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Procedures, Advantages And Disadvantages Of The Islamic And Conventional Banks In The GCC Area

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Abstract

This study aims to identify and discuss some of the major differences in the processes and business functions of Islamic banks and conventional banks, as well as conduct a thorough literature review on banking services in the Gulf region and around the world.

While some of the key concepts were explained later in the paper, the benefits and drawbacks of the two types were viewed and discussed, and then a study that examined the period 2005-2010 was embedded in the paper, the study was done by K.K. Siraj and P. Sudarsanan Pillai, and it studied the banks in the GCC region. The study concluded some expected and unexpected results, as there is an emphasis on the reason behind the study's selection of the specific time period of 2005 - 2010, which is also discussed later in the paper.

Introduction

Historically, very few studies focused on the genuine differences between Islamic and conventional banks. W. Mensi, A. Hamdi, S. J. H. Shahzad, M. Shafiullah, and K. H. Al-Yahyaee (2018). Profits, according to the flagging hypothesis, can flag management's perspective on a company's condition. As a result of the profit's impact on firm value, the factors that determine those pr[1]ofits merit investigation. One of the goals of this paper is to examine the significant differences in Saudi Islamic Banks' strategies, as well as the differences in routine-based and unexpected processes between the two types of Saudi banks.

As Saudi Arabia progresses toward financial development, it opened its stock exchange (Tadawul) to Qualified Foreign Investors a few years ago to allow investment from outside resources and potential financial backers. This was a significant milestone in the oil-rich countries' economic transformation efforts, which could soon attract foreign investment (Javaid, S., & Alalawi, S. 2018).

The opening of the Tadawul to new investors will boost market growth, increase institutional investors' cooperation, and reduce the role of retail financial backers (Zubairu, U. M., & Sakariyau, O. B. 2011).

The primary motivation for this review is to fill a gap in the literature by investigating the variables influencing profit strategy for Islamic and conventional Saudi banks.

This study has important implications for both theory and practice. It will add to the writing on profit strategy by distinguishing the determinants of profit strategy for Saudi banks in an

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interesting way. Banks and financial foundations are typically excluded from profit analysis due to their exceptional financial structures, accounting strategies, and corporate governance.

Understanding profit strategy not only improves profit estimation and the selection of appropriate valuation models, but it also provides a better understanding of the interrelationship between working, financing, and investing activities (ZUBAIRU, U. M., SAKARIYAU, O. B., & DAUDA, C. K. 2012).

Tadawul will benefit from the passage of unfamiliar institutions in developing a reputable emerging business sector proportionate to its size (Abdallah, F., & Knio, M. 2021).

While there are numerous stock exchanges in the GCC region, Tadawul is without a doubt the most well-known. Saudi Arabia has the largest economy in the Middle East, so it's not surprising that its stock market is among the top ten largest in the world by market capitalization, thanks largely to Saudi Aramco's new initial public offering (IPO) (Hvidt, M. 2013).

Tadawul, also known as the Saudi Stock Exchange, was established in 2007 and is the only entity in Saudi Arabia authorized to operate as a stock exchange. Tadawul provides values, Islamic securities, trade traded funds, and mutual funds, and it currently has approximately 150 organizations listed for trading on the exchange. The capital market authority directs and operates it. Only established institutional foreign investors or global institutions based in Saudi Arabia are permitted to trade and invest in protections listed on Tadawul. The Saudi Vision 2030 focuses on accelerating and focusing on digital projects. Through the full deployment of emerging technologies such as Artificial Intelligence (AI), Internet of Things (IoT), Blockchain, Big Data, Robotics, Machine Learning, and 5G across public and private sectors, the Kingdom of Saudi Arabia is poised to become the global leader in the digital economy (Vinodkumar, N., & AlJasser, H. K. 2020).

Literature Review

There are both hypothetical and experimental investigations into capital adequacy. Although the point has become increasingly important in recent years due to the financial connections of global banking operations, there have been prior investigations into capital design.

M. M. Hasan and J. Dridi (2010) demonstrated that capital design and, as a result, capital regulation are unimportant in an ideal financial market.

Capital requirements may influence bank behavior, influencing whether or not to face additional challenges. Sillah, B. M., and N. Harrathi investigate this issue. (2015) used a synchronous conditions model to study global banks.

M. D. Miah and H. Uddin (2017) examined the viability of bank capital sufficiency regulation by analyzing data from Spanish commercial banks from 1985 to 1991 using a disequilibrium model. They looked at two models: firms that are not affected by capital adequacy guidelines and firms that are. They discovered that market pressure, rather than administrative constraints, is the primary determinant of bank capital.

In their assessment of Islamic banks and capital adequacy, Johnes, J., Izzeldin, M., and Pappas, V. (2014) assumed that, regardless of government infusion, benefit excess, and other capital instruments, there are long haul apparatuses required to support capital to Islamic banks.

Rahim, S. R. M., and Zakaria, R. H. (2013) examined Malaysian Commercial Banks for the determinants of the Capital Adequacy Ratio and discovered that Return on Asset (ROA), Loan

to Assets Ratio (LAR), Risky Assets Ratio (RAR), and profits pay-out proportion decisively influence the Capital Adequacy Ratio (CAR), whereas Deposits Assets Ratio (DAR), size of bank, and Loan (CAR).

T. Alshammari (2017) examined the underlying differences between the two types of banks. They identified that Islamic banks generally rely on their value in financing, whereas conventional banks rely on acquired funds in financing, demonstrating a higher shock-engrossing limit for Islamic banks in comparison to conventional banks.

In a report on Islamic banks and conventional banking using the CAMEL test, Saif Alyousfi, A. Y., Saha, A., and Md Rus, R. (2017) detailed better performance of Islamic banks on adequate capital and liquidity position when compared to conventional banks.

This review discovered similarities between conventional banks and Islamic banks based on resource quality, while conventional banks were found to be prevalent in value management and procuring capacity.

It can be seen that the increased ubiquity of Islamic banking in recent times may be influenced by its adaptability to financial shocks and emergencies.

It does not imply that Islamic banks are not affected by the financial crisis; however, as stated by Parashar, S. P. (2010), it clarifies that Islamic banks are less affected by the financial crisis. This viewpoint is supported by Rosman, R., Abd Wahab, N., and Zainol, Z. (2014), who reported moderately better performance of Islamic banks during the financial crisis because Islamic banks have higher capitalization as well as higher liquidity reserves.

Based on a recent report, Chazi, A., and Syed, L. A. (2010) discovered that Islamic banks demonstrated greater flexibility during the global financial crisis.

F.A. Alkassim, (2005) used financial proportions and relapse models to analyze the performance of Islamic banking and conventional banking in the Gulf Cooperation Council (GCC).

M. Akhter, A. Raza, Orangzab, and M. Akram (2011) focused on the effectiveness and performance of Islamic banking using financial ratios. Merdad, H. J., Hassan, M. K., and W. J. Hippler III (2015). compared the influence and productivity of Islamic banks and conventional banks using a calculated relapse model and discriminant analysis

Kouser, R., Aamir, M., Mehvish, H., and Azeem, M. (2011) used the CAMELs rating framework as well as numerous discriminant analyses to distinguish between effective and low productive banks based on their effectiveness proportions. A. H. Al-Hussain (2009) used DEA (Data Envelopment Analysis) to compare the overall proficiency of Islamic and conventional banks in the GCC region.

Key Terms and Definitions

- Murabaha: Murabaha is a profit-making sale of a commodity in which the seller discloses the cost of the commodity as well as the amount of profit charged (Miah, M. D., & Suzuki, Y. 2020).

- Musharakah: A joint partnership in which two or more parties pool their capital or labor to form a business in which the profit or loss is shared according to a predetermined ratio (Muhammad, A. M. 2014).

- Wadiah: Under the rules of Fiqh, a depositor places property with another party for safekeeping. There are two types of Wadiah: Wadiah yad Amanah refers to property deposited

on the basis of trust (guarantee safe custody), and Wadiah yad Dhamanah refers to savings with guarantee or safe keeping (Rahmasari, O. A., & Febriandika, N. R. 2019).

- Ijarah (Islamic Leasing): A contract in which one party transfers the right to use an item he owns to another party for a set period of time in exchange for a fee (Gupta, N. 2015).

- Fiqh: The human understanding and practice of Sharia, that is, the divine Islamic law as revealed in the Quran and Sunnah (Jusoh, W. N. H. W., Ibrahim, U., & Napiah, M. D. M. 2015).

Islamic Banks

Islamic banking, also known as Islamic finance or Islamic Funds, is the practice of conducting financial transactions in accordance with Islamic principles. The sharing of profit and loss, as well as the prohibition on the collection and payment of interest by lenders and investors, are two major pillars of Islamic banking.

Between 2012 and 2019, there were a lot of Islamic banks all over the world. According to the Islamic Corporation for the Development of the Private Sector (2020), Islamic banking assets have increased from $1.7 trillion to $2.8 trillion and are expected to reach $3.7 trillion by 2024.

Islamic banking principles are derived from the Qur'an, Islam's central religious text. All transactions in Islamic banking must adhere to Fiqh, Islam's legal code.

Instead of charging interest, Islamic banks use equity participation, which means that a financial firm that conducts business in accordance with Islamic principles does not charge interest to the borrower, but in exchange, the borrower repays the Islamic bank by sharing an agreed-upon percentage of profit.

Islamic Banking Advantages (Al-Muharrami, S., & Hardy, D. C. 2014).

1. Fairness: The Islamic Banking model is founded on a profit-sharing principle, in which the risk is shared by the bank and the customer.

2. Access to All: Although based on Quran principles, Islamic Banking is not limited to Muslims and is also available to non-Muslims.

3. Transparency: Islamic banking is based on doing business in a transparent manner. guiding clients through the process to ensure complete understanding of potential risks and costs

Disadvantages of Islamic Banking (Sibghatullah, A., & Raza, M. 2020).

1. The interpretation of new financial services in the Quran is not always clear.

2. Some Murabaha are determined by current interest rates rather than economic or profit factors.

3. Because hedging is prohibited, Islamic banks cannot reduce their risks.

Conventional Banks Advantages (Rahman, A. 2016).

1. Loan availability in comparison to Islamic banks.

2. A broader global reach.

3. Easier comprehension of the rules governing new financial services.

Disadvantages of Traditional Banks (Paltrinieri, A., Dreassi, A., Rossi, S., & Khan, A. 2021).

1. Hidden expenses from compound interest.

2. Embedded fees for services are typically higher in comparison to Islamic banks.

3. Could be easily impacted by a potential financial crisis or other unfavorable event.

Study Method

The study's goal was to compare and contrast the performance of conventional banks and Islamic banks in the GCC region. Within the GCC region, there are twelve major banks, including six Islamic banks and six conventional banks. The study makes use of financial data from the years 2005 to 2010. Many banks in the GCC region offer both conventional and Islamic banking products. To compare and contrast Islamic and conventional banks, choose banks that can be classified as either conventional or Islamic.

Islamic Banks included in the study

1. Al Rajhi Bank, Saudi Arabia

2. Bahrain Islamic Bank, Bahrain

3. Dubai Islamic Bank, UAE

4. Qatar International Islamic Bank

5. Kuwait Finance House, Kuwait

6. Abu Dhabi Islamic Bank, Abu Dhabi, UAE

According to the MEED report, Al-Rajhi Bank was ranked first (MEED, 2009). Kuwait Finance House, Dubai Islamic Bank, and Abu Dhabi Islamic Bank ranked second, third, and fourth, respectively, among Islamic banks. Qatar International Islamic Bank is ranked 20th, and Bahrain Islamic Bank is ranked 25th. (MEED, 2009). The study included six commercial banks. The banks chosen were ranked as the top commercial banks in the GCC region. It should be noted that the Abu Dhabi Commercial Bank also added Islamic banking activity but was found to be comparably negligent (Ratio of income from Islamic financing to income from interest stands at 0.030:1, based on financial results 2010), so it was classified as part of the commercial banking group.

Important considerations that were taken into account while conducting the study:

1. The Emirates NBD has been chosen as one of the region's traditional banks. It should be noted that the bank has an Islamic banking division.

2. The study focuses on ratios and growth rates to infer bank group performance. The study does not use absolute values to indicate performance.

3. Banks are chosen from all GCC countries, with the exception of the Sultanate of Oman, where no fully operational Islamic bank exists.

Conventional banks included in the study

1. Bank Muscat, Sultanate of Oman

2. Commercial Bank, Qatar

3. Abu Dhabi Commercial Banking

4. Arab Banking Corporation, Bahrain

5. National Bank of Kuwait

6. Emirates Bank International

Profitability is a key metric used to evaluate the performance of any commercial organization. Profitability is reflected in a variety of indicators, including the Operating Profit Ratio (OER), Net Profit Ratio (NPR), Return on Asset (ROA), Return on Share Capital (ROCA), and Return on Total Equity (ROTE) (ROE). The above-mentioned ratios show the relationship between profit and total income, total asset, share capital, total equity, and so on. The Operating Expenses Ratio highlights the effectiveness with which an organization manages its operating expenses. Another important indicator of performance is capital adequacy, which is calculated by dividing total equity by total assets. A higher ratio indicates low risk and represents a larger share of the bank's ownership fund in total assets. In addition, indicators such as profit as a percentage of customer deposits, customer deposits as a percentage of total liabilities, and total equity as a percentage of total assets were calculated to compare conventional banks and Islamic banks.

Study Analysis

Operating profit is divided by total income to calculate OPR. When operating profit is considered, Islamic banks perform comparably better. Between 2005 and 2010, Islamic banks had an average OPR of 62%, while conventional banks had an OPR of 46%. Even though the ratio is favorable for Islamic banks, it is expected that the OPR of Islamic banks will fall after 2007, as a result of the global financial crisis that occurred in 2007. According to the study's findings, there is a significant relationship between Islamic banks and conventional banks in terms of operating profit transition.

Net profit is divided by total income generated to calculate NPR. Between 2005 and 2010, conventional banks received a higher NPR than Islamic banks. The average annual NPR for Islamic banks was 30.89%, while it was 38.49% for conventional banks. Similarly, to the trend in operating expense ratio, NPR ratio for Islamic banks decreased after 2007, while conventional banks reported a recovery of NPR from 2009 onwards. According to the study's findings, there is no significant difference in the movement of net profit between Islamic and conventional banks.

A lower OER demonstrates better control over operating expenses, emphasizing lower expenses and higher earnings. F.H. Hays, S.A. De Lurgio, and A.H. Gilbert Jr. (2009) used OER as efficiency ratios to distinguish between low and high efficiency banks. According to the analysis, Islamic banks had a lower OER ratio than conventional banks between 2005 and 2010. The study discovered two major trends in the OER ratio. First, after 2008, Islamic banks have a higher OER ratio. The same is true in the case of traditional banks. It suggests that bank groups may be vulnerable to financial crises. Banks must reduce their OER ratio in order to improve efficiency.

According to the study's findings, there is no significant difference in the movement of operating expenses between Islamic and conventional banks. It backs up the earlier observation about the relationship between Islamic banks and conventional banks in terms of net profit movement.

Total profit is divided by total asset to calculate ROA. The ratio is commonly used as an indicator of profitability. P. Cook and Y. Uchida (2004) used ROA to assess profitability and performance of various businesses. M.A. Peterson and I. Schoeman (2008) interpreted ROA as an important tool for indicating the bank's operational efficiency. According to the analysis, Islamic banks have a higher ROA than conventional banks. During the period 2005-2010, the ROA of Islamic banks was 2.63%, while that of conventional banks was 1.61%. There are no significant differences in the movement of Average Return on Asset between Islamic banks and conventional banks, according to the study analysis.

Divide net profit after tax by share capital to calculate ROCA. The equity capital denotes only the issued capital and excludes any reserves, etc. It defines the connection between profit after tax and share capital. According to the analysis, Islamic banks had a higher ROCA than conventional banks between 2005 and 2010. ROCA for Islamic banks was 59.06%, while it was 55.54% for conventional banks. It is often difficult to interpret efficiency based on ROCA; according to the study analysis, there is no significant relationship in the movement of ROCA among Islamic banks and conventional banks.

A higher ratio indicates better capital utilization. It is calculated by dividing total equity by net profit after tax. The total equity is the sum of capital and reserves. According to the results of the analysis, Islamic banks have a higher ROE than conventional banks. As with other performance indicators, the ROE ratio of Islamic banks has decreased over time. According to the study's findings, there is no significant difference in the movement of ROE on total equity between Islamic and conventional banks.

Customer deposits are a significant source of funding for banks. Banks' success can also be measured by their ability to manage customer deposits and convert them into revenue-generating investment opportunities. The bank must pay returns on customer deposits, which are denoted as interest expense in conventional banking and as share of profit in Islamic banking. Profit is calculated as a percentage of customer deposits by dividing profit after tax by total customer deposits. According to the analysis, Islamic banks make more money on customer deposits than conventional banks. Profit as a percentage of customer deposits for Islamic banks was calculated to be 17.57% between 2005 and 2010, while it was 2.90% for conventional banks. According to the study analysis, there is a significant relationship between Islamic banks and conventional banks in the movement of profit as a percentage of customer deposits.

Customer deposits constitute a significant portion of a bank's total liabilities. According to the analysis, Islamic banks carried a higher percentage of customer deposits in total liabilities between 2005 and 2010. Islamic banks hold an average of 73.80% of the bank group's deposits, compared to 55.12% for conventional banks. It is worth noting that customer deposits in total K.K. Siraj and liabilities decreased for Islamic banks between 2005 and 2010, while they increased for conventional banks from 55.27% to 61.87%. According to the study analysis, there exists significant relationship in the movement of customer deposits among Islamic banks and conventional banks.

It is also known as the Equity-to-Assets Ratio. The ratio depicts the company's relative percentage of total equity in total assets. A higher ratio is preferable because it indicates the presence of fewer external funds in the company's total assets. During the period 2005-2010, total equity as a percentage of total assets averaged 15.26% in Islamic banks, while it was 12.46% in conventional banks. According to the analysis, Islamic banks use more equity funds than conventional banks in relation to the total assets of the company. As a result, it is possible to conclude that Islamic banks are more equity financed than conventional banks. There is a

significant connection the movement of Total Equity as a percentage of Total Assets among Islamic banks and conventional banks.

Conclusion and Findings

Based on the study analysis, similarities and differences were discovered when comparing conventional and Islamic banks in the GCC region. Working profit grew faster in Islamic banks than in conventional banks. Despite differences in the development of working profit, the pattern followed is thought to be fundamentally related. In reality, the NPR proportion showed a different pattern; the conventional bank has a higher profit growth. NPR does not follow a comparative development example of conventional banks and Islamic banks. ROA is an important indicator of a bank's profitability. When compared to conventional banks, Islamic banks demonstrated a higher ROA. ROA does not track the development of Islamic and conventional banks in the same way. ROE also pursue comparative direction. Total profit as a percentage of client deposits is higher in Islamic banks. According to the findings, absolute benefit as a percentage of client deposits differs significantly between Islamic and conventional banks. The review confirms that Islamic banks are more value-financed, whereas conventional banks are more acquired fund-financed. A hypothesis test revealed a critical relationship between Islamic banks and conventional banks in client development. Furthermore, absolute value accounted for a greater proportion of total bank resources in Islamic banks than in conventional banks. Furthermore, it is discovered that there is a critical relationship between Islamic banks and conventional banks in the development of total equity as a rate on total assets. Between 2005 and 2010, Islamic banks' absolute assets increased by 21.53%, while conventional banks' assets increased by 18.42%. The analysis used AAG rate to feature change in selected execution pointers. All out working pay, working costs, working benefit, net benefit, absolute resources, client stores, and all out-value capital are among the presentation markers under consideration. During the period 2005-2010, Islamic banks had a higher AAG rate of all out working pay than conventional banks in the GCC region, according to the investigation. The AAG rate of all out working pay for Islamic banks is 24.62%, while it is 16.47% for conventional banks. It could be seen that the working pays of conventional banks showed a reduced growth from 2007 onwards, which could be attributed to the impact of the recessionary pattern caused by the global financial crisis. Working costs increased at the same rate as working pay. The review revealed an excellent situation of Islamic banks in which working pay increased faster than working costs increased. According to the investigation, Islamic banks announced a higher AAG rate of working benefit. During 2005-2010, the AAG rate for Islamic banks remained at 8.87%, while it announced a negative - 1.55% AAG rate. A further investigation revealed a decrease in development, primarily after 2007, owing to the financial crisis and recessionary tensions. Client stores in Islamic banks developed at an AAG rate of 17.35%, while conventional bank stores developed at an AAG rate of 18.42%. K.K. P. and Siraj Sudarsanan Pillai (2012) found that, similar to the pattern in other indicators, the rate of store growth slowed around 2007, possibly due to recessionary patterns and financial crises. In terms of the impact of the financial crisis on banking, the study found that Islamic banks in the GCC region were less affected than conventional banks. Despite the fact that there has been a decrease in pay and development of selected markers, the effect has been minimal when compared to the change seen in traditional banks. It supports previous research, particularly S. Syed Ali's (2011) contention that the financial crisis affected the performance of bank groups at various levels. Furthermore, the financial crisis had a significant impact on Islamic banks during 2008-2009, while it had little impact on conventional banks.

The researcher concurs with the study's findings, particularly in terms of Islamic banks' resilience and ability to avoid and protect their systems from financial crises. Which benefits

all parties involved, as clients can be easily affected in such unfortunate events, which is why many clients from other religious backgrounds prefer to conduct their business with Islamic banks, as a result of the ramifications of the financial crisis, as pointed out by Abdullah, A. A., Sidek, R., & Adnan, A. A. (2012) in a review done of the perception of non-Muslims of the Islamic banks.

This study attempted to clarify a few points that differentiate Islamic banks and conventional banks in their processes and business practices, as well as provide a rich and valuable literature review on financial services, different perceptions and viewpoints, and the global development of banking services.

In addition, some of the most important terms related to the subject were defined, as well as an explanation of the benefits and drawbacks of both types. This was followed by a study conducted by K.K. that aimed to evaluate and compare major performance indicators of conventional banks and Islamic banks in the GCC region. P. and Siraj Sudarsanan Pillai conducted the research between 2005 and 2010. The study discovered that Islamic banks had a higher AAG rate of operating profit, and that Islamic banks were less affected than conventional banks in the GCC region. Even though income and growth of the discussed indicators have decreased, the impact has been minimal in comparison to the impact seen in conventional banks.

It is worth noting that the study was conducted during this time period due to the global financial crisis, as this subject will undoubtedly be a target for more beneficial research in the future.

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