

# CHAPTER I

## INTRODUCTION

### 1.1 Research Background

There are two types of bank system based on its operational activities, conventional and Islamic system. The most distinguishing characteristic of Islamic banking systems is that they do not pay or charge interest on funds deposited by customers (Erol et al., 2014). The difference in operating systems encourages the many empirical studies conducted to compare the performance of conventional banks and Islamic banks.

Several studies (Al-Hares et al., 2013; Amjad et al., 2013; Iqbal, 2001) document that banks with Islamic systems have better performance than banks operating under conventional systems. Iqbal (2001), when comparing the financial performance of 12 Islamic banks and 12 conventional banks from 10 countries, found that the performance of Islamic banks was better than conventional banks in almost all fields and almost throughout the year. Furthermore, Al-Hares et al. (2013) compares the financial performance and quality of capital between 20 Islamic and 55 conventional banks in the Gulf Cooperation Council (GCC) region for the period of 2003 to 2011. The results showed that Islamic banks have higher capital, higher liquidity reserves, and also maintain stronger growth compared to conventional banks in almost all countries.

According to Sundararajan and Errico (2002), the size and number of Islamic banking in many countries in the world have grown rapidly. This is supported by Hanif (2014) who stated that Islamic banks continue to

experience rapid development and will become major global powers. This extraordinary growth has prompted many conventional banks to transform into Islamic banks as a whole. The success of Islamic banks in avoiding the world economic crisis recently has also been one of the causes of the phenomenon of traditional banks that have begun to change their form to sharia which is also known as conversion (Farooq and Yaccob. 2012).

A number of studies have been conducted to analyze the effects of conventional banks conversion into Islamic banks. The study by Hasan (2016), for instance, observe the effect of conversion of two banks in Bangladesh (which are EXIM Bank and First Security Islami Bank Limited) for the period of 2000-2015. Hasan evaluates the performance of the two banks before and after conversion by comparing Return On Asset, Return On Equity, Cost of Fund, Investment as a % age of Total Deposit, Internal Growth Rate and Sustainable Growth rate. This study found significant changes in the performance of the converted banks which were better than before the conversion except the Cost of Fund.



In a more recent study, Al-harbi (2020) investigate the effect of conventional banks conversion into Islamic banks in the Gulf Cooperation Council (GCC) countries. Based on the study, it was found the improvement and positive influence in the converted bank's financial performance, particularly in assets, deposits, equity and net income. However, several other indicators did not experience improvement such as profitability, efficiency, asset quality, liquidity, and risk indicators.

The phenomenon of conversion of conventional banks to Islamic banks

is also carried out by Regional Development Banks (also known as Regional Development Banks, abbreviated as BPD) in Indonesia. Regional development bank has an important role to improve the standard of living of the society and provide financial financing for development in the region, raise funds, and save regional money in addition to carrying out banking business activities.

The main objective of this research is to analyse the financial performance of Aceh Bank and NTB Bank before and after conversion into islamic system. This research is important because it can serve as a references for other BPDs in making decisions to change the system from conventional to sharia.



Government of Aceh demonstrated commitment in the implementation of sharia by realizing the conversion of the Aceh Bank into that operates fully using Sharia principles on May 25, 2015. The conversion operational license is determined based on OJK Board of Commissioners Decree Number. KEP-44 / D.03 / 2016 dated 1 September 2016 Regarding Granting Permits for Changing Conventional Commercial Bank Business Activities to become Sharia Commercial Banks of PT Aceh Bank.

The conversion of PT Bank NTB to Bank NTB Syariah is stipulated by the Regional Regulation of West Nusa Tenggara Province Number 08 of 2018 concerning the conversion of PT Bank NTB to Bank NTB Syariah and obtaining an operational license as a Sharia Commercial Bank from the Financial Services Authority Decree of the Board of Commissioners Member Number: KEP-145 /D.03/2018 dated 4 September 2018 and officially started operations in all Branch Offices on 24 September 2018.

Several studies have been conducted (to examine the effects of conversion on BPD performance, one of them is Aceh Bank as the first BPD to be converted into sharia. Silvia (2018) found that after being converted, Bank Aceh experienced an increase in the profitability ratio during 2015 to 2018. Furthermore, Anwar et.al (2019) conducted a study by analyzing the effect of conversion on the profitability and capital of Bank Aceh during 2016 to 2018. The study also found better performance at Bank Aceh after it was converted to sharia.

The importance of this research stems from the lack of empirical studies on the effect of conversion on the financial performance of banks, especially BPD. In addition, this thesis aims to develop research from two previous researchers by using more financial indicators over a longer period and more sample namely NTB Bank as the second BPD that convert to islamic system. This research will follow the method of Al-Harbi (2020) which uses ratio analysis and data on financial reports to capture the comparison of Aceh Bank before and after conversion. The results of this study can be used by various parties such as the government and bank managers in making decisions for the conversion program



## 1.2 Research Problem

Based on the description above, the problems to be studied are:

1. What is the financial performance of Aceh Bank before and after the conversion to sharia?
2. What is the financial performance of NTB Bank before and after the conversion to sharia?

3. How does the comparison between Aceh Bank and NTB Bank after conversion?

### 1.3 Research Objective

This study is designed to:

1. Examine the financial performance of Aceh Bank before and after the conversion to sharia
2. Examine the financial performance of NTB Bank before and after the conversion to sharia
3. Examine the comparison between Aceh Bank and NTB Bank after conversion

### 1.4 Research Benefits

This study is expected to provide benefits to those who are directly or indirectly related to this research, including:

- a. For Financial Services Authority (also known as *Otoritas Jasa Keuangan*), this study will provide information about the financial performance of BPD that can be used as a consideration in making policies about conversion program.
- b. For other BPD in Indonesia, the result of this research is useful to provide additional information for other BPD to consider the conversion strategy.
- c. For stakeholders (shareholders, managers, creditors, employees). The results of this study are expected to provide alternative discourse for users of financial statements and practitioners of company organizers in making decision process .
- d. For further researchers. The results of this study are expected to be able to



add references for further research in a broad and in-depth manner related to the effect of conventional bank conversion to Islamic bank.

## 1.5 Writing Systematic

The structure of this study is divided into several sections, starting from chapter I: introduction, this chapter begins a review of the urgency to make a comparison of the financial performance of Aceh Bank before and after conversion to sharia. This chapter consist of research background, problem statements, objectives and the benefits of research, and systematic writing. Chapter II: literature review, this chapter explains the theoretical basis that contains various theories, related research or that have been studied, research models or frameworks of thinking and developing hypotheses that underlie and relate to the topic of the problem to be studied.

Then proceed with chapter III: research methods. In general, this chapter explains the research plans and procedures that the authors undertake to address the problems that have been formulated and test the hypotheses that have been raised in the previous chapter. The things that need to be conveyed in this chapter are the types of research, data and acquisition techniques, and data collection techniques. After that, proceed with chapter IV: the results and analysis of the research section. This chapter contains a description of the research object, the results of the analysis as well as an in-depth discussion of the findings and explain their implications. Finally, chapter V: conclusion. This chapter will present the conclusions and limitations of the research that has been done as well as recommendations for related parties and further research.

