Productivity of Islamic and Conventional Banks of Malaysia: An Empirical Analysis

Farhana Ismail* and Rossazana Ab. Rahim**

The paper presents the productivity change of Malaysian banks for the period 2006-09 by employing Malmquist productivity index. The results reveal that throughout the study period, the productivity of Islamic banks (10.4%) was higher than that of the conventional banks (0.9%). Also, on an average, productivity across Malaysian banking industry increased at an annual rate of 5.4%, which was mainly due to technical change rather than efficiency change. Therefore, this study suggests that Malaysian commercial banking industry can further increase its total factor productivity by improving its efficiency component.

Introduction

Since the 1970s, especially after the establishment of Islamic Development Bank by the Organization of Islamic Countries (OIC), Islamic finance has grown tremendously (Mckinsey, 2008). In 2008, there were over 300 Islamic financial institutions worldwide across 75 countries. In Malaysia, the Islamic financial system, established in 1983, operates in parallel with the conventional financial system. Initially in 2001, there were only two full-fledged local Islamic banks which offered Islamic banking products in Malaysia. By the end of 2010, the number of Islamic banks in Malaysia had increased to 17, consisting of 11 local banks and 6 foreign banks (Bank Negara Malaysia, 2010). Before the emergence of Islamic financial system, conventional financial system played a significant role in the global financial performance. Nevertheless, the recent turmoil in the global financial markets has increased the awareness and appreciation among the international financial community on the distinct nature and inbuilt strengths of Islamic finance. Due to the fact that financial stability is very important in determining the broader economic development (McKinsey, 2008), the stable nature of Islamic finance has thus attracted many investors. Consequently, this has led to the rapid growth of Islamic finance worldwide.

The difference between Islamic banking and conventional banking is that Islamic banking is a system of banking that complies with Islamic law, also known as Shari'ah law. The underlying principles that govern Islamic banking are mutual risk and profit-sharing between the provider

* Lecturer, Faculty of Economics and Business, Universiti Malaysia Sarawak, Malaysia; and is the corresponding author. E-mail: ifarhana@feb.unimas.my

** Lecturer, Faculty of Economics and Business, Universiti Malaysia Sarawak, Malaysia. E-mail: arrossazana@feb.unimas.my