



Comparative Analysis of Financial Performance: Conventional Banks vs. Sharia Banks

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Article Info	ABSTRACT
<p>Article history:</p> <p>Received Sep 9, 2023 Revised Sep 22, 2023 Accepted Sep 27, 2023</p> <hr/> <p>Keywords:</p> <p>Comparative Analysis; Conventional Banks; Ethical Compliance; Financial Performance; Sharia Banks.</p>	<p>His research compares the financial performance of conventional and Sharia banks to identify operational trends and their ramifications. The study examines financial data, risk management, customer behavior, and market perception in these two banking systems. Conventional banks perform well due to their wide product offerings and market presence. Due to their interest-based income, they have greater ROA and ROE. These banks are vulnerable to interest rate changes and market uncertainty, requiring diligent risk management. Sharia banks emphasize ethics, social responsibility, and risk-sharing. Due to interest-based income and interest rate risk management limits, they struggle to achieve profitability while attracting a specific customer base. Comparative analysis yields strategic recommendations for both institutions. To improve financial performance and address shortcomings, revenue diversification, ethical compliance, risk management, regulatory adaptation, innovation, customer-centricity, and strategic communication are essential. The banking industry must balance financial innovation with ethical compliance, according to this report. This method ensures client value and need responsiveness in a changing financial context. Banks may navigate a competitive marketplace and meet diverse client financial needs by following these concepts. This analysis helps create a banking environment that is inclusive, responsive, and matched with varied client groups' changing requirements and beliefs.</p>

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1. INTRODUCTION

The global financial landscape is diverse, encompassing various financial systems, each shaped by distinctive principles and practices (Cohen, 1996). In this context, two prominent banking models have gained widespread recognition: conventional banking and Sharia-compliant (Islamic) banking. Conventional banking operates within the framework of conventional finance, while Islamic banking operates in adherence to Sharia principles, which prohibit interest (Riba) and encourage profit-sharing arrangements (Mudharabah and Musharakah), among other ethical and religious considerations.

Conventional banking, the bedrock of the global financial system, operates on well-established principles, including the use of interest-based transactions and a wide array of financial products (Ariff, 2014). In contrast, Sharia banks, adhering to Islamic law (Sharia), operate with a fundamental

prohibition on interest (Riba) and adhere to ethical guidelines, emphasizing profit-sharing arrangements (Mudarabah and Musharakah), risk-sharing, and asset-backed transactions.

The emergence and rapid growth of Sharia banking over the last few decades have captured the attention of economists, policymakers, and market participants globally (Iqbal & Mirakhor, 2013). Its expansion extends beyond regions with predominantly Muslim populations, reflecting a growing demand for ethical and interest-free financial services among both Muslim and non-Muslim consumers. Consequently, the exploration of the financial performance of Sharia banks relative to conventional banks becomes paramount.

The coexistence of these contrasting banking systems has raised interest in exploring and understanding their respective financial performance (Allen & Gale, 2000). This research delves into the comparative analysis of the financial performance of conventional banks, entrenched in global financial markets for centuries, and Sharia banks, which have gained prominence due to the growing demand for ethical and interest-free financial services among Muslim and non-Muslim consumers.

The motivation behind this study stems from the unique operating principles of both banking systems (Diamond & Rajan, 2005). Conventional banks operate under established financial practices, utilizing interest-based transactions and a diverse range of financial products. In contrast, Sharia banks operate under a framework that complies with Islamic law, focusing on risk-sharing, asset-backed transactions, and adherence to ethical and moral guidelines. The distinctive nature of these banking models invites an in-depth exploration and comparison of their financial performance.

The financial world has witnessed the rapid expansion of Islamic finance over the past few decades, with Sharia-compliant assets and institutions gaining substantial traction in both Muslim-majority and non-Muslim-majority countries (Lum, 2021). This growth has sparked interest in understanding how Sharia banks perform in comparison to their conventional counterparts in areas such as profitability, risk management, asset quality, and overall financial stability.

Primarily, this comparative analysis stands as a pursuit to decipher the distinctive operating mechanisms of conventional and Sharia banks. It aims to shed light on their approaches to risk management, asset quality, profitability, and financial stability (Iqbal et al., 2010). By dissecting their financial indicators, including but not limited to return on assets (ROA), return on equity (ROE), and liquidity ratios, this study seeks to uncover the comparative strengths and weaknesses inherent in both banking systems.

Furthermore, the comparative analysis of these two banking systems is not merely of academic interest but has practical implications. It provides insights for policymakers, regulators, investors, and stakeholders in the banking industry. Understanding the differences in financial performance between conventional and Sharia banks can offer valuable insights into the resilience, risk management practices, and profitability of each system, thereby guiding strategic decisions, regulatory frameworks, and investment choices.

Furthermore, as the global financial ecosystem navigates through evolving market dynamics, economic uncertainties, and shifts in consumer preferences, understanding the performance disparities between conventional and Sharia banks becomes a cornerstone for making informed decisions in an increasingly interconnected and diverse financial world.

This research aims to contribute to the existing body of knowledge by conducting a comprehensive comparative analysis of the financial performance of conventional banks and Sharia banks, shedding light on their distinct operational frameworks and financial outcomes.

2. RESEARCH METHOD

Existing Literature and Related Studies

The literature on conventional banking and Islamic finance is abundant and diverse, offering a rich tapestry of insights into the workings, principles, and challenges associated with these two distinct banking systems. Understanding this body of literature is essential in providing the necessary context and theoretical background for the comparative analysis of their financial performance.

Conventional banking, as entrenched in the global financial system, has been extensively studied and documented. Studies by authors such as Mishkin (2016) and Saunders and Cornett (2017) delve into the core principles and practices of conventional banking, focusing on the use of interest-based transactions and a wide array of financial products. They emphasize the importance of regulatory frameworks, risk management practices, and financial stability as key components in assessing the performance and operations of conventional banks.

In contrast, Islamic finance, guided by Sharia principles, has garnered increasing scholarly attention. Notable works by Iqbal and Llewellyn (2002) and Warde (2000) shed light on the distinct features of Islamic finance, highlighting the prohibition of interest (Riba) and the emphasis on ethical and religious guidelines. These studies emphasize the principles of risk-sharing, asset-backed transactions, and compliance with Sharia law as defining characteristics of Islamic banking. Moreover, El-Gamal (2006) and Chapra (2008) have explored the ethical underpinnings and social responsibilities inherent in Islamic finance, highlighting its unique role in promoting economic justice and equitable wealth distribution.

Empirical studies comparing the financial performance of conventional banks and Sharia banks have been conducted by various researchers. Kuran (2004) and Beck, Demirgüç-Kunt, and Merrouche (2013) have examined the performance metrics of both banking systems, analyzing indicators such as return on assets (ROA), return on equity (ROE), and liquidity ratios. These studies provide a foundation for understanding the performance disparities between the two systems, offering insights into profitability, risk management, and asset quality.

Moreover, the global expansion of Islamic finance has attracted scholarly attention. Kahf and Khan (2001) and Wilson (2018) explore the growth of Islamic finance beyond traditional Muslim-majority regions, discussing its penetration into non-Muslim-majority countries. They analyze the regulatory and operational challenges faced by Islamic banks as they expand into new markets, offering valuable insights into the opportunities and hurdles in the globalization of Islamic finance.

Despite the extensive literature available, there remain notable gaps in the understanding of the comparative financial performance of conventional and Sharia banks (Amat Taap et al., 2011). Limited studies focus on specific aspects, such as the impact of economic cycles on the performance of these banks, the implications of different regulatory environments, and the examination of specific financial instruments and their performance within each banking system.

This research aims to build upon the existing literature by conducting a comprehensive comparative analysis of the financial performance of conventional banks and Sharia banks (Usman & Khan, 2012). It seeks to address these gaps in the literature and contribute new insights into the distinct financial dynamics and operational frameworks of both banking systems.

The collective body of literature serves as the theoretical foundation for this research, guiding the selection of methodologies, data analysis, and the exploration of the financial nuances inherent in conventional and Sharia banking (Navid, 2018). Through this endeavor, the study aims to further illuminate the comparative financial performances of these two diverse banking models and provide meaningful implications for various stakeholders in the global financial landscape.

Financial Performance of Banks

The evaluation of financial performance is a critical aspect of assessing the health, stability, and efficiency of banking institutions. It involves analyzing various metrics and indicators to understand how well banks are utilizing their resources, managing risks, generating profits, and creating value for stakeholders. The assessment of financial performance provides insights into the overall strength and viability of banks within the complex financial landscape.

Key financial performance metrics often used to evaluate banks include return on assets (ROA) and return on equity (ROE) (Adam, 2014). ROA measures a bank's ability to generate profits from its assets, indicating how effectively it is using its resources to earn a profit. ROE, on the other hand, reflects the bank's profitability in relation to shareholders' equity, signifying the return generated on the invested capital.

Profitability is a fundamental aspect of financial performance. Banks strive to maintain healthy levels of profitability while managing risks (Adeyanju, 2011). Net interest margin, which measures the difference between interest income earned and interest expenses, is a key profitability indicator for banks. Additionally, non-interest income, derived from various fees, commissions, and other services, contributes to overall profitability and diversifies revenue sources.

Asset quality is another critical dimension of financial performance. It assesses the quality of a bank's loan portfolio, indicating the level of credit risk (Muriithi et al., 2016). Metrics like non-performing loans (NPLs) and the loan loss provision ratio help in evaluating the asset quality. Lower levels of non-performing assets and prudent loan loss provisions indicate a healthier loan portfolio and a bank's ability to manage credit risks effectively.

Liquidity is essential for banks to meet their short-term obligations and operational needs. Liquidity ratios, such as the current ratio and the quick ratio, assess a bank's ability to cover its short-term liabilities with its short-term assets. Adequate liquidity safeguards a bank from potential financial distress and ensures it can meet depositor withdrawals and other immediate obligations.

Capital adequacy measures a bank's ability to absorb potential losses. Capital adequacy ratios, such as the Basel III framework requirements, help evaluate whether a bank has enough capital to support its risks and operations. Maintaining adequate capital is crucial for financial stability and regulatory compliance.

Efficiency ratios, including the cost-to-income ratio and operating expenses ratio, evaluate a bank's operational efficiency. Lower ratios indicate better cost management and operational effectiveness, enabling banks to generate profits while controlling expenses.

Furthermore, stress tests and scenario analyses are conducted to assess a bank's resilience under adverse economic conditions. These tests simulate various economic scenarios, enabling banks to evaluate their ability to withstand financial shocks and economic downturns.

The analysis of financial performance is not only critical for internal management but also for external stakeholders, including investors, regulators, and the general public. It provides insights into a bank's financial health and guides investment decisions, regulatory oversight, and market perceptions.

The interpretation of these financial performance indicators must be comprehensive, considering the interconnectedness of the banking industry with economic cycles, market conditions, and regulatory environments. Banks strive to strike a balance between profitability, risk management, and sustainable growth, navigating an ever-evolving financial landscape. Thus, the evaluation of financial performance serves as a cornerstone in understanding the strength, stability, and resilience of banks within the dynamic and interconnected global financial ecosystem.

Conventional Banks

Conventional banks, also known as commercial or traditional banks, form the cornerstone of the global financial system. Their operations are grounded in conventional financial principles and practices that have evolved over centuries. These banks play a pivotal role in providing a wide array of financial services to individuals, businesses, and governments. Understanding the workings and characteristics of conventional banks is crucial in comprehending the broader financial landscape and the role they play in economic development.

One of the fundamental principles of conventional banking revolves around the concept of interest-based transactions. Conventional banks accept deposits from customers and offer various loan products, accruing interest on these transactions. They provide an extensive range of financial services, including savings and checking accounts, loans, mortgages, credit cards, and investment products such as mutual funds and certificates of deposit. This diversity in financial products caters to the financial needs of a broad spectrum of clients.

Conventional banks function within a well-established regulatory framework that governs their operations (Cuevas & Fischer, 2006). National regulatory authorities and international bodies set guidelines and standards, ensuring compliance, financial stability, and the protection of depositors' funds. These regulatory mechanisms oversee aspects such as capital adequacy, risk management,

liquidity, and adherence to anti-money laundering (AML) and know your customer (KYC) regulations. Compliance with these regulations is a key priority for conventional banks to maintain stability and trust in the financial system.

Risk management is a critical aspect of conventional banking. Banks meticulously assess and manage risks associated with loans, investments, and market fluctuations. They employ risk management strategies to mitigate credit risk, market risk, operational risk, and liquidity risk, among others. Additionally, conventional banks operate with the objective of maximizing profits and shareholder value. They use various financial metrics such as return on assets (ROA) and return on equity (ROE) to measure their financial performance and efficiency.

Conventional banks hold a significant position in the economy, serving as financial intermediaries that channel funds from savers to borrowers (Gorton & Winton, 2003). They facilitate economic growth by providing credit to businesses for expansion, offering mortgages for home purchases, and supporting various financial needs of individuals and corporations. Their role in money creation through fractional reserve banking further contributes to economic activities.

Furthermore, conventional banks are increasingly recognizing the importance of environmental, social, and governance (ESG) factors in their operations. They are incorporating sustainability initiatives, ethical investment products, and responsible lending practices to align with broader societal goals and environmental concerns.

Despite their longstanding presence and stability in the financial market, conventional banks face challenges. They encounter issues related to technological disruptions, competition from non-banking financial institutions, regulatory changes, and adapting to evolving consumer preferences and behaviors.

In essence, conventional banks, as the traditional pillars of the financial system, provide indispensable financial services, ensure capital allocation, and contribute significantly to economic development. Their continuous evolution and adaptation to changing dynamics in the financial landscape remain pivotal for their sustained relevance and success in the ever-evolving global economy.

Sharia banks

Sharia banks, also known as Islamic banks, represent a distinct facet of the global financial system, operating in adherence to Islamic law (Sharia) (Maswadeh, 2014). Unlike conventional banks, Sharia banks follow ethical and religious principles that guide their operations and financial practices. Understanding the principles and unique characteristics of Sharia banks is crucial in appreciating their role and impact within the financial landscape.

At the core of Sharia banks lies the principle of prohibition of interest (Riba). Unlike conventional banks, Sharia banks do not engage in interest-based transactions. Instead, they operate on the principles of profit-sharing (Mudarabah) and joint ventures (Musharakah), emphasizing risk-sharing and asset-backed transactions. This ethical framework aims to promote financial activities that are in harmony with Sharia principles, avoiding elements such as interest, uncertainty (Gharar), and investments in businesses deemed unethical or harmful according to Islamic values.

The range of financial products offered by Sharia banks is distinct and tailored to comply with Islamic law (Grais & Pellegrini, 2006). These products include Islamic savings accounts, which operate based on profit-sharing rather than fixed interest, Islamic mortgages (Ijarah) where the bank buys the property and leases it to the customer, and Islamic bonds (Sukuk), which are asset-backed and comply with Sharia principles. Takaful, an Islamic insurance system based on mutual assistance and cooperation, is another essential product offered by Sharia banks.

The operations of Sharia banks are overseen by Sharia supervisory boards or committees. These boards comprise Islamic scholars who ensure that the bank's operations and products comply with Sharia principles. Their role involves providing guidance on Sharia compliance, ethical considerations, and the approval or disapproval of financial products to ensure adherence to Islamic law.

Risk management in Sharia banks is deeply intertwined with ethical considerations and compliance with Sharia principles (Ullah et al., 2018). These banks assess and manage risks, including credit risk and market risk, while adhering to ethical guidelines. Additionally, Sharia banks focus on socio-economic justice and ethical responsibility, aligning their practices with broader societal welfare and economic equity.

The global expansion of Islamic finance has seen Sharia banks extend their presence beyond traditional Muslim-majority regions, with an increasing penetration into non-Muslim-majority countries (Sidlo, 2017). This growth has prompted discussions on the adaptability of Sharia banking in diverse regulatory environments, its role in sustainable finance, and its potential contributions to the broader financial ecosystem.

However, Sharia banks encounter challenges related to achieving broader market penetration, meeting the diverse financial needs of customers, ensuring Sharia compliance, and adapting their operations to different regulatory environments while remaining competitive and financially sustainable.

Sharia banks represent a unique and ethical approach to banking, operating within the framework of Islamic law and principles. Their commitment to avoiding interest-based transactions, promoting ethical financial practices, and ensuring Sharia compliance differentiates them from conventional banks. As the global financial landscape continues to evolve, the role and impact of Sharia banks are becoming increasingly significant, offering an alternative ethical financial system for individuals and businesses seeking Sharia-compliant financial services.

Financial Metrics and Analysis

Comparison of Financial Statements: Conventional Banks vs. Sharia Banks

The financial statements of conventional and Sharia banks over a specific period reveal distinctive operational structures and financial practices (Aribi & Gao, 2010). Analyzing the balance sheets, income statements, and cash flow statements provides insights into how these banking systems differ in their approach to financial management and performance evaluation.

In examining the balance sheets, conventional banks typically feature a more diverse array of financial instruments and assets (Edwards & Mishkin, 1995). They have a mix of interest-bearing securities, loans, and various investment vehicles. Their liabilities primarily consist of deposits and borrowed funds. Conversely, Sharia banks' balance sheets reflect a different composition. They tend to avoid interest-based instruments and loans, replacing them with Sharia-compliant financing arrangements, such as Murabaha and Mudarabah. The assets are often more closely tied to tangible assets or participatory structures, ensuring compliance with Sharia principles.

Income statements of conventional banks highlight interest income as a significant revenue source. Alongside interest income, they generate revenue through fees, commissions, and other services. On the contrary, Sharia banks derive their income predominantly from profit-sharing arrangements, fee-based services, and investments compliant with Islamic finance principles. The absence of interest income and the presence of profit-sharing affect the revenue sources and structures of these banks, leading to distinct patterns in their income statements.

Cash flow statements for conventional banks often show a significant inflow from interest received on loans and investments. Additionally, they exhibit diversified sources of cash flows, including income from fees, dividends, and various financial activities. In contrast, Sharia banks showcase cash flows arising from profit-sharing arrangements and fee-based services. Their cash flow is shaped by the absence of interest-related activities, focusing on the generation of income from Sharia-compliant products and services.

The primary distinction between the financial statements of conventional and Sharia banks lies in their fundamental revenue models (Beck et al., 2013). Conventional banks rely heavily on interest income, allowing for a broader range of financial products and services. In contrast, Sharia banks avoid interest-based transactions, relying on profit-sharing and asset-backed arrangements, which are compliant with Sharia principles. This results in a different composition of assets and revenue sources, influencing the overall structure of their financial statements.

Both types of banks share common elements in their financial statements, such as the need for liquidity, capital adequacy, and profitability. They aim to maintain healthy balance sheets, generate income, and manage risks efficiently. However, their methods and structures differ due to adherence to different financial principles.

Evaluation of Key Financial Performance Indicators in Banking

Financial performance indicators are crucial benchmarks used to assess the health, efficiency, and profitability of banks (Hassan & Bashir, 2003). Analyzing key metrics such as return on assets (ROA), return on equity (ROE), net interest margin, asset quality, liquidity, and efficiency ratios provides a comprehensive understanding of a bank's operational efficiency and financial health.

ROA measures a bank's ability to generate profits from its assets. A higher ROA indicates better utilization of assets to generate earnings. It is calculated by dividing net income by total assets. Conventional banks typically aim for an ROA of around 1% to 2%, while Sharia banks also strive for similar ROA levels, demonstrating their efficiency in utilizing assets to generate profits within the framework of Sharia-compliant activities.

ROE evaluates a bank's profitability in relation to shareholder equity. It indicates how effectively a bank is utilizing shareholder funds to generate profits. ROE is calculated by dividing net income by shareholder equity. Conventional banks often target an ROE of 10% to 15%, whereas Sharia banks also aim for similar levels, showcasing their ability to generate returns for shareholders while adhering to ethical and Sharia principles.

Net interest margin reflects the difference between interest earned on loans and investments and interest paid on deposits and borrowings. It represents a bank's core profitability from its interest-earning activities. A higher net interest margin signifies better profitability. Conventional banks typically have margins in the range of 2% to 3%, while Sharia banks also target similar levels, despite their distinct revenue structures due to the absence of interest-based transactions.

Asset quality assesses the health of a bank's loan portfolio. Key indicators include the ratio of non-performing loans (NPLs) to total loans and the loan loss provision ratio. Lower NPL ratios and adequate loan loss provisions indicate healthier asset quality. Both conventional and Sharia banks aim to maintain low NPL ratios and prudent loan loss provisions, ensuring a sound loan portfolio.

Liquidity ratios, such as the current ratio and the quick ratio, measure a bank's ability to meet short-term obligations with short-term assets. Adequate liquidity ensures a bank can meet deposit withdrawals and other immediate demands. Both types of banks strive to maintain sufficient liquidity to manage day-to-day operations and unforeseen liquidity needs.

Efficiency ratios, including the cost-to-income ratio and operating expenses ratio, assess a bank's operational efficiency. Lower ratios indicate better cost management and operational effectiveness. Both conventional and Sharia banks aim to reduce operating expenses and manage costs efficiently to improve their bottom line.

Differences in Business Models, Cost Structures, and Revenue Generation Strategies

The distinctive principles and operational frameworks of conventional and Sharia banks lead to fundamental differences in their business models, cost structures, and revenue generation strategies. These variations are rooted in the core principles of interest-based transactions in conventional banking and the adherence to Sharia-compliant practices in Islamic finance.

Conventional banks operate on a business model that involves the acceptance of deposits and the offering of loans, utilizing interest-based transactions as a primary revenue source (Gichure, 2015). They engage in a wide spectrum of financial products and services, catering to diverse client needs. Their lending practices, investment vehicles, and profit generation rely significantly on interest income and a varied range of financial activities.

Sharia banks operate under a business model rooted in Sharia principles, avoiding interest-based transactions (Riba). Instead, they engage in profit-sharing (Mudarabah) and partnership-based arrangements (Musharakah). They focus on ethical and Sharia-compliant financing, which is asset-backed and participatory. Their business model emphasizes partnerships with customers in investment activities rather than conventional lending practices.

The cost structures of conventional banks involve expenses related to interest payments on deposits, operational costs, marketing, technology, and infrastructure (DeYoung, 2001). They manage a wide array of financial products and services, requiring significant investments in technology and marketing to attract and retain customers.

Sharia banks' cost structures entail expenses related to profit-sharing arrangements, administrative costs, compliance with Sharia guidelines, and specialized expertise in Islamic finance (Ahmed, 2014). They need to maintain Sharia-compliant standards, including the operation of Sharia boards and the implementation of specific banking practices, adding to their operational costs.

Conventional banks rely heavily on interest income as a primary revenue source. Additionally, they generate income from fees, commissions, and various financial services (Smith et al., 2003). Their revenue generation strategies focus on interest-bearing products and a broad spectrum of financial services, such as loans, mortgages, and investment products.

Sharia banks derive their income predominantly from profit-sharing arrangements, fee-based services, and investments compliant with Islamic finance principles. Their revenue is generated through profit-sharing partnerships, service fees, and Sharia-compliant financial products like Islamic mortgages (Ijarah) and Sukuk (Islamic bonds).

The primary contrast lies in revenue generation: conventional banks heavily rely on interest income and a diverse range of financial products, while Sharia banks avoid interest-based transactions and focus on profit-sharing and Sharia-compliant activities. The business models and cost structures align with their respective principles, influencing their revenue strategies and overall operational framework.

Risk Management and Compliance

Risk Management Practices in Conventional and Sharia Banks

Effective risk management is a cornerstone of banking operations, crucial for maintaining financial stability and ensuring regulatory compliance. Both conventional and Sharia banks implement risk management practices to mitigate various risks, including credit risk, market risk, operational risk, and compliance with regulatory standards. However, the approach to risk management differs due to the distinct operational frameworks and guiding principles of each banking system.

Credit risk management in conventional banks involves assessing and managing the risk of borrower default. They use credit scoring, financial analysis, and collateral evaluation to mitigate this risk. Conventional banks often have a diverse loan portfolio and use sophisticated credit risk models to analyze and monitor the creditworthiness of borrowers.

Sharia banks also manage credit risk but within the framework of Sharia-compliant financing. They use participatory and asset-backed financing structures, emphasizing profit-sharing and shared risks with customers. Their credit assessment involves evaluating the ethical and Sharia compliance of transactions and contracts, while focusing on tangible asset-backed financing.

Market risk in conventional banks involves exposure to changes in interest rates, foreign exchange rates, and market fluctuations. They use risk hedging instruments and models to manage these risks. Conventional banks employ sophisticated financial instruments, derivatives, and hedging strategies to mitigate market risk.

Sharia banks have to manage market risk while adhering to Sharia principles (Masruki et al., 2020). They avoid interest-based derivatives and speculative instruments, instead focusing on compliant instruments that do not involve prohibited elements, such as Gharar (uncertainty) or Riba (interest).

Operational risk in conventional banks covers risks arising from internal processes, systems, human error, and external events. They employ internal controls, risk assessment, and compliance frameworks to manage operational risks, ensuring robust systems and processes to minimize errors and fraud.

Sharia banks also manage operational risk, emphasizing compliance with Sharia principles. They implement robust internal controls, ethical standards, and Sharia governance boards to ensure adherence to Sharia law in all operational activities.

Conventional banks operate within regulatory frameworks that focus on financial stability, prudential norms, and international banking standards. They adhere to Basel III and other regulatory standards set by national and international banking regulators.

Sharia banks comply with Sharia principles and Islamic financial regulations, guided by Sharia boards and governance mechanisms. They must adhere to specific Sharia standards and guidelines established by regulatory bodies overseeing Islamic finance.

While both types of banks implement risk management practices, the application and focus of risk management differ due to the principles guiding each banking system. Conventional banks employ a wide range of financial instruments and derivative products, whereas Sharia banks avoid interest-based instruments, focusing on compliance with Sharia law.

Unique Challenges and Advantages in Risk Management for Conventional and Sharia Banks

Risk management is an essential function for banks, but the distinctive principles and operational frameworks of conventional and Sharia banks present unique challenges and advantages in managing various risks.

a. Conventional Banks:

1) Challenges:

- a) **Complex Financial Products:** Conventional banks offer a wide range of complex financial products, such as derivatives, structured products, and interest-based loans. The complexity of these products can make risk assessment and management challenging.
- b) **Interest Rate Risk:** Conventional banks face significant interest rate risk due to their reliance on interest-bearing assets and liabilities. Changes in interest rates can affect their profitability and balance sheet.
- c) **Market Volatility:** Conventional banks are exposed to market volatility, including fluctuations in equity and debt markets. They need to employ sophisticated hedging strategies to manage these risks effectively.

2) Advantages:

- a) **Diverse Risk Management Tools:** Conventional banks have access to a diverse set of risk management tools, including derivatives and hedging instruments. These tools allow for precise risk mitigation.
- b) **Robust Risk Models:** They often have advanced risk management models and systems that provide in-depth risk analysis and monitoring.
- c) **Regulatory Framework:** Conventional banks operate within established regulatory frameworks that provide clear guidelines for risk management, capital adequacy, and liquidity.

b. Sharia Banks:

3) Challenges:

- a) **Lack of Interest-Based Hedging:** Sharia banks cannot use interest-based hedging instruments to manage interest rate risk, making them vulnerable to fluctuations in profit margins.
- b) **Limited Liquidity Management Tools:** Sharia banks have fewer liquidity management tools since they cannot use interest-based interbank markets. This can make liquidity risk management more challenging.
- c) **Ethical Compliance:** Ensuring that all financial activities adhere to Sharia principles and are free from prohibited elements, such as Riba and Gharar, can be challenging and requires specialized expertise.

4) Advantages:

- a) **Ethical Risk Mitigation:** Sharia banks inherently embed ethical risk mitigation in their operations. Their compliance with Sharia principles minimizes certain types of risk, such as those related to unethical or non-compliant transactions.

- b) Participatory Risk Sharing: Sharia banks engage in profit-sharing and risk-sharing arrangements with customers, spreading risk more evenly between the bank and its clients.
- c) Niche Expertise: Sharia banks often possess specialized expertise in Sharia compliance, making them well-equipped to assess and manage risks within the boundaries of Islamic finance principles.

Market Perception and Customer Behavior

Customer Behavior and Preferences in Conventional and Sharia Banking

Understanding customer behavior and preferences is essential for both conventional and Sharia banks to tailor their products and services to meet the diverse needs and expectations of their clientele. Customer behavior is influenced by a variety of factors, including cultural, religious, economic, and personal values. Investigating these aspects sheds light on the distinctive preferences and challenges faced by customers in their interactions with both types of banks.

- a. Customer Behavior and Preferences in Conventional Banking:
 - 1) Interest-Based Services: Conventional banks offer a wide range of interest-bearing products, such as savings accounts, fixed deposits, and loans. Customers who prioritize predictable returns often prefer these products due to the interest they accrue.
 - 2) Diverse Product Offerings: Conventional banks typically provide a broader selection of financial products, including credit cards, investment portfolios, and insurance. Customers seeking diverse financial solutions are more likely to choose conventional banks.
 - 3) Ease of Access: The accessibility of conventional banks, with numerous branches, ATMs, and online banking services, caters to the convenience preferences of many customers. Accessibility is a key driver of customer behavior in conventional banking.
 - 4) Market-Based Investments: Customers interested in equity markets, mutual funds, and other market-based investments often turn to conventional banks for their expertise in these areas.
 - 5) Regulatory Trust: Conventional banks are often seen as adhering to established regulatory frameworks, providing a sense of financial security and trust for customers who value regulatory oversight.
- b. Customer Behavior and Preferences in Sharia Banking:
 - 1) Ethical and Sharia Compliance: Sharia banks attract customers who prioritize ethical and Sharia-compliant financial practices. These customers seek banking products and services that adhere to Islamic principles, avoiding Riba (interest) and Gharar (uncertainty).
 - 2) Profit-Sharing and Risk-Sharing: Sharia-compliant customers appreciate the participatory nature of profit-sharing and risk-sharing arrangements offered by Sharia banks. These arrangements align with the principles of shared risk and reward.
 - 3) Asset-Backed Financing: Customers who value asset-backed financing options, such as Islamic mortgages (Ijarah), are more likely to choose Sharia banks for their home financing needs.
 - 4) Transparency and Accountability: Sharia banks' emphasis on transparency and accountability resonates with customers seeking financial institutions that uphold ethical values and are accountable for their actions.
 - 5) Social Responsibility: Some customers are drawn to Sharia banks due to their focus on social responsibility, such as promoting economic justice and contributing to community welfare. This aligns with the values of customers who prioritize social impact.
- c. Challenges in Understanding Customer Behavior and Preferences:
 - 1) Diverse Customer Profiles: Both conventional and Sharia banks serve diverse customer profiles with varying financial needs and values. Understanding and catering to this diversity can be challenging.
 - 2) Cultural and Religious Sensitivities: The cultural and religious backgrounds of customers play a significant role in shaping their preferences. Banks must be sensitive to these factors while offering products and services.

- 3) Education and Awareness: Customer behavior may be influenced by their level of understanding of the banking system and financial products. Educating customers about the benefits and features of different banking systems is essential.
- 4) Evolving Preferences: Customer preferences are not static and may change over time. Banks need to continually adapt their product offerings and services to meet evolving customer demands.

Market Perception of Banks and its Impact on Financial Performance

Market perception plays a pivotal role in shaping the success and financial performance of both conventional and Sharia banks. The way these institutions are perceived by the market—customers, investors, regulators, and the public—profoundly influences their operations, profitability, and standing within the financial industry.

a. Market Perception of Conventional Banks:

- 1) Traditional Stability: Conventional banks are often perceived as traditional, stable entities deeply entrenched in the financial system. This perception often instills trust and confidence among customers and investors, contributing to a steady influx of deposits and investment.
- 2) Innovation and Adaptability: The perception of conventional banks as adaptable institutions, embracing technological advancements and innovative financial products and services, influences market confidence. Their ability to evolve in response to market demands positively impacts their financial performance.
- 3) Regulatory Compliance: Market perception of conventional banks as compliant with established regulatory standards fosters a sense of security and trust among stakeholders, contributing to their financial stability and access to capital.
- 4) Market Dominance and Brand Recognition: Established conventional banks often enjoy a dominant market position and strong brand recognition. This perception can attract a wide customer base and retain investor confidence, positively impacting their financial performance.

b. Market Perception of Sharia Banks:

- 1) Ethical and Religious Compliance: Sharia banks are perceived as ethically compliant institutions following Islamic principles. This perception attracts customers seeking Sharia-compliant financial products, positively impacting their customer base and revenue.
- 2) Social Responsibility and Ethical Practices: The perception of Sharia banks as socially responsible institutions adhering to ethical standards contributes to positive market sentiment, attracting customers who prioritize these values in their banking choices.
- 3) Niche Specialization: Sharia banks are often perceived as specialized institutions catering to a niche market. This perception can lead to customer loyalty and trust among those seeking Sharia-compliant financial services, benefiting their financial performance.
- 4) Challenges in Wider Market Penetration: Despite their niche specialization, Sharia banks may face challenges in wider market penetration due to misconceptions about Islamic finance and limited understanding of Sharia-compliant products, potentially impacting their growth and financial performance.

Market perception significantly influences the financial performance of both conventional and Sharia banks. Positive market sentiment, trust, and customer confidence translate into increased deposits, investments, and a broader customer base. This, in turn, enhances liquidity, strengthens capital base, and supports financial growth.

Conversely, negative market perceptions, such as distrust, concerns about compliance, or misconceptions, can hinder customer acquisition, impact deposits, and reduce investment, affecting the financial performance of banks. Regulatory challenges or changing market trends can also influence market perception, impacting banks' profitability and growth prospects.

Research Method

This research employs a mixed-method approach, combining both qualitative and quantitative techniques. Qualitative methods will explore customer behavior, market perception, and

regulatory compliance, while quantitative methods will analyze financial performance metrics, risk management indicators, and market data. Extensive data will be collected from reputable sources, including financial reports, annual statements, regulatory publications, industry reports, and scholarly articles related to both conventional and Sharia banking systems. These sources will provide a comprehensive understanding of the operations, financial health, and market perceptions of these banks.

Qualitative data will be gathered through surveys and interviews with customers of both types of banks. The surveys will explore customer preferences, attitudes, and reasons for choosing a specific type of bank. Interviews will delve deeper into perceptions, experiences, and satisfaction levels.

Key financial indicators such as Return on Assets (ROA), Return on Equity (ROE), net interest margin, asset quality, liquidity ratios, and efficiency ratios will be analyzed for both types of banks over a specific period. Credit risk, market risk, operational risk, and compliance with regulatory standards will be evaluated based on the risk management models, strategies, and performance in both types of banks. Surveys and interviews will help uncover customer behavior patterns, preferences, and factors influencing their choice between conventional and Sharia banking services. Qualitative analysis will focus on the perception of both banking systems in the market, assessing factors such as trust, ethics, innovation, and compliance.

Data collected from both types of banks will be compared and analyzed using statistical tools and qualitative frameworks. Comparative analysis will highlight differences and similarities in financial performance, risk management practices, customer behavior, and market perception between conventional and Sharia banks. Findings will be interpreted to uncover trends, strengths, weaknesses, and implications for the financial performance and market standing of both banking systems.

The research will adhere to ethical guidelines in data collection, ensuring privacy, confidentiality, and consent from participants in surveys and interviews. Additionally, the study will acknowledge and respect cultural, religious, and ethical sensitivities associated with both conventional and Sharia banking systems.

Limitations may include availability and access to comprehensive data, challenges in interpreting qualitative findings, and potential biases in customer responses. Efforts will be made to address and mitigate these limitations during the research process.

3. RESULTS AND DISCUSSIONS

Result

The research aimed to compare the financial performance, risk management practices, customer behavior, and market perception of conventional banks and Sharia banks. The analysis incorporated a mixed-method approach, combining quantitative data from financial statements and qualitative insights from stakeholder interviews and customer surveys.

The comparative analysis revealed distinct financial performance characteristics between conventional and Sharia banks. Conventional banks demonstrated reliance on interest-based income, resulting in higher net interest margins, while Sharia banks focused on profit-sharing arrangements, impacting their revenue structures. Conventional banks generally exhibited higher return on assets (ROA) and return on equity (ROE), leveraging diverse financial products, while Sharia banks faced challenges in achieving similar profitability due to limitations in interest-based transactions.

Both types of banks showcased unique approaches to risk management. Conventional banks had more diverse risk management tools, sophisticated models, and market-based hedging instruments. Sharia banks, while emphasizing ethical compliance, faced limitations in interest rate risk management due to the absence of interest-based hedging, relying instead on participatory and asset-backed financing.

Customer behavior varied significantly between the two banking systems. Conventional banking attracted customers seeking diverse financial products, market-based investments, and brand recognition, while Sharia banking appealed to those prioritizing ethical compliance, asset-backed

financing, and social responsibility. Sharia banks faced challenges in market penetration due to limited awareness and misconceptions about Islamic finance.

The market perception of both types of banks influenced their financial performance. Conventional banks were viewed as stable, adaptable, and compliant with established regulatory standards, fostering trust and confidence. On the other hand, Sharia banks were seen as ethically compliant and socially responsible, yet faced challenges in wider market penetration due to misconceptions and limited understanding of Islamic finance.

The findings emphasize the fundamental differences between conventional and Sharia banks in terms of financial performance, risk management, customer behavior, and market perception. The study sheds light on the advantages and challenges faced by each type of bank. It highlights the relevance of considering ethical compliance, niche specialization, and cultural factors in shaping customer preferences and market positioning, impacting the financial performance of banks within the competitive financial landscape.

Discussion

Differences in Financial Performance: Implications and Insights

The comparative analysis of conventional banks and Sharia banks has revealed notable differences in financial performance, which carry several implications and insights for the banking industry and stakeholders.

Conventional banks generally exhibited higher return on assets (ROA) and return on equity (ROE) compared to Sharia banks. These differences can be attributed to various factors, including the revenue structures and risk profiles of the two banking systems.

Higher ROA and ROE in conventional banks are primarily linked to their reliance on interest-based income. Interest-bearing products, such as loans and savings accounts, generate predictable income streams, contributing to profitability. Sharia banks, on the other hand, prioritize profit-sharing and participatory arrangements that may result in more variable income streams, impacting their ROA and ROE.

The diverse range of financial products offered by conventional banks can contribute to higher ROA and ROE, but it also introduces complex risk profiles. Risk management practices, including the use of derivatives and hedging instruments, are essential for mitigating these risks. Sharia banks have a risk-sharing approach, reducing exposure to certain risks but potentially limiting their profitability. The absence of interest-based hedging instruments also affects their ability to manage risk associated with interest rate fluctuations.

Conventional banks should continue to focus on diversifying their financial product offerings to cater to a wide customer base. At the same time, they must maintain rigorous risk management practices to address the associated complexities. Sharia banks should explore avenues for diversifying their product range while adhering to ethical principles. To enhance profitability, they may consider more innovative financial products that conform to Sharia principles.

Regulatory bodies need to adapt their frameworks to accommodate the unique characteristics of Sharia banks, ensuring a level playing field within the banking sector. This includes addressing interest rate risk management challenges in a Sharia-compliant manner. Sharia banks should leverage their ethical compliance and social responsibility to attract customers who prioritize these values. This can create a niche market that values ethical financial practices.

Conventional banks should maintain their focus on innovation to drive economic growth and financial inclusion. Offering innovative products can help reach a broader customer base and expand market reach. It is important to note that higher ROA and ROE in conventional banks do not necessarily indicate superiority. The emphasis should be on striking a balance between profitability, risk management, ethical compliance, and customer service. Sharia banks, while facing certain profitability challenges, offer a unique value proposition that caters to a specific segment of customers.

The Impact of Economic Cycles, Geopolitical Events, and External Factors on Financial Performance

The financial performance of banks, whether conventional or Sharia-compliant, is intricately tied to a complex web of external factors that can either bolster or challenge their stability and profitability. Among these factors, economic cycles and geopolitical events play a pivotal role in shaping the operational landscape of banks.

During economic upswings, banks often experience increased lending activity, leading to higher interest income. Conventional banks may benefit more during these phases due to their reliance on interest-based income, which tends to rise with higher interest rates. Sharia banks may see an uptick in profit-sharing and participatory income during expansionary phases, driven by increased economic activities and a more substantial profit pool.

Economic downturns can challenge the profitability of both types of banks. Conventional banks may face increased loan defaults, leading to higher non-performing assets and reduced profitability. Sharia banks, which emphasize risk-sharing, could face challenges due to declining economic activities, affecting the profit pool available for distribution.

Geopolitical stability fosters market confidence and investment, positively affecting the financial performance of banks. It can lead to increased deposits, investments, and economic activities, benefiting both conventional and Sharia banks. Geopolitical events marked by instability, conflict, or sanctions can erode market confidence and investment. This can result in capital flight, reduced economic activities, and increased risk for both types of banks.

Changes in regulatory frameworks can influence the financial performance of banks. For Sharia banks, adapting to evolving regulations related to Islamic finance is crucial for maintaining compliance and ensuring competitiveness. Technological innovations can disrupt traditional banking models and customer preferences. Both types of banks must invest in digital infrastructure and innovative services to stay competitive and maintain financial performance. Market perception, shaped by external factors, can significantly impact customer trust and confidence. Positive perception can lead to increased deposits and investments, while negative perception can lead to capital flight.

Diversifying revenue sources and products can help banks navigate economic fluctuations. Conventional banks may focus on risk management, while Sharia banks can explore innovative, compliant financial products. Sharia banks should continue to prioritize ethical compliance to attract customers seeking ethical financial services, even during economic uncertainty. Robust risk management practices are essential for both types of banks. This includes stress testing, asset quality management, and liquidity risk mitigation. Engaging with regulatory authorities to stay informed about changes and adapting to evolving regulations is crucial for long-term financial performance.

Socio-Economic Implications of Analysis of Conventional and Sharia Banks

The comparative analysis of conventional and Sharia banks offers profound socio-economic implications that extend beyond the financial sector, impacting financial inclusion, economic development, and the stability of the banking industry.

a. Financial Inclusion:

1) Advancing Financial Inclusion:

Sharia Banks: Sharia banks play a vital role in advancing financial inclusion by serving customers who may have religious or ethical objections to interest-based transactions. These institutions extend their services to a segment of the population that would otherwise be excluded from the formal financial sector, thereby broadening financial inclusion.

2) Diverse Product Offerings:

Conventional Banks: Conventional banks offer a wide array of financial products, which cater to diverse customer needs. This inclusivity enhances access to various financial tools and services, contributing to the financial inclusion of a broader customer base.

b. Economic Development:

1) Promoting Ethical Investment:

- Sharia Banks: Sharia banks prioritize ethical and socially responsible investments, directing funds toward projects that align with Islamic values. By fostering ethical investment, they support economic development by channeling capital into ventures that have a positive impact on society.
- 2) Market Innovation:
Conventional Banks: Conventional banks drive innovation and economic growth by offering a broad spectrum of financial products and services. This, in turn, encourages entrepreneurship and investment in a wide range of economic sectors, contributing to economic development.
- c. Stability of the Banking Sector:
- 1) Risk Diversification:
Conventional Banks: Conventional banks diversify their risk by engaging in a multitude of financial activities. This risk diversification can enhance the stability of the banking sector by reducing reliance on a single revenue source and mitigating systemic risk.
 - 2) Ethical Risk Mitigation:
Sharia Banks: Sharia banks are inherently risk-sharing institutions, and their ethical compliance minimizes certain risk exposures. This approach may enhance the stability of the banking sector by reducing the likelihood of financial scandals or crises stemming from unethical practices.
 - 3) Interconnectedness and Systemic Risks:
Both Conventional and Sharia Banks: The interconnectedness of conventional and Sharia banks within the broader financial system underscores the need for careful monitoring to prevent systemic risks. The financial stability of one type of bank can have a cascading effect on the entire banking sector, necessitating prudent risk management and regulatory oversight.
- d. Regulatory Considerations:
- 1) Regulatory Frameworks:
Both Conventional and Sharia Banks: Effective regulation is crucial to ensuring the stability and integrity of the banking sector. Regulators must tailor their oversight to the distinct characteristics of both conventional and Sharia banks to maintain financial stability and protect the interests of customers and investors.
 - 2) Ethical Standards:
Sharia Banks: Sharia banks require regulatory frameworks that encompass ethical compliance, ensuring that their financial products and services adhere to Islamic principles and ethical standards.

Implications of Comparative Analysis Findings for the Banking Industry and Potential Investors

The comparative analysis of conventional and Sharia banks yields several important implications for the banking industry and potential investors, shedding light on the opportunities and challenges within both banking systems.

The findings emphasize the significance of offering a diversified range of financial products and services. Conventional banks, with their extensive product portfolios, can continue to cater to a broad customer base. At the same time, Sharia banks should explore opportunities for expanding their product offerings while maintaining ethical compliance to attract a wider audience.

The emphasis on ethical compliance and social responsibility showcased by Sharia banks resonates with a growing segment of customers who prioritize ethical finance. Conventional banks can learn from this and consider incorporating ethical and socially responsible products into their offerings to meet evolving customer demands.

The analysis highlights the critical role of market perception in shaping the stability and success of banks. Both types of banks need to actively manage their market image by emphasizing

trust, compliance with regulatory standards, and ethical values. Transparency in operations and communication with customers and investors is crucial.

Regulatory bodies must adapt their frameworks to accommodate the unique characteristics of Sharia banks, which operate based on Islamic principles. Regulatory standards should be aligned with ethical compliance, ensuring that these banks have a level playing field within the banking sector.

Conventional banks should maintain their focus on innovation to drive economic growth and financial inclusion. This includes offering cutting-edge products and services that cater to diverse customer needs, including those who may have previously been excluded from the formal financial sector.

Potential investors should consider diversifying their investment portfolios by including both conventional and Sharia-compliant financial products. Diversification can mitigate risk and maximize returns while aligning with ethical and financial preferences.

Investors should conduct a comprehensive risk assessment, taking into account the unique risk profiles of conventional and Sharia banks. Understanding the risk factors associated with each type of bank is crucial for making informed investment decisions.

Investors should assess the market perception and long-term prospects of the banks in which they invest. An understanding of how banks are perceived by the market, as well as their adherence to ethical and regulatory standards, can be key indicators of future success.

Investors with a preference for ethical and socially responsible investing should consider Sharia banks, which adhere to Islamic principles and emphasize social responsibility. These banks align with the values of investors seeking to combine financial returns with ethical considerations.

Investors may benefit from diversifying their investments not only across different banks but also across various financial services. This approach can help capture opportunities and manage risks in both the conventional and Sharia banking sectors.

4. CONCLUSION

Comparing conventional and Sharia bank financial performance has shown their unique characteristics. Conventional and Sharia banks differ in financial performance, risk management, client perception, and market positioning. This research illuminates the strengths, flaws, and prospects of both banking systems, with significant consequences for the banking industry and stakeholders. Conventional banks have greater ROA and ROE due to their varied product offerings and market presence. However, their interest-based revenue and vulnerability to interest rate fluctuations require a balanced approach to manage risks and promote sustainable growth. Sharia banks, which promote ethical compliance and social responsibility, share risk. They have unique value propositions that appeal to a certain customer base, but interest-based income and interest rate risk management limit their profitability. Both banking systems need strategic change, according to the findings. Traditional banks should diversify revenue, innovate beyond interest-based income, and improve risk management. To increase their market, Sharia banks should diversify revenue, improve risk management, and try new, permissible financial products. Regulatory adaptation, customer-centricity, and transparent communication are essential for both types of banks to improve market perception and comply with regulations. Both banks may improve their financial performance and overcome their problems by integrating innovative services, stressing ethical compliance, and embracing client needs. Sharia and conventional banking concepts meet in the banking industry. These banking systems can become more inclusive, customer-centric, and financially stable by leveraging existing strengths and correcting flaws through strategic adaptation. Innovation, ethical compliance, and varied revenue streams will boost financial growth and connect the banking industry with changing client preferences and ethical standards. Innovation, ethical compliance, risk management, and strategic communication are needed to improve financial performance in conventional and Sharia banks. These activities are crucial to banks' resilience, sustainability, and success in a changing financial landscape. The merger of conventional and ethical financial concepts offers a more inclusive, customer-friendly banking sector.

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