Comparative Study on Performance of Islamic Banks and Conventional Banks: Evidence from Oman

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ABSTRACT

This research aims to examine and compare the performance for Islamic banks (IBs) and conventional banks (CBs) in Oman during 2013-2015. Financial ratio analyses are employed to measure profitability, solvency and capital adequacy of seven CBs and two IBs. Independen samples t-test was used to determine the whether there is a difference in the performance for IBs and CBs. The finding of the research establishes that CBs are more profitable and significantly different from IBs in terms of return on assets, return on equity and net profit margin. While, IBs were performing better in term of efficiency ratio, debt to assets ratio. Debt to equity ratio and credit to deposits ratio total credit to total debit. The difference is statistical significant.

Keywords: Islamic Banks, Conventional Banks, Performance, Oman
JEL Classifications: G35, G38, M41

1. INTRODUCTION

The importance of banking sector comes from its role in achieving the financial balance and economic development and growth. Islamic banking (IB) is growing at a rapid speed and has showed unprecedented growth and expansion in last two decades in spite of mismatching of existing financial framework and business practices. It is estimated that the size of the IB industry at the global level was close to US$820 billion at end-2008 (Islamic Financial Services Board et al., 2010). Middle East is the centre of IB with contribution of approximately 80% while 20% share is contributed by rest of the world (Hanif, 2011). The GCC countries account for 40% of the $1.1 trillion global Islamic finance industry with Islamic finance expanding at a compounded average growth rate of 26.4% since 2006. Islamic finance remains concentrated in the Middle East, including Iran, with a share of 35.7% in total Islamic finance assets, Saudi Arabia with 13.9%, United Arab Emirates with 8.7%, Kuwait with 7.3%, Bahrain 5.3%, and Qatar with 4.8% (OIC Outlook Series, 2012).

According to the World IB Competitiveness report published by Ernst and Young (2012), IB assets with commercial banks globally grew to $1.3 trillion in 2011, suggesting an average annual growth of 19% over past 4 years. The IB growth story continues to be positive, growing 50% faster than the overall banking sector.

The sultanate of Oman is last GCC country initiated IBs. The first IB was established in 2011. The beginning of IB in the Sultanate was an important milestone in the process of financial inclusion. IB is expected to assume an important role in the financial sector of Oman by complementing the current conventional banking (CB) and thereby diversifying banking services. There were two full-fledged locally incorporated IB, namely, Bank Nizwa and Al Izz IB. Six out of the seven locally incorporated conventional commercial banks were also offering IB services through dedicated windows. The IBs and Windows operated with 29 branches have been started and provide their services to customers at the begging of January 2013. Central Bank of Oman Annual Report (2015).

IBs is based on the risk-sharing concept between the investor and entrepreneur, profit maximization theory based on Shariah restrictions, and entering into partnership form of business is the main operation of the IBs.

On the other hand, in CB, there is no risk sharing concept between the buyer and seller but assurance of fixed interest rate, profit maximization theory without any restriction, and lending and receiving money is the main operation of the CB.

The study of the comparative performance of IBs and CB is still considered as an important issue in the field of finance and investment. Many studies were undertaken on CB and IB across the world including Awan (2009), Hanif (2011) and Alkassim (2005) Most of the studies focused on comparing CB with IB. Some results reveal that IBs performed better rather than CB, while other results conclude that CB performed better than IBs. For example, Dridi and Hasan (2010) indicated that Comparing the performance of IBs to CBs globally would suggest that IBs performed better, given the large losses incurred by CBs in Europe and the US as a result of the International financial crisis Moin (2008) conducted a study to analyze the effectiveness of the pioneering bank in IB sector in Pakistan: Meezan Bank Limited (MBL). The study examined MBL in contrast with five traditional banks in Pakistan. Study analyzed following aspects: Profitability, risk, liquidity and efficiency for 2003-2007. The researched concluded that MBL was more solvent, less profitable, and less efficient as compared to the median of 5 traditional banks. However, there was no major distinction in liquidity between both streams of banks.

This research too is another attempt to look at a comparative performance evaluation between for IBs and CB in Oman during 2013-2015, we discuss the extent to which CBs and IBs satisfy its various performance indicators. We compare efficiency and effectiveness of operations of both bank-groups in terms of its return on equity (ROE), return on assets (ROA), and other performance indicators derived from the income statement and balance sheet of - both IBs and CB.

This research aims to provide both IBs and CB managers in Oman a basic understanding of the comparative performance and this will be of immense help in formulating their future decisions and competitive financial position. Also, this research may be useful in identifying its strengths and weaknesses.

The main objective of the research is to conduct a comparative analysis of the performance for IBs and CB in Oman during 2013-2015, to find out whether the IBs and CBs are operating efficiently. The research analyzed the data of seven CB and two IBs for the period 2013 to 2015.

The organization of the research is as follows; section (2) discusses and review literature concerning the theoretical and empirical studies of CB and IBs (3) provides a brief about the CB and IBs in Oman. Section (4) illustrates the data collection and methodology used in the research, section (5) deals with the empirical findings and finally, in section (6) the conclusion of the research is discussed.

2. LITERATURE REVIEW

Although Islamic commercial banks have many products similar to those offered by CBs, the two entities differ conceptually. One

key difference is that CBs earn their money by charging interest and fees for services, whereas IBs earn their money by profit and loss sharing (PLS), trading, leasing, charging fees for services rendered, and using other sharia contracts of exchange.

2.1. Origins of the CB and IBs
The establishment of first CB was nearly 424 years ago. As it has been stated in the book of Sudin Haron and Wan Nursofiza that Modern CB came into existence nearly 420 years ago with establishment if Banco Della Pizza at Rialto in Venice in 1587 (Homoud, 1985). However, IBs officially was established in 1963 which was Mit Ghamr Saving Bank in Egypt and its transactions were based on Shariyah principles and rules. Faizulayev (2011).

According to Metwally (1997) "IB was introduced in 1963 in a wee town of Egypt." This was done on an a study of performance. Experimental basis to validate its feasibility in a live environment. This experiment was a success as the deposits surged in 3 years.

2.2. Concept and the Basis of Transactions Between IBs and CB
IB attributes to a banking system or enterprise that is persistent with Islamic laws and principles (Sharia) in which interest rate is probated.

Lewis, 2008 on operation of IB briefed the essence of Islamic finance. IB focused on the principle that loans should be advanced free of interest for charitable bodies and on a PLS basis.

The basic purpose for establishing an IB is to promote and encourage Islamic principles. CBs are profit-making organizations that generally are not based on religious principles. That said, earning money is also a primary function of an Islamic commercial bank. Although the bank has a specific religious purpose, it can't serve that purpose unless it also meets the objective of earning money. Jamaldeen (2012), he goes on to illustrates that IBs operate based on Islamic business law (called fiqh-u-muamalat) for their basic transactions, and they also follow the financial laws and regulations of the countries in which they operate. CBs likewise operate based on a country's financial laws and regulations, but they don't have contact with any religious body.

The main difference between IBs and CBs are that, interest rate and speculative transactions, investment in alcohol, in tobacco and in pig made products are prohibited in accordance with Islamic Principles. Generally, CB principles are man-made, whereas in IBs principles and rules are based on Shariyah who set up the principles, simply to say transactions of IBs are based on PLS Faizulayev (2011).

2.3. Previous Studies
Profitability generally measures objective of private organization or firm as indicated by return on sales, assets, and owners equity. Profitability ratio can be simply defined as the ability of a business to earn a profit which is left of the revenue a business generates after it pays all expenses directly related to the generation of the revenue, such as producing a product, and other expenses related to the conduct of the business' activities Ali et al. (2012).

In addition, (Siraj and Pillai, 2012) argued argued that IBs, unlike other form of business is evaluated not only based on its profitability, but also criteria's such as quality of assets, liquidity management, risk management, etc., Most of the comparative studies also stressed the relevance of these performance indicators to compare CB and IB. The studies provide three different viewpoints.

Many studies have been conducted to examine and compare the IBs and CB performance for example, Abdus and Hassan (1997) assessed the differences of performance measures of Bank Islam Malaysia Berhad (BIMB) and eight CBs in terms of profitability, liquidity, risk and solvency. They come up with output of empirical results stating that BIMB relatively is more liquid and less risky compared to the group of eight CBs. In addition, IBs showed significant progress on ROA and ROE during 1984-1997. However, Samad and Hassan (2000) found that comparison of BIMB with group of 8 banks showed that difference in performance measures are statistically insignificant. They also found that the risk in BIMB increased and it is statistically significant. In addition, Moin (2008) conducted a study to analyze the effectiveness of the pioneering bank in IB sector in Pakistan: MBL. The study examined MBL in contrast with five traditional banks in Pakistan. Study analyzed following aspects: Profitability, risk, liquidity and efficiency for 2003 to 2007. The researched concluded that MBL was more solvent, less profitable, and less efficient as compared to the median of 5 traditional banks. However, there was no major distinction in liquidity between both streams of banks.

According to study of Alkassim (2005) who aimed to identify profitability of determinants of IBs and CBs. The profitability indicators ROE, ROA, and net interest margin (NIM) of two different types of banks are compared. As independent variable he used: Logarithmic of total assets, equity to assets, deposit to assets, total loans to assets and etc. He used cross country bank level data for Gulf Cooperation Council GCC countries to conduct Ordinary Least Square. He found the results which are consistent with Hassan and Bashir (2004) for IBs, and he also found in his analysis relationships between banks characteristics and profitability indicators for CBs. The result of variables showed their reflection towards profitability indicators differently. The logarithmic total assets TA have negative relationship with performance measure in CB System, but positive in IB System. The capital ratio or equity ratio has got negative association with performance measure of CBs and positive connection with IBs profitability indicators. He also found that lending improves the profitability of both IB and CBs, in other words total loans are positively related to determinant of profitability of both banks. In the same view, Siraj and Pillai (2012) conducted a study to review and compare performance of CBs and IBs operating in GCC region during 2005-10. The study selected six IBs and six CBs. A comparative study is undertaken based performance indicators such as OER, NPR, ROA, ROE, EOA, operating expense, profit, assets, operating income, deposits and total equity. Inferences based on analysis revealed better performance of IB during the study period. Our analysis revealed that IBs are more equity financed than CBs.

Recent studies carried out by Khamis and Senhadji (2010), Rashwan (2012), and Merchant (2012) to empirically contrast performance of IBs and CBs pre and post the global financial crisis argue that performance of IBs during the 2008 financial crisis was more efficient than their counterpart CBs.

On the other hand, Moin (2008) measured the performance of first IB in Pakistan with comparison of 5 CBs. The performance measure of this study was in the field of profitability, liquidity, risk and efficiency by using financial ratios. He found that CBs are more profitable and significantly different from first IB in terms of ROE. His findings showed that IBs are getting closer with conventional ones in terms of profitability. He found also positive relationship of net profits with profitability indicator, ROE. However, he did not find any difference between IB and CBs in term of liquidity, loan to deposit ratio. CBs are more risky and less solvent than IB due to high profitability. Another study has been conducted by Kakakhel et al. (2011) examined and evaluated the performance of the two IB (Meezan and Dubai Islamic) and two CBs (MCB and HBL) in Pakistan for the year 2008 to 2010. The result indicates that CBs are more profitable than IBs in Pakistan for year 2008 to 2010. IBs in Pakistan have better current, cash, debt to asset and asset turnover ratio while CBs have good performance in other remaining ratios. Although in some ratios performance of IBs are also good but according to overall results CBs of Pakistan are more efficient than IBs.

It is obvious from the above discussion that there are different pictures concerning the performance of IBS and CB, some researchers are indicate that IBs are more efficient than CB; other studies show that CB are more profitable than IBs. As we mentioned before, in many countries numerous studies have been conducted to evaluate the performance for IBs and CB, however, no studies have been done before in the Omani context to establish the relationship between JBS and CB performance this becauseIBs have been established in Oman recently (in 2012).

3. CB AND IB IN OMAN

The Sultanate of Oman has already identified the potential demand and opportunities offered by the Islamic finance industry and the Royal decree announced in May 2011 has paved the way for the adoption of a dual financial system where conventional and Shariah compliant products have been available to the people of Oman. Two IBs -Bank Nizwa and alizz IB - and window operations of CBs have launched innovative products to attract Omani customers, besides opening several branches in different parts of the country. Ali Hamdan Al Raisi, vice president, Central Bank of Oman, told the Times of Oman: IBs grew very well last year, and the trend is continuing this year. He said that there is still space for IBs to grow further, although there are challenges ahead (Time of Oman, 2016) (Table 1).

The locally incorporated conventional commercial banks were Bank Muscat (BM), National Bank of Oman (NBO), HSBC Bank Oman, Oman Arab Bank (OAB), Bank Dhofar (BD), Bank Sohar (BS) and Al Ahli Bank (AB). There were also two full-fledged locally incorporated IBs, namely, Bank Nizwa and Al Izz IB. Six

out of the seven locally incorporated conventional commercial banks offered IB services through dedicated windows. Central Bank of Oman Annual Report (2015). According to Oxford Business Group (2016) total assets held by IBs and the IB windows of conventional lenders in March 2016 amounted to OR2.5bn ($6.5 billion), compared to OR 1.5 billion ($3.9 billion) 1 year earlier, according to the CBO. This took the IBs market share from 5.1% of the financial system's overall assets in 2015 to 7.8% by March 2016.

4. DATA AND RESEARCH METHODOLOGY

As we illustrated before, the main objective of this paper is to examine and evaluate the comparative performance for IBs and CB in Oman. To achieve research objectives, the data was collected from seven CBs namely BM, NBO, BD, HSBC Oman, OAB, AB, and BS. and two Islamic Al Izz and - Nazwa banks during the period of 2013-2015.

In order to study the performance comparison between Islamic and CB in Oman, a comparative research is conducted. The data were collected from the balance sheet and income statements of the IBs, CB and Central Bank of Oman reports and other published reports. The researchers analyzed the data by using Descriptive statistical analysis, independent t-test is to determine the difference in the performance between IBs and CB. Many authors had used financial ratio analysis mentioned in the literature review. According to Samad and Hassan (2000) "İnter-temporal and interbank profitability of BIMB" has been evaluated by using financial ratio analysis tool. Saleh and Rami (2006) also used the financial ratios to evaluate the Jordanian exposure with IB.

To find out whether there is any difference in the performance for IBs and CB this research was relying on the following financial indicators.

4.1. Profitability Performance
The most common measure of bank performance is profitability. Profitability is measured using the following criteria.

4.1.1. ROA
Net profit/total assets shows the ability of management to acquire deposits at a reasonable cost and invest them in profitable investments (Ahmed, 2009). This ratio indicates how much net income is generated per £ of assets. The higher the ROA, the more the profitable the bank.

4.1.2. ROE
Net profit/total equity. ROE is the most important indicator of a bank's profitability and growth potential. It is the rate of return to shareholders or the percentage return on each of equity invested in the bank.

4.1.3. Efficiency ratio (EFR)
Total cost/total income. It is measures the income generated per O.R cost. That is how expensive it is for the bank to produce a unit of output. The lower the EFR ratio, the better the performance of the bank.

4.1.4. Net margin
It is the ratio of net profits to revenues for a company or business segment that shows how much of each dollar earned by the company is translated into profit.

4.2. Solvency Ratios
Van Horne and Wachowicz (2005), defined these ratios as "a measures the degree to which the business relies on debt financing." The following criteria are used to measure this ratio.

4.2.1. Debt to assets ratio (DAR)
The DAR is an indicator of financial leverage. It tells you the percentage of total assets that were financed by creditors, liabilities, debt. The DAR is calculated by dividing a corporation's total liabilities by its total assets.

4.2.2. Debt to equity ratio (DER)
DER=Total debt/total equity. It is also shows the extent to which shareholders' equity can fulfill a company's obligations to creditors in the event of liquidation.

4.3. Capital Adequacy Ratio.
This ratio is used to protect depositors and enhance the stability and efficiency of the banks keeping in view their risk exposures. This ratio is used to protect depositors and enhance the stability and efficiency of the banks keeping in view their risk exposures. In this research we used credit to deposit ratio (CDR) indicator which it can be used for both IBs and CB. CDR refers to total credits divided by total loans.

To conduct a comparative analysis of the performance for IBs and CB in Oman during 2013-2015, to find out whether the IB and CBs are operating efficiently. The following hypotheses were formulated and tested:

H_0: There exists no significant difference in performance among IBs and CB.
H_1: There is no significant difference among IBs and CB in terms (ROA).
H_2: There is no significant difference among IBs and CB in terms (ROE).
H_3: There is no significant difference among IB and CB in terms of EFR.
H_4: There is no significant difference among IBs and CB in terms of net profit margin (NPM).
H_5: There is no significant difference among IBs and CB in terms DAR.
H_6: There is no significant difference among IBs and CB in terms (DER).
H_7: There is no significant difference among IBs and CB in terms total credit to total debit (TCTD).

5. THE FINDINGS

In this section the results of the difference in the performance between IBs and CB is presented. Descriptive statistical analysis, independent Samples t-test is used to determine the means between two groups are the same on the seven variables and to examine whether the difference in financial performance between IBs and CB in Oman is statistically different during 2013-2015.

5.1. Profitability

Four indicators are used to measure the efficiency of Omani banks' performance: ROA (usually abbreviated as ROA), ROE and cost to income ratio (C/I).

H_1: There is no significant difference among IBs and CBs in terms of ROA.

H_2: There is no significant difference among IBs and CBs in terms of ROE.

The results from Tables 2 and 3 show that the mean for ROA was 0.04576 in the IBs compared to 0.00243 for foreign banks. The mean difference between two group is 0.04576 and this difference is statistically significant at 0.05%. This implies that the CB used their assets more efficiently than IBs. This may be attributed to limited experience of IBs in this regards. Also, ROE shows a similar trend to ROA, CB have a positive significant performance

concerning ROE than IBs, the mean for CB is.03286 compared to −0.05500 for IBs. Accordingly, H_1 and H_2 can be accepted.

H_3: There is no significant difference among IBs and CBs in terms of EFR.

The results from Table 4 reveal the different trend, to ROA and ROE. The mean for EFR was 3.45000 for IBs compared to 0.06381 for CB, this difference is statistically significant at 0.05%. This implies that the IBs were run their activities with low cost compared to domestic banks, this may attribute to higher numbers of employees who are recruited by CB and high other costs for these banks (CB). Accordingly, H_3 can be accepted.

H_4: There is no significant difference among IBs and CBs in terms of of NPM.

The results from Table 5 show that for NPM the CB are managing its assets better than IBs, the mean was 0.03667 for the CB compared to the −1.53333 for IBs and it's statistically significant at 0.05%. Also, this indicates that that the CB were able to make an optimal decision and control for their expenses. Accordingly, H_4 can be accepted.

We conclude from the above results that the profitability ratios for ROA, ROE, EFR and NIM reveals that CB have better performance than IBs in all these measures, the difference is statistically significant. This can be indicated that the CB were successfully in minimizing their cost and using their recourses more efficiently compared to IBs and The difference is statistical significant.

This results are consistent with Kakakhel et al. (2011) who examined and evaluated the profitability of the two IBs and two CBs in Pakistan for the year 2008-2010. The result indicates that

Table 1: Banking sector in Oman

Type	Date of establishment	Branch network
Local banks		
NBO	1973	63
OAB	1973	58
Bank Muscut	1981	137
BD	1990	64
Al Ahli	1997	12
Sohar Bank	2006	24
HSBC Bank Oman	(merged 2012 with OIB)	70
Islamic Banks		
Nazwa Bank	2012	10
Al IZ	2013	4

Source: Central Bank of Oman Annual Report (2015). OAB: Oman Arab Bank, BD: Bank Dhofar, NBO: National Bank of Oman

Table 2: Independent samples t-test for ROA

Variable	Mean		Mean difference	t	Significant
	Conventional Banks	Islamic Banks	0.04576	15.580	0.000
ROA	0.00243	−0.04333			

ROA: Return on assets

Table 3: Independent samples t-test for ROE

Variable	Mean		Mean difference	t	Significant
	Conventional Banks	Islamic Banks	0.08786	8.555	0.000
ROE	0.03286	−0.05500			

ROE: Return on equity

Table 4: Independent samples t-test for EFR

Variable	Mean		Mean difference	t	Significant
	Conventional Banks	Islamic Banks	−03.38619	−27.642	0.000
EFR	0.06381	3.45000			

EFR: Efficiency ratio

Table 5: Independent samples t-test for NPM

Variable	Mean		Mean difference	t	Significant
	Conventional Banks	Islamic Banks	1.570000	3.052	0.019
NIM	0.03667	−1.53333			

NIM: Net interest margin

Table 6: Independent samples t-test for DAR

Variable	Mean		Mean difference	t	Significant
	Conventional Banks	Islamic Banks	−0.20190	−13.188	0.000
DAR	0.09143	0.29333			

DAR: Debt to assets ratio

Table 7: Independent samples t-test for (DER)

Variable	Mean		Mean Difference	t	Significant
	Conventional Banks	Islamic Banks	−0.43881	−5.803	0.001
DER	0.24286	0.68167			

DER: Debt to equity ratio

Table 8: Independent samples t-test for TCTD

Variable	Mean		Mean difference	t	Significant
	Conventional Banks	Islamic Banks	−0.56666	0−5.096	0.001
TCTD	0.17667	0.74333			

TCTD: Total credit to total debit

CBs are more profitable than IBs. Also, the results are consistent with Moin (2008).

5.2. Solvency Ratios

H_5: There is no significant difference among IBs and CBs in terms of DAR.

H_6: There is no significant difference among IBs and CBs in terms of DER.

The results from Tables 6 and 7 show that for DAR the CB are relying on debt finance compared with the CB. The mean for IBs was 0.29333, while the mean for CB is 0.09143. The difference is statistically significant 0.05%. Also, DER shows a similar trend to DAR, CB have a positive significant performance concerning ROE than IBs, the mean for CB is 0.03286 compared to 0.68167 for IBs. Accordingly, H_5 and H_6 can be accepted. This implies that CB are more risky and less solvent than rather than IBs The results are consistent with Abdus and Hassan (1997) who concluded that IBs are less risky compared to CB.

5.3. Capital Adequacy

This ratio is used to protect depositors and enhance the stability and efficiency of the banks keeping in view their risk exposures.

H_7: There is no significant difference among IB and CBs in terms of TCTD.

The results from Table 8 reveal that the IBs are more stability and protect depositors rather than CB. The mean for IBs was the 0.74333 compared with 17667 for CB. The difference is statistical significant at 0.05%. This revealed that IBs are more equity financed than CBs. Accordingly, H_7 can be accepted. This result is consistent with Siraj and Pillai (2012).

6. CONCLUSIONS

The main objective of this research is to examine where there is any significant difference in the performance for IBs and CB in

Oman. The data used are collected from annual financial reports (Balance Sheet and Income Statement) of seven CB and two IBs in Oman, between 2013 and 2015. Seven standards were adopted to compare performance between IBs and CB.

The results show that that CBs are more profitable and significantly different from IBs in terms of ROA, ROE and NPM. While, IBs were performing better in term of EFR, DAR. DER and credit to deposits ratio TCTD. The difference is statistical significant.

This research expects to fill in the void in literature on the comparison of performance for IBs and CB in Oman in particular and Middle East in general. Both the IBs and CB in Oman should be able to understand that the dividend policy adopted by them will impact the stakeholder and can affect the investment decision and the investment climate in the country.

The study concentrated on focused attention financial performance during 2013-2015 The period has been covered is limited this because IBs have been started only before 3 years, Moreover, only seven measures have been used compare the performance for IBs and CB. In future researches attempts should be made to include more pertinent determinants so as to be able to explore the impact of those variables.

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