

**UNIVERSITI TEKNOLOGI MARA**

**COMPARATIVE STUDY OF BANK  
EFFICIENCY BETWEEN ISLAMIC  
AND CONVENTIONAL BANKS IN  
MALAYSIA**

**ATIQA H BATRISYIA BINTI ZAINALABIDEN  
TENGKU HANIM SYAMIMI BINTI TENGKU  
MOKHTAR**

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## ABSTRACT

Malaysian banking system is unique as it practices the dual banking system that comprises of Islamic and conventional banks. The dual banking system allows conventional banks to work in parallel with Islamic banks in the country. The practice of Islamic banks and conventional banks are different with the former follows the *Shariah* law and the latter consist of prohibited elements such as *riba* (interest), *gharar* (uncertainty) and *maysir* (gambling). Due to this reason, the study believes it is relevant to compare these two (2) groups of banks in term of their cost efficiency. The purpose of this study is twofold. First, is to examine the determinants of cost efficiency for Islamic and conventional banks and second, to compare the cost efficiency between the two (2). The sample of this study covers from the period of 2008 until 2017 and consists of 14 Islamic banks and 16 conventional banks with a total of 231 observations. This study uses financial ratio of overhead cost to revenue to measure the cost efficiency for banks in Malaysia. The study employs the Random Effect Model (REM) and develop three (3) models which include Islamic banks (Model A), conventional banks (Model B) and all banks (Model C). The study discovers that asset quality and profitability have significant impact on cost efficiency for both Islamic and conventional banks. On the other hand, size is only influential to the banks cost efficiency for the Islamic banks model. Aside from asset quality and profitability conventional banks must take into consideration capitalization and liquidity in managing their cost efficiency. This study is designed to guide the banking sectors and regulators in the process of managing and monitoring their cost efficiency.

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# CHAPTER ONE

## INTRODUCTION

### 1.0 Overview of the Study

This study starts by unfolding the banking system and define the types of financial institutions in Malaysia. The chapter continues by enlightening the concept of efficiency together with the discussion of input and output of banks in assessing the level of efficiency. Then, this study presents the problem statement, objective, scope and significance of the study.

### 1.1 Banking System in Malaysia

Banking system in Malaysia can be regarded as unique because it operates in dual banking system. It is a practice in which banking system operates non-interest-based Islamic banking alongside the interest-based conventional banks (Lee & Isa, 2017). At the end of 2017, the banking system consists of 26 commercial banks, 11 investment banks, and 16 Islamic banks. The existence of Islamic banking system which operates in parallel with the conventional banks that complement each other is to promote economic stability.

Financial institutions in Malaysia comprise banking system and non-banking system. The financial institutions act as a mechanism to transfer funds from the surplus unit to deficit unit. Each component plays an important role for the success and stability of the financial institutions. In the evolution of Malaysian financial institutions, various financial intermediaries have been established and a wide range of financial instruments have been introduced to facilitate the flow of funds between savings and investments such as Islamic banks and conventional banks (Nasser & Muhammed, 2013).

In the past, the financial crises left everlasting scars to the world economy. In fact, it affects financial institutions as a whole. The result from financial distress has