

REPORT

Efficiency of Islamic and conventional banks in the GCC

A comparison based on Financial Ratios and Data
Envelopment Analysis



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Introduction

Islamic banking has had a relatively short history. Demand for Islamic financial products grew as a consequence of the wealth accruing to Muslims during the 1970s oil boom (The Economist 2009). When the first Islamic bank was founded (the Dubai Islamic Bank in 1975) only the most fundamental contracts were available (safekeeping accounts, sale and PLS contracts). The growth of Islamic banking, however, made it necessary to introduce facilities that were already available in the conventional banking system. So in 1978 the first Islamic bond (sukuk) was launched granting Islamic banks access to capital markets, although the sukuk market would take another 20 years to gain significant size (Iqbal and Mirakhor 2007). In the early 1990s the first Islamic equity funds were launched. These were the Islamic response to the conventional mutual and hedge funds. In the late 1990s takaful was introduced allowing the privilege of Shariah compliant life and general insurance to millions of Muslims (Venardos 2006). The dawn of the 21st century witnessed the launch of Islamic indexes from Dow Jones, FTSE and more recently from S&P so that investors could track the performance of firms that comply with Islamic law. Nowadays many Islamic banks offer credit cards allowing their customers an overdraft facility despite

the fact that it was considered completely unlawful a few years ago. Moreover Islamic banks are investing time and money in the implementation of Internet, mobile phone and telephone banking and, in some more liberal countries, such as the UAE, Islamic banks have gone a step further by introducing special privileges for women clients following conventional practices (Dubai Islamic Bank website). Today more than 300 Islamic financial institutions spread across 70 countries of the world. Islamic banking clientele are not confined to Muslim countries but are spread over Europe, United States of America and the Far East. (IIBI website).

Islamic banking assets were at \$822 billion in 2009 from \$639 billion in 2008, and they projected to rise to \$1 trillion in 2010. Growth rates of 28% even amidst the global financial crisis verify the Islamic banking is gaining in popularity. Indeed, the recent financial crisis experienced in the conventional banking sectors around the world has focused attention on the Islamic banking sector where banks, which emphasise transparency and undue risk avoidance, have been largely insulated from the crisis (Hamdan 2009; Willison 2009).

Islamic banks use profit-and-loss sharing (PLS) instruments^{1} which do not guarantee a pre-determined profit to depositors and do not force borrowers to repay a pre-determined amount. In addition Islamic banks offer some fee-based services^{2}. Since the growth, efficiency and competitive environment of the financial sector are vital for economic development and stability (Al-Jarrah and Molyneux 2005; Brissimis et al 2009) it is important to assess the efficiency of Islamic compared to conventional banking. Another reason that necessitates a comparative study like this is the debate that exists in academic and business circles about whether Islamic finance follows the spirit of the Shariah law or mimics the conventional practises by circumventing Shariah whenever possible. The recent statement by the Scholar Sheikh Taqi Usmani (Financial Times 7-12-2009) arguing that “many Islamic bonds (sukuk) have gone too far in mimicking conventional interest-paying bonds, which are banned by Islam” and the immediate market reactions (e.g. Islamic markets fell and AAOIFI’s disapproval of another bulk of sukuk issues (Faizal Ahmad Manjoo, 2009) verify the point made above.

The paper of Johnes, Izzeldin and Pappas (2009), examines the cost, profit and revenue efficiency of the GCC Islamic and conventional banks over 2004-2007. Efficiency studies are

important as they are a way of measuring and comparing the performance of different bank types across time. Findings are useful for investors, bank managers and the state since they can identify weak and strong points and take necessary action. The authors combined Financial Ratio Analysis (FRA) and Data Envelopment Analysis (DEA) complemented by various statistical tests and procedures to reduce small sample bias. The interested reader is referred to Johnes, Izzeldin and Pappas (2009) for more details.

^{1} Mudarabah and Musharakah are some contracts that are based on the profit-and-loss sharing technique (PLS). In Mudarabah an investor (usually an Islamic bank) and an entrepreneur (individual or institutional) enter a joint venture where the investor provides the necessary funds and the entrepreneur provides knowhow. The investor cannot interfere with the running of the business which is left entirely to the entrepreneur. Both parties agree ex ante on a ratio according to which they will split the profits-which are unknown at the time of the arrangement (e.g. 70/30 bank and investor accordingly). In case of losses each party loses what he had contributed to the venture unless negligence of a party can be proven. Musharakah basically differs in the number of participants in the venture and the contributions each one is allowed to make.

^{2} Fee-based services include the widely used contracts of Murabahah and Ijarah. Murabahah is in essence a cost-plus-profit sale. The bank arranges to sell a good to a customer and it charges a fee on the price which incorporates risks, costs and a profit margin. Ijarah is a lease contract where the bank leases an asset to an investor (or consumer) and the latter pays fees for being allowed to use the asset.

Summary of results

Revenue efficiency, measured by *other operating income*, shows that Islamic banks attract clients and generate funds more easily than conventional banks. A reason that has contributed to the higher revenue efficiency of Islamic banks has been the fast economic development of the countries in the Gulf region (average real GDP growth 8.1% over 2004-2007) in conjunction with the PLS basis that Islamic banks operate. Another factor is the popularity that Islamic banks gain constantly due to the operational progress taking place within their sector.

In particular, Islamic banks, despite their being cost inefficient^{3} compared to conventional banks, they have managed to decrease the gap in the latter years of the sample. In 2004 Islamic banks were

31% less cost efficient compared to conventional banks, while in 2006 the figure dropped to 17%. In 2007 Islamic banks are slightly ahead (6%) of conventional banks in terms of cost efficiency. Islamic banks incur more costs than conventional banks for a variety of reasons. Firstly, they have to maintain a Shariah supervisory board; secondly, its higher complexity, mainly due to lack of product standardisation and because Islamic banking targets at the macro level where contracts are to a great extent customised for every client, raises the legal costs especially when ramifications for compliance with

^{3} Cost efficiency is represented by the cost-to-income ratio where a lower value shows that the bank is more cost efficient

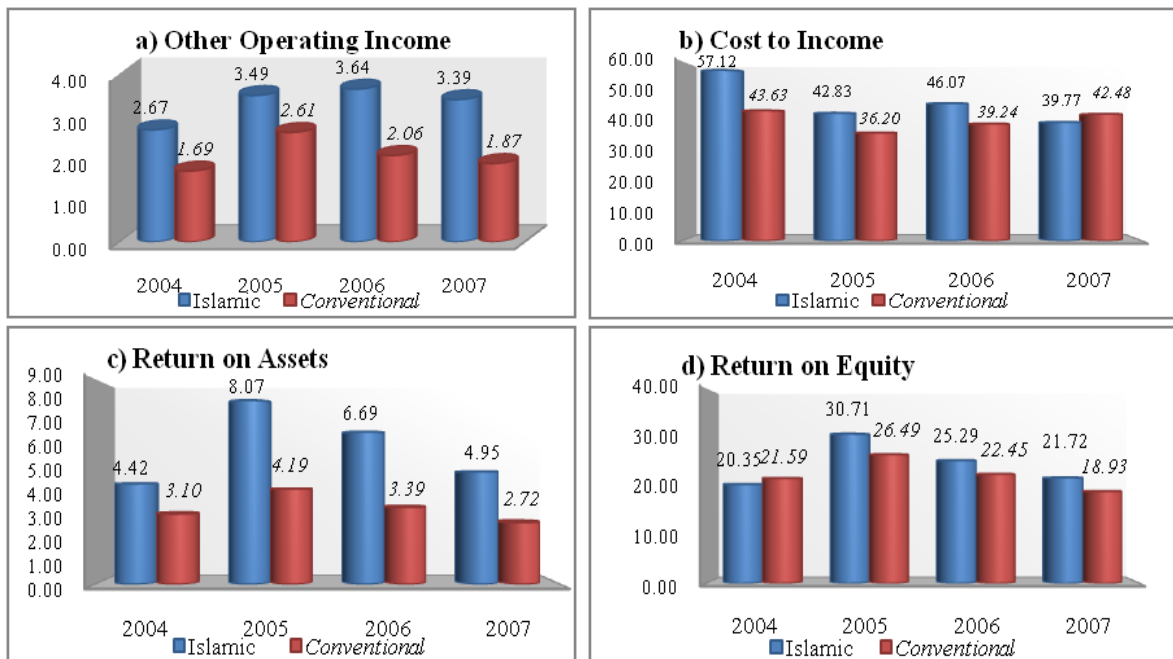


Figure 1 (a-d) Financial Ratio performance for Islamic and conventional banks in the GCC region; **a)** other operating income [revenue efficiency]; **b)** cost to income [cost efficiency]; **c)** Return on Assets (RoA) [profit efficiency]; **d)** Return on Equity (RoE) [profit efficiency]. *Source: Johnes, Izzeldin and Pappas 2009*

foreign laws is needed. In addition to that, we find that the reason for the Islamic banks' inefficiency is their way of doing business, which incorporates all these higher costs, and not because of inferior staff and managerial inadequacies. Finally, cost efficiency requires a critical bank size for scale and scope economies to emerge and Islamic banks are smaller than conventional ones in terms of assets and products they offer. In terms of profit efficiency, both bank types have similar return on equity (RoE) throughout the period indicating that the Shariah restrictions are not forcing Islamic banks into worse performance. Moreover return on assets (RoA) is higher for Islamic banks due to the investments in real assets, rather than debt contracts. A closer relationship between the banking sector and the real economy is evidenced here and this may be one reason why Islamic banks have been able to maintain and increase their

assets amidst the financial crisis.

A further investigation of the reasons that cost inefficiency of Islamic banks has decreased shows that they experienced a rise in technology of 18% (for conventional banks it was 6%) which is no doubt a consequence of the product and operational innovations taking place in the Islamic banking sector.

A country wise split of efficiency scores is reported in figure 2. In terms of investor profitability (according to profit efficiency ratios), Saudi Arabia and Qatar were best performers. In terms of cost and revenue efficiency (according to the corresponding ratios) Bahrain is the best performer, followed by UAE.

{4} We make the distinction of the macro level as opposed to the micro level. The macro level investments are addressed to companies undertaking big projects (e.g. hotels, stadiums, motorways). The micro level focuses more on financing of small and medium sized enterprises (e.g. working capital, change in machinery). Islamic banking, because of the lack of product standardisation and thus the higher costs incurred, cannot engage heavily in micro financing.

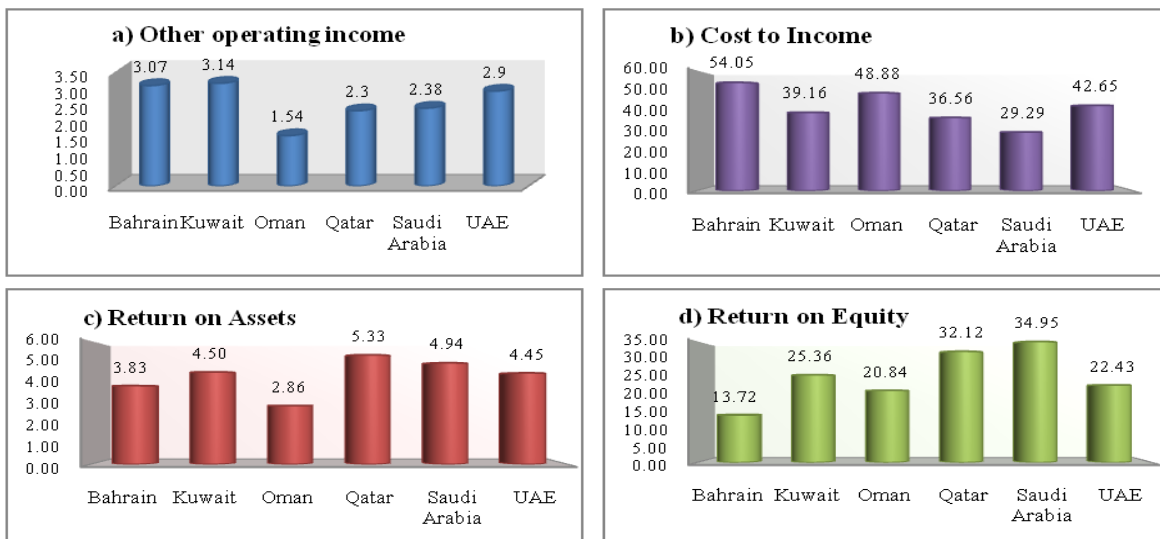


Figure 2 (a-d) Average Efficiency scores and Financial Ratios of the banking system in the GCC region. **a)** other operating income [revenue efficiency]; **b)** cost to income [cost efficiency]; **c)** Return on Assets (RoA) [profit efficiency]; **d)** Return on Equity (RoE) [profit efficiency]. *Source: Johnes, Izzeldin and Pappas 2009*

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