

# A Comparison of Financial Performance of Islamic and Conventional Banks in Bahrain

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## Abstract

The development of service sector is crucial in contributing to the GDP of any nation. The banking system plays a key role in the development of a country. The commercial banking system dominates the financial sector by dealing with the majority of financial transactions of a country. The existence of Islamic and conventional banks has contributed for the development of the economy. Commercial banks in Bahrain consist of interest-based conventional banks and interest-free Islamic banks (based on Islamic shariah). The performance of conventional and non-conventional banks is satisfactory in Bahrain. The present study focuses on the comparative analysis of financial performance of Islamic and conventional banks in terms of cost and income in Bahrain. The study uses financial tools like profitability, liquidity and solvency, commitment to economy and community, efficiency and productivity of both streams of banks.

**Keywords:** Islamic banks; Conventional banks; Performance analysis; Ratio analysis; trend analysis.

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## **1. Introduction**

The globalization, liberalization, and privatization have paved the way for the expansion of the financial sector. Commercial banks are the key players of financial system in creation of money in the economy. They convert savings into investment and contribute for the capital formation in the economy. Islamic banks also played an important role in development of some of the economies. In line with this, there has been tremendous growth of Islamic banks to boost the financial system in many parts of the world. Since 2008 till present, the banking system of the world has undergone several challenges due to the recessionary trends in the global economy. Banking sector has undergone lot of changes and faced big challenges in past few years in many parts of the world due to recessionary trends. Several conventional banks in US and European economy have to close down due to financial downturn. The stake holders like owners, Investors, debtors, creditors, government, depositors, bank managers and regulators are more concerned on the financial performance of the banks. Islamic Banks have not been exception to this downtrend despite the wide claim that Islamic banking fundamental and conceptual framework has supported these institutions from a serious failures and financial damages. The performance of banks is essential for the development of different sectors of the economy. Owners and Services sector especially banking sector is getting popularity due to an increasing contribution towards GDP. Banks play a significant role to stimulate saving and investment activities in the economy. In today's highly competitive environment banks should improve their profitability to satisfy the requirements of all stakeholders. The survival and the growth of the banks also depend on their financial performance. Credibility of the bank is crucial in building the strong customer base. Banks are crucial in pooling the funds from public and convert these savings into investments. Banks develop a link between surplus and deficit units to promote the trade and business activities. Banks are performing multiple functions to provide a variety of products and service for different segments of the economy. Due to the failure of conventional banking in other parts of the world, there is discussion about the resilience and the process of working in Islamic banks and whether the Islamic banks are really in a better position to face financial challenges.

## **2. Research Problem and Significance**

The volume of Islamic financial assets at the beginning of the millennium was estimated to be more than 150 billion dollars, it is currently deemed to be more than 700 billion dollars, including nearly 300 billion dollars of assets and over 400 billion dollars of financial investments managed exclusively by Islamic banks. There is increased consumers awareness on service quality. This has created a stiff competition among the banks and this resulted in effective performance management on the part of banks. Many researchers have worked on different dimensions of performance measurement. Since the opening of the first Islamic bank in Egypt in 1963, Islamic banking has grown rapidly all over the world. The recent development of Islamic banking activities has witnessed rapid progress and more than 500 Islamic financial institutions are actively functioning more than 75 countries concentrating mainly in Middle east and Southeast Asia. There is increased Islamic banks in many parts of the world especially Europe and USA. Bahrain and Malesia is the hottest destination for Islamic banks. Recently even in South Africa also shown interest in Islamic banks. Since there is lot of uncertainties on the part of conventional banks, now many countries of the world are considering Islamic banks as one of the strong alternative for conventional banks. The Islamic banking total assets worldwide are estimated to have exceeded

\$250 billion and are growing at an estimated pace of 15 percent a year.

### **3. Objective**

This objective can be achieved through various financial measurement tools like ratios such as profitability ratios, liquidity and solvency ratios, and some statistical measures. This helps in drawing inferences on the financial performance of both these banks. The objectives of the study are

1. To know the cost and income efficiency of Islamic and conventional banks in Bahrain.
2. To analyze the financial performance of Islamic and conventional banks in Bahrain.
3. To compare the financial performance of Islamic and conventional banks.

### **4. Research Methodology**

The researcher focuses on examining the financial performance of Islamic and conventional banks in Bahrain in terms of income and cost efficiency. Both these banks contributed to the growth of economic system of Bahrain. For this study, 13 Islamic banks and 13 conventional banks operating in Bahrain are selected. The period of study is 5 years. This study is based mainly on the secondary data. Primary data has obtained by interactions with few bank managers based on convenience. Data has been processed through "Statistical Package for Social Science" software or SPSS, Microsoft Excel. Hypothesis are formed and tested using different techniques to analyze the results regarding Islamic and conventional banks in Bahrain. Ratio analysis and trend analysis used in the study.

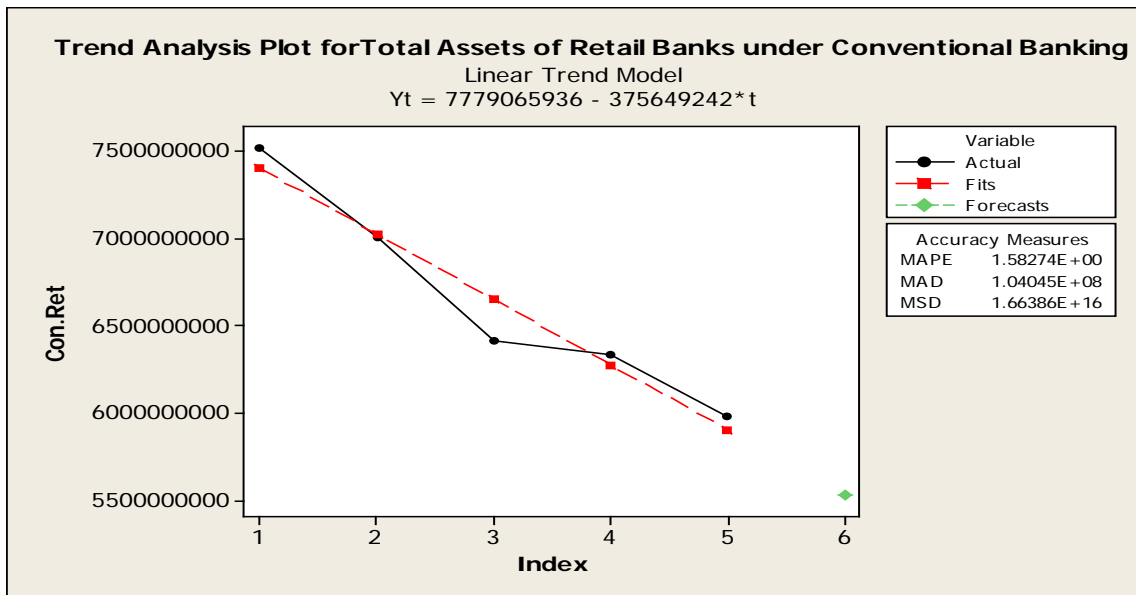
### **5. Review of Literature**

There are many studies conducted by different researchers on comparing financial performance of Islamic and conventional banks in different countries. Reference [14] Believes right measurement of performance of organizations depends on their objectives like profitability, market share and cost reduction. Different firms may have different objectives. Thus, one measurement tool may not be suitable for all organizations. Majority of the organizations choose the financial indicators such as return on investment (ROI), earning per share (EPS) and return on equity (ROE) for measurement of their development and growth. Reference [3] in his study on the determinants of eighteen Islamic banks performance in eight Middle Eastern countries such as Egypt, Bahrain, Jordan, Kuwait, Qatar, Sudan, Turkey and United Arab Emirates- from 1993 through 1998 used four parameters to measure the performance of banks. They are net non-interest margin (NIM), profit before tax to total assets (PBT/TA), Return on Equity, and Return on assets. Reference [11] Used financial indicators like return on assets, return on investments and current ratios to measure the financial performance of an organization. However, to weigh the financial health of the organization, it can use financial measurements in terms of profitability, liquidity, leverage, asset utilization and growth ratios. Reference [2] opined that bank's size reacts negatively with conventional banks' profitability, but positively with Islamic banks. The Islamic banks performance is positively associated with total equity there is negative relationship with conventional

banks. Total Expenses for conventional banks impact profitability negatively whereas Total Expenses for Islamic banks help profitability. The researcher also found that the profitability of conventional and Islamic banks is also assisted by non-interest expense. Reference [12] Focused on the different challenges banking sector due to the changing global environment. The study found that the efficiency and ability of the selected Islamic banks have increased and there is growth of the Islamic banks in Jordan. Banks in Jordan also played a significant role in the development of the economy. The study also reveals that there is lot of growth potential for Islamic banks in Jordan. Reference [13] Studied that the financial performance of the banks is influenced by the operational efficiency, assets management, and banks' size. However, better profitability performance of banks does not depend on amount of deposits or loans. Reference [1] proposes that Islamic bank depositors, as required by Islamic Law do not have any deposit insurance and normally bear the risk attached with PLS contracts in comparison with conventional banking. This leads depositor in Islamic banking more exposed to losses since their investments are not insured and PLS losses of Islamic banks may be substantial which are transferred to depositors. The absence of deposit Insurance means that Islamic banks are riskier than conventional banks Thus confidence of depositors in Islamic banks plays crucial role in the development of Islamic banking. Reference [9] Selected a sample of 100 samples (50 each from conventional and interactive banks) and compared the performance of banks based on service quality. The results of the study reveal that among the factors affecting selection of the banks, people give top most priority to reliability, human element at the second position, responsiveness at the third position, accessibility at the fourth position, and tangibility in the fifth position respectively. In a comparable way, [10] conducted gap analysis between conventional and interactive banks related to services provided by the banks. They concluded that the most principal factor leading to service gap is systemization or technological advancement among interactive and conventional banks. Reference [8] Evaluated the financial performance of retail and wholesale Islamic banks in Bahrain from 2009 to 2013 and found that operating efficiency of wholesale Islamic banks was better than retail Islamic banks for the period of 2009-2013 which was evident from asset utilization ratio. Using the result of correlation analysis of wholesale Islamic banks between various performance indicators, their study showed the existence of significant positive correlation of cost to income ratio with operational efficiency ratio and staff cost to income ratio. A similar study by [6] on the evaluation of financial performance level of retail and wholesale conventional banks in Bahrain from 2009 to 2013 confirmed that the operating efficiency of wholesale banks was superior to the retail conventional banks. The empirical results suggested no significant difference between the performance of retail and wholesale conventional banks operating in Bahrain. Reference [5] Analyses the impact of leadership and factors affecting leadership on the performance of banks in Bahrain. The results of the study revealed that team orientation and development is the crucial aspect in enhancing employees' performance. They study concluded that the leadership affect the performance of the banks in Bahrain. Reference [7] Found none of the companies selected for the study exhibited significant monthly returns for the study period except Bahrain Maritime and Mercantile International and study suggested that the absence of said calendar anomaly may be due to thin trading practiced in the Bahrain stock exchange. Similar to previous study [4] examined the performance of commercial retail banks (conventional and Islamic) in Bahrain and financial ratios were used for the period of 15 years 2001-2015 on parameters such as profitability, liquidity, operating efficiency, capital adequacy and leverage. The empirical results revealed that conventional retail banks, except for Bahrain development bank, have consistent performance in return on assets and return on equity while

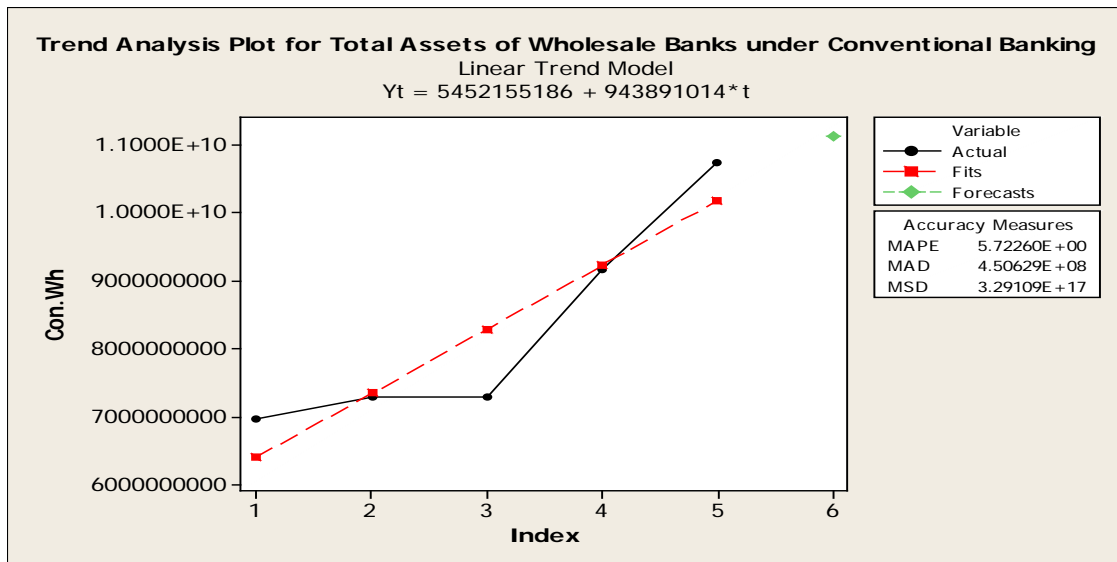
among the Islamic retail banks, the performance of Kuwait finance house is satisfactory in terms of profitability.

### 6. Empirical Results and Analysis



**Figure 1:** Trend Analysis for Total Assets of Retail Banks Under Conventional Banking

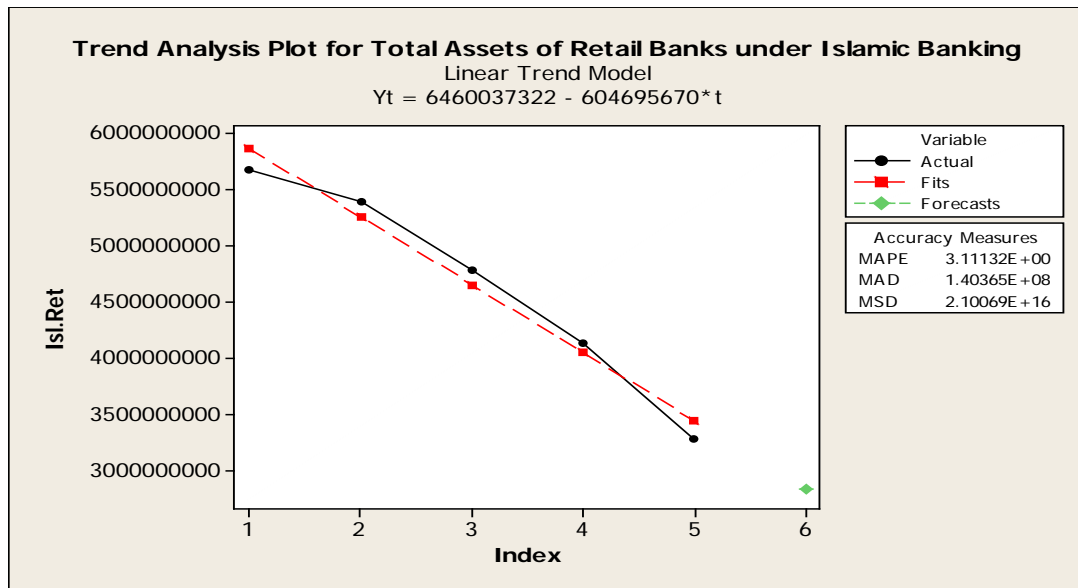
According (Figure 1) to MINITAB fitted trend equation for total assets; ( $Y_t = 7779065936 - 375649242*t$ ) with 1.58274E+00 MAPE and MAD value 1.04045E+08, the forecasted total assets for 2015 for retail banks under conventional banking is 5525170483



**Figure 2:** Trend Analysis for Total Assets of Wholesale Banks Under Conventional Banking

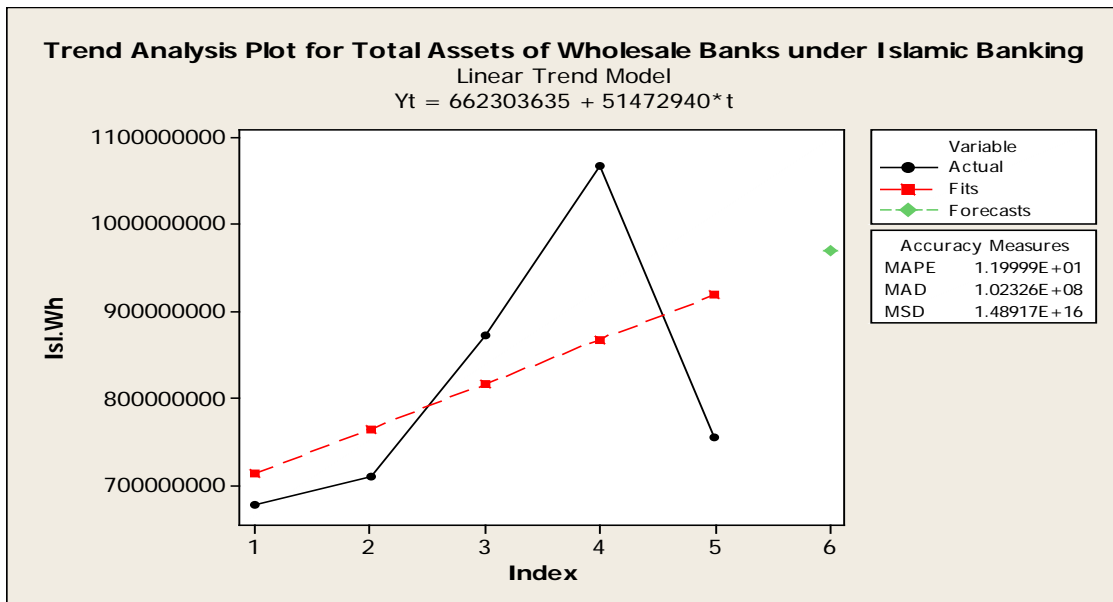
According to (Figure 2) MINITAB fitted trend equation for total assets; ( $Y_t = 5452155186 + 943891014*t$ ) with 5.72260E+00 MAPE and MAD value 4.50629E+08, the forecasted total assets for 2015 for Wholesale banks

under conventional banking is 11115500000



**Figure 3:** Trend Analysis for the Total Assets of Retails Banks Under Islamic Banks

According to (Figure 3) MINITAB fitted trend equation for total assets; ( $Y_t = 6460037322 - 604695670 * t$ ) with 3.11132E+00 MAPE and MAD value 1.40365E+08, the forecasted total assets for 2015 for retail banks under Islamic banking is 2831863301



**Figure 4:** Trend Analysis for the Total Assets of Wholesale Banks Under Islamic Banks

According to (Figure 4) MINITAB fitted trend equation for total assets; ( $Y_t = 662303635 + 51472940 * t$ ) with 1.19999E+01 MAPE and MAD value 1.02326E+08, the forecasted total assets for 2015 for Wholesale banks under Islamic banking is 971141272.

**Table 1:** Performance of Conventional and Islamic banks under Retail Banking Sector

Retail Banks						
	Retail Banks	Mean	Std. Deviation	Mean Difference	t - Value	Sig. (2-tailed)
Staff Cost Ratio	Islamic Bank	30.2440	9.62468	.3120	.097	.927
	Conventional Bank	29.9320	2.96141			
Cost to Income Ratio	Islamic Bank	69.4780	30.68442	67.6640	4.911	.008
	Conventional Bank	109.5429	0.14519			
Asset Utilization Ratio	Islamic Bank	1.8140	1.11006	-49.3880	-14.525	.000
	Conventional Bank	52.0720	6.54965			
Operating Efficiency Ratio	Islamic Bank	49.5200	34.95314	-2.5520	-.188	.860

**H<sub>0</sub>:** There is no significant difference between performance of Islamic and Conventional Banks under Retail Banking Sector.

**H<sub>1</sub>:** There is significant difference between performance of Islamic and Conventional Banks under Retail Banking Sector.

The paired sample t-test of various ratios measuring performance of Conventional and Islamic banks under Retail Banking Sector is depicted in the above table. It is clear from table that the Islamic banks and Conventional banks stand in the same position in relation to staff Cost to income ratio with the mean value of approximately 30%. The mean difference between conventional banks and Islamic banks are 0.3120, the t-value between the banks are .097 with p-value 0.927. Therefore, null hypothesis is accepted i.e. the mean difference is not significant.

The mean cost to income ratio of Islamic banks and Conventional banks is 69.4780 and 109.5429 respectively. The mean difference between the banks are 67.6640, the t-value between the banks are 4.911 with p-value .008. Therefore, null hypothesis is rejected stating that the mean difference is significant.

The mean Asset utilization ratio of Islamic banks and Conventional banks is 1.8140 and 52.0720 respectively.

The mean difference between the banks are -49.3880, the t-value between the banks are -14.525 with p-value .000. Therefore, null hypothesis is rejected stating that the mean difference is significant.

The mean operating efficiency ratio of Islamic banks and Conventional banks is 49.5200 and 52.0720 respectively. The mean difference between the banks are -2.5520, the t-value between the banks are -.188 with p-value .860. Therefore, null hypothesis is accepted i.e. the mean difference is not significant.

Therefore, we conclude that, there is no significant difference between performance of Islamic banks and Conventional banks in Retail Sector in relation to staff cost to income ratio and operating efficiency ratio and there exist a very significant difference between performance of Islamic banks and Conventional banks in Retail Sector in relation to cost to income ratio and asset utilization ratio during the study period.

**H<sub>0</sub>:** There is no significant difference between performance of Islamic and Conventional Banks under Wholesale Banking Sector.

**H<sub>1</sub>:** There is significant difference between performance of Islamic and Conventional Banks under Wholesale Banking Sector.

**Table 2:** Performance of Conventional and Islamic banks under Wholesale Banking Sector

Wholesale Banks						
	Wholesale Banks	Mean	Std. Deviation	Mean Difference	t - Value	Sig. (2-tailed)
Staff Cost Ratio	Islamic Bank	59.0560	35.72501	-7.9420	-.197	.854
	Conventional Bank	66.9980	68.17907			
Cost to Income Ratio	Islamic Bank	159.8380	126.75089	154.2380	2.728	.050
	Conventional Bank	5.6000	3.37158			
Asset Utilization Ratio	Islamic Bank	5.7920	4.26209	-81.4200	-1.871	.135
	Conventional Bank	87.2120	98.32917			
Operating Efficiency Ratio	Islamic Bank	138.7460	122.24586	29.2040	.355	.741
	Conventional Bank	109.5420	97.29261			



The paired sample t-test of various ratios measuring performance of Conventional and Islamic banks under Wholesale Banking Sector is depicted in the above table. It is clear from table that the mean staffs Cost to income ratio of Islamic banks and Conventional banks are 59.0560 and 66.9980 respectively. The mean difference between conventional banks and Islamic banks are -7.9420, the t-value between the banks are -.197 with p-value.854. Therefore, null hypothesis is accepted i.e. the mean difference is not significant.

The mean cost to income ratio of Islamic banks and Conventional banks is 159.8380 and 5.6000 respectively. The mean difference between the banks are 154.2380, the t-value between the banks are 2.728 with p-value .050. Therefore, null hypothesis is rejected stating that the mean difference is significant.

The mean Asset utilization ratio of Islamic banks and Conventional banks is 5.7920 and 87.2120 respectively. The mean difference between the banks is -81.4200, the t-value between the banks are -1.871 with p-value .135. Therefore, null hypothesis is accepted stating that the mean difference is not significant.

The mean operating efficiency ratio of Islamic banks and Conventional banks is 138.7460 and 109.5420 respectively. The mean difference between the banks are 29.2040, the t-value between the banks are .355 with p-value .741. Therefore, null hypothesis is accepted i.e. the mean difference is not significant.

Therefore, we conclude that, there is no significant difference between performance of Islamic banks and Conventional banks in Wholesale Sector in relation to staff cost to income ratio, asset utilization ratio and operating efficiency ratio and there exist a significant difference between performance of Islamic banks and Conventional banks in Wholesale Sector in relation to cost to income ratio during the study period.

## **7. Conclusion**

Banks have played crucial role in the development of many economies. Islamic and Conventional banks have got their identity and operations in the banking market. The present study has taken nineteen Islamic and thirteen Conventional banks to study the comparative performance in terms of cost and income efficiency. The study is conducted for five years from 2010-2014. Staff cost to income ratio, cost to income ratio, asset utilization and operating efficiency is higher in wholesale banks to retail banks in conventional and retail banks. This suggests that wholesale banks are better managed than retail banks in both the types of banks. There is no significant difference between performance of Conventional Banks and Islamic Banks, Retail Banks and Wholesale Banks under Conventional and Islamic Banks with respect to staff cost to income ratio, cost to income ratio, asset utilization ratio and operating efficiency ratio during the study period. The is similar to the findings of the study on the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks. The researcher did not find any major difference in profitability and liquidity performances between Islamic banks and conventional banks. The study found that there is a positive relationship among Staff Cost to Income Ratio, Operational Efficiency Ratio and Cost to Income Ratio retail and wholesale banks in conventional banking and wholesale banks in Islamic banking. There is negative relationship among Asset utilization ratio with Staff Cost to Income Ratio, Operational Efficiency Ratio and Cost to Income Ratio of retail banks in Islamic banking. The results suggest that there is similar performance on

the part of Islamic and conventional banks. The correlation analysis also suggests that there is positive relation among different parameters among the retail, wholesale banks in Islamic and conventional banks except in case of retail banks in Islamic banks. The awareness of Islamic banking principles must be conducted in all over the world to promote Islamic banks. There is clear evidence of the strength of Islamic banks in recent financial downturn. Many conventional banking principles do not guarantee stability in banking sector unlike Islamic bank principles. In this direction research can be conducted on the superiority of Islamic bank principles over the conventional banks in promoting the stability of banking sector.

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