ISLAMIC BANKS AND CONVENTIONAL BANKS IN THE UAE BEFORE AND AFTER RECESSION

[1]AQILA RAFIUDDIN & ZAFAR ALAM[2]

[1]Aqila Rafiuddin, Faculty, Department of Management, BITS Pilani, Dubai Campus UAE

[2]Dr.Zafar Alam, Associate Professor, College of Business Studies Al Ghurair Univeristy, Dubai UAE

ABSTRACT

Banks play an important role in the development of the economy and act as intermediaries for suppliers and investors. Globalization led to an emerging demand for various types of products and services in the financial markets particularly leading to the diversification of financial product and services, prominent among them was Islamic banking based on the principle of Shariah. UAE experienced a tremendous growth due to its Real Estate expansion had attracted investors round the Globe but with the Economic meltdown, people lost confidence in the financial markets and became more cautious in their approach towards banks. To restore public confidence and to provide stability in the flow of money, monetary authorities revised regulations and policies for a safe, transparent and efficient banking system. With the comparative analysis of Islamic Banks and Conventional Banks of the United Arab Emirates it can be concluded that Conventional banks are more profitable whereas Islamic banks are less risky and have high liquidity.

KEYWORDS: Comparative Performance, Conventional Banking, Islamic Banking, Ratio Analysis.

INTRODUCTION

Banks are one of the most important components of a thriving, developed economy and financial system of a nation. Functional banking system helps to create an effective and successful society. Banks act as an intermediary between the surplus and deficit sides of the society. The phase of tough competition in the national and international banking markets, changes towards monetary unions, technological innovations, major changes in banking environment, growing needs of the customers and other challenges of banks to make timely preparations in order to enter into new competitive financial environment had made banks to keep pace through a wide range of products and services in which Islamic banking is prominent and gaining momentum. Though Islamic banking had a history of more than three decades, post global economic crisis of 2008 had given a lot of importance to this sector of banking by the specialists of the financial system and is one of the emerging disciplines in the research activities by academicians. There is a need to focus on the relationship between Islamic banking and financial stability, as it was reported by leading market research agencies that Islamic banking was more resilient during the crisis and acted as a shock absorber. Industry specialists and academic researchers

suggest that lack of exposure to the type of assets associated with the conventional bank led to the crisis, where as the asset-based and risk-sharing nature of Islamic finance—have shielded Islamic banking from the impact of the crisis. Empirical studies and research reports show that the Islamic banks have a smaller market share in UAE but the global crisis has led to an increase in the demand for Islamic banks.

According to sources of IMF (International Monetary Fund), Islamic banking is one of the fastest growing segments in the financial industry tracking a 10-15% growth over the past decade. Islamic banking assets are estimated to grow around 15% a year to $1 trillion by 2016 globally. High growth expectation is due to the increasing demand from Muslims, growing oil revenues in the Middle East countries and attractiveness of Shariah based financial services to non Muslim investors also. Reports show attitudinal change with huge demand for Shariah-compliant products not only in the Middle East and other Muslim countries, but also globally, making Islamic Banking a global phenomenon. Besides its vast geographical expansion, Islamic banking is witnessing rapid expansion across the whole spectrum with a wide variety of financial activities including retail banking, insurance and capital market investments.

OBJECTIVES

i)   To analyze and compare the financial performance of Islamic banks and Conventional banks in United Arab Emirates with special reference to profitability, liquidity, and risk.

ii)   Understand the impact of recession on the banking system.

According to Delis and Papanikolaou(2009) investigations determinants like bank size, industry concentration and investment environment are positively related to bank's efficiency. Research on unbalanced pooled time series dataset of 23 Greek banks by Kosmidou (2008) during the period of financial integration concludes that high return on average assets (ROAA) was associated with well capitalized banks and lower cost to income ratios. When other variables like GDP and inflation were considered, it was observed that per capita GDP had a positive impact on ROAA, while inflation had a negative impact.

Five Omani commercial banks with more than 260 branches were financially analyzed(Medhat Tarawneh, 2009)and classified into cohesive categories on the basis of financial characteristics revealed by the financial ratios with an application of simple regression model to estimate the impact of asset management, operational efficiency, and bank size. It was strongly and positively influenced by the operational efficiency and asset management in addition to the bank size. These variables were positively correlated.

The development and performance of domestic and foreign banks in Arab gulf countries was studied by Mazhar M. Islam (2003). Study revealed that local and foreign banks in Arab Gulf countries have performed well over the past several years. Moreover, it was found that banks in these countries are well capitalized with a well developed and competitive banking environment.

Research in the efficiency, customer service and financial performance among Australian financial institutions (Elizabeth Duncan, and Elliott, 2004) showed that all financial performance measures like interest margin, return on assets, and capital adequacy are positively correlated with customer service quality scores.

Iqbal(2008) and Hassan and Bashir (2005)in their research concluded that Islamic banks are more efficient than conventional banks in terms of resource use, cost effectiveness, profitability, asset quality, capital adequacy and liquidity ratios than conventional banks.

A cross-country study (Al-Jarrah and Molyneux, 2005) on efficiency shows that Islamic banks are more efficient compared to conventional banks, this contrasts with the results of another cross-country study (Abdul-Majid, et al 2008) suggesting that Islamic banks have lower efficiency than conventional banks. Whereas Mokhtar et al (2008) found that technical and cost efficiency are lower for Islamic banks compared to conventional counterparts in Malaysia.

The impact of factors such as: financial development measured by financial interrelation ratio(FIR), the level of capitalization, size, age of the bank, business orientation measured by the ratio of non-interest income, and per capita GDP for Chinese commercial banks was studied by(Wum et al.2007). Results indicated that higher the levels of financial development, the better ROA performance for banks. The results also indicated a positive impact of per capita GDP on bank performance; however, a negative impact of size and business orientation on the ROA was found. (Ali,1996) compared the relative efficiency of Islamic banks with conventional banks in Bangladesh and found that the Islamic banks were relatively more efficient than conventional banks.

Samad (1999) evaluated the relative efficiency of the Islamic bank during 1992-1996, and compared with the conventional banks of Malaysia. Results indicated that Islamic banks were more efficient than conventional banks.

Investigations to identify the relationship between market structure measured by concentration and profitability of commercial banks in Malawi using time series data between 1970 and 1994 (Chirwa, 2003) found a positive relationship between concentration and performance. Determinants of the Tunisian deposit during the period 1980-1995were examined by (Naceur and Goaied, 2001) and results show the principal determinants of a bank's performance in order of importance are labor productivity, bank's portfolio composition, capital productivity and bank capitalization.

Kim and Kim (1997) conducted a comparative study on the structure-profit relationship of commercial banks in Korea and US by using of ROA and ROE to assess the profitability of the sample banks. ROA and ROE as two dependent variables and seven independent variables namely: shareholders' equity to total assets, liquid assets to assets, total loans to total deposits, fixed assets to total assets, total borrowed funds to total assets, reserves for loans to total assets and a reciprocal value of total assets. It was concluded that the banks in Korea in terms of efficiency and profitability were much

behind the US banks. The findings also indicated that the capitalization rate, reserves for loan losses, and the size of the bank were important factors affecting the profitability of the banks in both countries.

Zimmerman (1996) examined factors influencing community bank's performance in California during the early 1990s concluded that regional conditions, loan portfolio excessive reliance on lending caused decrease in the overall profitability. Lack of geographic diversification was also identified as the most important factor related to community bank's performance.

According to Yudistira (2003), empirical analysis on efficiency provides new evidences on the performance of 18 Islamic banks over the period of 1997-2000. Data extracted from balance sheets and income statements of the Islamic banks showed inefficiency of 10% for 18 Islamic banks compared to conventional banks. It was also found that Country specific factors mainly determine the efficiency differences across the sample data.

A study on efficiency measures of Islamic banks in Bangladesh (Sarker,1999) with Banking efficiency model claims that, Islamic banks can stay alive even within a traditional banking architecture in which Profit-and-Loss Sharing (PLS) modes of financing are less dominated. Further concludes that Islamic financial products have different risk characteristics and consequently need different regulations.

A Comparative performance analysis of Bahrain's Islamic banks and conventional during the post Gulf War period 1991-2001 was done by Samad (2004). Using nine financial ratios in measuring the performances with respect to (a) profitability, (b) liquidity risk, and (c) credit risk, and applying Student's t-test to these financial ratios, the paper concludes that there exists a significant difference in credit performance between the two sets of banks and found similarity in terms of profitability and liquidity between Islamic banks and conventional banks.

Research done by Kader and Asarpota (2007) utilizes bank level data to evaluate the performance of the UAE Islamic banks. Balance sheets and income statements of three Islamic banks and five conventional banks in the time period 2000 to 2004 were used to compile data for study. Financial ratios were utilized to examine the performance of the Islamic banks in terms of profitability, liquidity, risk and solvency, and efficiency. The results of the study showed Islamic banks of UAE were relatively more profitable, less liquid, less risky, and more efficient when compared to conventional counterparts. They conclude that there are two important implications associated with this finding: First, attributes of the Islamic profit-and-loss sharing banking paradigm are likely to be associated as a key reason for the rapid growth in Islamic banking in UAE. Second, UAE Islamic banks need to be supervised in a different way as the UAE Islamic banks practices and regulations are much different from UAE conventional banks.

METHODOLOGY

Data is collected from balance sheet, income statements and cash flow statements published by the leading Islamic Banks and conventional banks of Abu Dhabi, Dubai and Sharjah. Cross sectional study for a limited period of 5 years 2005-2009 is conducted. Average of both segments of the bank for

each year is calculated and compared for variables taken evaluation of profitability, liquidity and risk. Mathematically ratio analysis helps to summarize the large quantities of financial data to make qualitative judgment and compensates bank disparities. As banking firms are not equal with respect to sizes it removes disparities in sizes and brings them at par. Ratio analysis acts as a signal for the depositors and gives a clear picture in performance of the banks.

RESULTS AND DISCUSSIONS

PROFITABILITY PERFORMANCE

Financial ratios reflect the profitability of the bank, though many ratios are in this category, this paper is limited with three ratios shown below

Return on Assets (ROA) = net profit/total assets. ROA is a good indicator of a bank's financial performance and managerial efficiency. It shows how competent the management is in allocating asset into net profit. Higher the ROA, the higher is the financial performance or profitability of the banks.

Period of 2005, 2006 indicate high ROA for the conventional banks compared to Islamic banks which means higher performance and profitability was shown. However in 2007 identical growth was observed. From 2008 onwards Islamic banks gained momentum reflecting the impact of recession. For the period 2005 to 2007 ROA was nearly stable for the Islamic Banks (Figure 1 ROA)

Return on Equity (ROE) = net profits/equity. It shows a rate return on base capital, i.e., equity capital. The higher the ROE, the more efficient is the performance of the bank.

From the Figure 2 (ROE) it can be concluded that in 2005 Conventional banks were performing better than Islamic banks but from 2006 to 2009, both had shown similar trend but in 2009 the Islamic banks' performance was relatively poorer. The profitability of the Conventional banks was better than Islamic banks.

Profit Expenses Ratio (PER) = Profit before tax / Operating expenses .

Higher PER means the bank is cost efficient and is making higher profits. Measure of PER for 2005 in the conventional banks was high and gradually decreased in 2006 and 2007 where both conventional and Islamic banks had a similar pattern, but after 2008 there was improvement in the performance of the Islamic banks reflecting the investors interest towards this segment of the bank. (Figure 3PER)

LIQUIDITY PERFORMANCE

Liquidity ratio measures the Bank's ability to meet current obligations, assumed to be the most important aspect looked upon by the customers. It means how quickly the assets are convertible into cash at face value to meet demands of the depositors and borrowers. The higher the amount of liquid asset for a bank, the greater is the liquidity of the bank. The failure of the bank to meet its obligations will result in poor credit worthiness, loss of creditors and confidence. Among the various liquidity measures, the following ratios are applied in evaluation.

Loans to Deposit Ratio (LDR) = Loans/ Total Deposits

This ratio is commonly used to evaluate the performance in terms of its financial health with reference to liquidity. Bank with low LDR is considered to have excessive liquidity, potentially lower profits and less risk compared to the bank with higher LDR. Higher LDR indicates the stress taken up by the bank by offering excessive loans.

Results according to (figure 4 LDR) reveal higher value for conventional banks for period of 2005-2009 indicating high risk by providing the excess loans, whereas the Islamic banking low figures reflect risk averse nature of Islamic banks.

Loans to Asset Ratio (LAR) = Loans/total assets.

Similar to LDR, the bank with low LAR is considered to be more liquid compared to the bank with high LAR, However high LAR is an indication of potentially higher profitability but taking more risk.

Loan to Asset ratio of conventional banks for the year 2005 to 2008 were gradually increasing but after 2008 it had increased more than 4 times showing high risk and financial stress taken by the conventional banks. Low LAR of Islamic banks show more liquid and less risky situation. The LAR slightly increased after 2008 which shows the popularity among the people towards Islamic banks and increase in loans also from these banks but comparatively huge increase is shown for the conventional banks which reflects the financial stress.(Figure 5 LAR).

RISK AND SOLVENCY RATIOS

This category of ratios measures the risk and solvency of the bank, these ratios are also referred as debt of financial leverage ratios. It measures the extent to which a bank relies on debt financing rather than equity financing. It gives a clear understanding for measuring loan/credit risk performance of a bank. Two ratios mentioned below are taken for the study.

Debt- Equity Ratio (DER)

DER = Total Debt/ Shareholder's Equity.

This ratio is considered as one of the indicators of solvency closely monitored by the investors and creditors to evaluate growth prospects of the bank. In other words it is used to measure ability of bank capital to absorb the financial shocks. A bank with lower DER is considered to be better compared to the bank with higher DER.

In the year 2005 Islamic banks show (Figure 6 DER) higher values followed by the similar trend in 2006 but later years show the lower values for the Islamic banks and higher values are seen for the conventional banks reflecting better performance compared to the conventional bank and acting as shock absorber.

Debt to Total Assets Ratio (DTAR)

DTAR = Total Debt / Total Assets

This ratio measures the amount of total debt firm uses to finance its total assets. It is an indicator of financial strength of the bank. It provides information on the solvency and ability of the firm to obtain additional finance for potentially attractive investment opportunities. Higher DTAR means bank has financed its assets through debt as compared to the equity financing. Higher DTAR indicates that bank is more involved in more risky business.

DTAR was high for the Islamic banks in 2005 (Figure 7 DTAR) but later followed relatively lower trend compared to conventional banks, indicating that Islamic banks are involved in less risky business whereas the higher DTAR of the conventional banks shows their involvement in risky business

CONCLUSIONS

Findings conclude that the conventional banks are more profitable compared to the Islamic banks. High liquidity and low risk is observed in Islamic banks. Conventional banks take the stress making excessive loans. Finally it can be said that Islamic banks have shown relatively higher growth after the economic meltdown of 2008.

LIST OF FIGURES

Av IB, Av CB –Average of variables from sample of Islamic banks and conventional banks respectively. Percent –represents the total market value of that particular variables.
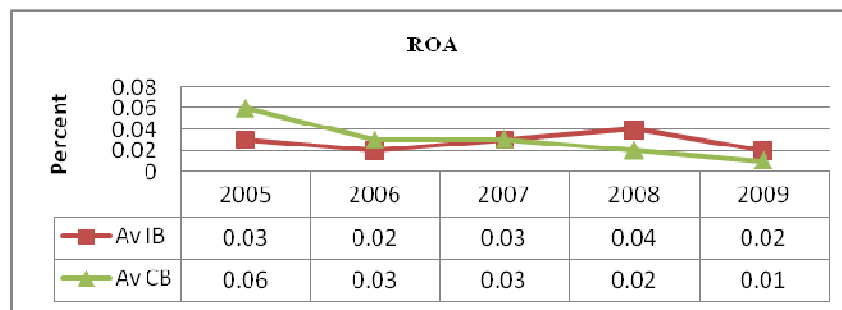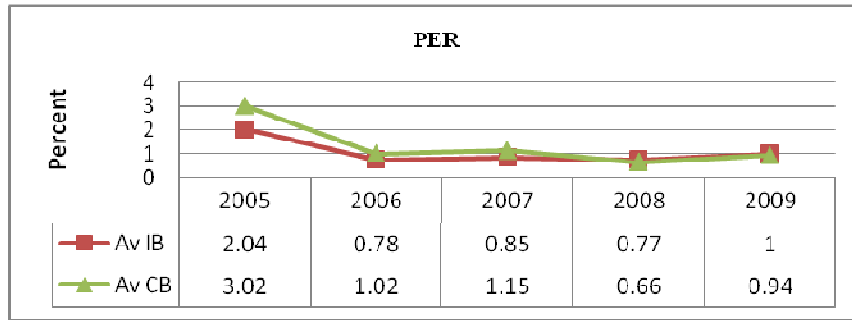

ROA	2005	2006	2007	2008	2009
Av IB	0.03	0.02	0.03	0.04	0.02
Av CB	0.06	0.03	0.03	0.02	0.01

Figure 1: ROA

ROE	2005	2006	2007	2008	2009
Av IB	0.18	0.16	0.17	0.13	0.07
Av CB	0.24	0.17	0.19	0.12	0.1

Figure 2: ROE

PER

	2005	2006	2007	2008	2009
Av IB	2.04	0.78	0.85	0.77	1
Av CB	3.02	1.02	1.15	0.66	0.94

Figure 3: PER

LDR

	2005	2006	2007	2008	2009
Av IB	0.14	0.17	0.16	0.06	0.08
Av CB	0.62	0.67	0.63	0.7	0.5

Figure 4: LDR

LAR

	2005	2006	2007	2008	2009
Av IB	0.17	0.19	0.22	0.08	0.15
Av CB	0.93	1.04	1.05	1.14	5.16

Figure 5: LAR

DER

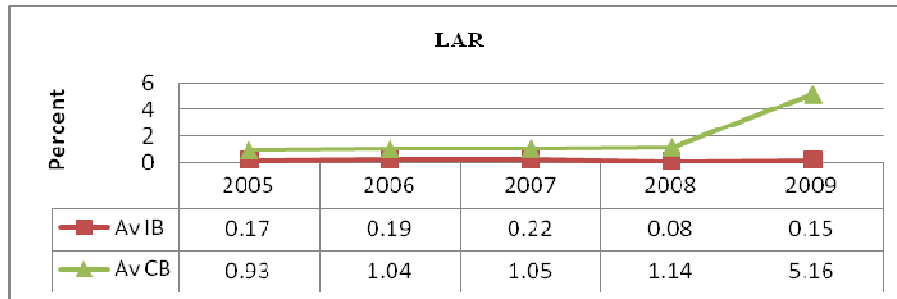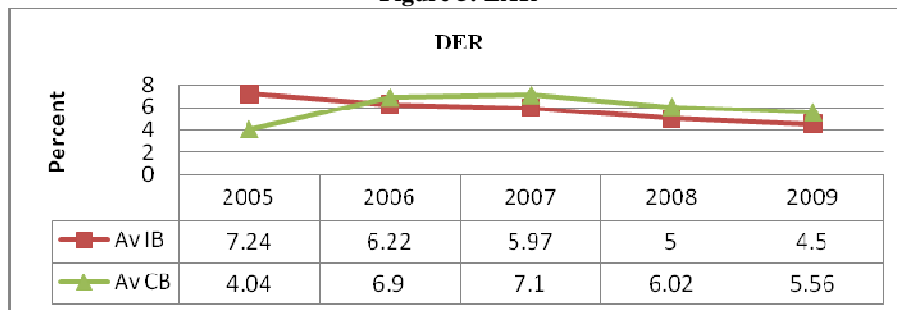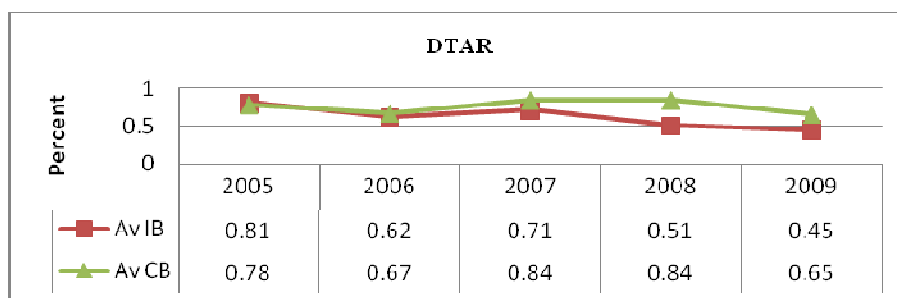|	2005	2006	2007	2008	2009
Av IB	7.24	6.22	5.97	5	4.5
Av CB	4.04	6.9	7.1	6.02	5.56

Figure 6: DER

Figure 7: DTAR

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