.1361	.12918
Loans	36	.01	.83	.3650	.23291
Size	36	6.13	12.86	10.5814	2.18491
Deposits	36	.02	.69	.2161	.24099
Credit risk	36	.00	.62	.0500	.10656
Valid N (list wise)	36				

Table 3: Descriptive Statistics of Conventional State-Owned Banks

	N	Minimum	Maximum	Mean	Std. Deviation
Profitability	36	.73	3.41	1.9253	.83305
Capital ratio	36	.08	.22	.1344	.03202
Loans	36	.05	.80	.6464	.11816
Size	36	6.61	9.05	8.2511	.73972
Deposits	36	.32	.84	.7169	.08661
Credit risk	36	.00	.16	.0522	.03448
Valid N (list wise)	36				

The regression results in Table 4 prove capital ratio, size, deposits and credit risk do not affect the profitability of Islamic private-owned banks while loan ratio does. On the other hand, Table 5 shows that only the size affects the profitability of conventional state-owned banks while capital ratios, loans, deposits and credit risk do not.

Table 4: Regression results in Islamic Private-owned Banks

Coefficients[a]

Internal Determinants	Unstandardized Coefficients	t	Sig
	B		
Constant	-.233	-1.505	.143
Capital ratio	.132	.676	.504
Loans	.197	2.630	.013
Size	.021	1.757	.089
Deposits	-.077	-1.008	.321
Credit risk	.089	.537	.595

a. Dependent Variable: Profitability

Table 5: Regression results in Conventional Stated-owned Banks
Coefficients[a]

Internal Determinants	Unstandardized Coefficients	t	Sig
	B		
Constant	-4.244	-1.403	171
Capital ratio	4.711	1.113	.275
Loans	.978	.773	.445
Size	.660	3.197	.003
Deposits	-.494	-.310	.759
Credit risk	-3.626	-.915	.368

a. Dependent Variable: Profitability

The capital ratio of Islamic private-owned banks and conventional state-owned banks have a positive but insignificant effect on profitability. This condition indicates that the role of capital owned by these two kinds of banks is hardly managed optimally. The composition of capital ratio is very small. The average range is 6% for Islamic private-owned banks and 13.4% for conventional state-owned banks. The small proportion of capital ratio allows the cause of the influence of capital ratios to profitability is not significant. Other indications that lead to the low contribution of capital ratios to bank profitability may be due to the existence of bank Indonesia regulations in 2016 which stipulated an increase in the bank's capital adequacy ratio from 8% to 12%. This condition makes banks unable to use their own capital to increase their profitability. The results of this research was the same research conducted by Bashir (2003), Idris et al. (2011) but different with the results of research by Alharthi (2016). Another determinant of profitability is loans. The results in table 2 and 3 mentions that loans of Islamic privately-owned banks had a positive and significant impact on profitability, while conventional state-owned banks had an insignificant effect on profitability. The results of this study indicate that Islamic private-owned banks are more effective in providing loans to customers compared to conventional state-owned banks though on average conventional state-owned banks providing loans that range from around 64% while Islamic private-owned banks are 36%. The positive effect of loans on profitability is also due to the application of Islamic private-owned banks concept which prioritises the sense of justice and togetherness to the customer.

Indeed, the fundamental difference between Islamic private-owned banks and conventional state-owned banks is in channeling funding to customers. In conventional state-owned banks, the relationship between banks and customers is only debtors and creditors relationship, while in Islamic private-owned banks the is partners relationship. This form of relationship causes a different pattern of cooperation between Islamic private-owned banks and conventional state-owned banks. In Islamic banks there is a funding pattern including musyarakah. In this pattern the bank provides loans to its partners as business capital by not setting interest on loans to customers but only in the form of ratios of nisbah. Nisbah is an agreement between the bank and the customer where the bank as shohibul mall and the customer as muthorib to determine the percentage of profit sharing. Meanwhile conventional state-owned banks set interest rates to customers in funding loans regardless of whether the customer is able to generate returns that can cover capital costs for loans from the bank and provide returns to customers. This condition can encourage customers of conventional state-owned banks not to be able to cover all costs that are charged so that it can cause bad credit, which in turn will have an ineffective effect on the bank's profitability. The data of conventional state-owned banks show that the level of bad loans is quite high. The intervention of parties may affect the management of conventional state-owned banks in channeling bank funds, as a result it can give bad effect on profitability. The results of this study is the same as the research conducted by Smaoui and Salah (2011).

The size of conventional state-owned banks has a positive and significant influence on the profitability of the bank while the size of an Islamic private-owned banks has a positive but not significant effect. Conventional state-owned banks are able to optimise the company's assets to increase company profits so that it has a positive impact on bank profitability. Meanwhile Islamic private-owned banks have not been able to optimise assets used. The results of this study supports the research done by Ben Khediri et al. (2010), but contradicts the research conducted by Bashir (2003)

Deposit is the amount of funds obtained by the bank as bank funding. Based on the results of a statistical tests which shows that the deposit has a negative impact but not significant on profitability for both conventional state-owned banks and Islamic private-owned banks. This condition indicates that the conventional state-owned banks and Islamic private-owned banks have been optimal in using external funds so that they have a negative impact, although it is not significantly. If we see the average deposits of Islamic private-owned banks around 21.6% while the conventional state-owned bank deposits are 71.67%. there is a considerable difference, but each bank has a different optimal funding. The results of this study support the study conducted by Massod and Ashraf (2012) but contradicted to the research of Mokni and Rachdi (2014).

The results of this study proved that the risk of Islamic private-owned banks is positive but insignificant while conventional state-owned banks has a negative effect but insignificant. This condition indicates that the increased risk still has a positive effect on the profitability of Islamic private-owned banks, although it is not significant. Meanwhile the risk of conventional state-owned banks have a negative effect on bank profitability, although it is also not significant. The risk management of Islamic private-owned bank is better than the risk management of conventional state-owned banks. The positive influence of credit risk on profitability in Islamic private-owned banks is inseparable from the operations of Islamic private-owned banks that refer to the concept of Islam in the provision of credit which prioritises togetherness and justice in business both for those who have capital and those who need capital. Conventional state-owned banks are more about determining interest rates and providing credit portfolios as well as interventions from certain parties in determining credit policy. Cases of fraudulent funds and bad credit at conventional state-owned banks often occur. This condition encourages an increase in credit risk where customers experience default, which in turn has a negative effect on the profitability of conventional state-owned banks. The results of this study is supported by the research conducted by Sufian and Abdul Majid (2011), Alharthi (2016) who proved that credit risk had a negative effect on profitability.

The parametric test results of the independent sample t-test (equal variance assumed) are shown in Table 6.

Table 6: Independent Sample t-Test

Internal Determinants	Levene's Test for Equality of Variances	
	F	Sig.
Capital ratio	22.42	.000
Loans	17.10	.000
Size	17.02	.000
Deposits	47.728	.000
Credit risk	1.66	.201

The Significance value of Levene's Test for Equality of Variances proves that there are differences in the average capital ratio, loans, size and deposits between Islamic private-owned and conventional state-owned banks while the credit risk does not differ in average. The amount of profit of conventional state-owned banks nominally compared to Islamic private-owned banks is inseparable from the size of the loans, of conventional state-owned banks. The development of Islamic private-owned banks in Indonesia if seen from total assets is indeed still far ahead from conventional state-owned banks. This condition certainly will cause a difference between Islamic private-owned banks and conventional state-owned banks in nominal terms from the aspects of profitability, capital ratio, loans and bank size. However, when viewed from the performance of capital ratios, loans, size and deposits in giving an impact on bank profitability of Islamic private-owned banks appear to be better than conventional state owned banks. There is no difference in credit risk, however, if there is an increase in credit risk in Islamic private-owned banks, it will still have a positive impact on bank profitability, but not with conventional state-owned banks where increasing credit risk will have a negative impact on the profitability of conventional banks. Owned banks nominally compared to Islamic private-owned banks are inseparable from the size of the loans, of conventional state-owned banks. According to the financial services authority the development of Islamic privately-owned banks in Indonesia seen from total assets is indeed still far ahead with conventional state-owned banks. This condition certainly will cause a difference between Islamic privately-owned banks and conventional state-owned banks in nominal terms from the aspects of profitability, capital ratio, loans and bank size. However, when viewed from the performance of capital ratios, loans, size and deposits in giving an impact on bank profitability of Islamic private-owned banks appear to be better than conventional state owned banks. There is no difference in credit risk, however, if there is an increase in credit risk in Islamic private-owned banks, it will still have a positive impact on bank profitability, but not with conventional government-owned banks where increasing credit risk will have a negative impact on the profitability of conventional banks.

Conclusion and Implication

This study investigates the impact of capital ratios, loans, size, deposits and risk credits on profitability in Islamic private-owned banks and conventional state-owned banks. The results of the study prove that only loans affect the profitability of Islamic private-owned banks while the capital ratio, size, deposits and credit risk do not affect profitability. Meanwhile, the results prove only size affects profitability of conventional state-owned banks while capital ratios, loans, deposits and credit risk have no effect. The results of the study also concluded that there were flat differences from the capital ratio, loan, size and deposits between private Islamic banks and conventional state-owned banks while credit risk did not have an average difference.

The results of this study have implications especially for management who manage both Islamic private-owned banks and conventional state-owned banks who should maximise the capital owned for funding to customers so that it can contribute to the increase in bank profitability. If the capital ratio is considered to be small in its capital structure, then the bank should try to increase its equity either by adding paid-in capital or increasing dividend policy on profits in the current year. If seen from the average capital ratio, both Islamic private-owned banks and private banks are still felt to be still small, so the role of capital ratios does not really have an impact on profitability. Bank management must also try to use funding sources from deposits and channel them with capital costs that can be covered from the distribution of these funds so that they are expected to have a positive effect on bank profitability. Conventional state-owned banks should be more careful in providing credit portfolios because otherwise they will not have a positive effect on profitability and even have a negative effect. Considering that Islamic private-owned bank's assets are still smaller than the conventional state-owned banks, Islamic private-owned banks should try to increase the assets of the banks so that it will provide bank flexibility in its operations so it is expected to have a positive effect on the profitability of Islamic private-owned banks. The results of this study provide a theoretical contribution that if management is not optimal in managing capital ratios, loans, size, deposits and credit risk then it will not have a significant impact on the bank's profitability.

This research certainly has several limitations. Given these limitations, there are a number of suggestions for subsequent research. The next study should add other variables related to the profitability of Islamic and conventional banks. Incorporating all conventional state-owned and Islamic private-owned banks. Extending the research period so that more smooth times series data will be obtained

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