

Comparative Analysis of Profit Rate of Islamic Banks on Investment (ROI) and Fixed Rate of Interest on Loan of Conventional Banks in Bangladesh

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The article measures the performance of profit rate on investments of Islamic Bank (i.e. Return on Investment or ROI) against fixed lending rate of local conventional banks, foreign conventional banks and state owned commercial banks in Bangladesh for the period of 2007 until 2010. About 8050 observations were categorized into term loan provided to large, medium and small scale industries, working capital provided to large and small scale industries, export trade financing, housing loan, consumer credit, credit to Non-banking Financial Institutions (NBFIs) and other classes. This study is an attempt to find whether there are any differences of profit rate on investments of Islamic Bank against fixed lending rate of local conventional banks, foreign conventional banks and state owned commercial banks in Bangladesh. Analyses reveal that the foreign commercial banks charged the highest rate on the borrowers during the selected periods. It has also been found that there is a significant difference in mean return between Islamic banks local conventional banks, foreign conventional banks and state owned commercial banks.

Keyword: Bank, Islamic Bank, Conventional Bank, Profit rate, Investment, Fixed interest rate and Loan.

Field of Research: Finance and Banking

1. Introduction

Bangladesh inherited an interest based banking system right from the British Colonial period and employment of the Muslims in banks was more or less restricted. During the period 1947-1971 when country was a part of Pakistan, banking of course came under Muslim control but the system did not changed (Sarker 2000). At present, Bangladesh has a mixed banking system comprising nationalized, private and foreign commercial banks. Bangladesh Bank is the central bank of the country and is in charge of monetary policies of the Government and all commercial banks. After independence the Government of Bangladesh initially nationalized the entire domestic banking system and proceeded to reorganize and rename the various banks. After that in nineteen eighties privatization decision of commercial banks revolutionize the overall banking system (Alam 2000).

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Since its inception Bangladesh saw a new trend in banking both at home and abroad. Islamic banking was successfully tried in Egypt. Following the Mit Ghamar Model, Naser Social Bank was in the process of establishment. During the seventies, Islamic Development Bank (IDB) and a number of Islamic banks at national levels were established in the Islamic world. At home, the Islamic groups were vigorously working for adoption of Islam as the complete code of life. They found Islamic banking in ready form of immediate introduction. Two professional bodies “Islamic Economics Research Bureau” (IERB) and “Bangladesh Islamic Bankers Association” (BIBA) were taking practical steps for imparting training on Islamic Economics and banking to a group of bankers and arranging some national and international seminars/workshops to mobilize local and foreign people and attract investors to come forward to establish Islamic bank in Bangladesh. Their professional and right-thought activities were reinforced by a number of Muslim entrepreneurs working under the aegis of Muslim Businessman Society (Sarker 1999).

Conventional banks provide different type of loans at a fixed interest rate which is the price of using the money for a specified period of time paid by the borrower to banker. On the other hand Islamic Banks invest their money following different mechanisms like Murabaha, Musharaka, Mudarabah, Bai-Muajjal, Bai-Salam, etc. to avoid fixed interest. In Islamic banking investment mechanisms, the Islamic financial relationships between investor and borrower are of a participatory in nature (Ahmad 1993).

In most of the earlier researches in Bangladesh about the comparison of Islamic and conventional banking aimed at the conceptual phenomena. A very few works have been done regarding their competitive attributes. Moreover, no such study is found comparing the profit rate on investment and lending rate of different banks which could facilitate the borrower to choose the cheap source for their borrowing in Bangladesh though a few researches have been done in this field in Malaysia. In Malaysia in a comparative research of deposit rate of Islamic banks and conventional banks and non banking financial institutions it was found that the Islamic banks provide the lowest rate of return on deposits than any other sort of banks and financial institutions which might create dissatisfaction among the depositors in Islamic banks (Erusan and Ibrahim). Considering these things, this paper is designed to measure the dissimilarity between profit rate on investments of Islamic banks (ROI) and fixed rate of interest on loan of conventional banks from year 2007 to 2010 among Islamic Bank, local conventional banks, foreign conventional banks and state owned commercial banks. The paper reveals that the Islamic Banks in Bangladesh are serving its customers by providing investment in a moderate rate which is lower than other conventional banks except state owned commercial banks resulting a very good trend of success over time.

2. Literature Review

2.1 Introduction of Islamic Bank

Islamic banks act as a non-interest based financial institution which complies fully with Islamic Laws and have creative and progressive financial engineering to offer efficient and competitive banking, investment, trade finance, commercial and real estate financing

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services. Islamic banks have been operating like other traditional banks for about four decades throughout the world. They also mobilize deposits and produce loans based on Islamic Law (Shari'ah), which are different from the other conventional or commercial banks. Therefore, Islamic banking differs from conventional banking in several ways, such as the prohibition of transactions based on interest rate and the requirement that bank's operations be carried out according to certain procedures through the use of certain financial instruments. However, the elimination of interest does not mean zero-return on capital. Rather, Islam forbids a fixed predetermined return for a certain factor of production i.e. one party having assured return and the whole risk of an entrepreneurship to be shared by others (Ahmed 1994). An Islamic bank can also offer products and services which are similar to those offered by a conventional bank. There are approximately 180 Islamic Banks and Financial Institutions operating in Asia, Africa, Europe and the USA with more than 8,000 branches with an estimated \$170 billion. The popularity of the Islamic banking system is not limited to the Islamic banks only. Increasingly large international conventional banks are showing interest in the Islamic banking system as well (Haque, Osman and Ismail 2009).

Islamic banking is an activity based on Islamic Shari'ah principles, which do not allow the paying and receiving of interest and promotes profit sharing in banking activities. The most important difference between Islamic and conventional banking is the prohibition of interest in Islamic banking. Islamic banking activity is based on the trading principles of buying and selling of assets. Following that, in conventional financing, customer's outstanding loan consists of principal plus the interest charged then onwards. The interest is actually the financial institution's cost in obtaining the funds and its profit. Islamic financing work is based on the concept of buying and selling where the financial institution purchases the property and subsequently sells it to customers above the purchase price (Nasir and Hafiz, A 2006).

While the banning of interest is rooted in Muslim theology, proponent of Islamic finance provides strong motivations to support the ban of interest rate. First of all, in an Islamic profit sharing contract the return on capital will depend on productivity and the allocation of funds will be primarily based on the soundness of the project, improving the allocation efficiency. Second, the Islamic profit sharing system will ensure more equitable distribution of wealth and the creation of additional wealth to its owners. Third, the profit sharing regime may increase the volume of investments and hence create more jobs. Such a regime accepts those projects whose expected returns are higher than the cost of debt, and therefore filter out projects which could be acceptable under the Islamic profit sharing system (Zahier and Hassan 2001).

2.2 Islamic Banking in Bangladesh

Islamic banks have been operating in Bangladesh for about 28 years alongside with the traditional banks. Out of over 47 banks only seven banks have been working on Islamic principles. Among the Islamic banks, Islami Bank Bangladesh Ltd., which was incorporated on 14th March, 1983, was the first in this field that went into operation on 30th March, 1983 and introduced a full package of banking services in August 1983, Islami Bank Bangladesh Limited is considered to be first interest-free bank in South East Asia.

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Following the foot steps of Islami Bank Bangladesh Ltd., other Islamic banks and traditional banks have also practicing Islamic Shari'ah based banking through opening Islamic Banking Wings. However, other six Islamic banks operating in Bangladesh are ICB Islamic Bank Limited (started as Al-Baraka Bank Bangladesh Limited on May 20, 1987), Al-Arafah Islami Bank Limited (September 27, 1995); Social Islami Bank Limited (November 22, 1995); Shahjalal Islami Bank Limited (May 10, 2001); Export Import Bank of Bangladesh Limited (3rd August, 1999 as Bengal Export Import Bank Limited and Islamic Baking since July/2004); and First Security Islami Bank Limited (25th October, 1999). Now-a-days almost all the traditional banks have their Islamic Banking Wings. In this regard the names of Prime bank Limited and Dhaka Bank Limited are to be mentioned as the pioneer banks to open their Islamic Banking Wings. Prime bank Limited has opened two Islamic banking branches on 18 December, 1995 and 17th December 1997 respectively while Dhaka Bank Limited has started operation with an Islamic Counter hand to hand at its Principal office Conjunction with conventional banking operations since inception of the bank on July. 1999. Like other traditional commercial banks, they do mobilize deposits and produce loans. But their mode of operation, based on Shari'ah, is different from the other traditional commercial banks.

It is worth to be mentioned that in most of the studies done in this field in Bangladesh are mainly based on theoretical perspectives. Thus, very few empirical researches have been found facilitating such comparison to help borrower well judged decision for borrowing from banks. This paper is an attempt to bridge the gap between the theoretical differences and empirical evidence of performance of different sorts of banks in operation in Bangladesh.

3. Objective of the Study

The main objective of this paper is to measure the dissimilarity in Islamic banking profit rate on investments (ROI) and conventional banking lending rate from year 2007 to 2010. The specific objectives can be summarized as follows;

- i) To find whether there is any difference between the Islamic banking profit rate on investments (ROI) and interest rate of local conventional banks, foreign conventional banks and state owned commercial banks.
- ii) To understand the reason for which there might be a difference between profit rate on investments (ROI) and conventional banking lending rate.

To materialize this objective the following hypotheses have been developed:

H0-1: There is no difference in the mean return of interest rate performance between ISLAMIC BANK and LOCAL CONVENTIONAL BANKS

H0-2: There is no difference in the mean return of interest rate performance between ISLAMIC BANK and FOREIGN CONVENTIONAL BANKS

H0-3: There is no difference in the mean return of interest rate performance between ISLAMIC BANK, and STATE OWNED COMMERCIAL BANKS.

4. Methodology of the Study

The article is mainly based on secondary data which are collected manually from money magazines as well as from the website of Bangladesh Bank (the Central Bank of Bangladesh). For clarification and analysis of certain factors prominent bankers have been consulted. The samples for the study have been selected on the basis of stratified random sampling. The selected strata are Islamic Banks, Local Conventional Banks, Foreign Conventional Banks and State Owned Commercial Banks. From each stratum proportional samples have been chosen on random basis. In such process, 3 banks have been selected under the head Islamic Banks while 8 local conventional banks, 3 foreign conventional bank and 3 state owned banks have been selected randomly from the respective populations. The selected Islamic banks are, Islami Bank Bangladesh Limited, Social Islami Bank Limited and Al-Arafah Islami Bank Limited. The selected local conventional banks are AB Bank Ltd., Prime Bank Ltd., Pubali Bank Ltd., Eastern Bank Ltd., National Bank Ltd., Uttara Bank Ltd., IFIC Bank Ltd. and United Commercial Bank Ltd. Similarly the randomly selected foreign conventional banks are Standard Chartered Bank, State Bank of India and Bank Al Falah. The randomly selected State owned Banks are Sonali Bank Limited, Agrani Bank Limited and Janata Bank Limited. Each bank's data consists of 4 years period from 2007 to 2010. A number of 805 observations were used in each category. Again data of each bank consists of 10 different variables like Term loan provided to Large, Medium and Small scale Industries, Working Capital provided to Large and Small Scale Industries, Export Trade Financing, Housing loan, Consumer credit, Credit to Non-banking Financial Institutions (NBFIs) and others. The data were analyzed using statistical software SPSS. To measure the performance of fixed lending rate of conventional banks and rate of return on investment of Islamic banks as well as to find whether there is any significant difference between the rates T-test has been applied. Most importantly, the data of the selected periods are free from any sort of bias as the global financial crises have no impact on the lending rate during that periods as such affect became noticeable in Bangladesh money market at the end of 2010 and have become an influencing factor in 2011 and 2012.

5. Findings of the Study

Since the main objective of this study is to measure and compare the performance of profit rate on investment in Islamic banks against fixed lending rate of local conventional banks, foreign conventional banks and state owned commercial banks, Table-1 has been presented with mean and standard deviation of Islamic banks, local conventional banks, foreign conventional banks and state owned commercial banks regarding rate of returns and interest rates.

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Table 1: Mean Return and Standard Deviation for Islamic Banks Local Conventional Banks, Foreign Conventional Banks and State Owned Commercial Banks:

Months	Islamic Banks		Local Conventional Banks		Foreign Conventional Banks		State Owned Banks	
	Mean	Standard Deviation	Mean	Standard Deviation	Mean	Standard Deviation	Mean	Standard Deviation
January	13.1754	2.68805	13.0362	2.54454	13.4029	2.47394	11.6207	2.42529
February	13.2456	2.59616	13.0000	2.60942	13.5882	2.48352	11.7051	2.40926
March	13.2522	2.57508	13.0474	2.54150	13.5817	2.47547	11.6336	2.46617
April	13.1886	2.55937	12.9751	2.53444	13.6042	2.43181	11.6336	2.46617
May	12.9408	2.55737	12.8950	2.52933	13.5093	2.51972	11.6336	2.46617
June	12.9217	2.51080	12.8562	2.53629	13.4650	2.50034	11.6789	2.42604
July	13.0043	2.46629	12.8979	2.45404	13.5542	2.46885	11.6140	2.36076
August	12.9605	2.46493	12.8892	2.44771	13.5420	2.45573	11.6247	2.36791
September	12.7675	2.32263	12.8513	2.42998	13.5238	2.46014	11.6247	2.36791
October	12.7675	2.32263	12.8703	2.42486	13.5238	2.46014	11.6247	2.36791
November	12.8448	2.40508	12.8585	2.42326	13.4929	2.45082	11.6495	2.36491
December	12.7434	2.31563	12.8685	2.43326	13.4858	2.45552	11.6595	2.3791
Average	12.9845	2.48145	12.9192	2.48927	13.5079	2.45892	11.6428	2.39545

The findings indicate that the highest total average of mean return of 13.5079% is charged by foreign commercial banks compared to that of Islamic banks, local conventional banks and state owned commercial banks of 12.9845%, 12.9192% and 11.6428% respectively. If we look at the performances in each individual month, it can be observed that the highest average of mean return on investment for Islamic banks is 13.2322% in the month of March while the highest rate charged by local conventional banks, foreign conventional banks and state owned commercial banks are 13.0474%, 13.6042% and 11.7051% respectively in the months of March, April and February respectively. Again the lowest rate is charged in the month of June by the State Owned Commercial Banks which is 11.616140%. The lowest rates for Islamic Banks, Local Conventional Banks and Foreign Commercial Banks are 12.7434%, 12.8562% and 13.4650% in the months of December, June and June respectively.

Thus, it is clear that all sorts of banks have greater return on investments around the first quarter of the year while the lowest rate is charged by all the banks except Islamic banks in the middle of the year. As we know the lending rate is determined on the basis of availability of fund (i.e. liquidity), the demand for loan and risk premium, it can be said that the banks might faced liquidity crises and high risk premium in the first quarter of the selected periods while they showed a trend of overcoming liquidity crises near the middle of the year of the selected periods.

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Table 2: T-Test Result between Islamic Banks and Local Conventional Banks:

Month	Islamic Banks		Local Conventional Banks		t-statistics
	Mean	St. Deviation	Mean	St. Deviation	
January	13.1754	2.68805	13.0362	2.54454	5.356
February	13.2456	2.59616	13.0000	2.60942	5.361
March	13.2522	2.57508	13.0474	2.54150	6.325
April	13.1886	2.55937	12.9751	2.53444	4.921
May	12.9408	2.55737	12.8950	2.52933	4.984
June	12.9217	2.51080	12.8562	2.53629	5.265
July	13.0043	2.46629	12.8979	2.45404	6.325
August	12.9605	2.46493	12.8892	2.44771	-4.235
September	12.7675	2.32263	12.8513	2.42998	-8.452
October	12.7675	2.32263	12.8703	2.42486	-7.235
November	12.8448	2.40508	12.8585	2.42326	-4.365
December	12.7434	2.31563	12.8685	2.43326	-6.32
Average	12.9845	2.48145	12.9192	2.48927	

T-test of Independence:

From table-2, it can be seen that the mean return on investment of Islamic banks from from January through December between the periods 2007-2010 are 13.1754%, 13.2456%, 13.2522%, 13.1886%, 12.9408%, 12.9217%, 13.0043%, 12.9605%, 12.7675%, 12.8448% and 12.7434% while lending rate for local conventional banks are 13.0362%, 13.0000%, 13.0474%, 12.9751%, 12.8950%, 12.8562%, 12.8979%, 12.8892%, 12.8513%, 12.8703%, 12.8585% and 12.8685% respectively. It is revealed that the mean returns on investment of Islamic banks are higher than the fixed lending rate of local conventional banks in the months of January, February, March, April, May, June, July and August and vice-versa in the months of September, October, November and December.

T-test has been applied to find whether the mean is significantly different from zero between Islamic banks and local conventional banks. Table-2 shows the two tailed test for the variables "Islamic Banks and Local Conventional Banks" that the table value is less than the calculated value resulting the rejection of null hypothesis (HO-1). Thus the difference in mean return is significant. The reasons of such significant may be the criteria and difference in the mode of investments between Islamic Banks and Local Conventional Banks.

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Table 3: T-Test Result between Islamic Banks and Foreign Conventional Banks:

Month	Islamic Banks		Foreign Conventional Banks		t-statistics
	Mean	St. Deviation	Mean	St. Deviation	
January	13.1754	2.68805	13.4029	2.47394	6.401
February	13.2456	2.59616	13.5882	2.48352	6.522
March	13.2522	2.57508	13.5817	2.47547	4.912
April	13.1886	2.55937	13.6042	2.43181	6.314
May	12.9408	2.55737	13.5093	2.51972	5.235
June	12.9217	2.51080	13.4650	2.50034	4.896
July	13.0043	2.46629	13.5542	2.46885	7.351
August	12.9605	2.46493	13.5420	2.45573	8.231
September	12.7675	2.32263	13.5238	2.46014	7.653
October	12.7675	2.32263	13.5238	2.46014	6.354
November	12.8448	2.40508	13.4929	2.45082	8.254
December	12.7434	2.31563	13.4858	2.45552	10.325
Average	12.9845	2.48145	13.5079	2.45892	

From table-3 it has been observed that in none of the months of all the year Islamic banks have greater return on investment than the fixed lending rate of foreign conventional banks. Thus the foreign banks always charge higher lending rate on their customers. It is also revealed that there is a significant difference in the mean return between “Islamic Banks and Foreign Conventional Banks” as the table value of t- statistics is greater than the calculated value resulting the rejection of null hypothesis (HO-2).

The Foreign Conventional Banks have such higher lending rate because the number of branches is the fewest among the different sorts of banks which increases its fixed operating cost and the scattered deposits of large number of people can not be availed at cheap rate for them. Moreover, the foreign banks have to follow the rules and instructions of the mother company regarding their investment policy and fixing lending rate. Hence they show no tendency to reduce their rate of lending.

Table 4: T-Test Result Between Islamic Banks and State Owned Commercial Banks:

Month	Islamic Banks		State owned Banks		t-statistics
	Mean	St. Deviation	Mean	St. Deviation	
January	13.1754	2.68805	11.6207	2.42529	4.123
February	13.2456	2.59616	11.7051	2.40926	3.910
March	13.2522	2.57508	11.6336	2.46617	5.301
April	13.1886	2.55937	11.6336	2.46617	6.123
May	12.9408	2.55737	11.6336	2.46617	7.201
June	12.9217	2.51080	11.6789	2.42604	5.201
July	13.0043	2.46629	11.6140	2.36076	4.601
August	12.9605	2.46493	11.6247	2.36791	3.992
September	12.7675	2.32263	11.6247	2.36791	4.501
October	12.7675	2.32263	11.6247	2.36791	8.501
November	12.8448	2.40508	11.6495	2.36491	7.543
December	12.7434	2.31563	11.6595	2.3791	6.531
Average	12.9845	2.48145	11.6428	2.39545	

The results of table-4 indicate that in all of the months of all the year Islamic banks have greater return on investment than the fixed lending rate of state owned banks. Hence, it can be concluded that the lending rate of the state owned banks is the least among all sorts of banks. From the results of t-test in table-4 it is observed that there is a significant

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difference between the mean return of “Islamic Banks and State Owned Commercial Banks” as the null hypothesis (HO-3) is rejected.

The State Owned Commercial Banks have the lowest lending rate in all the months the reasons of which may be identified as follows:

They have all sorts of logistic and other supports from the government whenever required

- i) They have the highest number of branches throughout the country having lowest operating cost.
- ii) They have no liquidity crises as they have a huge amount of deposits from different government sectors. Moreover, people show greater confidence on them as a secured custody of money since they are regulated by the government directly. So, many people deposit their money in state owned banks even at lower rate from other banks.
- iii) As people deposit their money in such banks even at lower rate, the cost of fund for them is lower than other types of banks.
- iv) Investment in secured projects only ensures lower risk premium which in turn make them able to charge lower lending rate.

A big portion of investments of State Owned Banks goes to the rural areas where the lending rate needs to be lower.

Policy Implications of the Study

- i) Government of Bangladesh may use the issues raised in this article in making policy for regulating and controlling banking sector in Bangladesh.
- ii) Banking organizations may use the findings of the study in determination of rate of return on investment or rate of return on loan for making them more competitive and earning more profit.
- iii) General public is also expected to use the issues enunciated in this article in choosing a bank for getting finance of their project at a lower cost.

Direction for Further Study

The present study is limited to compare the rate of return on investment of Islamic Banks and fixed rate of interest on loan of the conventional banks in Bangladesh. In this connection, the potential research areas may be as below:

- i) Comparative analysis of rate of return on investment of one Islamic Bank to another Islamic Bank in Bangladesh.
- ii) Comparative analysis of rate of interest on loan of one Conventional bank to Conventional banks in Bangladesh.

- iii) Comparative analysis of rate return or interest of one type of loan or investment to another type of loan or investment of different banks in Bangladesh.

6. Conclusion

The findings of this study revealed that the foreign commercial banks charged the highest rate on the borrowers during the selected periods and there is a significant difference in mean rate of return between Islamic banks local conventional banks, foreign conventional banks and state owned commercial banks. The significant differences in rate of return or interest among different types of banks operating in a country may have significant implications on the overall financial and economic aspects of the country. Therefore the issues raised in this paper require attention of Government, Bangladesh Bank and researchers to study the matters from different point of view.

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