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RESEARCH PAPER

Understanding the Impact of Conversion on Profitability in Islamic Banks

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Abstract
Conversion can be an alternative strategy for small Islamic banks compared to spin-offs. There are two conventional banks in Indonesia that have fully converted into Islamic banks, namely Bank of Aceh Sharia and Bank of NTB Sharia. The conversion strategy will improve the performance of Islamic banks. This study examines the impact of the conversion on the level of profitability of the converted bank. By using panel regression analysis, this study shows that the conversion decision has no impact on Islamic banks' profitability level. This study found that the variable that influences the level of profitability is the default rate which is proxied by the NPF. This condition happened because the bank was still focused on the internal consolidation process in the early years of conversion. This result implies that the conversion strategy must be carried out with various considerations and requires support from all stakeholders.
Keywords: Islamic Banking, Panel Regression, Performance, Return on Asset, Strategy.
JEL Classification: E59, G21, G34.

1. Introduction
Sharia Banking Act No. 21 of 2008 mandates spin-off obligations for conventional bank sharia units that meet the requirements. There are two requirements for the spin-off: it has reached 50 percent of the assets of the parent bank or 15 years after the law was enacted. This spin-off policy would improve the performance of Islamic banking. In 2016, one conventional bank chose to convert over spin-offs, namely the Bank of Aceh. This strategy was followed by the Bank of NTB in 2018 and the Bank of Riau Kepri in 2022.

The decision to convert into an Islamic bank is an alternative strategy for banks with a small size compared to the spin-off strategy. Al Arif et al. (2020) explained that the spin-off policy in the Islamic banking industry in Indonesia is the separation of Islamic units from conventional banks to become full-fledged Islamic banks. Small-sized banks have capital constraints when choosing a spin-off because parent banks are required to have a core capital of 3 trillion, and banks resulting from spin-offs are required to have a core capital of 1 trillion. This capital requirement will undoubtedly be challenging to fulfill for small banks, primarily regional banks. In addition, the spin-off strategy has a negative impact on the level of efficiency (Al Arif et al., 2018; 2020; Al Arif and Nabilah, 2022). Hasan and Risfandy (2021) found that sharia units are more stable when compared to those deciding to spin off. The imposition of a spin-off policy will result in many small Islamic banks. This condition certainly will insignificantly impact the level of competition in the Islamic banking industry. Even though the level of competition will be able to increase efficiency in the Islamic banking industry (Trinugroho et al., 2014).

However, on the other hand, several studies support the spin-off strategy of sharia units from conventional banks. Hosen and Mohari (2018) show that a bank's level of banking soundness will increase if the sharia unit decides to spin off. In addition, the spin-off policy can improve the performance of Islamic banks (Siswantoro, 2014), including increasing market share (Yuspin et al., 2020).

Damanuri (2012) states that one factor determining the number of banks to convert into Islamic banks is the promising prospects for the Islamic banking market. There are several benefits achieved from this conversion decision. Ramdan et al. (2020) show that there has been an increase in deposit funds of almost 40 percent annually at the Bank of NTB Sharia after conversion. In addition, conversion decisions will make them more capable of controlling financing risks (Al Kautsar et al., 2019; Pambuko and Pramesti, 2020). Then, Budianto and Sofyan (2021) also show a positive difference in performance between before and after conversion. On a more macro aspect, conversion decisions can positively affect people's welfare (Yoesoef and Khairisma, 2020).

Several studies show some of the problems arising from this full conversion strategy to become an Islamic bank. Shafii et al. (2016) showed that one of the problems that arose during the conversion process was the low quality and competence of human resources. In addition, product and service factors that are less competitive when compared to conventional banks are another problem that arises. Then, aspects of governance that are less effective after the full conversion to an Islamic bank have been completed (Adha et al., 2020).

The conversion strategy to become an Islamic bank has also been practiced in several countries. Two countries have fully converted their banking system to an Islamic one, namely Iran and Libya. El-Brassi et al. (2018) show that one of the challenges faced in Libya is the need for more guidance in the conversion process. Alani and Yaacob (2012) show that one of the motives underlying the conversion of many banks in the Middle East region is the low level of risk with high returns offered by Islamic banks. In addition, the high reserver requirement for conventional banks is an incentive to convert into Islamic banks in Bangladesh (Suzuki et al., 2020).

Although several studies have discussed conversion to Islamic banking, there still needs to be more studies that comprehensively examine this conversion strategy. The studies have only focused on one bank, while this research has tested two converted banks. Therefore, this study will analyze whether there are differences in profitability at the converted bank after the conversion process. In addition, this study uses in-depth interviews with the management of the two banks to support the empirical findings obtained from the quantitative analysis. This research will significantly contribute to the study of conversion to Islamic banking.

The balance of this paper is as follow. The next section will explain the literature review that has discussed bank conversion. The methodology and data used in this study will be discussed in section 3. The results and discussion of this study will be reported in section 4. Finally, section 5 provides the concluding remarks.

2. Literature Review

Adha et al. (2020) stated that the conversion strategy to become an Islamic bank is one of the methods for establishing Islamic banks in Indonesia. Three banks have decided to convert entirely rather than do a spin-off, namely Bank of Aceh Sharia, Bank of NTB Sharia, and Bank of Riau Kepri Sharia. One of the primary considerations in deciding to convert is the capital aspect. Regulations requiring parent banks to have a core capital of IDR 3 trillion and IDR 1 trillion for spin-off banks will burden small banks.

Another reason is to increase compliance with sharia principles and demand from local communities to have sharia banks that entirely operate according to sharia principles (Rohman, 2019; Rahmawati and Putriana, 2020; Yoesoef and Khairisma, 2020; Alamsyah and Amri, 2021). The three banks that decided to convert were in provinces with predominantly Muslim populations. This is the high demand for Islamic bank products and services (Trisnawati and Wagian, 2021). This condition follows a study conducted by Al Atyat (2007), where compliance with Sharia principles is the primary motivation for nearly 60 percent of conventional banks worldwide who decide to convert to become fully Islamic banks. Mustafa (2006) found similar facts in Saudi Arabia that 47% of conventional banks decided to convert based on compliance with Sharia principles.

Two perspectives have different opinions regarding the conversion strategy to become an Islamic bank. Budianto and Sofyan (2021) found differences in the risk profile of converted banks before and after conversion. In addition, changing the model to become an Islamic bank will positively impact company performance and risk levels (Al Kautsar et al., 2019). Fahdiansyah (2021) found an increase in performance at the Bank of NTB Sharia after the conversion strategy was carried out. Converted banks can have a better level of stability than before conversion (Al Kautsar et al., 2019). Budianto and Sofyan (2021) also found a difference in performance between before and after conversion.

Trisnawati and Wagian (2021) show that several factors support the conversion process in the Bank of NTB. First, the majority of the population of NTB are Muslims. This condition makes the level of customer acceptance when converting into a Sharia commercial bank relatively high. Second is the halal industry's development, which the central and regional governments are currently developing in the province of West Nusa Tenggara. Third, acceptance of interfaith Islamic banking at Bank NTB Syariah. Fourth, the number of remittances from migrant workers from NTB abroad is quite large each year.

Conversion decisions can increase the level of non-performing financing for converted banks if not appropriately managed. One thing that needs to be anticipated from the conversion is the risk of excessive withdrawal of funds from customers, which can impact the converted bank's default (Hosen and Muhari, 2017). This condition can have an impact on reducing the level of profitability (Pambuko and Pramesti, 2020).

The strategy to convert into an Islamic bank must be considered. Based on the experience of the three converted banks, this conversion process will take around 1 to 2 years. One of the things that must be considered seriously is increasing the motivation and competence of human resources (Ramdan et al., 2020). The conversion process needs to be more careful and will potentially reduce performance after completion (Shafii et al., 2016; Afrida et al., 2020).

Converting into an Islamic bank does not only take place in Indonesia, but several other countries have practiced this conversion. Libya and Iran are two countries that have fully converted their banking systems to Islamic banking systems. The decision to fully convert the banking system in Libya is based on Law No. 1 of 2013 (El-Brassi et al., 2018). Several banks in the Middle East region have fully converted into Islamic banks (Alani and Yaacob, 2012). Likewise, in Bangladesh, several banks choose to convert to become Islamic banks for reasons of reserve requirements (Suzuki et al., 2020).

Alani and Yacoob (2012) analyzed some reasons underlying the transformation of the conventional banking system into Islamic banking. They show that risk and profit are the leading indicators for banks to switch to the Islamic banking system. The finding is that the success of Islamic banking in meeting customer needs through a partnership relationship is considered safer and far from banking risks. The customer's alignment with the Sharia banking system is also a strong reason for banks to be able to provide Sharia financial services to meet customer needs.

3. Methods

This study aims to analyze the impact of the conversion on the number of deposit funds in the converted bank. The period used is from 2014 to 2021 from the financial report of the Bank of Aceh and Bank of NTB. The analysis technique used in this study is panel regression analysis with dummy variables. Several techniques are used to estimate the model parameters in regression with panel data. First, the common effect model; Second, the fixed-effect model; Third, the random effect model. The proposed mathematical equation is:

$$ROA_{it} = a + b_1\,D\_conv_{it} + b_2\,BOPO + b_3\,NPF_{it} + b_4\,CAR_{it} + b_5\,MSit + e_{it}$$

where:

ROA : profitability ratio measured by return on asset
D_conv is a dummy variable for a conversion policy
where: 0 = before conversion; 1 = post-conversion
BOPO : operational efficiency ratio
NPF : nonperforming financing
CAR : capital adequacy ratio
MS : market share of conversion banks

4. Results and Discussion

This study found that there was no difference in the level of profitability between before and after conversion. This fact is shown by the empirical results obtained in Table 1. This study uses a fixed effect model based on the Chow and Hausman test results. Pambuko and Pramesti (2020) found almost similar results: the level of profitability decreased after the conversion of Bank Aceh Syariah. However, it was effectively able to improve the ratio of non-performing financing. Therefore, converted banks must be able to improve their ability to improve their financial performance after they decide to convert. Budianto and Sofyan found a difference in profitability as measured by Return on Assets (ROA) between before and after conversion. However, there is no difference in the return on equity indicator before and after conversion.

Table 1. Empirical Result Impact of Conversion on Profitability

	CEM	FEM*	REM
C	56.13876	39.92493	56.13876
	4.772692***	12.65810***	4.928706***
D_konversi	-1.436428	1.470502	-1.436428
	2.805626	7.031801	2.897339
MS	-1.622442	-1.172656	-1.622442
	0.459145***	1.191395	0.474154***
bopo	-0.113120	-0.032450	-0.113120
	0.062991	0.108077	0.065050*
CAR	-0.0875664	-0.414168	-0.875664
	0.121468***	0.389553	0.125439***
NPF	-4.920016	-9.660801	-4.920016
	1.638207***	2.948001***	1.691758***
R-square	0.718542	0.860200	0.718542
Adj R-square	0.699264	0.679281	0.699264
F-stat	37.27276	4.754632	37.27276

Source: Research finding.

Table 2 shows the level of profitability at the Bank of Aceh Sharia and Bank of NTB Sharia. Bank of Aceh Sharia generally shows a fluctuating trend when using the ROA and ROE ratios. It reached its lowest point during the transition to becoming an Islamic commercial bank in 2016. Similar conditions were also seen at the Bank of NTB Sharia, which even tended to decline after the conversion was made. Based on the results of an interview with the Director of Funds and Services of the Bank of NTB Sharia. He explained that the tax examiner's tax audit for the 2016-2019 period showed an underpayment of 40 billion in taxes. This condition resulted in a decrease in the level of profitability experienced by the post-conversion Bank of NTB Sharia. In addition, this decrease was also due to changes in pricing with the entry of competitors.

Al-Atyat (2007) states that the primary motivation for bank conversion in Jordan is the desire to maximize profitability and comply with sharia rules. The aspect of compliance with sharia compliance is one of the main things in the conversion process to becoming a sharia bank. If we trace, it will be the same as the reason for the conversion that has been carried out at Bank Aceh Syariah and Bank NTB Syariah, where in both provinces, the majority of the population is Muslim. Rafay and Sadiq (2015) show that the transformation of conventional banking into Islamic banking is aimed at meeting the market share needs of Muslim customers.

Table 2. The Profitability Before and After Conversion (in percentage)

Years	Bank of Aceh		Bank of NTB	
	ROA	ROE	ROA	ROE
2012	3.66	23.31	5.62	38.99
2013	3.44	23.57	5.10	31.56
2014	3.13	22.94	4.61	30.70
2015	2.83	24.24	4.37	27.04
2016	0.52*	5.59*	3.95	20.76
2017	2.51	23.11	2.45	11.82
2018	2.38	23.29	1.92*	8.92*
2019	2.33	23.44	2.56	12.05
2020	1.73	15.72	1.74	9.54
2021	1.87	16.88	1.64	10.04

Source: Financial Service Authority (2022).

Note: *conversions' year

Alani and Yacoob (2012) analyzed several reasons underlying the transformation of the conventional banking system into Islamic banking. They show that risk and profit are the leading indicators for banks to switch to the Islamic banking system. This condition is accompanied by findings that the success of Islamic banking in meeting customer needs through a partnership relationship is considered safer and far from banking risks. Customer alignment with the Islamic banking system is also a strong reason for banks to be able to provide Islamic financial services to meet customer needs.

Shafi et al. (2016), in their comprehensive review of several studies regarding the conversion process, found that the conversion of conventional banks to Islamic banks was marked by complications caused by the conversion of the conventional banking system to the Islamic banking system. Conventional banking also needs a comprehensive framework for conversion policies related to sharia compliance, conversion resistance, human resources, sharia financial products, regulation, and legislation of legal products. The most crucial issue in the conversion process is recruiting employees who are expected to have technical banking experience and sufficient knowledge of the operational principles of Islamic banking. In addition, they also found that some factors influenced the policy process of converting conventional banks into Islamic banks, which consisted of low-qualified and unreliable human resources in carrying out Islamic banking activities, organizational management resistance to conversion policies as indicated by low employee support, low sharia compliance with the provisions of sharia principles and norms that must be met in carrying out sharia banking activities, regulatory and legislative support, as well as issues related to the development of sharia banking products. Budianto and Sofyan (2021) found that acts of governance (GCG) at Aceh Syariah banks were similar before and after the conversion.

Rafay and Sadiq (2015) show that the transformation of conventional banking into Islamic banking is aimed at meeting the needs of the Muslim customer market share. However, in practice, Islamic banking operates within the conventional financial system. The low awareness of stakeholders on the importance of Islamic banking, differences in the views of schools of Islamic law in addressing muamalah banking issues, and ineffective regulations are some of the problems in developing the framework in the banking transformation process. The sharia banking framework's development in practice differs from sharia principles and the needs of public financial services. This condition shows that the development of sharia finance is not in line with the objectives of compliance with sharia principles, prudential requirements in supervising banking activities, provisions for publishing information in financial reports, provisions for corporate governance and transparency, provisions for product development, and ethical behavior towards consumers. This factors is also the basis for the rejection by some groups of converting conventional banks into Islamic banks based on Qanun number 11 of 2018 (Alamsyah and Amri, 2021).

Eliana et al. (2020) stated that one of the challenges Islamic banks face is the low public interest in Islamic banks. Islamic banks must be able to innovate products in order to attract customers (Sulistyawati et al., 2020). Products and services are the factors that most determine a person's decision to use banking services (Abduh et al., 2013). Converted banks must be able to compete not only with fellow Islamic banks but also with conventional banks. Healthy competition will be able to increase the level of profitability (Sukmana and Ibrahim, 2021). In addition, religious, economic, and information factors positively impact a person's intention to become a customer of an Islamic bank (Purba, 2017).

The decision to convert to an Islamic bank has an impact on increasing the market share of the Islamic banking industry (Ribowo and Nurdin, 2022). Until the end of 2022, the market share of the Islamic banking industry in Indonesia has reached 6.70 percent or higher than the target of 5 percent, which has been launched since 2008. Market share is one indicator that determines positioning compared to its competitors (Adenan et al., 2021). Three parties must be actively involved in increasing market share in Islamic banks, namely internal Islamic banks, regulators, and the community (Hidayat and Trisanty, 2020).

Management must be able to take strategic steps to develop converted banks. Improving product quality, capital, network, and network affordability levels, human resources, technology, and governance are some things that must be done. Products that are designed must be innovative and not just imitate the products that already exist in conventional banks (Adebola et al., 2011). Besides that, Islamic banks should increase their promotional costs to accelerate market share (Budhijana, 2019; Hanafi, 2021). The conversion should invest more in technology because technology investment has a crucial role in enhancing innovation services for Indonesian Islamic banks (Lantara et al., 2022). Improving the quality of human resources is something that must continuously be improved in Islamic banks. The development of human resources is expected to help increase the market share of the Islamic banking industry (Budhijana, 2019). Therefore, the Islamic banking industry needs to continue improving the quality of its human resource through education and training.

5. Conclusion

The conversion decision is an alternative strategy that conventional banks can take besides the spin-off strategy. This study found that the conversion strategy had no impact on the converted bank's profitability level. Based on the results of the interviews, it was found that one of the things underlying this was the tax debt problem owned by the Bank of NTB Sharia prior to the conversion. In addition, improving product and service quality is a factor that must be addressed after conversion.

There are several policy recommendations offered from this research. First, the conversion decision can be an alternative strategy to the spin-off strategy. Second, stakeholders must fully support the conversion process to become an Islamic bank. Third, the converted bank must be able to innovate its products and services, especially in the digital aspect.

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