Operational Efficiency of Islamic Banks: The Case of Malaysia and Pakistan

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ABSTRACT

The role of Islamic financial institutions is pivotal in economic development of a country, it can never be underemphasized, so, it is imperative to appraise the operational efficiency of such institutions, as Islamic banking industry has emerged few decades ago and it has flourished vigorously. The study is intended to appraise and comparatively analyse the operating efficiency of selected Malaysian and Pakistani Islamic banks for the span of six years 2006 to 2011, by the application of commonly used ratio model. Secondary data have been obtained from the annual reports of respective banks, description is done through mean, standard deviation and coefficient of variation and t-test signifies the performance dissimilarities. Empirical findings demonstrate that Malaysian Islamic banks have appraised comparatively efficient operation subject to income-expense ratio and operating efficiency, while PIB have rigorously utilized assets. It is concluded that Malaysian Islamic banks are more efficient and PIB are tumbling in controlling operating expenses. The study signals policy makers to devise policies in the light of these findings to have prosperous operations.

Keywords: Financial performance, efficiency, Islamic banks and ratio analysis.

1. Introduction

The financial institutions either Islamic or non-Islamic play a pivotal role in the economic development of a country. They are market drivers, the economic progress is linked with the efficient functioning of financial institutions and it is imperative to appraise the efficiency of such institutions. The role of Islamic financial institutions can never be underemphasized. Modern age banking is providing praiseworthy and revolutionary services to customers. Collectively financial institutions are playing significant role in; financing development schemes, industrial and agriculture development, remittance of funds, provision of employment, financial encouragements to businesspersons, catering the needs of credit to various sectors of economy, providing investors opportunities to make investment in mega projects, business expansion, rural development, supporting farmers with low cost credit, financing infrastructural development projects, providing alternative parking options for saving sector and a variety of schemes for deficit sector. Moreover, banking persuades public to save the money, channelizing these saved funds into industrial use, curtailling unemployment through spare funds, promote economic growth and deliver risk-free gain to savers. Islamic banking system forbids the interest intensive business activities and permits the ventures established on the basis of risk-return where return is not fixed. It also encourages the equity financing rather than debt financing and Musharaka and Mudaraba are the most common establishments governing sharia principles.

Islamic banking emerged in 1963 in Egypt, in 1983 Malaysia established the Bank Islamic Malaysia Berhad (BIMB) to work according to Islamic laws and State bank of Pakistan has licenced to the Meezan Bank Limited (MBL) as first Islamic bank in 2002. Islamic banking industry has emerged in past few decades and it has flourished vigorously. Branch network, deposits, customers, assets, liabilities and equities of Islamic commercial banks are rapidly expanding especially in Muslim world. Almost every conventional bank is trying to initiate the Islamic branches or at least Islamic windows. The core factor enticing conventional bank management is the profitability of Islamic banking products and services. Pakistani Islamic banking Industry (IBI) reported an
expansion of 19 new branches with 7.70 percent quarterly growth and its assets reached to Rs. 644 (billion) at the end of March 31, 2012 and regarding assets its share in market slightly decreased, however, its deposit share remained stable at 8.40 percent. At the end of this quarter the Islamic banking industry has recorded the financing of 206 billion rupees with Mudarabah 40.10 percent, Diminishing Musharaka 35.10 percent and Ijara with 10.70 percent. 35.1 percent and Ijara 10.7 percent. Liabilities of the industry were 13.8 percent for last quarter which declined in this quarter due to 2.00 percent decrease in deposit volume, and only 0.20 percent is reported by the end of this quarter. The IBI’s earnings remained strong during the quarter with annualized ROA and ROE of 1.6 percent and 17.8 percent respectively, which are higher than that of overall banking industry (SBP, 2012).

The efficiency is one of the core parameters on the basis of which performance of banks is appraised. It is closely associated with profitability, liquidity and solvency. It is referred to the input-output ratio and how well assets, capital and other long term funds are utilized to yield higher return and sovereignty of managing efficiency is labelled with monitoring the functioning expenses and optimum exploitation of assets. A bank’s operational efficiency is termed as the ratio of operating expenses to income and eventually high ratio reflects inefficiency of management.

The study is worthwhile as literature reveals dearth in this area, because most of the studies have focused the performance comparison of conventional banks and conventional versus Islamic banking. Eventually there is a scant amount of studies on inter-Islamic banking performance evaluation, so this study is justifiable as it will enrich the literature in this regard. Bearing in mind this phenomenon this work is directed to comparatively appraise the operational efficiency of Islamic banking industry.

1.1 Research Objectives

The study is designed to achieve following objectives:

1. To appraise the operational efficiency of Pakistani Islamic banks.
2. To appraise the operational efficiency of Malaysian Islamic banks.
3. To comparatively analyse the relative efficiency of Islamic banks management.
4. To add in literature by valuable contribution on the subject of financial performance of Islamic banking industry.
5. To offer suggestions to policy makers for effectively devise and formulate policies.

2. Literature Review

A bank’s operating efficiency is measured by expense to income ratio, which is considered a proxy to operational efficiency and this ratio shows either the bank is managing operational cost efficiently which will ultimately has an influence upon bank’s profitability. Since expense to income ratio appraise the cost of administrating the bank as a percentage, the high ratio reveals inefficiency of management in controlling operational cost and it has unwanted impact on bank’s profitability (Rao&Lakew, 2012).

Jaskiran and Kunnath (2011) investigated the profitability, liquidity and efficiency of two Islamic and two non-Islamic Malaysian banks using ratio analysis for a period of three years from 2007 to 2009. They found not much difference regarding operational efficiencies of both stream of banks.

Pal (2012) used fifteen ratios to regress the effect of liquidity, solvency and efficiency on financial performance of Indian steel industry and concludes that in order to enhance the performance in positive way firms need to concentrate on improving these variables. Saifullah (2010) determined the productivity and efficiency of banks using ratio model. Verma and Singh (2012) applied set of financial ratios to assess the significance of working capital on performance of Dabur limited and components of working capital.

Saiful and Bakar (2003) used ratios and found that Islamic banks have yielded greater return to asset and governing reason is the low overhead outgoings. It was interesting that this yield does not correspond to efficiency, as they need to build their entire operation especially financing in compliance with Sharia rules.

Moin (2008) probed the comparative financial performance of Meezan bank and conventional banks by using financial ratios and reported that profitability, risk and efficiency of Meezan bank are very low, though it has greater solvency position and liquidity was not significantly different from conventional banks with which it was compared and it is conferred that trends in Islamic banking performance are increasing and in near future would be belonging to them.

Subject to operating efficiency, business growth, profits and liquidity Islamic banking is found superior to traditional banking, as Islamic banking practices are humanized and it is accelerating in not only Muslim but also non-Muslim countries (Hassan &Dridi, 2010).
Akhtar, Raza, Orangzab and Akram (2011) analysed the efficiency trends in progress is Islamic banks of Pakistan and results reveal positive and improvements in financial position. Sanobar and Anjum (2013) have investigated the studies on technical efficiency of Indian banking sector during last fifteen years and discussed the major findings. The study suggests that in Asian countries there is a need to conduct research on efficiency of decision making units because there are nominal work been done so far.

Mokhtar, Abdullah, and Alhabshi (2008) investigated the efficiency of Conventional and Islamic banks of Malaysia for a period of 1997-2003 and it is examined that conventional bank showing greater efficiency compared to well-established Islamic banks.

Widagdo and Ika (2008) have investigated the financial performance of Indonesian Islamic and conventional banks that what is the difference in performance of said banks prior and post fatwa released in 2004 with the help of set of financial ratios. The empirical results have shown the difference in performance but this difference in not statistically significant.

Derbali and Hallara (2013) explored the profitability indicators of Tunisian banks during 1999-2011 by using two commonly used ratios; net interest margin and return on equity as proxy for measurement of profitability and determined the effect of internal and external factors which have an influence upon profitability. The empirical results show a positive effect of size, composition of assets, credit risk concentration, market capitalization and crisis on profitability if it is termed as NIM and ROA.

Samad (2009) empirically tested the managerial and operational efficiency of an Islamic and a set of conventional banks of Malaysia, found that conventional banks are superior in managing the operations and there is no significant difference in case of productive efficiency.

3. Methodology

The ratio model is a suitable tool for evaluating the financial performance of banks and to draw the comparisons thereon. So, ratio tool is used in the study to comparatively analyse the operational efficiency of Pakistani and Malaysian Islamic banks for the span of six years from 2006 to 2011.

3.1 Model Description

Figure 1 has depicted the relationship between Operational Efficiency and its three dimensions; assets utilization, income to expense and operating efficiency.

3.2 Operational Efficiency

How effective and efficient is management in utilizing and controlling its physical and financial assets in generating revenues, maintaining asset quality and ensuring sound liquidity in prompt payments to vendors, effectively managing inventory, receivables and curtailing operating expenses, is measured by efficiency ratios. High efficiency ratios are an indication that management is committed, devoted and ethically utilizing economic possessions as to best capacity in yielding revenues and mitigating expenses. The operational efficiency of selected Islamic banks is assessed on the basis of Assets Utilization Ratio (AU), Income to Expense Ratio (ITE) and Operating Efficiency (OE).

3.3 Hypothesis

H₀(a): There is no difference in operational efficiency of Pakistani and Malaysian Islamic bank.

H₀(b): The Pakistani Islamic bank are relatively efficient than Malaysian Islamic banks.

H₀(c): There is an improvement trend in Pakistani Islamic banks efficiency.

H₀(d): There is an improvement trend in Malaysian Islamic banks efficiency.

3.4 Sampling, Data and Statistics

In this study five Islamic banks from Pakistani banking industry; Meezan Bank Limited, Dubai Islamic Bank Pakistan Limited, AlBaraka Bank (Pakistan) Limited, BankIslami Pakistan Limited and Burj Bank Limited and five Islamic banks; Bank Islam Malaysia Berhad, Bank Muamalat Malaysia Berhad, Affin Islamic Bank Berhad,
AmIslamic Bank Berhad and Hong Leong Islamic Bank Berhad were conveniently chosen from Malaysian Islamic banking industry. Financial statements from the Annual reports of respective Islamic banks are used to obtain data pertaining to the period 2006 to 2011. Data description is done through mean, standard deviation and coefficient of variation and t-test is applied to examine the significant differences in performance.

4. Data Analysis and Discussion

4.1 Operational Efficiency

4.1.1 Assets Utilization Ratio (AU)
Table 1 reflects the AU ratio of PIB and MIB for the period and on the basis of t-statistics rejected $H_{(a)}$ indicating a significant difference in performance. To examine the level of this significance $H_{(b)}$ is tested and accepted. It reveals that PIB have better utilized their assets compared to MIB. Inferences are consistent with descriptive statistics that declared PIB comparatively more efficient (Hassan & Dridi, 2010) in utilizing their asset as mean AU is 0.0805 and also consistently doing so. On the other hand MIB’s AU mean is less than PIB with greater deviation and CV, which indicates that they could not utilize assets to their full potential. The assets utilization difference has also been portrayed in figure 2.

4.1.2 Income to Expense Ratio (ITE)
Table 1 expresses the ITE ratio of PIB and MIB, reported ups and downs in performance and average ITE for PIB is 2.5332 which is less than the mean ITE if MIB. A minute variation has been observed for ITE as evident from CV. On the basis of t-statistics $H_{(a)}$ is rejected, that reflects a significant difference in the ratio for IBs of both countries, that’s why $H_{(b)}$ is tested and is being rejected as well. Its rejection reveals that MIB have comparatively maintained better ITE over the period. So, MIB are efficient compared to PIB but MIB are not consistently maintaining this ratio while PIB are found comparatively consistent that is contrasting Mokhtar (2008). The mean ITE ratio of Pakistan and Malaysian IBs is expressed graphically in figure 3 which clearly reflects the high performance of MIB management.

4.2 Operating Efficiency Ratio (OE)
Table 1 portrays the OE ratio of PIB and MIB and it is noted that both set of Islamic banks have shown mixed operating efficiency (Samad, 2009). Mean OE for PIB is 0.4017 that is greater than the mean OE if MIB which is 0.3253. Almost same standard deviation for PIB and MIB reflect the stability in operating efficiency but on the basis of mean value PIB are not more efficient than MIB. So, the results yielded by CV hint greater variation in efficiency trends for MIB and comparatively less for PIB. Rejection of $H_{(a)}$ demonstrates a significant difference in performance, that’s why $H_{(b)}$ is tested and accepted on laid down criteria. It states that OE ratio is high for PIB that is not a good sign and showing operational inefficiencies. On the other hand MIB are efficiently controlling operating expenses that is consistent with the findings of Hassan and Dridi (2010) and PIB fail to do so and results are favouring Saiful and Bakar (2003) and Moin (2008) that PIB are inefficient. Figure 4 has presented the mean OE ratio for the period and it is quite high for PIB.

4.2.3 Efficiency Trends
Figure 3 has portrayed the trends in operational efficiency indicators (AU, ITE and OE) of Pakistani and Malaysian Islamic banks over the period of six years from 2006 to 2011. Pakistani and Malaysian Islamic banks although utilized their assets at best capacity and on average AU ratio is relatively high for PIB but AU curves are almost straight which demonstrate a steady performance with not any noticeable improvement. The ITE curve shows that the Pakistani and Malaysian IBs have maintained sound income to the expenses ratio but a downward trend is observed in ITE curve for MIB whereas it has moved positively for PIB, indicates that the management of PIB is striving to ensure efficient operations by controlling operating expenses or maintaining improved profitable operations. The ITE curve has downward slope in case of MIB that alarms management to take corrective measures. The operating efficiency curves are revealing the stagnant performance for both streams with slight upswing in case of MIB while as it remained straight for PIB.

For first three years the OE ratio of the PIB have remained ahead to MIB but during 2011 OE curve of MIB has cut PIB OE curve and reported superior operation. It is concluded that relatively Malaysian IBs are operating efficiently but the expenses are also increasing while in case of Pakistan efficiency has improved over the period though the OE ratio was well ahead to MIB in early years.

5. Conclusion and Recommendations

5.1 Conclusion
Research findings have demonstrated that PIB are efficient in utilizing their assets to full capacity and MIB are not much focused on this facet. The only area in which PIB need to ponder over is to control the operating...
expenses, and utilize such sacrifices at their best to generate revenues. MIB have control over their expenses, and that is the core reason of being profitable. Operating efficiency for both has enhanced over the period and this improvement is supplemental for MIB that does not favour Fayed (2013). PIB are better in utilizing their assets, while regarding ITE ratio MIB have ensured high position. OE for PIB has been reported high, indicates that operational expenses are out of their control. PIB are utilizing asset very well but MIB are more efficient as they have command over controlling operating expenses.

Malaysian Islamic banks have shown comparatively efficient operation subject to income-expense ratio and operating efficiency while PIB have good assets utilization potential; however, these trends are tuning out in unfavourable directions for both sets. The only factor they need to retrench is the volume of operating and administrative expenses and these outflows required to be fully utilized to generate revenue.

5.3 Recommendations

On the basis of research findings and conclusions it is noticed that the Malaysian Islamic banks have yielded higher efficiency and Pakistani Islamic banks are tumbling at counterpart. One reason is that MIB are fully supported by government, who has launched full-fledged Islamic banking system parallel to conventional banking. While most of the Islamic banks operating in Pakistan are in private hands. Due to non-public ownership they are reluctant to formulate the risky and profitable policies. They are striving to play safe and that is the embedded reason of low efficiency. It is suggested that Islamic banking should fully be assisted by Pak government, so that they may have abundance of equitable funds and their administrators and policy makers may reframe the risk aversion policies and become courageous in taking aggressive and profitable steps.

It is suggested that Malaysian Islamic banks management required utilising assets at optimal capacity to bring an improvement in AU ratio. Although MIB are relatively efficient but the trend lines are declining and focus may be paid to probe the adverse trends and to take corrective measures. The PIB need to keep improving ITE and also attention may be paid toward positive assets utilization as well.

To make Pakistani Islamic banking catchier, worthwhile and to stimulate the desire and demand for Islamic banking for the public, seminars and conferences may be arranged at national level. In Pakistan there are only five full-fledged Islamic banks and it is suggested that like Malaysia, Islamic banking network needs to be expanded and at government level serious steps required to give lasting life to Islamic financial institutions.
References


Appendices

Figure 1 has depicted the relationship between Operational Efficiency and its dimensions.

Figure 4: Average Asset Utilization Ratio of Pakistani and Malaysian Islamic Banks
Figure 5: Average Income to Expense Ratio of Pakistani and Malaysian Islamic Banks

Figure 6: Average Operating Efficiency Ratio of Pakistani and Malaysian Islamic Banks
Table 1: Descriptive statistics and efficiency indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Bank</th>
<th>Mean</th>
<th>S.D</th>
<th>CV</th>
<th>t</th>
<th>Remarks</th>
</tr>
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<tbody>
<tr>
<td>AU</td>
<td>PIB</td>
<td>0.0805</td>
<td>0.0090</td>
<td>0.1118</td>
<td>4.3501</td>
<td>$H_{0(a)}$ Rejected $H_{0(b)}$ Accepted $H_{0(c)}$ Rejected $H_{0(d)}$ Rejected</td>
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<tr>
<td></td>
<td>MIB</td>
<td>0.0512</td>
<td>0.0173</td>
<td>0.3379</td>
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<td>$H_{0(a)}$ Rejected $H_{0(b)}$ Accepted $H_{0(c)}$ Rejected</td>
</tr>
<tr>
<td>ITE</td>
<td>PIB</td>
<td>2.5332</td>
<td>0.3602</td>
<td>0.1422</td>
<td>5.9125</td>
<td>$H_{0(a)}$ Rejected $H_{0(b)}$ Rejected $H_{0(c)}$ Accepted $H_{0(d)}$ Rejected</td>
</tr>
<tr>
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<td>MIB</td>
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<td>0.4718</td>
<td>0.1501</td>
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<tr>
<td>OE</td>
<td>PIB</td>
<td>0.4017</td>
<td>0.0588</td>
<td>0.1464</td>
<td>3.9144</td>
<td>$H_{0(a)}$ Rejected $H_{0(b)}$ Rejected $H_{0(c)}$ Accepted $H_{0(d)}$ Rejected</td>
</tr>
<tr>
<td></td>
<td>MIB</td>
<td>0.3253</td>
<td>0.0577</td>
<td>0.1774</td>
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<td>$H_{0(a)}$ Rejected $H_{0(b)}$ Rejected $H_{0(c)}$ Accepted</td>
</tr>
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</table>

Source: Calculations on the basis of secondary data