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Reprint of Economic turmoil and Islamic banking: Evidence from the Gulf Cooperation Council

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ABSTRACT

Using a panel of 101 banks across six Gulf Cooperation Council (GCC) economies, we investigate with the bank performance model CAMEL, whether Islamic banks outperformed conventional banks in the time of economic shocks over the period 1998–2012. We find that while Islamic banks performed better in terms of capitalisation, profitability and liquidity in the early stages of the global financial crisis (GFC), they performed worse in later stages with the real economic downturn, particularly in the areas of capitalisation, profitability and efficiency. Thus while the GCC Islamic banks may have avoided the consequences of more volatile financial instruments, they were not immune in the face of a major economic shock.

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1. Introduction

The 2007/2008 financial crisis period saw shocks across banking markets worldwide, followed by further shocks and stresses with the European sovereign debt crisis, but despite this, Islamic banking worldwide continued to grow at 10–12% per annum.¹ While most comparative Islamic and commercial bank performance literature for this period has tended to focus on the differences in efficiency performance or the differences in financial stability (Belouafi et al., 2015), our concern is with banks' financial performance.

The full effect of how the global crisis affected Islamic banks is not clear, particularly in the areas of asset quality, quality of management and liquidity. There is some suggestive evidence. The focus of the Hasan and Dridi (2010) study based on a sample from Gulf Cooperation Council (GCC) countries, Turkey and Malaysia for the years 2007–2009, was specifically: change in profitability, credit and asset growth and external ratings. Their results suggested that the profitability of Islamic banks declined further than for commercial banks in 2009 and that, the credit and asset growth of Islamic banks was higher than conventional banks in 2008–2009, and that external rating agencies re-assessment of Islamic banks was more favourable. There are some suggestions as to why that might have occurred. Ariss (2010) as with Beck et al. (2013) reported that Islamic banks allocate more assets to financing than conventional banks and hold more capital, but also that the competitive environment is less onerous for Islamic banking.

Hussein (2010) considered a GCC comparative sample between the years 2000–2007, and reported that Islamic banks held more capital and liquidity, and had higher consumer confidence than with regional conventional banks. Nevertheless, this does

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¹ World Bank, Islamic Finance, 15 March accessed at <<http://www.worldbank.org/en/topic/financialsector/brief/islamic-finance>>, 17 January 2016.

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not include the global crisis period. Beck et al. (2013) find few differences between Islamic and conventional banks, despite differences in business models. They report that Islamic banks were less cost effective but had a higher asset quality. However, their sample covered 22 fairly heterogeneous countries rather than focusing on a more homogeneous region.

Since the 1980s, the Islamic and conventional banking systems in the GCC region have both grown in step with the expansion of oil and gas development and production. Islamic banking has tended to be strong in the GCC region, growing at 16.1% from 2010 to 2014 (Ernst and Young, 2016). Meanwhile in the post-global crisis era of 2009 to 2012, GCC Islamic bank compound annual asset growth was 11% whereas conventional bank growth in the same market was 6.8% (Union of Arab Banks²). In 2012, the GCC accounted for some 66.2% of Islamic banking assets worldwide (Ernst and Young, 2015). Nevertheless, growth rates have not picked up and were less than 10% in 2014, no doubt reflecting the reductions in oil prices. This has led to calls for the Islamic banks in the region to expand overseas to maintain their rates of return (Potter and Solovieva, 2014).³

The 2008 global crisis followed by the 2014 drop in oil prices led to calls from the IMF for countries in the GCC to become more diversified (IMF, 2014). The uncertainty in regards to oil in particular has therefore left the GCC region more vulnerable than in the previous few decades. A comprehensive study of the performance of banks during the whole period may help us understand the likely impact of future financial crisis on the region's financial institutions.

The literature thus lacks a comprehensive study of the performance of Islamic and conventional banks in the GCC region with due consideration to the financial crisis and recovery period. We approach this by using the well-known CAMEL indicators developed by the Federal Deposit Insurance Corporation (FDIC) as part of their assessment of how much effort to expend in regards to bank supervision, with initial adoption as part of the Uniform Financial Institutions Rating System (UFIRS) from November 1979.⁴ The benefits from considering the performance of banks according to CAMEL is two-fold: it is a multi-faceted approach that can cover a wide range of performance characteristics; but also because of its wide usage in the literature it can both consolidate and extend previous findings.

Using multiple econometric estimators, namely, fixed effects as well as the dynamic panel generalized method of moments (GMM), we examine GCC bank performance according to CAMEL indicators during the global crisis and in the following recovery period. Results suggest that in the early phases of the GFC, Islamic banks outperformed conventional banks in terms of capitalisation, profitability and liquidity, as well as in narrowing the gap in efficiency, with no significant difference in asset quality.

The remainder of this paper is organised as follows: Section 2 considers the literature, Section 3 presents the data and methodology, Section 4 contains the results and Section 5 presents the conclusion.

2. Literature Review

2.1. Exposure of Conventional and Islamic Banks to the Global Crisis

The global crisis, which began in the U.S., led to various studies that tried to understand the characteristics of surviving banks. For instance, Cole and White (2012) found that commercial banks in the U.S. that survived had more capital, a higher asset quality, higher earnings and more liquidity. Meanwhile Beltratti and Stulz (2012) considered a cross-country sample and suggested that large commercial banks that performed well during the global crisis had more Tier 1 capital, more deposits, less exposure to U.S. real estate funding and less short term funding.

Some of the unique characteristics and practices pertinent to Islamic banks may have helped insulate them from the financial crisis. Warde (2012) for instance suggested that Islamic banks survived the first phases of the crisis because of restrictions imposed and practices of Shariah boards. The prohibition of *riba* (usury law) prevents the receipt or payment of any pre-set fixed rate of return on money borrowed or lent (Khan, 2009). This principle implies that the toxic assets considered the main cause of the global crisis do not comply with basic Islamic finance principles, as they are based on interest and debt-selling activity. According to Siddiqi (2009), these instruments do not comply given their lack of transparency and information asymmetry regarding potential risks, as well as the opaque and complex 'innovative' instruments for transferring the risk of default from financial institutions to the buyers of those instruments.

On the other hand, Islamic banking does not operate in a vacuum and is part of the global financial system, which can still lead to risks. Islamic banks lack sound risk mitigation tools due to restrictions on interest-based products. When managing liquidity risk for instance, the use of the interbank market and government securities are prohibited as are other risk management tools such as options, futures and forward contracts. These restrictions increase the operational risk for Islamic banks (Sundararajan and Errico, 2002). Islamic banks also tend to be generally smaller than conventional banks, so it can be assumed that Islamic banks operate in an environment of cost disadvantage and higher risk.

Even though the GCC has the largest proportion of Islamic banking assets worldwide, with some 66.2% of worldwide Islamic banking assets as of 2014 (Ernst and Young, 2015), they still constitute a relatively small segment of the banking sector in comparison with their conventional peers. This may place pressure on them to generate returns conforming to conventional banking practices. This explains their reliance on some widely used conventional benchmarks, such as the London Interbank Offered Rate

² Recent global developments of Islamic banking and finance are available at <http://www.uabonline.org/en/research/financial/recentglobaldevelopmentsofislamicbanking/7471/0>, accessed 28 December 2015.

³ The exception is for Saudi Arabian banks where domestic opportunities are still expected.

⁴ See for instance: <https://www.fdic.gov/regulations/laws/rules/5000-900.html>.

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