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# How profitability differs between conventional and Islamic banks: A dynamic panel data approach

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## ABSTRACT

This paper analyzes and compares the dynamics for the profitability of conventional banks and Islamic banks in the Organization of Islamic Cooperation countries and the United Kingdom between 2007 and 2013 using a sample of 74 Islamic and 354 conventional commercial banks. “Net interest margin” and “return on asset” are employed as variables representing the profitability and several new explanatory variables are introduced such as, the usage of self-service banking channels, penetration of financial services, crude oil/agriculture price indexes and asset ratio of non-*Murabahah* assets of Islamic Banking. Dynamic panel data estimates indicate that almost all explanatory variables of profitability for conventional and Islamic banks are different implying that profitability of Islamic banks relies on the different dynamics than that of conventional ones. Both profitability measures are not persistent over time and neither of them has significant relationship with the country specific macroeconomic variables. Estimation results imply the importance of new product and alternative channel development in enhancing the profitability of Islamic banks. Moreover, our analysis shows that the usage of products which promotes more risk sharing as compared to the products based on *Murabahah* structure can contribute to the performance of Islamic banks.

## 1. Introduction

The purpose of this paper is to compare and contrast the dynamics for the profitability of Islamic Banks (IBs) and conventional banks (CBs) so as to contribute to the analysis of current Islamic banking phenomenon in the Organization of Islamic Cooperation (OIC) countries and the United Kingdom (UK). Islamic finance, as an alternative approach to conventional finance practices, has gained a remarkable momentum in recent years. According to the ICD Thomson Reuters (2015) and Islamic Financial Services Board (2016) data the global size of Islamic financial assets is predicted to grow from 861 USD billion to more than 1.88 USD trillion from 2008 to 2015. This corresponds to a compound annual growth rate around 12%. As the flagship sector of Islamic finance industry, Islamic banking activities constitute around 74% of all Islamic financial assets as of the end 2014.

As per the county-wise distribution of Islamic finance assets, three countries come forward, namely Malaysia, Saudi Arabia, and Iran. These three countries host almost two thirds of Islamic financial assets worldwide. Gulf countries like the United Arab Emirates (UAE), Kuwait, Qatar, and Bahrain are other prominent markets in terms of Islamic finance holding almost one fourth of global assets. Countries, like Turkey, Indonesia, Bangladesh, Pakistan and Sudan are other important markets. Recent developments in markets like

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the UK and Luxemburg displayed that Islamic finance is not a phenomenon just confined to Muslim majority countries given the recent trend in some Western developed markets.

Besides the prohibition on interest receiving and taking (*Riba*), gambling (*Maisir*), excessive uncertainty (*Gharar*) and restriction on investing on some sectors producing products prohibited under Islamic jurisprudence, what makes Islamic finance peculiar is that even the financial contracts should be established based on assets through the principle of profit-loss-sharing (PLS). The requirements of these principles are to be fulfilled through some contractual obligations which are constructed upon buying and selling of (*Murabahah*), leasing (*Ijarah*) of or partnership in (*Musharakah/Mudharabah*) in an asset or a portfolio of assets (Iqbal and Mirakhor, 2011). It is argued that it is this PLS structure contributing to the capacity of Islamic banks in absorbing external shocks as compared to their conventional counterparts (Khan and Mirakhor, 1989) and to the capacity of adding to the overall economic growth by enabling long-term funding (Chapra, 1992; Imam and Kpodar, 2015). The advantageous nature of the PLS model employed by IBs has empirically supported by Hasan and Dridi (2010).

Despite those conclusions about the business model of Islamic banking the daily practice of IBs has always been a matter of discussion. Theoretically, it is assumed that the business model that should be employed by IBs which promotes profit and risk sharing both at the asset and liability side through rather asset based or asset-backed, partnership-like contractual structures. However, in practice, the contractual relationships constructed between IBs and their customers on the asset side are mostly based on transactional structures such as *Murabahah*, which leads to the conclusion that the behavior of IBs are alike to the CBs (Khan, 2010; and Azmat et al., 2015). On the liability side the relationships are usually established similar to the ones at CBs. This situation does also support the view that the operations of IBs are very similar to the CBs so that there would be no difference between the dynamics determining their performances (El-Hawary et al., 2007).

Besides the issue of the difference between the theory and practice of Islamic banking there are issues how Islamic banks fit in the overall banking and finance environment in terms of regulatory framework. Whether Islamic banks should be subject to different regulatory framework as compared to conventional banks, how the regulatory framework should be established and how different regulations affect the efficiency and profitability of IBs are some of the important themes (Song and Oosthuizen, 2014; Mejía et al., 2014; Bitar, 2014; Solé, 2007). The conclusions point into the differences in the regulatory practices across countries where Islamic finance activities are available, into the need for enhanced standards for the regulation of Islamic finance activities and into the different effects of similar regulatory frameworks on the efficiency and performance of IBs as compared to conventional financial institutions. Meanwhile one important point in this regard is the need for standardization in the Sharia governance practices for various Islamic finance activities. (Godlewski et al., 2014).

Questions such as of what are the dynamics of the performance of IBs and whether there are differences in those dynamics as compared the CBs have started to be asked more frequently due the recent growth trend in Islamic finance and banking industry. However, the aforementioned issues make it hard to analyze Islamic banking, their model, profitability and efficiency. Some empirical comparisons of IBs and CBs conclude that Islamic Banks have better asset quality, are better capitalized but have few business model differences (Beck et al., 2013), are more resilient to the financial crises (Hasan and Dridi, 2010; Beck et al., 2013) and can be distinguished via financial ratios (Olson and Zoubi, 2008). Khediri et al. (2015) also differentiate IBs via credit and insolvency risk, operating leverage and off-balance sheet activities but profitability and liquidity ratios are not very much different.

The main purpose of this paper is to contribute to the related literature by investigating the dynamics of performance for IBs in comparison to the CBs. Employing a dynamic panel data approach for a sample of 74 IBs and 354 CBs in the OIC countries and the UK for the period between 2007 and 2013, the study aims to reveal;

- key factors affecting both conventional and Islamic bank profitability using the dynamic panel data approach,
- how usage of self-service banking channels, level of financial penetration, Islamic Finance development within a country affect the profitability of banks, and
- how the breakdown of instruments of Islamic banks contributes to their profitability.

To a great extent, some findings of the study regarding the dynamics of CBs in the OIC countries and the UK turned out to be mostly in line with previous studies. However, our results for IBs imply important differences as respect with the existing literature. For instance, the estimation results imply that the profitability ratios used in the analysis turned out to be not persistent over time. In addition, unlike some studies in the literature, some explanatory variables used to explain the variations in the performance of IBs are found out to be insignificant in the analysis. For instance, the key determinants of net interest margin (NIM)<sup>2</sup> such as operation costs and loan to assets seem to have no significant effects for IBs. Further, considering the fixed effect estimations, the most widely used technique in the literature for IBs, and the GMM estimation results are substantially different. One of the main contributions of the study has thus been the usage of panel data method for the analysis, which provides the substantial evidence that the analysis of the performance dynamics of IBs is sensitive to the methodologies employed.

The rest of the paper is organized as follows: Section 2 summarizes the existing literature on the performance of IBs as compared to CBs while Section 3 describes the data set, statistical model, and variables. Section 4 reports the descriptive statistics and discusses

<sup>2</sup> Even though IBs do not engage in interest-bearing contracts and operations, the NIM concept can also be applied to them since NIM is a ratio related to the difference between revenues from financing operations and costs of those activities. In case of IBs, the revenues stand for revenues generated via investing and lending activities while the cost of financing may include the profits distributed to depositors or investment account holders. Therefore, within the study the performance measure of NIM has been used both for IBs and CBs in order for keeping the terminology simple and intact.

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