

ISLAMIC AND CONVENTIONAL BANKING IN THE NINETIES: A COMPARATIVE STUDY*

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There is a serious lack of empirical studies on Islamic banking. This paper attempts to fill that gap to some extent. Using data for the 1990-98 period, several hypotheses and common perceptions about the practice of Islamic banking have been tested. The performance of Islamic banks has been evaluated using both trend and ratio analyses. For this purpose, some objective "benchmarks" for various ratios have been developed for the first time. The performance of Islamic banks has also been compared with a 'control group' of conventional banks. It has been found that in general Islamic banks have done fairly well during the period under study.

1. INTRODUCTION

It has been quarter of a century since the first Islamic bank was established. During this period, the Islamic banking industry has witnessed a gradual and sustained expansion. In this respect, two distinct approaches have been followed. Firstly, Islamic banks and financial institutions were established in several parts of the World, including some non-Muslim countries, on private initiatives. The number of such banks and financial institutions is now more than one hundred. Secondly, attempts were initiated to convert the whole financial system to Islamic principles in some Muslim countries. These include Pakistan, Iran and Sudan. These experiments have also been in operation for 15-20 years. It is high time that both of these initiatives are assessed and evaluated. This study attempts to analyze the experience of the first group of banks. However, it must be pointed out that most of the conclusions apply to the second group of institutions also. In this study a number of hypotheses have been tested and a number of "common perceptions" evaluated against actual facts. Several of these have been found to be misconceived. It is hoped that this study will start an objective discussion about these to arrive at the truth.

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2. DATA AND METHODOLOGY

While several good theoretical studies on Islamic banking are available¹, there is a serious shortage of empirical studies. This study attempts to partially fill that gap. Needless to say, that there is need and scope for several studies of this kind.

The most important reason for the lack of empirical studies on Islamic banking is the lack of a long and consistent time series for the Islamic banks. There are so many variations in practices of reporting financial statements that construction of a consistent time series is a project in itself. For this study, a sample of twelve Islamic banks was chosen. These banks together account for more than 75 percent of total capital as well as total assets of "private" Islamic banks and thus form a very large sample from a statistical point of view. Therefore, we can safely assume that the results derived from this sample are representative of the "Islamic banking industry". The study covers the 1990-98 period. Data for a number of important variables were compiled from the annual reports of these banks.² Attempts have been made to reconcile the data over the period as well as across the banks to construct a comparable series.

For comparative purposes, another sample of twelve conventional banks was chosen. These banks were chosen from exactly the same countries from where Islamic banks were chosen. An attempt was also made to choose banks roughly of the same size as the Islamic banks. The data for these banks has been compiled from various issues of the Bankers' Almanac. The names of banks included in the two samples are given in Table 1.

¹ See for example, Ahmad, Ziauddin, et al. (ed) and Chapra, (1985).

² There were a few gaps in the data, which were filled through forecasting techniques.

Table 1

Banks Included in the Sample

No.	Islamic Banks	Conventional Banks
1	Al Rajhi Banking & Investment Corporation, Saudi Arabia (Rajhi)	Riyad Bank, Saudi Arabia
2	Kuwait Finance House, Kuwait (KFH)	National Bank of Kuwait SAK, Kuwait
3	Al Baraka Islamic Investment. Bank, Bahrain (BKBN)	Arab Banking Corporation (BSC), Bahrain
4	Bahrain Islamic Bank, Bahrain (BIB)	Bank of Bahrain and Kuwait BSC, Bahrain
5	Faysal Islamic Bank, Bahrain (FIBB)	National Bank of Bahrain BSC, Bahrain
6	Faisal Islamic Bank, Egypt (FIBE)	Egyptian American Bank, Egypt
7	Dubai Islamic Bank, UAE (DIB)	Mashreq Bank PSC, UAE
8	Jordan Islamic Bank, Jordan (JIB)	Bank of Jordan plc, Jordan
9	Qatar Islamic Bank, Qatar (QIB)	Qatar National Bank SAQ, Qatar
10	Islami Bank Bangladesh, Bangladesh (IBBG)	Arab Bangladesh Bank Ltd, Bangladesh
11	Bank Islam Malaysia Berhad, Malaysia (BIM)	The Pacific Bank Berhad, Malaysia
12	Al Barakah Turkish Finance House, Turkey (BKTFH)	Finansbank AS, Turkey

In the next two sections, the growth and performance of Islamic banking industry have been analyzed with the focus on inter-industry comparisons. In section four the performance of Islamic banking industry has been evaluated vis-a-vis conventional banking industry.

3. GROWTH OF ISLAMIC BANKING INDUSTRY (1990-98)

Every now and then we read press reports about the rates of growth of Islamic banking industry. Without supporting data, however, these are no more than "speculations". Data on some key variables for the period 1990-98 are given in Table 2 and analyzed in the following paragraphs. The period has been divided into two sub-periods to see the trends over time while minimizing yearly variations.

Table 2
Annual Growth Rates for Some Key Variables

Bank	Total Equity			Total Deposits			Total Investment			Total Assets			Total Revenue		
	1990-94	1994-98	1990-98	1990-94	1994-98	1990-98	1990-94	1994-98	1990-98	1990-94	1994-98	1990-98	1990-94	1994-98	1990-98
Rajhi	7.7	7.5	7.6	13.9	7.7	10.8	12.0	7.3	9.6	11.8	7.1	9.4	0.5	11.2	5.7
KFH	14.4	21.0	17.6	2.7	3.3	3.0	9.9	6.2	8.0	4.2	6.2	5.2	11.2	11.8	11.5
BKBN	0.2	3.1	1.6	-12.2	5.5	-3.8	-10.5	3.8	-3.6	-9.3	5.1	-2.3	14.9	23.3	19.0
BIB	17.5	2.4	9.7	5.8	4.6	5.2	7.1	4.5	5.8	6.7	4.5	5.6	-2.0	11.9	4.7
FIBB	16.3	5.4	10.7	5.2	4.3	4.7	4.3	4.8	22.6	31.4	-8.8	9.5	23.9	2.8	12.8
FIBE	-15.2	12.2	-2.4	-2.4	5.6	1.6	4.5	9.3	6.8	-1.2	5.1	1.9	-13.8	17.1	0.4
DIB	8.0	34.1	20.3	17.0	6.9	11.8	12.2	9.7	11.0	13.8	9.2	11.5	14.4	8.6	11.5
JIB	32.2	6.4	18.6	22.0	5.2	13.3	21.2	6.5	13.6	21.9	5.1	13.2	17.8	0.6	8.9
QIB	-1.3	11.9	5.1	6.2	4.1	5.1	10.4	3.6	7.0	11.7	4.1	7.8	2.9	12.5	7.6
IBBG	12.1	25.2	18.5	18.5	13.4	15.9	21.4	9.3	15.2	18.8	13.3	16.0	12.0	14.0	13.0
BIM	24.1	30.8	27.4	21.1	-2.4	8.7	21.7	1.3	11.0	21.5	3.3	12.0	19.9	7.6	13.6
BKTFH	-12.1	35.4	9.1	20.1	9.8	14.8	14.8	12.0	13.4	10.0	10.7	10.4	49.9	-27.9	4.0
Simple Average	8.7	16.3	12.0	9.8	5.7	7.6	10.7	6.5	10.0	11.8	5.4	8.4	12.6	7.8	9.4
Standard Deviation	14.0	12.4	8.6	10.7	3.8	6.0	9.1	3.1	6.3	11.0	5.4	5.1	15.9	12.7	5.2
Weighted Average	7.9	12.6	10.2	8.8	5.7	7.2	11.3	6.9	9.1	9.3	6.4	7.8	11.2	3.7	7.3

3.1 Total Deposits³

Total deposits during 1990-94 grew at an annual rate of 8.8 percent. This rate declined to 5.7 percent during 1994-98. Other studies have shown that deposits of Islamic banks were growing at 15 percent in 1980s.⁴ Against this background, the rate of growth for the 1990-98 period works out to be only 7.2 percent that is less than half the 1980s rate. There four possible reasons for this decline:

Firstly, during the 1980s there were a lot of immobilized funds due to the fact that many Muslim clients do not want to involve in any interest dealings. In the absence of a viable alternative, they were keeping their savings in private lockers etc. With the advent of Islamic banking in the late seventies, these people started dealing with these banks. As a matter of fact one of the biggest achievements of Islamic banking is to bring this huge amount into the formal sector. However, in the next 10-15 years, these savings found their way into the coffers of the Islamic banks. Accordingly the rate of growth of deposits started tapering off.

Secondly, during the 1990s an increasing number of conventional banks started offering Islamic products. These banks offered a new kind of competition to existing Islamic banks hitherto unknown. Many of these Western multinational banks brought with them their marketing expertise, international connections, superior technology and better customer relations. Therefore, some of the deposits must have been diverted to these banks. Due to the absence of any definite information, the extent of such diversion cannot be estimated though some indication can be obtained by comparing the growth rates of deposits of such banks with those of Islamic banks.

Thirdly, in the nineties a new trend in Islamic finance gained ground. This is establishment of Islamic Mutual Funds. Some of the deposits of the Islamic banks may have been diverted to these Funds.

The final reason for this trend is merely statistical. As the base gets bigger and bigger, it becomes increasingly difficult to maintain a given rate of growth.

Considering the fact that the Islamic Mutual Funds and the Islamic branches of the conventional banks that offer Islamic products are both part of the Islamic financial industry, it is safe to conclude that the rate of growth of the industry during 1990s was around ten percent.

The data show wide variations across the Islamic banks. In the case of two banks total deposits actually decreased during 1990-94. For the rest of the banks

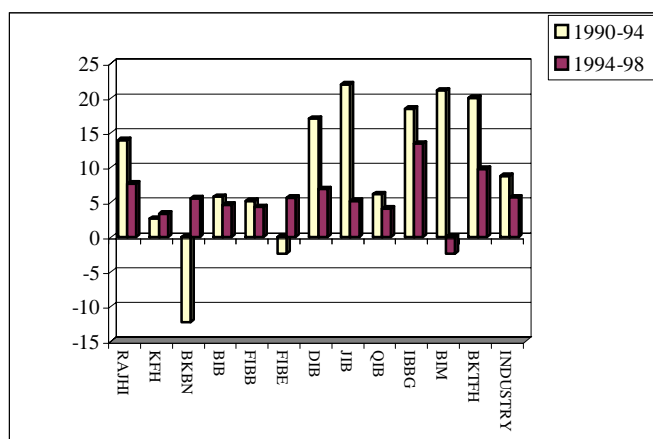
³ Including funds under management.

⁴ See Wilson, Rodney (ed) (1990).

the rate growth of deposits ranged from a low of 2.7 percent in the case of Kuwait Finance House (KFH) to as high as 21.1 percent in the case of Bank Islam Malaysia Berhad (BIM)⁵. During 1998, BIM was affected by the general slowdown in the Malaysian economy. Hence, for the 1994-98 period, it registered a negative rate of growth in deposits. All other banks registered positive, though varying, rates of growth in this period. The relative rates of growth for various banks in both the periods are shown in Chart 1.

Chart 1

Growth Rates of Total Deposits (%)



3.2 Total Equity

Total equity,⁶ which is the most important variable to measure the strength of a company, grew at a rate of 10.2 percent during the 1990s for the sample as a whole. There is a consistent upward trend throughout the period, with a growth rate of 12.6 percent for the 1994-98 period as against 7.9 percent for the 1990-94 period. As we will see in the next section, this has helped improving the capital asset ratio over time.

Once again, there is considerable variation within the sample, with such variation being smaller in the second period as compared to the first. During 1990-94 three banks registered negative rates of growth in equity. During the second period all banks registered positive rates of growth. BIM showed the highest rate of

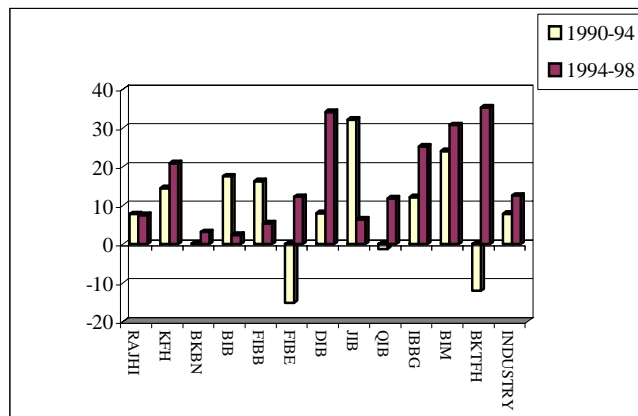
⁵ It must be noted, however, that these rates of growth are based on different sizes of initial values. It is relatively more difficult to achieve a high rate of growth over a large initial value, as in the case of KFH.

⁶ Includes paid up capital, reserves and undistributed profits.

growth followed by the KFH and the Islamic Bank Bangladesh (IBBG). However, since KFH's rates are calculated on a much larger base, the absolute increase in the equity was much higher in the case of the KFH. The relative rates of growth for both the periods are shown in Chart 2.

Chart 2

Growth Rates of Total Equity (%)



3.3 Total Investment

Growth in total investments naturally depends on the growth in deposits and equity. This is a very important variable because the overall profitability of the banks depends on this. The rate of growth for the entire period comes to 9.1 percent. However, the rate of growth in the second period (6.9 %) is much lower than that of the first period (11.3 %). This is due to the declining rate of growth of deposits. It has been somewhat moderated by a higher rate of growth of equity capital but since the absolute size of deposits is much larger than the equity, it follows the former more closely.

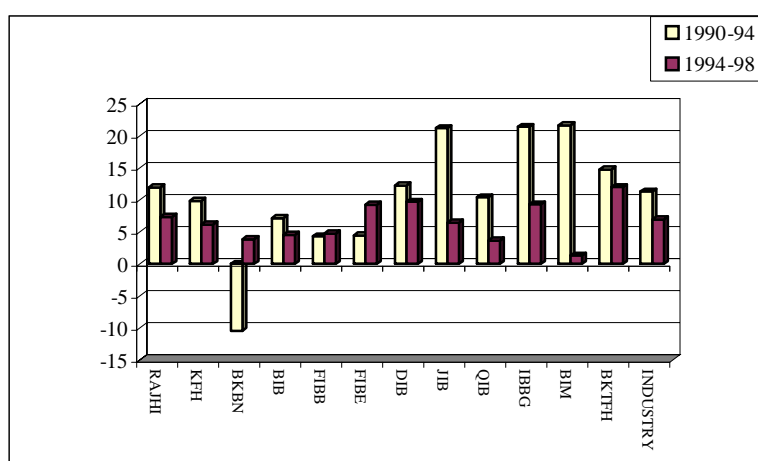
During 1990-94, one of the two banks that registered a negative growth rate in deposits, also posted a negative rate for growth in investment. The other bank, the Faisal Islamic Bank Egypt (FIBE) was able to insulate investments from the decline in deposits, partly because the rate of decline in deposits was much smaller and partly through better management of its resources.

The pattern of inter-bank variation is also similar to that of total deposits. BIM posted the highest rate of growth (21.7 %) during 1990-94 but registered a meager 1.3 percent growth in 1994-98 due to general recession in Malaysia. As may be

seen in Chart 3, the variation in the relative rates of growth was much smaller in the second period as compared to the first.

Chart 3

Growth Rates of Total Investment (%)

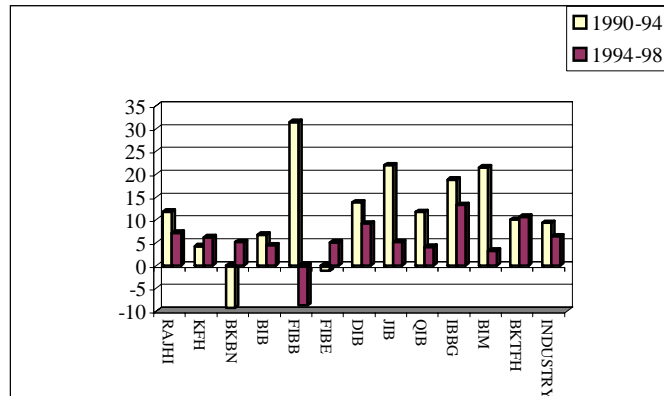


3.4 Total Assets

Total assets of the Islamic banking industry grew at 9.3 percent during 1990-94. Most of the banks, eight out of twelve, posted double-digit rates of growth. The industry witnessed a general slowing down in the later period. The overall rate of growth in that period was 6.4 percent with only two banks reaching double-digit rates of growth. Interestingly, the Faysal Islamic Bank Bahrain, which posted the highest rate of growth in the first period, registered a negative rate of growth in the second. Perhaps, the most plausible reason for that is an increasing movement toward management of funds business. Since that item is treated as off balance sheet, assets on the balance sheet have shown a decline. As in the case of total deposits, the Islami Bank Bangladesh showed the most consistent performance, making progress at a handsome rate. The growth of assets for all banks in the two periods is shown in Chart 4.

Chart 4

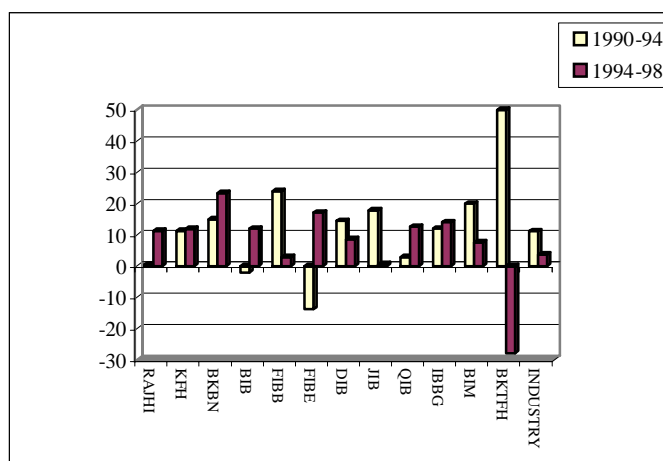
Growth Rates of Total Assets (%)



3.5 Total Revenue

Total operating revenue grew at a handsome rate of 11.2 percent in 1990-94 but only at a rate of 3.7 percent in 1994-98 giving an overall average rate of growth of 7.3 percent for the 90s. It must be noticed that while growth rate of total investments declined from 11.3 % to 6.9 % between the two periods, the decline in the rate of growth of revenue is much sharper. Does it mean that the rate of return on investments is declining? That could be so. But another reason is relative decline in fee-based operations. Contra accounts grew only at a paltry rate of 1.4 percent in 1994-98 as compared to a growth rate of 16.8 percent in the 1990-94 period. This trend may also have to do with the entry of Western multinational banks into the Islamic banking industry. With their vast international networks, they may be siphoning off the letters of credit, letters of guarantee business away from Islamic banks. This is an important trend for Islamic banks to watch. Fee-based income is a relatively secure part of banks' income. Its decline may have important implications for the overall profitability of Islamic banks.

Total revenue has shown a lot of variation not only across the banks but also for several individual banks over time. This again is not a welcome trend. However, the average rate of growth in revenue was smaller in the 1990-94 period as compared to the earlier period.

Chart 5**Growth Rates of Total Revenue (%)****4. RATIO ANALYSIS**

Ratio analysis is an important technique to evaluate the performance of any company. Combined with trend analysis, it provides useful information with respect to the health of a firm as well as important clues for predicting its future. There are several aspects of a firm's operations that need to be watched by financial managers. For this purpose, many ratios are commonly used. In this section we employ some of these ratios to evaluate the performance of Islamic banks. Table 3 presents these ratios for the Islamic banks and the same are analyzed below.

4.1 Capital Asset Ratio

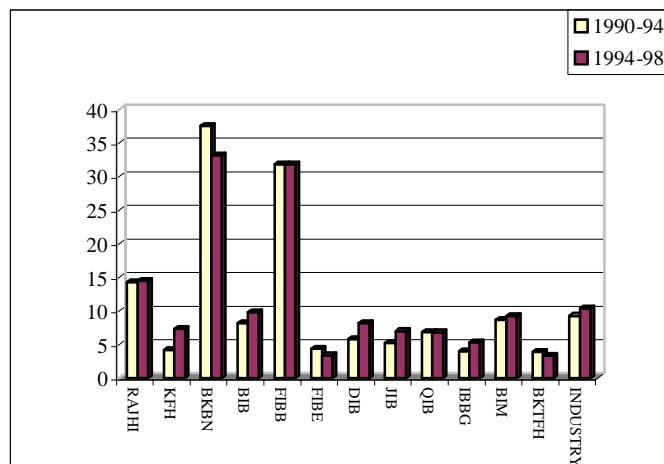
This is perhaps the most important ratio especially for financial firms. This reflects the strength of a bank and its ability to meet its obligations in a crisis situation. There are three major reasons for a bank to watch its capital asset ratio. First, regulatory authorities require a minimum amount of bank capital. Second, the size of the bank capital has some safety implications as it provides some cushioning, albeit limited, against the possibility that the bank cannot satisfy its obligations to its creditors. Third, the amount of capital affects the rate of return to the bank equity holders. There is a trade off between the return to the owners and the safety of the bank. Given the return on assets, the smaller the bank capital, the higher the rate of return to the owners of the bank. Therefore, the owners of the bank have a natural tendency to keep lower capital/asset ratios. However, the lower capital/asset ratios increase the risk of bank failures. It is for this reason that the

regulatory agencies prescribe certain minimum capital/asset ratios. According to Basle Agreement (1988), the Basle Committee on Banking Supervision has defined international standards on banks' capital adequacy. According to these standards, a bank must meet two capital requirements: It must have a "core" or Tier 1 capital (stockholder equity capital) of at least 4% of total risk-adjusted assets, and total capital (Tier 1 capital plus Tier 2 capital, which is made up of loan loss reserves and subordinated debt)⁷ of at least 8% of total risk-adjusted assets.

In the absence of data on loan loss reserves and subordinated debt in the case of Islamic banks, and also the "risk adjustment" calculations, it is not possible to reach a judgment with respect to "total capital" requirements. Therefore, for the purpose of this study we assume that the ratio to total assets of the sum of paid-up capital, reserves and undistributed profit, should lie in between Tier 1 and Tier 2 capital standards, i.e. 6 percent. As against this standard, the overall capital assets ratio for the Islamic banks was 9.3 percent during 1990-94 and 10.4 percent during 1994-98. Though this figure is well above the Basle Standards, the disaggregated figures present a slightly different picture.

Chart 6

Capital Asset Ratio (%)



⁷ Subordinated debt is debt that is paid off only after depositors and other creditors have been paid.

Table 3**Period Averages for Some Key Ratios: 1990-94 And 1994-98**

Bank	Cap/Asst Ratio		Liquidity Ratio		Deployment Ratio 1		Deployment Ratio 2		Cost/Income Ratio		ROA		ROE	
	1990-94	1994-98	1990-94	1994-98	1990-94	1994-98	1990-94	1994-98	1990-94	1994-98	1990-94	1994-98	1990-94	1994-98
Rajhi	14.3	14.5	15.0	13.5	99.2	97.7	84.5	84.4	36.6	34.2	3.8	3.7	25.9	25.6
KFH	4.2	7.3	19.3	8.1	89.8	105.0	81.7	90.6	83.8	61.6	0.4	2.2	6.6	29.3
BKBN	37.5	33.2	8.9	12.3	90.6	91.1	84.8	81.6	62.1	69.7	1.2	2.4	3.6	7.3
BIB	8.1	9.8	5.1	4.4	96.7	97.2	94.4	95.1	80.7	78.8	0.9	1.1	10.8	11.1
FIBB	31.8	31.8	9.0	7.2	54.6	91.8	33.9	54.1	43.1	47.1	5.4	4.9	16.8	15.9
FIBE	4.3	3.4	31.2	17.9	80.3	98.9	68.9	83.1	91.1	87.4	0.2	0.1	3.7	1.3
DIB	5.8	8.1	16.3	15.6	96.9	89.2	84.7	84.3	70.3	74.6	0.5	0.6	8.7	8.5
JIB	5.2	7.0	39.4	31.5	69.0	76.9	62.5	69.9	75.4	76.7	0.9	0.8	19.2	11.3
QIB	6.8	6.8	6.5	10.2	105.6	100.0	90.4	85.7	65.4	69.3	0.4	1.1	-2.3	16.4
IBBG	4.0	5.3	36.3	32.8	70.5	77.8	61.4	68.6	81.9	80.0	1.4	1.4	32.9	28.8
BIM	8.6	9.2	10.2	20.6	91.4	87.5	86.1	80.6	79.4	78.5	1.1	0.9	13.2	13.2
BKTFH	3.9	3.3	13.7	12.8	96.7	91.7	81.3	84.4	40.0	59.4	1.8	1.3	42.9	38.3
Simple Average	11.2	11.6	17.6	15.6	86.8	92.1	76.2	80.2	67.5	68.1	1.5	1.7	15.2	17.3
Standard Deviation	11.4	10.2	11.8	8.9	15.1	8.5	16.9	11.0	18.5	15.3	1.5	1.4	13.2	10.9
Weighted Average	9.3	10.4	17.6	13.6	92.2	96.5	80.7	84.2	55.9	53.4	1.9	2.3	19.9	22.1

Two things need special mention: Firstly, in the case of two banks, the Al Barakah Investment Bank, Bahrain (BKBN) and the Faysal Islamic Bank, Bahrain (FIBB), the ratio is more than 30 percent which is unusually high. The reason for this is that these banks "manage" a large amount of *mudharabah* funds that are treated as an off- balance sheet item. Though the owners of these funds are liable to share losses, some equity is still being kept to support the assets generated by these funds. If we exclude these two banks and calculate the weighted average ratio for the other ten banks, it comes to 8.7 and 9.8 respectively for the two periods, which is still above the Basle standard.⁸

Secondly, the overall satisfactory ratio conceals the fact that there are several banks for which this ratio is below the minimum international standards. The number of such banks during 1990-94 is 6. The situation is better in the second period when the number of such banks is only 3. From these numbers and the increase in total ratio, we can conclude that in general, Islamic banks are well capitalized and/or are becoming increasingly so.

4.2 Liquidity Ratio

This ratio measures the ability of a firm to meet its current liabilities. In the case of banks, the current liabilities are the demand deposits. Therefore, In the case of banks, the equivalent of what is known as "Current Ratio"⁹ in financial statement analysis would be the ratio of liquid assets to demand deposits. However, since time deposits could also be of short maturity and in many cases, withdrawals from such accounts are possible by means of a short advance notice of withdrawal, we have calculated the liquidity ratio as follows:

$$\text{Liquidity Ratio} = \frac{\text{Cash and Accounts with Banks}}{\text{Total Deposits}}$$

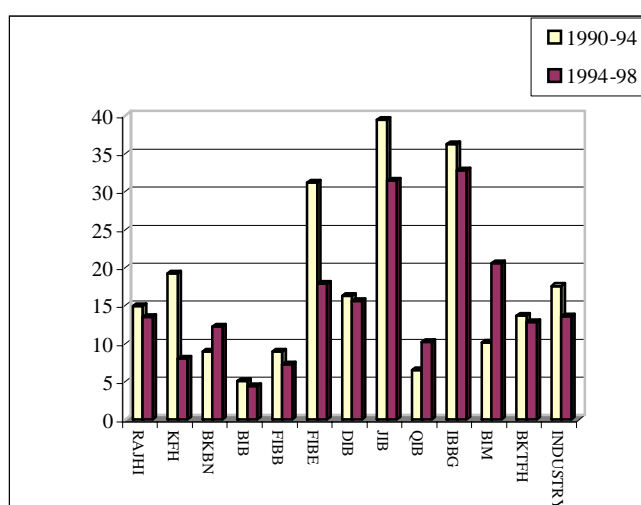
There is a general impression that Islamic banks have an excess liquidity. In a survey of opinions of practical bankers and scholars of Islamic banking conducted by this author last year, more than sixty percent of the respondents believed that Islamic banks were suffering from excess liquidity, implying that they do not have enough investment opportunities. Even some researchers have made such claims. In order to check this hypothesis, we need, first to determine what does "excess liquidity" mean.

Unlike other firms, banks are legally required by the regulating agencies to keep a minimum amount of liquidity. These are known as 'legal reserve requirements'. The ratio of legal reserves varies from country to country. In the case of countries from where our sample is drawn, this ratio on average is around 10 percent of

⁸ For the whole period the average comes out to be 9.3 percent.

⁹ Current Ratio= Current assets/Current liabilities.

deposits.¹⁰ In addition, it is customary that all banks keep some more liquid assets as 'prudent reserves'. Therefore, for the purposes of this study we can set the desired liquidity ratio at 12-15 percent depending upon the ratio of current deposits to total deposits. Within this range, the higher the ratio of current deposits to total deposits for a bank, the higher the desired liquidity ratio.

Chart 7**Liquidity Ratio (%)**

The industry average for Islamic banking during 1990-94 works out to be 17.6 percent that seems to lend some support to the excess liquidity hypothesis. However, one cannot say the same for the 1994-98 period when the ratio was 13.6 percent. Moreover, we need to consider the fact that in the case of Islamic banks the possibilities of borrowing from the Central bank in the case of a need are either not available or not desirable due to involvement of interest, it is prudent for them to remain relatively more liquid. Considering these factors, we do not find any strong support for the "excess liquidity hypothesis" even for the first period. It may also be noted that Islamic banks have clearly improved their liquidity management over time. More importantly, the excess liquidity phenomenon is not as wide spread as believed. While the industry average was a little higher than desired during 1990-94, most of the banks were either close to the desired level or even lower. In the next section we will employ "benchmarking technique" to examine the hypothesis from another angle. Therefore, let us delay a final judgment on this matter until then.

¹⁰ Legal reserve requirements are usually different for current and time deposits, with current deposits having a higher requirement. This ratio is a rough average.

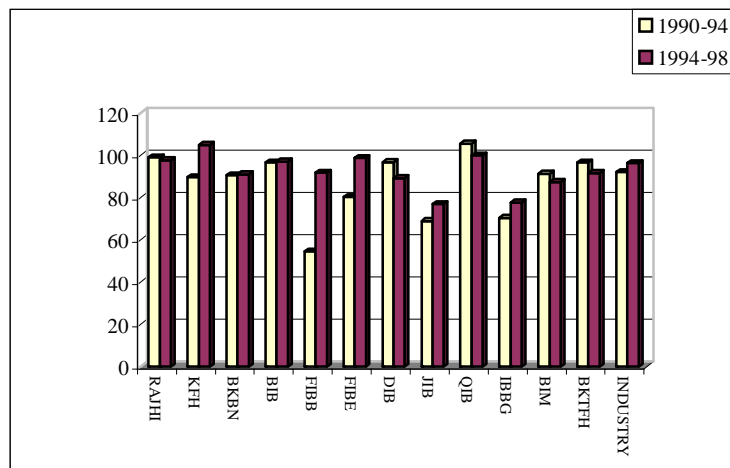
4.3 Deployment Ratios

Another aspect of performance evaluation is to see how best a bank is using its resources. For this purpose we have calculated two ratios. The first, Deployment Ratio 1 is defined as follows:

$$\text{Deployment Ratio 1} = \frac{\text{Total Investment}}{\text{Total Equity} + \text{Total Deposits}}$$

During the 1990-94 period, this ratio was 92.2 percent for the industry as a whole which obviously is quite high. Islamic banks improved it further to 96.5 percent in the second period. Even for the banks taken individually, the ratio is quite high for a vast majority of banks.

Chart 8
Deployment Ratio 1 (%)



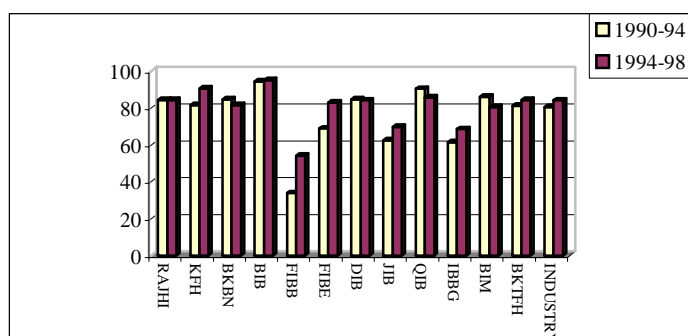
Realizing that for short periods of time, 'margin' deposits and the depositors' share of profits also remain with the banks in addition to customer deposits and equity, a second deployment ratio was calculated as follows:

$$\text{Deployment Ratio 2} = \frac{\text{Total Investment}}{\text{Total Liabilities}}$$

This of course is a much more stringent test of efficiency in the use of resources at the disposal of banks because it includes the use of amounts deposited for short periods of time and that too not for return. It turns out that Islamic banks are doing a fairly good job in the utilization of their resources. The overall ratio comes to 80.7 percent for the first period and improves further to 84.2 percent in the second

period. In absolute terms these ratios appear to be very good but in the absence of any "standard" it is difficult to say how good these ratios are. Once again, in the next section we will see how these ratios compare with conventional banks.

Chart 9
Deployment Ratio 2 (%)



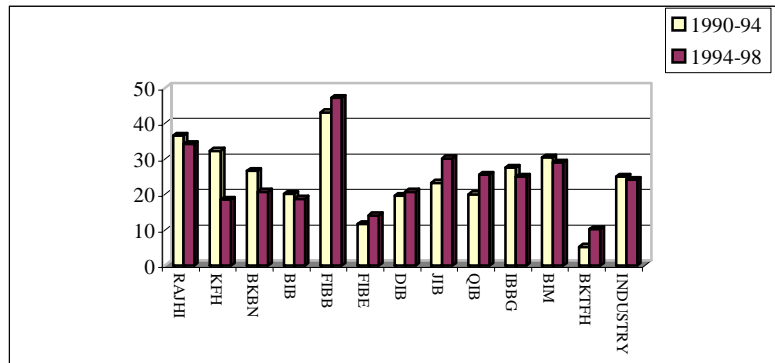
4.4 Cost/Income Ratio

This is a measure of overall efficiency. Theoretically, no standard for this ratio is available in the literature. However, *The Banker* magazine, which publishes a list of Top 1000 banks in the World every year, is reporting this ratio for the last three years. We calculated the average ratios for the 1000 banks for these years and they came out to be 62.1, 60.5 and 62.0 respectively for 1996, 1997 and 1998. We should also point out here that several studies have shown that there are economies of scale in the banking business just like other lines of business. Considering this evidence and the fact that Islamic banks are generally of a smaller size, we can use 65 percent as the "benchmark" for this ratio.

Against this standard, the overall cost/income ratio for the Islamic banks during 1990-94 was 55.9 percent. It further improved to 53.4 percent in the 1994-98 period. Therefore, overall, Islamic banks appear to be working in an efficient and cost-effective manner. However, when we look at the ratios for individual banks a different picture emerges. Only five out of twelve banks were up to (or better than) the standard. The overall average is pushed down largely because of the low ratio for Al Rajhi, which being the largest bank in the sample carries a lot of weight. The ratio for Al-Rajhi in turn, is unusually low because it has no (or negligible) cost of funds. Almost all of its funds come from current accounts on which no return is paid.

Chart 10

Cost to Income Ratio (%)



If we look at the simple average figures for this ratio, these are 67.5 and 68.1 percent for the two periods respectively, both of which are higher than the benchmark. Therefore, we conclude that in general, Islamic banks are not working in a cost-effective manner.

4.5 Profitability Ratios

There are several ratios, which are used to measure the profitability of firms. The two most often used are Rate of Return on Assets (ROA) and the Rate of Return on Equity (ROE). We will now analyze the profitability of Islamic banks on the basis of these two ratios.

4.5.1 Rate of return on assets (ROA)

The weighted average rate of return on assets for the period 1990-94 for the Islamic banks was 1.86 percent. The same rate stood at 2.29 percent during the 1994-98 period indicating a rise in profitability. In order to make some judgment on the performance of Islamic banks, once again we need an objective benchmark. For this purpose, we calculated the ROA for the Top 1000 banks. It worked out to be 0.9521 percent during 1990-94. When we compare the performance of Islamic banks against this benchmark, we find that six out of twelve Islamic banks posted higher rates than this. Similarly, the ROA for the Top 1000 banks in the World during 1994-98 was 1.08 percent. During this period, eight out of twelve Islamic banks posted higher returns than this.

The highest rate of return in both the periods was registered by the Faysal Islamic Bank Bahrain (FIBB) and the lowest in both periods by the Faysal Islamic Bank Egypt (FIBE). There was considerable variation within the industry. Table 4 presents the Rate of Return on Assets and Rate of Return on Equity for various banks.

Table 4
Performance Ratios for the Islamic banks

Bank	ROA			ROE		
	1990-94	1994-98	1990-98	1990-94	1994-98	1990-98
Rajhi	3.77	3.72	3.78	25.89	25.65	25.97
KFH	0.43	2.16	1.30	6.65	29.34	17.38
BKBN	1.24	2.42	1.81	3.60	7.29	5.36
BIB	0.87	1.09	0.97	10.80	11.15	11.05
FIBB	5.37	4.92	5.31	16.84	15.87	16.36
FIBE	0.22	0.06	0.15	3.68	1.26	2.74
DIB	0.52	0.63	0.58	8.70	8.47	8.57
JIB	0.92	0.79	0.84	19.24	11.31	15.37
QIB	0.38	1.12	0.69	-2.27	16.36	5.33
IBBG	1.38	1.40	1.34	32.88	28.82	28.94
BIM	1.10	0.94	1.01	13.21	13.19	13.00
BKTFH	1.77	1.34	1.68	42.86	38.30	43.03
Weighted Average	1.86	2.29	2.09	19.90	22.14	21.05
Simple Average	1.50	1.71	1.62	15.17	17.25	16.09
Standard Deviation	1.54	1.39	1.48	13.22	10.94	11.64

4.5.2 Rate of return on equity (ROE)

The weighted average rate of return on equity for the period 1990-94 for the Islamic banks was 19.9 percent. During the second period it increased to 22.1 percent, again pointing towards an improvement in profitability. As for benchmark, the rate of return on equity for the Top 1000 banks in the world was 15.54 during 1990-94. Five out of the twelve Islamic banks scored higher rates than that. In the second period, the average for the Top 1000 banks in the world was 15.08. In this period there were six Islamic banks with the ROE higher than this. Al-Barakah Turkish Finance House (BTFH) registered the highest rate of return on equity in both the periods.

From the evidence given above, it appears that Islamic banks' performance in terms of profitability in general, at least meets, if not surpasses, international "standards". However, it should be noted that conventional banks' depositors are guaranteed their principal amounts, and hence bear less risk than Islamic banks' depositors. Therefore, the depositors of Islamic banks would genuinely expect a higher rate of return to compensate for the extra risk. The current rates of profits on assets of the Islamic banks may not be enough to meet that expectation. As a matter of fact, if one looks at the rates of return offered to depositors, it can be seen that in general these are not attractive. In many cases these rates are even lower than the market rate of interest. Therefore, we can conclude that while Islamic banking is quite attractive as a business, there is need to make the rates of return paid to depositors more attractive. In the long run Islamic banks cannot and should not rely merely on the "loyalty" of their customers for religious reasons. They must be able to pay them more than the market rate of interest by an amount equivalent to a risk premium for sharing risk with the bank.

5. ISLAMIC AND CONVENTIONAL BANKS:A COMPARATIVE ANALYSIS

In this section the performance of Islamic banks has been evaluated viz a viz conventional banks. For this purpose, a sample of twelve conventional banks was chosen to serve as a "Control Group" for comparative analysis. Since the data for these banks has been taken from a secondary source, The Banker's Almanac, the data were not as detailed as in the case of Islamic banks. Therefore, only some major variables, for which data for both the groups was available, will be analyzed. The period is also slightly different. The Balance Sheet data in the Almanac was available to us only until 1997. Therefore, the first period chosen for comparison is the same i.e.1990-94, while the second period is 1994-97. Moreover, the Income Statements data was not available before 1993. Therefore, for cost and profit ratios only the latter period is used.

5.1 Growth Analysis

The rates of growth for four important variables are shown in Table 5, and plotted in charts. 11-14. It may be noted that In the case of all the variables, the rates of growth achieved by Islamic banks are higher than the conventional banks in the control group during 1990-94 as well as for the 1990s as a whole.

The rate of growth of total equity for the whole period was 9 percent per annum in the case of Islamic banks as against 5.6 percent for the control group. The rate of growth of total deposits in the case of control group banks was 3.1 percent per annum during 1990-94 whereas the same rate was 9.3 percent in the case of Islamic banks. However, the rate of growth in deposits declined to 6.1 percent in the case of Islamic banks for the second period and that of the conventional banks increased

to 7.2 percent in the same period partly reversing the increasing market share of Islamic banks during 1990-94.

Table 5

Comparative Annual Growth Rates (%)

	Total Equity		Total Deposits		Total Investments		Total Assets	
	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks
1990-94	7.9	6.4	9.3	3.1	11.3	-0.8	9.3	4.8
1994-97	10.5	4.7	6.1	7.2	7.3	9.1	6.8	6.6
1990-97	9.0	5.6	7.9	4.8	9.6	3.3	8.2	5.6

A similar trend is observed in the case of total investments, which grew at a handsome rate of 11.3 percent during 1990-94 in the case of Islamic banks while the control group banks witnessed a negative rate of growth. During the second period growth in investment in the case of Islamic banks declined to 7.3 percent while in the case of conventional banks it increased to 9.1 percent surpassing the growth rate of Islamic banks.

In the case of total assets Islamic banks posted a higher rate of growth in both the periods. During 1990-94, it was 9.3 percent as against 4.8 percent while during 1994-97, it was 6.8 percent against 6.6 percent for the conventional banks.

CHART 12

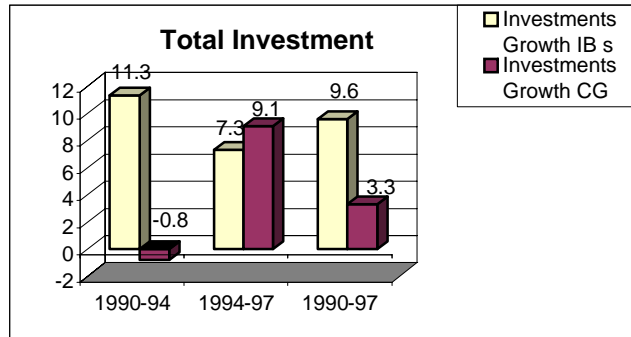


CHART 11

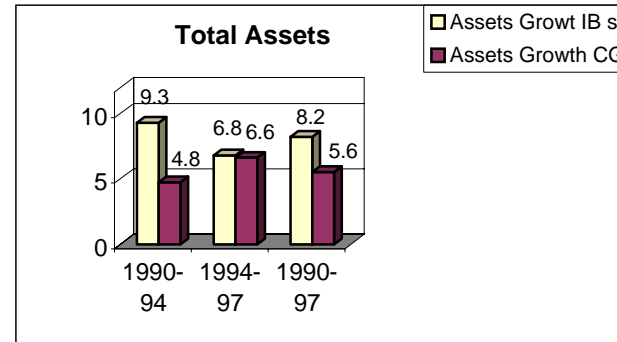


CHART 14

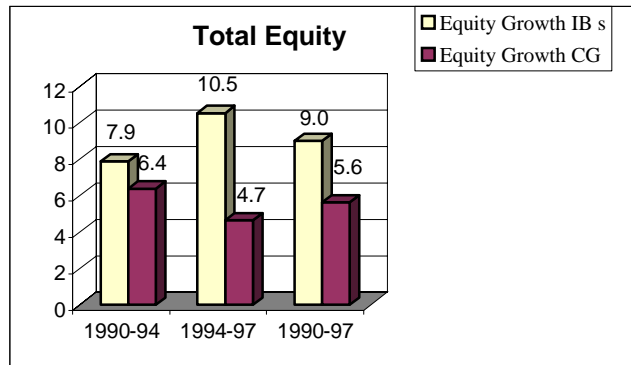
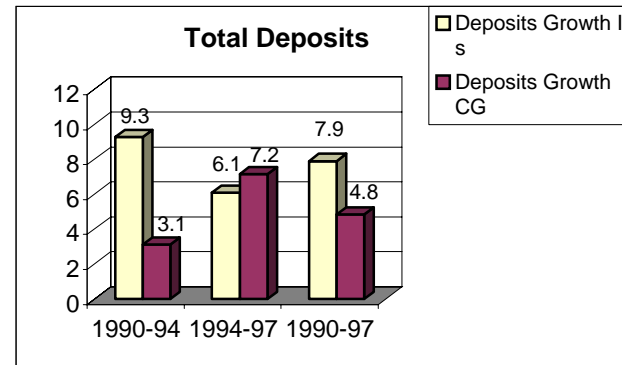


CHART 13



5.2 Ratio Analysis:

Some of the key ratios used in the balance sheet analysis have been computed for both the groups and are reported in Table.6

Table 6
Comparative Ratios (%)

Ratios	1990-94		1994-97		1990-97	
	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks
Capital Asset Ratio	9.3	9.0	10.0	9.0	9.6	9.0
Liquidity Ratio	20.2	27.7	15.7	39.3	18.5	31.9
Deployment Ratio 1	92.2	75.8	96.0	69.0	93.7	73.3
Deployment Ratio 2	80.7	72.3	84.0	63.1	82.0	68.9
Cost/Income Ratio	55.9	NA	52.4	60.3	55.4	NA
ROA	1.9	NA	2.3	1.4	2.0	NA
ROE	19.9	NA	22.6	15.0	21.2	NA

The first of these ratios is the capital asset ratio, which measures the strength of the banks. The weighted average capital asset ratio for the Islamic banks for the 1990-97 period works out to be 9.6 percent while this ratio for the same period was 9.0 percent In the case of conventional banks. There has been virtually no change in this ratio for the entire period In the case of conventional banks while In the case of Islamic banks the ratio has increased from 9.3 percent in the first period to 10.4 in the second period.

With regard to liquidity, the comparative analysis given below allows us to conclusively reject the hypothesis that Islamic banks are suffering from excess liquidity. The liquidity ratio calculated as the ratio of liquid assets to total deposits (including *mudharabah* funds in the case of Islamic banks) is in fact lower for the Islamic banks as compared to the control group banks. This ratio for the whole period was 18.5 percent In the case of Islamic banks as against 31.9 percent for the control group.

The Islamic banks have also made a better use of resources. The two deployment ratios defined earlier are plotted in charts 17 and 18. It can be seen that

in both cases the ratios are higher for the Islamic banks as compared to the conventional banks.

In terms of cost effectiveness also the Islamic banks as a group perform better than the conventional banks, the cost to income ratio being 52.4 percent for the Islamic banks as against 60.3 percent for the conventional banks. However, as noted earlier the ratio for the Islamic banks is unduly pushed down because of high weightage of Al-Rajhi for whom the ratio is very low due to no financing costs as the bank relies heavily on demand deposits not carrying any rate of return.

The profitability ratios are available for only one period i.e. 1994-97 for the control group. During this period both ROA and ROE for the Islamic banks are substantially higher than the conventional banks. The two ratios are respectively 2.3 and 22.6 percent for the Islamic banks as against 1.35 and 15 percent for the control group.

CHART 15

CHART 16

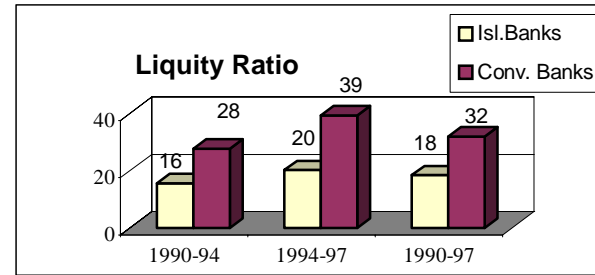
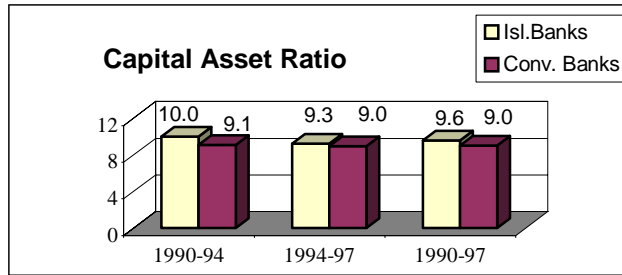


CHART 17

CHART 18

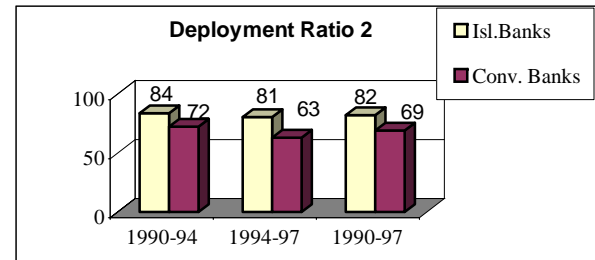
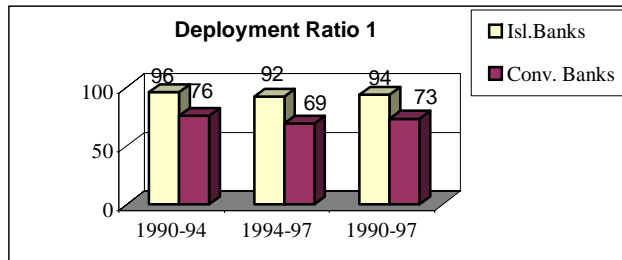
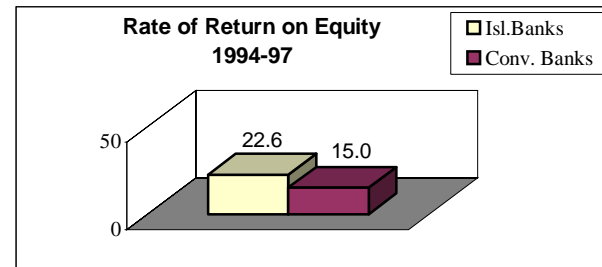
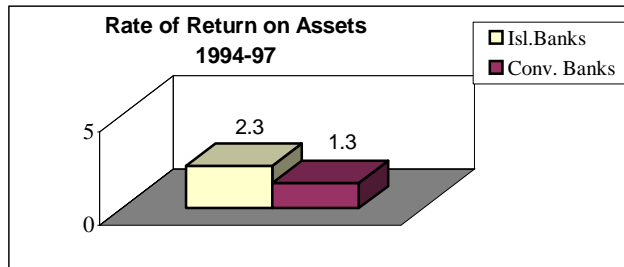


CHART 19

CHART 20



6. CONCLUSIONS

The study has tested a number of hypotheses and perceptions using empirical data on Islamic banking pertaining to the period 1990-98. Several new results have emerged. Following major conclusions need to be noted:

1) The trend analysis provided in this study, points to a general and gradual slowdown in the growth of Islamic banking industry as compared to the 1980s. This is not unexpected, though. As any industry matures, its rate of growth usually tapers off. In absolute terms, the industry is still expanding at a handsome rate of about ten percent per annum. Four reasons have been identified for this trend. Firstly, during the 1980s there were a lot of immobilized funds due to the fact that many Muslim clients do not want to involve in any interest dealings. In the absence of a viable alternative, they were keeping their savings in private lockers etc. However, in the next 10-15 years, these savings found their way into the coffers of the Islamic banks. Accordingly the rate of growth of deposits started tapering off. Secondly, during 1990s an increasing number of conventional banks started offering Islamic products. It is quite likely that some of the deposits of the Islamic banks were diverted to these banks. Thirdly, in the nineties there was the trend of establishing Islamic Mutual Funds gained ground. Some of the deposits of the Islamic banks may have been diverted to these Funds also. Finally the decline in the rate of growth is merely a statistical phenomenon. As the base gets bigger and bigger, it becomes increasingly difficult to maintain a given rate of growth.

2) The evaluation of the performance of Islamic banks through a number of key ratios yields fairly satisfactory results. In general, Islamic banks are well capitalized, profitable and stable. They also seem to be making an effective use of the resources at their disposal. However, they do not appear to be cost-effective in their operations.

3) While their profitability ratios compare favorably with international standards, it should be noted that conventional banks' depositors are guaranteed their principal amounts, and hence bear less risk than Islamic banks' depositors. Therefore, the depositors of Islamic banks would genuinely expect a higher rate of return to compensate for the extra risk. The current rates of profits on assets of the Islamic banks may not be enough to meet that expectation.

4) The study does not lend any support to the general belief that Islamic banks are suffering from excess liquidity.

5) When compared with conventional banks, Islamic banks as a group out-performed the former in almost all areas and in almost all years. However, there are considerable variations among Islamic banks in terms of growth as well as performance. Such variations are quite natural. As a matter of fact, one objective of

this study was to study the comparative performance of various Islamic banks, something that has never been done before in such detail. Similar variations are there even in the case of conventional banks.

This paper is one of the few empirical studies conducted so far on the experience of Islamic banking. Therefore, the results should be taken only as indicative rather than conclusive. It is hoped that further empirical research will be done to arrive at more definitive results and empirical realities.

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