ISSN No:-2456-2165

Islamic Banking and Conventional Banking: A Comparative Study in Bangladesh

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Abstract:- Islamic banking is a nascent branch of banking and finance that has grown in importance in many Muslim countries. One of the countries that has embraced a dual banking system is Bangladesh. Traditional banks borrow money at a low interest rate from depositors and lend it to borrowers at a higher rate. On the other hand, interest is prohibited, hence Islamic banks enter into profit-sharing agreements with both depositors and borrowers. The purpose of this research is to examine if different banking arrangements based on different ideologies result in different outcomes. This study largely relies on secondary data because banks' refusal to disclose green data makes it difficult to do thorough and accurate comparisons. However, two heads of sustainable banking departments from conventional banks and two from Islamic banks have been interviewed in order to assess the authenticity and trustworthiness of secondary data. According to the study, Islamic banks that do not charge interest outperform conventional banks that do in terms of production, efficiency, and commitment to the local economy and community. Nevertheless, in terms of promoting business, profitability, liquidity, and solvency, interest-free Islamic banks perform better than interest-based conventional banks. That is, when it comes to financial performance, Islamic banks beat traditional, interest-based banks.

***Keywords**:- Islamic Banking, Conventional Bank, Financial Performance.*

I. INTRODUCTION

The financial institutions, notably the banking sectors, play a major role in a country's economic development. The banking sector has a substantial impact on the economy's growth. Bangladesh's banking sector is always performing well, and the country's banking sector is divided into two pillars: conventional and Islamic banks. Islamic finance has been rapidly growing over the world. The Islamic financial business has been in Bangladesh for more than 30 years. The health of a country's banking industry determines its economic growth and stability (Mengesha, 2016). Bangladesh's banking industry continues to play a vital role in the country's dynamic economy (Babu, 2018). Banks, according to Prakash et al. (2017),

The comparison of Islamic and conventional banks in terms of profitability, lending, behaviour, risk-taking, deposit growth, and stock market returns has gotten a lot of attention lately, especially with Islamic banking's growing presence in the financial system and their response to the global crisis (Khediri et al. 2015). The world's conventional banks have been in operation for a few hundred years. They were taking deposits in people's savings and current accounts and lending money to persons with good credit (riba). In Islam, riba (interest) is forbidden. As a result, riba cannot be used in the Islamic financial system. The Islamic scholars were expected to run Islamic banking using a Shariah-approved profit-loss sharing method. In 1973, Muslim experts with expertise in Islamic Fiqh (law), economics, and banking systems joined forces to build an Islamic banking system that would suit the needs of Muslims who did not want to take or grant interest-bearing loans. As a result, many Islamic banks sprang up across the globe in the 1970s and 1980s. Because Islamic banks operate in a comparable financial environment, they share some characteristics with conventional banks.

However, due to their unique contractual and financial activities, Islamic banks face more complicated operational risks. Bangladesh pioneered the Islamic banking system more than four decades ago. It is an important aspect of Bangladesh's banking system. The performance of Islamic banks operating in Bangladesh is the subject of this report. In 1983, Islami Bank Bangladesh Limited was the first bank in Bangladesh to establish commercial banking based on Islamic Shariah with foreign shareholdings. Since then, Islamic banking has grown at a steady pace alongside mainstream bank. Bangladesh now has eight fully functional Islamic banks, 19 Islamic banking branches, and 35 Islamic banking windows in conventional banks (Bangladesh Bank, 2019).

➢ *Research objectives*

The main objective is to compare the existing practises and performance of Bangladesh's Islamic and conventional banks. Therefore, the specific objectives are divided into the following categories:

RO$_1$. To review the individual concepts of Islamic banking and conventional bank

RO$_2$. To analyse the history of Islamic banking

RO$_3$. To evaluate the current practice and performances of the Islamic banks and conventional banks of Bangladesh.

II. LITERATURE REVIEW

Islamic banks operate alongside conventional banks, and a parallel market for Islamic financial goods and services has emerged. Both deficit and surplus units in the economy have the opportunity to utilise the services offered by each banking system. If religious foundations for the supply of financial services are significant, then only Islamic banks will attract bank customers. This study examines the competitiveness of conventional and Islamic banking in Bangladesh. Islamic banks' business models are fundamentally different from those of conventional banks, as the former is founded on financial principles and thereafter bases its operations on lending principles. This provides new dangers and opportunities for both financial systems. This study contributes to the existing literature on Islamic banking and finance by comparing the business outlooks of conventional and Islamic banks.

A. *Overview of Islamic bank and Conventional Bank*

➢ *Islamic Bank*

Islamic banking applies to banking that is based just on Islamic Shariah (without interest). Islamic banking is founded on Islamic Shariah Law, which stipulates that all financial issues be resolved in accordance with Islamic standards. Interest is completely prohibited in Islam, according to Islamic law, because it has numerous negative impacts on society, including lowering the earning capacity and purchasing power of the interest provider, as well as increasing poverty, unequal income distribution, and financial crises. Hassan & Aliyu (2018) established Islamic banks to address the danger associated with widespread financial transactions. Islamic banks follow the rules of Islamic law, which say that interest, gambling, speculation, and derivative transactions are all bad for the economy (Akbar & Dey, 2020; Hassan & Aliyu, 2018; Khan, 2010).

Additionally, a number of studies found that Islamic banks, which compete with traditional ones, have evolved into a financial diversion to maintain a nation's resilience to exogenous shocks brought on by the global financial crisis (Alexakis et al., 2019; Beck et al., 2013; Berger et al., 2019). Islamic finance and banking provide alternate approaches and methods for addressing the global financial crisis. The performance of Islamic banks as commercial enterprises and their development must be measured. The findings of prior performance measurements are used by management to define targets, goals, and organise future actions. The evaluation of the health of the banks is based on performance measurement, which is an important factor (Nurindrasari et al., 2018).

➢ *Conventional Bank*

Traditional banking is based on interest and a pure financial intermediation model, in which banks borrow primarily from savers before lending to businesses or individuals. They earn from the interest rate differential between borrowing and lending. Other banking services, such as letters of credit and guarantees, are also available. Low-cost money obtained from demand deposits account for a chunk of their profit. The interest rate in traditional banking is pre-determined. As a result, traditional banks earn from the difference between the interest rate given to depositors and the interest rate obtained from borrowers (Mohamad, Hassan & Bader, 2008). This banking system totally rely on interest, there is no restriction in interest. There is no concept of Halal (legal) and Haram (illegal) from the view point of Islamic Shariah.

➢ *Similarities and differences between conventional banks and Islamic banks*

Islamic Financial Institutions (IFIs) work in the same society as traditional banks and do everything you would expect from a financial institution. IFIs help the business world by offering all the services needed to keep the economy running smoothly. However, their ideas and ways of doing things are different. In this section, we will look at how IFIs work and what they offer compared to traditional banks. Any financial system should help the economy run by doing the following, which are grouped under two headings. First: Getting savings from savers to business owners and Second: providing general utility services, such as transferring money, helping with international trade, consulting, keeping valuables safe, and any other service for a fee. As long as the service is not against Sharia, IFIs are free to offer it. There are, however, differences in how savers and entrepreneurs raise money, as described below. There are two parts to mobilizing savings: accepting deposits and giving loans and making investments.

Deposits: No matter if a bank follows the traditional system or the Islamic system, they both collect deposits from savers in order to pay them back. The difference is in how the reward is set up. In the traditional system, the reward is set and known ahead of time. In the Islamic system, deposits are accepted through Musharakah and Mudaraba, and the reward is different for each. In traditional banking, the return on long-term deposits is higher than the return on short-term deposits. In Islamic banking, profit is also shared with people who put money in. Higher weight for profit sharing is given to long-term deposits that banks can use to invest in long-term projects with higher returns, while short-term deposits that can't be invested in long-term projects get less weight. The only difference between the traditional and Islamic systems is how the risk and reward are split. Under the traditional system, the bank takes on all the risks and gets all the rewards after taking care of the depositors at a fixed rate. Under the Islamic system, however, both the risk and the reward are shared with the depositors. IFIs give money back to depositors based on how well their investments work out. Under the Islamic financial system, IFIs will only be able to collect deposits from people who trust them. This will help the financial industry run at its best.

Financing and Investments: The second step in the process of putting savings to work is giving credit to businesses and industries in exchange for something. Both Islamic and traditional institutions give money to productive channels in exchange for a reward. The difference is in how the money is paid back. IFIs can't do this because they can't charge interest on loans. Conventional banks offer loans in exchange for a fixed fee. IFIs can charge interest on loans but not on investments. In traditional banking, customers can get three kinds of loans: short-term, overdraft, and long-term. Islamic banks can't lend money, except for interest-free loans (Qard e Hasana), but they can still do business by giving clients the assets they need.

Short term loans: Conventional banks give customers short-term and medium-term loans to meet their working capital needs. Firms need working capital to invest in their inventory and accounts receivable and pay their bills. As far as investing in inventory goes, Islamic banks offer this service through Murabaha. IFIs provide funding for a business's day-to-day costs through participation term certificates, which divide the profit of a certain period (like a quarter, six months, or a year) into equal parts. Due to the risk involved for IFIs, financing through participation term certificates is not as easy as getting a short-term loan from a traditional bank. If a company wants a short-term loan from an IFI, it has to show the investor that the project or business can work. So far, there is no way for the Islamic financial system to help non-profits get the money they need for working capital. IFIs also don't give out loans for personal use. However, anyone with enough money can buy anything for personal use through Murabaha financing, in which a certain percentage of profit is added to the cost by IFIs. Murabaha financing is a great way for businesses, non-profits, and individuals to get the money they need in the short to medium term. Murabaha financing is based on the value of an asset, and anyone can ask an IFI to give them an asset that is usually used for lawful purposes. Under the Islamic financial system, IFIs can't lend money with interest as a rule. The only exception is the Qard e Hasan, or charity loan. One of the things that makes Murabaha unique is that if a customer pays late, the IFI can't ask for extra money because of the time value of money, like regular banks do. But a penalty is imposed on the person who doesn't pay back the loan if it's written in the original contract of Murabaha and signed by the customer. This penalty, though, can't be added to the IFI's income. This fine must be used to help other people.

Under the Murabaha scheme, the financing facility is tied to the asset, which makes the economy more stable and connects the real and financial sectors. It's not a zero-sum game because people get value from services and products, not from trading paper money. Even though IFIs use Murabaha successfully and have been able to meet the short- to medium-term needs of businesses by replacing traditional loans with it, there are still some differences between the two types of financing. First, under Murabaha, you can't get cash. IFI buys the second asset and then gives it to the customer, so IFI shares in the risk. Under Murabaha, there is no third option for refinancing. Fourth, if the buyer doesn't pay, the price of the commodity can't go up. However, a penalty can be added if it was written into the original contract of Murabaha, but it can't be added to the IFI's income. Fifth, IFIs can only give assets under the Murabaha system that can be used in a way that doesn't go against Sharia law (e.g., supply of a machine to produce liquor).

Medium to long term loans: Firms can get medium- to long-term loans to buy or build fixed assets to grow or replace what they already have. In the Islamic financial system, Murabaha, Bai Muajjal, and Istisna are used to meet the needs of both businesses and individuals. Profit sharing under Musharakah and Mudaraba is another option for long-term financing. Even though financing through Murabaha, Bai Muajjal, and Istisna looks a lot like traditional loans, the only difference is that the client gets an asset instead of cash. There are differences in the contracts that change the risks and returns. IFIs and businesses find it hard to finance under Musharakah and Mudaraba. Under Sharia-based financing schemes, businesses have to prove to IFIs that their project or business will work and make money. If they can't, they won't get the money.

Investments: Traditional banks have many ways to keep their cash on hand, such as buying government bonds, making short-term loans and loans on demand, leasing company bonds, investing in stocks, etc. Not only do traditional banks with central banks have to keep reserves, but they also get paid interest for doing so. Traditional banks can also get more cash by issuing bonds against the money they owe. The central bank also protects commercial banks by giving them cash in bad times in exchange for interest. Commercial banks also pay interest on deposits made with other banks. There aren't many ways for IFIs to both create the liquidity they need and make money by investing in short-term, liquid securities. Because they are based on interest, IFIs can't invest in government securities, short-term loans, bonds, or money that can be called up quickly.

IFIs have to keep a mandatory reserve with the central bank, but they don't get paid like regular banks do. Looking to the central bank in bad times to keep money flowing is also not as easy because the central bank wants interest. IFIs can't ask for interest on deposits made between banks. For two reasons, IFIs are not free to invest in any equity security when it comes to investing in marketable securities. First, the underlying company needs to have a halal business. Second, there shouldn't be any interest in the firm's financial operations. Considering how common traditional banking is and how business is done now, it's safe to say that very few businesses meet both requirements

A security must meet these most important things to be considered Sharia-compliant. To be called Sharia-compliant, a security must pass the following tests: First, the company's main business should be halal. Second, the company's assets that can't be sold quickly should make up 20% of all its assets. IFIs can't buy shares in a company that only deals in liquid assets because those shares don't follow Sharia law. Third, all interest-bearing debts, including preferred stock, should make up less than 40% of the company's total assets. Fourth, the share of the company's total assets that aren't in line with Sharia law should be less than 33%. Fifth, the money made from investments that don't follow the rules should make up less than 5% of the company's total income, and even then, IFIs have to spend this money on charity to clean up their earnings. Lastly, the market price per share should be higher than the value of the share's net liquid assets.

B. Performance of Islamic and conventional banking

In the study of banking, several facets of the industry are explored (Hossain, 2019). Apart from that, (Rana, Hossain, & Rekha, 2016) discovered that Islamic banks in Bangladesh outperform conventional banks in terms of profitability and liquidity. Conventional banks, on the other hand, are more profitable in Bangladesh than Islamic banks, according to (Islam, Alam, & Hossain, 2014). In their respective studies, however, (Uddin, Ahsan, & Haque, 2017) and (Islam & Ashrafuzzaman, 2016) discovered no substantial differences between conventional and Islamic banks in Bangladesh.

In the emerging market, Zainuldin & Lui (2020) looked into the earnings management capabilities of conventional banks and Islamic banks. Researchers also evaluated the ownership structure that affected how conventional and Islamic banks managed their earnings. The outcome demonstrated that Islamic banks have a better ability to manage earnings than traditional banks. In their 2017 study, Miah and Uddin compared the business propensity, productivity, and stability of conventional and Islamic banks. Yanikkaya et al., 2018; Ali and Khattak, 2020). Mursyid et al. (2021) used the Simple Additive Weighted Method (SAW) to look at the performance of Islamic banks using their annual reports from 2015 to 2020. This was done to solve problems with making decisions based on more than one factor. In this context, the authors also made use of ROA and ROE. The conventional banks suffered less from cost effectiveness and profitability than the Islamic banks (Alqahtani et al., 2017).

Islamic banking has been acknowledged as one of the most dominant and well-liked banking services, and demand from the general public is steadily rising. Islamic banking now controls a 25% market share of the banking sector in Bangladesh. Through its large contribution to impact investment, it is considerably advancing the Sustainable Development Goals (SDGs). According to Bangladesh Bank's data as of June 2020, ten fully operational Islamic banks are currently operating in Bangladesh out of the country's 59 private banks. Out of the 10588 branches of the 59 designated banks, these full-fledged Islamic banks have a total of 1274 branches. Additionally, a total of 21 traditional commercial banks began running Islamic banking windows and branches. Additionally, a few traditional banks, like Mercantile Bank, Midland Bank, and NRB Commercial Bank, have begun providing Islamic banking based on Shariah. Standard Bank, Jamuna Bank, and NRB Global Bank are three of these banks that have been given authorization to convert to fully functional Islamic banks by 2021. The Islamic banking sector has made major contributions to Bangladesh's economy and economic development. Due to the sector's lower Statutory Liquidity Ratio (SLR) and greater Loan-Deposit Ratio, conventional banks find it to be more and more profitable (LDR). The sector has clearly seen tremendous growth and expansion in the nation as both deposits and investments have increased over time. The sector's operations are shown in Chart 1, which is briefly covered below:

Total Deposit: At the end of March 2022, total deposits in the Islamic banking industry had grown to BDT 3996.79 billion, up BDT 65.68 billion (1.67 percent) from the end of December 2021 and BDT 418.87 billion (11.71%) from the same quarter the previous year.

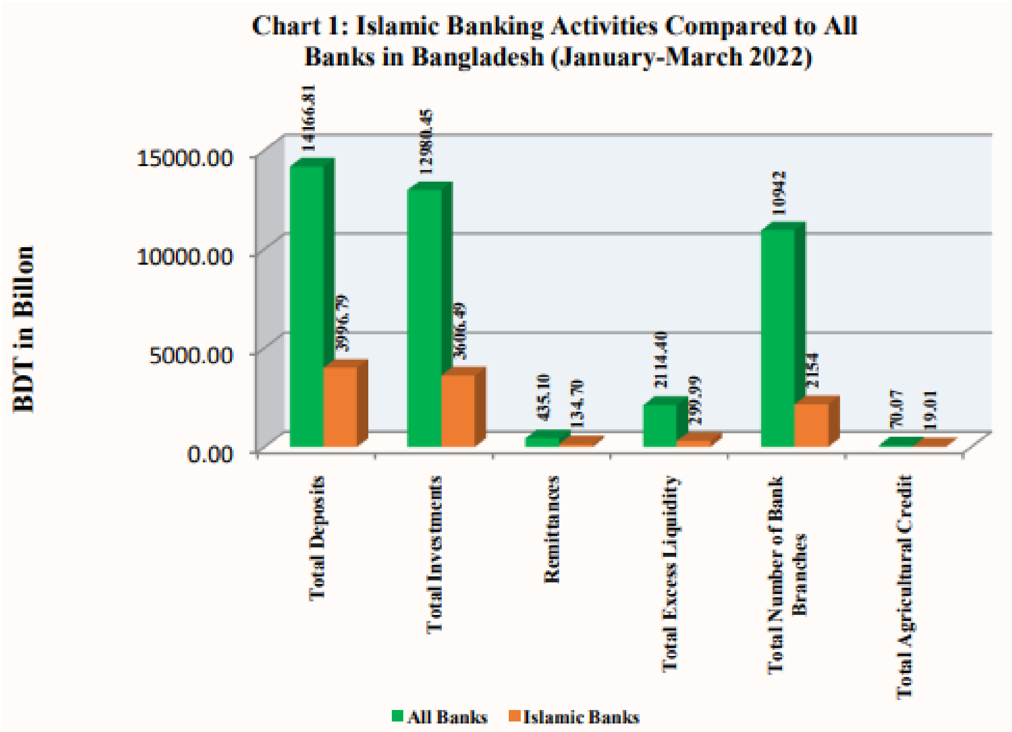
Total Investment: When compared to the end of December 2021 and the end of the same quarter of the previous year, the total investment (loans and advances in the conventional banking system) of the Islamic banking sector stood at BDT 3606.49 billion at the end of March 2022. This represents an increase of BDT 72.01 billion or 2.04 percent and BDT 382.51 billion or 11.86 percent, respectively.

Total Remittance: During the months of January through March 2022, the total amount of remittances mobilised by the Islamic banking sector was BDT 134.70 billion. This figure was lower than that of the prior quarter and the same period in 2021 by BDT 68.98 billion (33.87 percent) and BDT 22.64 billion (14.39 percent), respectively.

Excess liquidity: At the end of March 2022, Islamic banking had a BDT 299.99 billion market capitalization, down BDT 36.26 billion (9.90%) and BDT 4.10 billion (1.35%) from the end of December 2021 and the same period the previous year, respectively.

Total Number of branches: 2154 Islamic banking branches, including those of traditional commercial banks, were operational as of the end of March 2022, up from 2080 at the end of December 2021 and 1755 at the end of March of the previous year.

Total Agricultural Credit: All banks 70.7 Islamic banks 19.01 billon and Share of Islamic banks among all banks 27.13% (Jan- March-2022) and 21.74% (Oct- Dec- 2021)



Source: (Statistic Department, MPD and ACD Bangladesh Bank, Jan- March 2022)

III. METHODOLOGY OF THE STUDY

This research used a quantitative research approach to delve deeper into the factors that influence Islamic banks' adoption of internet banking. Library research was used as a qualitative research method. Library research is a type of study that gathers data from documents, reports, books, and other scientific sources. Library research, according to Mirzaqon & Purwoko (2018), comprises obtaining data and information from books, scientific literature references, and other scientific references such as proceedings and reports from an official institution or organisation. In this study, the author used the Systematic Literature Review approach. Ahmad et al. (2021) say that the Systematic Literature Review strategy is a set of ways to find, analyse, and make sense of all the available study materials in order to answer predetermined research questions.

IV. CONCLUSION AND RECOMMENDATION

Islamic banking has made significant strides over the past few decades in Bangladesh and the rest of the world, but because conventional banking still exists, it is still in its infancy. Increased profitability and overall efficacy of Islamic banks can be achieved by increasing client awareness and making the modes of operation clear to both current and potential customers. Naturally, there should be a beginning point in relation to an expressed marketing and education programme to educate and enlighten the public about Islamic banks and alternative forms of finance that are now available. Islamic banks should take more proactive measures to raise customer awareness of Islamic banking systems, including holding seminars and other gatherings and implementing various motivational programmes. Both conventional and Islamic banks must work to strengthen their current practises in order to address their deficiencies if they are to succeed in the future.

The key to running a profitable banking operation is to provide superior value to all of the parties involved. Since their beginning, private banks have functioned exceptionally well. There are conventional banks and conventional commercial banks among private banks. Both organisations strive to provide better customer service. Both, however, have fallen short of offering the clients the services they had come to anticipate. Finally, this study showed that private traditional commercial banks are less successful at providing high-quality services than Islamic banks. According to the study, there is a significant difference between conventional banks and Islamic banks in terms of profitability, credit risk,

ISSN No:-2456-2165

capitalization, and bank size. On efficiency and leverage, they do not differ greatly from one another. The report also reveals that compared to conventional banks, Islamic banks are smaller and have lower profitability, credit risk, efficiency, and liquidity. Islamic banks have higher capitalization than normal banks, nevertheless. The study's conclusions show that because of their low efficiency, small bank sizes, and the absence of specialised regulatory frameworks in Bangladesh, Islamic banks are unable to use their large capitalization to increase profitability. This predicament has been brought about by Bangladesh's Islamic banks' inability to run themselves effectively and provide investment products that comply with Shariah. Given the situation, the central bank must set up a specific regulatory policy framework to improve management capacity and investment opportunities. This will allow Islamic banks to invest their large amounts of capital over a range of maturity periods.

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