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A B S T R A C T

We compare the efficiency of Islamic and conventional banks during the period 2004–2009 using data envelopment analysis (DEA) and meta-frontier analysis (MFA). The use of the non-parametric MFA allows for the decomposition of gross efficiency (i.e. the efficiency of banks when measured relative to a common frontier) into 2 components: net efficiency (the efficiency of banks measured relative to their own bank type frontier) and type efficiency (the efficiency which relates to modus operandi). This approach is new to the Islamic banking literature. The analysis is performed in two stages. The first stage employs DEA and MFA to compare banks on the basis of gross efficiency and its components (net and type). We find that Islamic banks are typically on a par with conventional ones in terms of gross efficiency, significantly higher on net efficiency and significantly lower on type efficiency. Second stage analyses, which account for banking environment and bank-level characteristics, confirm these results. The low type efficiency of Islamic banks could be attributed to lack of product standardization whereas high net efficiency reflects high managerial capability in Islamic banks. These findings are relevant to both policy-makers and regulators. In particular, Islamic banks should explore the benefits of moving to a more standardized system of banking, while the underperformance of conventional bank managers could be examined in the context of the on-going remuneration culture.

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1. Introduction

The recent financial crisis led to difficulties in many conventional banks across the globe. Islamic banks, in contrast, were largely insulated from the crisis (Willison, 2009; Yılmaz, 2009). It appeared that their highly regulated operational environment guided by Shariah principles prohibited investment in the type of financial products which adversely affected conventional banks and which prompted the crisis (Hasan and Dridi, 2010).

As a consequence, the traditional values of Islamic finance have increasing appeal to Western investors who are disillusioned with the banking practices of conventional banks in the wake of the global financial crisis (Arthur D Little Report, 2009). Islamic banks are therefore no longer limited to traditional Muslim regions: there are more than 300 Islamic financial institutions spread across 70 countries. Indeed, there are now 5 Islamic banks in the UK, and 19 Islamic financial institutions in the USA.

The success of Islamic banks relative to conventional banks in the macroeconomic environment, however, is in contrast to expectations of their performance (by which we mean technical efficiency) in a microeconomic context. Islamic banks

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1 We use the term conventional to refer to commercial banks not involved in Islamic banking products.

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might be expected to have lower technical efficiency than conventional banks for a number of reasons. First, the strict application of Shari’ah rules means that many of the Islamic banking products are bespoke thereby increasing operational costs. Second, Islamic banks are typically small compared to conventional banks (Chapra, 2007), and there is evidence that technical efficiency increases with size in the banking industry (see, for example, Miller and Noulas, 1996; Abdul-Majid et al., 2005a; Chen et al., 2005; Drake et al., 2006). Third, Islamic banks are typically domestically owned and there is evidence to support the contention that foreign-owned banks are more technically efficient than their domestically owned counterparts (see, for example, Sturm and Williams, 2004; Matthews and Ismail, 2006).

The rapid increase in Islamic banking, and the importance of the sector for the economies of some countries (for example, Malaysia, Bahrain and the United Arab Emirates) make it important to have a greater understanding of efficiency and its drivers. Indeed, given the international spread of Islamic banking practices, a study comparing the performance of Islamic and conventional banking is of widespread interest. Previous studies which specifically focus on the performance of Islamic banks relative to conventional banks are inconclusive in their findings. We therefore aim to fill a gap in the literature by investigating two questions to which previous studies have failed to provide adequate answers. First, which types of banks (Islamic or conventional) are more technically efficient? Second, what are the underlying reasons for any differences in efficiency between Islamic and conventional banks?

We focus our empirical study on countries with a substantial (at least 60%) Muslim population and where there are both Islamic and conventional banks in operation. Our analysis comes in two stages. In a first stage, we assume a degree of competition between Islamic and conventional banking sectors and compute (using a non-parametric approach) and directly compare the efficiency of 45 Islamic banks with 207 conventional banks across 18 countries over the period 2004–2009 (a period which covers the start of the global financial crisis). As part of this first stage, we adopt a meta-frontier approach (MFA) which decomposes efficiency into two components: one due to the modus operandi and one due to managerial competence at converting inputs into outputs. The use of non-parametric MFA is new to the Islamic banking context. In a second stage we investigate the determinants of the two components of efficiency (rather than just the overall efficiency) and are thereby able to uncover and discuss more effective ways in which managers and policy-makers can improve efficiency. The econometric investigation of the factors underlying all three types of efficiency is also new to the Islamic banking literature.

Our approach reveals new insights into Islamic banking efficiency. First of all, we find in the first stage that there is no significant difference in mean efficiency between conventional and Islamic banks when efficiency is measured relative to a common frontier. The decomposition of overall efficiency using a MFA, however, reveals some fundamental differences between the two bank types. In particular, the modus operandi in Islamic banking appears to be less efficient on average than the conventional one. Managers of Islamic banks, however, make up for this as mean efficiency in Islamic banks is higher than in conventional banks when efficiency is measured relative to their own bank type frontier. The differences, shown in this study, in relative performance of Islamic and conventional banks on gross efficiency and its 2 components perhaps provide an explanation of why the results of previous studies have provided apparently conflicting results.

A second-stage analysis verifies that differences between the two banking systems remain even after banking environment and bank-level characteristics have been taken into account. These findings are important and relevant to both policy-makers and regulators.

The paper is in six sections of which this is the first. Section 2 provides a brief literature review while a discussion of the methodological approaches to efficiency measurement is presented in Section 3. Section 4 describes the sample data and the empirical model, and results are presented and interpreted in Section 5. Conclusions and policy implications are discussed in Section 6.

2. Literature review

There is an abundant literature on the efficiency of banking institutions: detailed (albeit somewhat outdated) reviews can be found elsewhere (Berger and Humphrey, 1997; Berger and Mester, 1997; Brown and Skulky, 2002). A small subset of this literature focuses on Islamic banking either in isolation or in comparison to conventional banking (see Table 1 for details of studies which use frontier estimation methods to derive measures of efficiency). The remainder of this section will focus predominantly on the comparative literature.

We have previously hypothesized that Islamic banks will typically have lower efficiency than conventional banks. The evidence from previous empirical studies of Islamic and conventional banking is mixed: some find no significant difference in efficiency between the two types of banking (Abdul-Majid et al., 2005b; El-Gamal and Inanoglu, 2005; Mokhtar et al., 2006; Bader, 2008; Hassan et al., 2009; Shahid et al., 2010); some studies do not test whether observed differences in efficiency are significant and this is mainly due to small sample size (Hussein, 2004; Al-Jarrah and Molyneux, 2005; Said, 2012). One study (Al-Muharrami, 2008) claims that Islamic banks are significantly more efficient than conventional banks, but results of significance tests are not shown, and the result is based on a sample which only contains 7 Islamic banks. Only a small number of studies find, as expected a priori, that Islamic banks are significantly less efficient than conventional banks, but the possible reasons for the difference are not explored further (Mokhtar et al., 2007, 2008; Srairi, 2010).


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2 This is not an unreasonable assumption given the growing appeal of Islamic financial products, and given that large ratings agencies such as Moody’s have begun to get involved in Islamic finance (Alexakis and Tsikouras, 2009).
One group of studies deserves particular mention because they make a distinction between 'gross' and 'net' efficiency (Abdul-Majid et al., 2008; Johnes et al., 2009; Abdul-Majid et al., 2010, 2011a,b). Gross efficiency incorporates both managerial competence and efficiency arising from *modus operandi*; net efficiency isolates the managerial component and therefore provides a measure of managerial efficiency. In one study based on banks in Malaysia, gross efficiency scores are derived from a stochastic frontier analysis (SFA) estimation of a cost function which makes no allowance for various characteristics of each bank (including whether or not it is Islamic), while net efficiency scores are estimated by taking into account the operating characteristics of banks in the SFA cost function (Abdul-Majid et al., 2008, 2011a,b). Gross efficiency is found to be highest for conventional banks and lowest for Islamic banks, and the significance of the Islamic dummy in the cost equation including the environmental variables suggests that this difference is significant. There are, however, only slight differences in net efficiency between the different types of banks. The findings from this study are questionable for two reasons. First they are derived from an estimated cost function for a sample of Islamic and conventional banks, and this implicitly assumes an objective of cost minimization on the part of all the banks in the data set. Second, the estimation technique (SFA) applies the same parameters\(^3\) to all observations and hence does not allow for differences in objectives between the different types of banks in the sample.

\(^3\) This point is explained and discussed further in Section 3.

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**Table 1**
Islamic banking efficiency studies (frontier estimation approach).

<table>
<thead>
<tr>
<th>Context</th>
<th>Method</th>
<th>Studies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic banks are significantly more efficient than conventional banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GCC: Bahrain; Kuwait; Oman; Qatar; Saudi Arabia; UAE</td>
<td>DEA</td>
<td>Al-Muharrami (2008)</td>
</tr>
<tr>
<td>Islamic banks are significantly less efficient than conventional banks</td>
<td>SFA</td>
<td>Srairi (2010)</td>
</tr>
<tr>
<td>GCC: Bahrain; Kuwait; Oman; Qatar; Saudi Arabia; UAE</td>
<td>DEA</td>
<td>Mokhtar et al. (2007, 2008)</td>
</tr>
<tr>
<td>Islamic banks have (significantly) lower efficiency than conventional banks and it is predominantly a consequence of <em>modus operandi</em> rather than managerial inadequacies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 countries: Bahrain; Bangladesh; Indonesia; Iran; Jordan; Lebanon; Malaysia; Saudi Arabia; Sudan; Tunisia; Yemen</td>
<td>DEA</td>
<td>Abdul-Majid et al. (2010)</td>
</tr>
<tr>
<td>GCC: Bahrain; Kuwait; Oman; Qatar; Saudi Arabia; UAE</td>
<td>SFA</td>
<td>Johnes et al. (2009)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>SFA</td>
<td>Abdul-Majid et al. (2008, 2011a,b)</td>
</tr>
<tr>
<td>The efficiency of Islamic and conventional banks is compared, but the significance of any difference is not tested</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cross-country: Conventional banks in the USA and randomly drawn Islamic banks</td>
<td>DEA</td>
<td>Said (2012)</td>
</tr>
<tr>
<td>4 countries: Jordan; Egypt; Saudi Arabia; Bahrain</td>
<td>SFA</td>
<td>Al-Jarrah and Molyneux (2005)</td>
</tr>
<tr>
<td>Bahrain</td>
<td>SFA</td>
<td>Hussein (2004)</td>
</tr>
<tr>
<td>Studies of Islamic banks only</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 countries: Algeria; Bahamas; Bahrain; Bangladesh; Brunei; Egypt; Gambia; Indonesia; Iran; Jordan; Kuwait; Lebanon; Malaysia; Mauritania; Qatar; Saudi Arabia; Sudan; Tunisia; UAE; UK; Yemen</td>
<td>SFA DEA</td>
<td>Hassan (2005, 2006)</td>
</tr>
<tr>
<td>16 countries: Bahrain; Bangladesh; Egypt; Gambia; Indonesia; Iran; Kuwait; Malaysia; Pakistan; Saudi Arabia; Turkey; UAE; Qatar; South Africa; Sudan; Yemen</td>
<td>DEA</td>
<td>Sufian (2009)</td>
</tr>
<tr>
<td>12 countries: Algeria; Bahrain; Egypt; Gambia; Indonesia; Jordan; Kuwait; Malaysia; Qatar; Saudi Arabia; Sudan; UAE; Yemen</td>
<td>DEA</td>
<td>Yudistira (2004)</td>
</tr>
<tr>
<td>13 countries: Algeria; Bahrain; Bangladesh; Brunei; Egypt; Indonesia; Jordan; Kuwait; Malaysia; Qatar; Saudi Arabia; Sudan; UAE; Yemen</td>
<td>DEA</td>
<td>Viverita et al. (2007)</td>
</tr>
<tr>
<td>14 countries: Algeria; Bahamas; Bangladesh; Bahrain; Brunei; Egypt; Jordan; Kuwait; Malaysia; Qatar; Saudi Arabia; Sudan; UAE; Yemen</td>
<td>DEA</td>
<td>Brown (2003)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>SFA</td>
<td>Hassan and Hussein (2003), Saaid et al. (2003), Saaid (2005)</td>
</tr>
</tbody>
</table>

* The study includes both fully-fledged Islamic banks and conventional banks with Islamic windows.

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A later study by the same authors (Abdul-Majid et al., 2010) corrects the first problem by estimating an output distance function; the shortcomings of the SFA estimation technique, however, remain. This study, based on a sample of banks across 10 different countries, finds that the Islamic dummy is not a significant determinant of net efficiency; hence any inferior performance of Islamic banks is mainly due to the constraints under which they operate rather than the shortcomings of their managers.

Johnes et al. (2009) take a different approach by examining gross and net efficiency using an output distance function estimated using data envelopment analysis (DEA). They find (like Abdul-Majid et al., 2008, 2011a,b) that the lower performance of Islamic banks in the Gulf Cooperation Council (GCC) region is due to modus operandi rather than managerial incompetence.

These studies are interesting and offer a way forward in terms of isolating the underlying causes of the differing performance of Islamic and conventional banks. There is a need, however, for a comparison of efficiency between conventional and Islamic banks based on a large sample of banks using an approach which makes no underlying assumptions regarding the banks’ objectives, and which allows for inter-bank differences in outlook. It is also necessary to investigate the factors underlying the gross and net efficiency scores. Thus, it is not enough to know whether it is modus operandi or managerial inadequacies which underpin a bank’s performance; bank managers need to know how and to what extent their behaviour can affect their efficiency. A detailed second stage analysis of both gross and net efficiency scores will provide this information.

3. Methodology

Studying banking efficiency can be done in two possible ways: either by use of traditional financial ratio analysis (FRA); or by the distance function approach which leads to frontier estimation methods such as DEA and SFA. The pros and cons of FRA as a method of efficiency measurement are well known (Ho and Zhu, 2004; Hasan, 2005). In the context of Islamic banking, the most severe drawback is the assumption underlying financial ratios of cost minimization or profit maximization; these are unlikely to be the most pressing objectives in the context of Islamic banking (Abdul-Majid et al., 2010). The distance function approach, whereby a firm’s observed production point is compared to a production frontier which denotes best practice, does not assume any specific optimizing objective on the part of the firms, and is therefore our preferred method of approach.

It is worth reflecting upon our intention to compare directly the efficiency of Islamic and conventional banks. Critics argue that the objectives of the two banking systems differ so much that such a comparison is invalid: for example, conventional banks can be seen to be motivated only by profit; Islamic banks have additional objectives which encompass social value and ethical behaviour (in line with Shariah principles). Objections to a direct comparison can be rejected using one or other of two possible arguments:

(a) Conventional and Islamic banks increasingly compete in similar markets comprising customers who are seeking products which conform to their religious principles and customers who are not so constrained (Warde, 2010). Evidence cited includes: Islamic subsidiaries and/or windows opened by conventional banks; the availability of Islamic financial products outside of Islamic countries; the establishment of Islamic banks in non-Islamic countries; and the targeting of some Islamic products at all types of customers (Warde, 2010). Direct competition between the two bank types in the same markets allows a direct comparison between Islamic and conventional banks.

(b) In the event that the objectives and markets of the two types of banks are indeed different, we believe that it is still possible to make a direct comparison so long as the estimation method appropriately allows for differences between (and within) the banking systems. We have a choice of estimation methods, namely the parametric SFA or the non-parametric DEA (Majumdar, 1995; Coelli et al., 2005) both of which make the assumption that production units are comparable. While the general advantages and disadvantages of each of these are well-known one aspect must be emphasized. DEA, by estimating a frontier which envelops the observed production points with piecewise linear segments, allows each bank to have its own objectives as it will only be compared with banks of similar input and output mix. For example, a small Islamic bank, financing its loans using a balanced mix of equity and deposits, would not in DEA be compared with a large conventional bank with a different input–output mix financing its loans predominantly using deposits. Similarly, an Islamic bank mainly involved in sale and mark-up transactions will not be compared with one which undertakes joint venture finance as they will have different mixes of outputs. SFA, on the other hand, applies the same parameters to all observations in the sample. By choosing DEA rather than SFA as our estimation method in the first stage, we therefore overcome any criticism of pooling banks with different objectives as DEA only compares like with like.

The effectiveness of policies to improve bank efficiency depends on the source of inefficiency, for example, whether it is managerial incompetence or whether it is the banking system in which the bank operates. We adopt a meta-frontier methodology (similar to one introduced by Charnes et al., 1981) for decomposing the efficiency of banks into two components: one

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4 This is not an entirely original approach and there are examples in previous literature (see Section 2 for details).

5 A random parameter variant of SFA would also allow firms to differ in their objectives. But this method requires large numbers of degrees of freedom and can be difficult to fit in practice.

which is due to the *modus operandi*, i.e. the context in (or rules under) which the bank operates (namely conventional or Islamic); and one which is due to managerial competence at converting inputs into outputs within the context in which the bank operates. Whilst relatively new to the Islamic banking literature, this type of method has been applied in banking more generally (Bos and Schmiedel, 2003) as well as in other contexts including education, sport and the water industry (De Witte and Marques, 2009; Tiedemann et al., 2011; Wongchai et al., 2012).

The first stage decomposition can be illustrated by means of a simple example whereby we assume that each bank produces one output (for example loans) from one input (for example deposits). The hypothetical production points for a number of banks are plotted in Fig. 1. The boundary ABCDEFG envelopes all banks in the sample, and banks lying on the frontier are efficient relative to others. Bank Y lies inside the frontier and has an efficiency score of $0y/0y′$.

In order to assess the sources of inefficiency of bank Y, we need to consider each bank’s efficiency relative only to the banks of the same bank type. Let us assume that banks in the sample can be categorized into two types: type 1 (represented by crosses) and type 2 (represented by dots). The original boundary ABCDEFG is the *gross efficiency boundary*. HIDEFG is the boundary for type 1 banks, and ABCKL is the boundary for type 2 banks. We call these the *net efficiency boundaries*. Bank Y, a type 2 bank, has a net efficiency score of $0y/0y′$ which represents the proportion of output obtained by bank Y relative to the best possible output achievable by type 2 banks only and given bank Y’s input level. The distance between the net and gross boundaries measures the impact on output of bank type. The type efficiency score of bank Y is therefore $0y′/0y′′$ and indicates the impact on bank Y of operating under a type 2 system.

There are some potential problems with this approach but we have taken steps to minimize the effect of these. First of all, it should be clear from the previous exposition that the estimation of gross and net efficiencies is based on different samples of banks. Efficiencies calculated using DEA, which is a non-parametric method, are affected by sample size (Zhang and Bartels, 1998), and hence the results of the MFA can be biased when DEA is used to perform the calculations and comparisons (De Witte and Marques, 2009). In order to guard against this problem, we resort to bootstrapping methods to deliver bias-corrected efficiency scores which correct for sampling variability.\(^6\)

Second, the approach requires an assumption regarding concavity of the meta-frontier. A concave meta-frontier implies that points on the line segments of the gross efficiency frontier are feasible for both types of observations. In Fig. 1, for example, this means that since point C is obtainable by type 2 banks and point D is obtainable by type 1 banks, then points on the line joining C and D are attainable by both types of banks, but are currently not being observed because of some constraint or limitation of one or other of the two banking systems (not because of managerial inefficiency). A non-concave meta-frontier (Tiedemann et al., 2011) implies that the meta-frontier comprises entirely of line segments which are on either of the net efficiency frontiers. In Fig. 1, for example, line segment CD would not be part of the non-concave meta-frontier, but would be replaced by CJD. The effect of choice of concavity assumption on results is likely to be smaller the larger the

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\(^6\) Bias-corrected efficiencies are calculated using the homogeneous bootstrapping algorithm of Simar and Wilson (2008).
sample size. Both concave and non-concave meta-frontiers have been applied in the literature. For ease of estimation we assume a concave meta-frontier, as in Charnes et al. (1981).

Differences between Islamic and conventional banks in gross, net and type efficiency (respectively) might be a consequence of some other underlying characteristic(s) of each group of banks and not purely operation within the given system. Thus we intend to perform a second stage analysis which will ascertain the determinants of each efficiency component and which will include as one of the explanatory variables an indicator of bank type.

We use a (bank) random effects estimation approach with heteroscedasticity-corrected standard errors in our second stage analysis as recommended in recent work which compares various second stage approaches (Hoff, 2007; McDonald, 2009). This contrasts with previous studies which have adopted a Tobit regression approach (examples in the banking context include: Jackson and Fethi, 2000; Casu and Molyneux, 2003; Drake et al., 2006; Ariff and Can, 2008; Sufian, 2009). The choice of a Tobit model, however, is based on the premise that the dependent variable comprising DEA efficiency scores is a censored variable, whereas efficiency scores are not censored but are fractional data (McDonald, 2009), thus making Tobit analysis inappropriate.

4. Sample data and models

The empirical analysis presented in this study focuses on countries where at least 60% of the population is Muslim and where both bank types coexist. We include in the sample banks for which a complete set of data for the DEA model can be compiled using the data source Bankscope, for the period 2004–2009. This is an interesting time period over which to undertake this study as it also allows us to gain insights into the effects of macroeconomic turmoil and instability on the efficiency of the banking sector (two studies examine Islamic and conventional banks over the same period: Rokhim and Rokhim, 2011; Beck et al., 2013).

Banks are designated Islamic or conventional on the basis of the Bankscope definition, and conventional banks which operate Islamic windows are not included in our sample. Data for 252 banks (207 conventional and 45 Islamic) across 18 countries are extracted from the consolidated data in US dollars (USD) having been converted from own currencies by end of accounting year exchange rates. In addition, all variables are deflated to 2005 prices using appropriate deflators.

Both banking sectors (conventional and Islamic) in the sample countries are required to follow national and international regulatory requirements under the supervision of the banking authorities of their host country, and both bank types adhere to the same accounting standards (Alexakis and Tsikouras, 2009). Thus data should be consistent across the two bank types, and any discrepancy in practice (for example, Islamic banks must also conform to the requirements of the Shariah supervisory board) is allowed for in the first stage by the use of DEA.

4.1. First stage analysis: estimation of efficiencies

The choice of variables qualifying for the DEA model is guided by previous literature and data availability. We assume that banks perform an intermediary role between borrowers and depositors (Pasiouras, 2008) and that they use (i) deposits and short term funding, (ii) fixed assets, (iii) general and administration expenses and (iv) equity as inputs to produce (i) total loans and (ii) other earning assets.

Islamic banks do not offer loans in the same way as conventional banks, and so the term 'total loans' is a generic term used to encompass the equity financing products they use. Conventional banks earn money from the spread between lending interest and borrowing interest rates. Islamic banks have a similar spread which is defined in terms of profit share ratios between the entrepreneurs (borrowers) and the depositors (lenders). Fixed assets are included to represent capital input, while general and administration expenses are used as a proxy for labour input. While it may not be a perfect reflection of labour input, it is more easily available than better measures (e.g. employee numbers or expenditure on wages) and has been used in previous studies (e.g. Drake and Hall, 2003) where it is argued that personnel expenses make up a large proportion of general and administration expenses.

It has been suggested that an indicator of risk-taking should explicitly be incorporated into any model of banking efficiency (Charnes et al., 1990), and this aspect is likely to be particularly important in a context which compares Islamic and conventional banks where one would expect a difference in risk-taking behaviour (Sufian, 2006). There are several suggestions of measures of risk-taking activity. Some studies use off-balance sheet items (Pasiouras, 2008; Lozano-Vivas and Pasiouras, 2010) but this variable has the disadvantage that data are not widely available and the sample is consequently severely reduced by its inclusion. Other studies use equity which is more widely available; moreover bank attitudes to

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7 An alternative approach using data mining can be found elsewhere (Emrouznejad and Anouze, 2009, 2010).
8 Note that Bankscope moved to International Financial Reporting Standards (IFRS) from 2004 onwards, and so data should be comparable over time.
9 We cross-check the banks listed as ‘Islamic’ in Bankscope with other databases of Islamic banks including the International Finance Information Service (IFIS), the Islamic Development Bank (IDB) and Zawya.
10 The countries are: Bahrain; Bangladesh; Brunei; Egypt; Indonesia; Jordan; Kuwait; Malaysia; Mauritania; Pakistan; Palestine; Qatar; Saudi Arabia; Sudan; Tunisia; Turkey; United Arab Emirates; Yemen. Details of the number and type of banks included in the sample and population can be found here: http://www.lancs.ac.uk/people/ecajj/islamicbanking2013.htm.
11 These were calculated using data from World Development Indicators (WDI) and Global Development Finance (GDF).
holding equity have responded quickly to changes in the financial climate, and this makes it particularly attractive in a study which encompasses a period of financial crisis. Indeed, equity has been used to reflect risk in previous studies which have covered times of financial crisis: the East Asian crisis (Abdul-Majid et al., 2008), and the savings and loans crisis in the USA (Alam, 2001). We therefore feel that the variable equity captures the general attitudes towards risk (enforced or preferred) of the two types of banks over the period, and use it to reflect risk in our own study.

Descriptive statistics of the DEA variables are presented in Table 2. Over the whole period of study, the typical conventional bank has just over US $6000 million in total loans and US $2500 million in other earning assets. These are 1.5 and 3 times the values for Islamic banks (respectively). There has been growth in these output variables in both banking sectors over the period but this has slowed down (understandably given the world economic climate) towards the end of the period. Input variables are typically up to twice as big in the conventional compared to the Islamic banking sector.

4.2. Second stage analysis: determinants of efficiency

In a second stage, an investigation of the possible determinants of the different types of efficiency scores (gross, net and type) of the banks is undertaken. We consider two broad categories: the characteristics of the individual banks, and the banking context, over which managers have no control, and which is particularly relevant in cross-country studies (Dietsch and Lozano-Vivas, 2000; Lozano-Vivas et al., 2002). The proposed explanatory variables and their potential impact are discussed below. The effects of these variables have not all been explored in an Islamic banking context and so we draw on the conventional banking literature for inspiration in choosing variables. We consider eight variables to reflect bank-level characteristics.

• A binary variable to reflect whether or not the bank is classified by Bankscope as fully-fledged Islamic (ISLAMIC). This variable is included in the second stage to assess whether any differences in efficiency between the two types of banks remain after the economic environment and the bank’s own characteristics have been taken into account.

• A dummy variable to reflect whether the bank is listed on the stock market (LIST) and an interaction term between ISLAMIC and LIST (ISLIST). Listing on the stock market has been found to have a positive effect on efficiency in the context of conventional banks in Europe (Casu and Molyneux, 2003) but a negative effect in the context of Islamic banks (Yudistira, 2004) – hence the inclusion of both the listing dummy and interaction term.

• The value of a bank's total assets (ASSETS). Value of total assets is included to reflect bank size. Islamic banks are typically smaller than conventional banks and so it might be size which causes any observed differences in efficiency. Indeed, cost efficiency appears to be negatively related to size in the context of Islamic banks (Beck et al., 2013). We check for a non-linear relationship between efficiency and size by also including the square of ASSETS (ASSETSSQ).

• The ratio of loan loss reserves to loans (LOANLOSS/LOANS). This variable acts as a proxy for credit risk (the higher the loan loss reserves ratio the lower the credit risk). In managing increasing credit risk, banks may incur additional expenses to monitor their loans (Barajas et al., 1999) which might lead to lower efficiency; on the other hand, a lower ratio has been associated with increased profit margins (Miller and Noulas, 1997) and this may lead in turn to higher efficiency. Islamic and conventional banks may well manage credit risk differently, and this variable is included to capture any potential effect of that possibility. Previous evidence, derived from an analysis of conventional banks, finds no significant relationship between the ratio of loan loss reserves to loans and efficiency (Staiikouras et al., 2008).

• The ratio of total loans to total assets (LOANS/ASSETS) and the ratio of net loans to total assets (NETLOANS/ASSETS). Total loans are the sum of reserves for impaired loans (relative to non-performing loans) and net loans. By including both variables we obtain the effect on efficiency of the components of total loans. Thus the sum of the coefficients on these two variables will reflect the effect on efficiency of net loans (relative to total assets), and the coefficient on LOANS/ASSETS will indicate the effect on efficiency of the value of reserves for impaired loans (relative to non-performing loans): the greater are these reserves, the higher is the bank’s liquidity and hence the lower its exposure to defaults; on the other hand, the lower are

Note: All variables are reported in US $ millions at 2005 prices. The number of observations in each year is 45 Islamic banks and 210 conventional banks.

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Table 2
Descriptive statistics for the DEA input and output variables.

<table>
<thead>
<tr>
<th>All years</th>
<th>Conventional</th>
<th>Islamic</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Median</td>
<td>SD</td>
</tr>
<tr>
<td>Deposits and short-term funding</td>
<td>5638</td>
<td>1551</td>
<td>9113</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>95</td>
<td>28</td>
<td>291</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>156</td>
<td>42</td>
<td>426</td>
</tr>
<tr>
<td>Equity</td>
<td>1163</td>
<td>615</td>
<td>1312</td>
</tr>
<tr>
<td>Total loans</td>
<td>6120</td>
<td>3453</td>
<td>5835</td>
</tr>
<tr>
<td>Other earning assets</td>
<td>2587</td>
<td>584</td>
<td>5012</td>
</tr>
</tbody>
</table>

Note: All variables are reported in US $ millions at 2005 prices. The number of observations in each year is 45 Islamic banks and 210 conventional banks.

See http://www.lancs.ac.uk/people/ecaij/islamicbanking2013.htm for further details.

Note that this variable (total assets) is distinctive from the variable fixed assets included in the first stage DEA.
the reserves, the higher are potential returns. Thus the potential overall effects of NETLOANS/ASSETS and LOANS/ASSETS on efficiency are unclear, a priori, although previous research has suggested a positive relationship between liquidity and efficiency in both Islamic and European banks (Hasan and Dridi, 2010).

We consider five variables – sourced from World Development Indicators (WDI) and Global Development Finance (GDF) databases – to reflect the overall banking environment:

- **The normalized Herfindahl index (HHI).** This variable reflects the competitive environment of each country’s banking sector. The index is calculated using all the banks (contained in Bankscope) for a given country and hence assumes that Islamic and conventional banks compete against each other. The ‘quiet life’ theory suggests that increased industry concentration is related to lower technical efficiency as there is little incentive to be efficient when competition is low (Berger and Mester, 1997). The ‘efficiency hypothesis’, on the other hand, argues that concentration and efficiency are positively related. There is evidence from previous studies in the context of conventional banks to support both the ‘quiet life’ theory (Yudistira, 2004; Staikouras et al., 2008) and the ‘efficiency hypothesis’ (Dietsch and Lozano-Vivas, 2000; Koutsomanoli-Filippaki et al., 2009).

- **The degree of market capitalization i.e. the percentage valuation of listed firms across all sectors relative to the country’s GDP (MCAP).** This is included to reflect the level of stock market activity in the economy, and its possible effect on bank efficiency is unknown a priori.

- **Growth in real GDP (GDPR) and Inflation (INF).** These variables are included to capture the buoyancy of the economy in which the bank is located. While their precise effects are unknown a priori, previous evidence, derived from studies of conventional banks, has shown a positive relationship between GDP growth and banking efficiency (Staikouras et al., 2008; Awdeh and El Moussawi, 2009).

- **Per capita GDP (GDPPC).** This variable reflects the level of institutional development and the supply and demand conditions in the market in which the bank is located. While previous evidence based on conventional banks has shown a positive relationship between per capita income and costs (Dietsch and Lozano-Vivas, 2000), the precise effect of this variable on efficiency is ambiguous a priori.

We include additional variables to reflect the time and regional dimensions of the data:

- **Year dummies** are included to allow for changes in banking efficiency over time; these are used in preference to a trend variable to allow for different effects on efficiency in different years. These dummies may also pick up the effect on efficiency of any idiosyncratic (year by year) changes in data recording or bank behaviour. In addition the interactions between the Islamic dummy and year dummies are included to examine whether Islamic and conventional banks have experienced different effects on their efficiency over the time period.

- **Region dummies** are included to allow for differences in efficiency between three broad regions. Historically, there has been some diversity between countries in interpretation of Shariah law which might impact on efficiency, although more recently countries have been seeking common ground (Werde, 2010).

We estimate, using random effects, with heteroscedasticity-corrected standard errors, the following equation:

\[ y_{n,t} = \alpha + \beta X_{n,t} + \gamma Z_{c,t} + \delta D_r + \psi F_t + \mu_n + \varepsilon_{n,t} \]

where: \( n = 1, \ldots, N \), represents banks; \( t = 1, \ldots, T \) represents time; \( c = 1, \ldots, C \) represents country; \( r = 1, \ldots, R \) represents region; and \( \varepsilon_{n,t} \), \( \mu_n \) or \( \varepsilon_{n,t} \) and \( \mu_n \) are estimated for gross, net and type efficiency respectively; \( \alpha \) is the intercept term and denotes the mean of the unobserved heterogeneity; \( \mu_n \sim \text{IID}(0, \sigma_n^2) \) is the random heterogeneity specific to the nth bank and is constant over time; \( \varepsilon_{n,t} \sim \text{IID}(0, \sigma_t^2) \) and is uncorrelated over time; \( X_{n,t} \) is an \( N \times 8 \) matrix of bank-level explanatory variables (see Section 4.2); \( Z_{c,t} \) is an \( N \times 5 \) matrix of country-level explanatory variables (see Section 4.2); \( D_r \) is an \( N \times 2 \) matrix of regional-level dummies (see footnote 16); \( F_t \) is an \( N \times 10 \) matrix of year dummies, and year and Islamic interaction dummy variables.

Descriptive statistics of the variables included in the second stage analysis are presented in Table 3. There are clear differences between Islamic and conventional banks in terms of these variables. Most notably Islamic banks are much smaller (less than half the size) and, through their country location, they face a much higher (nearly double) per capita GDP than their conventional counterparts.

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14 The normalized Herfindahl index is \( H_h = \frac{H_h}{H_h - 1/N} \) where \( H_h \) is the Herfindahl index, calculated using market shares (based on total assets) at year end, and \( N \) is the number of firms (Bikker and Haaf, 2002; Čihák and Hesse, 2010). The normalized Herfindahl index ranges from 0 to 1 and gives lower rankings than the original Herfindahl index for industries with small number of firms (Busse et al., 2007). It is therefore more appropriate in the present context. Bankscope is not entirely comprehensive in its coverage, but omitted banks are likely to be small and hence the HHI calculated on this basis should adequately reflect the competitive environment.

15 This is justified on the grounds that Islamic banking products increasingly appeal to non-Muslim customers; and large ratings agencies are getting involved in Islamic finance (Alexakis and Tsiouras, 2009; Arthur D Little Report, 2009).

16 The regions are: Middle East and North Africa (MENA) = Egypt, Jordan, Mauritania, Palestine, Sudan, Tunisia, Turkey, Yemen; Gulf Cooperator Council (GCC) = Bahrain, Kuwait, Qatar, Saudi Arabia, United Arab Emirates; Asia = Bangladesh, Brunei, Indonesia, Malaysia, Pakistan. GCC and ASIA are the dummy variables included in the equation.
Table 3
Descriptive statistics for the second stage explanatory variables.

<table>
<thead>
<tr>
<th></th>
<th>Conventional</th>
<th>Islamic</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>Median</td>
<td>SD</td>
<td>n</td>
</tr>
<tr>
<td>ASSETS</td>
<td>8.090</td>
<td>2.245</td>
<td>13435</td>
</tr>
<tr>
<td>LOANLOSS/LOANS</td>
<td>6.126</td>
<td>3.510</td>
<td>7.067</td>
</tr>
<tr>
<td>LOANS/ASSETS</td>
<td>0.533</td>
<td>0.560</td>
<td>0.173</td>
</tr>
<tr>
<td>NETLOANS/ASSETS</td>
<td>0.536</td>
<td>0.559</td>
<td>0.162</td>
</tr>
<tr>
<td>HHI</td>
<td>0.136</td>
<td>0.101</td>
<td>0.080</td>
</tr>
<tr>
<td>MCAP</td>
<td>113.235</td>
<td>89.950</td>
<td>105.870</td>
</tr>
<tr>
<td>GDPGR</td>
<td>5.701</td>
<td>5.850</td>
<td>3.393</td>
</tr>
<tr>
<td>INF</td>
<td>8.874</td>
<td>8.550</td>
<td>6.712</td>
</tr>
<tr>
<td>GDPPC</td>
<td>7.815</td>
<td>1.543</td>
<td>12.496</td>
</tr>
</tbody>
</table>

Note: ASSETS is in US $ billions at 2005 prices; GDPPC is in US $ thousands at 2005 prices. The number of observations in each year varies because of data availability.

5. Results

5.1. First stage results

Bias-corrected\(^\text{17}\) DEA efficiencies, calculated using an output-oriented constant returns to scale (CRS) approach, on the assumption that production conditions vary over time,\(^\text{18}\) are reported in Table 4 and displayed in Fig. 2. We discuss the findings in the context of, respectively, gross efficiency, type efficiency and net efficiency as defined in Section 3.

In terms of gross efficiency there is no evidence to suggest significant differences in mean efficiency levels between conventional and Islamic banks. Thus, when measured against a common frontier, each type of bank typically has the same level of efficiency.

In the context of type efficiency, we see that conventional banks have higher efficiency, on average, than the Islamic banks, and this difference is significant in all years of the study. These results provide clear evidence that the Islamic banking system is less efficient than the conventional one. This is in line with conclusions from earlier studies derived using SFA and DEA (Abdul-Majid et al., 2008; Johnes et al., 2009; Abdul-Majid et al., 2011a). The fact that the Islamic banking modus operandi is less efficient than its conventional counterpart comes as no surprise for a number of reasons. First, an Islamic bank operates mainly with customized contracts which are either equity-type (profit and loss sharing) or services-type (leasing agreements, mark-up pricing sale). These contracts are tailor-made as many of the relevant parameters (such as maturity, repayments and collateral) are client-specific. The bank, as the financer, needs to conduct a feasibility and profitability analysis for equity-type contracts; this is costly and time-consuming, depending on nature and size of project. Second, an Islamic bank needs to seek approval for its financial products from the Shariah board of the bank. This is done for every Islamic bond issue (sukuk) and also for the majority of equity-based contract; exceptions are fee-based contracts which tend to be more standardized and hence rarely require the approval of the Shariah board. Thus Islamic banks incur greater administration costs and higher operational risk than conventional banks.

Turning now to net efficiency, Islamic banks consistently have higher average levels of efficiency than conventional banks and the differences are largely significant over time. Thus, when banks are measured against their own frontier, Islamic banks are more efficient, on average, than conventional banks. The implication of this finding is that managers of Islamic banks appear to make up for the inefficiencies arising from modus operandi (evident from the type efficiency results) by being more efficient than their counterparts in conventional banks. We return to this in the following section.

\(^{17}\) Results calculated without bootstrapping can be found here http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2071615.

\(^{18}\) This means that the DEA is performed for each year separately. Given the expanding populations and markets in many of the sample countries, this is likely to be a valid assumption. For comparison, the efficiencies were also generated on the assumption that production conditions do not vary over time. In practical terms, this means that the DEA is performed on the pooled data. Broad conclusions are identical to those reported here.

Table 4
First stage DEA results by year for all countries – mean and median values.

<table>
<thead>
<tr>
<th></th>
<th>Gross</th>
<th>Net</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Conventional</td>
<td>Islamic</td>
<td>All</td>
</tr>
<tr>
<td><strong>Pooled</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.798</td>
<td>0.789</td>
<td>0.796</td>
</tr>
<tr>
<td>$P$ value (t test)</td>
<td>0.295</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.810</td>
<td>0.812</td>
<td>0.810</td>
</tr>
<tr>
<td>$P$ value (MW)</td>
<td>0.716</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$P$ value (KS)</td>
<td>0.134</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2004</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.850</td>
<td>0.842</td>
<td>0.849</td>
</tr>
<tr>
<td>$P$ value (t test)</td>
<td>0.608</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.875</td>
<td>0.870</td>
<td>0.872</td>
</tr>
<tr>
<td>$P$ value (MW)</td>
<td>0.456</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$P$ value (KS)</td>
<td>0.490</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2005</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.822</td>
<td>0.826</td>
<td>0.823</td>
</tr>
<tr>
<td>$P$ value (t test)</td>
<td>0.802</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.845</td>
<td>0.867</td>
<td>0.848</td>
</tr>
<tr>
<td>$P$ value (MW)</td>
<td>0.689</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$P$ value (KS)</td>
<td>0.742</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2006</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.781</td>
<td>0.768</td>
<td>0.779</td>
</tr>
<tr>
<td>$P$ value (t test)</td>
<td>0.511</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.797</td>
<td>0.801</td>
<td>0.798</td>
</tr>
<tr>
<td>$P$ value (MW)</td>
<td>0.780</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$P$ value (KS)</td>
<td>0.363</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2007</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.778</td>
<td>0.753</td>
<td>0.774</td>
</tr>
<tr>
<td>$P$ value (t test)</td>
<td>0.300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.797</td>
<td>0.805</td>
<td>0.797</td>
</tr>
<tr>
<td>$P$ value (MW)</td>
<td>0.360</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$P$ value (KS)</td>
<td>0.411</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2008</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.777</td>
<td>0.772</td>
<td>0.777</td>
</tr>
<tr>
<td>$P$ value (t test)</td>
<td>0.807</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.779</td>
<td>0.806</td>
<td>0.784</td>
</tr>
<tr>
<td>$P$ value (MW)</td>
<td>0.967</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$P$ value (KS)</td>
<td>0.816</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2009</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>0.777</td>
<td>0.773</td>
<td>0.776</td>
</tr>
<tr>
<td>$P$ value (t test)</td>
<td>0.825</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.779</td>
<td>0.805</td>
<td>0.781</td>
</tr>
<tr>
<td>$P$ value (MW)</td>
<td>0.965</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$P$ value (KS)</td>
<td>0.789</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

** Significant at 5% significance level; t test tests the null hypothesis that the means of the two samples are equal (equal variances are not assumed); MW (Mann–Whitney U test) tests the null hypothesis that the two samples are drawn from the same distributions (against the alternative of the difference in location); KS (Kolmogorov–Smirnov 2-sample test) tests the null hypothesis that the two samples are drawn from the same distributions (against the alternative that their distributions differ in location and shape).

The above results can be illustrated in a simple banking model by referring back to Fig. 1. The conventional banks are most closely represented by the crosses in Fig. 1. The gross efficiency frontier is mainly (but not exclusively) determined by crosses – i.e. conventional banks. But a large number of conventional banks are highly inefficient and lie at some distance from the gross (net) efficiency frontiers. In contrast, relatively few Islamic banks determine the gross efficiency frontier, but many of them lie close to the gross (net) efficiency frontiers with only a few being highly inefficient. The average gross efficiency score is therefore similar for the two types of banks, but the net efficiency score is much higher, on average, amongst Islamic banks compared to conventional banks.

The composition of banks forming the gross efficiency frontier (dominated by conventional banks) combined with the location of the different types of inefficient banks is such that the peer groups of both Islamic and conventional banks are likely to be dominated by conventional banks. An examination of the peers from the DEA generally confirms this finding. There is a subtle difference between the two groups however: for the study period as a whole, the composition of the peer group of a typical inefficient Islamic bank is 38% Islamic banks, and 62% conventional banks; for a typical inefficient conventional bank the percentages are 32% and 68% respectively.
Table 5 presents the results of the second stage analysis, the main finding of which is that, having taken into account a range of macroeconomic and bank-level variables, the distinctions between Islamic and conventional banks found in Section 5.1 still remain. Thus there is no significant difference between Islamic and conventional banks in terms of gross efficiency; the net efficiency of Islamic banks is significantly higher (by 0.08) than in conventional banks, while type efficiency is lower (by 0.07) for Islamic banks than conventional banks. The Islamic method of banking results in lower efficiency than conventional banking (as indicated by type efficiency), but the managers of the Islamic banks make up for this disadvantage (as indicated by net efficiency), and this is the case even after taking into account other contextual and bank-level characteristics. The efforts of the managers of Islamic banks in terms of recouping efficiency lost due to *modus operandi* is an interesting finding and is in contrast to reports from the late 1990s which suggested that managers of Islamic banks were lacking in training (Iqbal et al., 1998).

It seems therefore that the expansion of demand for Islamic financial products has coincided with an improvement in managerial efficiency. We need to look at how Islamic banks have responded to the increase in customer base in order to understand why this has happened. Operating with tailor-made financial products (as in Islamic banks) requires considerable human input, and so, as demand has increased, Islamic banks have spent more on human resources than conventional banks (Pellegrina, 2008). In addition, Islamic banks have generally opted to specialize in some key financial products as demand has increased rather than to offer a full array of products and services (Garbois et al., 2012). Thus managers can focus and become experts on a limited range of products. A final reason for improved managerial performance is that the expansion in demand has led to Islamic banking products becoming generally better understood in recent years (and specifically over the period of the study) as a consequence of, for example, marketing campaigns.19

Other reasons for the apparent discrepancy in performance between Islamic and conventional bank managers might include remuneration systems and project viability. Remuneration of managers in conventional banks comprises a fixed

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19 To this end, Bank Syariah Mandiri in Indonesia sponsors documentaries on Islamic finance while Emirates Bank in the UAE waives loan payments during Ramadan as part of marketing campaigns (Bloomberg).
element (salary) and variable components (shares, bonuses and other benefits). Most recently, bonuses have been criticized for being attached to short-term goals. It is to be expected that managers focus upon goals to which bonuses are attached, and these are usually quantity-oriented (i.e. the number of loans) rather than quality-oriented (i.e. viability of the project). Here, the long investment horizon of conventional financial products, which can be up to 20 or 30 years, could be an impediment to the manager’s focus and judgement of the pecuniary worth. Bonuses are not part of the Islamic banking culture. It is also plausible that the shorter horizon of financial projects in Islamic banks alongside the personalized services (i.e. custom-based contracts) force managers to perform more efficiently, although we have no evidence to support this contention.

Some other results in Table 5 are worthy of further discussion. A number of variables are significant in explaining gross and net but not type efficiency. Increasing size initially decreases gross and net efficiency but beyond an asset value of around $40 billion gross and net efficiency tend to increase with size. Given that mean size is around $7 billion, many banks (and nearly all Islamic banks) experience the negative relationship between gross and net efficiency and size.

The ratio of total loans to total assets and the ratio of net loans to total assets are the two remaining bank-level variables which significantly affect gross and net efficiency, the former positively and the latter negatively. These results need to be considered together since total loans are the sum of net loans and reserves for impaired loans (relative to non-performing loans). Thus the coefficient on the ratio of total loans to total assets reflects the effect of holding reserves for impaired loans on efficiency: in this case the higher the reserves (and hence the higher the protection for the bank from bad loans) the higher are gross and net efficiency. This suggests that banks which behave prudently in terms of insuring against bad loans reap rewards in terms of higher gross and net efficiency. The sum of the two coefficients suggests that the size of net loans (relative total assets) has little effect on gross and net efficiency.

Three macroeconomic (country-level) variables are significant in the net and gross efficiency equations at the 10% significance level. First, the significantly negative coefficient on HHI provides support for the ‘quiet life’ hypothesis. Second, a higher level of market capitalization (and hence stock market activity) leads to lower gross and net efficiency. Third, increasing GDP growth is associated with higher efficiency (gross and net) as expected.

The two dummy variables to reflect geographical region are also significant with banks in the Asian region having higher gross and net efficiency (than banks in MENA) by 0.04, and banks in the GCC having lower efficiency (than banks in MENA) by around 0.08. We speculate that the size of population may account for such regional differences: Asia has the largest population, followed by the MENA region, and then by the GCC. It is possible that higher demand for banking products in the highly populated region leads to greater standardization of products, and the possibility of reaping economies of scale. The opposite may be the case for the smallest region. Further research is necessary to confirm these conjectures.

Finally, year fixed effects indicates that, compared with the first year of the study (2004) all years have seen significantly lower gross efficiency, with 2006 and 2008 seeing the worst performance. This pattern is the same for conventional and Islamic banks. The time pattern of net efficiency, on the other hand, differs between the two types of banks. Conventional banks have seen increasing falls in net efficiency (relative to 2004) with the nadir being in 2008; there is an improvement in 2009, but the position is still lower relative to 2004. Islamic banks have experienced a similar pattern in net efficiency between 2005 and 2008 – Islamic banks have seen a slightly bigger (smaller) fall in 2006 (2008) compared to conventional banks – but 2009 reveals a significant difference between the two types in that Islamic banks have seen a rise in net efficiency relative to 2004. Managers of Islamic banks seem therefore to have coped with the recent financial crisis better than managers of conventional banks (as signalled by the net efficiency results). However, the crisis seems to have had a more adverse effect on type efficiency in Islamic than conventional banks: thus the efficiency disadvantage of operating under Islamic rules appears to have become greater over the period of crisis.

6. Conclusion

Our purpose in this paper has been to compare efficiency, using DEA, amongst a sample of Islamic and conventional banks located in 18 countries over the period 2004 to 2009. The DEA results provide evidence that there are no significant differences in gross efficiency (on average) between conventional and Islamic banks. This result is in line with a number of previous studies (El-Gamal and Inanoglu, 2005; Mokhtar et al., 2006; Bader, 2008; Hassan et al., 2009).

By using a non-parametric MFA we have been able to decompose gross efficiency into two components: net efficiency provides a measure of managerial competence, while type efficiency indicates the effect on efficiency of modus operandi, and by doing this we have discovered that the result of no significant difference in gross efficiency between banking types conceals some important distinctions. First, the type efficiency results provide strong evidence that Islamic banking is less efficient, on average, than conventional banking. Second, net efficiency is significantly higher, on average, in Islamic compared to conventional banks suggesting that the managers of Islamic banks are particularly efficient given the rules by which they are constrained. The apparent inefficiency of the Islamic banking system is counterbalanced by the efficiency of the managers of Islamic banks.

We investigate, in a second stage analysis, the determinants of gross, net and type efficiency in order to provide more information to managers and policy-makers regarding ways of improving performance. The main finding is that the

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20 For example, the Gulf Finance House in Bahrain does not give any form of performance related bonuses (Gulf Finance House Annual Report, 2010). The Dubai Islamic Bank gave bonuses that amounted to less than 0.1% of the total staff expenses in 2011 (Dubai Islamic Bank Annual Report, 2011).

distinctions between Islamic and conventional banks in terms of net and type efficiency are observed even after taking into account other banking and macroeconomic factors.

Each type of banking could therefore learn from the other. Islamic banks need to look at the conventional banking system for ideas on how to make their own system more efficient. An obvious possibility would be to standardize their portfolio of products as in conventional and the larger Islamic banks. Conventional banks need to examine the managerial side of Islamic banking for ideas on how to improve the efficiency of their own managers. If there is little difference in the inherent ability or the training of managers in each type of bank, then other aspects, such as the remuneration systems and project viability might hold the key.

The second stage analysis finds that the relationship between efficiency and bank size is quadratic, and most banks in the sample are operating on the downward sloping part of the function. Managers should also take note of the beneficial effects on efficiency of prudent behaviour in terms of holding reserves relative to non-performing loans.

In a period of financial turmoil, the banks in this sample have typically suffered falls in their gross efficiency relative to the start of the period. The year 2008 had a particularly bad impact on gross efficiency, but there has been a limited recovery in 2009. An examination of the components of gross efficiency indicates, however, that the managers of Islamic banks have coped with the crisis better than those of conventional banks (based on the results for net efficiency), but that the gap between the conventional and Islamic frontiers has widened during this same period (based on results for type efficiency). This implies that the efficiency advantage of the conventional over the Islamic operating system has increased during the period of financial turmoil, suggesting that a shift to a more standardized process would help Islamic banks to maintain efficiency in the face of future crises.

These are important results but rely on the validity of the sectoral-level approach taken here. Future studies at the sectoral level would benefit from the use of extended data sets and alternative estimation methods which allow for unbalanced panel data. In addition, case studies into selected banks could offer insights into why managers of Islamic banks appear to perform more efficiently than those of conventional banks, and would complement the econometric analyses of bank level data.

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