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OPERATING PERFORMANCE AND SHARI'AH COMPLIANCE AWARENESS OF THE ACQUIRED BANKS: A CASE STUDY OF BAHRAIN

BY

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A dissertation submitted in fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance

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ABSTRACT

Mergers and Acquisitions M&A are a popular practice in the modern financial world, firms – including banks – tend to merge or acquire to achieve numerous benefits, including financial and operating synergies. Economies of scale play significant role in acquiring such synergies, whereby additional resources will be added for the firms, hence, lower cost of production or more effective controls will arise. In 2009, Al Salam Bank Bahrain –ASBB- acquired the Bahraini Saudi bank-BSB-, in which the former is an Islamic bank and the later is a conventional bank, raising a question of feasibility of this transaction. The interesting factors of productions would influence the efficiency of the two banks, therefore, this paper would apply the Data Envelopment Analysis –DEA- to measure if there was any operating synergy gains resulted from this unique case. Efficiencies are to be analyzed within three periods, the pre-acquisition era, post acquisitions and on the year of the acquisition itself, this will be compared with the efficiency of the other banks within the same period. The results suggests that Operational Efficiency, Pure Technical Efficiency and Scale Efficiency improved for BSB and SE evolved for ASBB, furthermore, the study argues that the Bahraini banking sector improved its relative efficiency for the same period, whereas the sources of inefficiencies were mainly due to scale efficiency. Furthermore, the paper assessed the Islamic banking perception of the employees, and by processing the survey, it was found out that the respondents were lacking the essential knowledge needed to safeguard the bank from operational and Shari'ah non-compliance risks.

ملخص البحث

تبحث هذه الدراسة عن الزيادة في الفعالية و الكفائة الناتجة من استحواذ مصرف السلام-البحرين على البنك البحريني السعودي. وتتبلور أهمية هذه الدراسة في أن المصرفين يختلفان في طريقة عملهما، حيث ان الاول مصرف اسلامي، والثاني تقليدي، لذلك قامت الدراسة بتحليل الفعالية النسبية لهما بالنسبة إلى القطاع المصرفي البحريني في الفترة ما بين 2007-2011 باستخدام تحليل المعلومات الظرفية -DEA- وبالمقارنة بين الفعالية الكلية-OE- والفعالية الفنية الصافية – - PTE- وفعالية مقياس التنفيذ SE نجد ان المصرفين نجحا في تحقيق تطور ناتج عن عملية الاستحواذ، وان القطاع المصرفي البحريني ككل يواجه اشكالية في فعالية SE وانها مصدر النقص في الفعالية الكلية. و بحثت كذلك الدراسة في مدى تصور الموظفين عن المصرفية والمالية الاسلامية، وخلصت إلى ان الموظفين بحاجة ماسة لزيادة معارفهم و خبراتهم في المجال، وإلا نجم عن ذلك ارتفاع نسبة المخاطر القانونية، والتنفيذية، ومخاطر عدم مطابقة احكام الشريعة

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 dissertation for the degree of Master of Islamic Banking and Finance.

…………………………………
Ahamed Kameel Mydin Meera
Supervisor

I certify that I have 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 dissertation for the degree of Master of Islamic Banking and Finance.

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Examiner

This dissertation was submitted to the Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance.

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Ahamed Kameel Mydin Meera
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DECLARATION

I hereby declare that this dissertation 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.

Ahmed Shawqi Alsada

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This research paper is dedicated to my parents, wife and children

for their encouragements and support

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In the name of Allah, the Most Compassionate and the Most Merciful. Praise be to Allah, Lord of the Universe and to His Messenger, Muhammad PBUH.

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF ABBREVIATION

DEA	Data Envelopment Analysis
M&A	Mergers and Acquisitions
IB	Islamic Banking
IFIs	Islamic Financial Insitutions
SFA	Stochastic Frontier Anlaysis
FDH	Free Disposal Hull
CB	Conventional Banking
ASBB	Al Salam Bank Bahrain
BSB	Bahraini Saudi Bank
OE	Overall Efficiency
PTE	Pure Technical Efficiency
SE	Scale Efficiency
VRS	Variable return to scale
CRS	Constant return to scale
CCR	Charners, Cooper and Rhodes
BCC	Banker, Charnes and Cooper

CHAPTER ONE

INTRODUCTION

1.0 INTRODUCTION

The modern sector of the financial world has been evolving vastly in recent times. Banks have been practicing new models of operations, fund flows started to move within more sophisticated channels, moreover, the banking institutions started to create bigger, resourceful, and consolidated banks through a process named Mergers and Acquisitions - M&A.

Numerous mergers occurred, the 1999 combination between Daimler-Benz and Chrysler created the new DaimlerChrylser automobile firm, in 2005 an announcement was made that Procter& Gamble Company acquired its competitor Gillette. (DePamphilis, 2010). An eye-catching figure shows that the volume of M&A transactions in 2010 were more than 19,000 announced deals worldwide with an overall volume of $ 1.1trillion.[1]

Several scholars have defined the later terms, for an instance DePam-philis defined mergers as "*A combination of two or more firms in which all but one legally cease to exist*" (2010). Still, other defines it as "*Any transac-tion that forms one economic unit from two or more previous units*"(Weston, Chung, & Siu, 1998). Moreover, it can be stated that "*It is the actual combi-nation of two independent companies*"(Ravenscraft, 1991). In contrast, the acquisition is to take over a controlling interest in a particular firm (Weston, Chung, & Siu, 1998). Breaking down the mentioned terms, could lead a re-

[1] Bedell, D. (n.d.). Global Finance, *Largest M&A deals 2009 and 2010*. Retrieved October10, 2011, from http://www.gfmag.com/tools/global-database/economic-data/10551-largest-maa-deals-2009-and-2010.html#axzz1aLeCPsgd

searcher to draw certain characteristics of a merger; the merger process has to have an economic utility as it is reflected by combining two economic entities. Additionally, it takes operational alteration as long as the firms have already ceased into a single unit –as the case of merger- or into a parent-son relationship in the case of an acquisition. Still, the attribute of the controlling interest reflects a need of maximizing the shareholders' value through this interest.

Using this stand point, M&A are powerful tools to construct gains to the participating parties, hence banking industry indeed. The banks can benefit from such a process via being consultants to the participating entities, or by merging with each other to obtain such gains.

1.1 THE BANKING INDUSTRY

A household behavior shows that they are always looking forward to increase their utility; therefore, a continuous investment seeking is being practiced by them. However, some people had excess resources, and on the contrary, some had a shortage of resources, such mismatching leads to inefficiency in the economic system. An individual with excess and idle resources is looking for a method to generate return on his/her funds, and the individual who has a shortage of funds, might consider to share some of his profit if he is able to use that excess fund of the saver. Yet, the question arises: what would match a farmer in a rural area with an individual whom has an excess fund and lives in a city? The most efficient answer to that is to have an intermediary to match savers with borrowers, and that is the major function of what's so called a bank.

1.1.1 Conventional Banking

Simpson (1981) explains the commercial bank function as the organization that obtains funds principally by offering different classes of deposits such as: checking, savings and time deposit accounts. And then it uses these funds to make loans for borrowers and to purchase securities. This is complying with the principle of matching borrowers with the lenders. Therefore, the bank functions in a way that it collects deposits create an asset to depositor, and a liability to the bank. This fund will increase the cash in the banks possession, and it can finally create the debt instrument that will be lent out to the borrowers (Ritter & Silber, 1983).

As being illustrated earlier, banks are those intermediary institutions between surplus and shortage units in the society. In very simple terms, banks will borrow from surplus units, and will lend these funds to the shortage units, and earn the difference of interest in the two processes. Sprenkle (1987) has described the proper borrowing and lending process relative to the timelineness of the process, he said banks are institutions which borrow short and lend long. This is what represents in process of creation liabilities to the bank, by accepting deposits, and on contrast creating assets, hence generating revenue (Mishkin, 2008).

In according to this process, uncertainty was introduced to banking instisutions, this uncertainty was derived by several forces, such as withdrawl by depositers, timed varying investment opportunity, interest rate fluctations and credit risk (Ferstl & Weissensteiner, 2010;Sprenkle, 1987;Hanweck &kilcollin, 1984). Therefore, proper Assets and Liabilities management instruments has to be in practice.

Therefore, the banking operation has to implement strategies in order to maximize the its revenue, such as increasing net interest income, stabilize the total assets of the firm, or generate noninterest income (Koch, 1995). Moreover, the bank will have to be exposed to liability management procedures in order for it to minimize whatever cost may be incurred.

However, this lending process doesn't come for free, the bank will charge the borrower some usury for using its funds, hence, and the repayment will be in two portions, the principle and interest.

This process of money mobilizing using the Asset and Liability management shows that the conventional operation is reflected on its balance sheet items. The liability section of a conventional bank shows the sources of the depositor's funds such as: demand deposits, time and saving deposits, and some other non-deposit sources. The assets sides of a bank shows cash assets, loans in its several forms such as commercial loans or loans to Financial Institutions, other assets may include investments and fixed assets (Simpson, 1981). Loans differ with respect to the risk of default, and their term of maturity, this reflection of Time Value of Money concept[2] drives the banking institution to charge interest on the loans.

1.1.2 Islamic Banking

To Muslims, Islam and Shari'ah is a way of life, certain practices were prohibited for them to carry on. Additionally, Shari'ah has its main objectives has been described by Imam Al Ghazali and carried on from a generation to generation. Those objectives are: Safeguarding Faith, Intellect, wealth, and

[2] Which is a dollar today worth more than dollar in the future.

posterity. Moreover, Islamic Law[3] allows most of the transactions, yet, it prohibits few, such as usury, uncertainty, gambling, and unlawful possession.

Examining the modern conventional banking industry, its cornerstone is lending in order to generate the revenue out of the usury, which is clearly forbidden in Islam. According to Abdulraheem (2010) Riba has two classes: *Riba al nassee'ah* which is defined as the increase over the principle by requiring the borrower to increase the debt if the maturity date was to be extended. The second class of riba is *al fadl* that is selling money for money and commodity for commodity with an increase over the original value. He also states that the reason for prohibition is to allow the society to live in comfort, that such a debt instrument will allow the lender to gain easy, risk free revenue, and the borrower will be in the burden of keep on paying the interest until he settles the original principle. This prohibition will insure the socio-economic goals of Islam and makes the Maqasid attainable.

In accordance to that, Muslims are not to practice banking in the same way conventional does; as a matter of fact many issues which contradict with Shari'ah occur in the conventional practice. The problem of Usury, Uncertainty, and the elements of Gambling all occur in the discipline. Hence, a need for a banking system that complies with Shari'ah existed to satisfy these requirements.

In contrast, Islam encourages trade and investment; however, a person cannot execute any transaction without a feasible contract. Contracts in Islam can be classified into characteristics basis, purpose and effect basis, time of

[3] The sources of Islamic Law are generally: The Quran, Hadith, Consensus.

execution basis, and nominated and non-nominated basis (Muhammad Yusuf, 2010).

Therefore, for an Islamic Bank to act as an intermediary should not work on lending basis, and shouldn't deny the right of human to give and take credit(Yahia, 2010). It has to act on investment basis, and comply with the Shari'ah contracts. Therefore, Islamic Banks started to mobilize depositor's funds in new instruments which complies with the Shari'ah Law and doesn't charge interest, or contains elements of uncertainty. To name few: *Murabahah, Ijarah, Salam, Musharakah.* Examining each single element of those contracts leads to understand different conditions and attributes, leads the bank to practice different accounting practices to record them. Mudharabah for example is a contract that takes the fund from the capital provider and gives it to an investor, and any financial loss should be held by the capital provider (Abdul rahim, 2010); therefore special accounting treatment is needed. Accounting and Auditing Organization for Islamic Financial Institutions – AAOIFI- defined it as a special investment account which is neither liability nor equity (AAOIFI, 2010). Moreover, for such practices, the risk drivers will have to differ than its counterpart in the conventional system.

In short we can summarize the differences between the Islamic and the Conventional banking into this table (Yahia, 2010).

Table 1.1
A comparison between Islamic and Conventional Banks

Category	Islamic Bank	Conventional Bank
Dominant Attractor	Life and Maqasid Al Shari'ah	Money
Purpose of Investment	Increase beneficial input to the society	Maximize Profit
Products	Shari'ah Complaint	Centered in the debtor-creditor relationship
Accounting Treatment	Satisfy the general accepted practices and the conditions of Islamic Contracts	Satisfy the general accepted practices
Risk Drivers	General Economic Risk: interest rate level, default etc. and Other special risks which is inherited by the Islamic Contracts	General Economic Risk: interest rate level, default etc.
Legal Framework	The domestic Banking Act, and on the top of that the Islamic Law	The Domestic Banking act.

1.2 CAN AN ISLAMIC BANK AND A CONVENTIONAL BANK MERGE?

Going through the conceptual differences and the operational differences, can they actually practice M&A processes? The issue rises from the major framework of the conventional debtor-creditor relationship, and the prohibition of usury in Islam. Moreover, the accounting treatments of several accounts and transactions, still, the assessing of risk drivers, and attaining many processes with Shari'ah requirements. How efficient is the new entity will be? And is it feasible to create values to the shareholders?

Surprisingly, an event occurred in Bahrain, in 2009, Al Salam Bank Bahrain –ASBB – and the Bahraini Saudi Bank – BSB- were the participants of the acquisition process. This happened though issuing and swapping common shares. Interestingly that ASBB as an Islamic Bank how did it manage the Shari’ah compliance throughout this action, and what measurements it took to increase its efficiency and stockholders value?

1.2.1 Al Salam Bank Profile

The bank was incorporated in January 2006 with a paid up capital $ 318 million, Al Salam Bank headquarters in Bahrain and it defines itself as a differentiated Islamic Bank. The bank operates within the Islamic Jurisprudence and the regulatory requirements for Islamic Banks issued by the Central Bank of Bahrain. Al Salam Bank provides services in wealth management such as: private equity investment, Sukuk, Investment funds, Safe custody, Leverage Facility, and Long-term deposits. Additionally ASBB practices retail banking by offering checkable, savings and call accounts. Real estate financing via Ijarah, Murabahah, and Istisna’a in order to satisfy the client’s needs of Islamic Financing instruments. In the field of corporate banking, ASBB practices it by providing Ijarah, Murabahah, Musharakah, and Istisna’a financing, Letters of guarantor and many other products. Their Investment focus is in: agri-business, alternative energy, aviation, education and healthcare.

1.2.2 Bahraini Saudi Bank Profile

In 1983 the Bahraini Saudi Bank was established with a paid up capital of BD20 million, the bank offers commercial and retail banking services to its customer. However, the bank’s majority shares were acquired by ASBB in 2009 leading it to practice Islamic Banking as a subsidiary of ASBB.

As of today, with addition to its treasury services the bank practices retail and commercial banking.

1.3 PROBLEM STATEMENT AND RESEARCH QUESTIONS

Realizing the two different concepts of the Islamic and conventional banks, leads to question the performance gains in the case of merging the two entities, this occurred when ASBB acquired BSB. Moreover, understanding the fact the both of the participating parties are practicing banking in different approaches, determining the effect in the cultural adaptation is crucial.In terms of operations did Al Salam Bank expand its efficiency by acquiring BSB; finally, were there any Shari'ah Compliance issues in the acquisition event.

1.4 OBJECTIVES

- To analyze the operational synergy (if any) resulted from the process

Any M&A transaction looks for some economic benefits, but what were the performance and operating benefits that an Islamic Bank might generate from acquiring a Conventional Bank.

- To examine the Shari'ah awareness and perception

The complicated tasks associated with Islamic banking, and being converted into an Islamic bank recently, the study aims to look into the bankers' perception on the industry of Islamic banking and finance.

1.5 SCOPE OF THE STUDY

The analysis of this dissertation will focus on the acquisition BSB by ASBB. Even though there are numerous cases in the Banking area, however, this particular case was chosen because of the uniqueness in the difference of those banks nature. It'll review the performance pre and post- acquisition, and highlight the Shari’ah Compliance perceptionof the staff in the post transaction period.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

The second chapter of this dissertation is the literature review chapter, such review of previous literature helps to go through previous researches within the field of M&A in order to gain some insight on the architecture of how guided research in this area is being conducted. Therefore, this chapter will include the following subsections: Islamic banking, which would discuss the background, contracts and contemporary issues of Islamic banking and Finance. Secondly, the proceeding section will discuss mergers and acquisitions in a deeper scope, while the motivations, financial synergies and operational synergies will be discussed. The third section will discuss banking efficiency, and hence banking institutions –conventional and Islamic- in different regions and different time periods.

2.1 ISLAMIC BANKING

2.1.1 Islamic Banking Essentials

Islamic law clearly forbids usury, which can be defined as any interest earned on the time evolvement of a borrowed sum. This is illustrated in the holy Quran (2:275)

> That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury.

It is not only the theological foundations that argues the prohibition of interest from an Islamic perspective, researchers argued some statistical considerations for such prohibition. Mohammad Zakir (2009) asserts that business and interest are different from the very fundamental perspective, he also illustrates that usury would only lead to economic exploitation which is not only unjustified, yet, it causes damage to the welfare of the society, interestingly, he points out using some different techniques that banks that are interest-free are able to attract deposits, manage funds and investment efficiently and promote financial stability. This view is consisted with the view of Masudul Alam & Md. Mostaque (2005) whom discuss the link between finance, economy, community and socity, furthermore, they also assert that the prohibition of interest didn't stop Islamic banks from effectively manage their balancesheets in an ethical manner.

Still, there are several statements by the prophet –PBUH- prohibited other practices which include: hoarding, gambling, excess uncertainty, and the like. Therefore, Islamic jurists had to come up with rulings and contracts that complies with all the Shari'ah requirements. In very simple terms, those contracts have to be equity based, and in the case that it was a debt based contract, usury has to be eliminated. In according with the fact that Islamic Banks are financial intermediaries, the analysis of the contract that underlies it has to reflect its balance sheet. Hence, an asset and liability sides contracts will be given to acquire proper insight to the matter.

However, the current market condition of focusing on Murabahah-based Islamic banking shows a trend of looking into personal *maslahah* over the social *maslahah*, this issue was contributed by the adverse conditions the Islamic banks operate within; therefore, the Islamic banks are to be encouraged to utilize different financing modes, such as Musharakah and Mudharabah(Ismail, 2012). This view is similar to what Asyraf Wajdi (2008) found in his study that distributed 1500 questionnaire among stakeholders whom regard Islamic banking as "*an intituion that*