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Risk and profitability of Islamic banks: A religious deception or an alternative solution?

Naama Trad^a, Mohamed Ali Trabelsi^{b,*}, Jean François Goux^c

^a *Groupe d'Analyse et de Théorie Economique Lyon St.Etienne (Gate-LSE), 93 Chemin des Mouilles, 69130 Écully, France / University of Tunis El Manar, Tunisia*

^b *Faculty of Economic Sciences and Management of Tunis, University of Tunis El Manar, Campus Universitaire Farhat Hached - B.P. 248, El Manar II, 2092, Tunisia*

^c *Université Lumière Lyon II, 18 Claude Bernard, 69365, Lyon Cedex 07, France*

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ABSTRACT

The aim of this paper is to examine whether Islamic finance could be an alternative to the traditional financial system and could guarantee stability in times of crisis. To this end, 78 Islamic banks in 12 countries have been studied over the 2004–2013 period. A series of bank-specific and other country-specific indicators are combined to explain the soundness of Islamic banking in terms of profitability as measured by ROA and ROE, and risk divided into credit risk measured by IMLGL and EQL, and insolvency risk measured by Z-SCORE. The aim is to estimate five regressions using dynamic panel data econometrics (GMM system). The results indicate that bank size and capital are the main factors responsible for increasing profitability and stability of Islamic banks and reducing their credit risk. However, the ratios forming the variable liquidity and asset quality often lead to inconclusive results. It is also found that macroeconomic variables, except inflation, are able to improve Islamic banks' stability. This is not the case for credit risk where the ratio is still unfavorable.

The conclusion is that there are no major differences between IBs and CBs in terms of their profitability and risk features.

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1. Introduction

The subprime lending crisis that shook the world in 2007 showed the limits of the traditional financial system (Fakhfekh, Hachicha, Jawadi, Selmi, & Idi Cheffou, 2016; Trabelsi, 2011). All financial institutions have been destabilized and the economy was crippled while the Islamic financial system kept its stability and sustainability (Ftiti, Nafti, & Srairi, 2013; Mat Rahim & Zakaria, 2013). The emergence of this crisis and the economic recession that followed have raised several questions about the role of banks in such an incident and led various stakeholders to seek solutions to financial failures (Bourkhis & Nabi, 2013; Rosman, Abd Wahab, & Zainol, 2014). Therefore, special attention has been given to Islamic finance as a remedy for a system that continues to present difficulties by questioning its strength and ability to absorb the turmoil dominating the financial landscape (Hasan & Dridi, 2010; Said, 2012; Zarrouk, 2012). Survival and sustainability of these banks attracted the attention of everyone. Several studies claim that the current financial crisis could have been avoided if Islamic finance

was introduced instead of conventional finance because it provided alternatives and promised a better future for humanity (Beck, Demirgüç-Kunt, & Merrouche, 2013; Choong, Thim, & Kyzy, 2012). According to them, to ensure the effective functioning of the global financial system, the shortcomings of conventional finance need to be addressed. Hence, valuing Islamic finance appears to be a cure to various problems.

Experts and ethical finance supporters have always claimed that an Islamic bank (IB) free of interest is not only fair, but is also more stable with a higher capacity for shock absorption than a conventional bank (CB) (Ftiti et al., 2013; Mat Rahim & Zakaria, 2013; Zehri & Al-Herch, 2013). However, some studies have questioned the effectiveness of Islamic finance by suggesting that shock absorption capacity and prevention of crises is limited (Ariff, Bader, Shamsher, & Hassan, 2008; Said, 2012). With the trust crisis that currently prevails the world of finance, better risk management has become a need. Since IBs are now part of the global banking landscape, they are concerned by this need. In light of these events, banking crisis and Islamic finance are more than ever at the heart of the debate. The former is an adverse event because of poorly mastered risk-taking and deterioration of solvency while the latter presents itself as a possible alternative for funding national and international projects. Lack of consensus on the strength of these banks calls for

* Corresponding author.

E-mail address: daly1704@yahoo.fr (M.A. Trabelsi).

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more specific attention. This is one of the issues behind the motivation of this study to examine specifically the strength of IBs in times of crisis and also, to determine whether Islamic finance could be a true growth vector that deserves to be an alternative or just a financial system at its preliminary stages.

The methodology consists of combining a series of micro and macro variables and testing their effects on the profitability and risk of 78 IBs in 12 countries of the MENA region and Pakistan, known by a strong presence of IBs over the 2004–2013 period. The selected period takes into account the effects record before and after the 2007 subprime crisis. Indeed, since the aftermath of the credit crunch and the global financial crisis (2007–2009), CBs have been severely criticized, while IBs became increasingly considered as an alternative form of banking. The parameters are estimated by the GMM system method.

The second section consists of a review of the literature dealing with the strength of IBs during the global financial crisis. The description of data and methodology are discussed in the third section. Results are analyzed in the fourth section, followed by conclusion and implications.

2. Banking crises: a literature review

Several researchers have studied the profitability of IBs (Choong et al., 2012; El Khamlichi, Sarkar, Aroui, & Teulon, 2014; Fun Ho, AbdRahman, Muhamad Yusuf, & Zamzamin, 2014; Hasan & Dridi, 2010; Jawadi, Jawadi, & Louhichi, 2014; Mat Rahim & Zakaria, 2013; Onakoya et al., 2013) and their level of risk (Bourkhis & Nabi, 2013; Rajhi & Hassairi, 2013) and this is by combining micro- and macro-economic indicators and making a comparative analysis with the conventional financial system.

Using ordinary least squares (OLS), Wasiuzzaman and Tarmizi (2010) examined the impact of internal and external factors on the profitability of 16 Malaysian IBs. The study concluded that, unlike the sign of the liquidity variable, assets quality and capital negatively affect bank profitability, which is inconsistent with the results of Kosmidau, Tanna, and Pasioures (2005). Choong et al. (2012) found a positive effect of credit risk, concentration and liquidity on the performance of 13 Malaysian Islamic commercial banks. Similarly, using multivariate regression models, Akhtar, Ali, and Sadaqat (2011) found that capital ratios have a significant positive impact on the performance of IBs in Pakistan during the 2006–2009 period, unlike the variable bank size which acts negatively on the performance of these institutions. However, despite inflation and the official exchange rates that have led to financial instability, Rajhi and Hassairi (2013) found that bank size, its liquidity and GDP growth have contributed to banking stability. However, Asharaf, Rizwan, and L'Huillier (2016) found that GDP growth has no significant effect on the financial stability of 136 IB over the 2000–2013 period. Likewise, using a GLS regression and the CAMELS model, Rashid and Jabeen (2016) studied the performance of a group of IBs and CBs during the 2006–2012 period. The results indicate that the impact of GDP and credit interest rate on performance is negative for the groups of banks. However, bank size positively yet insignificantly affects their performance.

After an inter-period comparison (before and after the crisis) of 20 IBs of the GCC countries, Zarrouk (2012) showed that bank-specific factors have a negative impact on banking performance in 2008. However, when real economic activity was affected by the crisis in 2009, a sharp decline in profitability and liquidity was recorded for IBs in Bahreïn, UAE and Kuwait. However, excessive risk-taking was observed for IBs in UAE during and after the crisis compared to other countries.

To reach more robust results on the financial stability of Islamic banking, some researchers have conducted comparative studies

with conventional banking. Indeed, Beck et al. (2013) compared 88 IBs to 422 conventional banks (CBs) in 22 countries where both groups of banks coexist over the period 1995–2009. The results of this study show that IBs are better capitalized and have better asset quality and an ability to take risks. Moreover, Mat Rahim and Zakaria (2013) compared the stability of a group of Malaysian IBs and CBs during the period 2005–2010 using the Z-score and NPL as proxies for financial stability. These authors found that IBs are more resistant in times of crisis compared to CBs. These findings are in line with the work of Onakoya et al. (2013) and Zehri and Al-Herch (2013) who found that IBs are more profitable and stable during the 2007–2008 crisis because of *Shariah* requirements. However, these conclusions are not always checked like in a comparative analysis of the performance of 3 IBs and 6 CBs in Egypt over the period 2008–2010. Indeed, Fayed (2013) showed the superiority of CBs in terms of liquidity, credit risk management, solvency and profitability. Similarly, Miah and Sharmeen (2015) showed that CBs are more efficient in managing cost than IBs. In terms of financial risk, Jawadi, Chaffou, and Jawadi (2016) showed that there are only a few significant differences between IBs and CBs.

Bearing the above assumptions in mind, the following three hypotheses can be formulated and tested, using econometric regressions.

- H₁.** There is significant relationship between profitability of IBs and micro and macro-economic indicators.
- H₂.** There is significant relationship between insolvency risk of IBs and micro and macro-economic indicators.
- H₃.** There is significant relationship between credit risk of IBs and micro and macro-economic indicators.

3. Data and methodology

Unlike previous studies, this is a study on the strength of IBs in terms of both risk and profitability. The sample consists of 78 IBs in 12 countries of the MENA region with the addition of Pakistan noted by MENAP (Table 1) over the 2004–2013 period. The sample is large enough to provide reliable conclusions. Data are taken from the Bankscope base.

3.1. Definition and selection of variables

To evaluate the financial and banking system, taking profitability and risk indicators as dependent variables seems useful. A bank is said to be stronger than another if it is stable with a higher capacity to absorb risks, on the one hand, and increased performance on the other hand, during a crisis.

Table 1
Country included in the sample.

	List of country	Number of IB
1	Yemen	3
2	Iraq	5
3	Bahreïn	19
4	UAE	10
5	Kuwait	7
6	Saudi Arabia	3
7	Qatar	4
8	Pakistan	4
9	Jordan	3
10	Iran	12
11	Sudan	4
12	Turkey	4
	Total	78

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