FACTORS INFLUENCING PERFORMANCE OF THE BANKING SECTOR IN GCC COUNTRIES: ISLAMIC BANKS VERSUS CONVENTIONAL BANKS

BY

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ABSTRACT

This Study used a panel data of 72 commercial banks located in GCC countries, 28 Islamic banks and 44 conventional banks observed over the period 2007 – 2011. The aim of the study is to investigate the internal and the external factors which influence the GCC banking sectors' profitability, as well as compare between Islamic and conventional banks to see which one is performing better in GCC banking sector. This study used regression models that relate bank profitability ratio against eleven explanatory variables which consist of six variables for bank's specific characteristics and five variables for macroeconomic conditions. In this paper, the ratio of return on asset (ROA) and the ratio of return on equity (ROE) were used as proxy of profitability. The results indicate that there are four major internal factors which influence profitability in GCC banking sector. Those four factors are size, bank diversification, capitalization which showed a positive significant influence and credit risk which showed a negative influence on profitability of GCC banking Sector. In terms of macroeconomic factors, the results show that GCC banking sector was more profitable in pre-crisis period compared to post crisis period. The findings of the paper also revealed that Islamic and conventional banks were similar in terms of the internal factors that influence profitability, except for credit risk, which shows negative significant influence on Islamic banks' profitability. Though, Islamic banks and conventional banks in GCC banking sector had been exposed to similar factors, the comparison study of this paper showed that conventional banks outperformed the Islamic banks in GCC banking sector. In conclusion, it is wished that this study could provide not only banks manger but also regulators of the central banks in GCC countries, with better comprehension and guideline to promote and enhance the GCC banking sector particularly the financial position of Islamic banks.

ملخص البحث

وظفت هذه الدراسة عينة من مصارف و بنوك منطقة الخليج العربي العادية منها و التقليدية مشكلة عينة من 72 مصرفا، تشكل المصارف الاسلامية منها 28 مصرفا، في الفترة ما بين 2007-2011 هادفة لقياس العوامل المؤثرة على مقياس الربحية لهذه المصارف ، مما يؤدي الى مقارنة العوامل المؤثرة على المصارف الإسلامية بالمصارف التقليدية. باستخدام التحليل الإحصائي regression قامت الدراسة بمحاولة تفسير الربحية التي يعبر عنها بمتغير ROA عبر استخدام عدد من المتغيرات التي تصف حال البنوك ذاتها، و متغيرات اقتصادية كلية. ترجح الدراسة وجود أربعة عوامل رئيسة تؤثر على ربحية المصارف ، أولها حجم البنك ، رأسمالة البنك، التنوع المصرفي ، و مخاطر الديون ، حيث ان الثلاث الأول تعد ذات علاقة طردية مع معدل الربحية ، و مخاطر الديون تشكل علاقة عكسية معها. و علاوة على ذلك، ترشح الدراسة أن البنوك التقليدية كان أداؤها الربحي أفضل من المصارف الاسلامية في منطقة دول مجلس التعاون الخليجي. أخيرا، تقترح الدراسة على المشرعين المصرفيين و الماليين، بأن يوجدوا تشريعات تعزز من الموقف المالي للبنوك الاسلامية في المنطقة.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Islamic Banking and Finance.

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This research paper was submitted to IIUM the Institute of Islamic Banking and Finance and is accepted as a fulfillment of the requirement for the degree of Master of Islamic Banking and Finance.

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DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Abdullah Ahmed Bamaas

Signature.................................. Date. 25/05/2013

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Affirmed by Abdullah Ahmed Bamaas.

25/05/2013
Date

Signature

This research paper is dedicated to my parents

for their encouragements and support

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GCC	Gulf Cooperation Council
U.A.E	United Arab Emirates
GDP	Gross Domestic Product
ROA	Return on Asset
ROE	Return on Equity
NIM	Net Non-Interest Margin
ROAA	Return on Average Assets
ROAE	Return on Average Equity
U.S	United states
UK	United Kingdom
GMM	Generalized Method of Moments
AU	Asset Utilization
OER	Operation Efficiency
NOM	Operation Margin
OLS	Ordinary least square
IMF	International Monetary Fund
DEA	Data Envelopment Analysis
COS	Cost to Income Ratio
LLP/LT	Ratio of Loan loss provision divided by Total loans
Loan/TA	Ratio of Total loan divided by Total Asset

NII/TA	Ratio of non-interest income divided by Total asset
NlogTA	The natural logarithm of the accounting value of the total asset
OV/TA	Ratio of overhead expenses divided by Total Asset
TE/TA	Ratio of Total Equity divided by Total Asset
NlogGDP	Natural logarithm of gross domestic product
INF	Annual inflation rate
DUMTRAN1	Dummy variable that take the value of 1 for first tranquil period pre-crisis and 0 otherwise
DUMCRIS	Dummy variable value 1 for crisis period and 0 otherwise
DUMTRAN2	Dummy variable that take value of 1 for second tranquil period or post crisis and 0 otherwise

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

This paper aims to evaluate the factors influencing performance of the banking sector in **Gulf Cooperation Council** (GCC) countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and The United Arab Emirates from 2007-2011. This period also include the assessment of the impact of the financial crisis on profitability. Lastly, a comparison between Islamic banks and Conventional banks is to assess which was performing better during the period 2007-2011.

1.1.1 Islamic Banks and Conventional Banks

The functions and operating modes of Islamic banks are based on the principles of Islamic *Shari`ah* (Ahmad and Hassan, 2007). Both conventional and Islamic banks are institutions that serve as financial intermediary. A financial intermediary is an institution that acts as a middle man between cash surplus unit (Savers) and deficit spending unit (user of the funds). A financial intermediary in conventional banking is a "borrower-lender" institution. The relationship between banker and the client is borrower-lender. These institutions will not survive unless they at least cover operating expenses, where an income must be generated from such arrangement or dealings and through this process the interest comes into the picture. On the other hand, an Islamic bank is an equity-based system whereby the structure of the contract can be Ijarah based, partnership based or sale and purchase based. Islamic bank has the same purpose as conventional banks except that Islamic banks tend to operate in accordance with rule and instruction of Shari'ah law. The basic principle of Islamic bank is sharing profit and loss and prohibition of interest.

There are several Shari'ah principles which are essential for the operation of the Islamic banks. These principles include the prohibition of Riba, the avoidance of Gharar, and the prohibition of Maysir (Aziz, 2009).

In the Quran, Allah S.W.T allows "trade and commerce but prohibition of Riba"

1.1.2 The Banking Sector GCC Countries

The financial sector in the GCC is generally dominated by the banking sector, which is relatively concentrated with a few domestic players dominating the market. The GCC banking industry has several features that make it unique and different from other regions. First, the sector is largely dependent on oil sector activities and protected from foreign competition. Second, the banking industry's main lending activities are concentrated in construction, real estate and consumer loans. Third, the public sector continues to have a prominent role in the banking sector of the GCC countries (Olson and Zoubi, 2008). From the ownership aspect the banking sector is largely domestically owned. This reflects entry barriers and licensing restrictions for foreign banks, including GCC banks. Except for Bahrain, all GCC countries have limits on foreign ownership: Oman 35%, Kuwait and Qatar 49%, Saudi Arabia 40% for non-GCC nationals and 60% for GCC nationals, and U.A.E. 40%. Therefore, the cross-border presence of GCC banks and other foreign banks is limited and is mostly in the form of branches, in many cases as single branches. However, foreign bank presence in Bahrain and the U.A.E. is important, at 57% and 21 % of total assets, respectively. Market shares of foreign banks by total assets in the rest of the GCC are 2 per cent in Saudi Arabia, 12 % in Oman, 10 per cent in Qatar, and 10 per cent in Kuwait.

Additionally, from the political aspect, some governments in the GCC have been very supportive of Islamic finance, notably the government of Bahrain, which has become the major centre for Islamic banking and *takaful*, and Kuwait, which has helpful legislation. Oman has been totally negative and Saudi Arabia surprisingly opposing, although this has not prevented Islamic banking playing a major role in the kingdom's financial sector.

Islamic banks have grown in recent years to become a prominent source of financial intermediation in the Gulf countries, controlling on average 24 percent of the region's banking system assets (Al-Hassan, Khamis and Oulidi, 2010).

The value of *shari'ah*-compliant assets is impressive in the GCC, as total assets are worth over US$262.6 billion when the figures for Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain and Qatar are aggregated as total *shariah*-compliant assets worldwide amounted to around $640 billion at the end of 2007 (Wilson, 2009). This implies that the GCC countries accounted for around 41 per cent of the total.

The GCC's Islamic banking is currently at the heart of the Islamic banking industry, with some of the world's largest Islamic banks originating from the region. This includes Al Rajhi Bank in Saudi Arabia and Kuwait Finance House in Kuwait with total assets amounting to a staggering $46.0bn and $40.4bn, respectively, as at end-1Q10. In terms of the share of Islamic banking industry by country, Kuwait's Islamic banking sector accounted for 34.3% of the country's total banking assets, followed by Qatar 19.3%, Saudi Arabia 15.9%, the UAE 14.0%, and Bahrain 10.9%.

1.1.3 Impact of the financial crisis on GCC economy

The global financial crisis or credit crunch brought panic to the world's financial market in the summer of 2007. The panic cause The United states' housing bubble to burst which caused the global economic recession and reducing 1 trillion from The value of world economy. The idea of free trade being adopted without proper regulation and globalization in the third world countries which includes GCC countries, became part of the capitalistic financial markets where large sums of wealth were the subject of speculation on the state of the economy and future revenue flows.

In September 2008, stock prices in the GCC fell dramatically, similar to other developing economies. GCC total stock market capitalization fell by about $320 billion from September 10 to October 15, 2008 which is about 38% of the combined GCC GDP for 2007 (Batini, Nicoletta, and Levine, 2009). With increasing shortage of global liquidity, the international financial institutions and banks became more risk averse and the cost of borrowing at GCC increased sharply. Inflation was in double digits and interest rates were in the lower single digits growth which led to large negative real interest rates in the GCC countries and did not provide an incentive to save. In this paper we will examine the impact of the global crisis on performance of the Islamic banks in GCC countries.

1.2 PROBLEM STATEMENT

Islamic finance and banking have performed well and showed high growth period of the industry. However in the presence of globalized economy and exposure of the financial crisis, maintaining sustainable growth is becoming one of the major challenges facing Islamic banking and finance. Secondly, the industry participants had increased in number especially when conventional banks became aware the importance and which will make tough competition. This research paper raised some important questions: why do some conventional banks perform better than others? To what degree is divergency in banks' profitability due to differences in internal factors under the control of the banks' management, and to what extent do external factors impact the financial performance of these banks? Answers to these questions would be helpful to identify the determinants of GCC banks' profitability (including Islamic banks) in order to formulate policies for improved profitability of these institutions.

1.3 RESEARCH QUESTIONS

1) What are the variable that determines the influence of both Islamic banking and conventional banks' profitability in GCC banking sector?
2) What is the effect of the banks' specific determinants on profitability in GCC banking sector?
3) What is the effect of the macroeconomic determinants on the profitability of GCC banking sector?
4) What are the differences between the performance of Islamic banks and conventional banks in GCC countries?

1.4 RESEARCH OBJECTIVES

1- To study the bank specific determinants and Macroeconomic determinants that influences the profitability of GCC banking sector between 2007-2011.

2- To compare performance of Islamic banks' specific determinants against conventional banks' specific determinants in GCC banking sector 2007-2011.

3- To assess the impact of the global financial crisis on the GCC banking between sector 2007-2011.

1.5 CONTRIBUTIONS OF THE STUDY

The results of this study will positively contribute towards more comprehension of the factor that influences performance in GCC banking sector. This study is also useful for providing valuable information to relevant parties, such as bank customers, bank management and bank regulators in constructing an efficient management policy decisions for Islamic banks to gain higher profits. The benefits will extend to other parties such as the government, academicians, students ,investors and shareholders.

1.6 ORGANIZATION OF THE STUDY

This research paper will be divided into five chapters. This chapter will provide the background on the GGC banking industry; highlight objectives and benefits gained from the research. The second chapter aims to review the related studies with respect to the Islamic banking industry as well as conventional banks performance evaluation. The literature review is done by comparing past studies in terms of sample, data collection, methodology, variables used and results obtained.

The third chapter will discusses the research design and will highlight the data, identify the sources and explain the methodology which is employed in this study. Chapter three will also define and highlight the profitability measures, and the internal and external variables used in this study. Hypotheses are developed in this chapter as well, and the possible links between dependent and the independent variables are discussed. Then Chapter four presents the empirical results and the interpretation of the analyses, discusses the hypotheses tested and elaborates on the findings obtained from the regression. The last Chapter which is chapter five will discuss the main findings and present the conclusion to this research with a discussion of implications, conclusion of this study and suggestions for future research.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter will discuss the review of some of the literatures that is relevant to the topic of the study. It mentions some of the academic articles written about performance while focusing in profitability determinants literature in the banking sectors which consist of the Islamic banks and conventional banks mentioned either individually or comparatively. The purpose of this chapter is to realize two components. The first component is by comparing past studies in terms of their sample, data collection, methodology, variables used and results obtained while, the second component is realized by addressing the gap in the literature and how this study can contribute to the Literature. In order to facilitate the approach to these two components, the researcher divided this chapter into two parts. The first part will focus particularly on reviewing the literature pertaining conventional banks' performance, and the second part will focus on reviewing literature pertaining Islamic banks performance.

A lot of literature and research have been conducted in the field of performance of commercial banks in terms of efficiency and profitability. From a demographical view, this kind of research is being extensively conducted in US, Australia and Eastern Europe and the more we move outside those regions the lesser this kind of research is being conducted. This research will focus on the profitability in banking performance, and among the latest papers are written by Athanasoglou, Delis, and Staikouras , (2006), Athanasoglou, Brissimis and Delis, (2008), Goddard, Molyneux and Wilson, (2001) Hoffmann, (2011), Kosmidou and Pasiouras, (2004) Kosmidou, (2008) , Fadzlan, (2011). These papers focus on the commercial banks. However , very few papers are written about the performance of Islamic banks (Bashir, 1998),(Haron, 1996), (Mokhtar et al., 2008) ,(Rosly & Bakar, 2003) ,(Olson & Zoubi, 2008), (Samad, 2004) ,(Hassan and Bashir, 2003) and (Fadzlan, 2010).

2.2 CONVENTIONAL BANKING PERFORMANCE

Among famous early literatures in bank performance (Bourke, 1982), studied banks' performance of twelve countries located in North America, Australia and Australia. Between his objective was to examine the internal and external determinants of profitability in different countries. His pooled data were secondary data retrieved form financial statements of 90 banks between 1972 -1982. In his approach Brouke divided his data into internal and external determinants; the independent variables used in his study were staff expenses, liquidity ratio, capital ratio, market growth, bank concentration, inflation and interest rate and government ownership. His dependent variables were return to asset (ROA) and return to equity (ROE). The major findings of his study were capital ratio; liquidity ratio and interest rate are positively related to profitability. His rationale for positive sign of capital ratio is that well capitalized banks enjoyed cheaper source of funds, because of lower risk which will increase profitability.

Kunt and Huizinga (1999) used regression analysis fixed effect module to analyze how bank characteristics and macroeconomic condition effects the functioning of banks, as reflected in net interest margins (NIM) and bank profitability (ROE). Additionally, they used other special variables i.e. taxation variables, the deposit insurance index, financial structure variables, and legal and institutional indicators. Their data consist of cross-country data set with bank-level data of 80 countries from year1988 to 1995. Their output highlighted the positive relationship between capitalization and profitability, as well as a negative relationship between reserves and profitability. Furthermore, larger bank asset to GDP ratio and a lower market concentration ratio lead to lower margins and profits, foreign ownership have positive significant effect on interest margins and bank profitability. Lastly, they also highlighted that reserves also have a major impact on margins and profitability in developing countries than in developed countries.

Hoffmann (2011) examined the profitability determinants of the U.S banking industry. He assessed both the bank specific determinants and macroeconomic determinants by using GMM method. The significant finding of the study indicates the negative relationship between capital ratio and profitability. The increase in capital will lead to a decrease in the bank's profitability, because the higher the capital ratio will lower the risk on equity which will decrease the return in equity. This result will indicate the attitude of the bank of being over cautious and ignore profitable opportunities.

Kosmidou and Pasiouras (2004) have investigated the differences in performance of domestic banks in UK with comparison to the performance of the foreign banks in the same market. By using a variety of performance tools such as profitability, liquidity, risk and efficiency has led to the result that domestic bank have higher performance than foreign banks.

Athanasoglou et al. (2008) examined the bank specific and industry specific and macroecnomic determinants of Greek banks profitability, which covers the period of 1985- 2001. The study used ROA and ROE as two alternative measures for profitability. Three profitability determinants have been used which are, bank specific determinants, industry specific determinants and macroeconomic determinants. Firstly, using bank specific determinants, the researcher used capital, credit risk, productivity growth, operating expenses and size. Both credit risk and operating expenses seem to have negative correlation with profitability; however production growth showed positive relationship and size was noted to have no effect on profitability. Secondly the researcher used ownership and concentration with regard to industry specific. Lastly, for the macroeconomic determinants, inflation and cyclical output seem to have significant relation to profitability.

Bennaceur and Goaied (2008) assessed the impact of the banks' characteristics, financial structure and macroeconomic indicators on banks' net interest margins and profitability in the Tunisian banking industry for the 1980-2000 periods. Two measures of performance are used in the study: the net interest margin (NIM) and the return of assets (ROA). The internal determinants consist of five's bank characteristics indicators which are ratio of overhead to total assets, ratio of equity capital to total asset, ratio of bank loan to total asset and log of bank asset size. The finding of the paper highlighted that there is a relationship between high net interest margin with profitability and high capital with large overhead. It also found that stock market development has a positive effect on bank profitability. Lastly, the need to boost the development of the equity market in order to improve banks' profitability as banks and the stock market were found to be complementary.

Kosmidou et al. (2006) assessed the profitability of UK ,commercial owned banks, with their study sample consisted of an unbalanced panel data for 32 commercial banks within the period 1995-2002. They used fixed effect regression module to explain the relation of the dependent variables used in the study, Return on Average Asset (ROAA) and Net Interest Income (NIM) against bank-specific