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Efficiency of Islamic banks during the financial crisis: An analysis of Middle Eastern and Asian countries

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ABSTRACT

The world economy is still suffering from the severe global financial crisis that caused the failure of several banks. This has encouraged economists worldwide to consider alternative financial solutions and attention has been focused on Islamic banking and finance as an alternative model. Hence, this study examines the efficiency level of Islamic banks during the financial crisis specifically in Middle Eastern and Asian countries from 2007 to 2010. Moreover, bank-specific and risk factors were examined to understand the determinants of efficiency. The efficiency of Islamic banks is measured using data envelopment analysis by adopting the intermediation approach. The financial information is extracted from BankScope database for a four year period (2007–2010) which includes 79 Islamic banks across a number of countries. The study also critically analyses pure technical efficiency and scale efficiency of the Islamic banks in Middle Eastern and Asian countries and estimates their return to scale. The findings explain that Islamic banks were able to sustain operations through the crisis. However, the study also shows that the majority of these Islamic banks were scale inefficient. Most of the scale inefficient banks were operating at decreasing returns to scale. This study also found that both profitability and capitalisation were the main determinants of Islamic banking efficiency. Hence, the findings of this study have policy implications and make a contribution to policy-making by providing empirical evidence on the performance of the Islamic banks and their efficiency levels.

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1. Introduction

The salient features of Islamic banking are prohibition of interest payments in all transactions, and prohibition of undertaking or financing anti-social and unethical behaviour such as gambling, pornography and alcohol (Abdul-Majid et al., 2010). Specifically, *Shari'ah*-compliant finance does not allow the charging of interest payments (i.e., *riba*), as only goods and services are allowed to carry a price; further, it does not allow speculation, and prohibits the financing of specific illicit activities (Beck et al., 2013).

A severe financial crisis, traced back to mid-2007 till the end of 2009, caused the collapse of investment banks largely due to loss of confidence in mortgage credit market in the United States. This financial crisis has focused attention on weaknesses of conventional financial systems which in turn has led to identification of Islamic finance as an alternative. It has been contended that Islamic finance is resilient to shocks due to its inherent stability (Mirakhor, 2008) and that the world of banking and finance without *riba* (usury) and *maysir* (gambling) is a better alternative to the current scenario (Siddiqi, 2008). Iqbal and Llewellyn (2002) emphasised that by, various means, international financial systems can benefit from diversified financial products and operations, such as those available in Islamic banks which are characterised by distinct risk-sharing features for each type of contract. Moreover, academics and policymakers alike point to advantages of *Shari'ah*-compliant financial products, such as mismatch of short-term, on-sight demandable deposit contracts with long-term uncertain loan contracts being mitigated with equity and risk-sharing elements (Beck et al., 2013) and some observers have pointed to their superior performance during the crisis (Hasan and Dridi, 2010). However, Kuran (2004) stated that Islamic banks do not have any advantage in efficiency as compared to conventional banks. Hence, this study aims to shed light on this issue by examining pure technical efficiency (PTE) and scale efficiency (SE) of Islamic banks in the Middle Eastern and Asian countries during the financial crisis. Fundamentally, this study estimates the relative efficiency of both groups of Islamic banks in Middle Eastern and Asian countries as Islamic financial institutions have a relatively high market share in several emerging markets, such as Malaysia and several Middle Eastern countries (Beck et al., 2013) and is currently practised in more than 50 countries worldwide (Chong and Liu, 2009) majority of which are in Middle East and Asia.

Consequently, it is crucial to understand how Islamic banks in both Middle Eastern and Asian countries perform during the financial crisis due to the fact that majority of Islamic banks are operating in these two regions. The operations and performance of these Islamic banks show the importance of Islamic banking and finance in the global financial markets. Additionally, very limited cross national comparison studies were undertaken on the efficiency of Islamic banking especially during the recent financial crisis to explain its determinants.]

The aim of this study is to fill the significant gap in the literature by providing up-to-date empirical evidence on the efficiency of Islamic banks in twelve Middle Eastern countries and seven Asian countries during 2007–2010 that includes the period of the 2007/2008 financial crisis. The efficiency estimate of each Islamic bank is computed by using the non-parametric data envelopment analysis (DEA) method. This method allows us to estimate three different types of efficiency measures, namely, overall technical, pure technical, and scale efficiency. In addition, this method enables us to distinguish between three types of return to scale (RTS), namely: the constant return to scale (CRS), decreasing return to scale (DRS) and increasing return to scale (IRS).

The remainder of this paper is organised as follows. Section 2 provides a brief literature review focused on the efficiency of Islamic banks across countries; followed by a description of the methodology in Section 3. Section 4 reports the results of the analysis, comprised of the pure technical efficiency and scale efficiency estimates for both specific frontiers as well as the return to scale estimates. Finally, Section 5 offers some conclusions.

2. Review of the literature

Despite the rapid growth of the Islamic banking and finance industry, analysis of Islamic banking at a cross-country level is still in its infancy (Sufian and Noor, 2009). Existing studies in this area are classified in two groups. The first group includes the studies that evaluate the efficiency of Islamic banks geographically (see, for example: Yudistira, 2004; Sufian, 2006, 2007; Sufian and Noor, 2009). While the second group includes the comparative analysis of the efficiency of the Islamic banks and conventional

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