FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN THE UNITED ARAB EMIRATES, PAKISTAN AND JORDAN: A CASE COMPARATIVE STUDY IN A DUPONT APPROACH

Sahar Zulfiqar[1], Hossam Haddad[1], Yahya Al-Shehhi[1], Dr. Domicián Máté[2]
[1] *Károly Ihrig Doctoral School of Management and Business, University of Debrecen, Debrecen, Hungary.*
[2] *Faculty of Economics, University of Debrecen, Debrecen, Hungary.*
Seharzulfiqar@gmail.com
Hossam.haddad@econ.unideb.hu
Yahya.alshehhi@econ.unideb.hu
Mate.domician@econ.unideb.hu

Abstract: *Islamic banking system has observed a high remarkable growth in the circles of global finance since the last three decades. This paper is intended to provide a perspective of Islamic banking in three countries, namely in the United Arab Emirates (UAE), Jordan and Pakistan by analyzing the financial performance of Dubai Islamic Bank (DIB) operating in these countries. A DuPont method is used for our financial analysis. This article consists of two main parts. The first one provides an overview of Islamic banking system and the other represents some empirical findings. In this perspective our study highlights that the financial performance (return on equity) of DIB is better than in UAE comparing to Pakistan and Jordan. The variability of our results can be attributed to several determinants; i.e. different profitability, efficiency and debt policy, and the Islamic institutional environment. Consequently, the age of banks and length of implementation of Islamic banking in the respective countries are also matter.*

Keywords: Islamic Banks, Financial Performance, Dupont Method

JEL classification: G21; G29; G24; L25

1. Introduction

The term of Islamic banking, representing the system of natural processes or business transactions that take place according to the values and principles of Islam called “Sharia". The Sharia based on not acceptance of interest rate “Riba” in the form of lending and accepting of money. In Islamic banking, the banks are disallowed to offer a business in term of goods or services with an interest rate which considered as forbidden (Aḥmad, 2007).

Islamic banking system has witnessed a high remarkable growth in the circles of global finance since the last three decades. Worldwide in 70 countries the Islamic Banks were established (Warde, 2000). By the year 2008 the value of Islamic Banks assets reached about $700 billion (Khan et al., 2008), and the growth of them from 2005 to ten years later was 15% per year (Benaissa et al., 2005). In terms of growth of the Islamic investment portfolio was created by Dow Jones in 1999 called "Islamic Index", which was offering a Sharia-compliant investment. In summation, many Western banks also started offering Islamic financial products such as Bank of America, Citibank, HSBC, ABN Amro, Standard Chartered, and in

Switzerland the Union Bank was offering to their customers an Islamic Financial Products through their subsidiaries. According to Cetin (2014) the Islamic Banks could account all saving about 50% of the Muslim Worlds in 2010.
Today, in the globalized market the Islamic Banking and Fianace (IBF) became a major participant and the fastest growing sector in the world (Khan, 2010). Unfortunatelly, because of the limited literature available about the Islamic banking performance, especially in the context of their operations in the Islamic states there have been no clear evidences. This study is intended to extend the debate on the Islamic banking by providing the perspective of Islamic banking in three Islamic countries (Dubai, Pakistan, and Jordan.) by analyzing one Islamic bank (Dubai Islamic Bank) operating in these countries. This article firstly provides an overview of Islamic banking and secondly represents an empirical results of the banks' performance.

2. Literature Review

2.1. Islamic Banking

Interest is the major element of financial systems all across the world. Islam prohibits interest and favors more profit sharing. Islamic banks do banking without charging interest. Islamic banking is different from the conventional banking in a way that it follows Profit and Loss (PLS) paradigm. Under the PLS paradigm the bank and depositors/borrowers share profit (Mudarabah) and loss (Musyarakah) with each other (Chong & Liu, 2009). There are advisory boards in the Islamic banks comprising of Islamic scholars who review the products and performance of the banks according to the Shariah principles. Another unique feature of Islamic banks is the tax (Zakat) charged on the accumulated funds that is kept aside to support the charities and help the deprived in the society (Kazi &. Halabi, 2006).

2.2. Islamic Banking and Conventional Banking

Contenders of Islamic banking believe that because of this profit and lose sharing Islamic banks are better than conventional banks as the financial losses are shared by the depositors. The PLS paradigm allows Islamic banks to invest in high risk projects that lead to increase economic growth. Another reason for the variability of Islamic banking is that the Islamic banks have to be more disciplined as the chances of losing is more for them as compared to the conventional banks so they monitor more strictly customers (Chong & Liu, 2009). In this regard Anwar (2003) agreed with the comparative findings of Munawar Iqbal and suggested that the Islamic banks, as a group, outperformed the interest based banks in almost all areas including Return on Assets (ROA) and Return on Equity (ROE).

2.3. Features of Islamic banking

Khan and Mirakhor (1990) identified the following features of Islamic banking system as described below:

2.3.1. Funding sources

Beside capital and equity, the two important sources of funds for Islamic banks are transaction and investment deposits. The banks do not have to pay any return on transactions deposits whereas investment depositors are considered more like shareholders who share the profit and loss with no guaranteed return. Only the portion of profit and loss to be shared is initially decided with the mutual consent of both parties in the contract.

2.3.2. Asset Acquisition

Islamic banks can acquire assets by two modes: Mudarabah and Musharakah. In the case of Mudarabah the lenders acts as a single entrepreneur and invest in profit sharing assets at the predetermined rate and bear all losses. In this case lose is not transferred to the borrower. Whereas in Musharakah many parties can be involved and profit and loss shared is in proportion to the capital invested by each party. Islamic banks have introduced many products that are based on the notion of profit and loss sharing that include:

- Qard al-Hasanah is an interest free loan. The finial institutions that offer such loans only charge borrower the administrative cost incurred in the form of service charges.
- Bai' Mua'jal is mode of transactions involves sales of the product in the form of deferred payments (installments or lump-sum amount) without any charges for deferred payments.
- Bai' Salam or Bai' Salaf is a full payment made by the buyer to the seller for the product that is promised to be delivered in the future.
- Ijara (Leasing): In this mode bank buy the asset and leases it to the customer for definite sum and time period.
- Jo'alah: in this mode one party agree to pay charges to the other party for using any service in the form of specific fee that is mutually agreed by both parties.
- Takafol (insurance) is based on the principle of brotherhood in Islam against the risk of future bankruptcy. Here, both parties agree to pay compensation to the affected party if the insured event wil happen. The investments under this are only made in the projects that are acceptable by Shariah.

2.4. Islamic Banking in Muslim Countries

Islamic banking was initiated by the gulf peninsula. There were different factors that lead to this initiation, but can be broadly categorized into religious and political factors. The strong religious orientation of Muslims and their reluctance to invest the wealth in the banks was the prime reason to charge interest. Beside the religion another reason was the region included the oil-producing countries, such as the United Arab Emirates and Saudi Arabia and the huge overflow of funds resulting from the export of oil lead to the emergence of Islamic banking that turned the concept of Islamic banking from theory to practice (Aldohni, 2008).

2.4.1. Islamic Banking in United Arab Emirates

United Arab Emirates is among the list of most developed Muslim countries with high economic growth rate. The banking sector in UAE is among the largest in the GCC countries with 46 banks and comprise of both conventional and Islamic banks. There are nine Islamic banks in UAE i.e. Dubai Islamic Bank, Abu Dhabi Islamic Bank, Emirates Islamic Bank, Noor Islamic Bank, Al Hilal Bank, HSBC

Amanah, Sharja Islamic bank, Badr Al-Islami (Islamic Banking Division of Mashreq Bank), Attijari Al Islami (Islamic Banking arm of Commercial Bank of Dubai). The performance of Islamic banks outperforms the conventional banks and this is the reason why many conventional banks have converted to Islamic operations (Bley& Kuehn, 2004).

2.4.2. Islamic Banking in Jordan

Jordan perhaps smaller in size, but still one the most developed Muslim countries. The significant proportion of the Jordanian population uses banks. The interest based transactions are the major mode of banking transactions in Jordan but the interest rate is relatively low and seldom customers are charged an interest rate over 10 percent. But still the people having Islamic orientation were not happy with the interest based transactions so the need was felt by the Central Bank of Jordan to initiate the parallel system of banking that can address the issues of interest and Hlalal transactions. As a result the first Islamic banking was introduced in 1978 with the name of Jordan Islamic Bank of Finance and Investment (JIBFI). Beside the JIBFI there are two other banks, Islamic International Arab bank and Jordan Dubai Islamic bank. Ajlouni & Omairi (2013) found strong growth patterns in the Jordanian Islamic banking industry as all the three banks were found to be efficiently performed with increased product innovation capacity.

2.4.3. Islamic Banking in Pakistan:

The concept of Islamic banking in Pakistan started almost in 1977-78 when the government tried to eliminate the interest from the operations of financial institutions. But the serious effort to introduce Islamic banking in Pakistan was initiated by the state bank of Pakistan with the establishment of the Islamic banking department. As a result the first Islamic bank Meezan Bank Limited established in 2002. Currently there are five Islamic banks in Pakistan Meezan Bank Limited, Al Baraka Bank, Bank Islami Pakistan Limited, Burj Bank and Dubai Islamic Bank. But beside these Islamic banks, many conventional banks have started Islamic window for the customers who are interested in interest free truncations. The financial performance of Islamic banks in Pakistan is weak as compared to the conventional banks in terms of profitability and liquidity. One possible reason for weak performance is that Islamic banking is not having a long history of Islamic banking in the other Muslim countries such as Jordan and UAE (Moin, 2008).

2.5. Dubai Islamic Bank (DIB)

Dubai Islamic Bank established in 1975 as the first complete provider of Islamic Finance products. It is considered as a large bank headquartered in Dubai, Dubai Islamic Bank attracted more dealers even from non-Muslims, which it moves them to distinguish committed to transparency and high ethical values of the Islamic banking system ((DIB), 2016). Dubai Islamic Bank (DIB) listed stock in Dubai Financial Market (DFM), and it is a joint public stock company. DIB has a local and international partnerships and its business expanded to different countries such DIB Pakistan Limited in Pakistan (200 branches in 62 major cities in Pakistan) a wholly owned subsidiary, also representative offices in Turkey, and Jordan Dubai Islamic Bank in Jordan.

3. Data and Methodology

The data for the study was secondary in nature. The data were collected from the annual reports (P&L Statements, Balance Sheets etc.) of DIB published on the websites of the bank. The financial analysis in the current study is conducted using the DuPont method.

DuPont analysis is common method used to measure the financial performance of firms. DuPont analysis breaks down the ROE into three components: profit margin, asset turnover and equity multiplier. The DuPont analysis helps in analyzing the higher or lower sources of return in the financial statements. The profitability is calculated by profit margin, operating efficiency is measured by using asset turnover and financial leverage is calculated by equity multiplier. The decomposition of ROE in three complements help to analyze the financial performance of the banks. In the comprehensive manner as profit margin help to analyze income statement; asset turnover provide analysis of the left side of the balance sheet and finally equity multiplier help to analyze the right side of the balance sheet. DuPont analysis is used by Kirikal, Tallinn & Vensel (2004) and Almazari (2012) to access the financial performance of the banks. And, can be expressed in the following formula:

$$\text{ROE} = (\text{Profit Margin}) * (\text{Asset turnover}) * (\text{Equity Multiplier}) \quad (1)$$

The results of the analysis show higher ROE for DIB UAE followed by DIB Pakistan and DIB Jordan as Figure 2.

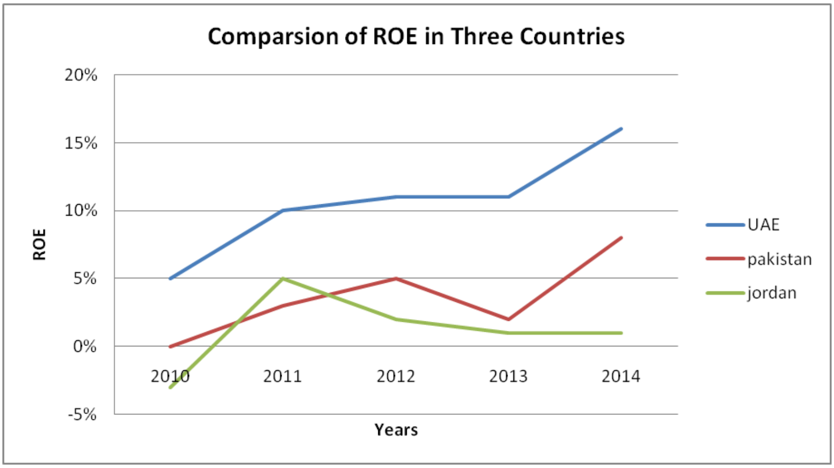

Figure 1: Comparison of ROE in Three Countries
Source: based on Author’s Calculation

Table 1: DuPont analysis of Dubai Islamic Bank in three countries.

Country	Year	Profit Margin	Asset Turnover	Equity Multiplier	ROE (%)
UAE	2010	0.118	0.052	8.749	5%
	2011	0.211	0.055	8.904	10%
	2012	0.237	0.052	9.031	11%
	2013	0.329	0.045	6.932	11%
	2014	0.441	0.051	6.996	16%
Pakistan	2010	0.001	0.111	6.595	0%
	2011	0.037	0.105	7.718	3%
	2012	0.054	0.101	9.348	5%
	2013	0.021	0.081	11.581	2%
	2014	0.069	0.085	13.485	8%
Jordan	2010	-0.721	0.017	2.425	-3%
	2011	0.331	0.051	3.045	5%
	2012	0.147	0.031	3.741	2%
	2013	0.084	0.032	4.086	1%
	2014	0.105	0.027	5.042	1%

Source: Based on Annual Reports and Author's calculations.

Based on the data collected and the author's calculations Table (1) show that the Return on Equity (ROE) ranged from 5 % in 2010 to 16 % in 2014 and increased in UAE, ranged from 0% in 2010 to 8 % in 2014 and increased in Pakistan and aranged from -3% in 2010 to 5% in 2014 and decreased in Jordan. In UAE the profitability was higher than in Pakistan and increased permanently. Here the turnover ratio was stable and banks could decrease their debts. Comparing the performance of DIB in UAE to Pakistan an increasing growth profitability tendency was appeared with less risk of bankruptcy. Although, In Pakistan there was an increase in ROE and profit margin, but the banks' equity multiplier was higher than earlier. In Jordan thanks to the lower profitability, and turnover the ROE is decreased in the examined periods. Moreover the risk of insolvency is increased with the improved leverage as well.

4. Discussion and conclusions

The Islamic banks are different from conventional banks as there are no specific sales of tangible products and interest income. The total income for Islamic banks is taken as a proxy for sales in the current study. The income for Islamic banks mainly consists of income generated on Islamic to finance customers, investments in securities, deposits in other financial institutions and foreign exchange. Consequently, the financial ratios for the banks are also different from the typical organizations.

In the simplest form of return on equity is a measure of how efficiently the banks is generating profit from shareholders' money, but as the DuPont method offers more in depth analysis. The net profit margin for DIB in UAE is showing continuously higher trend almost 3 times more in 2014 as compared to 2010 as compared to Pakistan and Jordan which shows that UAE is more efficient in converting its sales into profit. Jordan’s profit margin is better than Pakistan, but showing a decreasing trend.

Asset turnover shows that in UAE and Jordan there are lower asset turnover as compare to Pakistan. Moreover, DIB in UAE have a higher profit margins followed by Jordan which shows that DIB UAE and Jordan can do business without having additional costs that can negatively affect profit margins. As DIB in Pakistan is having a low profit margin comparatively so reply more on increasing sales volume to make profit. It shows that asset management policies of DIB Pakistan are better than in Jordan as ROE is higher, although DIB Jordan has a better profit margin.

The final element of DuPont model is equity multiplier which is used to calculate the financial leverage. DIB in Pakistan is surely having higher values of equity multiplier followed by DIB UAE and Jordan. The higher trend of the financial leverage of DIB Pakistan indicates that DIB Pakistan is using more debt financing for its assets. One reason of the better ROE for DIB Pakistan can be the higher equity multiplier (raising the debt). It can be a problem in the future that if the DIB is if already adequately levered, raising additional debt can increase higher risks for investors. So it can be concluded that the DIB in UAE is clearly performing better than Pakistan and Jordan.

Moreover the variability of financial performance can be attributed to several other factors; one of the most important is the bank’s age and the length of implementing Islamic banking system in the respective country. In the UAE it started its operation in 1975; in Pakistan in 2006, whereas in Jordan the Dubai Islamic is new as it was established in 2010 and 2006. Moreover the Islamic banking in the UAE and in Jordan was started much earlier than in 1960 and the 1970’s whereas in Pakistan the Islamic banking was introduced much later than in the 2000’s. However, all three countries are having a Muslim majority population that can serve as a potential for increasing their income, profits and eventually improved ROE.

An additional research direction has also emerged in this study. We argue that the institutional economic perspective is relevant since it extends the achievements and existing frontiers of macroeconomic theories. Although, these approaches stated that financial institutions originated assumptions of growth, but recently serious debates have taken place in an attempt to explain the role of institutions and their interactions as they might influence their productivity. However, no clear theoretical consensus has yet emerged and several unanswered problems remained our empirical findings could demonstrate the importance of productivity growth in Islamic banking. Hence, further research in this sectoral approach could be more fruitful.

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