Seref Turen
Performance and Risk Analysis of Islamic Banks: The Case of Bahrain Islamic Bank

Journal of King Abdulaziz University: Islamic Economics, Vol. 7, 1415/1995

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I have some general as well as specific comments on this paper. My general comments are concerned with the paper's overall theme and its conclusion while my specific remarks encompass my views on its methodology and the data. Let me begin with my general comments. For an objective comparison of the performance of two or more economic institutions it is essential that one identifies samples from the two populations on the basis of a similar set of economic, legal, institutional and operational criteria.

In my judgment the Islamic and the Western type of financial institution are quite different. Therefore, their performance outcomes are not quite comparable. I feel this way primarily because in performing of the two significantly important banking functions namely, raising and lending capital as well as many other operational characteristics, Islamic and Western banks represent two distinct and very different types of financial organizations. The author has also recognized the distinction between the two in the following statement "The risk level of an Islamic bank is the combined effect of the *three new statues* governing the operation of the institutions, namely deposit holders are replaced by equity holders, interest payments to depositors are converted into profit and loss sharing and loans to customers are transformed into capital participation" (p. 12).

Since the two groups of institutions, work under different set of rules, follow different mode of operations and draw investors and customers with different commitments, and expectations, the two groups constitute completely different populations. Hence, the outcomes of their operations cannot be considered comparable. Also, it is quite clear that if investors in BIB are rewarded with higher return without taking extra risks, somebody else must be paying for it. It is either the depositors who may not be receiving their fair share or the society at large whose long term interest may have been overlooked by BIB bank because of its over involvement in short-term quick return investments at the expense of long-term economic capital formation.

Let me now address the specific problems with methodology and the data that the author has used to demonstrate the superiority of BIB performance over all other.

Let me now address the specific problems with methodology and the data that the author has used to demonstrate the superiority of BIB performance over all other banks. While conducting a detailed analysis of the methodology and the data one is confronted with the absence of a detailed breakdown of the various items that compose the assets portfolio of BIB. In order to conduct a comparison of the profitability and the relative riskiness of assets of the two financial institutions one needs detailed data on their assets, balance sheet, income statements, sources and uses of fund, as well as rates of returns earned on various specific items of its portfolio. Since most of this information is privy to the organization one is forced to rely on indirect assessment of these data from secondary sources as well as on researcher's knowledge and experience. This indirect assessment and judgmental analysis leads us to the following conclusions with regards to the performance of BIB.

1. It is very likely that the bulk of BIB financing may have been concentrated to mark up Murabaha. This type of financing is known to be highly profitable and less risky. Also, in the PLS system of banking funds originate from three sources. These include, depositors, PLS Murabaha participants and original equity holders. However, the demand and short-term savings deposits are not entitled to any return. Yet the bank still has access to a substantial amount of these funds to finance and profit from short-term Murabaha contract. BIB may have used these funds. Earning above normal returns securing short-term funds at zero cost and using these funds on 100% full secured and colletorized short-term loans definitely places banks such as BIB at a comparative advantage over all other type of banks. Therefore, a fair and meaningful comparison between the rates of return of the two groups can only be carried out after one has eliminated that specific portion of the earnings which is attributed to the zero cost sources of funds, from the total earnings of the BIB. Since this was not done by the author the obvious result has been an exaggerated rate of return on the total portfolio.

2. I also have reservations about the way risk in BIB and other banks portfolios are measured. In the absence of detailed information on the breakdown of total assets into various components and the amount of exact Basle weights that are assigned to each as well as the absence of any economic and statistical analysis that can provide a rationale for using different weights in the calculation of an index for risk, the entire exercise appears to be arbitrary and subjective. A reference to Basel weights is not enough, one needs very strong theoretical and empirical evidence to support the assignment of say 100% weight to measure risk

in foreign currency holding as opposed to 60% to certain other type of assets say inventory financing.

3. A heavy concentration of investment portfolio in high return low risk short-term markup type of Murabaha financing also explains the reason for higher stable earning and therefore less volatility and higher prices for the shares of BIB on the stock market. This makes the BIB stock appear in 17 of the 30 least risky portfolios that the author has prepared from the data. This is evidently another reflection of the same makeup, heavy short-term concentration of loans in the BIB portfolio.

BIB's extraordinarily heavier involvement in short-term financing becomes further evident when one compares Table I and Table II in the paper. Table I shows a ratio of 1.92 for return on assets (ratio of net profits over total assets) for BIB as compared to a ratio of 1.26 for all other banks. However, the ratio of Gross income to risk weighted assets for BIB jumps up to 7.81 in comparison with the same ratio of 3.11 for all other banks. The 100% extraordinarily higher ratio of risk adjusted returns for BIB can only be explained by either a substantial under weighing of the denominator (lower risk adjustment) or an above average returns on loans (the numerator). Again, the lower denominator value as well as an above average value for the income may have been the result of a preponderance of very short-term inventory, trade or currency secured markup loans in the BIB portfolio.

To conclude, I would like to stress that a continuation of this type of financing although lucrative for the banks and their investors is quite unhealthy for the long-term progress of the Islamic banking as well as overall balanced growth of the economies of the countries which promote such short-term investments. Also, in order to make universally acceptable claims of - superiority we need an expansion of our research from few selected special situations to much broader populations which include institutions that provide financing for both short and long-term needs of the society.