Saudi Journal of Business and Management Studies (SJBMS) **ISSN 2415-6663 (Print)**
Scholars Middle East Publishers **ISSN 2415-6671 (Online)**
Dubai, United Arab Emirates
Website: http://scholarsmepub.com/

Comparative Analysis of Islamic and Conventional Banks

Mrs. Elham Qawariri[1*], **Mrs. Zertaj Fatima**[2]
[1,2]Community College for Girls, Jazan University, in Jazan, Saudi Arabia

***Corresponding author**
Mrs. Elham Qawariri

Article History
Received: 22.11.2017
Accepted: 27.11.2017
Published: 30.12.2017

DOI:
10.21276/sjbms.2017.2.12.4

Abstract: Saudi banks under the guidance of SAMA, had expanded their branch network, introduced stronger management methods and new technologies, raised new capital, improved their profitability and set aside large provisions for doubtful accounts. The aim of this paper is to analyze the capital adequacy ratio and its impact on Saudi Arabian Banking Sector. We compared the Capital Adequacy Ratio of Islamic and Conventional banks listed in Tadawul Stock. After analyzing the financial statements of the banks for five years (2013-2017) the present study concluded that. Alinma Bank had the highest mean among the Islamic Banks while Samba Bank had the highest mean among the Conventional Banks. The present study also studied the BASEL III norms of banks in Saudi Arabia. The two-way ANOVA test was applied to evaluate the financial performance of Islamic and Conventional Banks. Our results also indicate that there was no significant difference between the Capital Adequacy Ratio of the Islamic and selected Saudi Conventional Banks.

Keywords: Saudi Arabian Banking Sector, Capital Adequacy Ratio, Financial Statements, Islamic, Conventional and Tadawul Stocks.

INTRODUCTION

Capital Adequacy Ratio of a bank

The method of using various ratios to measure capital competence is a method of Capital Adequacy.

If the CAR ratio is good it will boost the confidence of the depositor. This parameter also helps to analyze whether the banks comply with regulations and it also pertains to risk-based net worth requirement of a bank.

Saudi Arabian Banking Sector

The Saudi Arabian Banking Sector comprised of 12 domestic and 12 foreign banks. The domestic nationalized banks are again classified into 4 Islamic and 8 Conventional banks. The Banks in Saudi Arabian banking sector provides different types of retail and wholesale banking products and services. Four of them namely, Al Rajhi Bank, Bank Al Bilad, Al Jazira and Alinma Bank claim full compliance with Sharia's law in the dealings of all their products and services. The remaining eight banks provide a combination of Sharia's compliant and conventional banking products and services. The Saudi Banking Sector had significantly expanded its services over the past decades to include Murabaha (a structure in Islamic Finance in which an intermediary buys a property with free and clear title), speculation, participation securitization and forward contracts.

Banks have also made significant advances in their performance in asset management services, such as portfolio investment accounts and investment funds that target stocks and bonds of the local, regional and international market, money market instruments, and real-estate investment. Hence, as a result of huge developments in the banking sector, several international institutions strongly endorsed the practices and banking system of Saudi Arabia, which also contributes to the growth of Saudi Arabia's economy and its financial stability.

Saudi Arabian Monitory Agency

Saudi Arabian Monitory agency known as SAMA controls the banking sector as a central bank of the Kingdom of Saudi Arabia, which was established in 1952. SAMA has played a secured role in ensuring that the financial institutions under its supervision deal with consumers honestly and fairly.

Table-1: Banking Laws Governed by SAMA

s.no	Title	Published Date
1.	Anti-Forgery Law	03/11/2015
2.	Anti-Money Laundering Law	25/06/2014
3.	Credit Information Law	03/03/2014
4.	Anti-Money Laundering Law (AML)	24/11/2012
5.	Charter of the Saudi Arabian Monetary Agency	02/12/2008
6.	Currency Law	29/11/2008
7.	Banking Control Law	29/11/2008
8.	Banking Control Law	11/06/1966

(Source: SAMA, 2017)

Capital Adequacy Ratio (CAR)

SAMA has introduced a common standard for Capital Adequacy based on BIS Capital Adequacy standards. The SAMA standards recommend a minimum 8% ratio of capital to risk weighted assets, including off-balance sheet risk. Assets are categorized into four risk groups carrying varying risk weights according to the risk assessment of the counterparty. There are also two levels of country risk; one is of low risk, while the second is of higher risk. The Kingdom falls within the low risk countries. The SAMA standard considers the low risk countries to include all the gulf council states as well as the member countries of the Organization for Economic Cooperation and Development ("OECD") and others that have special lending arrangements with the International Monitory fund under its general agreement relating to borrowing. Whereas according the standard of BIS only Saudi Arabia, not all the GCC countries, is considered a low risk country. The other major difference is that the SAMA standard accounts for mortgage loans as 100% risk as opposed to 50% under BIS standards. Deposit liabilities of Saudi Banks are limited to 15 times capital and reserves. In cases where this ratio is exceeded, Saudi banks have to place interest free deposits of half the excess amount with SAMA. Furthermore, 25% of net profits have to be transferred to statuary reserves until the reserve balance equals paid-up capital. SAMA has issued a number of circulars relating to the implementation in the kingdom of the Basel committee's proposed reforms in late 2010in respect of Capital Adequacy requirements for banks.

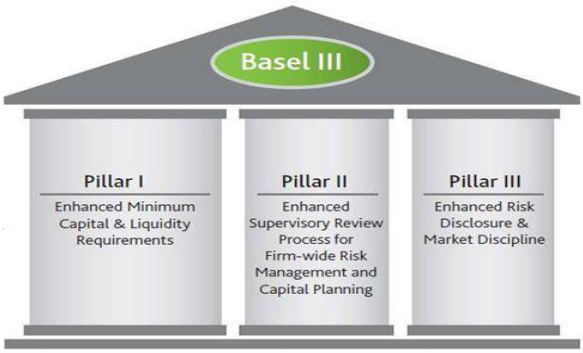

Fig-1: BASEL III Framework
(Source: www.iasgs.com)

In response to the global financial crisis which commenced in 2007, the BCBS enhanced its capital measurement and capital standards by issuing the Basel III Framework. The Basel III Framework focuses on strengthening the quality of regulatory capital, raising the minimum capital requirements, enhancing risk coverage and reducing the impact of the economic cyclicality on the regulatory capital.

It introduces new leverage and liquidity ratio requirements and capital buffers to promote the buildup of capital. These enhancements are to be implemented by means of a staggered approach up to 2019. Since 2011, SAMA had introduced main standards of the Basel III Framework in accordance with the time lines approved by the BCBS. This included the introduction of the leverage ratio in 2011, the liquidity ratio in 2012 and the Capital Adequacy Ratio in 2013. The leverage and liquidity ratios are currently being monitored for Saudi Banks in accordance with SAMA's phase-arrangements. The Basel III framework requires Saudi Banks' exposures to be backed by a high quality capital base. To this end, the predominant form of Tier 1 capital must be common shareholder's equity which is the highest "Loss Absorbent" through the following measures: improving the quality of Tier 1 capital and increasing its minimum requirements: charging with any withholdings from the regulatory capital to the common equity: The gradual cancellation of the mixed instrument which are (limited laws absorbents) of Tier 2

components of the regulatory capital: and increasing the levels of transparency through full disclosure of the components of the regulatory capital and comparing them to the shareholders' equity. After completing the implementation of Basel III standards related to capital, the minimum requirements for the regulatory capital will be as follows: common Equity Tier 1 must be at least 4.5% of risk-weighted assets at all times: tier 1 Capital must be at least 6.0% of risk-weighted assets at all time: and total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of risk-weighted assets at all times.

LITERATURE REVIEW

Examined in his research how the bank's capital creates liquidity for the bank. Due to fact that deposits are most fragile and prone to bank runs hence, greater bank capital reduces the chance of distress [1].

Empirically examined how Capital Adequacy Ratio shows the internal strength of the bank to withstand losses during crisis [2]. Nevertheless, it is not without drawbacks because it induces weak demand for liability, but the source of fund Capital Adequacy is the level of capital required by the banks to enable them to withstand such as market, credit and operational risks they are exposed in order to absorb the potential losses and protect the bankdebtors. In their research examined how the capital is one of the banks specific factors which influence the level of bank profitability and the bank performance has a positive relationship with the bank's profitability [3, 4].

Empirically examined how the Capital Adequacy Ratio is directly proportional to the resilience of the bank during crisis and that the CAR directly affect the profitability of banks by determining its expansion too risky, but profitable ventures or areas [5]. The adequacy of capital is judged on the basis of Capital Adequacy Ratio (CAR) was investigated by Dang [6].

Rosly and Abubaker [7] in their research found that Islamic banks are less efficient due to large scale effect enjoyed by the conventional banks. This cannot be a robust reason as evidenced in the case of small-sized banks fair better than the large-sized ones.

Makhtar *et al.* [8] in their research have also concluded that Islamic banks are less efficient than Conventional banks. Shadi [5] and Akhter *et al.* [9] reviewed that there is no significant difference between both bank types. But in the highly developed Islamic banking industry of Malaysia, the foreign Islamic banks are less efficient than the domestic Islamic banks.

Al-Jarrah [10] investigated in his research how the Data Envelopment Analysis (DEA) approach is used to investigate cost efficiency levels of banks operating in Saudi Arabia, Bahrain, Egypt and Jordan in the period 1992-2000. The result suggested that the same level output could be produced with approximately 50-70% of their current inputs if banks under study were operating on the most efficient frontier.

Almazari and Almumani in their research studied capital adequacy of listed banks in Saudi Arabia in the period 2007 to 2011, they found that capital adequacy and interest risk, liquidity risk and return on assets were positively correlated while credit risk, capital risk and return on equity, earning power were negatively correlated [11].

Alkhathlan and Malik [12] empirically examined the efficiency of Saudi banks by using Data Envelopment Analysis (DEA) models like; Banker-Charnes-Cooper (BCR) and Charnes-Cooper-Rhodes (CCR). The study reviewed 10/12 operating banks in Saudi Industry from 2003 to 2008. The empirical analysis showed that most of the Saudi banks have efficient financial resources by 93.97% and 86.17% as BCR and CCR approached respectively.

OBJECTIVES OF THE STUDY

- To compare the efficiency of Islamic and Conventional Banks in terms of Capital Adequacy Ratio.
- To evaluate the impact of Capital Adequacy Ratio on Saudi Arabian Banks performance.

LIMITATIONS OF THE STUDY

The Saudi Arabian Banking Sector has been classified into four fully Shariah Compliant Banks and the remaining eight Conventional Banks. Only four banks were chosen from Conventional Banks in order to compare with four Islamic Banks for this study.

RESEARCH METHODOLOGY

Methodology

The difference of total assets and total liabilities is known as Capital Adequacy Ratio which is also known as CAR indicates the ability of the banks could be honoured.

$$CAR = \frac{\text{Capital Funds (i.e. Tier I capital + Tier II capital)}}{\text{Risk Weighted Assets}} \times 100$$

Tier I= Losses without a bank lease trading.
Tier II= which absorbs losses in the event of windup.
Risk weighted assets= Operational Risk + Credit Risk + Market Risk.

The Statistical tools used in the presence study are Average mean, Standard deviation, Maximum, Minimum and Two Way ANOVA for analysis and Interpretation.

Data Collection

The secondary data has been gathered from banks websites and also from Argaam financial statements for banking sector of Saudi Arabia.

Sample Size

The present study analyzes the financial statements of 4 Islamic Banks and 4 selected Conventional Banks from Saudi Arabian Banking Sector.

Period of the Study

The first four years financial data had been collected from annualized financial statements whereas the current year (i.e. 2017) financial data had been collected from the Q2 financial quarterly report of the banks.

ANALYSIS AND INTERPRETATIONS

Table-2: Table showing Capital Adequacy Ratio of Islamic and Conventional Banks

Banks/Years	2013	2014	2015	2016	2017	Average	S.D	Max	Min
Al Rajhi	19.6	19.59	20.83	21.98	22.13	20.826	1.23115	22.13	19.59
Al Jazeera	15.01	14.05	15.83	19.86	20.75	17.1	3.009302	20.75	14.05
Alimna	28	26	23	21	20	23.6	3.361547	28	20
Albilad	17.14	16.71	15.88	20.11	19.26	17.82	1.787163	20.11	15.88
Riyad bank	17.1	17.3	18.4	18.6	18.1	17.9	0.667083	18.6	17.1
BSFR	15.58	17.26	17.08	17.78	17.74	17.088	0.8955	17.78	15.58
NCB bank	17.1	17.2	17.2	19.2	18.2	17.78	0.91214	19.2	17.1
Samba bank	19.4	19.9	20.1	22.5	19.7	20.32	1.245793	22.5	19.4

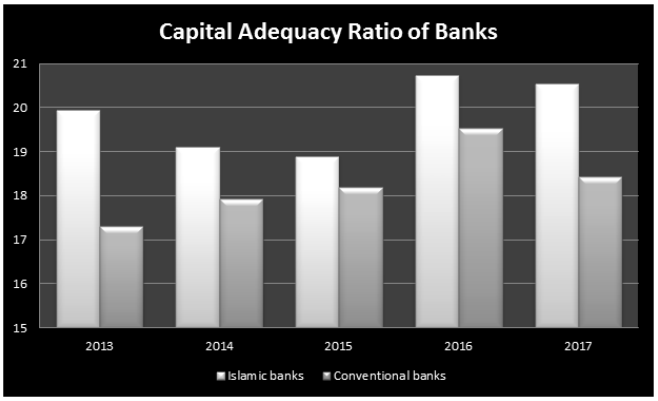

Fig-2: Capital adequacy ratio of banks

In the comparison of Capital Adequacy Ratio from the financial statements of the banks, the above table depicts that Alinma Bank maintains the highest position in the period Dec 2013 to Dec 2015, whereas in the period of Dec 2016 to June 2017 it shows that Al Rajhi Bank gains the highest position among the Islamic Banks in Saudi Arabian Banking Sector.

In the comparison of the selected conventional Saudi Arabian banks, the above table shows that SAMBA bank is the only bank which has got the highest position of attaining a Capital Adequacy Ratio for the duration of annual financial statements from Dec 2013 to June 2017.

H_0: There is no significant difference between the Capital Adequacy Ratio of Islamic and selected conventional banks in Saudi Arabian banking Sector.

Table-3: ANOVA (Two Factors with Replication)

SUMMARY	2013	2014	2015	2016	2017	Total
Islamic banks						
Count	4	4	4	4	4	20
Sum	79.75	76.35	75.54	82.95	82.14	396.73
Average	19.9375	19.0875	18.885	20.7375	20.535	19.8365
Variance	32.40803	26.35469167	13.02643	0.925492	1.5007	12.30269
standard error	2.846402	2.566841038	1.804608	0.481012	0.612515	
Conventional banks						
Count	4	4	4	4	4	20
Sum	69.18	71.66	72.78	78.08	73.74	365.44
Average	17.295	17.915	18.195	19.52	18.435	18.272
Variance	2.482767	1.7529	1.9681	4.2856	0.750233	2.337196
standard error	0.78784	0.661985649	0.701445	1.035085	0.43308	
Total						
Count	8	8	8	8	8	
Sum	148.93	148.01	148.32	161.03	155.88	
Average	18.61625	18.50125	18.54	20.12875	19.485	
Variance	16.94828	12.43889821	6.562257	2.656841	2.224686	

Table-4: ANOVA

Source of Variation	SS	Df	MS	F	P-value	F crit
Sample(banks)	24.4766	1	24.4766	2.86427	0.100929	4.170877
Columns(years)	16.81762	4	4.204404	0.492002	0.741585	2.689628
Interaction	4.975335	4	1.243834	0.145554	0.96356	2.689628
Within	256.3648	30	8.545494			
Total	302.6344	39				

(Compiled by Authors)

Interpretations

As the 'F' calculated value is lower than the 'F' critical value at 5% level of significance in the table, the Null hypothesis (H_0) is accepted and hence it can be concluded that there is no significant difference between the Capital Adequacy Ratio of the Islamic and selected Conventional banks in Saudi Arabian banking Sector. The p-value is also greater than the 0.05 level of significance. The results indicate that there is no significant difference between the Capital Adequacy Ratios of Islamic and Conventional banks of Saudi Arabian Banking Sector.

FINDINGS AND CONCLUSION

After comparing the Capital Adequacy Ratios of Islamic and conventional banks in Saudi Arabian Banking Sector this study concludes that there is no significant difference in their efficiency. The annual financial statement of year 2016 shows the overall growth of the Saudi Arabian Banking sector.

Few of them were as follows

- Capital adequacy Tier I ratio posted 17.6%, whereas the Capital Adequacy Tire I + Tier II ratio came in at 19.7%, which is exceeding the requirement limit by SAMA.
- In terms of liquidity, it remained at a high level as total cash jumped 27% in 2016.
- The three large banks (NCB, Al Rajhi, and Samba) possessed 45% of the banking deposits, with market shares of 19%, 16% and 10% respectively. While the other nine banks shared the remaining 55% of the market deposits.
- Al Rajhi and NCB acquired nearly 42% of the sector profitability

But the case will be different in banking sector of other countries, like Indian Banking Sector which consists of a vast number of conventional banks and a few selected Islamic banks. As per the market conditions in the Middle East Banking Sector, the Islamic Banks are also fully efficient in regard to performance of Capital Adequacy Ratio. Whereas the market conditions in Asian and European Banking Sector has very fewer Islamic Banks in compared to a vast presence of Conventional Banks.

Evaluation of banks performance is a process which needs continuous development and improvement in order to compete with the increasing demands of customers. Thus, as per current research in the current financial years Quarter two financial statements, the Capital Adequacy Ratio of Islamic Banks stood up to 20% and the Conventional Banks Capital Adequacy Ratio was also near to 20%.

Further, the present research concludes that, all the banks in Saudi Arabian banking sector whether it is Islamic or a Conventional bank attained minimum Capital Adequacy Ratio and the impact of Capital Adequacy shows the Saudi banking sector falls in low risk countries.

REFERENCES

1. Morgan, D., Diamond, D. M., Gottschall, P. E., Ugen, K. E., Dickey, C., Hardy, J., & Connor, K. (2000). Aβ peptide vaccination prevents memory loss in an animal model of Alzheimer's disease. *Nature*, *408*(6815), 982-985.
2. Aburime, T. (2008). Determinants of bank profitability: company-level evidence from Nigeria.
3. Flamini, V., Schumacher, M. L., & McDonald, M. C. A. (2009). *The determinants of commercial bank profitability in Sub-Saharan Africa* (No. 9-15). International Monetary Fund.
4. Ongore, V. O., & Kusa, G. B. (2013). Determinants of financial performance of commercial banks in Kenya. *International Journal of Economics and Financial Issues*, *3*(1), 237.
5. Nazir, T. (2010). Analyzing Financial Performance of Commercial Banks in India: Application of CAMEL Model. *Pakistan Journal of Commerce & Social Sciences*, *4*(1).
6. Bukhari M. S Silah, Imran Khokhar, Muhammad Nauman Khan. (2014). The Performance of Saudi Banking Industry 2000-2011: Have the Banks Distinguished Themselves from One Another? *International Journal of Financial Research , 5 , 2*. by Sciedu Press121.
7. Zehri, C., Abdelbaki, A., & Bouabdellah, N. (2012). Effects of the current financial crisis on Islamic banks compared to conventional banks. *Banks and Bank Systems*, *7*(1), 83-93.
8. Mokhtar, H. S. A., Abdullah, N., & Alhabshi, S. M. (2008). Efficiency and competition of Islamic banking in Malaysia. *Humanomics*, *24*(1), 28-48.
9. Akhter, I., Sheikh, Y., Khan, S., & Kanade, T. (2011). Trajectory space: A dual representation for nonrigid structure from motion. *IEEE Transactions on Pattern Analysis and Machine Intelligence*, *33*(7), 1442-1456.
10. Al-Jarrah, M., Pothakos, K., Novikova, L., Smirnova, I. V., Kurz, M. J., Stehno-Bittel, L., & Lau, Y. S. (2007). Endurance exercise promotes cardiorespiratory rehabilitation without neurorestoration in the chronic mouse model of Parkinsonism with severe neurodegeneration. *Neuroscience*, *149*(1), 28-37.
11. Ahmed Aref Almazari. (2014). Impact of Internal Factors on Bank Profitability: Comparative Study between Saudi Arabia and Jordan. *Journal of Applied Finance & Banking , 4 , 1*, 125-240. Scienpress Ltd.
12. Alkhathlan, K. A., & Malik, S. A. (2010). Are Saudi Banks Efficient? Evidence using Data Envelopment Analysis (DEA. *International journal of economics and finance*, *2*(2), 53.