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# Comparison of capital structure, risk, and profitability between Islamic and conventional banks in Indonesia

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## ABSTRACT

This study aims to compare Islamic and Conventional Banks in Indonesia in terms of Capital Structure, Profitability, and Risk handling. Data for the analysis were taken from the quarterly financial reports of nine Islamic and Conventional Banks for the 2013Q1 – 2020Q3 period. Binary logistic regression was employed as an analysis tool using SPSS 19 software. The results show that Islamic and Conventional Banks are significantly different in terms of capital structure, profitability, and risk handling. Conventional banks have better capital structures and profitability. Islamic Banks, on the other hand, have better risk management.

**Keywords:** capital structure, conventional banks, equity proportion, islamic banks, profitability, risk

## 1. INTRODUCTION

Islamic Banking (hereafter occasionally called IBs) was established to meet the needs of Muslims for banking services in accordance with Islamic teachings. Previously, Conventional Banks (hereafter occasionally called CBs) operated on the basis of interest. Conventional banks can satisfy the need for banking services but cannot satisfy the need to fulfil Islamic teachings. Without the existence of an Islamic Bank, a practical Muslim would face a trade-off between his faith and his needs.

It is important to maintain the growth and expansion of Islamic Banks so that they can provide halal banking services to more Muslims than ever before. Unfortunately, the market share of Islamic Banks in Indonesia has grown very slowly. The market share of Islamic Banks in Indonesia when the Islamic Banking Law was enacted in 2008 was 2.05 percent (OJK, 2008). As of June 2019, the market share of Islamic Banks reached only 5.95 percent (OJK, 2019). Thus, for nearly 11 years, the market share of Islamic Banks in Indonesia has increased by only 3.9 percent.

Many internal and external factors affect Islamic Banks' market share. One of them, from a bank's interval perspective, is profitability. Profits can be a source of funds for banks to raise their assets through retained earnings. From a Financial Management perspective, one of the factors that influences profit is the capital structure. An ideal capital structure minimizes the cost of capital and maximizes profit (Brigham & Houston, 2019). Otherwise, the optimization of the capital structure to achieve high profits can result in default risk for the company. Hence, the ideal capital structure must consider, on the one hand, profit maximization and, on the other hand, risk control.

Al-Kayed et al (2014) found that capital structure proxied by capital ratio (proportion of equity) is significantly related to profitability. This means that the better the profitability, the more ideal the capital structure. However, capital structure is also bound to risk (Brigham & Houston, 2019). This means that the more risk can be controlled, the more ideal the capital structure.

Brigham and Houston (2019) suggested that The Benchmark Theory measures a company's variable by comparing it with the leading market company. In Indonesia, Conventional Banks are the leading companies in the banking market. Hence, Conventional Banks can be employed as a benchmark to measure the performance of Islamic Banks in creating profit and controlling risk, as well as optimizing capital structure. Hence, it is important to empirically investigate the comparison of profitability, control risk, and capital structure of Islamic and Conventional Banks.

Several studies have been conducted in Indonesia on the capital structure of Islamic Banks. However, comparisons between Islamic and Conventional Banks in terms of Capital Structure, Profitability, and Risk Control are still relatively rare or even nonexistent. One of the topics that have been widely discussed is the influence of Sharia banks' capital structure on profitability (Apriliani & Ibnu, 2018; Wahyudi et al., 2020). Another widely discussed topic is the determinants of capital structure (Hutauruk, 2020; Mardhatillah et al., 2020; Nasrah & Resni, 2020).

According to several previous studies, there is still a gap in the building of Islamic banks' capital structure studies, namely the comparison of Islamic and Conventional Banks in terms of capital structure, profitability, and risk. Hence, the objective of this study is to assess the quality of Islamic Banks' capital structure on the basis of profitability and risk level by comparing all three variables between Islamic and Conventional Banks in Indonesia

## 2. LITERATURE REVIEW

The term capital refers to investor-supplied funds, which consist of debt and equity. Debt represents external sources of capital, and equity represents internal sources of capital. Capital structure is the percentage of each component of capital to the total capital of the firm. The optimal capital structure is a mix of debt and equity that maximizes a firm's value (Brigham & Houston, 2019). In the short run, the optimal capital structure is indicated by profitability and risk levels. An optimal capital structure leads to optimal profitability and controlled risk. Thus, theories relating to capital structure, profitability, and risk handling of firms, especially Islamic Banking, are discussed in this section.

Three capital structure theories are presented in this paper. Each theory examines the capital structure with its approach. The static trade-off theory was constructed from the perspective of a cost-benefit relationship. Agency theory uses a stakeholder interest approach. Finally, the pecking order theory was built based on an asymmetric information viewpoint.

The static trade-off theory suggests an optimal capital structure with a cost-benefit debt approach. A firm's optimal debt ratio is determined by the trade-off between the cost and benefit of debt. Debt is considered low-cost capital relative to equity because it is tax-deductible. However, debt carries bankruptcy risk. Thus, managers must reach an optimal combination of equity and debt to maximize a firm's value (Brealey et al., 2020).

Jensen and Meckling (1976) predicted capital structure choice based on the existence of agency costs due to conflicts of interest. Conflicts of interest arise between shareholders, managers, and creditors. Balancing all agency costs will bring firms to their ideal capital structure (Ayanda et al., 2013).

Pecking order theory can be described as capital structure choices that start with an internal source as the main source of funds, followed by debt and equity as a last resort (Brealey et al., 2020). This theory is relatively irrelevant for Islamic Banks because, as an intermediary institution, one of the main functions of a bank is to collect funds from the surplus sector. Hence, in banking practices, external sources of funds are usually prioritized over internal sources of funds.

### 2.1 Islamic Banks Capital Structure

Toumi et al (2012) developed the classical theory of capital structure in an Islamic finance context. They found that Islamic ethical constraints and the involvement of the Shariah supervisory board make Islamic Banks' capital structure different from that of Conventional Banks. Islamic Banks have relatively low bankruptcy costs because they are bound by the tangibility principle. Hence, Islamic Banks also have low capital ratios. Previous empirical studies also reveal that Islamic Banks hold a higher proportion of equity than their conventional counterparts (Bitar and Madiès, 2017; Olson and Zoubi, 2008, 2017).

According to agency theory, there are conflicts of interest between shareholders, managers, and creditors (Jensen and Meckling, 1976; Myers, 1977). In an Islamic Bank context, there are more actors involved in governance schemes (Abdelsalam et al., 2016). There are two additional stakeholders in Islamic Banking: Sharia supervisory boards (hereafter occasionally called SSB) and profit-sharing investment account (hereafter occasionally called PSIA) holders. The additional stakeholders in Islamic Banks lead to additional agency costs that could modify their capital structure of Islamic Banks (Toumi et al., 2013).

### 2.2 Islamic Banks Profitability

The determinants of bank profitability have been a major focus of empirical studies on both Islamic and conventional banks (Abedifar et al., 2013; Metwally, 1997; Mokni and Rachdi, 2014; Olson and Zoubi, 2008, 2017; Yanikkaya et al., 2018). One of the factors among the determinants is the equity ratio, which represents the capital structure of Islamic Banks. Consequently, the equity ratio could negatively affect profitability. Olson and Zoubi (2011) showed that equity levels negatively impact profitability.

### 2.3 Islamic Banks Risk

Islamic banks are bound by Islamic ethics. This could make Islamic banks less vulnerable than Conventional Banks (Mollah et al., 2016). Theoretically, the prohibition of maysir and gharar eliminates Islamic Banks' access to speculative risky activities. In addition, the prohibition of riba leads to different forms of portfolio diversification (Chatti, 2012). Portfolio diversification leads to lower risk than a homogenous portfolio. The market model suggests that specific risks can be eliminated through diversification (Sharpe, 1964).

Capital structure has a significant influence on the bank's risk level, especially default risk. The greater the level of debt in a bank, the riskier it is. The authority has made regulations to handle this risk, namely regulations on capital adequacy requirements (Asutay et al., 2020). These regulations limit the debt level of banks, and hopefully, default risk can be avoided.

**2.4 Theoretical Framework**

Based on the theoretical basis and previous studies, the theoretical framework of this study was developed. Since the main objective of this study is to compare Islamic and Conventional banks, the variable of interest in this study is a dummy variable, namely, bank type. The dummy variable, bank type, has two values. The first value is Islamic banks (represented by 1), and the second value is conventional banks (represented by 0). Finally, after creating a variable of interest for the type of banks, the comparison can be depicted in a model, where the model represents the effect of capital structure, profitability, and risk on the type of banks.

The first relationship that needs to be tested is that between capital structure and bank type. The theoretical basis and prior studies cannot conclude which is better between Islamic and Conventional Banks in terms of capital structure. Hence, the following hypothesis is proposed:

$H_1$: Capital structure negatively affects the type of banks (Islamic or Conventional Banks)

The meaning of H1 is as follows: First, if the effect is positive, the higher the capital structure, the higher the probability that the bank is an Islamic bank (because Islamic Banks are represented by 1). Otherwise, the lower the capital structure, the higher the probability that the banks are conventional (since conventional banks are represented by 0). Second, if the effect is negative, the higher the capital structure, the higher the probability that the banks are conventional banks and vice versa.

In terms of the relationship between profitability and bank type, Islamic banks tend to be less profitable than conventional banks. This conclusion is derived from agency theory, which states that Islamic Banks have a larger number of stakeholders. A large number of stakeholders can drive conflicts of interest and hinder a company's performance. In addition to the number of stakeholders, Islamic Banks also face many restrictions in their operations due to the prohibition of riba, gharar, and maysir. This restriction reduces the opportunity to create income and profitability. The hypothesis that profitability influences the type of banks is $H_2$.

$H_2$: The profitability negatively affects the type of banks (Islamic or Conventional Banks)

The meaning of $H_2$ can be described in the same way as $H_1$. The negative effect between profitability and bank type means that the higher the profitability, the higher the probability that the bank is a conventional bank, and vice versa.

Finally, the relationship between risk and the type of banks can be seen from two points of view: involvement in high-risk investment and financing diversification. The prohibition of maysir and gharar hinders Islamic banks from speculative high-risk investments, and the prohibition of riba leads to diversification of financing. Consequently, Islamic banks have lower risks than conventional banks. In other words, Islamic banks have higher risk-handling capabilities than conventional banks. The relationship between risk and bank type is explained by Hypothesis 3 ($H_3$). The meaning of $H_3$ can be explained in the same way as $H_1$ and $H_2$.

$H_3$: The risk handling positively affects the type of banks (Islamic or Conventional Banks)

## 3. METHODOLOGY

### 3.1 Data

This study uses quantitative panel data with 279 observations of each variable for each type of bank. Data were taken from the quarterly financial reports of nine Islamic banks (IBs) and nine conventional banks (CBs) in Indonesia from the period 2013 quarter of 1 to 2020 quarter of 3. The Conventional Banks chosen are those that do not have Islamic Bank subsidiaries. As Conventional Banks have Islamic subsidiaries, their financial reports are a combination of the parent company and subsidiary.

### 3.2 Variables Measurement

This study has four main variables. The type of bank as a variable of interest is a dummy variable, where 0 represents conventional banks and 1 represents Islamic Banks. A summary of the symbols and operationalization of each variable is presented in Table 1.

**Table 1. Summary of Variable Measurements**

| No | Variables | Proxies | Symbol | Formulation |
|---|---|---|---|---|
| **1** | The type of Banks | Dummy Variable (1 represents Islamic Banks and 0 represents conventional banks) | TOB | 1 or 0 |
| **1** | Capital Structure | The ratio of total equity to the total asset (Equity on Asset) | EOA | $\frac{Total\ Equity}{Total\ Assets}$ |
| **2** | Profitability | The ratio of net profit to total assets (Return on Asset) | ROA | $\frac{Net\ Profit}{Total\ Assets}$ |
| **3** | Risk Level | The ratio of "the sum of return on asset and equity on asset" to standard deviation of return on asset (Stability of ROA) | Z-Score | $\frac{ROA + EOA}{SD\ ROA}$ |

*TOB = Type of Banks; EOA = Equity on Assets Ratio; ROA = Return on Assets Ratio; SD = Standard Deviations

### 3.3 Analysis Method

The methods of analysis that are widely used to predict dummy variables are binary logistic regression and linear discriminant analysis (Toumi, 2020). Between the two, the linear discriminant analysis requires more assumptions about the underlying data, especially normally distributed data. Otherwise, binary logistic regression is assumed to be more flexible and robust in the case of violations of the assumptions (Pohar et al., 2004).

Since this research needs a more flexible method of analysis due to the use of panel data, binary logistic regression is selected to employ the analysis. The dependent variable is a dummy variable, namely, the type of bank. A value of 1 represents Islamic banks; otherwise, a value of 0 represents Conventional Banks. The explanatory variables are EOA, ROA, and Z-Values. Figure 1 shows the binary logistic regression model used in this study.

$$\ln\left[\frac{P_1}{1-P_1}\right] = \alpha + \sum_{j=1}^{n} \beta_j X_j + \varepsilon_{ij}$$

**Figure 1. Binary Logistic Regression Model**

Where $P_1$ is the probability that a given bank belongs to group 1, $\alpha$ is the constant, $\beta_j$ is the coefficient of the $n_{th}$ predictor, and $X_j$ is the predictor variable.

The analysis results will show whether a predictor is significant or not to distinguish between Islamic and Conventional Banks. The coefficient of each predictor shows the correlation direction between the predictors and the dependent variables. A positive sign of the predictor coefficient means that the higher the ratio of predictors, the higher the probability that the bank is an Islamic Bank. Otherwise, a negative sign means that the lower the predictor ratios, the higher the likelihood that it is an Islamic bank.

A robustness check was also conducted in this study using a t-test analysis. A T-test is conducted to reveal whether the difference between Islamic and Conventional Banks in the case of capital structure, profitability, and risk level is statistically significant. As a support for the result of a binary logistic regression test that was conducted before, the t-test tests once again the significance of the difference between Islamic and conventional banks in terms of capital structure, profitability, and risks, in a slightly different way.

## 4. RESULT AND DISCUSSION

### 4.1 Statistical Descriptive Test

This section presents the descriptive statistical test results for Islamic and conventional banks. This analysis includes key financial indicators, such as total assets, capital structure, risk levels, and profitability ratios. By comparing these indicators, this study aims to provide a general overview of the financial characteristics and performance differences between Islamic and conventional banking institutions. Descriptive statistics serve as a foundation for understanding data distribution and are essential before proceeding to more advanced statistical analyses.

**Table 2. Descriptive Statistics of Islamic Banks**

| Variables | N | Range | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|---|
| **EOA IBs** | 279 | 25,14 | 3,18 | 28,32 | 12,5880 | 4,97478 |
| **ROA IBs** | 279 | 15,63 | -10,77 | 4,86 | ,6945 | 1,26897 |
| **Z-Score IBs** | 279 | 29,09 | -5,98 | 23,11 | 10,4671 | 4,12594 |

**Table 3. Descriptive Statistics of Conventional Bank**

| Variables | N | Range | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|---|
| **EOA CBs** | 279 | 59,29 | 4,93 | 64,22 | 18,5539 | 10,43515 |
| **ROA CBs** | 279 | 13,65 | -7,47 | 6,18 | 1,0837 | 1,34763 |
| **Z-Score CBs** | 279 | 43,04 | 3,92 | 46,97 | 14,5720 | 7,77938 |

Tables 2 and 3 present the statistical descriptions of Islamic and Conventional Banks, respectively. The main thing that needs to be discussed from the results is the existence of variability, as shown by the standard deviations. According to both tables above, there are variabilities in the data, then the estimation with logistic regression is eligible.

### 4.2 Binary Logistic Regression Test

The estimation and hypothesis testing were conducted using a binary logistic model, and Table 4 shows the test results.

**Table 4. Binary Logistic Regression Analysis Results**

| Variables | Coefficients (β) | Standard Error | P-Value |
|---|---|---|---|
| **EOA** | - 0.532 | 0.087 | 0.000 |
| **ROA** | -0.308 | 0.091 | 0.001 |
| **Z-Score** | 0.552 | 0.111 | 0.000 |
| **Constants (α)** | 1.520 | 0.259 | 0.000 |

Based on the P-value, it can be inferred that all of the predictors are significant in predicting the dependent variable at the 1 percent significance level. In other words, EOA, ROA, and the Z-score are good predictors for distinguishing between Islamic and conventional banks.

Based on this result, it can be concluded whether to accept or reject the hypothesis. Starting from $H_1$ (hypothesis 1), it can be concluded that the hypothesis is accepted, where the capital structure, proxied by EOA, negatively affects the type of banks. The negative sign means that the higher the EOA (ratio of equity to assets), the higher the probability that the banks are Conventional Banks. Otherwise, the lower the EOA, the higher the probability that the banks are Islamic Banks. Furthermore, the value of the coefficient (β), 0.532, represents the magnitude of the influence of EOA on the type of banks. Every 1 unit of account change in EOA will affect the probability of the type of banks by 0.552 or 55,2 percent.

Moving to hypothesis 2 ($H_2$), the testing result also shows that ROA (a proxy for profitability) significantly and negatively affects the type of banks. Accordingly, it can be concluded that $H_2$ is accepted. This result indicates that the higher the profitability, the higher the probability if the banks are conventional banks. Otherwise, the lower the profitability, the higher the probability that the banks are Islamic Banks. The magnitude of the influence is 0.308, which is represented by the regression coefficient (β). This means that an increase in the ROA by one unit of account will increase the probability that the bank is a conventional bank by 0.308 or 30.8 percent.

Finally, the last hypothesis test evaluates Hypothesis 3 ($H_3$). $H_3$ states that risk handling positively affects the type of bank. According to the test results, it can be accepted the $H_3$. This finding means that the higher the Z-Score (risk handling capability), the more likely the bank is to be an Islamic Bank. Otherwise, the lower the Z-score, the higher the probability that the bank is a conventional bank. This finding is in line with the theory that states that Islamic banks are riskier than conventional banks because of the prohibition of riba, gharar, and maysir. It shows that the dominant role of the prohibition of riba, gharar, and maysir is nothing but to minimize the risks instead of maximizing profitability

$$\ln\left[\frac{P_1}{1-P_1}\right] = 1.520 - 0.532\ \text{EOA} - 0.308\ \text{ROA} + 0.552\ \text{Z-Score}$$

**Figure 2. Final Model**

Finally, as discussed before, the ideal or better capital structure is assessed based on profitability and risk. The better the profitability, the better the capital structure, and the better the risk handling, the better the capital structure. If profitability and risk are contradictory, as in the findings of this study, profitability will be prioritized. Since conventional banks are more profitable than Islamic Banks, it can be inferred that CBs' capital structure is better than IBs' capital structure.

### 4.3 Robustness Check

A robustness check in this research was conducted by employing a t-test, namely the independent sample t-test (see Table 5).

**Table 5. T-Test Results**

| Variable | T-Values | P-Values |
|---|---|---|
| **EOA** | 8.620 | 0.000 |
| **ROA** | 3.513 | 0.000 |
| **Z-Score** | 7.786 | 0.000 |

The result of the independent sample t-test can be interpreted as whether the average value (mean) of each variable is statistically and significantly different between the two types of banks (Islamic and Conventional). The indicator of significance, P-Values, shows that the significant level of each variable is 0.000, which is less than the significant level threshold of 1 percent. Hence, Islamic Banks are statistically and significantly different from Conventional Banks based on equity proportion, profitability, and risk level. Hence, it can be concluded that one is better than the other. This result supports the findings of the binary logistic regression and strengthens the robustness of this study.

## 5. CONCLUSSION

Since the objective of this study is to compare IBs and CBs based on capital structure (equity proportion), profitability, and risk level, this research confirms that the performance of Islamic Banks in terms of Profitability and Capital Structure is still worse than that of Conventional Banks. However, Islamic banks have better risk handling due to the prohibition of riba (usury), maysir (gambling), and gharar (speculation). This study has some limitations. This research is forced to use panel data to satisfy the minimum data size requirements. For the next research, the use of cross-section or time series data with enough sample size should be better to explain this phenomenon.

**Ethical approval**
This research did not require ethical approval

**Informed consent statement**
Informed consent was not obtained for this study.

**Author's Contributions**
AL led the research design, data analysis, interpretation of findings, and served as the corresponding author, managing the submission and review process. IAF contributed to the conceptualization of the study, theoretical framework, and literature review. HE contributed to data collection, statistical processing, and the preparation of the manuscript draft.

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No potential conflict of interest was reported by the author(s).

**Data availability statement**
The data presented in this study are available upon request from the corresponding author for privacy reasons.

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