

DOES CONVERSION INCREASE DEPOSIT FUNDS IN ISLAMIC BANKS IN INDONESIA? THE CASE OF BANK OF ACEH AND BANK OF NTB

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ABSTRACT

This study examines the effect of the conversion strategy on deposit funds in converted banks. One of the concerns when converting to an Islamic bank is the transfer of customers to conventional banks. This condition underlies this research to be conducted. Using panel regression analysis, this study found a positive difference in the number of deposited funds after the conversion. This fact shows that the concern about transferring customers after the conversion has not been proven. There was an increase in deposit funds after the conversion strategy was carried out at the two converted banks. This finding has implications that the conversion strategy can be carried out at regional banks that have a small size and are supported by the local government and the people in the area. The findings of this study contribute significantly to the development of the Islamic banking industry in Indonesia that conversion to Islamic banking is an alternative corporate strategy besides spin-offs and mergers.

Keywords: conversion, deposit funds, Islamic banks, panel regression.

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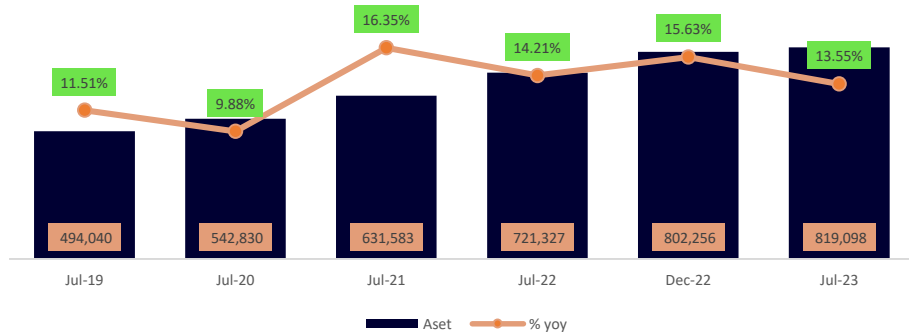
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1. INTRODUCTION

The development of Islamic banking in Indonesia has been relatively rapid after the financial crisis that hit Asia in 1997/1998. The financial crisis shows that Islamic banks are more resistant to crises than conventional banks. This condition underlies the issuance of Banking Law No. 10 of 1998, which began to allow banks with sharia principles to operate. There are two forms of Islamic banks in Indonesia, namely full-fledged Islamic banks and Islamic units of conventional banks. Then, in 2008, Law no. 21 of 2008 regarding Islamic banks. The regulation stipulates an obligation for conventional holding banks to spin off sharia units that meet the criteria or 15 years after the law is enacted. After the birth of this rule, five sharia units carried out spin-offs. The development of the sharia banking industry in terms of assets has increased significantly (See Figure 1).

Figure 1: The Development of Islamic Banking Asset in Indonesia



The spin-off policy that is required by law to be carried out by July 2023 raises pros and cons. On the one hand, this spin-off policy aims to strengthen the role of Islamic banks in the economy by improving banking health (Hosen & Mohari, 2018). In addition, the spin-off policy will improve the performance of spin-off banks (Siswantoro, 2014), including increasing the market share of Islamic banks (Yuspin et al., 2020). However, on the other hand, this spin-off policy has some disadvantages, such as losing the benefits of diversification by conventional parent banks (Prasetyo et al., 2019). In addition, there is a decrease in efficiency after the spin-off (Al Arif et al., 2018; Al Arif et al., 2020; Al Arif & Nabilah, 2022). Hasan and Risfandy (2021) conclude that Islamic windows are more stable rather than they are converting into full-fledged Islamic banks. The forced spin-off policy will result in the emergence of full-fledged Islamic banks with small sizes. Many small banks certainly have little impact on the level of competition in the Islamic banking industry. Trinugroho et al. (2014) show that the level of competition will increase efficiency in the banking industry. The competition will increase the Islamic banks' profitability (Sukmana & Ibrahim, 2021).

The spin-off policy creates a disincentive for small conventional holding banks. If they decide to separate their sharia unit, they must provide a minimum capital of IDR 3 trillion for the parent bank and IDR 1 trillion for the bank resulting from the spin-off. This requirement is undoubtedly difficult for small regional banks. This condition later became one of the reasons for the emergence of a strategy to convert into an Islamic bank. In 2016, the conventional holding bank that decided for the first time to carry out a full conversion was the Bank of Aceh, followed by the Bank of NTB in 2018. Finally, in August 2022, the Bank of Riau Kepri received approval from the Financial Service Authority to convert it into an Islamic bank. The conversion of two regional banks into full-fledged Islamic banks in 2016 and 2018 has been able to free the Islamic banking industry in Indonesia from the 5 percent market share trap. This condition shows that the conversion strategy implemented is able to increase the growth of the market share of Islamic banks in Indonesia.

The conversion strategy to become an Islamic bank has also been practiced in several countries. Several countries, such as Iran and Libya, have fully converted their banking systems to Islamic banking. One of Libya's challenges was the need for more guidance in the conversion process (El-Brassi et al., 2018). The characteristics of Islamic banks that have a low level of risk with high profits are one of the motives underlying the conversion of Islamic banks in the Middle East region (Alani & Yaacob, 2012). Regulations regarding higher reserve requirements for conventional banks are one of the incentives for the conversion process to become Islamic banks in Bangladesh (Suzuki et al., 2020). In addition, the motive to improve performance is one of the reasons for converting Islamic banks in GCC countries.

Promising prospects in the Islamic banking industry are one of the determining factors for many banks to convert into Islamic banks (Damanuri, 2012). Several advantages can be obtained after the conversion process to become an Islamic bank. Bank of NTB Sharia was able to increase deposit funds by almost 40 percent every year after conversion (Ramdan et al., 2020). In general, the deposit fund products in Indonesia do not have too many product innovations that are different from conventional banks. This is different from savings products from other countries such as Malaysia. Amin et al. (2022) explains one of the innovation products in Malaysia such as Islamic fixed online deposit account.

In addition, this conversion positively influences people's welfare (Yoesoef & Khairisma, 2020). Complete conversion to an Islamic bank will make them more capable of controlling financing risks (Al Kautsar et al., 2019; Pambuko & Pramesti, 2020). Other findings also show that the conversion strategy can provide a difference in performance for the converted bank (Budianto & Sofyan, 2021). However, this conversion strategy can also cause various problems in governance. The problem of low quality and competence of human resources is a problem that arises during the conversion process (Shafii et al., 2016). Another problem is related to products that are less competitive than conventional banks. In addition, aspects of corporate governance become less effective after the full conversion to an Islamic bank has been completed (Adha 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. Almost the previous

studies only focused on one bank, while this research has tested two converted banks. Therefore, this study will analyze whether there are differences in deposit funds 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.

2. LITERATURE REVIEW

After the issuance of Law no. 10 of 1998 in Indonesia, there are two forms of Islamic banks: full-fledged and Islamic units from conventional banks. Conventional banks that wish to have Islamic bank subsidiaries have two options: establishing full-fledged Islamic banks or in the form of sharia units. For those conventional who want to establish full-fledged, the alternative is to acquire small conventional banks and convert them into full-fledged Islamic banks. However, in this study, the focus was on something other than that. This research focuses on conventional parent banks that decide to convert entirely to become Islamic banks rather than spin off their Islamic units.

Complete conversion from conventional banks to Islamic banks is one of the methods to establish Islamic banks in Indonesia (Adha et al., 2020). The conversion carried out by three regional banks, namely Bank of Aceh, Bank of NTB, and Bank of Riau Kepri, is the chosen business strategy besides carrying out a spin-off of their sharia unit. For small regional banks, the spin-off strategy requires large capital. The minimum capital for parent banks is IDR 3 trillion, and IDR 1 trillion for spin-off banks. This condition will certainly make it difficult for banks that have small sizes. This condition is one of the reasons for the complete conversion to become an Islamic bank.

The practice of converting conventional banks into Islamic banks occurs in several countries. Iran is one of the countries that have fully converted its banking system to an Islamic banking system. Then Libya issued Law no. 1 of 2013, which decided to convert the entire banking system into Islamic banking (El-Brassi et al., 2018). Alani and Yaacob (2012) pointed out that several banks in the Middle East region have fully converted from conventional banks to Islamic banks. Several banks in Bangladesh have also carried out the conversion process to become Islamic banks (Suzuki et al., 2020).

In addition, another reason is to increase compliance with sharia principles and demand from local communities to have banks that entirely operate based on sharia principles (Rohman, 2019; Rahmawati & Putriana, 2020; Yoesoef & Khairisma, 2020; Alamsyah & Amri, 2021). Bakhouché et al. (2022) state that the main reason why some banks in those countries do the conversion is to pursue activities complies with sharia principles. Al Atyat (2007) also indicated that the primary motivation of almost 60% of conventional banks worldwide to convert is to comply with sharia principles. Mustafa (2006) also finds the similar result that 47% of the conventional banks in Saudi Arabia were motivated to comply with sharia law. Besides that, another determining factor for the full conversion into a sharia commercial bank is that the province's population is predominantly Muslim. This condition will undoubtedly increase the need for Islamic banking services (Trisnawati & Wagian, 2021).

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 conventional banks suffer more from uncertainty in terms of stability in countries with higher religiosity and with a higher profit-loss sharing contracts (Bilgin et al., 2021). The other reason that we cannot ignore is the profit factor because some studies had shows that Islamic banks are more profitable than conventional banks (Siraj & Pillai, 2012). 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. Boubaker et al. (2023) state that Islamic banking model helps build a safer asset portfolio. Besides that, the Islamic banks' resilience from crisis, including the pandemic covid-19 crisis also becomes one of the reasons for doing conversion (Ghouse et al., 2022; Rizwan et al., 2022). Belkhaoui (2023) shows that Islamic banking in MENA countries will leads to economic growth.

Budianto and Sofyan (2021) found several facts related to changes in performance in Aceh Syariah banks after conversion. From the aspect of the risk profile using non-performing financing indicators, it shows a difference between before and after the conversion. Hosen and Muhari (2017) show that Islamic banks face a high risk if core depositors withdraw money rashly and become the default. Al Kautsar et al. (2019) also stated that changing the business model to sharia at Bank Aceh will change the company's financial performance and the level of risk accepted.

The conversion decision improved the level of problem financing in the converted bank. On the other hand, it turned out that there was a decrease in the level of profitability (Pambuko & Pramesti, 2020) and bank health (Bensaadi et al., 2021). In addition, Fahdiansyah (2021) found that the post-conversion post-conversion financial performance of the Bank of NTB increased, although it could have been more optimal. Then, other research shows differences in financial performance between before and after conversion (Budianto & Sofyan, 2021). Converted banks have a better stability level than before conversion (Al Kautsar et al., 2019).

The conversion process from a conventional bank to an Islamic bank must be carried out carefully. Experience in the three conversion banks, the conversion preparation process takes 1 - 2 years. One of the things that must be done is to increase the motivation and ability of human resources (Ramdan et al., 2020). Complete conversion to an Islamic bank must be adjusted to the characteristics of the customers and the areas served. A careless conversion process creates a much higher complexity of the problem (Shafii et al., 2016; Afrida et al., 2020).

3. METHODOLOGY

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. These two banks are conventional banks that decided to fully convert

to Islamic banks in 2016 and 2018. This is the reason why the focus of this research is only on these two banks.

The analysis technique used in this study is panel regression analysis with dummy variables. Panel regression, also known as pooled time-series cross-sectional data analysis, is a statistical method used to analyze data that has both time-series and cross-sectional dimensions. Each entity in the panel is observed over multiple time periods. Panel data allow for more efficient estimation by utilizing both cross-sectional and time-series variations. Besides that, the fixed effects help control for unobservable differences between entities that might affect the dependent variable. The proposed mathematical equation is:

$$\text{Ln_Dep}_{it} = a + b_1 \text{D_Conv}_{it} + b_2 \text{EFF}_{it} + b_3 \text{NPF}_{it} + b_4 \text{CAR}_{it} + b_5 \text{ROA}_{it} + e_{it}$$

Where:

- Dep : total of deposit funds in log natural
- D_Conv is dummy variable for conversion policy
where: 0 = before conversion; 1 = post conversion
- NPF : non performing financing
- ROA : profitability ratio measured by return on asset
- EFF : operational efficiency ratio
- CAR : capital adequacy ratio

Several techniques are used to estimate the model parameters in regression with panel data. First, the common effect model; Second, the fixed-effect model. Fixed effects are included in the model to control for unobserved heterogeneity across entities; Third, the random effect model. Random effects are assumed to be uncorrelated with the independent variables.

4. RESULTS AND DISCUSSION

The empirical findings in Table 3 show a positive difference in the number of deposited funds before and after conversion. Therefore, the concern that there will be a decrease in customers who transact at Islamic banks after conversion is not proven. These results are consistent across all three models, namely Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM). Based on the Chow and Hausman test results (see Table 1 and Table 2), the best model used in this study is the fixed effect model.

Table 1: Chow-test Result

Effect test	Statistics	d.f.	Prob
Period F	2.212079	(39,33)	0.0109
Period Chi-square	101.506418	39	0.0000

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. Ramdan et al. (2020)

show similar results, where there is an increase in deposit funds by 40 percent annually at the Bank of NTB after the full conversion to full-fledged Islamic banks. Purwanto (2018) also found differences in the amount of deposited funds at the Bank of Aceh after conversion. Apart from that, there is also an intermediary function at the bank of Aceh after the conversion. Al-Harbi (2020) also finds the similar result that the conversion helps to improve the deposits of converted banks in Gulf Cooperation Council (GCC) countries. These results indicate that conversion decisions can increase customer decisions to save at converted Islamic banks. One of the reasons for this increase may be due to better service. Sari et al. (2022) found that the service quality after the conversion process is better than before.

Table 2: Hausman-test Result

Test Summary	Chi-square Stat.	Chi-square d.f.	Prob.
Period Random	73.683376	6	0.0000

As previously explained, the reason for converting is compliance with sharia principles. There is a demand from local communities to have banks that entirely operate based on sharia principles (Rohman, 2019; Rahmawati & Putriana, 2020; Yoesoef & Khairisma, 2020; Alamsyah & Amri, 2021). Communities in these two regions are people who have a high level of religiosity. Religiosity is a determining factor in the decision to choose an Islamic bank (Soma et al., 2017). Islamic banks claim to possess shariah capabilities (Ullah et al., 2023). This religious emotional bond which in turn makes Islamic bank customers loyal and do not switch when the conversion is carried out (Athief & Ma'ruf, 2023).

Table 3: Empirical Result Impact of Conversion on Deposit Funds

	CEM	FEM*	REM
C	7.668329 0.333560***	9.518696 0.668273***	7.668329 0.259163***
D_conversion	0.389031 0.196057*	1.183490 0.369891***	0.389031 0.152329***
MS	0.232346 0.032084***	0.260981 0.062646***	0.232346 0.024928***
Efficiency	0.013749 0.004418***	-0.000864 0.005686	0.013749 0.003433***
CAR	-0.009057 0.008533	-0.044426 0.020610**	0.009057 0.006630
NPF	0.529745 0.114696***	1.079288 0.155017***	0.529745 0.089114***
ROA	-0.000217 0.002403	-0.000808 0.002686	-0.000217 0.001867
R-square	0.675052	0.910093	0.675052
Adj R-square	0.647973	0.787493	0.647973
F-stat	24.92897	7.423257	24.92897

Next, we will try to discuss in detail the development of deposit funds at the two converted banks, namely Bank of Aceh and Bank of NTB. Table 4 shows the development of deposit funds in the two converted banks showing a positive trend. The data in Table 4 shows that the deposit funds successfully collected at Bank Aceh prior to the maximum conversion were 14 trillion. However, after the Bank of Aceh was converted, deposit funds could penetrate above 20 trillion. A similar trend was also seen at the Bank of NTB, where there was an increase in deposit funds from year to year, especially after the conversion to become a full-fledged Islamic banks. However, Table 4 shows a decrease in deposit funds while the conversion process was being carried out. This condition is reasonable considering that during this transition period, customers are given a choice whether they want to survive and switch to becoming customers of Islamic banks; or want to withdraw funds and choose another conventional bank.

Table 4: The Development of Deposit Funds(in IDR billion)

Years	Bank of Aceh	Bank of NTB
2012	10.672,34	2.834,75
2013	11.749,48	3.156,74
2014	12.030,24	4.097,98
2015	14.151,72	4.561,20
2016	18.759,19*	5.211,42
2017	22.612,01	7.190,68
2018	23.095,16	4.921,38*
2019	20.924,60	6.816,36
2020	21.574,04	7.408,92
2021	24.018,01	8.143,06

Note: *) conversions¹ year

Director of Financing from the Bank of NTB, Mr. Muhammad Usman, explained in an interview session that the decrease in deposit funds in 2018 was carried out to offset the decrease in financing due to the conversion transition to an Islamic commercial bank. However, the number of customers withdrawing their funds from Bank of NTB Sharia is minimal. Even though corporate customers withdraw their funds due to product factors that still need to be varied, the company's provisions govern the existence of a fixed margin from the bank. Of course, Islamic banks cannot provide fixed margins yearly because of the profit-sharing system, which is the operational basis of Islamic banks.

One of the factors that often hinder the conversion process into an Islamic bank is the concern that customers will flee to conventional banks. Abduh et al. (2013) stated that product is the main factor for someone to choose a bank regardless of whether it is sharia or conventional. Islamic banks are faced with competition not only with fellow Islamic banks but also with conventional banks. Therefore, converted banks must strengthen their products. However, competition will impact bank profitability (Sukmana & Ibrahim, 2021). Purba (2017) shows that religious, economic, and information factors positively affect the intention to save at Islamic Aceh banks. Product innovation is needed to attract deposit funds in Islamic banks (Sulistyawati et al., 2020). Kamarulzaman and Madun (2013) also suggest that Islamic banking institution should be more proactive and innovative in marketing their products.

The conversion carried out by the two banks increased the market share of Islamic banking in Indonesia to reaching 6.70 percent in December 2021. So far, the market share of Islamic banking has not reached 5%. Even though the target of 5% should have been achieved in 2008, this fact shows that converting into an Islamic bank is one of the right strategies to increase market share in Indonesia. Ribowo and Nurdin (2022) also found an increase in market share in the two converted banks after the process was carried out. Adenan et al. (2021) stated that market share is an indicator of the market's position compared to its competitors.

Meanwhile, the spin-off strategy has yet to increase market share; instead, it has effectively produced small-sized banks. The conversion strategy is an exit strategy that regional banks can carry out because the problem they are experiencing is capital. The spin-off strategy requires a conventional holding bank to have a core capital of IDR 3 trillion; an Islamic bank resulting from a spin-off must have a capital of IDR 1 trillion. This requirement is a big problem for regional banks in meeting these capital requirements.

Eliana et al. (2020) stated that one of the challenges Islamic banks face is the low public interest in Islamic banks. Even though converting into an Islamic bank is one of the ideal strategies for increasing market share, the converted bank must still increase public interest in using Islamic banks. Three parties must be actively involved in increasing market share in Islamic banks, namely internal Islamic banks, regulators, and the community (Hidayat & Trisanty, 2020). Bensaadi et al., (2021) suggest that converted banks should optimally utilize the assets to increase the banks' efficiency. Suhail and Nurzaman (2020) also suggest that Islamic banks should reduce wasteful resources to improve the efficiency.

Wiliasih and Shadrina (2017) stated that six dominant factors encourage customers to save at Islamic banks. The six factors are promotion, service, institutional credibility, conformity with sharia, location of the institution, and the customer's living environment. Therefore, Islamic banks must develop an effective business strategy targeting these six dominant factors. Besides that, Islamic banking must be able to develop an effective Islamic financial literacy model (Fathony et al., 2022).

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).

The full conversion process into a conventional commercial bank must be carefully prepared. At each stage of the conversion must be able to increase the motivation of human resources that the conversion that is being carried out will give good results in the development of human resources in the Bank of NTB (Ramdan et al., 2020). The same condition also happened in Libyan Banks that the availability of qualified human resources (Abdalla et al., 2015). 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. Full conversion to a sharia commercial bank must be adjusted to the characteristics of the customers and the areas served.

A careless conversion process creates a much higher complexity of the problem (Shafii et al., 2016; Afrida et al., 2020). Muzan et al. (2022) state the conversion policy can raise the problem of an ineffective corporate governance mechanism. Islamic banks may suffer a loss in their value since the adoption of the third layer of binding practices (Mamatzakakis et al., 2023). Rizal et al. (2023) found some challenges that faced by converted banks such as technology, human resources, socialization, and local wisdom.

Trisnawati and Wagian (2021) shows that several factors support the conversion process in the Bank of NTB. First, the majority of the populations 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, the acceptance of interfaith Islamic banking at the Bank NTB of Sharia. Fourth, the number of remittances from migrant workers from NTB abroad is quite large each year.

One strategy to enhance the Islamic banks' market share is increase the financial literacy of the customer. Financial literacy is a measurement of a person's understanding of financial concepts and the ability and confidence to manage personal finances through the right decisions (Fathony et al., 2022). The stakeholder of the sharia banking industry must be able to develop an effective Islamic financial literacy model so that this will be able to increase the sharia market share in Indonesia. Three strategies can be used to increase the market share of Islamic banks. The first strategy is financial literacy to increase public awareness and understanding of financial institutions, products, and services. Second, a wise financial attitude and behavior aim to build a society with solid financial resilience in dealing with various financial conditions. Third, access to finance aims to increase the number of users of financial products and services in the community (Fathony et al., 2022).

5. CONCLUSION

This study concludes that the conversion of two regional banks into Islamic commercial banks can increase the deposit funds of the converted banks. In general, some studies found that conversion can increase the deposit funds by almost 30-40 percent per year. The concern that arises that converting into an Islamic bank will cause customers to flee is not proven in this study. The facts show the opposite result, where there has been an increase in deposits in the two converted banks.

There are several policy recommendations offered from this research. First, converted banks must innovate products that can compete with conventional banks. Second, the regulator must provide incentives for banks that will convert to become Islamic banks. Third, the government

must carry out an affirmative policy by requiring state-owned enterprises to place part of their funds in Islamic banks. Fourth, the conversion strategy must be a corporate strategy that is supported by all stakeholders.

Besides that, there are some future studies recommendations due to the topic of conversion from conventional banks into full-fledged Islamic banks. First, future studies must include banks that have also decided to convert to full-fledged Islamic banks in 2022, namely Bank of Riau Kepri. Second, future research must include not only internal variables but also external variables such as macroeconomic variables in the research model. Third, future research can use difference-in-difference analysis techniques to strengthen the results obtained in this research.

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