



بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ



MCFS Symposium

Islamic financial services: What role for Australia?

Melbourne Centre for Financial Studies

Asialink and National Centre of Excellence for Islamic Studies Australia

*Is Islamic Banking a Successful Alternative
to Conventional Banking :
A Comparison of Two Banking Systems*

by

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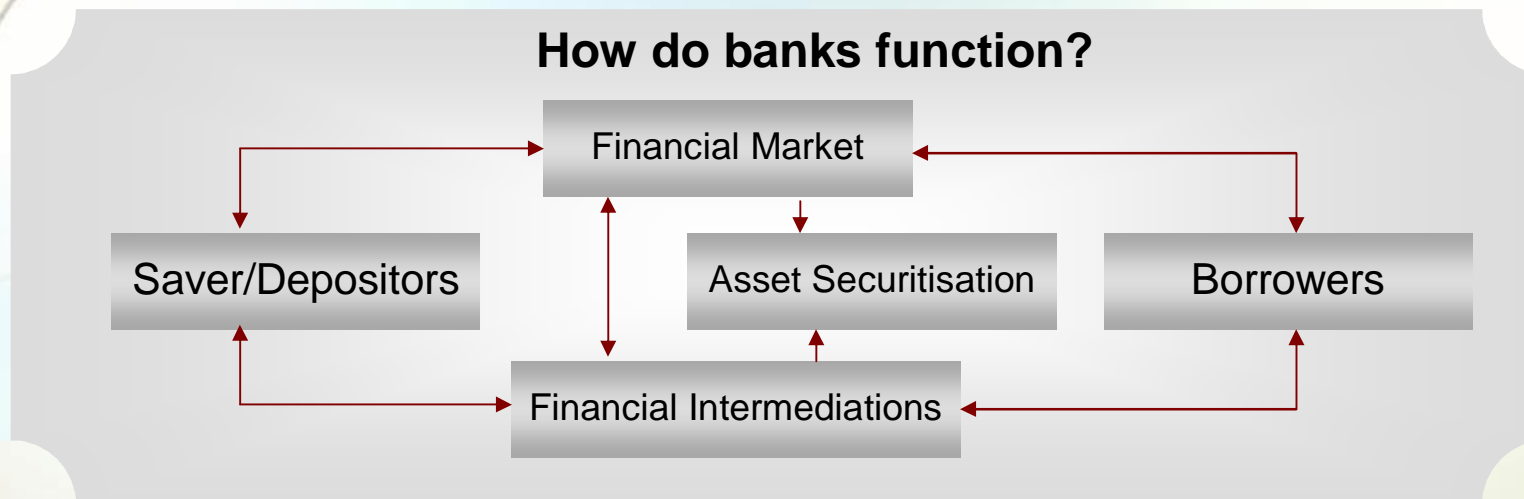
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What is special about banks?

How do banks function?



Why do banks exist?

1. Delegated monitoring
2. Information production
3. The role of banks as a 'commitment mechanism'
4. Liquidity transformation
5. Consumption smoothing

What are banks benefits?

Benefits to ultimate lenders

liquidity, simplified lending decision,
reduce transaction cost

Benefits to ultimate borrowers

loans availability, lower transaction cost
lower interest rate

Benefits to society as whole

more efficient economy ↓ rate of lending
risk ↑, improving in availability of funds

Conventional vs. Islamic Banking

CB system

IB system

Products & Services

*Universal (intermediation transaction contracts)
(Casu, Giradone & Molyneux 2006, Salamah 2006)

Income Sources

* Net interest
* Commission
(Casu, Giradone & Molyneux 2006)

* Fee

* Morabaha
* Modaraba
(Zaman, Movassaghi 2004; IFIC 2003)

* Mosharaka
* Ijara

Competitive Environment

* High competition
* High regulated
(Bergger & De Young 1997)

Restricted by:
* Shari`a Law
* Fatwa Board
(Mirakhor 1989; Hakim & Neaime 1998)

Strategic Focus

* Creating shareholder value (ROE)
• * ↑ Returns
(Powell et al. 2004; Santomero 1997)

* Growth assets
* Prohibition of interest
(Zaman, Movassaghi 2001)

* P/ L - Sharing

Customer Focus

* Demand led
* Creating value for customers
(Stomper 2005)

* Customers' satisfaction
* Customers' attitude towards
(Salamah 2006; Simon & Abdel 2006)

Elements Involved in IB Transactions

- ***Rib`a*** is prohibited in all transactions;
- Business and investment are undertaken on the basis of ***Hallal*** (legal, permitted) activities;
- Transactions should be free from ***Gharar*** (speculation or unreasonable uncertainty);
- ***Zakt***, is to be paid by the bank to benefit society;
- All activities should be in line with **Islamic principles (*shari`a*)**, with a special ***shari`a*** board to supervise and advise the bank on the priority of transactions.

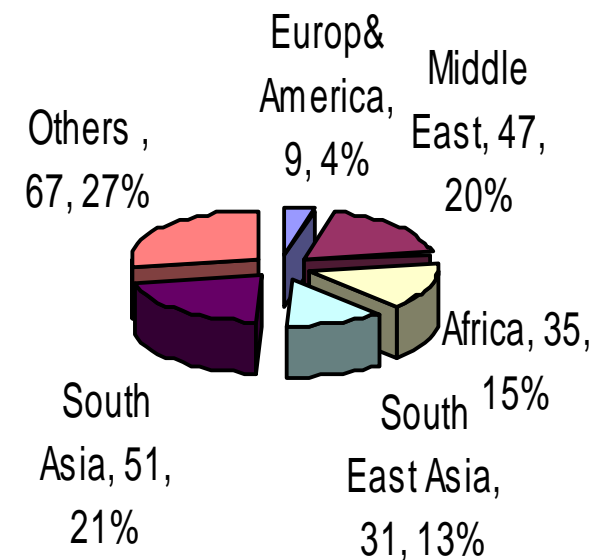
Islamic Financial Institutions

at year-end 1996 (in \$ million)



Region	Capital	Total Assets	Total Deposits	Return on assets %
South Asia	962	45,201	27,042	0.8
Africa	213	1,951	603	2.0
South East Asia	136	3,801	1,572	4.8
Middle East ¹	4,060	67,142	54,288	0.6
GCC ²	1,340	18,084	16,494	3.8
Europe & America	559	952	1,164	5.7
Total	7,270	137,131	101,163	1.2

Islamic Banks Distribution



1 - Middle East includes Egypt, Iran, Iraq, Jordan, Lebanon, Turkey, and Yemen.

2 - GCC stands for *Gulf Cooperation Council*, consisting of Bahrain, Kuwait, Qatar, Saudi Arabia, and United Arab Emirate (UAE).

SOURCE: International Association of Islamic Banks (1998), Jeddah, Saudi Arabia.

What is the research asking for?

How do banking institutions determine and assess risk factors and how do those factors influence the optimality of lending decision policies in conventional & Islamic banking systems?



- 1. How do conventional and Islamic banks determine and assess risk factors?
What factors are they? How are they measured? What is the relative importance of each factor in lending decisions?*
- 2. How do those factors influence the optimality of lending decision policies in CB & IB systems?*
- 3. Is there a difference in lending decision performance between the two banking groups?*

Objectives of the Study !

- To offer a potentially powerful tool for clarifying how risk factors influence the optimality of lending decisions in both systems.
- To realise risk factors and risk measurement methods in conventional and Islamic banking systems.
- To evaluate whether both banking systems are managing the different risk factors, and recognizing the lending and risks relationships.
- To investigate reasons beyond these issues within discussions of particular risk factors [internal / external] which influence the optimality of lending decisions.
- To present the similarities and differences between IB and CB systems in issues related to default risk field

Motivation !

- There is strong argument in Islamic countries about **starting financial transactions according to Islamic shari`a (law)**. For Muslims satisfaction, later Muslim communities want to introduce this service in their financial market (El-Hawary, Grais & Iqbal 2004) .
- Making comparison between conventional and Islamic systems about **managing risk and credit activities to provide knowledge of credit risk evaluation and management** in both systems (Tom 2004; Cowling, Marc & Westhead 1996) .
- Providing a basis for **understanding reasons for the fluctuating level of decision optimality** and which factors can be considered especially to reduce credit defaults in both systems (Powell et al. 2004) .
- **Providing a basis to avoid an increase in default loans** as a consequence of weak decisions and therefore an increase in banks' losses or deficit in their balance (Fujiwara 2003; Hakenes 2004) .

Literature Review



Islamic and conventional banking systems interface: (consistence and compare)

(Allen, L. & Saunders 2002; Krahnen & Weber 2001; Feakins 2004)

Optimal lending decision policies & financial risks

(Pastor 2002; Elsas 2003, p. 2; Harenes 2004)

Risks and performance analysis : forms and formative (management & assessment)

(Edelstein 1975; Barnhill and Maxwell 2002; Campbell and Huisman (2003, p. 121)

Profile of Risk Factors (IB & CB)

(1) Transaction risks (2) Business risks (3) Treasury risks
(4) Governance risks (5) Systemic risks

Internal Risk Factors

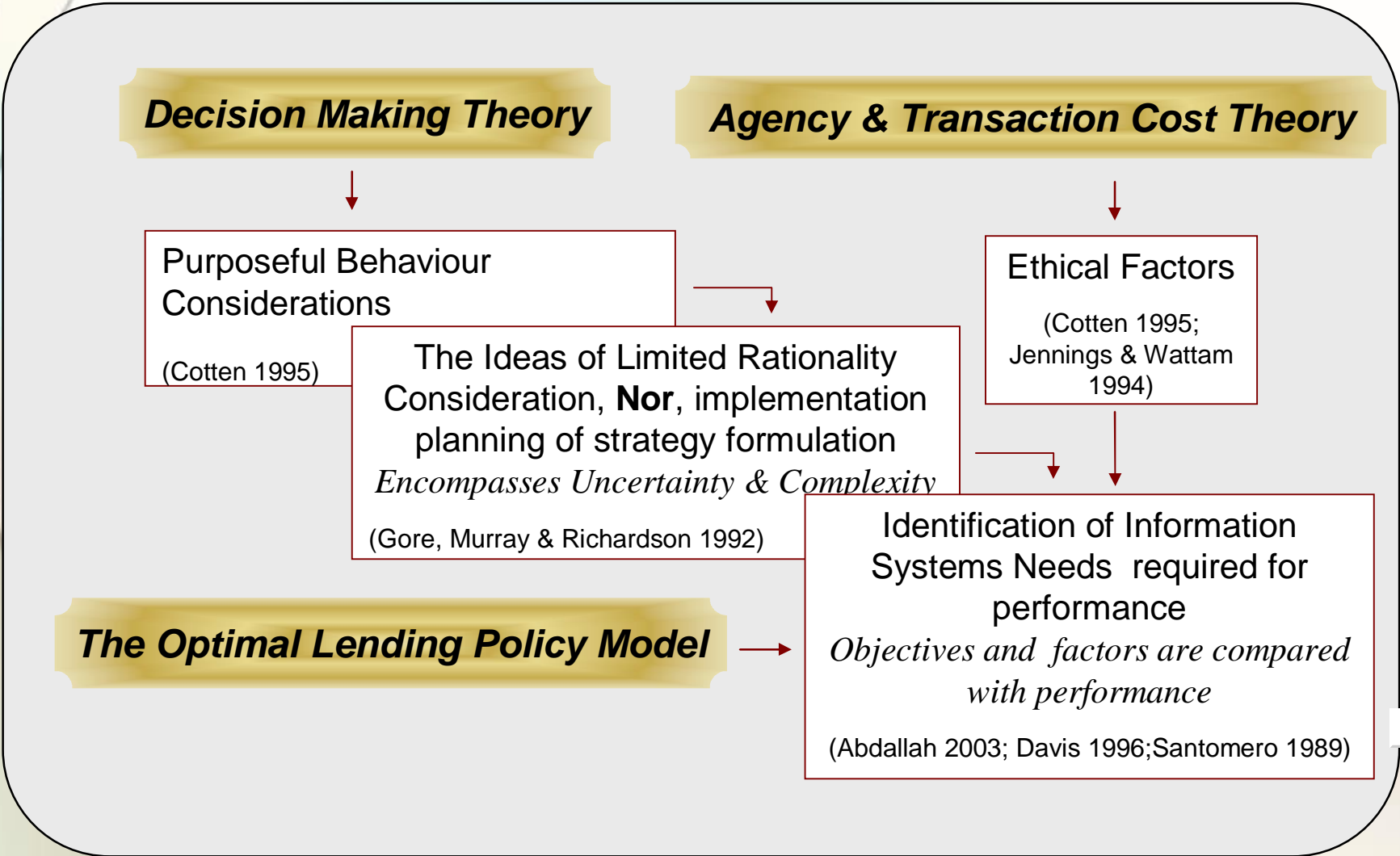
- Ø Borrower's financial condition
- Ø Profession
- Ø Loan-specific characteristics
- Ø Lender characteristics
- Ø Ratings rate
- Ø Interest rate

External Risk Factors

- Ø Regulations
- Ø Environmental
- Ø Governmental
- Ø Social culture
- Ø Market and industries
- Ø Relationships & transactional lending

Sources: Altman & Saunders 1998 ; El-Hawary, Grais & Iqbal 2004; Santomero 1984; Santomero 1997; Archer & Ahmad 2003; Chapra & Ahmad 2002; Errico & Farrahbaksh 1998; Mahmoud 2002; Zimmerman 1996; Fujiwara 2003;

Theoretical Based and Model



The Model

The optimal lending policy (d^*)

$$d^*_{(t,L,r)} = \begin{cases} 1 & \text{if } r \geq r^*(t,L) \\ 0 & \text{otherwise} \end{cases}$$

Where

$$r^*(t,L) = [U(t,L) - U(t,L+1)], \text{ and}$$

No increasing in time of loan application arrive $t \in [0, T]$, and
 No decreasing in total borrowing & lending $L = \bar{L}$ over planning period $[0, T]$

(Lopez & Saidenberg 2000; Deshmukh, Greenbaum & Kanatas 1983; Dimakos & Aas 2003)

Conceptualisation of Theoretical Framework

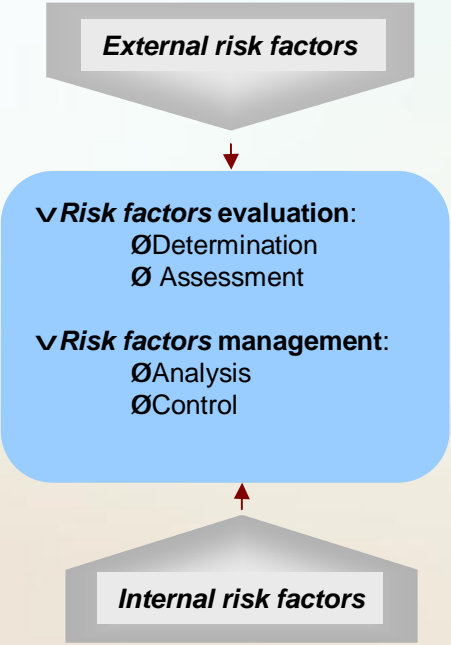
Stage 1 - demand

Stage 2 - process

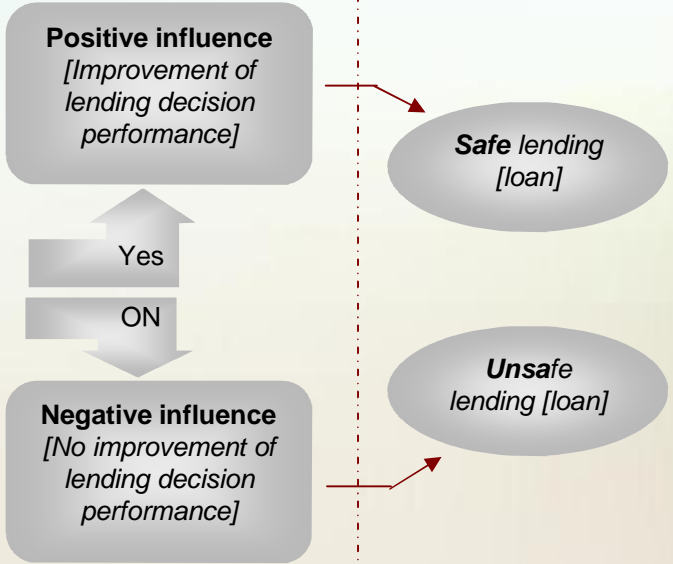
Stage 3 - making

Stage 4 - result

Loan request $1 \dots L$

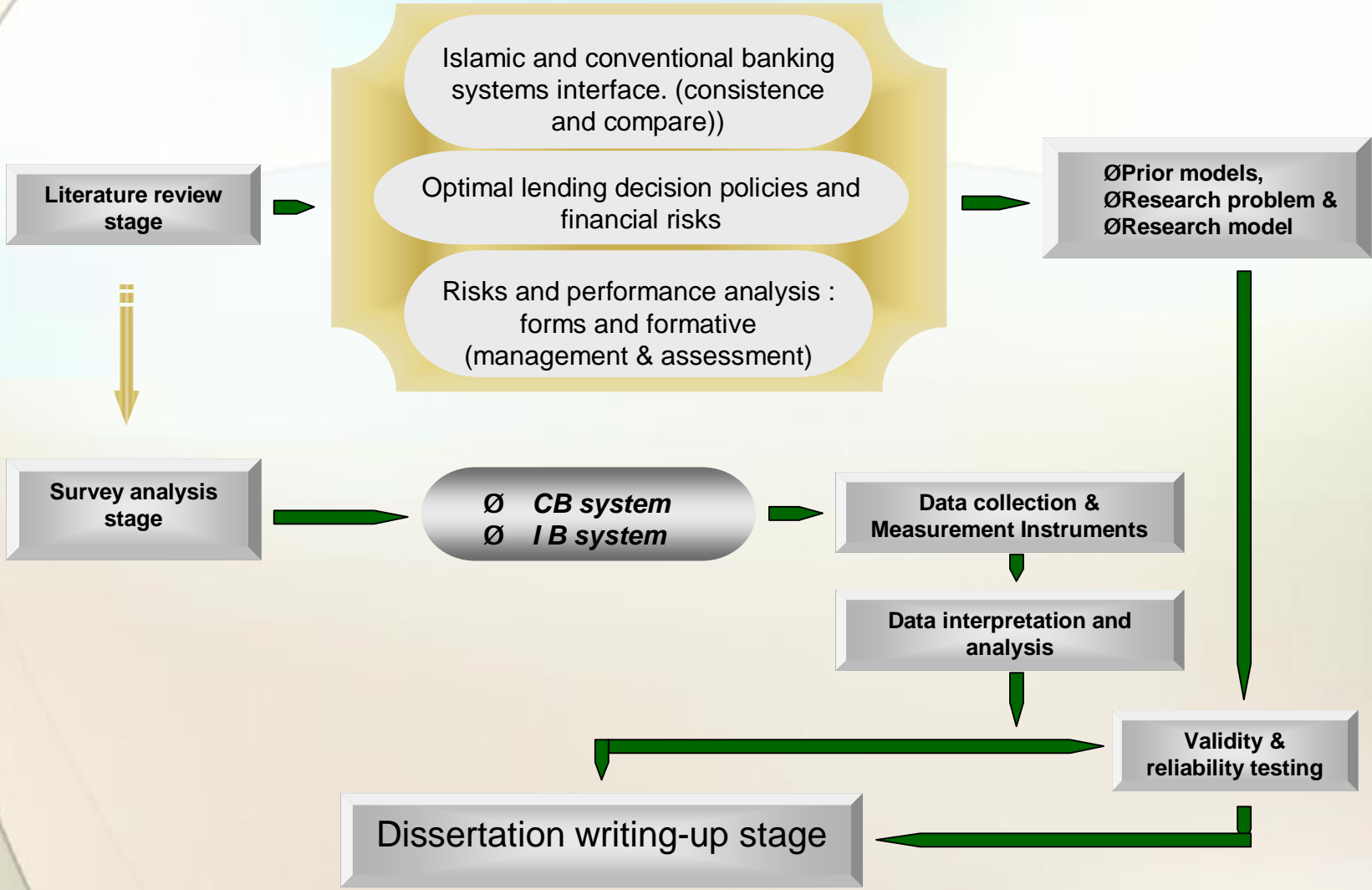


if



- H1:
- H2:
- H3:

Research Design



Research Methodology !

Research Methodology

Group 1

Group 2

Target Population

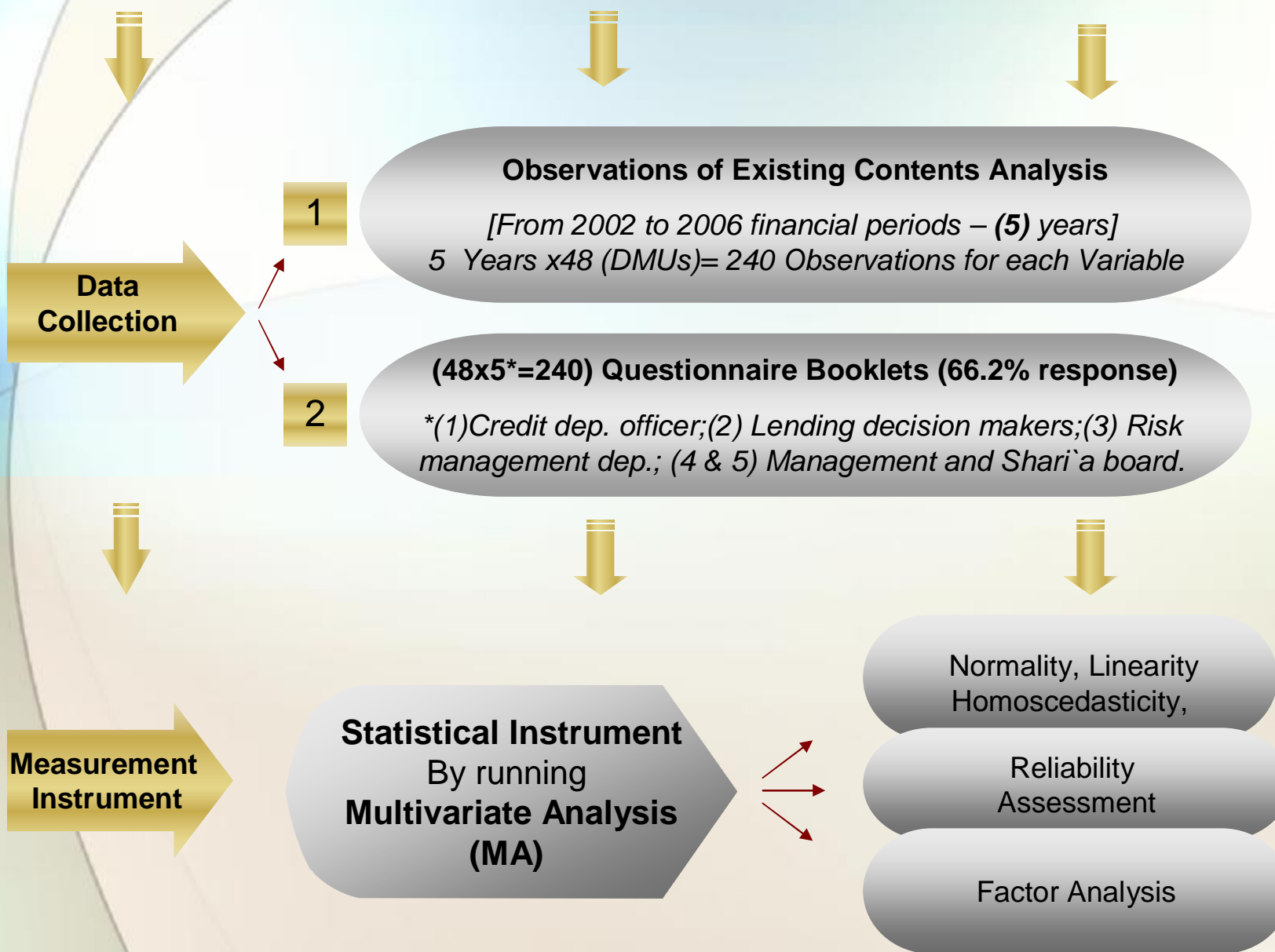
conventional system, banks in four (5) counties in Middle East
(24 banks)

Islamic system, banks in four (5) counties in Middle East region
(24 banks)

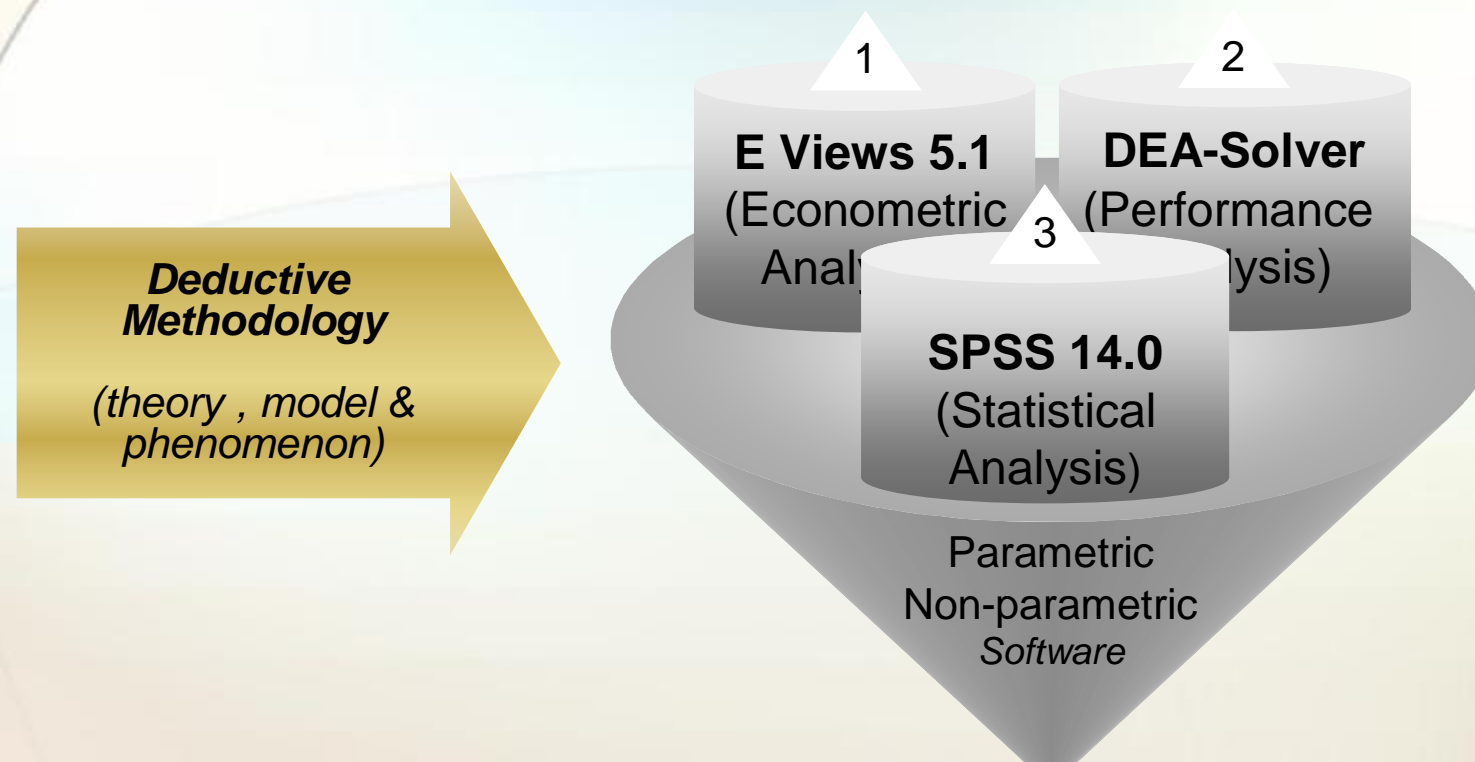
Sampling Selection

(24 = 27%) Main banks selected randomly from Libya, Bahrain, Qatar and United Arab Emirates

(24 = 66.5%) Main banks selected randomly from Libya, Bahrain, Qatar and United Arab Emirates



Data Interpretation & Analysis



- Ø Principle Component (PC): significance of relationship among Ind/dep variables
- Ø Nonlinear *Probit* model (PM): factors into decision & each factor effect outcome
- Ø Data Envelopment Analysis (DEA) : analysis efficiency of lending performance

Expected Research Contribution

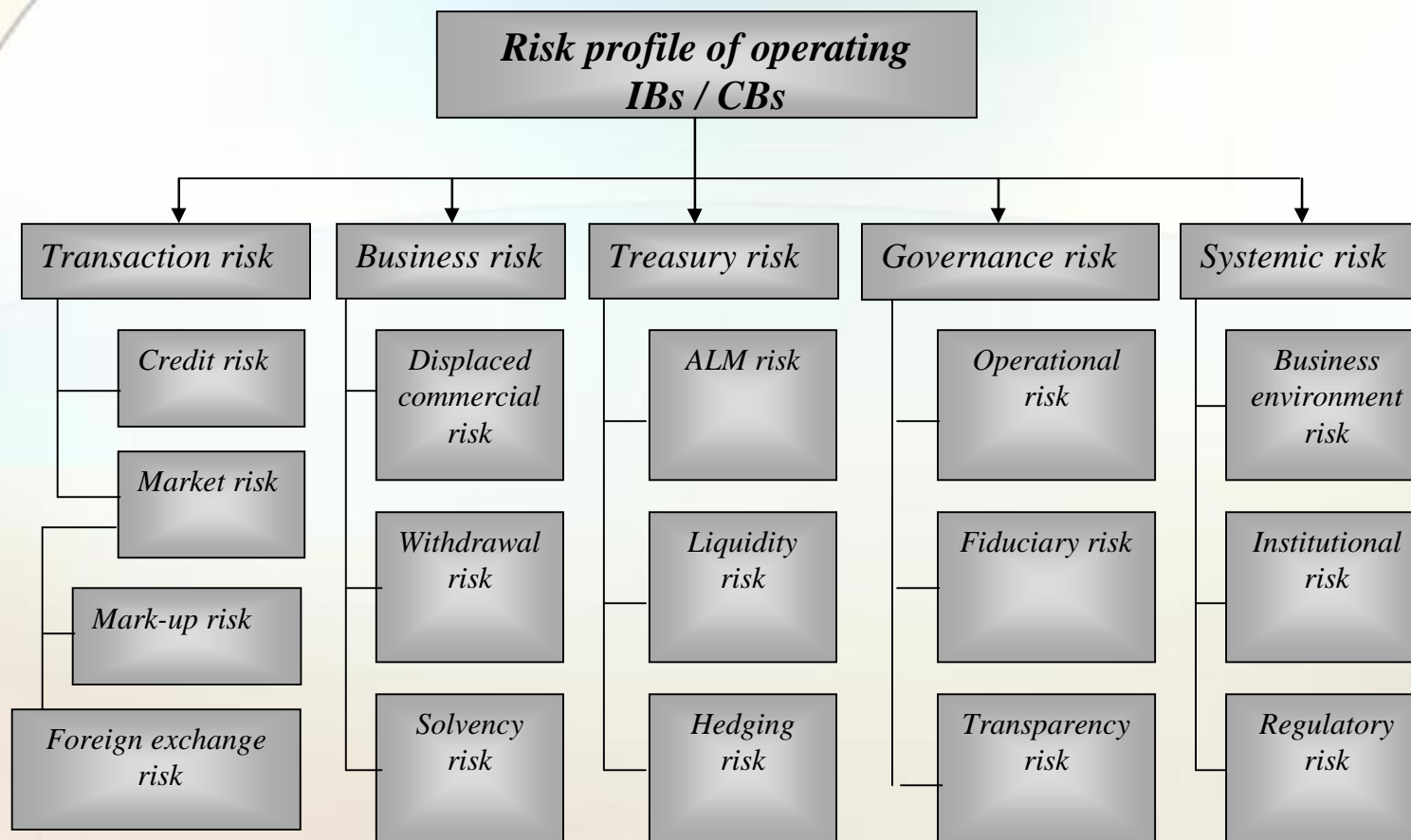
- **Extend bankers' knowledge** and aspects of operational approaches (theoretically and empirically) to manage and measure risks by understanding whole variables around making the lending decision (Koford & Tschoegl 1997; Fujiwara 2003).
- It will **increase understanding of dominating risk factors** and the difference in performance in both systems (Pastor 2002) .
- It will **help lending decision-makers** conduct effective evaluation and control for risks (Janice, Abdul & Peter 2005) .
- Clarify which system has **more ability to manage, measure, and control risk factors that may affect lending decisions.**
- The literature survey indicated there is **no evidence of a study which has been tested or applied on the factors which influence lending decisions** (Arpa et al. 2000; Megbolugbe 1993; Lane & Quack 2002) .

Conclusion (Findings Highlight)

- There is somewhat difference between CB and IB in terms of risk **visibility**, but risk **feasibility** are almost same.
- There is **no difference between CB and IB in terms of risk assessment**, but the difference revealed by using factor analysis that some risks which are **applicable** to CB, are **inapplicable** to IB (e.g. some transaction risks), and the opposite was correct (e.g. sharing risk)
- There is no specific **models of risk measurement** have been used by both to measure such types of risk.
- There is a significant **relationship between risk assessment and the failure of making a successful lending decision** (good loans), **and to some extent, these risk factors influence lending decision-making with different levels.** (the relationship not significant with some underlying risk factors)
- Overall **technical** and **scale** efficiency of IB were higher than CB, and IB experienced a best trend between 2002 - 2006 (outperformance)



***Thanks For
Participating***



Islamic Finance Instruments

Mudaraba (Trustee finance contract): *Rabb -ul- mal* (**capital's owner**) provides the entire capital needed to finance a project while the **entrepreneur** offers his *labour* and *expertise*. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by *rabb -ul- mal*. The liability of the entrepreneur is limited only to his time and effort.

Murabaha (Mark-up financing): The **seller** informs the **buyer** of his cost of acquiring or producing a specified product. The profit margin is then *negotiated* between them. The total cost is usually paid in instalments.

Musharaka (Equity participation): The **bank** enters into an equity **partnership agreement** with one or more partners to jointly finance an investment project. Profits (and losses) are shared strictly in relation to the respective capital contributions.

Kifala: It is a *pledge* given to a **creditor** that the **debtor** will pay the debt, fine or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.