ISLAMIC AND CONVENTIONAL BANKS IN THE GULF REGION, PROCESSES, BENEFITS AND DRAWBACKS

Mohammad Kamal Kamel Afaneh, Imam Mohammad Ibn Saud Islamic University (IMSIU)

ABSTRACT

This study aims to clarify and discuss some of the major differences in the processes and business functions in Islamic bank and conventional ones, in addition to a deep literature review discussing the banking services in the Gulf area, and around the world.

While some of the key concepts were explained later on in the paper, the benefits and drawbacks of the two types were viewed and discussed, then a study that examined the period of 2005-2010 was embedded in the paper, the study was done by K.K. Siraj and P. Sudarsanan Pillai, as it studied the banks in the GCC region, both types, and some expected and unexpected results were concluded from the study, as there is an emphasize on the reason behind the selection of the specific time period of 2005 – 2010 of the study that is also discussed later on in the paper.

Keywords: Islamic Banks, Conventional Banks, Gulf Area

INTRODUCTION

Over the previous decades, very few studies focused on the genuine contrasts between Islamic banks and conventional ones Mensi, Hamdi, Shahzad, Shafiullah & Al-Yahyaee (2018). Flagging hypothesis predicts that profits can flag management's perspective on a company's condition. Thusly, attributable to the profit's effect on firm worth, the elements that decide those profits merit examination. One of the goals of this paper is to look at the significant contrasts between Saudi Islamic Banks' strategies, and the distinctions in the routine-based and unexpected processes between the two types of banks in Saudi Arabia.

As Saudi Arabia progressively moves toward financial growth, it opened its stock market for exchanges (Tadawul) to Qualified Foreign Investors a couple of years back to permit investment from the outside resources and possible financial backers. This was a noteworthy stage in the oil-rich countries economic change endeavors that could draw in abroad investments before very long (Javaid & Alalawi, 2018).

The launch of the Tadawul to unfamiliar investment will give more prominent market growth, increment institutional investors' cooperation and lessen the job of retail financial backers (Zubairu & Sakariyau, 2011).

The major inspiration of this review is to connect the current hole in the writing by investigating the variables impacting profit strategy for Islamic and conventional Saudi Banks.

This research has significant ramifications for both hypothesis and practice. It will expand the writing on profit strategy by distinguishing interestingly the determinants of profit strategy for Saudi Banks. Banks and financial foundations are normally rejected from profit investigation due to their extraordinary financial constructions, accounting strategies, and corporate governance.

Understanding profit strategy not just improves the estimate of profit installments and the decision of suitable valuation models yet in addition gives better knowledge into the

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interrelationship among working, financing, and investing exercises (Zubairu, Sakariyau & Dauda, 2012).

The passage of unfamiliar institutions will assist Tadawul with developing a regarded emerging business sector proportionate with its size (Abdallah & Knio, 2021).

While there are many stock trades in the GCC area, the most notable is without a doubt Tadawul. Saudi Arabia is probably the biggest economy in the Middle East so it's nothing unexpected that its stock trade is positioned in the best 10 biggest on the planet by market capitalization, for the most part because of the new first sale of stock (IPO) of Saudi Aramco (Hvidt, 2013).

Tadawul, known as the Saudi Stock Exchange, was officially framed in 2007 and is the sole element authorized in Saudi Arabia to carry on like a stock exchange. Tadawul offers values, Islamic securities, trade exchanged funds, and mutual funds, and it right now has roughly 150 organizations recorded for trading on the exchange. It is directed and worked by the capital market authority. Just settled institutional foreign investors or worldwide establishments situated in Saudi Arabia are permitted to trade and invest in protections recorded on Tadawul. With Saudi Vision 2030, the Kingdom has a focus on accelerating and focusing on digital projects. The Kingdom of Saudi Arabia is set to become the global leader of the digital economy through the full deployment of emerging technologies such as Artificial Intelligence (AI), Internet of Things (IoT), Blockchain, Big Data, Robotics, Machine Learning, 5G across public and private sectors (Vinodkumar & AlJasser, 2020).

LITERATURE REVIEW

There are hypothetical and experimental explores on capital adequacy. Although the point is more important especially for the last a very long time because of the financial connections of the worldwide banking exercises, there are prior investigations made on the capital design.

Hasan & Dridi (2010) demonstrated that in an ideal financial market capital design and subsequently capital regulation is unimportant.

Capital necessities might influence bank conduct to face more challenge or not. Such an issue is examined by Sillah & Harrathi (2015) on global banks by utilizing a synchronous conditions model.

Miah & Uddin (2017) dissected the viability of bank capital sufficiency regulation by assessing a disequilibrium model for Spanish Commercial Banks information from 1985 to 1991. They looked at two models where firms are not impacted by capital adequacy guidelines and firms that are impacted. They observed that market pressure is the principal determinant of banks' capital rather than the administrative limitation.

Johnes, Izzeldin & Pappas (2014) in their assessment of Islamic banks and capital adequacy presumed that notwithstanding government infusion, benefit excess, and other capital instruments there are long haul apparatuses needed to support capital to Islamic banks.

Rahim & Zakaria (2013) read Malaysian Commercial Banks for the determinants of the Capital Adequacy Ratio and tracked down that Return on Asset (ROA), Loan to Assets Ratio (LAR), Risky Assets Ratio (RAR), and profits pay-out proportion decidedly influence the Capital Adequacy Ratio (CAR) while Deposits Assets Ratio (DAR), size of Bank and Loan Provision Ratio (LPR) adversely influence the Capital Adequacy Ratio (CAR).

Alshammari (2017) viewed underlying differences between the two bank types. They distinguished that Islamic banks generally depend on their value in financing while conventional banks depend on acquired funds in the financing, consequently demonstrating a higher shock-engrossing limit with respect to Islamic banks in contrast with conventional banks.

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Saif Alyousfi, Saha & Md Rus (2017) in a report on Islamic banks and conventional banking utilizing CAMEL test detailed better performance of Islamic banks on adequate capital and liquidity position contrasted with conventional banks.

This review observed similitudes between conventional banks and Islamic relying upon resource quality while conventional banks were tracked down prevalent in the management of value and procuring capacity.

It could be seen that the expanded ubiquity of Islamic banking in current days may be affected by its flexibility to financial shocks and emergencies.

It doesn't imply that Islamic banks are not under any condition impacted by the financial crisis, nonetheless, it clarifies, as brought up by Parashar (2010) that Islamic banks are less effected by the financial crisis. This view is additionally upheld by Rosman, Abd Wahab & Zainol (2014) and announced moderately better performance of Islamic banks during the financial crisis since Islamic banks hold higher capitalization in addition to higher liquidity reserves.

Chazi & Syed (2010) found dependent on a near report that Islamic banks showed more flexibility during the global financial crisis.

Alkassim (2005) utilized financial proportions and relapse models to 128 comparative study on performance of Islamic and conventional banks analyze the performance of Islamic banking and conventional banking in GCC.

Akhter, Raza, Orangzab & Akram (2011) used financial ratios to concentrate on the effectiveness and performance of Islamic banking. Merdad, Hassan, & Hippler III (2015). utilized a calculated relapse model and discriminant examination to look at the influence and productivity of Islamic banks and conventional banks.

Kouser, Aamir, Mehvish & Azeem (2011) utilized the CAMELs rating framework also, numerous discriminant investigation to separate among effective and low productive banks dependent on their effectiveness proportions. Al-Hussain (2009). Utilized DEA (Data Envelopment Analysis) to break down the overall proficiency of Islamic banks and conventional banks in the GCC area.

Key Terms and Definitions

- Murabaha: Murabaha is not a loan given on interest rather it is a sale of a commodity at profit, it’s a sale where the seller discloses the cost of the commodity and amount of profit charged (Miah & Suzuki, 2020).
- Musharakah: A joint partnership where two or more parties combine their capital or labor, forming a business where involved parties share the profit or loss according to a specific ratio (Muhammad, 2014).
- Wadiah: A depositor places property with another party for safekeeping under the rules of Fiqh, There are two types of Wadiah, Wadiah yad Amanah refers to property is deposited on the basis of trust (guarantee safe custody), and Wadiah yad Dhamanah refers to savings with guarantee or safe-keeping (Rahmasari & Febriandika, 2019).
- Ijarah (Islamic Leasing): A contract where one party transfers the right to use an item he owns to another party for a specified period in exchange for an agreed consideration (Gupta, 2015).
- Fiqh: The human understanding and practices of the sharia, that is human understanding of the divine Islamic law as revealed in the Quran and the Sunnah (Jusoh, Ibrahim & Napiah, 2015).

Islamic Banks

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Islamic banking, also known as Islamic finance or Islamic Funds, refers to financial transactions that adhere to the Islamic rules. Two main pillars of Islamic banking are the sharing of profit and loss, and the prohibition of the collection and payment of interest by lenders and investors.
Islamic banks are well spread around the globe, between 2012 and 2019. According to Islamic Corporation for the Development of the Private Sector, (2020) Islamic banking assets raised from $1.7 trillion to $2.8 trillion and are expected to grow to around $3.7 trillion before 2024.
The principles of Islamic banking are derived from the Qur'an–the central religious text of Islam. In Islamic banking, all transactions must be compliant with Fiqh, the legal code of Islam.
Islamic banking avoids the utilization of charging interest, instead, Islamic banks use equity participation, which means, a financial firm who conduct business according to the Islamic way doesn’t charge interest from the borrower, but in return, the borrower pays the Islamic bank back by sharing an agreed upon percentage of profit.

Islamic Banking Advantages (Al-Muharrami & Hardy, 2014).

1. Fairness: The foundation of the Islamic Banking model is based on a profit-sharing principle, whereby the risk is shared by the bank and the customer.
2. Available for All: Although based on Quran principles, Islamic Banking is not restricted to Muslims only and is available to non-Muslims as well.
3. Transparency: Islamic Banking is built about conducting business in a transparent way. Guiding clients through to ensure full understanding of potential risks and costs.

Islamic Banking Disadvantages (Sibghatullah & Raza, 2020).

1. Quran interpretations of new financial services is not always clear.
2. Some Murabaha are based on prevailing interest rates rather than economic or profit. conditions.
3. Islamic banks cannot minimize their risks as hedging is prohibited.

Conventional Banks Advantages (Rahman, 2016).

1. Availability of loans in comparison to Islamic banks.
2. Wider reach around the world.
3. Easier understanding of the rules when it comes to new financial services.

Conventional Banks Disadvantages (Paltrinieri, Dreassi, Rossi & Khan, 2021).

1. Compound interest hidden expenses.
2. Embedded fees associated with services are usually higher in comparison to Islamic banks.
3. Could be easily affected by a potential financial crisis, or a similar unfortunate event.

Study Method

The study aimed to measure and differ the performance of conventional banks and Islamic banks in GCC region. Twelve major banks including 6 Islamic banks and six conventional banks within the GCC area. The financial information from the period of 2005-2010 is used in the study. In GCC region, many banks operate with both conventional and

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Islamic banking products. To compare and contrast on Islamic and conventional banks, it is necessary to select banks which can be either classified as conventional or Islamic banks.

Islamic Banks included in the study

1. Al Rajhi Bank, Saudi Arabia
2. Bahrain Islamic Bank, Bahrain
3. Dubai Islamic Bank, UAE
4. Qatar International Islamic Bank
5. Kuwait Finance House, Kuwait
6. Abu Dhabi Islamic Bank, Abu Dhabi, UAE

Al-Rajhi Bank was ranked No.1 according to the MEED report (MEED, 2009). Among Islamic banks, followed by Kuwait Finance House, Dubai Islamic Bank, Abu Dhabi Islamic Bank, ranked 2,3 and 4 respectively. Qatar International Islamic Bank is ranked 20, while Bahrain Islamic Bank was ranked 25th in the list. (MEED, 2009). Six commercial banks were selected for the study. The banks selected were ranked as leading commercial banks in GCC region. It may be noted the Abu Dhabi Commercial bank added Islamic banking activity as well but is found comparably negligent (Ratio of income from Islamic financing to income from interest stands 0.030:1, based on financial results 2010) , hence selected under commercial banking group.

Important considerations that were taken into account while conducting the study

1. The Emirates NBD is selected as one of the conventional banks operating in the region. It may be noted that the bank also possesses Islamic banking division.
2. The study concentrates on the ratios and growth rates to infer on performance of bank groups. While the absolute values indicating performance is not used in the study.
3. Banks are selected from all GCC countries except for Sultanate of Oman since no fully operating Islamic bank exists.

Conventional banks included in the study

1. Bank Muscat, Sultanate of Oman
2. Commercial Bank, Qatar
3. Abu Dhabi Commercial Banking
4. Arab Banking Corporation, Bahrain
5. National Bank of Kuwait
6. Emirates Bank International

A major tool used to assess the performance of any commercial organization is its profitability. Profitability is reflected in various indicators that include Operating Profit Ratio (OER), Net Profit Ratio (NPR), Return on Asset (ROA), Return on Share capital (ROCA) and Return on Total Equity (ROE). The above-mentioned ratios indicate the relationship of profit on total income, total asset, share capital, total equity etc. The efficiency with which an organization manages its operating expenses is highlighted in Operating Expenses Ratio. Another major indicator of performance is capital adequacy and is measured using Equity to Asset Ratio, calculated by dividing total equity by total assets. A higher ratio indicates low risk and represents a higher share of ownership fund in total asset of the bank. In addition, indicators such as profit

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as a percentage of customer deposits, customer deposits as a percentage of total liabilities, and total equity as a percentage of total assets were computed to compare between conventional banks and Islamic banks.

Study Analysis

OPR is calculated by dividing operating profit by total income. An evaluation of operating profit results a comparably better performance of Islamic banks. On an average, Islamic banks registered an OPR of 62% during 2005-2010, while it stands 46% for the conventional banks. Even though the ratio is favorable for Islamic banks, it is viewed that there is a decline in OPR of Islamic banks after 2007, which is affected by the financial crisis that impacted the whole world during 2007. According to the study analysis, there is a significant relationship in the transition of operating profit among Islamic banks and conventional banks.

NPR is calculated by dividing net profit by total income generated. Conventional banks got a higher NPR than Islamic banks between 2005-2010. Islamic banks registered an average annual NPR of 30.89%, while it stood at 38.49% for conventional banks. Similar to the trend in operating expense ratio, NPR ratio also showed a reduced trend after 2007 for Islamic banks, while conventional banks reported a recovery of NPR from 2009 onwards. According to the study analysis, there is no significant relationship in the movement of net profit among Islamic banks and conventional banks.

A lower OER shows better control over operating expenses and highlights lower expenses and higher earnings. Hays, De Lurgio & Gilbert Jr, (2009), used OER as efficiency ratios to differentiate between low efficiency and high efficiency banks. It may be observed from the analysis that Islamic banks shows a lower OER ratio compared to conventional banks during 2005-2010. The analysis inferred two major trends in OER ratio. First, Islamic banks shows higher OER ratio after 2008. The same is true in the case of conventional bank as well. It indicates the possible susceptibility of bank groups towards financial crisis. To improve efficiency, banks need to reduce its OER ratio.

According to the study analysis, there is no significant relationship in the movement of operating expenses among Islamic banks and conventional banks. It supports the earlier observation on relationship in the movement of net profit among Islamic banks and conventional banks.

ROA is calculated by dividing total profit by total asset. The ratio is widely used as a proxy for profitability. P. Cook and Y. Uchida, (2004) utilized ROA to assess profitability and evaluate performance of different enterprises. M.A. Peterson and I. Schoeman, (2008) interpreted ROA as an important tools indicating operational efficiency of the bank. It may be observed from the analysis that Islamic banks enjoy higher ROA than conventional banks. The ROA of Islamic banks stand 2.63% during 2005-2010, while it stands for 1.61% for conventional banks. According to the study analysis, there exist no significant differences in the movement of Average Return on Asset among Islamic banks and conventional banks.

ROCA is calculated by dividing net profit after tax by share capital. The equity capital denotes the issued capital alone and does not include any reserves, etc. It establishes the relationship between profit after tax and share capital. It may be observed from the analysis that Islamic banks possess higher ROCA compared to conventional banks during 2005-2010. ROCA stood at 59.06% for Islamic banks while it stands 55.54% for conventional banks. An interpretation of efficiency based on ROCA is often difficult, according to the study analysis, there is no significant relationship in the movement of ROCA among Islamic banks and conventional banks.

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A higher ratio indicates better use of capital. It calculated by dividing net profit after tax by total equity. Total equity is sum total of capital and reserves. It may be observed from the analysis that Islamic banks carry a higher ROE compared to conventional banks. As may be seen in other performance indicators, there exists a decline in ROE ratio of Islamic banks over the years. According to the study analysis, there is no significant relationship in the movement of ROE on total equity among Islamic banks and conventional banks.

Customer deposit is a major source of fund for banks. The success of banks can also be determined based on its efficiency in managing customer deposits and converting it into revenue generative investment opportunities. The bank has to pay returns on customer deposits, which in conventional banking denoted as interest expense, while in Islamic banking is denoted as share of profit. Profit as a percentage of customer deposits is calculated by dividing profit after tax by total customer deposits. It may be observed from the analysis that the Islamic banks provide more profit on customer deposits than conventional banks. Profit as a percentage of customer deposits is calculated as 17.57% for Islamic banks between 2005-2010, while it stands 2.90% for conventional banks. According to the study analysis, there exists significant relationship in the movement of profit as a percentage of customer deposits among Islamic banks and conventional banks.

Customer deposit is a major part of total liabilities of any bank. It may be observed from the analysis that Islamic banks carry higher percentage of customer deposits in total liabilities during 2005-2010. Islamic banks hold an average of 73.80% deposits in total liabilities of the bank group, while it stands 55.12% for conventional banks. It may be interesting to note that customer deposits in total K.K. Siraj and liabilities have reduced for Islamic banks during 2005-2010, while it showed an improved trend in case of conventional banks from 55.27% to 61.87%. according to the study analysis, there exists significant relationship in the movement of customer deposits among Islamic banks and conventional banks.

It is also known as Ratio of Equity to Assets. The ratio shows the relative percentage of total equity in total assets of the company. A higher ratio is preferable as it indicate the presence of less external funds in total assets of the company. The total equity as a percentage of total assets showed an average rate of 15.26% in Islamic banks during 2005-2010, while it stands 12.46% in conventional banks during the period. It may be observed from the analysis that Islamic banks utilize more equity funds compared to conventional banks towards total assets of the company. Hence, it may be concluded that Islamic banks are more equity financed than conventional banks. there exists significant relationship the movement of Total Equity as a percentage of Total Assets among Islamic banks and conventional banks.

CONCLUSION AND FINDINGS

In light of the study analysis, similitudes and dissimilarities were found while contrasting conventional and Islamic banks in GCC district. Working profit expanded at a quicker rate in Islamic banks than conventional banks. Despite the fact that there are contrasts in development of working profit, the pattern followed is viewed as fundamentally related. In actuality, NPR proportion showed an alternate pattern; with conventional bank has a higher growth in profit. NPR doesn't follow comparative example of development between conventional banks and Islamic banks. ROA is a significant mark of profitability bank. Islamic banks revealed a higher ROA contrasted with Islamic banks. ROA doesn't follow comparable development between Islamic bank and conventional banks. ROE additionally pursue comparative direction. Total profit as a level of client stores is equivalently higher in Islamic banks. It very well might be seen from the investigation that absolute benefit as a level of client stores contrast altogether in Islamic banks and conventional banks. The review upholds the view that Islamic banks are

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greater value financed, while conventional banks are more acquired fund financed. A speculation test uncovered a critical relationship in the development of client among Islamic banks and conventional banks. Additionally, absolute value enlisted a higher extent in complete resources of bank in Islamic banks contrasted with regular banks. Further, it is additionally observed that there exists critical relationship in the development of total equity as a rate on total assets among Islamic banks and conventional banks. The absolute assets of Islamic banks developed by 21.53% during 2005-2010, while the growth rate is 18.42% for conventional banks. The review utilized AAG rate to feature change in chosen execution pointers. The presentation markers contemplated incorporate all out working pay, working costs, working benefit, net benefit, absolute resources, client stores and all out-value capital. The investigation discovered that Islamic banks have a higher AAG pace of all out working pay than conventional banks in GCC area during 2005-2010. The AAG pace of all out working pay is 24.62% for Islamic banks, while it is accounted for at 16.47% for conventional banks. It could be seen that the working pays of conventional banks showed a diminished growth from 2007 onwards which might be credited with the impact of recessionary pattern because of financial crisis that emitted around the world. Like growth in working pay, working cost showed an expanded AAG rate. The review uncovered a great situation of Islamic banks where working pay expanded at a quicker rate than expansion in working costs. The investigation discovered that Islamic banks announced a higher AAG pace of working benefit. The AAG rate remained at 8.87% for Islamic banks during 2005-2010, while it announced a negative - 1.55% AAG rate. A further investigation uncovered a decreased development chiefly after 2007 for the most part because of financial crisis and recessionary tensions. The client stores in Islamic banks developed with an AAG rate of 17.35%, while the stores filled in conventional banks at an AAG rate of 18.42%. Siraj & Sudarsanan (2012) Similar to the pattern in different pointers, the growth pace of stores was decreased starting around 2007, might be owing to the recessionary patterns and financial crises. As to the effect of financial crisis on banking, the examination uncovered that Islamic banks were less impacted contrasted with conventional banks in the GCC area. Despite the fact that there exists a fall in pay and development of chose markers, the effect was least contrasted with the change saw in conventional banks. It upholds the previous investigations, especially Syed-Ali, (2011) who contended that financial crisis affected performance of bank bunches in various levels. Further the effect of financial crisis is fundamentally seen during 2008-2009 for Islamic banks, while it created sway on conventional banks.

The researcher agrees with the study findings, especially regarding Islamic banks resiliency and ability to avoid and shield their systems from financial crisis. Which benefits all involved parties, as clients in such unfortunate events, could be easily affected, that’s why many clients from other religious backgrounds prefer to conduct their business with Islamic banks, as a result of the ramifications of the financial crisis, as pointed out by Abdullah., Sidek & Adnan (2012) in a review done of the perception of non-Muslims of the Islamic banks.

This study attempted to clarify a few angles that differs the Islamic banks and conventional banks in their processes, ways of conducting business, in addition to a rich and valuable literature review on the financial services, the different perceptions and viewpoints, and the development of the banking services globally.

Also, some of the most important terms regarding the matter in hand were defined, in addition to the explanation of advantages and disadvantages of both types, then followed by a study that aimed to evaluate and compare major performance indicators of conventional banks and Islamic banks in GCC region, done by Siraj & Sudarsanan, the study examined the period between 2005 – 2010. The study found that Islamic banks reported a higher AAG rate of operating profit, it also revealed that Islamic banks were less affected compared to conventional

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banks in the GCC region. Even though there is a fall in income and growth of discussed indicators, the impact was little in comparison to the impact seen in conventional banks.

It is worth noting that the study was done during this specific period, due to the global financial crisis that took place during this period, as this subject for sure sill be a target for more beneficial research in the future.

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