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IMPACT OF FINANCING TOWARD THE FINANCIAL PERFORMANCE: A COMPARATIVE STUDY BETWEEN ISLAMIC BANKS AND CONVENTIONAL BANKS IN GCC

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ABSTRACT

The study aimed to compare the financial performance of both banking system and to investigate the different impact of financing products (Islamic loans and conventional loans) on bank's profitability in GCC countries (Saudi Arabia, United Emirate, Bahrain, Qatar, Kuwait, and Oman) over the period between 1999 and 2014. The study used two profitability measures namely, return on average assets (ROAA) and return on average equity (ROAE). The study used unbalanced panel data set of 1228 observations with total of 45 Islamic banks and 49 conventional banks. The empirical results estimated by generalized method of moment indicated that loans of both banking system had positive and significant relationship with bank's profitability. The result also found that conventional banks performed better than its Islamic counterparts in terms of ROAA and ROAE signified by the dummy variable. Moreover, the study indicate that Islamic loans have significant different impact on ROAA comparing to conventional loans. While no significant different impact between Islamic loans and conventional loans on ROAE. Finally, Gross domestic product (GDP) has positive relationship with the profitability of Islamic and conventional banks while Inflation has negative but insignificant impact.

INTRODUCTION

Both Islamic banks and conventional banks are institutions that act as the intermediary between the borrower (fund user) and the lender (fund provider). Islamic banking includes the products that do not involves *riba* (interest) and based on Shari'ah principles [1]. Islamic banking has included a sense of

recklessness or uncertainty (*gharar*), exploitation of ignorance (*jahl*) and gambling (*maysir*) [2]. Approximately 16% of compound annual growth rate from Islamic finance industry between 2010 and 2014 [3].

The profitability is the primary goal of all business ventures and without profit, the business will not survive in long run [4]. Thus, measuring the factors that affect the profitability of the bank is very important especially with the existence of instability in the global market due to credit crunch and subsequent banking crisis.

The essential principles of Islamic finance are 'risk-sharing' and 'profit-and-loss sharing' along with the prohibition of interest, limitation of speculation and uncertainty [5]. However, there has been debate and argument in the literature regarding the practice of Islamic institutions stating that the evaluation of the performance of Islamic financing sector shows that Islamic finance has been converging towards conventional financial practices and institutions through the shari'a compliant practices.

A core argument in support of Islamic banking has been that its risk-sharing approach enhances the stability of the financial system and thus may contribute to lower vulnerability to financial crises [6]. Various studies have tried to evaluate such assertion by assessing the differences in profitability, risk profile and ease of transmission of crises between conventional and Islamic banking systems.

The suggestions of lower risk in Islamic banks, Jawadi et al. (2016) recently reported that the financial risk in Islamic banks did not differ significantly from financial risks in conventional banks. This study found a near zero mean return for conventional banks and a mean negative return for Islamic banks. Such results indicated that Islamic banks could have been engaged in more risky business compared to conventional banking, but further analysis through panel vector Autoregressive approach showed that differences in financial risk profiles between conventional and Islamic banks were not significant [7]. Siraj and Pillai (2012) reported better performance of Islamic banks in the GCC region between 2005 and 2010. The diverse results indicated the differences in methodologies used for the studies and sample selection differences [8].

The banking sector has clarified the significant differences between the performance of the conventional and Islamic banks. This significance is due to the nature of the banking framework that was related to the causes of the recent global crisis. This study aimed to investigate the difference in the impact of financing on bank's profits of Islamic banks and conventional banks. There are important questions to help in achieving the study objectives such as variation in banks' profitability due to differences in financing and external factors such as Gross domestic product (GDP) and inflation impact the profitability of these banks operating in different countries.

METHODOLOGY

The data for all banks in the sample compiled from Bank scope database and the macroeconomic variables gathered from World Bank development

indicator of the year 1999 to 2014. The collected secondary data was transformed into percentages and ratios so that comparison can be made between the different types of banks. This study utilizes unbalanced Panel data set, which includes cross-sectional units (that is banks); with unequal number of time series observation.

The sample of this study included Islamic and conventional banks operating in GCC countries such as Saudi Arabia, United Arab Emirates, Kuwait, Bahrain, Oman, and Qatar, while excluded any non-commercial banks such as insurance companies, investment companies and financial companies. Consequently, sample process included 94 banks in total, with 49 conventional banks and 45 Islamic banks covering five countries (Saudi Arabia, United Arab Emirates, Kuwait, Qatar, and Bahrain).

Descriptive Statistics included mean, standard deviation, minimum and maximum was compared and analysed the performance of Islamic and conventional banks. The dependent variables included return on assets (ROA) and return on equity (ROE) while independent variables included net loan/total asset and dummy. Meanwhile, control variables included gross domestic product (GDP) and inflation.

RESULT AND DISCUSSION

Result

In Table 1, whole sample have on average, Return on Assets (ROA) of 2.15%, ROAE of 11.46% and LTAR = 53.63% over the entire period of 1990 to 2014. In Table 2, the average ROAA of conventional banks (CBs) was 2.15%, standard deviation of 2.86 and average ROAE of 13.87% with standard deviation = 23.27. In Table 3, the average ROAA for Islamic banks (IBs) were 2.13% with standard deviation = 6.19 and average ROAE of 8.23 % with standard deviation = 17.63. The profitability measurements (ROAA and ROAE) of CBs on average were greater than of IBs. This result consistent with the findings of Momeneen et. al (2012) that asserted that CBs are more profitable than IBs [9].

Table 1. Descriptive Statistics (All Banks)

	ROA	ROE	LTAR	GDP	INF
Mean	2.122	11.465	53.640	5.367	3.361
Median	1.956	13.317	56.951	4.855	2.796
Maximum	35.102	138.500	98.917	26.170	15.204
Minimum	-49.272	-519.149	0.046	-7.076	-4.884
Std. Dev.	4.549	21.254	19.484	4.735	3.422
Skewness	-0.809	-13.376	-0.734	0.823	1.258
Kurtosis	32.839	322.715	3.488	6.263	4.830
Jarque-Bera	45692.290	5266743.856	122.410	683.523	495.324
Probability	0.000	0.000	0.000	0.000	0.000
Sum	2605.859	14079.577	65869.580	6590.527	4127.916
Sum Sq.	25385.541	554254.198	465805.263	27513.578	14367.964

Dev					
Observation	1228.000	1228.000	1228.000	1228.000	1228.000

Meanwhile, independent variable (LTAR) in Table 1 on average was 53.63%, which implied that loans make up approximately 53.63% of the bank assets, reflected the concentrations of the entire sample in lending activities. Moreover, CBs has on average LTAR= 54.67% with standard deviation= 14.95 in Table 2, whereas IBs revealed on average LTAR of 52.03% with standard deviation= 24.43 in Table 3. This result indicated that IBs have lower net loans to total assets on average than CBs and higher standard deviation by 9.48.

Table 2. Descriptive Statistics (Conventional Banks)

	ROA	ROE	LTAR	GDP	INF
Mean	2.153	13.875	54.677	5.374	3.340
Median	2.100	15.040	56.699	4.762	2.755
Maximum	22.161	58.283	88.107	26.170	15.050
Minimum	-49.272	-519.149	0.272	-7.076	-4.863
Std. Dev.	2.867	23.276	14.955	4.766	3.561
Skewness	-7.412	-17.562	-0.981	0.922	1.197
Kurtosis	155.461	393.220	4.191	6.248	4.438
Jarque-Bera	691217.514	4522013.109	155.218	411.015	229.858
Probability	0.000	0.000	0.000	0.000	0.000
Sum	1521.989	9809.801	38656.682	3799.419	2361.616
Sum Sq. Dev	5804.968	382502.789	157895.138	16035.779	8951.046
Observation	707	707	707	707	707

In regards both Islamic and conventional banks, the value of the skewness of ROAA= -0.73, ROAE = -13.38 and LTAR= -0.74 were negative which indicated that the distribution was negatively skewed. Meanwhile, GDP and inflation had a value larger than zero, which indicated that the distribution was positively skewed.

Table 3. Descriptive Statistics (Islamic Banks)

	ROA	ROE	LTAR	GDP	INF
Mean	2.074	8.170	52.177	5.336	3.388
Median	1.540	8.080	57.004	4.880	2.796
Maximum	35.102	138.500	98.917	26.170	15.204
Minimum	-27.530	-101.980	0.046	-7.076	-4.884
Std. Dev.	6.125	17.626	24.233	4.703	3.221
Skewness	0.268	-0.843	-0.471	0.684	1.368
Kurtosis	13.423	16.050	2.520	6.254	5.519
Jarque-Bera	2373.838	3773.299	24.365	271.540	301.266
Probability	0.000	0.000	0.000	0.000	0.000
Sum	1084.581	4272.698	27288.711	2790.634	1771.911
Sum Sq. Dev	19584.934	162164.799	306526.266	11543.894	5416.874

Dev					
Observation	523.000	523.000	523.000	523.000	523.000

In Table 4, the results of Islamic banks were discussed with Return on average asset (ROAA) followed by return on average equity (ROAE).

Table 4. Islamic Banks Empirical Result

Variables	ROAA	ROAE
Islamic financing	+0.044 (3.365)***	+0.142 (3.749)***
GDP	+0.441 (3.183)***	+1.654 (4.163)***
Inflation	-Insignificant	+Insignificant
Adj-R square	0.094	0.137

Significance level:

*** Significant at 1%, ** significant at 5%, * significant at 10%

The result show that the relationship between financing products provided by Islamic banks and the profitability is positive, with a coefficient of 0.044 and t-statistic of 3.365 significant at least at 1% level as shown in Table 4. This result indicated that return on average assets may increase by 4% with the increase in banking loans. Thus, the null hypothesis of no positive and significant impact of Islamic loans on ROAA is rejected.

The indicators tested were Gross domestic products as growth rate (GDP) and the inflation rate (INF) of the selected countries. The estimated coefficient of GDP= 0.441 was positive with t-statistic = 3.183 statistically significant at least at 1% level indicated that there was positive relationship between GDP and return on assets of Islamic banks.

In addition, inflation showed a negative but insignificant relationship with ROAA of Islamic banks, thus the study cannot reject the null hypothesis of no relationship between Inflation and ROAA of Islamic banks. Finally, the adjusted R-square which indicated the percentage of variance in dependent variable explained by the variance in independent variables. The result indicated only 9% of the variance in ROAA of Islamic banks is explained by the variance in Islamic financing and GDP.

In the case of return on average equity of Islamic banks, the results showed a positive significant relationship between Islamic loans and ROAE at 1% level with coefficient= 0.142 and t-statistic= 3.74. Therefore, the result indicated that the null hypothesis of no positive significant impact of Islamic financing on ROAE was rejected. This finding meant that bank's non-interest-bearing financing products have positive relationship with the profitability by 14% of the bank when measured by return on equity.

The relationship between GDP and ROAE of Islamic banks resulted with coefficient = 1.654 and t-statistic= 4.163 significant at 1% level. Hence, the study could reject the null hypothesis and there was a positive relationship between GDP and ROAE of Islamic banks. Meanwhile, inflation had insignificant relationship with ROAE of Islamic banks. Thus, the study did not reject the null hypothesis of no relationship between inflation and ROAE Islamic banks. Finally, the adjusted R-square points out to be 0.137, which indicate that 13.7% of the variation in the dependent variable (ROAE) can be explained by the variation in independent variables (Islamic financing and GDP).

In Table 5, the result of conventional banks was discussed with return on average asset (ROAA) followed by return on average equity (ROAE).

Table 5. Conventional Banks Empirical Result

Variables	ROAA	ROAE
Conventional loans	+0.034 (3.785) ***	+0.239 (3.215) ***
GDP	+0.147 (2.824) ***	+ Insignificant
Inflation	-Insignificant	-Insignificant
Adj-R square	0.056	0.046

Significance level:

*** Significant at 1%, ** significant at 5%, * significant at 10%

In Table 5, the result showed the relationship between interest bearing loans for conventional banks. This result indicated that there was a positive significant relationship at least at 1% level, with coefficient= 0.034 and t-statistic= 3.785. Hence, the study could estimate that the null hypothesis of no positive significant impact of conventional loans on ROAA was rejected. This result meant there was an increase in loans of conventional banks, profit was increased by 3.4% as measured by return on average assets.

The result showed a positive significant at least at 1% level relationship between conventional loans and return on average equity of conventional banks with coefficient = 0.239 and t-statistic= 3.215. This result indicated that the null hypothesis of no relationship between ROAE and loans of conventional banks in GCC was rejected. Hence, this finding stated that conventional banks could increase their return on average equity by 23% when providing loans.

The macroeconomic variables (GDP and inflation) showed insignificant relationship with conventional banks' return on average equity as the p-values were greater than the significant levels. This finding indicated that economic conditions do not affect conventional banks profitability in terms of return on equity.

In Table 6, the all-banks results were discussed with ROAA followed by ROAE.

Table 5. Conventional Banks Empirical Result

Variables	ROAA	ROAE
Loans	+ Insignificant	+3.125 (2.472) **
Loans*dummy	+0.033 (2.780) ***	+ Insignificant
Dummy	-1.844 (-2.522) **	-6.416 (-1.842) **
GDP	+0.188 (2.955) ***	+0.596 (1.962) **
Inflation	- Insignificant	- Insignificant
Adj-R square	0.120	0.103

Significance level:

*** Significant at 1%, ** significant at 5%, * significant at 10%

In Table 6, the loans provided by Islamic and conventional banks turned to be insignificant in relationship to return on average assets. Thus, the null hypothesis of no relationship between loans of the combined sample and ROAA cannot be rejected. This result can be explained by the role of the moderating effect of the bank type when added in the equation. However, the financing products of Islamic banks had a greater impact on ROAA of Islamic banks as indicated by the coefficient of the moderating effect (LTAR*Dis). Furthermore, the results for GDP and inflation remain consistent and did not change in significant with ROAA by the moderating effect.

The study is willing to see if there is difference in the effect of financing products and the profitability with respect to bank type whether it is an Islamic bank or a conventional bank. From the result above the different effect of financing on ROAA from (LTAR*Dis) showed a positive coefficient = 0.033 with t-statistic= 2.78 at 1% significant level. Thus, the null hypothesis of no difference in the effect of loans on ROAA with respect to bank type –whether it is an Islamic bank or a conventional bank is rejected. This finding indicated that there was a positive significant different effect of non-interest financing products on return on assets by 3% compared to interest bearing financing products at 1% level. Moreover, the dummy indicated if there was difference in the performance of ROAA between Islamic banks and conventional banks, the result shows a negative coefficient = - 1.844 with t-statistic = -2.522 at 1% level. Thus, the Islamic banks generated lower return on assets than conventional banks.

In regards ROAE, the result showed a positive significant relationship between loans of both banking system and ROAE with coefficient = 3.12 and t-statistic= 2.47 significant at 5%. This proves that, loans provided by banks in GCC over the period of the study have positive impact on ROAE. Moreover,

GDP showed a positive relationship by 0.596 with ROAE at 5% level while inflation showed insignificant relationship with ROAE of the combined sample.

The (Loans*Dis) showed a positive insignificant t-statistic as the p-value is greater than 0.10. Thus, the null hypothesis of no difference in the effect of financing products on ROAE with respect to bank type whether an Islamic bank or a conventional bank cannot be rejected. Indicating that both financing products (Islamic loans and conventional loans) may have same impact on the returns from shareholders equity. Meaning that both sources of loans (from Islamic banks and conventional banks) can be a good source to increase banks profitability measured by ROAE. Meanwhile, from the bank type dummy (Dis) the result showed a negative coefficient of 6.416 with t-statistic = -1.842 significant at 5%. This result indicated that Islamic banks have LOWER return on average equity than the conventional banks.

DISCUSSION

The focus of this study was to investigate the relationship between loans provided by Islamic and conventional banks operating in GCC and profitability. In addition, to test the different influence of Islamic loans comparing to conventional loans on profitability of the bank. As the main different between Islamic financing and conventional financing is the structure nature of each, where Islamic finance deals with profit and loss sharing principle avoiding interest and uncertainty. On the other hand, conventional financing depends mainly on interest.

The impact of Islamic financing on the profit of Islamic banks in GCC measured by ROAA & ROAE. In addition, the impact of conventional loans on conventional banks profitability in GCC measured by ROAA and ROAE. The study intended to run two-regression model on Islamic banks and conventional banks separately. The results indicated that both financing products impact bank's return on assets and return on equity positively. In other words, the banks increase their profit by given more loans Although, the study used net loans to total asset to represent the independent variable, this ratio (net loans to total asset) measure as well the liquidity position of the bank under risk management quality. Hence, many researchers used this ratio to compare between liquidity management of Islamic banks and conventional banks in various countries. A study done by Almazari (2014) on Saudi and Jordanian banks supports this study finding that financing instruments have significant impact on profitability [10]. On other hand, Javaid, Anwar and Zaman (2011) studied the impact of loans on profitability of banks in Pakistan and found insignificant result that, higher loans contribute towards higher profitability. Over all, this study can conclude that, the findings are in line with most of the previous studies done [11].

The study introduced two variables as independent variables in the regression model. The dummy variable (Dis) which represented the bank type Islamic banks=1 and conventional banks= 0 as well as an interaction variable between the loans and (Dis) which was represented by the moderating effect variable (Loan*Dis). The results indicated that there was different effect in the financing products on ROAA, explained that Islamic loans had a positive

significant impact on profit in terms of ROAA more than the impact of interest-bearing loans on ROAA. In other words, the result can be explained that conventional loans may not had strong impact on return on assets as Islamic loans which can illustrate that equity-based financing and the investments in real assets by Islamic banks, rather than debt contracts as in conventional banks does make Islamic banks efficient. Hence, this result may encourage banks to provide Islamic loans also would encourage policy maker to support the innovation of Islamic products as well as may encourage western conventional banks to adapt Islamic financing in their windows.

In regard to ROAE, the results indicated that there was no different effect of financing products on return on equity which means that both (Islamic loans and interest-bearing loans) may have same influence on profit in terms of ROAE.

Besides, the control variables used also important in this study. The theory of GDP and its impact on ROAE and ROAA whether any correlation with regression results. The GDP meant that the monetary value of all of the finished products (goods and services) produced within a country in a desired time period, which was mostly one year or one fiscal year. The database of GDP was calculated with the help of private and public consumption, government outlays, investments and exports fewer imports. Furthermore, when the Loan/TA is intercepting with GDP per capita, there was significant positive impact in profitability.

CONCLUSION

In conclusion, the macroeconomic variables expected to have a positive relationship with profitability. However, findings in this study illustrated that GDP had a significant positive impact on profitability while inflation rate has negative insignificant impact on profitability. Economic growth can enhance bank's profitability by increasing the demand for financial transactions such as the household and business demand for loans. During periods of strong economic growth, loan demand tends to be higher, allowing an Islamic bank to provide more profit and loss sharing (PLS) loans. Strong economic conditions are also characterized by high demand for financial services, thereby increasing the bank's cash flows, profits, and non-interest earnings. Accordingly, fewer PLS loans would default during strong economic conditions.

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