

# Efficiency and stability: A comparative study between islamic and conventional banks in GCC countries

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## Abstract

This research aims at examining the differences between Islamic and conventional banks in terms of business orientation, stability, and efficiency. Data for this research are collected from 48 conventional banks and 28 Islamic banks of the Gulf Cooperative Council (GCC) countries over the period 2005 to 2014. Collected data are analyzed using accounting ratios, Stochastic Frontier Analysis (SFA), and ordinary least square (OLS) regression technique. Results show that conventional banks are more efficient in managing cost than their Islamic counterparts. However, Islamic banks are more solid in terms of short-term solvency but no such difference exists as far as the long-term stability is concerned. Regression estimation further shows that the operations of Islamic banks are different from their conventional counterparts and the results remain statistically significant even after controlling for bank specific variables. Moreover, larger banks have less intermediation ratio which indicates diseconomies of scale. Results also indicate that highly capitalized banks are more stable but cost inefficient which proves that capital-rich banks have failed to capitalize on the leverage effect.

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## 1. Introduction

Comparative studies between Islamic and conventional banks have been growing with renewed interest especially after the recent worldwide financial meltdown that was triggered by the US subprime mortgage crisis. The crisis resulted in the collapse of large financial institutions, bailout of banks by national governments, and downturns in stock markets. Scholars, in the post-crisis period, are increasingly interested to assess if profit and loss sharing based Islamic banking is more stable than their conventional counterparts (Čihák & Hesse, 2010; Smolo & Mirakhor, 2010; Farooq & Zaheer, 2015). Stability of a bank can be defined as the ability to withstand against adverse internal and external economic and financial shocks or the ability to meet promised obligations without outside interference.

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In the conventional banking model, risks are reflected in both asset and liability sides of a bank's balance sheet. Banks collect funds by selling deposits and lend these funds to borrowers for investment. There is an inherent mismatch between banks sources and uses of funds. For instance, banks sell demand deposit to depositors which can be withdrawn by them without prior notice. On the other hand, banks use these funds particularly financing long-term projects of investors which cannot be liquidated instantly without losing much of their value. This mismatch in maturity can instigate bank run eventually (Farhi & Tirole, 2009). A study by OECD (2010) shows that banks which rely mostly on wholesale funds including funding from other banks and money markets have been severely affected by the recent financial crisis.

In contrast, banks which rely heavily on depository funding have been very resilient to financial crisis and are expected to be more stable. In this particular regard, Islamic banks can be considered more stable than their conventional counterparts because the former collect funds through two categories of deposits- demand deposits and investment deposits. For demand deposits, Islamic banks apply 100% reserve and are expected to be more stable (Khan, 1986). However, this stability may be achieved at the cost of their efficiency. Efficiency implies the ability of a bank to turn its resources into revenues. A bank is considered more efficient if it can produce a given level of output using minimum level of resources. Since Islamic banks employ larger amount of demand deposit which requires higher level of mandatory provision to be maintained, this cluster of banks thus, holds less available funds at its disposal for investment. As a result, Islamic banks are expected to be more stable but less efficient than their conventional counterparts.

The source of difference between Islamic and conventional banks in terms of stability and efficiency can be attributed to the nature of their business practices. Islamic banks are completely prohibited from dealing with interest and uncertainty, two dominant features embedded with the business practices of conventional banks. Instead, Islamic banks offer various financial products complying with *Shariah* principles which allow profit and loss sharing (PLS) based mode of financing instead of fixed-rate loans. For instance, *Musharaka* (joint venture) and *Mudharabah* (profit-sharing agreements) are purely PLS modes of financing. Under the PLS paradigm, assets and liabilities of Islamic banks are integrated in the sense that borrowers share profits and losses with the banks, which in turn share profits and losses with the depositors (Chong and Liu, 2009). There are other financial contracts permissible in Islam and are practiced by Islamic banks across the world. For example, *Murabaha* (mark-up) financing is most popular among Islamic banks whereas *Ijarah* (leasing), *Bai'-muajjal* (variant of Murabaha), *Bai'-salam* (forward sale contract), *Istisna* (commissioned or contract manufacturing) are also offered by Islamic banks. These products, although permitted in Islam, do not conform to the spirit of PLS based financing.

Despite theoretical differences, literature provides conflicting evidence on the difference between Islamic and conventional banks in terms of the above mentioned parameters. In respect of business orientation, Chong and Liu (2009), Ariff and Rously (2011) argue in the context of Malaysian banking system that Islamic banking is not very different from conventional banking. Similarly, Aggarwal and Yousef (2000) and Khan (2010) contend that Islamic banking activities in most instances are still functionally indistinguishable from conventional banking. In the same token, Suzuki, Miah, Wanniarachchige, and Sohrab (2017) raise the issue that although Islamic banks comply with *Shariah* principles, their mode of investment is dominant by *Murabaha* or mark-up lending which is close to conventional banking practice. On the other hand, Beck, Demirgüç-Kunt, and Merrouche (2013), drawing evidence from a large number of banks worldwide, find that Islamic banking activities are different from conventional banking. This finding is supported by many studies (Metwally, 1997; Olson & Zoubi, 2008) and by far the dominant argument among comparative analysis.

Differences between Islamic and conventional banks in respect of efficiency and stability are also evident in the existing literature. The conclusion of these studies however, varies. For instance, Srairi (2010) conducts a comparative study between Islamic and conventional banks of GCC countries in terms of their efficiency and finds that Islamic banks are less efficient than conventional banks. This finding is confirmed by Hassan (2006) in the context of OIC (Organization of Islamic Conference) countries, Beck et al. (2013), Abdul-Majid, Saal, and Battisti (2010) for international data, and Miah and Sharmeen (2015) for banks in Bangladesh. Contrasting to the above findings, Brown, Hassan, and Skully (2007) find that cost efficiency of Islamic banks is higher than the conventional banks in the dual banking system. Similarly, Pradiknas and Faturohman (2015) find that Indonesian Islamic banks are more efficient than conventional banks. Some studies (Bader, Mohamad, Ariff & Hassan, 2008; Hassan, Mohamad & Bader, 2009; Metwally, 1997; Mohanty, Lin, Aljuhani & Bardesi, 2016; Yahya, Muhammad & Hadi, 2012) however, find no significant difference between Islamic and conventional banks in terms efficiency.

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