CHAPTER 2

LITERATURE REVIEW

The empirical literature on the performance of Islamic banks has been quite limited. This has been attributed to the lack of detailed data on bank behaviour and performance (Bashir, 1999). Bashir attributed this inadequacy to a few reasons : confidentiality of information of which is unavailable to researchers, undeveloped financial markets in countries where the practice Islamic banking is the strongest, lack of private agencies specialising in the gathering and selling of information on Islamic banks and lastly, many Islamic banks not being subjected to periodic disclosure of information.

Islamic banking is practised in both Muslim and non-Muslim countries in the world. In some Muslim countries, Islamic banking is introduced as a process of islamisation of the entire economy. Under this process, Islamic banking is introduced in stages; it begins with the introducing of a few Islamic banks that set the standard and direction for Islamic banking. Gradually the operations of existing conventional banks are 'converted' to banking ala Islamic mode.

In other countries, Islamic banking operates parallel with conventional banking. The purpose of Islamic banking in these countries is to provide a banking alternative for the Muslim community in accordance to the principles of Islam. Empirical studies have been done in both types of countries. Malaysia falls under the category of a parallel banking system.

Therefore, in reviewing the work done by other authors on this subject, care has been taken to select works on countries, which have a parallel banking system, similar to the experience of Malaysia. This is to ensure that comparisons of previous studies can be made with the empirical results obtained from Malaysia.

2.1 Performance Evaluation of Islamic Banks in Other Countries

2.1.1 Middle East

One of the earliest works on Islamic bank performance was done by **Khan (1983)** who examined some of the Islamic banks operating in Middle-Eastern countries like Kuwait, United Arab Emirates, Egypt, Jordan, Sudan and Bahrain. His study found that the profitability rates of Islamic banks ranged from between 9 to 20% while the rates of return to deposits ranged between 8 to 15%. This was found to be almost on par with interest rates offered by conventional banks in the area of study. This means that Islamic banks can be as competitive as conventional banks.

2.1.2 Egypt

El-Ashker (1990) examined the development of Islamic banks in Egypt and carried out an analytical appraisal of the financial performance of these banks. In his appraisal, El-Ashker compared the performance of the two Islamic banks with a conventional western-style bank in Egypt between 1982-1986 using key financial ratios. He divided the ratios into three groups; growth, activity and efficiency.

In terms of deposit growth, El-Ashker found the two Islamic banks growing rapidly since they were established. However in later years, deposit growth slowed down. In terms of activity, Islamic banks have higher deposits to assets ratios compared to conventional banks. In the use of funds, the Islamic banks have been effective in providing finance to their customers according to their financial capacity. This is evidenced by a higher total finance to total assets ratio.

In terms of efficiency, the profit margin, return on assets (ROA) and rate of return on assets figures indicate that the conventional bank outperformed the two Islamic banks in the period of study. The capital-turnover ratio was favourable for the Islamic banks. El-Ashker commented that if the two Islamic banks were to improve overall profitability, they would have to improve their profit margin even at a lower capital turnover. On the argument that conventional banks would normally have higher ROA because of the additional earnings through interest rate differences between loans and deposits, El-Ashker recalculated the ROA for the conventional bank by modifying the ratios to exclude interest earnings and payments for the conventional

bank. When this was carried out, the Islamic banks were found to be just as competitive as the conventional bank.

El-Ashker concludes by commenting that overall, Islamic banks have shown that they can compete, grow and expand together with conventional banks.

2.1.3 Jordan

Shallah (1990) reviewed the experience of the Jordan Islamic Bank between 1980-1987 examining its growth, activities, performance, liquidity and the extent to which Islamic finance is attractive to both savers and investors within a western oriented financial structure in a stagnant period of Jordan's economy.

In terms of the volume of deposits, the first few years did not see very significant increases. But by the end of 1987, the volume of deposits had increased significantly. However, although the total amount of deposits was increasing over the years, the growth of deposits was declining in the period of study. [5] In terms of total assets, total asset growth has also exhibited a declining trend with increases only in 1983-84 and 1985-86.[6]

In terms of branch activities, the Jordan Islamic Bank grew from one branch to fourteen branches in a span of nine years reflecting significant expansion unparalleled by conventional banking. The bank's source of funds comes from shareholders' equity and deposits. In terms of shareholders' equity, Shallah observes

[5] Total deposits growth was calculated from Table 6.1 of Shallah (1990)
[6] Total asset growth was calculated from Table 6.4 of Shallah (1990)

that reserves and retained profits make up 66.3% of the net profits in 1985. Therefore, the bank is said to adopt a cautious conservative policy. Also, capital adequacy was found to be comparable with conventional banks. This meant the bank's risk of becoming insolvent was not any higher than that of a conventional bank.

In terms of profitability, it is found that favourable returns to depositors only occur in the first year of the bank's operation. Since 1982, rates of return to depositors have declined in comparison to rates of return to shareholders, which have risen and stabilised over the period of study. In terms of liquidity, the bank has always exceeded required liquidity requirements implying that risk to depositors is very minimal. In terms of use of funds, the Jordan Islamic Bank appeared to concentrate on short-term financing, of which has been criticised as being contradictory to the ideology of Islamic banking.

Shallah's main criticism of the Jordan Islamic bank was that it was partial toward short-term financing and this had not benefited the agricultural sector of the Jordanian economy.

2.1.4 Kuwait

Wilson (1990) evaluated the Kuwait Finance House (1978-1987) in terms of its activities, performance, profitability, liquidity position and returns to depositors and investors. The Kuwait Finance House was deemed the most successful Islamic commercial bank of the 70s and 80s. Wilson sought to explore issues on how the House fared in comparison with other conventional banks in Kuwait, the uniqueness of the House, its future prospects and expansion possibilities.

The House showed strong growth in deposits in the first five years of its establishment. It was rated sixth amongst Kuwait's banks in terms of deposits. This strong growth was attributed to its success in penetrating a niche market of Islamic clientele who had formerly kept their money in other forms of savings. The collapse of the unofficial Kuwaiti stock market, Souk al-Manakh also benefited the House as investors switched their funds to safer institutions. However deposit growth did not continue the uptrend. After 1983, deposit growth exhibited a declining trend attributed to a maturing House and to falling oil prices of the mid-80s. However, it was noted that Kuwait Finance House fared better than other commercial banks in Kuwait.

In terms of competitiveness, Kuwait Finance House has endeavoured to offer returns to investment account holders which compare favourably with the interest rates offered by conventional banks. In terms of profitability, the Kuwait Finance House experienced profits every year with aggregate income peaking in 1982. This

declined considerably between 1983-85 as a result of difficult conditions in the Kuwait economy.

In terms of liquidity, the House has always maintained a secure liquidity position in order to meet withdrawal demands. Also, the depositors of savings and investment accounts of the House have a tendency to place their money on a long-term basis. Therefore, deposit liabilities are less liquid as withdrawal risk has been low. This has placed the House in a more secure position with regards to long-term funding compared to conventional banks.

Wilson concludes that the Kuwait Finance House has achieved remarkable success both as a deposit-taking and funding institution. Wilson also highlights the limitations of the House in domestic expansion as most of the residential and commercial areas in Kuwait have already been penetrated. He feels that the House' concentration on international trade operations would be beneficial towards its growth.

2.1.5 Sudan

In a slightly different analysis, **Bashir (1999)** examined the effects of scale on bank performance using data from two Islamic banks in Sudan i.e. Faisal Islamic Bank Sudan (FIBS) and Tadamon Islamic Bank Sudan (TIBS) between 1979-1993. Bashir noted that FIBS was the first Islamic bank in Sudan and that both FIBS and TIBS were established in an era when the whole banking system was dominated by conventional banks.

In his study, it was found that both banks experienced exponential growth in their size (assets) and sustained growth in their deposits over the years. It was also found that in the early years of FIBS, the rates of return exceeded those of the conventional bank. This was attributed to firstly, bank expansion to different geographical and sectoral areas and secondly, to the ability of the bank to fulfil previously unmet needs of a number of Muslim depositors. However, the rates of return and average profitability exhibited cyclical behaviour and were found to decline after 1983.

Bashir attributed this decline to three factors; political and economic stability and competition from new Islamic banks. On factors affecting bank performance, Bashir's results showed that bank performance increased with bank size while operating risk decreased with bank size.

2.2 Performance Evaluation of the Islamic Bank in Malaysia: Bank Islam Malaysia Berhad (BIMB)

Various studies have also been done to evaluate the performance of Bank Islam Malaysia Berhad (BIMB), the sole Islamic bank in Malaysia for the last 16 years.

Man (1988) did a preliminary evaluation of BIMB performance from 1984 to 1985 i.e. during its first two years of operation. He found that total deposits of BIMB grew by 70% while total assets grew by 41.4% within one year. In terms of profitability, the rates of return on equity and assets also improved during the same period. This meant that BIMB had achieved remarkable results at the early stages of operation.

In terms of uses of funds, the ratio of finance and investment to total assets increased from 29% (1984) to 41%(1985). However, this was found to be much lower than the industry average suggesting that BIMB had not fully utilised its funds. In terms of capital adequacy, the capital-asset ratio was twice the industry average implying that there was a lot of coverage for the shareholders. In terms of liquidity, BIMB had a

liquidity ratio of 21% in 1985 compared to the industry average of 14.7% suggesting that BIMB was highly liquid.

Man concluded that in spite of BIMB's remarkable success, its weakness was reflected in the under-utilisation and inefficient use of funds as there were a lot of funds lying idle.

Radiah (1993) evaluated BIMB's performance over the first eight years of its operation (1983-1993) to assess BIMB's viability as a financial intermediary in a well-established conventional banking industry. In addition, she also sought to ascertain the reasons why BIMB only captured a marginal share of total banking deposits in a country which is predominantly Muslim. The performance of BIMB was evaluated in terms of market share, mobilisation of deposits, utilisation of funds, profitability and liquidity.

In terms of market share of assets, it was found that BIMB's growth over the first eight years had transformed it from a small sized bank (assets worth RM 563 m) in 1984 to a medium sized bank (assets worth RM 1.7b) in 1989. This also placed BIMB in the thirteenth position among commercial banks in terms of asset size. In its peer group of medium sized banks, BIMB's asset size was found to have surpassed two other established banks. BIMB's market share of deposits also grew from 0.8% to 2% of industry total between 1984-1989, climbing from nineteenth to twelfth position among the commercial banks. However, BIMB's market share in terms of shareholders' funds increased only marginally between 1989-1989 as BIMB slipped from seventh to tenth position among commercial banks.

In terms of deposit growth, BIMB was found to exhibit a trend of high deposit growth in the first two years of establishment, moderate growth between 1985-88 and declining growth between 1990-91. Radiah attributes this observation to the fact that the initial depositors who bank with BIMB did so because of religious motives. However, beyond this group of clientele, other depositors were more attracted to high returns. As evidence, Radiah observes that high interest rates on fixed deposits

offered by conventional banks in that period had caused depositors to deposit with commercial banks.

In the utilisation of funds, BIMB's financing portfolio was found to favour trade or sale related financing (mark-ups). Financing in the form of equity participation was small and confined to large corporations. This reflects BIMB's risk averse and conservative policies. As for sectoral contribution, BIMB's lending priorities were mainly to the property sector specifically toward residential properties. Apart from the property sector, the construction and real estate sectors also received attention over the years and was close to the industry ratio of 17% in 1991.

In terms of profitability, BIMB's pre-tax profits were low during the recession of 1985-86, grew strongly between 1987-90 but moderated between 1990-91. However, the pre-tax ROA has improved tremendously between 1988-91 reflecting the expansion in the financing and fee-based activities over the period. As for the ROE, it has been rising every year except for 1997.

In terms of liquidity, BIMB's primary liquidity ratio has always exceeded the primary liquidity requirements. Radiah attributes this observation to the lack of Islamically accepted short-term investments in the secondary market.

Radiah concludes that BIMB has proven itself to be a viable financial intermediary in the midst of conventional banks. The religious factor associated with high deposit growth in its initial years shows that BIMB has fulfilled a role of providing an alternative banking system which conventional banks were unable to fulfil.

However, significant withdrawals of investment deposits in later years imply that the future growth of deposits will depend upon the availability of BIMB to offer competitive rates of returns. In terms of funds utilisation, BIMB is found to fall below its developmental role because of its lack of commitment toward equity participation and profit sharing methods of financing.

Wong (1995) evaluated the performance of BIMB from 1984 to 1991 with the objective of examining the viability of Islamic banking in Malaysia. Performance was evaluated based on the growth of deposits and total assets, profits and returns to depositors and shareholders, modes of financing and usage of funds and finally how BIMB discharges its social obligation as an Islamic bank.

The amount of deposits and total assets increased over the years but the growth rates were on a declining trend over the ten-year period. This contrasts industry performance where growth rate declined between 1989-1990 but increased again after 1990. Wong attributed BIMB's weaker performance to the liberalisation of the

base lending rate. Because the base lending rate was no longer fixed by the Central Bank, conventional banks were free to set higher rates of return to depositors. This may have resulted in some of BIMB depositors switching to conventional banks to take advantage of higher returns.

In terms of rates of returns to depositors, BIMB's rate of return on 12-month deposits was lower than those offered by conventional banks. In terms of rates of return to shareholders, BIMB offered lower rates compared to the dividend rates offered by

two prominent conventional banks. In terms of profit margin, although BIMB occurred a loss in its first year of operation, it managed to break-even 18 months later. Over the ten-year period, profits increased by 220%. In terms of profitability, the ratios of returns on assets, equities, deposits and to financing showed that BIMB's profitability position had improved within the eight year period of 1985-1993 but was not significant enough.

In terms of financing, BIMB is found to be partial towards short-term financing in the *murabahah* and *bai bithaman ajil* mode. Also, funds are channelled mainly into manufacturing, wholesale, retail and trade sectors similar to the practices of conventional banks.

Wong also finds that BIMB's social obligation to be insignificant as Qardul-hassan loans only contribute 0.07% of total financing in 1991. Wong concludes that in terms of performance, BIMB has proven its ability to maintain its viability and growth in a capitalistic financial environment. However, he finds weaknesses in two areas; its mode of financing which was partial toward short-term financing and its social obligation because it has not done much to contribute toward a more equitable distribution in the Malaysian economy.

In a more recent study, **Samad and Hassan (1999)** did an inter-temporal and inter-bank comparison on BIMB performance in terms of profitability, liquidity, risk and solvency using financial ratios and significance tests. The performance of BIMB was first compared inter-temporally between two periods of 1984-1989 and 1990-1997. Then the performance of BIMB was compared with the performances of eight other conventional banks between 1984-1997. This study also sought to test two hypotheses. First, liquidity ratios of Islamic banks are expected to be higher in the early years of operation because of the learning curve. Secondly, the volumes of two true Islamic financial modes of lending (mudharabah and musharakah) are expected to grow larger in later years of operations.

Their results showed that BIMB had made significant progress in its profitability evidenced by statistically significant difference in the return to assets, return to equity and profit expense ratios in the two periods of study. However, in comparison with the average conventional bank in the study, BIMB was found to be lagging behind. Samad and Hassan attribute this lag to three reasons; the limited scope of investment for BIMB in lieu of its religious constraints, major investment in lower-returns government bonds and its commitment toward the guaranteeing of deposits.

In terms of liquidity, BIMB was found to maintain more liquidity compared to the other banks. Results also show no significant difference in the liquidity position of both time periods. BIMB maintained the same liquidity position over the years and did not become less liquid in the later years of its establishment compared to its early years.

In terms of risk and solvency, BIMB's involvement in risky business increased over the years evidenced by significant differences in its debt-equity and equity multiplier ratios. But when this was compared to conventional banks, BIMB was found to be less risky and more solvent than conventional banks. In the uses of funds, although financing via mudarabah and musharakah has increased in terms of percentage, it is not statistically significant. The reason behind for this poor response is because these modes of financing are deemed more risky and less profitable.

Samad and Hassan concluded that BIMB performance had improved significantly over the years and is generally comparable with that of conventional banks. In terms of risk and solvency, BIMB is found to be less risky and more solvent.

In conclusion, the literature review on the Islamic banking experience in Malaysia and other countries seem to exhibit the following characteristics. Growth in deposits and assets are particularly strong in the initial years of operations but seem to exhibit a declining trend after that. The rates of return to profits on the whole seemed to be competitive with conventional banks. Finally in the uses of funds, Islamic banks tend to concentrate on short-term financing.