Finance and accounting

Abstract

This paper intends to present a comparative study on the performance of traditional Islamic banks and commercial banks of UAE. Based on this discussion, it has been found that Islamic banks of UAE have been able to reach to the maximum number of the customers. Furthermore, the efficiency of the Islamic banks in UAE is more compared to that of the commercial banks.

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CW 1b.

Introduction

The financial institutions have been experiencing fast-paced competition across the borders in recent years. One of the fast growing banks is the Islamic ones. It has been recorded that there are about 160 Islamic institutions worldwide. Every bank in developed nations has begun to tap the demand of Islamic banks products. The market share of Islamic banks all over the world has increased by 15% in the last decade (Rizvi, 2013). One of the countries, where demand for the Islamic bank products is huge, is UAE. However, there have been evidences that the market share of Islamic banks in UAE is smaller relative to that in other countries. Though UAE is a Muslim country, yet people there preferred conventional banks over Islamic ones. The Islamic banks in UAE have performed well over the years and have established a respectable position among all the national banks. The main difference that exists between the performance of Islamic and conventional banks in UAE is that the latter follows interest based principle and the former follows principle related to interest free and profit and loss sharing.

Due to the severe financial crisis, there has been high demand of the Islamic bank products in UAE. The growth in demand of the Islamic banks in UAE forced three of the national banks to convert into Islamic ones and they concentrated on providing Islamic products and services to the people in UAE. The development of Islamic banks has been compared with performances of the conventional banks in this research paper by elaborating different functions of the both. The difference or similarities between the products offered by Islamic and conventional banks in UAE are highlighted in order to evaluate efficiency of the both (Dubaibusiness, 2014).

Islamic Banks Vs Conventional Bank products in UAE

The conventional banking system of UAE comprises a number of banks with respect to the Islamic banks. Islamic banking constitutes a small part (about 16%) of the UAE banking sector. The Islamic banking system in UAE identifies the spirit of Islamic legal code i.e. Shari'a. The banks are providing services and products to customers, which are in accordance with Shari'a principle. It has been seen that the products of Islamic banks are affected by the agency problem, which arises due to the difference in information between the borrower or investor and lender. It is well-known that the Shari'a principle does not support charging of interest payment and the products and services are permitted to carry price (Ghose, 2013). The principle rather relies on profit and loss and risk sharing, which is levied on both asset and liability. It has been noticed that the Islamic scholars have tried to develop products, which resembles those of conventional banking and is devoid of interest payment as well as discounted with fees and payments for contingency. The leasing products are also quite famous among the Islamic banks as they are directly related with the real sector transactions (Dalakian, 2013). The equity style products add up to the agency problem risks in Islamic bank structure. There is little difference between the two banking system in terms of cost efficiency, orientation and stability. However, differences can be portrayed with respect to both the banks. The Islamic banks in UAE are more cost effective than the conventional ones.

There is no significant difference between the business orientations of both the banks. They are measured with respect to the share fee based on the total income or the investment of share on the non-deposit for the total funding. There is also no substantial difference between the two banking systems. The capital asset ratio of the Islamic bank is higher than that of the conventional one. In UAE, the market share of Islamic bank has been on the rise, after the financial crisis of 2008. Thus, in UAE, cost effectiveness of the Islamic banks is lower than that of conventional banks. Nonetheless, Islamic banks are highly stable in UAE as compared to the latter. The liquid holdings of the Islamic banks are higher than that of the conventional ones, which have originated from different products that are available in the Islamic banking system (Ponce, 2012). The investors had relied more in the stocks of Islamic banks in UAE, during the financial crisis period. Therefore, it is evident that Islamic banks are more profitable than the conventional banks, since the latter had failed to provide good returns to investors, during the same period (Ika and Abdullah, 2011).

Shari’a products are regarded as those financial transactions that do not violate the principles of Koran. The Islamic banks are prohibited to trade in financial risk products, like, the financial derivatives. The financial risk products are traded by the conventional banks. There has been an effort by different banks, apart from Islamic ones, to comply with the principles of Shari’a products. The most important product of the Islamic bank is the partnership loan. A specific contract, called the Mudaraba contract, has been formulated to provide borrowers with resources. The risk of losing the contract is borne by the banks and profits are divided between bank and the borrower in a predetermined ratio. The Musharaka contract allows all investors to get the share of the profit, which is earned by the bank. The deposits that are made by customers do not imply fixed deposit, but are preset as the profit and loss sharing. The investments are, thus, linked either with profit of the bank or investment that is made by the investor (Halkos, and Salamouris, 2004).

Banks and Products

The three banks in UAE are the Dubai Islamic banks, Noor Islamic Bank and the Abu Dhabi Islamic Bank. The banks follow the Shari'a principle and have grown in business to a great extent since the people of UAE preferred these banks to invest their hard earned money. Dubai Islamic bank has been the largest bank in UAE which has satisfied their customers with a number of products. The products comply with Shari'a principle which enables the investors understand the products and invest in it. The following are data from the annual report of Dubai Islamic Bank, 2012 that depicts the performance of the bank:

Figure 1: Income statement of Dubai Islamic Bank

	Note	2012	2011 (Restated)
		------- Rupees in '000 -------	
Profit / return earned	22	5,682,122	4,632,785
Profit / return expensed	23	2,807,792	2,395,995
Net spread earned		2,874,330	2,236,790
Provision against non-performing Islamic financings and related assets - net	10.7	(192,853)	(17,205)
Provision for diminution in the value of investments		-	-
Bad debts written off directly		-	-
		(192,853)	(17,205)
Net spread earned after provisions		2,681,477	2,219,585
OTHER INCOME			
Fee, commission and brokerage income		436,736	400,539
Dividend Income		30,812	76,792
Income from dealing in foreign currencies		155,112	69,189
Gain on sale of securities	24	64,774	55,008
Unrealized gain on revaluation of investments classified as held for trading		-	-
Other income	25	7,910	14,952
Total other income		695,344	616,480
		3,376,821	2,836,065
OTHER EXPENSES			
Administrative expenses	26	2,846,195	2,496,656
Other provisions / write offs		16,918	14,250
Other charges	27	12,703	9,030
Total other expenses		2,875,816	2,519,936
		501,005	316,129
Extra ordinary / unusual items		-	-
PROFIT BEFORE TAXATION		501,005	316,129
Taxation			
- Current	28	(39,436)	(50,899)
- Prior years	28	(6,911)	(2,076)
- Deferred	28	(108,960)	(72,668)
		(155,307)	(125,643)
PROFIT AFTER TAXATION		345,698	190,486

(Source: Dubai Islamic Banks, 2012)

From the above table it is evident that Dubai Islamic Bank is earning profit to a great extent. It is evident that being the largest bank in UAE it outperforms in its product delivery and this is the reason why the customers prefer the bank to invest in their products. The benefits that they offer help them to attract more and more customers across the nation to become an account holder of the bank.

The products that are offered by the banks are:

1. Murabaha is regarded as a sales contract that specifies the price of goods that are required frequently by the customers.

2. Sukuk is regarded as the Islamic bond issued by Dubai Islamic Bank.

3. Ijara is regarded as the lease contract in which the bank leases properties to the customers and in return the later has to pay a pay rental for a specified period of time. After the expiry of the lease contract the bank promises to return the title of the property to the customer if the customers have made full payment.

4. Musharika is identified to be a partnership program which is organized Dubai Islamic Bank. The bank helps in financing new projects or even the existing ones and distributes the returns of the shares among the partners.

5. Mudaraba is regarded as the partnership that exists between an enterprise and bank for an agreed period of time. The bank invests in the new projects that are undertaken by the companies and also helps in continuing the projects.

In conventional banks, the concept of Murabaha contract resembles that of leasing. It involves the purchase of products that restricts the payment of any return to the contract holder. In such a contract, the bank is liable to purchase an investment product, on behalf of the customer and following that, sells the product to the latter. The sale is succeeded by staggered payments, along with negligible payment of profit. Thus, it violates the principle of Shari'a. This also reasons why Islamic banks are preferred in UAE with respect to profit margin. The depositors' loan in the conventional banks has similar approach to that of the Islamic ones. However, the former provides interest rates, even though investors are not allowed to share the profit margin of the bank (Business Media Group, 2014)

The Islamic banks, in order to cope with the agency problem, have designed alternative contracts, which provided the customers or investors with the right of retaining profit to a certain level, while the bank is liable to receive a fixed fee. Thus, the banks share the profit until the threshold value, which can be provided as profit, is reached. This arrangement effectively turns from a profit-loss form to a debt like instrument. According to the Shari'a principle, the product of Islamic banks reflects different business models, which are obvious from the income statement and balance sheets. Three aspects are considered during the evaluation of banking performances. They are shares bearing interests and non-interest revenue; importance of wholesale funding and retailing; and the ratio that exists between loan and deposit (Kosmidou, et al., 2003). The Islamic banks provide with higher non-interest revenues for shares, but they charge higher fees for compensating the higher interest payment. The revenue of the share, related to non-lending and investment bank activities, are significantly low for the Islamic banks. The same is quite high for the conventional banks in UAE. The Islamic banks rely on market funding more than the conventional banks (Ali, et. al., 2012).

The efficiency of both the banks is compared in order to evaluate the one with the better performance. The screening and monitoring cost for the Islamic banks in UAE is lower, which in turn reduces the agency problem. The complex structure of Islamic banks results in higher cost and thus, their efficiency is questioned in this regard. It is not clear whether Islamic banks provide higher equity incentives or not for monitoring and assessing the risk, which is associated with the investments of investors. The Islamic banks, however, offer risk reducing factors to the investors. Through these risk reducing factors, they safeguard the interest rate risk. So, it can be inferred that the risk management tool of Islamic banks are highly efficient, compared to conventional banks in UAE.

The Islamic banks in UAE have gained traction, since 60% of the residents are holding at least one product from Islamic banks. A survey among 5,300 respondents revealed that 50% of them, who own Islamic banking products, are satisfied with the transparent fees and rates, which are provided to them. Thus, the Islamic banks have succeeded in establishing their products among the mass. The Arabs and UAE nationals do not choose between the conventional bank products and that of the Islamic bank, rather they definitely rely on the latter. The survey also revealed that Islamic banking products are sold to the mass, irrespective of age, income and nationality. It is found that the respondents below 25 years of age are the enthusiastic investors of these products. It is also identified that portions of the mass, who are not the holder of Islamic banking products, do not really understand the Shari’a principle. 40% of the mass are not educated regarding the prescriptions of Shari’a. Therefore, the Islamic banks should be concentrating more on educating the rest of the mass in UAE about the principles of Shari’a. The primary principle is the forbiddance of interest and so, risks that are associated with investment are shared between the banks and customers. Hence, it can be concluded that the Islamic banks put great emphasis on the income generating mechanisms, like, profit rates and fixed fees for product financing.

It is evident that the “Islamic window is becoming an important part of the UAE’s conventional banking landscape” (Ghose, 2013), where leading lenders are venturing into new divisions in the banking system, thereby providing increased share to overall financial fate of the group.

Conclusion

It can be inferred that the Islamic bank products have made greater contribution to the mass in UAE, than the conventional banks. Also, efficiency of the Islamic banks is higher than that of the conventional banks, with regard to the payments of different benefits. Benefits of the contracts, which are provided by the Islamic banks, are preferred by customers and thus, they are naturally attracted towards products of the banks. They do not favour the conventional banks, as far as benefits are concerned, since the losses incurred in conventional banks are borne by customers themselves. Nonetheless, any losses incurred in the investment made by customers in the Islamic banks are shared by both of them.

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