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**Dissertation**

**The Development of Islamic Banking and Comparison  
of the Performance of Islamic and Conventional Banks:  
Evidence from Turkey**



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## **ABSTRACT**

This dissertation is written in order to clarify the nature of Islamic banking which expands globally. In the first stage, the information are provided the brief history of Islamic banking, and products are explained. In the second stage, provided brief information about Development, Efficiency, Profitability and Stability in Islamic Banking. In the last stage, examined and evaluated the performance of the Islamic banks in Turkey in comparison a group of 28 Turkish conventional banks. The study evaluates performance of the two groups of banks in profitability, liquidity, and capital adequacy ratios for the period of 2010-2012. T-test is used in determining the significance of the differential performance of the two groups of banks. The results showed that, islamic banks do not seem to fulfill their stability function in the financial system. which is clear with their lower capital adequacy ratios, liquidity ratios, and higher loan and non-performing loan ratios. Still these banks present a good investment opportunity for their owners with higher ROA and ROE, but nevertheless they stand as riskier than conventional banks.

The study recommend that, the managers of the islamic banks should be careful about their riskier positions in the financial markets and should seek out ways to handle these risks. Moreover, the policy makers should monitor the performance of these banks and should set some policies to decrease the risk levels of the islamic banks. Despite their different nature these banks should be kept in line with Basel standards to decrease the fragility and possibility of failure for these banks.

## **INTRODUCTION**

The phenomenon of Islamic banks is the premier event on the level of the banking arena in the Arab and Islamic countries, and even in the global level. Especially in the last quarter and due to the difference of the Islamic and conventional banks in principal, the practical application of Islamic economics in the modern era through Islamic financial institutions spread through than 284 institutions spread in more than 60 countries in a short period, in addition to the movement of activities to deal with the tools of Islamic investment in the financial markets of Islamic countries, and even the markets and the global stock markets.

Ahmad (1989) describes "Islamic banking is essentially a normative concept and could be defined as conduct of banking in consonance with the ethos of the value system of Islam".

General Secretariat of the Organization of The Islamic Conference's definition of Islamic bank is, " a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations".

In three decades, Islamic banks have grown in number as well as in size world wide and are being practiced on even more intensive scale. Some countries like Sudan and Iran, have converted their entire banking system to Islamic banking. In other countries where conventional banking is still dominating the Islamic Banking is operating alongside. Today, Islamic banks are operating in more than sixty countries (Aggarwal and Yousaf 2000).

The Islamic economic system is the combination of rules, values and standards of conduct that organize economic life and establish relations of production in an

Islamic community. These items are based on the Islamic order as recognized in the Koran and Sunna of jurisprudence opus which was developed over the last 1435 years till now by thousands of jurist, responding to the changing conditions and evolving life of Muslims all over the world.

The work of Islamic banks has evolved during the last decade in terms of the diversity of banking products and services and funding provided by customers, reaching Islamic banking services provided to customers for more than thirty banking service in conformity with the law, including credit cards, and letters of credit and letters of guarantee, in addition to providing financial tools to customers with income such as deposits and certificates and Islamic investment funds,.

As there is a huge demand and interest on islamic banking performance all over the world, this thesis aims to provide information about the impression of islamic banking, its history, development and different types of islamic banking products.

Moreover, this thesis provides brief information about islamic banks in Turkey and the performance comparision of Islamic and deposit banks in Turkey from 2010 till 2012.

# CHAPTER 1

## 1. Islamic Finance:

Islamic finance definitions range from the very narrow (interest\_free banking) to the very broad (financial operations conducted by Muslims). Gait, and Worthington (2007) define Islamic finance as following: a financial service principally implemented to comply with the main tenets of Sharia (or Islamic law). In turn, the main sources of Sharia are the Holy Quran, Hadith, Sunna, Ijma, Qiyas and Ijtihad.

According to Iqbal (1997), Islamic finance aims to make an actual moral and equitable distribution in resources and social fairness in all (Muslim) societies. while the prevailing Western financial system focuses on the capitalistic features of economic and financial processes.

Another useful definition is the following: Islamic financial institutions are those that are based, in their objectives and operations, on Koranic principles. According to Warde (2000) they are thus set apart from 'conventional' institutions, which have no such preoccupations. This definition goes beyond simply equating Islamic finance with 'interest-free' banking. and allows to take into account of the operations that may or may not be interest-free, but are nonetheless imbued with certain Islamic principles: the avoidance of riba (in the broad sense of unjustified increase) and gharar (uncertainty, risk, speculation); the focus on halal (religiously permissible) activities; and more generally the quest for justice, and other ethical and religious goals.

Two aspects of Islamic finance must be singled out. First is the risk-sharing philosophy: the lender must share in the borrower's risk. Since fixed, predetermined



interest rates guarantee a return to the lender and fall disproportionately on the borrower, they are seen as exploitative, socially unproductive and economically profuse. The preferred model of financing is profit-and-loss sharing (PLS). Second is the advancement of economic and social development through fixed business practices and through zakat (almsgiving).

Most of Islamic institutions have a Shariah board – a committee of religious consultants whose opinion is sought on the agreeable of new instruments, and who attitude a religious audit of the bank's activities – as well as other features reflecting their religious status.

Shortly, the striking difference between deposit banking and Islamic banking is that while 'conventional' finance usually seeks profit maximization within a given regulatory framework, Islamic finance is also guided by other, religiously-inspired aims.

No definition of Islamic finance is completely favorable. To every general criterion – a financial institution owned by Muslims, catering to Muslims, supervised by a Shariah Board, belonging to the International Association of Islamic Banks (IAIB) etc. – one can find some great exemption.

Indeed, even the criterion of self-identification – i.e., an Islamic institution is one that calls itself Islamic – would leave out the Turkish Finance Houses or Saudi Arabia's Al-Rajhi Banking and Investment Company, which, for reasons the author Warde (2000) explained, do not refer explicitly to their Islamic symbol.

As for the principal concentrate on profit-and-loss sharing (PLS) activities, it remains more an ideal than a fact.

Islamic banking also contains concept that are more than banking. It includes mutual funds, securities firms, insurance companies and other non-banks.

According to Warde (2000) Islamic banks were few in numbers and easily identifiable, the phenomenon has become quite amorphous with the proliferation of Islamic institutions and the blurring of the lines between traditional banking and other forms of finance.

## **1. 2. The History of Islamic Finance**

### **1.2.1. History-A brief information:**

The financial industry has historically played an very important role in the economy of every society. Banks mobilize funds from investors and channel them to investments in trade and business. The history of banking is long and varied, with the financial system as we know it today directly descending from Florentine bankers of the 14th – 17th century, (Schoon 2008).

However, even before the invention of money, people used to deposit valuables such as grain, cattle and agricultural implements and, at a later stage, precious metals such as gold for safekeeping with religious temples in about the 5th century BC, the ancient Greeks started to include investments in their banking operations . Temples still offered safe-keeping, but other entities started to offer financial transactions including loans, deposits , exchange of currency and validation of coins. Financial services were typically offered against the payment of a flat fee or, for investments, against a share of the profit .

The views of philosophers and theologians on interest have always ranged from an unlimited forbiddance to the prohibition of usurious or excess interest only, with a bias towards the absolute prohibition of any form of interest.

The first foreign exchange contract in 1156 AD was not just executed to facilitate the exchange of one currency for another at a forward date, but also because profits from time differences in a foreign exchange contract were not covered by canon laws against usury.

At a time when financial contracts were largely governed by Christian beliefs prohibiting interest on the basis that it would be a sin to pay back more or less than what was lent, this was a major advantage.

### **1.2.2. History and emergence of Islamic banks**

Al Isma`il (2011) conclude that, many people consider Islamic banks a modern phenomenon, but they do not realize them as the essential part of the Islamic economic system which is part of our tolerant `Aqeedah (creed). Therefore, the one who follows the history and emergence of Islamic banks realizes the importance of these banks which had proved their role and presence a day after another.

Indeed, reviving the Islamic banking system was, first, due to those Islamic awakenings which came after liberation of the occupation to which the Arab countries subjected, in addition to increasing the financial resources of most Muslim countries, especially under the consecutive successive oil leaps.

Stages of emergence and development of Islamic banking were due to:

- Individual initiatives.
- Initiatives from Governments.
- Initiatives of international nature.
- Comprehensive initiatives.

### **1.2.2.1. Individual Initiatives:**

The experience of establishing the local savings banks in Egypt in 1963, the first real attempt to start working with an Islamic banking system. It was done by Dr. Ahmad An-Naggar where such experience was based on legitimate speculation through the collection of personal savings from the people and investing them in an Islamic system which allocates profits according to the signed agreement between both parties. There were also several personal tries in Haydarabad, Malaysia, Iran and Pakistan as well, (Al Isma`il 2011).

### **1.2.2.2. Initiatives from Governments:**

Al Isma`il (2011) find that, through the mutual agreement between the Muslim governments or their representatives to support the establishment and consolidation of Islamic banking system was a great transition point in support of the Islamic banking notion where the following appeared:

#### **A- Islamic Development Bank:**

It was established in 1975 in Jeddah - Saudi Arabia. It is an international financial foundation for development financing, developing the foreign trade, providing the training means, and conducting the necessary researches. All Islamic banks participated in this bank to provide support for the economic development and social advancement to the people of the member states according to the principles of Islamic Shari'ah, (Amqran 2007).

## B- International Union of Islamic bank:

It was established in 1977 in Makkah and it has a general secretariat in Cairo. It aimed to confirm the Islamic nature and support the bonds and coordination between the Islamic banks' activities, (Naggar 2008).

### **1.2.2.3. Initiatives of International nature:**

Al Isma`il, (2011) remark that, it is one of the most important stages in establishing the Islamic banking system and made the dream come true through establishing Islamic banks all over the world, which are:

- Dubai Islamic Bank:

It was established in the United Arab Emirates in 1975 and it was the first integrate Islamic bank.

- Faisal Islamic Bank 1977.
- Kuwaiti Finance House: 1977.
- Islamic Bank of Bahrin: 1979.
- Abu Dhabi Islamic Bank: 1997.

and many other Islamic banks.

### **1.2.2.4. Comprehensive Initiatives:**

According to Al Isma`il (2011) to Islamize the entire Islamic banking first, it is a must to prove the ability of Islamic economy and the functions and duties that are carried out by the Islamic banks to encourage Muslim countries to change the traditional banking system to entire integrated Islamic banking system such as Pakistan, Sudan, and Iran.

We still see the huge prosperity of Islamic banks and the speed of their circulation to the extent that they do not only exist in Muslim countries but also in other non-Muslim countries. Moreover, we see the opening of Islamic banks or branches of Islamic banks in the most developed Western countries which depend on usury in their financial and banking systems.

During medieval times (1,000 – 1,500 AD), Middle Eastern tradesmen would engage in financial transactions on the basis of Sharia'a, which indiscriminately was guided by the same principles as their European counterparts at the time. The Arabs from the Ottoman Empire had strong trade relationships with the Spanish, and established financial systems without interest which worked on a profit- and loss-sharing basis. These instruments catered for the financing of trade and other enterprises.

As the Middle Eastern and Asian regions became important trading partners for European companies such as the Dutch East India Company, European banks started to establish branches in these countries, which typically were interest-based.

With the increasingly important role Western countries started to play in the world economy, conventional financial institutions became more dominant. On a small scale, credit union and co-operative societies based on profit- and loss-sharing principles continued to exist, but their activities were very much focused in small geographical areas.

Although it was not until the mid 1980s that Islamic finance started to grow exponentially, the first financial company in recent history based on Sharia'a principles was the Mit Ghamr savings project in Egypt. Mit Ghamr was a co-operative organisation in which the depositors also had a right to take out small loans for productive purposes.

In addition, the Project attracted funds to invest in projects on a profit-sharing basis. In 1971 the project was incorporated in Nasser Social Bank. From a handful of banks in the late 1970s, including the Islamic Development Bank and Dubai Islamic Bank, the Islamic banking industry has grown significantly.

Since the late 1990s the industry has been growing at a rate of 10 – 15% per year, and is expected to keep on growing at this rate for some years to come. The number of banks offering Islamic financial services is growing and is no longer limited to small niche banks, and large conventional banks are offering Islamic finance through their ‘Islamic Windows’. However, the balance sheet size of fully Sharia’a-based banks on a consolidated basis is not even remotely close to that of any of the large conventional banks, which has an impact on the transaction size they can execute on an individual basis.

Large deposit banks on the contrary have the advantage of a big balance sheet and structuring capabilities that are well beyond the current potential of Islamic banks.

In addition, the proven track record of conventional banks provides a higher degree of certainty than a newly established Islamic bank.

On the other hand, Islamic banks operate completely within the ethical framework of Sharia’a and offer skill and expertise in structuring Sharia’a-compliant instruments.

Thus, the two types of players are complementary, and by working closely together can achieve high market penetration and work on reaching the full potential of the market.

### **1.3. The Main Prohibitions and Business Ethics in Islamic Finance :**

Ayub (2007) expresses that Islam has constrained the freedom to engage in business and financial transactions on the basis of a number of prohibitions, ethics and norms. Besides some major prohibitions, Islamic law has prescribed a number of other norms and boundaries in order to avoid inequitable gains and injustice. As Shariah compliance is the raison of the Islamic financial system, concern for the Shariah tenets should dominate all other concerns of Islamic financial institutions. It is only through the compliance of Islamic banking operations with the norms and the principles of the Shariah that the system can develop on a sustainable basis and can ensure fairness for investors, the business community and institutions..

The prohibitions of Riba, generally known as “interest” in traditional commercial terminology, Qimar (gambling), Maisir and Gharar or excessive suspicion about the subject and/or the price in exchanges and the norms and ethics of transaction and finance in the Islamic framework. These standards and ethics demand that all economic agents in a community must get rid of oppression and unfair dealing with others and that harm should not be inflicted upon anyone.



### **1.3.1. Prohibition of Riba**

Metwally (2006, p. 17) defines Riba as: “Usury is translated to mean Riba which literally means an excess or addition above the principle lent. Since interest, however small, is an excess over the capital lent”. Riba is an Arabic word which means any increase or growth in a loan that must be paid by the debtor to the lender, regardless of whether the increase is large or small Siddiqi (2004).

The word “Riba”, meaning prohibited gain, has been explained in the Holy Quran by juxtaposing it contra (profit from) sale. Ayub (2007) explains that all revenue and earnings, salaries and wages, remuneration and profits, usury and interest, rent and hire, etc, can be categorized either as:

- profit from trade and business along with its liability – which is permitted; or
- return on cash or a converted form of cash without bearing liability in terms of the result of deployed cash or capital – which is prohibited.

Riba, according to the criterion, would include all gains from loans and debts and anything over and above the principal of loans and debts and covers all forms of “interest” on commercial or personal loans. In this regard, conventional interest is Riba.

It is interest or Riba on loans and debts .Prohibition of Riba from Quran and Sunnah :

From Quran :

- Surah al-Rum, verse 39 “That which you give as Riba to rises the people’s wealth rises not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold.” (30: 39).

• Surah al-Nisa', verse 161 "And for their taking Riba although it was prohibited for them, and their wrongful takeover of other people's property. We have prepared for those among them who reject faith a grievous punishment." (4: 161).

From the Sunnah :

1. Jabir said (Gbpwh): "The Prophet (pbuh) cursed the receiver and the payer of interest, the one who records it and the witnesses to the bargain and said: 'They are all alike [in guilt]'."

2 Anas ibn Malik said (Gbpwh): "The Prophet said: 'When one of you grants a loan and the borrower displays him a dish, he should not accept it; and if the borrower displays a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually.'"

### **1.3.2. Prohibition of Gharar**

El-Gamal (2000, p.7) defines Garar as “ the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling”.

“Gharar” means hazard, chance, stake or risk (Khatar). Khatar/Gharar is found if the liability of any of the parties to a contract is uncertain or contingent; delivery of one of the exchange items is not in the control of any party or the payment from one side is uncertain Ayub, (2007).

In the legal terminology of jurists, “Gharar” is the sale of a thing which is not present at hand or the sale of a thing whose “Aqibah” (consequence) is not known or a sale involving hazard in which one does not know whether it will come to be or not, e.g. the sale of a fish in water, or a bird in the air.

Material obtainable about Gharar in the literature on Islamic economics and finance is far less than that on Riba. However, the legists have tried to discuss different sides to determine whether or not any transaction would be non-Shariah compliant due to the involvement of Gharar.

In order to avoid doubt, Islamic law denies the power to sell in the following three cases:

1. Something which, as the object of a lawful transaction, do not exist.
2. Something which exist but which are not in ownership of the seller or the availability of which may not be predictable.
3. Something which are exchanged on the basis of uncertain delivery and payment.

### **1.3.3. Prohibition of Maysir/Qimar (Games of Chance):**

Maysir is regarded by most Islamic scholars as gambling or any games of chance (including lotteries, lotto, casino-type games and betting on the outcomes of animal races). Together, these share a desire for obtaining return through deliberate risk-taking, (Al-Saati 2003).

The words Maisir and Qimar are used in the Arabic language identically. Maisir refers to easily available wealth or acquisition of wealth by chance, whether or not it deprives the other's right. Qimar means the game of chance – one gains at the cost of other(s); a person puts his money or a part of his wealth at stake wherein the amount of money at risk might bring huge sums of money or might be lost or damaged Ayub, M. (2007).

While the word used in the Holy Quran for prohibition of gambling and wagering is “Maisir” (verses 2: 219 and 5: 90, 91), the Hadith literature discusses this act generally in the name of “Qimar”.

According to the legists, the difference between Maisir and Qimar is that the latter is an important kind of the former. “Maisir”, derived from “Yusr”, means wishing something valuable with ease and without paying an equivalent compensation (‘Iwad) for it or without working for it, or without undertaking any liability against it, by way of a game of chance.

“Qimar” also means receipt of money, benefit or usufruct at the cost of others, having entitlement to that money or benefit by resorting to chance. Both words are applicable to games of chance.

References from the Holy Qur'an:

- “O you who believe! intoxicants and gambling, sacrificing to stones, and divination by arrows, are abominable actions of Satan; so abstain from them, that you may prosper.” (5: 90).
- “Satan intends to excite enmity and hatred among you with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer; will ye not then abstain?” (5: 91).

## **1.4. Islamic Finance Products**

### **1.4.1. Musharakah :**

Ibn Arfa (1984) defined it as: “An agreement between two or more persons to carry out a particular business with the view of sharing profits by joint investment”. Khan (1990) defines a musharakah or partnership as: “A contract between two persons who launch a business of financial enterprise to make profit”.

The literal meaning of Musharakah is sharing. The root of the word "Musharakah" in Arabic is Shirkah, which means being a partner. It is used in the same context as the term "shirk" meaning partner to Allah. Under Islamic jurisprudence, Musharakah means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. It is an ideal alternative for the interest based financing with far reaching effects on both production and distribution. The connotation of this term is little limited than the term "Shirkah" more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts, it will be pertinent at the outset to explain the meaning of each term, as distinguished from the other. "Shirkah" means "Sharing" and in the terminology of Islamic Fiqh, it has been divided into two kinds:

Shirkat-ul-milk (Partnership by joint ownership):

It means joint ownership of two or more persons in a particular property.

Shirkat-ul-Aqd (Partnership by contract):

This is the second type of Shirkah, which means, "a partnership effected by a mutual contract". For the purpose of brevity it may also be translated as "joint commercial enterprise

Musharakah is a relationship founded by the parties through a mutual contract. That is why, it goes without saying that all the indispensable ingredients of a valid contract must be present here also. For example, the parties should be able of entering into a contract; the contract must take place with free consent of the parties without any constraint, fraud or misrepresentation, etc.

#### **1.4.2. Mudarabah**

The Mudarabah (or capital trust) is a form of profit or loss (equity-based) sharing used by tradesmen in Mecca before Islam. The best evidence for its existence is Muhammad employed Mudarabah with a rich woman named Khadijah about fifteen years prior to the establishment of Islam, (Abdul-Gafoor 2006).

Mudaraba, in jurisprudence, is "...a mode of financing through which the bank (the owner of the capital or rabb-al-mal) provides capital finance for a specific venture indicated by the customer (the entrepreneur or mudarib)" (Obaidullah, 2005, p.57).

"Mudarabah" is a special kind of partnership where one partner gives money to another for investing it in a commercial project. The investment comes from the first partner who is called "rabb-ul-mal", while the management and work is a specific responsibility of the other, who is called "mudarib". Mudaraba arrangement is a form of partnership, where profits are shared and losses are borne exclusively by the capital provider, (Hurley 2010).

### **1.4.3. Murabahah**

Murabahah is one of the most commonly used modes of financing by Islamic Banks and financial institutions. Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit thereon. Thus, Murabahah is not a loan given on interest; it is a sale of a commodity for cash/deferred price, (Usmani 2002).

Murabaha is an Islamic instrument for buying and reselling the purchase or import of capital goods and other commodities by institutions, including banks and firms, Gait (2007).

The Bai' Murabahah involves purchase of a commodity by a bank on behalf of a client and its resale to the latter on cost-plus-profit basis. Under this arrangement the bank discloses its cost and profit margin to the client. In other words rather than advancing money to a borrower, which is how the system would work in a conventional banking agreement, the bank will buy the goods from a third party and sell those goods on to the customer for a pre-agreed price. Murabahah is a mode of financing as old as Musharakah. Today in Islamic banks world-over 66% of all investment transactions are through Murabahah.

#### **1.4.3.1. Difference between Murabahah and Sale**

A simple sale in Arabic is called Musawamah - a bargaining sale without detecting or mention to what the cost price is.

However when the cost is detected to the client, it is called Murabahah. A simple Murabahah is one where there is cash payment and Murabahah Muajjal is one on deferred payment basis.



#### **1.4.3.2. Basic rules for Murabahah**

Following are the rules governing a Murabahah bargain, (Usmani 1998):

A. The subject of sale must exist at the time of the sale. Thus anything that may not exist at the time of sale cannot be sold and its non-existence makes the contract void.

B. The subject matter should be in the ownership of the seller at the time of sale. If he sells something that he has not acquired himself then the sale becomes void.

C. The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. For example, 'A' tells 'B' on 1<sup>st</sup> January that he will sell his car on 1<sup>st</sup> February to 'B', the sale is void because it is attributed to a future date.

D. The subject of sale must be in physical or constructive possession of the seller when he sells it to another person. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity yet it has come into his control and all rights and liabilities of the commodity are passed on to him including the risk of its destruction.

E. The subject matter should be a property having value. Thus a good having no value cannot be sold or purchased.

F. The subject of sale should not be a thing used for an un-Islamic purpose.

G. The subject of sale must be specifically known and identified to the buyer. For example, 'A' owner of an apartment building says to 'B' that he will sell an apartment to 'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed to the buyer.

H. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

I. The certainty of price is a necessary condition for the validity of the sale. If the price is uncertain, the sale is void.

J. The sale must be unconditional. A conditional sale is invalid unless the condition is recognized as a part of the transaction according to the usage of the trade.

### **1.4.3.3. Issues in Murabahah**

Usmani (1998) conclude that, following are some of the issues in Murabahah financing:

#### **A. Securities against Murabahah**

Payments coming from the sale are receivables and for this, the client may be asked to furnish a security. It can be in the form of a mortgage or hypothecation or some kind of lien or charge.

#### **B. Guaranteeing the Murabahah**

The seller can ask the client to furnish a third party guarantee. In case of default on payment the seller may have recourse to the guarantor who will be liable to pay the amount guaranteed to him.

#### **C. Penalty of default**

Another issue with Murabahah is that if the client defaults in payment of the price at the due date, the price cannot be changed nor can penalty fees be charged.

#### D. Rollover in Murabahah

Murabahah transaction cannot be rolled over for a further period as the old contract ends. It should be understood that Murabahah is not a loan rather the sale of a commodity, which is deferred to a specific date. Once this commodity is sold, its ownership transfers from the bank to the client and it is therefore no more a property of the seller. Now what the seller can claim is only the agreed price and therefore there is no question of effecting another sale on the same commodity between the same parties.

#### F. Rebate on earlier payments

Sometimes the debtors want to pay early to get discounts. However in Islam, majority of Muslim Scholars including the major schools of thought consider this to be un-Islamic. However if the Islamic bank or financial institution gives somebody a rebate on its own, it is not objectionable especially if the client is needy.

#### G. Calculation of cost in Murabahah

The Murabahah can only be effected when the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained then Murabahah cannot take place. In this case the sale will take place as Musawamah i.e. sale without reference to cost.

#### H. Subject matter of the sale

All commodities cannot be the subject matter in Murabahah because certain requirements need to be fulfilled. The shares of a lawful company can be sold or purchased on Murabahah basis because according to the principles of Islam the shares represent ownership into assets of the company provided all other basic

conditions of the transaction are fulfilled. A buy back arrangement or selling without taking their possession is not allowed at all.

#### **1.4.4. Ijarah (Leasing):**

Ijarah is the reward or recompense that proceeds from a rental contract between two parties, where the lessor (the owner of the asset) leases capital asset to the lessee (the user of the asset), (Gait 2007). Ijarah literally means "...to give something on rent", (Lewis and Algaoud 2001).

In the Islamic jurisprudence, the term 'Ijarah' is used for two different situations. In the first place, it means 'to employ the services of a person on wages given to him as a consideration for his hired services.

" The employer is called 'musta'jir' while the employee is called 'ajir'.

Therefore, if Y has employed X in his office as a manager or as a clerk on a monthly salary, Y is musta'jir, and X is an ajir.

Comparably, if A has hired the services of a porter to carry his baggage to the airport, Y is a musta'jir while the porter is an ajir, and in both cases the transaction between the parties is termed as Ijarah. This kind of Ijarah contains every transaction where the services of a person are leased by someone else. He may be a lawyer, a teacher, a laborer or any other person who can render some beneficial or worthy services.

Everyone of them may be called an 'ajir' according to the nomenclature of Islamic law, and the person who hires their services is called a 'musta'jir', while the wages paid to the ajir are called their 'ujrah' Labor.

The second kind of Ijarah relates to the usufructs of assets and estates, and not to the services of human beings. 'Ijarah' in this sense means 'to transfer the usufruct of a special property to another person in exchange for a rent supposed from him.' In this case, the term 'Ijarah' is analogous to the English term 'leasing'. Here the lessor is called 'Mu'jir', the lessee is called 'musta'jir' and the rent payable to the lessor is called 'ujrah'.

Both these kinds of 'Ijarah' are thoroughly discussed in the literature of Islamic doctrine and each one of them has its own set of rules. The rules of Ijarah, in the sense of leasing, is very much similar to the rules of sale, because in both cases something is transferred to another person for a valuable sight.

The only difference between Ijarah and sale is that in the latter case the frame of the property is transferred to the buyer, while in the case of Ijarah, the corpus of the property remains in the ownership of the transferor, but only its usufruct i.e. the right to use it, is transferred to the lessee. That is why, it can easily be seen that 'Ijarah' is not a model of financing in its origin. It is a normal business activity like sale.

However, due to certain reasons, and in particular, due to some tax concessions it may carry, this transaction is being used in the Western countries for the purpose of financing also. Instead of giving a simple interest - bearing loan, some financial institutions started leasing some equipment's to their clients. While determining the rent of these equipment, they calculate the total cost they have incurred in the purchase of these assets and add the stipulated interest they could have professed on such an amount during the lease period. The aggregate amount so calculated is divided on the total months of the lease period, and the monthly rent is determined on that basis. The question whether or not the transaction of leasing can be used as a mode of financing in Shari'ah depends on the terms and conditions of the contract.

As aforementioned earlier, leasing is a normal business transaction and not a model of financing.

#### **1.4.5. Salam**

Iqbal and Molyneux (2005, p. 25) defined Salam as follows:

“Salam is a sale contract in which the price is paid in advance at the time of contracting against delivery of the purchased goods/services at a specified future date”.

Salam is a forward financing transaction, where the financial institution pays in advance for buying specified assets, which the seller will supply on a pre agreed date. What is given in exchange for the advance payment of the price should not in itself be in the nature of money. For the payment in advance, the contracting parties stipulate a future date for the supply of goods of specified quantity and quality.

Salam may be considered as a kind of debt, because the object of the Salam contract is the liability of the seller, up to the agreed future date, to deliver the object for which advanced payment of the price has already been made. There is consensus among Muslim jurists on the permissibility of Salam, notwithstanding the general principle of the Shari’ah that does not permit the sale of a commodity which is not in the possession of the seller, because the object of the contract is that the goods are a recompense for the price paid in advance, just as the price is recompense paid for getting the goods in advance. The transaction is considered Salam if the buyer has paid the purchase price to the seller in full at the time of sale.

The notion of Salam is to supply a mechanism that ensures that the seller has the liquidity they expected from entering into the transaction in the first place. Muslim

jurists are unanimous that full payment of the purchase price is key for Salam to exist.

However, Salam cannot occur in money or currencies as these are subject to rules relating to bai al-sarf, wherein exchange has to be simultaneous. So as to the Salam contract deals with the delivery of an asset which is not in existence, the Shari'ah highlights that strict rules must be adhered to in order to ensure that the right of all parties are protected.

Actually, it is essential that the quality of the commodity is fully specified leaving no ambiguity which may lead to a dispute. All the possible specifics in this respect must be expressly mentioned.

Salam can be effected in those commodities only the quality and quantity of which can be specified exactly. The commodity should be generally available in the market at the time of delivery. And all goods that can be categorized as belonging to the same species can be the subject of Salam. However, Salam cannot take place between identical goods. Besides, the time and place of delivery of the goods should be precisely fixed; and the quality and the quantity of the goods should be clearly specified. The specification of goods should particularly cover all those characteristics which could cause variation in price.

Different rules apply to Salam contract, is that the seller in Salam need not be the manufacturer or producer of the asset. The seller may be an agent to deliver the asset. Moreover, a Salam contract can stipulate that that, in the event of late delivery of the goods, the supplier pays a certain amount as a penalty to the buyer, which amount must be used for a charitable purpose; it cannot be taken into the buyer's income. The buyer has also the right to demand security or collateral from the seller to ensure

that the seller delivers the goods on the agreed date, the buyer has the right to dispose of the security and purchase the specified goods from the market; the buyer is entitled to deduct the advance payment from the proceeds of the security realised and return any surplus to the seller.

#### **1.4.6. Istisna'a**

Istisna'a is a relatively new method in Islamic banking, defined as a manufacturing contract which allows one party to obtain industrial goods with either an upfront cash payment and deferred delivery or deferred payment and delivery, (Gait 2007).

It has been translated by El-Gamal (2000, p 17) as a "...commission to manufacture" usually used to cover work progress in the manufacturing and building industries. Istisna'a is a contract whereby a party commitments to produce a specific thing which is possible to be made according to certain agreed-upon specifications at a determined price and for a fixed date of delivery. This undertaking of production includes any process of manufacturing, construction, assembling or packaging, Islamic Development Bank (2002).

In Istisna'a, the work is not conditioned to be accomplished by the commitment party and this work or part of it can be done by others under his control and liability. Istisna'a, an instrument of pre-shipment financing and it is a contract where the deal can be mentioned to something not in existence at the time of concluding the contract, while Murabaha is an order to buy goods or goods which are in existence in hand or possible to be found in the market.

As the Islamic development bank (2002) consider the main aim of the Istisna'a mode of financing is to promote manufacturing ability in the IDB (Islamic Development Bank) member countries. This may relate to manufacturing of complete assets in the



form of capital goods. These goods may benefit the industrial, agricultural or infrastructure sector ...etc.

This mode of financing can also be applied to Long Term Trade Financing (LTTF) to promote intra-trade among IDB member countries. Istisna'a provides medium term financing to meet financing requirement for manufacturing/supplying/sale/marketing of identified goods and services, such as industrial/construction equipment, machinery, cargo vessels, oil tankers, trawlers, dredgers, locomotives, etc., transport equipment, pipelines for water and oil distribution, gas and electricity and their transmission/distribution lines, electric generators and transformers, telecommunication equipment, oil rigs, hospital equipment, etc, (Islamic Development Bank 2002).

In this regard, it is possible to finance intangible assets like gas, electricity, etc. It is also possible, unlike under leasing and installment sale, to finance working capital. Istisna'a financing period is determined by the time desired for procurement of essential materials and manufacturing of the goods according to the agreed contract. The value of the goods in a contract of Istisna'a could be paid either in advance or in arrears, and could be paid in one payment or by installments during the manufacturing of the goods and services or in the future date, Islamic development bank (2002). The manufacturer is bound and compelled to deliver the goods within the agreed time. Failure to deliver within the agreed time will make the manufacturer susceptible to pay the buyer liquidated damages and losses in accordance with the contract unless such postponement is due to force majeure .

The option of manufacturer/contractor of assets will be fixed to contractors/manufacturers from IDB member countries (Islamic Development Bank) in conformity with IDB Procurement Guidelines.

expenditure will follow transactions as adopted by IDB and contained in the relevant guidelines.

An advance payment of up to 20%, against acceptable Bank Guarantee, is allowable. After the finalization of the contract and award of bids, the Bank would ask the manufacturer or contractor to open a letter of credit in favor of the supplier of materials or reimburse the expenses already sustained upon submitting the in demand supporting documents and confirmed by the relevant departments of IDB.

Reimbursable expenses should not be took place before signing of the Istisna'a agreement or contract. In this regard financing will encourage and facilitate the full use of the talent and technical ability in the IDB member countries in the area of capital goods production. It will promote intra-trade in goods and transfer of technology among the IDB member countries.

Deficiency of financial capital, thus, may not be an barrier for production of capital goods. It could also finance infrastructure enterprises like roads, buildings, etc. This model would allow financing of trade, enterprises, and projects just like that, foundation linkage between the two in the framework of pre-shipment financing which would contain financing of working capital, which is not otherwise possible under leasing and payments sale financing, Islamic development bank (2002)

#### **1.4.7. Sukuk**

“Certificates of equal value, representing after closing subscription, receipt of the value of the certificates and the putting to use as planned, common titles to shares

and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity” YUNIS and Wessing, (2005).

Sukuk generally are asset -based, stable income, tradable and Shariah compatible certificates Al-Zarqa (2012). Sukuk is a plural of sakk. Sukuk are certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity (AAOIFI, 2008).

#### **1.4.7.1 Types of Sukuk:**

There are many types depending on the type of islamic modes of financing

##### **Sukuk ijarah:**

This is one of the most common Sukuk issuance kinds, especially for project finance. Sukuk ijarah is leasing structure coupled with a right available to the lessee purchase the asset at the end of lease period. the certificates are issued on stand-alone assets identified on the balance sheet Bt.Mohamed (2008).

##### **Sukuk Mudharabah:**

This is an agreement made between a party, who provides the capital and another party (an entrepreneur), to enable the entrepreneur to carry out the business projects, which will be on a profit sharing basis, according to predetermined ratios agreed on earlier. in this case of losses, the losses are born by the provider of the funds only. Sukuk Mudarabah are used to enhance public participation in big investment projects Bt.Mohamed (2008).

### **Sukuk Musharakah:**

These are investment Sukuk that represent ownership of Musharakah equity. the structure of Musharakah requires that both partys provides financing to the projects. in the case of losses, both partys will lose in proportion to the size of their investment. Sukuk Musharakah are used to mobilize funds to establish new projects. or to develop an existing one, or to finance a business activity on the basis of partnership contracts Bt.Mohamed (2008).

### **Sukuk istisna':**

This type of Sukuk has been used for advance of funding for real estate development, major industiral projects or large items of equipment of such as turbines, power plants, ships or aircraft ( construction/manufacturing financing ) Bt.Mohamed (2008).

#### **1.4.7.3. Benefits of Sukuk Investments:**

The main benefits of investing in Sukuk instruments:

- Sukuk are priced competitively in line with deposit bond cases.
- Sukuk usually have better risk profile.
- Sukuk can be tradable and fill the exis ting need for Shariah compatible tradable means.
- Short Term Islamic Financial Market generally can benefit from Sukuk.

## **CHAPTER 2**

### **2.1. Development of Islamic Banks**

The Islamic banking system is currently spreading fast through many Arab and Muslim countries. The success of this new system is indicated by the rapid growth in number of banks, branches, accounts, and sums of money it handles.

This enormous success has caused some Western style commercial banks, in Sudan for example, to consider changing to the Islamic banking system. It is also drawing the attention of governments of some Muslim countries to seriously supporting the system.

Although the main reason for these successes is believed to be the Islamic beliefs of the people of these countries, an empirical study conducted with the customers of Faisal Islamic Bank of Sudan (FIBS) identifies other more important and entirely non-religious factors. Surprisingly these factors not only focus on the reasons for the current success of Islamic banks but also highlight the dangers that future operations of the Islamic banking system might encounter.

#### **2.1.1. Strategies for Successful Development of Islamic Banks**

Bashir (1984) conclude that, to ensure future success of Islamic banks, they must be well managed to fulfill customer's objectives as identified above. But if achievement of high returns to equity share-holders of the bank is also an important purpose (which might well be the case of all Islamic commercial banks), then the customers' objectives contradict or at least conflict with maximization of returns to equity-holders.

To achieve high returns to equity-holders would require more profitable investments (which are long-term investments) and a low profit rate to be offered to depositors.

That would display less banking services and short-term investments and lower returns to depositors. But lower depositor returns will cause the withdrawal of funds and possibly lead to failure of the bank. Thus, an optimal policy must be selected to fulfill the customers requirements, to achieve sufficient returns to equity-holders, and to ensure future successes of the bank.

Bashir (1984) expounds that, the following three objectives seem to be the most important for any commercial Islamic bank.

A. increase of returns to equity share-holders.

B. Achievement of sufficient returns to depositors.

D. increase of the bank's risk of loss.

In a special questionnaire designed for the management of FIBS, these objectives are confirmed to be of tantamount importance to its Islamic business operations.

Achieving the first two objectives would require constructing a highly profitable portfolio and an optimal profit-sharing ratio for the distribution of these profits. These seem to be two independent decisions, but they are not. The profit-sharing ratio that will determine the return to depositors, affects the volume of funds to be deposited for investments and hence the bank's capacity of investment.

The bank cannot use funds in its immediate accounts for long term investments. Thus unless there are sufficient funds deposited for investment the bank cannot invest in high profit business and make sufficient profits. Therefore, these two decisions, the optimal portfolio mix and optimal profit-sharing ratio are mutually dependent. A rationally low profit-sharing ratio with a highly profitable portfolio or a higher profit-

sharing ratio with a less profitable one may sufficiently satisfy the requirements. But the optimal policy might well be in between these two cases.

To present a low profit-sharing ratio with a highly profitable portfolio would require huge investments on long term projects and less in banking services and short-term loan investments, (Bashir 1984). Such a policy might be very risky on the one hand and on the other may reduce the volumes of funds supplied to the current accounts due to reduction in banking services and short-term loan investments.

Showing a high profit-sharing ratio and holding a less profitable portfolio may be less risky and could bring huge volumes of funds to the bank (in both current and deposit accounts). But such a less risky portfolio would reduce the profitability of the bank and also the return to equity and deposit holders (equity-holders may be greatly affected). Neither of these two policies fully satisfies the requirements, and an optimal policy has to be found using an optimization technique.

The third objective (risk minimization) stands as a constraint to the achievement of the first two. High profits to satisfy the return objectives can only be achieved at high risk. In the case of Islamic banks, high risk could simply lead to bank failures. This is because depositors can simply withdraw their funds from these investment accounts before losses occur, leaving the bank with the burden of these losses.

Most clients will prefer to move their funds to personal use rather than to current or saving accounts if losses are expected. This will subject the Islamic bank to an even greater risk of funds withdrawal which might possibly lead to its failure. In the deposit theory of portfolio selection, risk is usually treated as a constraint to a maximization issue. However, in Islamic banks minimization of risks below specific

maximum accepted level is an objective in itself and is to be treated as a third objective rather than a constraint, (Bashir 1984).

## **2.2. Principles Underlying the Islamic Banking System**

It has been obviously stated in the Qur'an that trading is allowed but that interest is forbidden (2:275 and/or 3:130). These Islamic principles are aimed at the betterment of mankind in all economic and social spheres of life, (Bashir 1984).

The following are some basic rules :

- Business and trade activities should be undertaken on the basis of fair and legitimate profits.
- Monopoly, gambling and certain forms of speculation are to be prohibited.
- Usury and interest (interest being a special type of usury) are to be prohibited for all types of transactions.

The third is the most fundamental of these principles and is also significant to the operations of the banking system. Many reasons have been advanced as to why usury has been forbidden, but perhaps the most important is the belief that capital should not generate profit unless combined with human effort or unless risk is involved. Interest on loans is thus an inequitable payment since under conditions of uncertainty no borrower can guarantee that enough profit will be made to pay the interest due. Uncertainty about the future therefore makes it unjust to guarantee return on capital or loan and when no human effort has been exerted. Notwithstanding this rationalization, the ultimate reason is that the Quran lays down a clear and unambiguous order against all types of usurious transactions. The reasons presented in the foregoing discussion, therefore, may only be interpreted as illustrating the type



of arguments currently advanced. The chief alternative to interest, consistent with the Islamic principles, is the various forms of profit-sharing. This it is believed will bring justice and equitable distribution of the profits as well as sharing of the risks of investment. This principle is followed by all Islamic economic institutions, and forms the basis of the operations of existing Islamic banks, (Bashir 1984).

### **2.3. The Promise of the Islamic Banking Model**

Economists usually evaluate any blueprint or project on the basis of its allocative efficiency, equity, stability and growth implications.

#### **2.3.1. More fairness**

Molyneux (2005) conclude that, Islam is a religion which confirms fairness to all people. A contract based on interest involves fairness to one of the parties, occasionally to the borrower and sometimes to the lender. The interest contract is unfair to the borrower because if somebody takes a loan and uses it in his project, he may earn a profit or he may end up with a loss. Now, in the case of loss, the person using that money, let us call him the businessman, loses his labor. Furthermore to this loss, he has to pay interest and the capital to the lender. The lender, in spite of the fact that the business of the project has ended up making a loss, gets his money as well as his interest. So it is unfair. Many people do not realize that a interest contract can be unfair to the depositor and not always so to the borrower. In most of the underdeveloped countries perhaps it is more unfair to the lender. This is because depositors may be paid a rate of interest that is in fact generating negative real returns if inflation is greater than the rate charged. If borrowers take out loans and invest these in successful projects that yield returns essentially better than the rate of

inflation then they benefit as they only have to make modest loan repayments that are not linked to the performance of the investment.

Actually, they might be repaying at a rate that relates to negative levels of real interest while generating essential positive real returns from their investments. In contrast, depositors may be rewarded with negative real return on their deposits. This would mean that depositors became comparatively poorer and borrowers comparatively richer in real terms, which participates to better financial and economic inequality in the system. In this regards he suggested, on the basis of economic reasoning, Islamic banking is upper to an interest-based configuration because it ensures equity between the borrower and the lender. Both of them share the accrued return which the project generates, (Molyneux 2005).

### **2.3.2. Improved allocative efficiency**

A profit-sharing system is also more efficient. It is more efficient because Islamic bank financing is solely based on the productivity of the project. In an interest-based system the sole criterion for the distribution of credit is the credit-worthiness of the borrower. In Islamic banking, the productivity of the project is more important, and so the finances will go to more productive projects. In this way the resources, instead of going to low-return projects belonging to credit-worthy clients, will flow to high return projects even if the credibility of the borrower is lower. Therefore, the system is more efficient in its allocation of resources. It is also more efficient, because the bank's return is now linked to the project. In case of interest-based systems, banks need not care much about project evaluation and may focus more on collateral and security. In the case of profit-sharing, they have a much greater interest in the project itself so they will evaluate the project very carefully and allocate funds to more efficient projects. Since the return of Islamic banks depends on the success of the

project, they may also contribute to the management of the project. Since they specialize in the area of finance and investment, their expertise will improve the profitability of the project, (Iqbal and Molyneux 2005).

This issue is also evaluated in empirical papers. Ahmad and Noor (2011) investigate the efficiency of the 78 Islamic banks in 25 countries for the period of 1992-2009. They find that profit efficiency is positive and statistically significant with operating expenses against asset, equity, high income countries and non performing loans against total loans. Their empirical findings seem to suggest that the World Islamic Banks have exhibited high pure technical efficiency. They also find positive correlation between bank profitability and technical efficiency levels, indicating that more efficient banks tend to be more profitable. Interestingly, their empirical results show that more profitable banks are those that have higher operating expenses against asset, more equity against asset and concentrated at high income countries demonstrating close relationship between monetary factors in determining Islamic banks profitability.

### **2.3.3. Stability of the banking system**

From the stability point of view also, the Islamic banking model is more stable than the conventional banking model. In an interest-based system, there is a lack of symmetry in the cash flow of the banks and the cash flow of the enterprise. The entrepreneurs or the businessmen have to return a stipulated interest repayment to the banks that bears no relationship to the actual return of the project. Therefore, if the project is not going well in some stages of the project or in the entire life of the project, there develops an asymmetry between the cash inflow and cash outflow. That creates instability in the entire business sector. From the other side, the bankers also lack equilibrium in their assets and liabilities because their liabilities are fixed

while their assets are variable. When there is any external shock, there is no automatic mechanism which can restore equilibrium between the assets and liabilities of the bank. In the case of an Islamic system, the liabilities of the bank are on the basis of *mudarabah* and hence are also variable. If there is any shock, it affects the assets side as well as the liability side of the banks' balance sheet. For example, if recession occurs, banks' assets will go down, but, at the same time, their liabilities will also go down since they do not have to pay a fixed or guaranteed rate of return to the depositors. Thus, their liabilities are related to the actual performance of the projects they finance. The assets and liabilities are mutually linked and this mechanism restores equilibrium between the assets and liabilities of the Islamic banks, so there is a smaller likelihood of bank failure, (Iqbal and Molyneux 2005).

Čihák and Hesse (2010) examine the relative financial strength of Islamic banks, it is assessed empirically based on evidence covering individual Islamic and commercial banks in 19 banking systems with a substantial presence of Islamic banking. The contrast between the high stability in small Islamic banks and the relatively low stability in large Islamic banks is particularly interesting. They suggest that Islamic banks, while relatively more stable when operating on a small scale, are less stable when operating on a large scale.

#### **2.3.4. Promotion of growth**

Another criterion on which economists usually judge a scheme is that of growth. From the growth point of view also the Islamic banking system is preferable to the conventional banking system for the following reasons: First, the Islamic banking model promotes innovation. Innovation is not something on which the big industrialists have a monopoly: anybody can be an entrepreneur, and anybody can have a good idea. In Islamic banking, if a small or middle-class entrepreneur has a

better project, he has (i) a possibility of getting it financed, and (ii) he will not be held back by the fear of tremendous risks. It is known that innovations involve risks. Since risk is shared between the financier and entrepreneur, the Islamic banking system results in a better distribution of risk. Business risk is spread over a larger number of people. The entrepreneur is risking only his labour and the bank is risking its capital. Therefore, ingenious entrepreneurs will be forthcoming and innovation will be promoted. Second, conditions which dictate the cost of capital, one of the determinants of the rate of investment in any economy, are more favourable under the Islamic system. The cost of capital in an interest based system which is the rate of interest, is fixed in that the rate of interest paid or charged does not vary with the productivity of the projects which banks finance. In an Islamic economy, the cost of capital varies with productivity. There is no fixed cost of capital. In the periods when there is a recessionary trend in the economy, productivity goes down but, at the same time, the cost of capital for the clients of Islamic banks also goes down. Thus it does not have that deterrent effect on investment which a fixed cost of capital has. As a result, even in that period, relatively speaking, there will be greater investment in an Islamic economy or in the profit-sharing economy as compared to an interest-based economy. So, for these reasons, from the growth point of view the Islamic banking system fares better, (Iqbal and Molyneux 2005).

Alam (2011) found that there is generally an increasing trend in the total assets, total deposits, total financing, total investments, total number of branches, profits, earnings per shares, share holder equity and other financial indicators which shows the financial growth and development of the financial institutions. Credit rating of the Islamic banks is normally satisfactory. Islamic banks are performing their

operations in Pakistan successfully. Acceptance of Islamic banking system in the country shows that people are very satisfied with the practices of Islamic banking.

As Islamic banking is still a new concept and people know little about it so there is a need to educate the people about what Islamic banking is. To develop Islamic banking system there is a need of trained human resource whose specialization will be in Islamic economic system not in the interest base economic system. To develop Islamic banking, it is mandatory to create harmony in the opinion of different sects. Central bank should bring improvement in interest free banking infrastructure. Banks should extend the interest free financial services towards low level income community.

The regulatory bodies of banking system should make rules and regulations regarding the Islamic banking and make it sure that there is proper implementation of corporate governance in interest free banking system. Introduction of dual capacity efforts interest free financing also help the Islamic banking to grow.

Promotion and improvement of interest free banking system in Pakistan can only be done by creating a communication channels with developed economy as well as local and abroad money and funds provider and investors.

Introduction of liquidity and monetary policies and management is now basic necessity for the promotion of Islamic banking system. Interest free bank should also introduce new products and services to capture the maximum portion of the banking sector.

## **2.4. Efficiency, Profitability and Stability in Islamic Banking :**

### **2.4.1. Efficiency in Islamic Banking :**

Noor and Bt Ahmad (2012) investigate the efficiency of the Islamic banking sector in 25 countries during the period 1992-2009 using data for 78 Islamic banks using the nonparametric DEA approach. They find that during the period of study, PTE outweighs SE in the World Islamic banking sector, implying that the Islamic banks have been managerially efficient in exploiting their resources to the fullest range. The findings suggest that the World Islamic banks have exhibited high PTE. During the period of study, they find that pure technical inefficiency has greater effect in locating the total technical inefficiency of the World Islamic banking sector. Moreover that TE is negatively associated with loans intensity and market capitalization, and is positively connected with size. They also show that technically more efficient banks are those that have lower market share and high non-performing loans ratio. They also find positive relation between bank profitability and TE levels, indicating that the more efficient banks resort to to be more profitable.

The results also suggest that favorable economic conditions display positive relationship with bank efficiency. The study could be extended in a variety of ways. First, the scope of this study could be further expanded to explore changes in cost, allocative, and technical efficiencies over time. Second, further investigation of the Islamic banking sector's efficiency is suggested, considering the risk exposure factors. Third, future research of the efficiency of the Islamic banking sector could also consider the production function along with the intermediation function. Finally, investigation of changes in productivity over time as a result of technical change or technological progress or regress by employing the Malmquist total factor productivity index could be yet another extension to the paper.

Nevertheless, the study also provides further insight into bank-specific management as well as helping the policy makers with regard to accomplishing optimal utilization of capacities, improvement in managerial expertise, efficient allocation of scarce resources and most productive scale of operation of the banks in the industry.

This may also facilitate trends for sustainable competitiveness of World Islamic banking operations in the future.

Noor. M. Bt Ahmad. and Sufian (2010) examine the performance of the Asian Islamic banks that consist of 4 countries namely Bangladesh, Indonesia, Malaysia and Pakistan during the period 2001-2006. The efficiency estimates of individual banks are evaluated using the non parametric Data Envelopment Analysis (DEA) approach. They suggest that during the period of study, pure technical inefficiency outweighs scale inefficiency in the Islamic banking sector implying that the Islamic banks have been managerially inefficient in exploiting their resources to the fullest extent. They find that banks from Indonesia were the most efficient from the Asian region, followed by banks from Pakistan and Bangladesh and the Malaysian Islamic banking sector were the least efficient.

The finding get together with Viverita et al. (2007), finding that Malaysia had been expected to be the most efficiency-improved country due to its innovation in Islamic products, but Indonesia obtained the best overall efficiency, the only different is Viverita et al (2007) were using Malmquist Total Factor Productivity in their study.

The study have also provide further insight to bank specific management as well as the policymakers with regard to attaining optimal utilization of capacities, improvement in managerial expertise, efficient allocation of scarce resources and most productive scale of operation of the banks in the industry.



Abu-Alkheil, Burghof, And Khan. (2012) examine the efficiency of the Islamic Bank of Britain (IBB) against conventional banks in UK, and also against Islamic banks from Muslim countries, the analysis covers the period from 2005 to 2008.

Their results based on the extensive analysis in their paper appear that the IBB is technically inefficient. It has, on average, a poor and under-performing financial performance. IBB is also inefficient in exploiting the economies of scale given its scale of operations. It appears that the IBB inefficiency is driven, to a large extent, by inappropriate management compared with small Islamic banks in Muslim-majority countries and small conventional banks from UK. In comparison with large banks, either Islamic or deposit, the IBB relative inefficiency becomes largely cause the non-optimal size.

IBB, however, exhibits, in comparison to other Islamic banks, an growing trend in efficiency performance over sample years due to small size and recency. IBB, as well as all small Islamic banks, resort also to have better financial performance than large Islamic banks mainly due to credit risk monitoring arrangements. Large conventional banks, on average, have an upward trend of estimated efficiency, generally with declining increments. Despite the prevailing market conditions being adverse, small Islamic banks (including IBB) and small conventional banks exhibit initially, compared to the large Islamic and conventional banks, poor efficiency scores which subsequently gradually increase with the passage of time. These results show that, with a favorable environment and further resources, IBB has a substantial room for improvements to sustain its competitive edge in the banking industry by decreasing costs and increasing revenues.

However, IBB is, on average, better in utilizing its resources and controlling costs than generating optimal levels of revenues. Overall, results suggest that the optimal

size for the IBB to achieve better levels of efficiency performance is neither large nor small rather medium. The idea of medium-size banking has bloomed at the time of the current global crisis. They find further illustrate that the DEA-efficiency measures are highly correlated with ROA and ROE, and thus can be used separately or concurrently with the standard accounting measures of performance in determining the performance of Islamic banks in UK (IBB) and in Muslim majority countries. Although not widely used, DEA can be adopted along with financial ratios to make comparisons of performance more robust.

Finally, overall results suggest that the banks with higher efficiency levels, are larger in total assets (size), tend to exhibit higher profitability and loans intensity, on average acquire less levels of debt and have a smaller market share. IBB, however, is relatively superior in terms of lending intensity and capital adequacy.

Shahid, Ur Rehman, Khan Niazi, and Raof (2010) investigates the comparison between the efficiency of Conventional and Islamic Banks of Pakistan. Financial Sector in Pakistan has gone through a number of changes during last two decades.

These include:

- 1) liberalization of bank opening policy which resulted with the reemergence of private banking sector in the economy.
- 2) strengthening the role of controlling authorities such as State bank of Pakistan and the Security Exchange Commission of Pakistan.

Financial sector reforms have also changed the ownership structure of banking sector of Pakistan. In year wise comparison of efficiencies values for Conventional and Islamic banks except TE, Islamic banks show a healthy competition with Conventional banks for CE and AE values. This is one of the signs for economy that Islamic banks are on the horizon of improving trends every year. However, one of

the limitations of Islamic banks is short market operations and lack of awareness in general public. In spite of the fact that Islamic Banking is still in its early ages of operations in Pakistan, its premium bank Meezan performed at par of Conventional banks in term of efficiencies. Pakistan is also concentrate on improvements in Islamic Banking sector and State Bank already implemented Islamic Window Operations within existing Conventional based banking.

Overall outcome of this study is the efficiencies level of conventional and Islamic banks are improved over the period of time.

The deposit banks execute better than the Islamic banks in terms of technical efficiency but in terms of cost and allocative efficiencies Islamic banks give tough time to conventional banks. The t-statistics results show there is no significant difference in the mean efficiency scores of Islamic and deposit banks over the sample period except in 2008.

San et al (2011) study utilizes non parametric Data Envelopment Analysis (DEA) to analyze and compare the efficiency of foreign and domestic banks in Malaysia. The analysis is based on a panel data set of 9 domestic banks and 12 foreign banks in Malaysia over the period of 2002-2009.

They found out that the average pure technical efficiency (PTE) of domestic banks (0.9781 or 97.81%) is higher than the average pure technical efficiency (PTE) of foreign banks (0.9492 or 94.92%).

Moreover, if compared the year to year, researcher found that the domestic banks exhibited higher level of efficiency than foreign banks. This reflected that domestic banks are relatively more managerially efficient in controlling their costs as home field advantage hypothesis can disadvantage to foreign banks in terms of higher costs.

Their finding seem to imply that the pure technical efficiency (PTE) of banks in Malaysia was not affected by the Global Crisis 2008 as Malaysian banking system has healthy volume of international reserves, strong capitalization and ample liquidity.

The finding of this study also show that the pure technical efficiency (PTE) is positively got together with liquidity and profitability. This study also show that the pure technical efficiency (PTE) is positively correlated with liquidity and profitability.

Tahir and Haron (2010) examine the cost and profit efficiency of Islamic banks in four regions of the world: Africa, the Far East and Central Asia, Europe and the Middle East during the period of 2003-2008.

They find that the average cost and profit efficiency of the Islamic banks increased during the survey period. This suggests that banks were relatively better in controlling cost than generating profits.

Hence, this result supports the findings by Hassan and Hussein's (2003) and Kamaruddin et al. (2008) that Islamic banks are relatively better in controlling cost than generating profits.

This finding, contra-dicts to the study found by Mohamad et al. (2008), who reported that Islamic banks are better in generating profits than utilising its resources. The intertemporal comparison of the efficiency scores suggest that the trend for both the cost and profit efficiency of Islamic banking is upward, suggesting that the sample of Islamic banks has improved their efficiencies over the study period. They find also that Islamic banks in Europe are more cost and profit efficient than the other groups of Islamic banks.

Overall, banks in the Far East and Central Asia scored the lowest cost efficiency, while African Islamic banks scored the lowest profit efficiency.

Muhamad Abduh, Hasan and Pananjung (2013) investigate the efficiency and performance of five Islamic banks in Bangladesh namely, Islami Bank Bangladesh Limited, Al- Arafah Islami Bank Limited, Social Islami Bank Limited, Shahjalal Islami Bank Limited and First Security Islami Bank Limited. Data are collected through their published annual reports from the year of 2006 to 2010.

Moreover, the result of DEA reveals that the trend of all Islamic banks was on the rising stage during the study's years, suggesting that the Islamic banks have developed their efficiency over the study period. In every aspect, Islami Bank Bangladesh Limited, Al- Arafah Islami Bank Limited, Social Islami Bank Limited, Shahjalal Islami Bank Limited and First Security Islami Bank Limited seem competent in terms of efficiency.

#### **2.4.2. Profitability in Islamic Banks :**

Idris, Asari, Taufik, Salim, Mustaffa and Jusoff (2011) examine the determinants of profitability for Islamic Banking Institutions in Malaysia for the period 2007-2009.

They find that the Bank Size is the most important factor in explaining the variation of profitability for Islamic banking institutions in Malaysia as larger bank size will fundamentally have better access to capital markets, lower cost of borrowing and be able to generate higher income. The time series factors are also found to be statistically significant in influencing the level of profit individually and are stable over time.

Hassan and Bashir (2003) examine the performance indicators of Islamic banks' worldwide during 1994-2001. First, the Islamic banks' profitability measures

respond positively to the increases in capital and negatively to loan ratios. The results revealed that larger equity to total asset ratio leads to more profit margins. They find that intuitive and consistent with previous studies. It indicates that adequate capital ratios play a weak empirical role in explaining the performance of Islamic banks. Islamic Banks' loan portfolio is heavily biased towards short-term trade financing. As such, their loans are low risk and only contribute modestly to the bank profits. Bank regulators may use this as an evidence for prompt supervisory action.

Second, the results also indicate the importance of consumer and short-term funding, non-interest earning assets, and overhead in promoting banks' profits. A high CSTF to total asset ratio is shown to lead to low non interest margins. The counter intuitive finding about the association between NNIM (net non interest margin) and overhead suggests that high profits earned by banks may be appropriated in terms of higher wages and salaries. It appears that the expense preference behavior appears to be holding in the Islamic banking market.

Third, the results suggest that the regulatory tax factors are important in the determination of bank performance. However, their findings seem to suggest that reserve requirement does not have a strong impact on the profitability measures.

Fourth, favorable macroeconomic environment seems to stimulate higher profits. Higher growth rate of GDP seem to have a strong positive impact on the performance measures. However, per capita GDP seem to have limited effect on performance. Inflation rate and its interaction term with GDP do not seem to have a significant impact on performance. Finally, the size of the banking system has negative impact on the profitability except net non interest margin.

Karim, Sami and Hichem (2010) study the effect of factors that contribute to the profitability of Islamic banks in Africa over the period 1999-2009. Using panel data techniques.

The findings of this study suggest that bank profitability is affected by both internal characteristics and external factors. They find that capital is important in explaining bank profitability. Also, size positively affects bank profitability, providing evidence of economies of scale. Moreover, net loans to total assets and cost income ratio exhibit negative and significant impact on bank profitability.

As regards macroeconomic indicators, they find that higher economic growth and inflation have a positive and great effect on the profitability of Islamic banks in Africa.

Regarding industry-specific variables, they find a positive and significant relation between bank concentration and bank profitability, providing evidence of the SCP hypothesis.

On the contrary, the size of banking sector, as measured by the total assets of Central Bank to GDP and the total assets of deposit money of the bank to GDP, has a negative effect on profitability of Islamic bank in Africa. Islamic banks in Africa are ought to reinforce their equity in order to reduce the likelihood of bankruptcy and increase their size to benefit from the economies of scale.

Moreover, banks should develop the management of their loans with respect to total assets via better screening and monitoring of credits. Islamic banks should manage their costs efficiently with respect to income to get the best return on assets. As the financial system stability is one of the main preoccupations of countries, the authorities should foster economic growth and set up the appropriate macroeconomic

policies which motivate competition within the financial sector and fast adjustment of anticipated inflation.

Hassoune (2002) finds that, Islamic banks' profitability seem less volatile than that of conventional peers, but it is also higher on average, at least in the GCC region. These two elements are essential for assessing the soundness of Islamic banks' financial profile and creditworthiness. Islamic banks thus seem less vulnerable to the cyclical nature of returns on assets and costs of liabilities. Does it mean that Islamic financial principles are the panacea for all bankers in the Islamic world? Of course not, for mainly two reasons. On one hand, not all bank clients are necessarily willing to earn no return on their deposits. Making Islamic banks a general model for an entire banking industry in a given country would certainly lead the vast majority of depositors to ask for investment deposits with returns close to those prevailing in non-Islamic markets, and the comparative advantage of Islamic banks (i.e. cost of funds) would consequently vanish. Islamic banking could not easily be generalized to a whole banking sector, even in a country like Saudi Arabia. Islamic banks can benefit from the funding "subsidy" as long as they operate a niche strategy, capturing a certain category of clients and depositors, who are prepared to accept only moral benefits, not economic tangible returns considered as "riba". On the other hand, Islamic banks lose on the grounds of liquidity, assets and liabilities concentrations and operational efficiency what they tend to win in the field of profitability. Nevertheless, Islamic banks' ability to smooth their return on assets by absorbing shocks remains a positive element, particularly in a banking sector that is characterized by its systemic nature, where the collapse of one entity could spur contagion to the whole industry. Islamic banking could be a further guarantee, however still marginal, against systemic risks in certain emerging financial markets.



Hameed and Bashir (2003) examine the performance indicators of Islamic banks across eight Middle Eastern countries between 1993 and 1998. They use cross-country panel data, that the Islamic banks' profitability measures respond positively to the increases in capital and loan ratios. The results revealed that larger equity to total asset ratio and larger loan to asset ratio interacted with GDP lead to higher profit margins. They find that intuitive and consistent with previous studies. They indicate that adequate capital ratios and loan portfolios play an empirical role in explaining the performance of Islamic banks.

Bank regulators may use this as an evidence for prompt supervisory action. The results also indicate the importance of consumer and short-term funding, non-interest earning assets, and overheads in promoting banks' profits. A high CSTF to total asset ratio is shown to lead to high non-interest margins.

The counter intuitive finding about the association between performance and overheads suggests that high profits earned by banks may be allocated in terms of higher wages and salaries or investment in costly technology used by these banks. Maybe, the expense preference behavior appears to be holding in the Islamic banking market. Foreign ownership seems to have participated greatly to Islamic banks' profitability. Especially, foreign capital had motivated the operation of Islamic banks in many low-income countries. The positive engagement between the ownership dummy and the performance measures indicates that foreign-owned banks may have technological advantages.

Moreover, foreign banks are increasingly looked upon to provide the capital, technology, and know-how needed in banking. The results suggest that the tax factors are much more important in the locating of bank performance. The inverse

and statistically great effects of taxes indicate that financial repression is distorting the performance of Islamic banks.

The negative effect of the reserve ratio, for example, reveals the opportunity cost of holding reserves. In fact, since deposits in Islamic banks are treated as shares, and accordingly their nominal values are not guaranteed, holding reserves wound Islamic banks and their depositors in two ways. First, holding reserve requirement decreases the amount of funds available for investment and, hence, the expected returns. Second, reserves do not yield any return to the banks and, therefore, depositors are uncompensated for that part of their deposits. Higher GDP per capita and higher inflation rates sound to have a strong positive effect on the performance measures. Their results also imply that, stock markets and banks play different yet complementary roles.

Rahman, Ali jan, Iqbal and Ali (2012) evaluate the effect of banks parameters and microeconomic meter on the conventional and Islamic banks profitability in the Pakistan for the period of 2006-2010. As the asset of the bank and network increase there may be the inefficiency in the management. In this study they concluded that major internal factor i.e. Assets, Capital, Lone and Deposits provide shield of safety and maximally contribute in the bank profitability in the Pakistan.

Farooq and Khan (2012) find out the factors influencing the profitability of Meezan bank related to the balance sheet and operational factors for the period 2002 to 2011.

Meezan bank is one of the largest Islamic commercial banks of the Islamic banking industry in Pakistan. It has achieved a remarkable success in a brief period of time.

The regression results based on the balance sheet factors of the bank reveal that except two variables namely operating fixed assets (OFA) and capital work-in-

progress (CWP), the other variables have great positive relationship with the profitability of Meezan bank.

They find that the operational factors affecting the profitability of the bank reveal that the variables administrative and operating expenses (AOE) and number of staff (NS) have positive relationship with the profitability, while tax charges (TC), provision for diminution, in investments and impairment (PDII) and fee, commission, forex and other income (FCFOI) have inverse relationship with the profitability of Meezan bank. Moreover, gross banking income (GBI) has also nothing to do with the profitability of Meezan bank which seems very interesting.

In this regard the regression results can be safely inferred that the bank can increase its profitability further by increasing the volume of INV, EQT, FIN and AOE and by expanding the banking net work to other suitable parts of Pakistan.

Farooq (2013) in his study ‘Forecasts of Future Profitability based on Disaggregated Earnings: A Comparative Analysis of Islamic and Conventional Banks’ confirms that disaggregated earnings is more informative for Islamic banks and less informative for conventional banks during the period from 2007 to 2012 in Pakistan. Earning is in general disaggregated on the basis of markup income and non-markup income. Islamic banks performed better than deposit banks on the basis of aggregated earnings model, non-markup earnings model and collective earnings model. Almost of the operations and activities of the deposit banks are based on interest (riba/sood), therefore, they carried out well than Islamic banks on the basis of markup earnings model. Inclusive, the disaggregated earnings components of Islamic banks are more informative than deposit banks to forecast future earnings.

### **2.4.3. Stability of the Islamic Banks :**

Hussein (2010) examine the behaviour of key bank-level stability factors of liquidity, capital, risk-taking and consumer confidence in Islamic and conventional banks that operate in the same market. Using fixed effect for a sample of 194 banks of Gulf Cooperation Countries between 2000 and 2007, he found that liquidity is not determined by the bank's product mix but rather attributed to systematic factors.

Though, nonperforming assets (representing loans to sub-prime borrowers) have a positive and great relationship with liquidity, implying that during the crisis Islamic banks tend to take stringent risk strategies compared to conventional banks.

Moreover, Islamic banks generally tend to provide higher consumer confidence levels as they were more capitalized than deposit banks, although conventional banks had carried higher averages of liquidity compared to Islamic banks. Consumer dependability levels or depositors' discipline as proxied by deposits and customer funding over liabilities generally appear to be higher in Islamic banks than deposit banks.

Beck, Demirgüç-Kunt and Merrouche (2010) discussed about Islamic vs. Conventional Banking Business Model, Efficiency and Stability, the implications of Sharia-compliant products of Islamic banking for agency problems using traditional theory of financial intermediation.

While theory suggests great repercussions of the equity-like nature of Islamic banking for business orientation, efficiency, risk-taking and stability, anecdotal evidence suggests that Islamic banks' business model might be not too different from conventional banks' business model. Their empirical estimations show little significant differences between Islamic and deposit banks.

The tentative conclusion of the cross-country, cross-bank comparison of deposit and Islamic banks is therefore that either objecting effects of Sharia-compliant banking cancel each other out or that the differences between these two models are smaller than often assumed. Though, there are certainly regulatory and supervisory challenges for countries that see an increasing entry of Islamic banks, and our preliminary results suggest that conventional banks that operate in countries with a larger share of Islamic banks are more cost effective but less stable.

Youse et al (1997) used a testing methodology proposed in Darrat (1988) and claimed that the evidence does not support interest-free banking in the case of Iran. The empirical results they reported for Iran indeed corroborate the superiority of interest-free banking system according to the majority of the criteria used.

Only over one criterion ; viz, the monetary aggregate/price link, the results appear at variance with the superiority of the interest-free banking system. In particular, it is shown that, the results suffer from simultaneity bias and also from specialization errors due to the neglect of significant cointegration between the interest free monetary aggregates and prices.

Correcting for both problems, the results gained for Iran using similar data and model structure suggest that only the interest-free banking system provides a reliable link between money growth and inflation both in the short- and in the long-run.

Clearly, these empirical results for Iran, a country with a relatively extensive experience with interest-free banks, are quite consistent with those found earlier for Tunisia that lacks a similar experience Darrat (1988). It shows, that the empirical evidence in support of the efficiency of interest-free banking system may not be

country-specific and perhaps stronger and more robust than what was earlier believed.

Okumus and Artar (2012) analyse the financial strength of Islamic banks based on the data covering individual Islamic and commercial banks in the GCC, including Turkey. They find that the financial stability of the large Commercial banks is more stable than the financial stability of the large Islamic banks.

On the other hand, the financial stability of the small islamic banks is more stable than the deposit stability of the small commercial banks. Pooled panel regression results show that the effects of the macroeconomic variables and financial ratios on the z-score vary across banking groups. One of the important reasons of this case is the management skills differences across the banking systems in the face of the risks from the changes in the macroeconomic variables and financial ratios.

As a result, as growing the management skills of any banking systems, the negative effects of the changes of the macroeconomic variables and financial ratios decreases or vice versa.

Čihák and Hesse (2010) examine the relative financial strength of Islamic banks is assessed empirically based on evidence covering individual Islamic and commercial banks in 19 banking systems with a substantial presence of Islamic banking. The contrast between the high stability in small Islamic banks and the relatively low stability in large Islamic banks is specially interesting. They suggest that Islamic banks are relatively more stable when operating on a small scale while less stable when operating on a large level.

Their findings suggest that to reap these efficiency benefits, appropriate attention needs to be paid also to prudential risks, which—other things being equal—tend to

be greater for larger Islamic banks. They also examine the impact of a bigger presence of Islamic banks on the soundness of other banks in a country's financial system. They find that the impact is not so big.

Hamieed, Al-ali and Yousfi (2012) examine and comparing the financial stability of a sample of Jordanian Islamic and conventional banks listed in Amman Stock Exchange pre and post the financial crisis, using the daily returns for the period (02/01/2005 to 26/01/2010).

Islamic banks are more stable than conventional banks pre and post the recent financial crisis, and their stability appeared to be less affected by bad news. They find, that conventional banks' stability is affected by the damaging effects of the recent financial crisis, they also find that the investors' confidence is diminished after the crisis.

The Islamic banks stability may due to the nature of Islamic banking that works on the basis of risk sharing. The customer and the bank share the risk of any investment on agreed terms, which growing the confidence of investors in these banks. In particular that it does not deal in debt trading or rely on bonds or stocks and distances itself from market speculation. These are barred under Islamic Sharia law, unlike most conventional banks. These lineaments make Islamic banks' activities more closely related to the real economy and tend to reduce their contribution to excesses and bubbles.

Eventually, Islamic banks have several alternatives [to conventional banking products] such as Ijara, Murabaha, Musharaka, Mudaraba, Sukuk, Amana etc. which demonstrate that Islamic banking is a sound and systematic alternative banking system that others should take as an example. Islamic finance is expected to growing

on the international level and its number of customers is also expected to rise as they search for an alternative banking system.

Rahim and Zakaria (2013) examine stability between Islamic and conventional banks from banks specific and macroeconomics perspectives by focusing on Malaysia scenario. They find that variables that have been specified as the significant factors towards risk (probability to defaults) for Islamic banks were cost income ratio, total assets, Herfindahl Index, market share, inflation and real GDP while conventional bank stability were effect by loan asset ratio, cost income ratio, total assets, income diversity, Herfindahl Index, market share and real GDP.

Computation of Z-score and NPL suggest that on average Islamic banks are relatively more stable than their conventional counterparts. Their analysis suggests that factors affecting both Islamic and deposit banks stability are close, except for the degree of diversification in income. They also find that stability is not a function of income diversification for Islamic banks but it is in the situation of deposit banks.



## CHAPTER 3

### **The performance comparison of islamic and deposit banks in Turkey:**

#### **3.1 Islamic Banks in Turkey**

Islamic banking in Turkey dates back to 1985, when the government, led by the late Turgut Özal, passed legislation for interest-free banking. In this regards, the goals of introducing Islamic banks were three folds. First, it was to bring into the economy all funds that were being kept out of the conventional banking system, including foreign exchange kept under pillows and jewelries of families oppose to interest. Second, it was to develop economic linkages to the oil-producing Arab states and to attract a fair amount of the Gulf capital which also avoids interest-paying financial institutions. In secular but cash-strapped Turkey, Islamic banks mostly from oil-rich Gulf states were welcomed, but were not allowed to use the word Islam in their name, nor explicitly refer to their Islamic character. In those years, Turkey also obtained substantial aid from other Arab and Islamic sources, particularly the Islamic Development Bank (Warde 2000: 24, 79). Third, by encouraging the Islamic banks, Ozal cemented his ruling coalition of the center-right by developing domestic political counterbalance to the secular left, which he was seeking to destroy to help pave the way for structural adjustment (Henry 1996: 130-132).

The first Islamic bank was the Al Baraka Katılım Bankası A.Ş. established in February 1985 followed by the Faisal Finance House two months later, , Both were partly owned by Arab capital. The Turkish private investors established three banks: Anadolu Finance House in 1991, Ihlas Finance House in 1995, and Asya Finance House in 1996.

Wouters (2008) concluded that the Turkish participation banks (before called Special Finance Houses) were poised to aim at the Turkish market as a whole. Therefore they did not really target the small niche of the “convinced” Muslim population in particular.

This of course influenced marketing and product development. Part as a consequence of this strategy (and compared to Indonesia), the Turkish participation banks could have a faster growth and now cover roughly 3.5 % assets of the total Turkish banking industry. One may also note the strong growth of the sector that outperforms the conventional counterpart now for 8 consecutive years.

### **3.2. Data and Methodology:**

The study is aimed at comparing financial performance of islamic banking vis-à-vis conventional banking in Turkey. Specifically, study makes comparison of AlbarakaTurk, BankAsya, KuveytTurk and Türkiye Finans (TFKB) (Islamic bank) and a group of 28 conventional banks performances each year in 2010-2012. The data for this study is collected from the web page of Turkish Banking Association for the conventional banks and from the web page of Participation Banks Association of Turkey.

Data for each year have been compiled from the income statements and balance sheets of these two sets of banks. The data for the Islamic banks is available since 2010, so the analysis are limited based on the availability of the data.

### **3.2.1. The Variables Used in The Analysis**

The study analyze and compare some of the ratios that are considered as important for the performance of a bank. These ratios consider the capital adequacy, profitability, liquidity and loan portfolio of the banks.

#### *3.2.1.1. Capital Adequacy:*

The Reserve Bank. (2007) conclude that Capital adequacy ratios are a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. Capital Adequacy calculated as following:

$$\text{Capital Adequacy} = \frac{\text{Total Equity}}{\text{Total Assets}} \quad (1)$$

#### *3.2.1.2. Profitability ratios:*

Pamela peterson Drake (2007) conclude that Profitability ratios compare components of income with sales. they give us an idea of what makes up the company's income and what are usually expressed as a portion of each dollar of sales.

Elio D'Amato (2010) noted that Profitability ratios measure a company's performance and provide an indication of its ability to generate profits. As profits are used to fund business development and pay dividends to shareholders, a company's profitability and how efficient it is at generating profits is an important consideration for shareholders.

Van Horne (2005) noted that these ratios indicate firm's profitability after taking account of all expenses and income taxes, the efficiency of operations, firm pricing policies, profitability on assets and to shareholders of the firm.

- **Return on assets (ROA)**

Return on Assets: The ratio of net income to total assets measures the return on total assets (ROA) after interest and taxes. The ratio indicates the efficiency with which management has used its resources to obtain income, (Lesáková 2007)

D'Amato (2010) conclude that Return on assets, commonly referred to as ROA, is a measurement of management performance. ROA tells the investor how well a company uses its assets to generate income. A higher ROA denotes a higher level of management performance. (ROA) : calculated as following:

$$\text{Return on assets (ROA)} = \frac{\text{Net Profit (Loss)}}{\text{Total Assets}} \quad (2)$$

- **Return on Equity (ROE) :**

Return on equity is the bottom line measure for the shareholders, measuring the profits earned for each dollar invested in the firm's stock, Van Horne (2005). Return on equity indicates the profitability to shareholders of the firm after all expenses and taxes.

Samad & Hassan (2000) conclude that It measures how much the firm is earning after tax for each dollar invested in the firm. In other words, ROE is net earnings per dollar equity capital.

ROE calculated as following

$$\text{Return on Equity (ROE)} = \frac{\text{Net Profit (Loss)}}{\text{Shareholders' Equity}} \quad (3)$$

### *3.2.1.3. Liquidity Ratios:*

Arab British Academy for Higher Education noted that Liquidity ratios provide information about a firm's ability to meet its short term financial obligations. They are of particular interest to those extending short term credit to the firm. Two

frequently-used liquidity ratios are the current ratio (or working capital ratio) and the quick ratio.

Khan and Jain (2008) find that Liquidity ratio is measuring the ability of a firm to meet its short-term obligations and reflects the short-term financial strengths/solvency of a firm.

Drake (2007) conclude that provides information on a company's ability to meet its short-term, immediate obligations.

D'Amato (2010) find that liquidity ratios indicate whether a company has the ability to pay off short-term debt obligations (debts due to be paid within one year) as they fall due. Generally, a higher value is desired as this indicates greater capacity to meet debt obligations. Liquidity Ratios calculated as following:

$$\text{liquidity indicator} = \frac{\text{Liquid Assets}}{\text{Total Assets}} \quad (4)$$

#### *3.2.1.4. Loan Portfolio Ratios*

##### **Loan to Asset Ratio (LAR) :**

LAR measures liquidity of the bank in terms of its total assets. The loans to assets ratio measures the total loans outstanding as a percentage of total assets. The higher this ratio indicates a bank is loaned up and its liquidity is low. The higher the ratio, the more risky a bank may be to higher defaults. Loan to Asset Ratio (LAR): calculated as following:

$$\text{Loan to Asset Ratio (LAR)} = \frac{\text{Total Loans and Receivables}}{\text{Total Assets}} \quad (5)$$

##### **Non-Performing Loan Ratio**

Banks often report their ratio of nonperforming loans to total loans as a measure of the quality of their outstanding loans. A smaller NPL ratio indicates smaller losses

for the bank, while a larger (or increasing) NPL ratio can mean larger losses for the bank as it writes off bad loans. Non-Performing Loan Ratio calculated as following:

$$\text{Non-Performing Loan Ratio} = \frac{\text{Non-Performing Loans}}{\text{Total Loans}} \quad (6)$$

### 3.2.2. Tests of Equality:

This test is single-factor, between-subject, analysis of variance (ANOVA). The basic idea is that if the subgroups have the same mean, then the variability between the sample means (the group) should be the the same as the variability within any subgroup (within group).

Denote the  $i$ -th observation in subgroup  $g$  as  $x_{ig}$  where  $i = 1, \dots, n_g$  for group  $g = 1, 2, \dots, G$ . The between and within sums of squares are defined as:

$$SS_B = \sum_{g=1}^G n_g (\bar{x}_g - \bar{x})^2 \quad (1)$$

$$SS_W = \sum_{g=1}^G \sum_{i=1}^{n_g} (x_{ig} - \bar{x}_g)^2 \quad (2)$$

Where  $\bar{x}_g$  is the sample mean within group  $g$  and  $\bar{x}$  is the overall sample mean. The F-statistic for the equality of groups means is computed as:

$$F = \frac{SS_B/(G-1)}{SS_W/(N-G)} \quad (3)$$

Where  $N$  is the total number of observations. The F-statistic has an F- distribution with  $G-1$  number degree of freedom and  $N-G$  denominator degree of freedom under the null hypothesis of independent and identical normal distributed data, with equal means and variances in each subgroup.

When the subgroup variances are heterogeneous can may use the Welch (1951) version of the test statistic. The basic idea is to form a modified F-statistic that accounts for the unequal variances. Using the Cochran (1939) weight function,

$$W_g = n_g/s_g^2 \quad (4)$$

Where  $s_g^2$  is the sample variance in subgroup g, we form the modified F-statistic

$$F^* = \frac{\sum_{g=1}^G W_g (\bar{x}_g - \bar{x}^*)^2 / (G-1)}{1 + \frac{2(G-2)}{G^2-1} \sum_{g=1}^G \frac{(1-h_g)^2}{n_{g-1}}} \quad (5)$$

Where  $h_g$  is a normalized weight and  $\bar{x}^*$  is the weighted grand mean,

$$h_g = w_g / \{ \sum_{k=1}^G w_k \} \quad (6)$$

$$\bar{x}^* = \sum_{g=1}^G h_g \bar{x}_g \quad (7)$$

The numerator of the adjusted statistic is the weighted between-group squares and the denominator is the weighted within-group mean squares. Under the null hypothesis of equal means but possibly unequal variances,  $F^*$  has an approximate F distribution with  $(G-1, DF^*)$  degrees-of-freedom, where:

$$DF^* = \frac{(G^2-1)}{3 \sum_{g=1}^G \frac{(1-h_g)^2}{n_{g-1}}} \quad (8)$$

For tests with only two subgroups ( $G=2$ ), EViews also reports the t-statistic, which is simply the square root of the F-statistic with one numerator degree of freedom.

Note that for two groups, the Welch test reduces to the Satterthwaite (1946) test.

### 3.3. Empirical results

The selected ratios of the two types of banks are compared by using t-tests. The results of the analysis is reported in Table 1.

Table 1 shows means and standard deviations of various performance measures of islamic banks and conventional banks and their mean differences for the period between 2010 and 2012.

**Table 1. The Results of the Tests of Equality**

	Islamic Banks		Deposit Banks		Difference	
	Mean	Std. Dev.	Mean	Std. Dev.	Mean	t-Stat
<b>Capital Adequacy: Total Equity/ Total Assets</b>						
2010	0.124	0.015	0.154	0.092	-0,03	-0.655
2011	0.109	0.014	0.144	0.097	-0,035	- 0.725
2012	0.077	0.053	0.184	0.132	-0,107	1.570
<b>Total Loans and Receivables / Total Assets</b>						
2010	1.357	0.033	0.512	0.190	0,845****	8.716
2011	1.387	0.077	0.511	0.194	0,876****	8.804
2012	1.105	0.734	0.554	0.182	0,551**	-3.465
<b>Non-Performing Loans / Total Loans</b>						
2010	0.024	0.023	0.011	0.009	0,013**	2.052
2011	0.021	0.025	0.010	0.009	0,011*	1.803
2012	0.009	0.016	0.016	0.036	-0,007*	-0.347
<b>Liquid Assets / Total Assets</b>						
2010	0.203	0.026	0.387	0.216	-0,184*	-1.676
2011	0.215	0.038	0.412	0.217	-0,197*	-1.789



2012	0.189	0.136	0.376	0.192	-0,187*	1.865
<b>Net Profit (Loss) / Total Assets</b>						
2010	0.017	0.001	0.014	0.010	0,003	0.598
2011	0.014	0.001	0.012	0.009	0,002	0.443
2012	0.011	0.007	0.020	0.017	-0,009	-0.989
<b>Net Profit (Loss) / Shareholders' Equity</b>						
2010	0.141	0.013	0.107	0.093	0,034	0.703
2011	0.135	0.024	0.103	0.084	0,032	-0.738
2012	0.109	0.073	0.112	0.049	-0,003	0.100

\*, \*\* and \*\*\* represent statistical significance at 10%, 5% and 1% respectively.

According to the results it is seen that the capital adequacy of the deposit banks are much higher than the islamic banks but this difference is not found as statistically significant. But still it is striking that capital adequacy ratios of islamic banks are falling down.

The results also show that the Loan to Asset Ratio of the islamic banks are much higher than the deposit banks and this difference is found as statistically significant at 1% in 2010 and 2011, and at 5% in 2012. The loan generation of islamic banks is comparatively high and this increasing trend in 2010 and 2011 of Islamic bank Loan to Asset Ratio (LAR) is clear evidence of more financial stress which Islamic bank is taking by making excessive loans and holding less liquid assets. However, this is an indication of potential for increases in profitability.

In terms of non-performing loan ratio, the study finds that conventional banks' performance is inferior in 2010 and 2011 to that of Islamic banks, and in 2012 the

opposite. Significant differences for the non-performing loan ratio between Islamic banks and conventional commercial banks at 5% in 2010 and at 10% in 2011 and 2012. The conventional banks' higher non-performing loan ratio can be explained with the write-offs that are due to the global crisis. The higher non-performing loan ratio of Islamic banks indicates that Islamic banks are not cautious about its credit advancement. The Islamic banks' management should be more aware that they cannot afford a bank failure due to bad credit.

For profitability, it can be seen that the profitability position of Islamic Banks has not changed over three years. Both of mean difference of two measures of profitability, i.e. return on asset (ROA), return on equity (ROE) , are not statistically significant. In other words, the means between the two periods are not statistically different, thus indicating that the two groups' profitability is not significantly different between 2010 and 2012. But still in 2010 and 2011 Islamic Banks have higher profitability ratios.

In terms of liquidity, comparison in Table 1 showed that liquidity measure is statistically significant at 10%. Unlike conventional banks, the scope of Islamic Banks investment is limited by the Shari'ah, i.e. the Islamic Law. The higher liquidity ratio of conventional banks compared to that of Islamic Banks stems from this reason. Islamic banks are not permitted to invest in un-Islamic investment opportunities such as speculation, alcohol and related projects, even though these investments may be highly profitable.

## CONCLUSION

Since the banks appeared in the Muslim world which is becoming increasingly important day after another, and because the banks today is considered as the balance of economic advancement of the countries, the increased of possibilities and its financial activities reflected on the overall the economy of the country, therefore all nations of the world seeking and struggling to control the financial institutions and banks affiliate status systems and policies to ensure their protection until the banking system is not affected by the banking system of the State.

Islamic banks seek to achieve the objectives of a humanitarian nature and social as well as achieve the goal of profitability which is necessary for the survival and growth of the bank. And these banks has taken rising dramatically around the world. According to some estimates, that the number of Islamic banks in the world by the end of 2013 to about 520 to 800 banks and banking institution by 2015, and the assets could be top \$2 trillion by the end of 2014.

I've been to clarify the nature of the work of Islamic banks and privacy, Islamic banks employ the money and invest through direct investment, Mudarabah (legitimate speculation), Murabaha, Musharakah, Ijarah, Salam, Istisna'a .. etc, the Bank offers several non- interest-based human services, social, economic ..etc.

The Muslim countries were able to create an international Islamic bank to lend the countries which need liquidity, one of the model such as International Monetary Fund (FMI), it moves from day to day and over time increase the expansion of Islamic banks and increase their numbers , and branch offices in many countries of the Muslim world or non-Muslim, despite this development, the Islamic countries should maintain this type of banks through keep pace with technology and find a

strategy, and a strong complementary to ensure a good processes work. And thus, the Muslim countries may be able to independence from western even with an idea or curriculum that represent the Islamic banks system.

The aim of this dissertation is to compare the performance of Islamic and conventional banks in Turkey for the period 2010-2012. The limitation of the period is due to limitation of the data available for the islamic banks. Turkey is important to analyze in the way that, it is one of the countries where you can analyze and compare the two groups that operate in the same environment.

The analysis applies t-tests in order to compare the financial ratios of islamic banks and conventional banks in terms of capital adequacy, liquidity, profitability, and loan positions. According to the results the islamic banks have lower capital adequacy ratios, but this difference is not statistically significant. But still, the managers of these banks should be aware of the importance of capital buffers in order to eliminate further risks in the future. In terms of loan generation islamic banks are far above their counterparts with statistical significance. Followingly their non-performing loan ratios are significantly higher in 2010 and 2011. When we compare the profitability ratios, islamic banks are much more profitable in 2010 and 2011, but the difference is not significant. Again the higher ROA and ROE of the islamic banks can be explained by the higher loans generated by the islamic banks. In terms of liquidity the conventional banks beat the islamic banks with a 10% significance.

As a general conclusion, it is possible to say that the islamic banks do not seem to fulfill their stability function in the financial system. This is clear with their lower capital adequacy ratios, liquidity ratios, and higher loan and non-performing loan ratios. Still these banks present a good investment opportunity for their owners with

higher ROA and ROE, but nevertheless they stand as riskier than conventional banks. The managers of these banks should be careful about their riskier positions in the financial markets and should seek out ways to handle these risks. Moreover, the policy makers should monitor the performance of these banks and should set some policies to decrease the risk levels of the islamic banks. Despite their different nature these banks should be kept in line with Basel standards to decrease the fragility and possibility of failure for these banks.

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