

FINANCIAL PERFORMANCE OF CONVENTIONAL VS ISLAMIC BANKS

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Why study Islamic banks?

- n Islamic banks are licensed to operate in competitive regulatory environments
- n Islamic banks growing very fast, so needs verification of its financial efficiency
 - 15% growth vs 3% growth of conventional
- n Conventional banks operate on pre-fixed interest, Islamic banks on profit-sharing
 - Are these two pricing modes alternatives?
- n Both aim to minimize cost, maximize profits
- n Nothing is know about Islamic bank performance. Conventional, we know
 - Little is known of financial performance
 - Especially on a identical samples basis

Why do we want to study Islamic banks?

International Monetary Fund:

- n The number of Islamic Banking institutions rose from 75 in 1975 to over 300 in 2005, in more than 75 countries. In 2008, it has further increased to closer to about 500
- n Total assets of banks are estimated to be \$4-5 trillion, which is growing at about 15 percent per year, at five times the rate of conventional banks.
- n This size is still very small, amounting to no more than 1-3% of traditional
- n 2007 (before WFC): Three top banking groups had large assets:
 - UBS of Switzerland (\$1,533 billion); Citigroup of U.S. (\$1,484 billion); and Mizuho Financial Group of Japan (\$1,296 billion). Bank of America, ranked as the tenth, has assets of \$1,110 billion, which is 4 times greater than the assets of all Islamic financial institutions put together.
- n As a new niche player, it needs close scrutiny.

Islamic Banking Efficiency

One group of studies includes studies that assess the performance of Islamic banks using traditional financial ratios (e.g. Abdus-Samad, 1999; Bashir, 1999; and Hassan and Bashir, 2003).

- n A second group of studies focus on banks' efficiency and utilize frontier analysis approaches (e.g. Yudistira, 2003; Al-jarrah and Molyneux, 2003, Hussein, 2004; Hassan, 2005).
- n Most of those studies utilized returns on assets (ROA), returns on equity (ROE), Assets Utilization (AU) and other traditional financial indicators to assess Islamic banks' performance.
- n What can we say about IB after 46 years?

What is financial performance?

How to study performance?

- n Three financial ratios used to get at the core performance
- n **1. Cost Efficiency Financial Ratios**
 - Cost to Income Ratio (CTIR)
 - Net Interest Expenses/Average Assets (NIER)
- n **2. Revenue Efficiency Financial Ratios**
 - Other Operating Income/Average Assets (OPIR)
 - Net Interest Margin (NIM) Accounting based performance of abnks
- n **3. Profit Efficiency Financial Ratios**
 - Return on Average Equity (ROAE):
 - Return on Average Assets (ROAA): Economic Efficiency Measures
- n We measure these three core performance dimensions using 6 measures.
- n We do this by creating a matched sample of conventional vs Islamic banks operating:
 - In same countries
 - Adjusted for different size, age and locations.
- n (A parallel study examined economic efficeincy of profit/revenue maximization and cost minimization)

Data

Cross-country data from the financial statements of 43 banks in 21 Muslim-majority countries

n The primary sources of data are the bank balance sheets and income statements

n The data were available as annual financial items in BankScope database over 1992-2005.

n The countries included in the sample are classified as follows:

- Africa (Algeria, Egypt, Gambia, Senegal, Sudan, Tunisia)
- Middle East and Turkey (Bahrain, Iran, Jordan, Kuwait, Lebanon, Qatar, Saudi Arabia, Turkey, UAE, Yemen)
- South Asia (Bangladesh, Pakistan)
- South East Asia (Brunei, Indonesia, and Malaysia)

Important Findings

Record of Financial Performance

n Based on our analysis

- Islamic banks appear to have “steady” cost efficiency”
- Revenue efficiency appears to be more volatile, and that is the nature of all businesses since revenues are more closely related to business conditions, and may also vary widely

n We tried to see any differences between small and big banks?

- Smaller banks appear to be more stable in establishing steady profit efficiency as well as revenue efficiency despite their disadvantage of scale and scope for profits
- Big banks have more volatile experience in this regard
- But the differences are not big enough

n See the following two charts

Overall Financial performance: 14 yrs

Table 1: All Banks: Cost, Revenue and Profit Efficiency, 1990-2005

| | | Cost Efficiency Ratios | | Revenue Efficiency Ratios | | Profit Efficiency Ratios | |
|----------------|------------|------------------------|--------------|---------------------------|--------------|--------------------------|---------------|
| Category | Statistics | CTIR | NIER | NIM | OPIR | ROAA | ROAE |
| All Banks | N | 80 | 80 | 80 | 80 | 80 | 80 |
| | Mean | 58.041 | 4.174 | 3.780 | 2.892 | 1.345 | 10.688 |
| Std. Deviation | 20.170 | 3.313 | 2.517 | 3.447 | 1.699 | 16.604 | 1.699 |
| Maximum | 105.486 | 19.550 | 15.360 | 16.156 | 9.907 | 69.197 | 9.907 |
| Minimum | 24.093 | 0.745 | -0.225 | 0.380 | -3.049 | -87.416 | -3.049 |

These numbers indicate the statistics for the combined sample of 80 banks x 14 years.

Not much revealing information as we need to break it down by type of banks.

Important: No difference across two types of banks

Table 2: Conventional and Islamic Banks: Cost, Revenue and Profit Efficiency

* No Significant differences between means of conventional versus Islamic banks at 0.05 percent level.

| | | Cost Efficiency Ratios | | Revenue Efficiency Ratios | | Profit Efficiency Ratios | |
|------------------------------------|----------------------------|------------------------|--------------|---------------------------|--------------|--------------------------|---------------|
| Category | Statistics | CTIR | NIER | NIM | OPIR | ROAA | ROAE |
| Conventional Banks | N | 37 | 37 | 37 | 37 | 37 | 37 |
| | Mean | 58.165 | 4.097 | 3.919 | 2.449 | 1.274 | 9.614 |
| | Std. Deviation | 19.905 | 3.559 | 2.811 | 3.395 | 1.954 | 20.255 |
| | Maximum | 102.687 | 19.550 | 15.360 | 16.156 | 9.907 | 69.197 |
| | Minimum | 25.878 | 0.745 | 0.793 | 0.380 | -3.049 | -87.416 |
| Islamic Banks | N | 43 | 43 | 43 | 43 | 43 | 43 |
| | Mean | 57.935 | 4.240 | 3.660 | 3.272 | 1.405 | 11.611 |
| | Std. Deviation | 20.630 | 3.127 | 2.262 | 3.485 | 1.466 | 12.847 |
| | Maximum | 105.486 | 14.925 | 8.442 | 14.340 | 6.010 | 43.388 |
| | Minimum | 24.093 | 1.095 | -0.225 | 0.423 | -1.820 | -22.918 |
| Significance of t-test (2-tailed)* | Equal variance assumed | 0.96 | 0.85 | 0.65 | 0.29 | 0.73 | 0.60 |
| | Equal variance not Assumed | 0.96 | 0.85 | 0.65 | 0.29 | 0.74 | 0.61 |

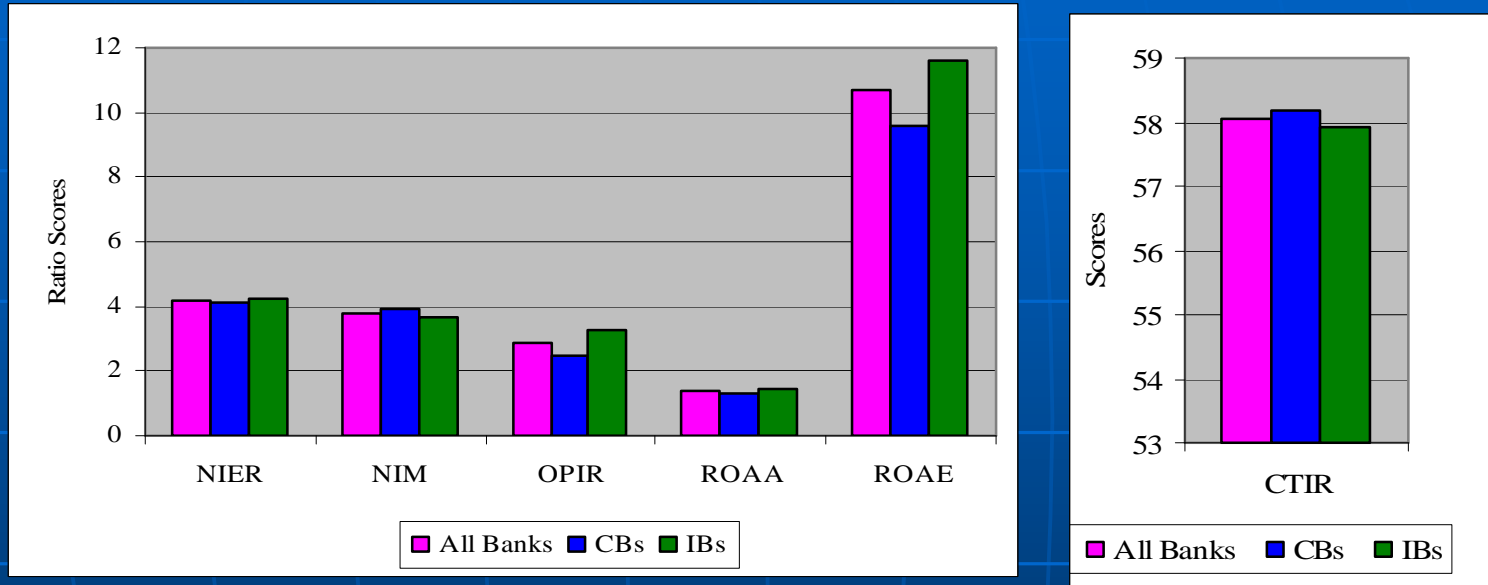
Statistical tests of performance difference of the two bank types show no significant differences

That is both bank types are equally good/bad performers!!

Efficiency Results of All Islamic Banks

Figure 1: Average Ratios of Conventional, Islamic, and All Banks

The slight differences in this chart are not statistically different: see Table 2.



These charts show slight differences in financial performance across two bank types. But the size of differences not great

Does size of banks make a difference?

Table 5: Cost, Revenue and Profit Efficiency of Big and Small Banks, 1990/1-2005/6

* No Significant differences between means of big versus small banks at 0.05 percent level.

| | | Cost Efficiency Ratios | | Revenue Efficiency Ratios | | Profit Efficiency Ratios | |
|--|----------------------------|------------------------|--------------|---------------------------|--------------|--------------------------|---------------|
| Size | Statistics | CTIR | NIER | NIM | OPIR | ROAA | ROAE |
| Big Banks | N | 38 | 38 | 38 | 38 | 38 | 38 |
| | Mean | 54.327 | 3.604 | 3.518 | 2.472 | 1.379 | 11.909 |
| | Std. Deviation | 19.204 | 3.333 | 2.068 | 3.420 | 1.836 | 21.329 |
| | Maximum | 105.486 | 19.550 | 8.835 | 16.156 | 9.907 | 69.197 |
| | Minimum | 25.878 | 0.745 | 0.551 | 0.380 | -3.049 | -87.416 |
| Small Banks | N | 42 | 42 | 42 | 42 | 42 | 42 |
| | Mean | 61.402 | 4.690 | 4.016 | 3.271 | 1.314 | 9.589 |
| | Std. Deviation | 20.657 | 3.248 | 2.869 | 3.468 | 1.587 | 10.865 |
| | Maximum | 102.687 | 14.925 | 15.360 | 14.340 | 6.010 | 43.388 |
| | Minimum | 24.093 | 1.095 | -0.225 | 0.423 | -1.820 | -13.263 |
| T-Test Significance (2-tailed)* | Equal variance assumed | 0.12 | 0.14 | 0.38 | 0.30 | 0.87 | 0.54 |
| | Equal variance not assumed | 0.12 | 0.15 | 0.37 | 0.30 | 0.87 | 0.55 |

Control for size? Again the results are not different

Does age make a difference?

Table 8: Average Cost, Revenue and Profit Efficiency of Old and New Conventional and Islamic Banks, 1990/1-2005/6

* The mean difference is significant at the 0.05 percent probability level.

| | | Cost Efficiency Ratios | | Revenue Efficiency Ratios | | Profit Efficiency Ratios | |
|--------------------------|----------------|------------------------|--------------|---------------------------|--------------|--------------------------|---------------|
| Age Category | Statistics | CTIR | NIER | NIM | OPIR | ROAA | ROAE |
| OCBs | N | 27 | 27 | 27 | 27 | 27 | 27 |
| | Mean | 55.993 | 3.502 | 3.232 | 2.451 | 1.309 | 13.476 |
| | Std. Deviation | 21.015 | 3.630 | 2.067 | 3.746 | 1.867 | 13.537 |
| | Maximum | 102.687 | 19.550 | 8.835 | 16.156 | 9.907 | 69.197 |
| | Minimum | 25.878 | 0.745 | 0.793 | 0.380 | -0.605 | -8.083 |
| OIBs | N | 23 | 23 | 23 | 23 | 23 | 23 |
| | Mean | 56.347 | 3.535 | 3.541 | 2.254 | 1.439 | 12.531 |
| | Std. Deviation | 17.482 | 2.233 | 2.376 | 2.615 | 1.302 | 13.748 |
| | Maximum | 85.049 | 10.490 | 8.177 | 11.670 | 5.228 | 43.388 |
| | Minimum | 28.400 | 1.095 | -0.225 | 0.425 | -0.272 | -22.918 |
| NCBs | N | 10 | 10 | 10 | 10 | 10 | 10 |
| | Mean | 64.027 | 5.703 | 5.774 | 2.445 | 1.181 | -0.812 |
| | Std. Deviation | 16.017 | 2.942 | 3.746 | 2.360 | 2.277 | 30.759 |
| | Maximum | 88.910 | 12.345 | 15.360 | 8.935 | 5.855 | 17.512 |
| | Minimum | 46.253 | 2.672 | 2.377 | 0.760 | -3.049 | -87.416 |
| NIBs | N | 20 | 20 | 20 | 20 | 20 | 20 |
| | Mean | 59.762 | 5.051 | 3.796 | 4.444 | 1.366 | 10.553 |
| | Std. Deviation | 24.091 | 3.813 | 2.175 | 4.028 | 1.669 | 11.991 |
| | Maximum | 105.486 | 14.925 | 8.442 | 14.340 | 6.010 | 33.730 |
| | Minimum | 24.093 | 1.221 | -0.110 | 0.423 | -1.820 | -13.263 |
| Oneway ANOVA Significant | Between Groups | 0.70 | 0.14 | 0.05* | 0.14 | 0.98 | 0.12 |

Age of banks does not matter (except revenue performance)

Does location make a difference?

Table 11: Cost, Revenue and Profit Efficiency of Banks in Different Regions

* The mean difference is significant at the 0.05 percent level.

| | | Cost Efficiency Ratios | | Revenue Efficiency Ratios | | Profit Efficiency Ratios | |
|---------------------------|----------------|------------------------|--------------|---------------------------|--------------|--------------------------|---------------|
| Region Category | Statistics | CTIR | NIER | NIM | OPIR | ROAA | ROAE |
| Africa | N | 21 | 21 | 21 | 21 | 21 | 21 |
| | Mean | 61.782 | 5.550 | 4.173 | 4.675 | 1.181 | 12.635 |
| | Std. Deviation | 22.053 | 3.354 | 2.660 | 3.911 | 2.186 | 17.196 |
| | Maximum | 102.687 | 12.345 | 8.835 | 13.448 | 9.907 | 69.197 |
| | Minimum | 25.878 | 1.228 | 0.551 | 0.380 | -1.820 | -13.263 |
| Asia | N | 19 | 19 | 19 | 19 | 19 | 19 |
| | Mean | 59.111 | 3.457 | 3.618 | 1.409 | 0.644 | 4.646 |
| | Std. Deviation | 20.359 | 1.819 | 2.127 | 0.739 | 1.251 | 24.218 |
| | Maximum | 93.473 | 8.761 | 8,148 | 3.405 | 3.303 | 33.730 |
| | Minimum | 25.410 | 1.760 | 0.793 | 0.425 | -3.049 | -87.416 |
| Middle East and Turkey | N | 40 | 40 | 40 | 40 | 40 | 40 |
| | Mean | 55.570 | 3.791 | 3.650 | 2.660 | 1.763 | 12.535 |
| | Std. Deviation | 19.210 | 3.676 | 2.647 | 3.624 | 1.497 | 10.620 |
| | Maximum | 105.486 | 19.550 | 15.360 | 16.156 | 6.010 | 33.293 |
| | Minimum | 24.093 | 0.745 | -0.225 | 0.423 | -0.605 | -22.918 |
| Oneway ANOVA Significance | Between Groups | 0.51 | 0.08 | 0.71 | 0.01* | 0.052 | 0.19 |

No significant difference (except in revenue performance)

Conclusions

Conclusions

Several conclusions emerge:

n First, the average financial performance across all Islamic bank categories and that of conventional banks is similar over the 14-year period across the world.

n This study examined three sets of financial performance over 14 years using 80 matched sample of banks. It is a large study.

n Controls:

- Size: did not matter
- Age: did not matter
- Location: did not matter

n Thus, after 46 years of history, the Islamic banking has appeared to have performed financially as well as the conventional banks

n REASONS:

- Entry of experienced banks post-2002
- Entry of experienced banks
- Carefully structured regulatory regime (although traditionalist would still argue against it)
- Presence of markets for the products.

n Theoretically, a claim is made that the Islamic banking is Islamic-law compliant rather than "Islamic Finance" based on true profit sharing basis of pricing.

n Pricing is still dominated by the interest rates in the system. Thus, a similarity to conventional banking is bound to occur. For it to be truly Islamic banks, in the spirit of the moral codes, Islamic banks ought to outperform.

n Further research needed in this direction.

Thanks