

Financial Performance of Islamic Banks vs. Conventional Banks: The Case of UAE

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ABSTRACT

Unquestionably, banks have a significant impact on every country's economy. The good performance of a bank is one of the main factors that lead to the country's economic stability. In this study, the financial performance of the two banking systems; the Islamic and the conventional banking systems in the United Arab Emirates, is being studied. The study's prior objective is the comparison of the profitability ratio of banks and their Return on Assets (ROA) and Return on Equity (ROE). 4 Islamic banks and 7 Conventional banks in the UAE were chosen so that both the Islamic and Conventional banking systems would be compared and examined. The data used in this study were taken from the Banks's yearly financial reports through the years 2005-2014. E-views software was applied to see what type of banking sector performed better over this period. Consequently, we cannot say that one banking system performed better than the other one since the independent variables affect the profitability of both banking sector negatively.

Keywords: Islamic Banking, Conventional Banking, Profitability.

ÖZ

Tartışmasız, bankalar her ülkenin ekonomisinde önemli bir etkiye sahiptir. Bir bankanın iyi bir performansı, ülkenin ekonomik istikrarı için ana faktörlerden birisidir. Bu projede, Birleşik Arab Emirlikleri'nde, İslami ve geleneksel (konvansiyonel) olmak üzere iki bankacılık sisteminin finansal performansı üzerine çalışmaktadır. Bu çalışmada, öncelikli hedef bankaların karlılık oranı ve onların sermaye ve öz kaynağa dönüşünü karşılaştırmaktır. İslami ve ticari bankacılık sistemlerinin karşılaştırılması ve incelenmesi için 4 islami banka ve 7 ticari banka Birleşik Arab Emirlikleri'nde seçildi. Bu çalışmada, kullanılan veriler 2005-2015 yılları arasındaki senelik finans raporlarından alındı. Bu program (E-views software), bu dönemde bankacılık sektörünün nasıl çalıştığını görmek için uygulanmıştır. Sonuç olarak, iki bankacılık sistemlerinin karlılığı , bağımsız değişkenlerin çoğundan olumsuz etkilendiği için bir bankacılık sistemi diğerinden daha iyi çalıştı, diyemeyiz.

AnahtarKelimeler: İslam Bankacılık, Geleneksel Bankacılık, Karlılık

To My Family

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LIST OF ABBREVIATIONS

ASQ	Asset Quality
CAMEL	Capital, Adequacy, Asset Quality, Management, Earnings, and Liquidity
CAR	Capital Adequacy
EFF	Efficiency
E-VIEWS	Econometric Views
IPS	Im Pesaran and Shin w-stat
LLC	Levin, Lin, and Chu
LQR	Liquidity
LOGSIZE	Logarithmic of bank size
PP	Phillips-Perron
ROA	Return on Assets
ROE	Return on Equity
UAE	United Arab Emirate

Chapter 1

INTRODUCTION

1.1 Background

The world has witnessing important development at all levels since the major industrial revolution began in the second half of the 19th century. This development included the banking sector significantly, especially in the last 30 years, where banks dramatically and widely competed against each other by offering many services and products that aim to facilitate our daily life and raise the standard of living, and at the same time it would be the source that earns the banks' profit. Based on that, it can be argued that the banking sector is nowadays considered the spine of every country's economy; thus, the good performance of the banking sector at any country leads to financial success and vice versa, the bad performance leads to major financial recession which in turn leads to financial crisis similar to what happened in 2008 (the Global Financial Crisis).

As it is well known, there are two basic banking systems around the world: the Islamic banking system and the conventional banking system. And it is doubtless that each bank has its own way to earn profit.

The work of the commercial banking system is mainly and directly based on deposit and lending through which the bank earns profits, therefor the bank here is playing

the role of an intercessor and the system is based on interest. According to that, we can define the conventional bank earnings as the difference between the interest paid by the bank to depositors and the interest received by borrowers.

The Islamic banks follow the Islamic law which governs all their transactions, therefore this kind of banks does not deal with interest (riba) that is forbidden in Islam. All the Islamic banks' services are thus interest free (Siraj and Pillai, 2012).

Four main rules govern the investment behavior of Islamic banking, namely: (Suleiman, 2000):

- a. The absence of interest-based (riba) transactions;
- b. The avoidance of economic activities involving speculation (ghirar).
- c. The introduction of an Islamic tax, Zakat.
- d. The discouragement of the production of goods and services which contradict the value pattern of Islam (Haram).

The year 1975 witnessed the founding of the first Islamic bank in the United Arab Emirates, Dubai Islamic bank, which then helped develop the Islamic banking. The United Arab Emirates witnessed a vast acceleration of the Islamic banking work, where the number of Islamic banks reached the total of 6 banks, in addition to Islamic windows in conventional banks, which shows the expansion, the high prevalence and success of Islamic banks in the UAE.

1.2 Aim of Study

All that matters when the depositor wants to take the appropriate decision in what bank he must deposit his savings, is getting a clear picture that shows the banks' financial performance. So this study comes to examine the profitability for both banking systems in the UAE. Therefore this study will involve 4 Islamic banks and 7 conventional banks in the UAE during the period of 2005- 2014 and both measurement profitability ratios (ROE and ROA) will be applied as dependent variables. On the other hand, Asset Quality, Liquidity, Capital Adequacy, Management Efficiency and Bank Size will form the independent variables. According to banks performance and finding from data analysis, the main question which will be replied is: which system had the better performance during this period of time?

1.3 Framework of the Study

This thesis is structured as follows: chapter 1 is the introduction, while chapter 2 presents the literature review of previous identical studies. Chapter 3 covers the background about banking sector in UAE. Furthermore, explains the research methodology, data and variables used in data analysis. Finally, chapter 5 presents the analysis part of this study and results while the chapter 6 appertain conclusion.

Chapter 2

LITERATURE REVIEW

The year 1963 witnessed the foundation of the very first Islamic bank in Egypt, ever since that year and until today researchers are still interested in making researches that study the performance of both banking systems. The global financial crisis that the world experiences every once in a while as in 2008, was the cause of the increase of the number of researchers, as they are interested in studying the financial performances of both systems; knowing that these studies can help preventing the crisis that may happen in the future.

Samad (2004) used profitability, liquidity risk, and credit risk in his search to counterweight the performance of the Islamic banks and commercial banks of Bahrain through the period of 1991-2001. By the use of the t-test he figured that there is no significant distinction in profitability and liquidity amidst Islamic banks and conventional banks. In addition, he pointed that regardless of the Islamic banks' fresh entrance to the trade market they are giving the same performance as conventional banks. Moreover, Islamic banks are at a lower risk for outrunning conventional banks with regard to credit risk.

Jaffar and Manarvi (2011) surveyed the execution of Islamic banks and conventional banks in Pakistan through 2005-2009. They used CAMEL framework to resolve capital adequacy, asset quality, earning ability, management quality, and liquidity

position of five of each Islamic and conventional banks. They concluded that the reason behind Islamic banks being more secure than conventional banks is that Islamic banks provided the capital for their assets by equity more than providing it by debts. The research showed that Islamic banks did not gain much on their assets, while conventional banks gained more profit. Moreover, because of the use of high loan to asset ratio, each bank of the both banking systems encountered higher obligation and default hazard. Yet, if we compared Islamic banks to conventional banks, Islamic banks showed lower loan to asset ratio which indicates that their liquidity status was higher than conventional banks.

Siraj and Pillai (2012) examined practicability of 6 of each Islamic and conventional banks in the countries of the Arab league in the years between 2005-2010. To valuate the performance of the banks they used operating expense, profit, assets, operating income, deposits, and total equity as variables, and depending on the ANOVA test, it showed that Islamic banks distinguish themselves from conventional ones in terms of ROA and ROE. It was demonstrated in this survey that Islamic banks are basically financed by equity, while conventional banks are financed by scrounged funds. It shows that the proportion of equity fund was 73.80% in Islamic banks while in conventional banks it was 55.12%. In Islamic banks the operating income raised faster than the operating expenses unlike its conventional peers. Lastly, this study showed that the financial crisis which took place in 2008 did not impact the Islamic banks as much as it affected their equals of conventional banks in the previously mentioned countries.

Anjum Iqbal (2012) researched and contrasted the liquidity hazard administration of 5 of each Islamic and conventional banks in Pakistan over the years starting 2007 till 2010. Iqbal had to use the bigness of the bank, nonperforming loan (NPLs), Capital Adequacy Ratio (CAR), ROA, and ROE as the explanatory variables, he also used liquidity risk as a explained variable. Depending on this study, Islamic banks seemed to have had better liquidity than the similar conventional banks. The direction of non-performing loans (NPL) in Islamic banks was reducing. Because the onset of Islamic banking was in 2006, the Islamic banks are still smaller in size compared to the size of conventional banks. As for the capital adequacy ratio, it is higher in Islamic banks than in conventional banks.

Rosly and Abu Bakar (2003) based on performance of both Islamic and Conventional banking systems in Malaysia through the years 1996-1999, they saw that in Islamic banks the return on assets (ROA) were found to be are greater than conventional ones. The Islamic banks' regain on assets is elevated because the overhead expenses they have are less. But the Islamic bank' competence is not necessarily implied to be higher than conventional banks. In addition they saw that Islamic banks' depressed asset employment and investment margin ratios have no match between each other.

The Islamic and commercial banks in Bangladesh have been examined by Safiullah (2010). Based on the research that studied factors like profitability, liquidity, business development, solvency, commitment to economy and community, efficiency, and productivity, the performance of Islamic and conventional systems is notable. Concerning the obligation to economy and community, productivity and efficiency conventional banks showed better performance than Islamic banks while

Islamic banks did a good job regarding profitability, liquidity, solvency, and business development.

Cihak and Hesse (2010) mentioned in their survey that the Islamic banking apportion the risk based on Mudaraba and Musharakah. And in details, they said that banks in the Islamic banking system endure all economical risks and borrower and it does not call for attention for any forfeit or other factors that affected banks' business. In this system it is only the bank's responsibility to deal with any loss or gain which means that this loss or gain does not affect depositors or borrowers in any way. In conclusion, Islamic banks endure all the results of loss while creditors and depositors can only enjoy the advantages.

In his study, M.S. Moin (2008) gauged the interpretation of Pakistan's first Islamic bank in terms of profitability, liquidity, risk and efficiency by utilizing financial ratios, as he compared it with 5 conventional banks. The study showed that conventional banks are more lucrative and greatly distinct from the first Islamic bank in terms of ROE. He found that Islamic banks are catching up with conventional banks concerning profitability. He as well detected an advantageous relationship of bottom lines with profitability indicator, ROE. On the other hand, concerning liquidity and loan to deposit ratio, the study did not show any distinction between Islamic and conventional banks. And because of the Conventional banks' high profitability they are at higher risk than Islamic banks, and they have lower financial competence.

In the analysis of the profitability ratio (ROA & ROE) of Islamic and conventional banks made by Ansari and Rahman (2011) in Pakistan during 2006-2009, their study showed that the interpretation of Islamic banks was not greatly distinct from that of conventional banks concerning capital. While, when it comes to liquidity, compared to conventional banks, Islamic banks were proved to be more liquid, had a better income ratio, and were less risky. Therefore, the thorough conclusions were on the side of Islamic banks then conventional ones.

To evaluate the interpretation of Islamic banks in Jordan, Saleh and Zeitun (2006) studied the experience with Islamic banking, for Jordan Islamic Bank for Finance and Investment (JIBFI), and Islamic International Arab Bank (IIAB), Jordan's first and second Islamic banks. They, as well, focused on the local and international defiances this sector encounters. The paper shows a number of significant findings while managing profit maximization, capital structure, and liquidity examinations as interpretation valuation methodology. First, the two banks' competence and capacity have gotten higher and they have widened their employments and activities. Second, the two banks have a significant part in funding projects in Jordan. Third, the concentration of both banks was on the short-term investment. Fourth, it was shown that the Bank for Finance and Investment (JIBFI) had high profitability. And lastly, the overall findings show that the Islamic banks' credit facilities and profitability had witnessed an elevated expansion.

Faizulayev (2011) used CAMEL framework to study and counterweight Islamic banks and Conventional banks in a number of countries. He found, after using regression analysis to evaluate effect of profitability indicators and ANOVA tests to

gauge the significance that Conventional banks are distinct from Islamic banks concerning capital adequacy, asset quality, earnings quality, liquidity quality and management quality and Islamic banks are not as liquid as conventional banks since they generally deal with long term investment. Moreover, he said that the moderating impact of bank sort had an important influence on bank interpretation.

Ibrahim (2015) used liquidity, profitability, management capacity, capital structure, and share performance to measure the performance of Dubai Islamic bank and Abu Dhabi Islamic banks between 2003 and 2007. By using five main groups of parameters, this research came to the result that in order to reach the maximum profits both banks have adopted compatible financial tools which yield financial feasibility for both banks. In addition, in terms of liquidity, that of Dubai Islamic bank is lower than that of Abu Dhabi Islamic bank. Moreover, he found that Dubai Islamic bank's profitability level is higher than its competitor's, while, the tests of the indicators of capital structure indicate that the structures for the two banks are almost the same.

Four Islamic banks and 19 conventional banks were taken to study their performance in Turkey for the period of 2001-2009. The analysis has been performed in terms of Capital adequacy, Asset quality, Management adequacy, Earnings power, Liquidity and sensitivity to market risk. It was found that the profitability and asset management ratios showed a better performance for Islamic banks but tardiness in sensitivity to market risk ratio (Erol et. Al, 2014).

A study has measured the Profitability, liquidity management, credit risk management and solvency of three Islamic banks and six Conventional banks in Egypt through the period of 2008-2010. The findings showed that the Conventional banks appear to differentiate themselves in all ratios. It was concluded that, the Islamic banks' experience in Egypt had witnessed a divergence from the Islamic finance's hypothetical framework and an obvious deflection from its purposes (Fayed, 2013).

The 3 Islamic and 16 conventional banks of Jordan have been compared by a study Milhem and Istaiteyeh (2015) made to examine their performance. The comparison has been made by using profitability ratios, liquidity ratios, risk and solvency ratios, and efficiency ratios for 5 years (2009-2013). Data were collected from the annual financial statement of banks. In addition, there were another data obtained from minor sources like banks' annual reports. After applying t-test, in terms of profitability, the study found that there are no statistically significant differences between both banking systems. In contrast, t-test showed that there are statistical significant differences in Cash Deposit Ratio, Current Ratio and Current Asset Ratio which mean that Islamic banks are more liquid than conventional banks and these are the normal results due to the forbiddance of interest which lead to restricted investment opportunities. In addition, they found that Islamic banks are better than conventional ones in paying for their debtors because they are less risky and more solvent.

A study was made by Hasan and Dridi (2010) to analyze the interpretation of Islamic and conventional banks during the world financial crisis, where they studied the

influence the crisis left on banks' profitability, assets and credit expansion. It was detected that because of several agents in the Islamic banking business pattern like better diversification, economies of scale, and better repute, a lower negative influence on profitability was left comparing to conventional banks. Even though Islamic banks experienced a diminution in the returns of assets, yet no vast losses and bankruptcy were endured like the conventional banks particularly in The United States and countries of the European Union. Not forgetting that, during crisis, the asset expansion of the Islamic bank was significantly higher compared to conventional banks. The overall findings show that this crisis emphasizes the liquidity risks' significance for both bankers and policymakers; and as a conclusion, it is important for banks to take having a well-functioning liquidity management into account.

Chapter 3

UAE BANKING SYSTEM

The UAE economy is considered one of the most rapidly growing economies in the Arab Gulf region and Asia. And the credit in this growth goes, in the first place, to the increase of the prices of oil in the past. The UAE government nowadays seeks to develop the non-oil economic sectors through adopting some wise policies like attracting foreign investments and facilitating their work in the country (AL-Malkawi and Pillai, 2013).

It appeared as the second biggest economy in the Arab world and the 30th economy in the world in 2014. The UAE Gross Domestic Product (GDP) was equal to 401.647 billion us dollars in 2014 according to the World Bank (2015). In the same year the GDP of UAE was amounting to 0.52 percent to the world economy.

The first step in establishing the central bank of UAE was in 1973 where the monetary council was founded, this council issued the first national currency which succeeded the other currencies that were in circulation, like Bahraini Dinar and Qatari Riyal. The central bank of UAE officially came into being in 1980, and it was put in charge of many tasks such as: currency issuing and working on supporting the currency and achieving its internal and external stability. In addition, it does the job of the government bank retaining the government's reserve of gold and foreign currencies.

According to the central bank of UAE (2014), there are 23 locally incorporated banks including 17 commercial banks and 6 Islamic banks, plus, 28 foreign commercial banks. In addition, there are 2 investments banks and 5 wholesaling banks. All of these banks work under control of UAE central bank.

As it can be seen in the table 1, National Bank of Abu Dhabi, Abu Dhabi Commercial Bank, Emirates NBD Bank, and First Gulf Bank are the four biggest Banks in terms of Bank size formed almost 73% of the local commercial market share. In contrast, Abu Dhabi Islamic Bank and Dubai Islamic Bank are the biggest two Banks among the local Islamic Banks in terms of their percentages in the local Islamic market share which is almost 63%.

Table 1: Local Commercial Banks in UAE¹

NO.	Banks	Date founded	Total assets in 2014 (AED'000)
1	National Bank of Abu Dhabi	1968	376,098,712
2	Abu Dhabi Commercial Bank	1975	204,019,463
3	Arab Bank for Inv.& Foreign Trade	1976	14,335,246
4	Union National Bank	-	93,463,243
5	Commercial Bank of Dubai	1969	46,917,254
6	Emirates NBD Bank	2007	363,020,991
7	Bank of Sharjah	1974	25,054,383
8	United Arab Bank	1975	25,709,285
9	Invest Bank	1975	13,829,848
10	The National Bank of R.A.K	1976	34,830,157
11	Commercial Bank International	1991	19,683,444
12	National Bank of Fujairah	1982	24,586,314
13	National Bank of U.A.Q	1982	13,226,766
14	First Gulf Bank	1979	212,168,501
15	Dubai Bank	2002	-
16	Ajman Bank	2008	11,231,288
17	Mashreq Bank	1967	105,840,278

¹ http://www.centralbank.ae/en/pdf/bsed/List-of-Foreign-Banks-Branches-En_30102014.pdf,
(Accessed on (7/12/2015))

Table 2: Local Islamic Banks²

NO.	Banks	Date established	Total assets in 2014 (AED'000)
1	Abu Dhabi Islamic Bank	1997	111,903,803
2	Emirates Islamic Bank	2004	42,913,219
3	Sharjah Islamic Bank	2002	26,012,888
4	Noor Islamic Bank	2008	29,012,955
5	Dubai Islamic Bank	1975	123,887,359
6	Al Hilal Bank	2008	41,407,872

² http://www.centralbank.ae/en/pdf/bsed/List-of-Foreign-Banks-Branches-En_30102014.pdf, (Accessed on (7/12/2015))

3.1 Islamic Banking System

The year 1975 had witnessed the foundation of the first Islamic bank, Dubai Islamic bank, in the United Arab Emirates followed by the foundation of several banks and financial institutions in different Islamic countries like Malaysia, Egypt, Pakistan, and Bahrain. According to the World Bank, the Islamic finance industry is vastly expanding and has achieved an annual percentage of 10-12%, while the financial assets that subject to the Islamic law are nowadays estimated to \$2 trillion (the World Bank 2015). Moreover, the Islamic banking system today is no longer trapped on Islamic countries, knowing that there are 5 Islamic banks in the UK and 19 institutions that offer Islamic financial services in America (Mobarek and Kalonov, 2014). Islamic banking is a system based on the Islamic law, in which all the operations that these banks make must conform to the principles of the Islamic law. To make sure that these operations correspond with the Islamic law, there is a sharia monitoring committee in each bank that monitors the bank's daily operations and observes whether all services are compatible with Islamic law before submitting them to the customer.

According to Quran (Holy Book of Muslims) that says “So, because of the transgression of the Jews, We forbade them pure things which had been allowed to them, and also because of their hindering many men from Allah's way. And because of their taking interest although they had been forbidden it, and because of their devouring peoples Wealth wrongfully. And we have prepared for those of them, who disbelieve, a painful punishment”³ Riba (interest) is prohibited.

³ An-Nisa (160-161) Al-Qur'an

One of the Islamic banks' significant qualities is the fact that they do not give nor receive interest with predefined rates (Cihek and Hesse, 2010). The Islamic bank does not deal with interest; thus, it neither gives interest for the recourses received from its account owners, nor it receives interest from people it capitalizes like commercial banks do when they give loans. Another quality the Islamic banking system has is that it is a fair system based on the principle of loss sharing and profit sharing, that's why Islamic banks are considered less risky compared to commercial banks, since if there was losses, both the bank and the customer will carry the burden (Rafiuddin and Alam, 2012). Furthermore, the Islamic bank does not fund the activities that are forbidden in Islam, such as the trade of drugs and alcohol.

3.1.1 Islamic Banking Instruments

This passage represents the Islamic banking modes of financing which conform to the Islamic sharia'a:

Murabaha (cost plus financing): originally comes from the Arabic word Ribh. Ribh means profit. We can define Murabaha as the contract between two parties, the bank and the bank's customer, and it is the most common and utilized contract in the Islamic banks. Murabaha can be considered the customer's method of financing that replaces loans which commercial banks usually give. This contract is based on The customer's intention to buy a certain good or assets such as a house or a car, after that the bank and the customer agrees on a certain profit percentage that is then added to the original cost of the good. In other words, this contract is made only when the bank's customer asks to buy a good. In order for this contract to completely conform to the Islamic law, Fayad mentioned that the bank must first have full ownership of the good and have the complete right to use it the way it wants, and then sell it to its customer (Fayad, 2013). Therefore, the cost plus financing is implemented in two

phases, the first, is when the bank buys the customer the goods which the customer had previously pledged to buy. And the second is selling the good to the customer with the price that both parties had agreed on, which includes the bank's profit.

Musharakah (Partnership): Musharakah is considered one of the most important modes of financing in the Islamic banks right after Murabaha, since it accords with the Islamic banks' nature, thus it can be used in all different economic activities. Musharakah is, as its name implies, a relation, based on the partnership between the bank and the customer in a specific venture. In partnership, the bank and the customer are partners in a specific percentage of the capital in a certain venture (Gerrard and Cunningham, 1997). In the case of profit, both parties share the profit according to a prior agreement that clarifies the percentage each party gets. While on the other hand if loss occurs, each party shall bear the loss according to its contribution to the capital. Not forgetting that all parties can participate in the management of the venture.

Mudaraba: is another contract which carries the trait of partnership between two parties. But in Mudaraba the role of the first party is to provide the money which is used to fund a certain venture, while the other party is responsible for the management of this venture, by which its effort is presented (Ika et al., 2011).

Al Ijarah (leasing): There are several forms of Ijarah, but the most common form is known as (Ijarah muntahiya bi tamlik) or Ijarah ended with ownership. In this contract the bank buys an asset as requested by the customer and then they sign an Ijarah ended with ownership contract for a specific period of time, when this period

is ended the bank transfers the ownership of the asset to the lessee and gives him the choice to own the asset before the end of the specified period by paying an amount of money. The method of calculating this money would be specified when the parties sign the contract. The bank calculates the total payment based on the cost of the assets in addition to the banks profit, and the payment is then divided on previously decided periods.

Bai salam: we can simply define this contract as a prior payment given by the bank to the seller who has agreed on providing the goods in a specified time in the future (Hamedian, 2013). The price, quantity and quality of these goods must be previously determined.

Qard hasan (good loan): is when the bank gives interest free loan for people who need help, so that they would financially rehabilitate themselves.

3.2 Conventional Banking System

Conventional Banking System is a system that founded on interest (Siraj and Pillai, 2012). The bank is considered a kind of financial institution which activity is based on taking deposits and funding investors by giving loans. Thus, in this concept the bank is considered an intermediary between those who have surplus funds and those who need these funds. The main objective, as a conventional bank, is to achieve the highest amounts of profit. As a financial intermediary founded on interest, the conventional bank gives interest to the applicants and imposes it on the people it gives loans to, in which the amount of imposed interest is higher than the paid interest. Therefor, the bank aims to create a positive gap of interest.

There are two types of banks which fall under the name of the conventional bank. The first type is the commercial bank which is, as we mentioned before, a system founded on the profit made by difference between the interest paid to the applicants and the interest taken from investors which the bank funds. The other type is investment bank which also functions as an intermediary that carries out several kinds of services. The specialty of Investment bank lies in complex financial transactions and large financial transactions like underwriting, performing the role of an intermediary between a securities issuer and the investing public, simplify mergers and other companies' reorganizations, performing the role of an intermediary and/or financial adviser for institutional customers.

The investment banking sector is likely one of the most globalized industries: there is a constant competition between investment banks from different countries to get customers all over the world (Radić, Fiordelisi, and Girardone, 2012).

3.3 Differences between Islamic and Conventional Banks

As mentioned before, Islamic banking is a system based on the Islamic law, in which all the operations that these banks make must conform to the principles of the Islamic law. On the contrary, Conventional Banking System is a banking system founded on interest. In table 3 some differences of both banking systems will be highlighted.

Table 3: Differences between Islamic Banks and Conventional Banks⁴

Conventional Banks	Islamic Banks
1. The functions and operating modes of conventional banks are based on fully manmade principles.	1. The Islamic bank's functions and working methods are founded on standards set by the Islamic sharia.
2. The investor gets an interest of a previously specified value.	2. It encourages apportioning the risks between investors and entrepreneurs.
3. Its objective lies in increasing profit without limitations.	3. Its objective is as well increasing its profit yet under the Sharia law limitations.
4. The bank's transactions do not include Zakat.	4. In accordance with the modern Islamic banking system, the Islamic banks has not only become zakat collection centers, but also they pay zakat themselves
5. The conventional bank's main function is giving loans and retrieving them with redoubled interest.	5. The Islamic bank's main function is engagement in partnership business, which results in the deep comprehension of the customer's business.
6. Defaulters must pay extra money (penalty and compounded interest).	6. There is no term that imposes defaulters to pay extra money. They only take an indemnification of a small value which is then granted for charity. The bank has the freedom to choose to give discounts for early settlement.
7. The bank gets concerned in becoming distinguished. It does not try to secure growth with equity.	7. It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
8. It is comparatively simpler for commercial banks which are based on interest to scrounge from the money market.	8. In Islamic banks, it should be from sharia based bargains.
9. It does not give enough significance to improving project evaluations since its revenue is stable.	9. It has a great concern in improving project evaluation Because its profits and losses are portioned with its customers.
10. The conventional banks care more about how much the customer is creditworthy.	10. While Islamic banks care more on the projects' permanence

⁴ http://zaharuddin.net/index.php?option=com_content&task=view&id=297&Itemid=72, accessed on (10/12/2015)

11. The relation between the conventional bank and its customers is a relation of creditor and debtor.	11. While the Islamic bank and its customers are joint by a relation of partnership, they are investors and trader, buyer and seller.
12. In conventional bank all deposits must be ensured.	12. In Islamic bank only deposits for a deposit account based on al-wadiah principle are ensured in which the fund of the depositors would be ensured to be repaid. But the customer will be obliged to share the loss if his account was based on mudarabah concept.

3.4 The 2008 Global Financial Crises on UAE Banking Sector

The UAE, like other gulf countries, is considered an oil producing country, and a large percent of its income depends on oil industries. Knowing that the oil prices have dropped during the crisis by up to 50%, the UAE was affected by the global financial crisis as a normal result to this decrease. Al-Malkawi and Pillai mentioned in their research that the global financial crisis succeeded in leaving its mark in the real estate and contraction sector in UAE where the prices and rents decreased by 20-50 percent (Al-Malkawi and Pillai, 2013). In addition, in his study, Mehta came to the result that the UAE banking sector has been affected by the global financial crises where the profitability and liquidity of UAE banks decreased during that global crisis (Mehta, 2012).

In order to limit the damages caused by the crisis, the central bank of UAE decided to give short term loans to banks through a facility totaling fifty billion AED (\$13.61 billion). The central bank also assigned facilities for banks so that they can use them as exceptional bank loans to reduce the tensions in the banking sector.

Chapter 4

DATA AND METHODOLOGY

4.1 Data

First, this study covers 4 Islamic banks and 7 Conventional Banks in UAE banking sector during the period of 2005-2014. Second, these 11 banks were selected according to their asset size which is the biggest among local banks in UAE. Third, the Data of these banks were taken from the balance sheet and income statement which are published at their websites.

Table 4: Selected Islamic Banks

NO	Name of Banks
1	Abu Dhabi Islamic Bank
2	Dubai Islamic Bank
3	Emirate Islamic Bank
4	Sharjah Islamic Bank

Table 5: Selected Conventional Banks

NO	Name of Banks
1	National Bank of Abu Dhabi
2	Abu Dhabi Commercial Bank
3	First Gulf Bank
4	Emirate NBD Bank
5	Mashreq Bank
6	Union National Bank
7	Commercial Bank of Dubai

4.2 Variables

This study comes to examine the profitability for both banking systems (Islamic and conventional) in the UAE. Therefore this study will involve 4 Islamic banks and 7 commercial banks in the UAE during the period of 2005- 2014 and both measurement profitability ratios (ROE and ROA) will be applied as dependent variables. On the other hand, Asset Quality, Liquidity, Capital Adequacy, Management Efficiency and Bank Size will form the independent variables.

4.2.1 Dependent Variables

This research utilized CAMEL methodology, which is used in studying the interpretation of banks, to know the bank's profitability. Returns on Assets (ROA)

and Returns on Equity (ROE) are the most significantly ratio measurements which can be duly used. The use of these variables is being repeatedly employed in the analysis of banks' financial interpretation.

Return on Assets (ROA):

Return on Assets Ratio is finding by dividing Net Income to Total Assets. This ratio is a key indicator which used to evaluate how comfortable company is in the relationship with total Assets. Asset contains items like cash, plant, buildings and equipment. Naceur (2003) said that we can determine the profit earned of total assets by Return on Assets ratio.

Return on Equity (ROE):

Return on Equity is calculated from Net income over total Equity. ROE shows how much profit a bank has made in a specific time period according to total shareholder's equity (Gul et al., 2011). The higher the ROE, the better performance is (Samad, 2004).

4.2.2 Independent Variables

Capital Adequacy (CAR):

In order to determine the capital adequacy ratio the total equity of the investor is divided by total assets. The capital adequacy ratio presents the capital of the bank to its risk. Thus, with reference to Capital Adequacy, it is the speculation of the bank's capacity to prevent the bank failure from harming both lenders and depositors. it was affirmed that it would be very helpful for the bank to have a good reserve in order to expand the credit projects, to decrease the unexpected risks and to help the

association in (charming asset losses) breaking the asset losses down (Akhtar et al.,2011)

Asset Quality (ASQ):

In order to determine the Asset Quality ratio the provision to loan losses is divided by total loans. Asset quality represents the capability of the bank in dealing with pending loans. Providing loans for debtors is of primary interest to the banks as well as it is a primary source of minting funds. Merchant (Merchant, 2012) confirms that it is required of banks to be worried about prospective losses if they keep providing bad loans.

Management Efficiency (EFF):

We can determine the Management Efficiency by dividing Interest Income by Interest Expense. Using Management quality helps evaluating the bank's performance, as in the way it uses its assets and liabilities inwardly. If the management quality ratio is high, it means that the bank managed to make a profit that is considerably higher than the expenses.

Liquidity (LQR):

It is equal to Cash divided by Total Asset. If banks had a problem with liquidity they are likely to end up with insolvency, which means that suffering from any liquidity problem may eventually lead in to bankruptcy; that is why liquidity is extremely essential for all banks. We can define liquidity as the bank's capacity to transform its assets to money with ease, which means that if the bank, has a sufficient amount of cash to pay for its short term commitments (faizulayev, 2011).

Bank Size:

Total Assets are used to estimate the size of the bank. (Athanasoglou et al., 2005) said that the bank's profit will be higher when the size of the bank is greater, except if the size of the bank was lavish it is likely to have an unfavorable influence on the banks' profitability.

4.3 Methodology

In research the panel data that was received from the banks' financial statement, is used to make a regression analysis evaluating bank profitability. Yet, knowing if this data is stable or not is very important. The change of time will not affect the variable, or in other words the variable will not face autocorrelation or distinction if the data is stationary (Davydenko, 2011). It was concluded, after using several methods such as unit root test based on Levin, Lin & Chu (LLC), Im Pesaran and Shin w-stat (IPS), and Phillips-Perron (PP), that the variables were stable. We can know if there exist multicollinearity issues by examining correlations among two independent variables. Thus, there exist multicollinearity issues if the correlation between two independent variables is elevated, then the independent variables are indefinite and the variables' standard errors would be unlimited (Gujarati, 2011). Thus, we can carry on with regression analysis on data by employing E-views software.

The next step after getting stationary variables at their levels is to check Hausman test. Hausman test can be easily defined as the process employed in experimental panel data study to differentiate the model of the random and fixed effects. The null hypothesis Hausman test is random effect model is appropriate, while, the alternative hypothesis is random effect is not appropriate for our model.

The models which will be used in this research are:

$$ROA = \beta_0 + \beta_1(CAR_{i,t}) + \beta_2(ASQ_{i,t}) + \beta_3(EFF_{i,t}) + \beta_4(LQR_{i,t}) + \beta_5(LOGSIZE_{i,t}) + \epsilon_t$$

$$ROE = \beta_0 + \beta_1(CAR_{i,t}) + \beta_2(ASQ_{i,t}) + \beta_3(EFF_{i,t}) + \beta_4(LQR_{i,t}) + \beta_5(LOGSIZE_{i,t}) + \epsilon_t$$

Where β_0 is the intercept of the regression

$\beta_1, \beta_2, \beta_3, \beta_4$ and β_5 are the coefficients of the independent variables.

Chapter 5

EMPIRICAL ANALYSIS AND RESULTS

We have to begin with studying the data with regards to stationarity. The criterion suppositions would not be true for the asymptotic analysis When the series is not stationary (Gujarati, 2011). The unit root test was employed for both Islamic and Conventional Banks to study the data's stationarity. The unit root tests' findings that were made relying on Levin, Lin & Chu (LLC), Im Pesaran Shin (IPS), and Phillips-Perron (PP) shown in tables 6 and 7 illustrate that the null hypothesis can be rejected, while the alternative hypothesis cannot be rejected.

H0: data has unit root.

H1: data has no unit root.

Table 6: Unit Root Tests for Islamic Banks

Variables		Levels		
		LLC	IPS	PP
ROA	τ_T	-0.44	0.74	6.46
	τ_μ	-2.66*	-0.94	22.40*
	τ	-2.71*	-	17.75*
ROE	τ_T	-2.51*	0.10	6.13
	τ_μ	-2.75*	-1.19	12.57
	τ	-2.20**	-	12.15
CAR	τ_T	-4.00*	-0.85	33.43*
	τ_μ	-6.11*	-3.10*	30.36*
	τ	-1.00	-	10.37
ASQ	τ_T	-3.45*	-0.09	8.67
	τ_μ	-3.16*	-1.18	10.86
	τ	-1.83**	-	10.07
EFF	τ_T	-2.45*	-0.20	27.20*
	τ_μ	3.49	3.01	8.17
	τ	5.56	-	3.98
LQR	τ_T	-1.34***	0.04	14.26***
	τ_μ	-1.38***	-0.07	11.04
	τ	0.36	-	7.06
SIZE	τ_T	-6.07*	-1.45**	36.95*
	τ_μ	-4.85*	1.59***	37.66*
	τ	3.05	-	0.08

Table 7: Unit Root Tests for Conventional Banks

Variables	LLC	Levels IPS	PP
ROA			
τ_T	-5.37*	-0.10	32.51*
τ_μ	-8.53*	-4.21*	69.51*
τ	-2.50*	-	39.93*
ROE			
τ_T	-2.23**	0.54	12.50
τ_μ	-4.22*	-1.81**	41.00*
τ	-2.94*	-	36.73*
CAR			
τ_T	-9.40*	-2.12**	48.8**
τ_μ	-5.51*	-3.17*	40.57*
τ	0.40	-	11.94
ASQ			
τ_T	0.27	1.14	4.31
τ_μ	-2.50*	-0.59	10.33
τ	-1.53***	-	12.53
EFF			
τ_T	-1.98**	0.85	25.69**
τ_μ	6.47	6.76	0.04
τ	7.03	-	0.11
LQR			
τ_T	-8.73*	-1.86**	48.99*
τ_μ	-6.25*	-2.87*	39.38*
τ	-1.40***	-	15.24
SIZE			
τ_T	-15.25*	-5.03*	39.64*
τ_μ	-14.77*	-7.55*	110.59*
τ	5.24	-	0.32

Note: ROA represents return on assets; ROE represents return on equity; CAR represents capital adequacy ratio; ASQ represents asset quality ratio; EFF represents management efficiency; LQR represents liquidity ratio's size represents bank size; τ_T represents the most general model with a drift and trend; τ_μ is the model with a drift and without trend; τ is the most restricted model without a drift and trend. trend. *, **, * representing rejection of H0 (non-stationary) at the 1%.5% and 10% respectively. Tests for unit root have been carried out in E-VIEWS 7(katircioglu et al., 2009).

5.1 Correlation analysis

Correlation analysis is utilized to figure out the strength of the relation among variables. This relation can happen among independent variables and dependent ones, as well as it can be among independent variables facing other independent variables. Generally, the use of Correlation analysis shows the strength of the relationship between them.

In this examination, we have tested correlations in Islamic Banks and Conventional Banks in detach groups.

Table 8: Correlations for Islamic Banks Variables

	ROA	ROE	CAR	ASQ	EFF	LQR	LOG SIZE
ROA	1						
ROE	0.71	1					
CAR	0.44	-0.25	1				
ASQ	-0.76	-0.63	-0.31	1			
EFF	-0.06	-0.19	0.07	0.11	1		
LQR	-0.42	-0.45	-0.06	0.30	0.40	1	
LOGSIZE	-0.11	0.25	-0.60	0.19	0.25	0.02	1

In the case of Islamic banks, table 8 illustrate that the effect on ROA is positive from CAR negative from ASQ, EFF, LQR, and LOGSIZE. In addition, positive impact on

ROE from LOGSIZE and negative impact from CAR, ASQ, EFF, LQR, and LOGSIZE can be noticed.

Table 9: Correlations for Conventional Banks variables

	ROA	ROE	CAR	ASQ	EFF	LQR	LOG SIZE
ROA	1.00						
ROE	0.53	1.00					
CAR	0.55	-0.29	1.00				
ASQ	-0.50	-0.48	0.06	1.00			
EFF	0.024	-0.11	0.22	0.09	1.00		
LQR	-0.18	-0.04	-0.16	0.17	-0.04	1.00	
LOGSIZE	-0.66	-0.21	-0.55	0.24	0.12	-0.04	1.00

In the case of Conventional Banks, referring to table 9, impact on ROA is positive from CAR and EFF; in opposite, ASQ, LQR, and LOGSIZE have affected it negatively. In addition, negative impact of CAR, ASQ, EFF, LQR, and LOGSIZE on ROE can be noticed.

5.2 Hausman Test

The next step after getting stationary variables at their levels is to check Hausman test. Hausman test can be easily defined as the process employed in experimental panel data study to differentiate the model of the random and fixed effects. The null hypothesis of Hausman test is random effect model is appropriate, while, the alternative hypothesis is random effect is not appropriate for our model.

5.2.1 Effects Testing for Islamic Banks

First of all, we failed to apply Hausman test. The reason behind that was that Random effect estimation requires number of cross sections more than the number of coefficients. The next step is to check whether Fixed effect is appropriate or not. As mentioned before, the null hypothesis of fixed effect test is fixed effect is not appropriate. The tables 10 and 11 show that the null hypothesis in both ROA and ROE models test cannot be rejected since it is not significant at 1%, nor at 5%, and nor at 10% levels of significance, so, the models which will be adopted are the regression models without any effects.

Table 10: Fixed Effect Testing Result of ROA model for Islamic Banks

Effects Test	Statistic	d.f.	Prob.
Cross-section F	1.363542	(3.31)	0.2721
Cross-section Chi-square	4.957874	3	0.1749

Table 11: Fixed Effect Testing Result of ROE Model for Islamic Banks

Effects Test	Statistic	d.f.	Prob.
Cross-section F	0.783873	(3.31)	0.5120
Cross-section Chi-square	2.924763	3	0.4034

5.2.2 Effect Testing for Conventional Banks

After applying Hausman test on both ROA and ROE models we came to the result, which is shown in tables 12 and 13, that we can reject the null hypothesis which says that random effect model is appropriate for our models.

Table 12: Random Effect Testing Result of ROA model for Conventional Banks

Test Summary	Chi-sq. statistic	Chi-sq. d.f.	Prob.
Cross- section random	15.436655	5	0.0087

Table 13: Random Effect Testing Result of ROE Model for Conventional Banks

Test Summary	Chi-sq. statistic	Chi-sq. d.f.	Prob.
Cross- section random	29.960810	5	0.0000

After knowing that Random effect model is not appropriate for ROA and ROE models, we checked whether fixed effect is appropriate or not. The null hypothesis of fixed effect test is that fixed effect model is not appropriate, so, in order to adopt the fixed effect model we should reject the null hypothesis. The following two tables, 14 and 15, show the results which indicate that fixed effect model is appropriate for both, ROA and ROE, models.

Table 14: Fixed Effect Testing Result of ROA Model for Conventional Banks

Effects Test	Statistic	d.f.	Prob.
Cross-section F	10.048258	(6,58)	0.0000
Cross-section Chi-square	49.888470	6	0.0000

Table 15: Fixed Effect Testing Result for ROE Model

Effects Test	Statistic	d.f.	Prob.
Cross-section F	7.286569	(6,58)	0.0000
Cross-section Chi-square	39.324263	6	0.0000

5.3 Regression Analysis

Regression analysis is a method used to study the effect that dependent and independent variables have on each other, and it is considered of the most prevalent and convenient techniques used in econometrics concerning this type of study. The aim of this research is, as explained in the previous chapters, to figure out the bank's particular variables that have an impact on the financial interpretation of banks with regards to profitability. We must remember that the dependent variables are ROA and ROE and we seek to figure out the influence of CAR, LQR, ASQ, and EFF. In a measure, the independent variables have the capability to leave either a good or a bad impact on dependent variables.

The table 16 shows the expected effect from the independent variables on ROA and ROE on the one hand, and, the actual effect that we got by using E-views software on the other hand.

Table 16: The Variables Notation and Their Measurement:

			Islamic Banks		Conventional Banks	
	Variables	Expected Relationship with ROA and ROE	The Effect on ROA	The Effect on ROE	The Effect on ROA	The Effect on ROE
Independent Variables	Capital Adequacy	(-)	(+)	(-)	(-)	(-)
	Asset Quality	(-)	(-)	(-)	(-)	(-)
	Efficiency	(+)	(+)	(-)	(+)	(+)
	Liquidity	(-)	(-)	(-)	(-)	(-)
	Bank Size	(+)	(+)	(+)	(-)	(-)

5.3.1 Regression Analysis Results for Islamic Banks

Table 17: Simple Regression Results of ROA Model for Islamic Banks

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.008294	0.010000	-0.829470	0.4126
CAR	0.043649	0.013954	3.128061	0.0036
ASQ	-0.482459	0.067039	-7.196696	0.0000
EFF	9.66E-05	0.000876	0.110326	0.9128
LQR	-0.030863	0.016013	-1.927364	0.0623
LOGSIZE	0.002299	0.001069	2.151077	0.0387
R-squared	0.713507			
Adjusted R-squared	0.671376			
S.E of regression	0.005137			
F-statistic	16.93530			
Durbin-Watson stat	1.207259			

Table 18: Simple Regression Results of ROE for Islamic Banks

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.102820	0.094048	1.093277	0.2820
CAR	-0.425800	0.081732	-5.209687	0.0000
ASQ	-4.767146	0.559324	-8.523054	0.0000
EFF	-0.000980	0.005949	-0.164732	0.8701
LQR	-0.313694	0.122493	-2.560918	0.0150
LOGSIZE	0.014540	0.009434	1.541205	0.1325
R-squared	0.729054			
Adjusted R-squared	0.689209			
S.E. of regression	0.043424			
F-statistic	18.29727			
Durbin-Watson stat	1.611016			

Intercept

The intercept is known as the worth of change in the explained variables when there is no change in the explanatory variables. Referring to tables 17 and 18, the intercept in both ROA and ROE models is statistically insignificant at 1%, 5%, and 10% levels of significance.

Capital Adequacy

CAR was statistically significant in both ROA and ROE models at 1% level of significance and it has a positive impact on ROA while a negative impact on ROE. That means, if CAR increase by 1 unit ROA will increase by 0.043649 units while ROE will decrease by 0.425800 units. In the case of ROE Model, we can say that if the management of Islamic banks will rely more on their Capital adequacy, they might not be able to generate enough profit from their assets.

Asset Quality

ASQ is statistically significant at 1% significance level in both ROA and ROE models and it has negative effect on both models. In other words, if ASQ increase by 1 unit ROA will decrease by 0.482459 and ROE will decrease by 4.767146 units. The result means that banks managers should be careful about giving loans in order to decrease the amount of PLL to the minimum so they can reduce the possibility of falling into losses.

Efficiency

EFF is statistically insignificant in both ROA and ROE models.

Liquidity

LQR is statistically significant at 10% and 5% significance levels in both ROA and ROE models respectively. LQR has a negative impact on the dependent variables in both ROA and ROE models where the coefficients are equal to (-0.030863) and (-0.313694) respectively. That means when LQR increase by 1 unit ROA will decrease by 0.030863 units and ROE by 0.31 units approximately. In order to find the liquidity ratio we divided cash by total assets. Since LQR has a negative impact on ROA and

ROE the banks managers should not excess in using cash to liquid their assets which leads to a solvency problem.

LOGSIZE

In the model where ROA is dependent variable, LOGSIZE is statistically significant at 5% significance level. The coefficient is equal to 0.002299. This result means that if LOGSIZE increase by 1% ROA will increase by 0.002299 units. In opposite, LOGSIZE is not statically significant in the model where ROE is dependent variable.

5.3.2 Regression Analysis Results for Conventional Banks

Table 19: Regression Results with Fixed Effect of ROA Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.154730	0.030326	5.102244	0.0000
CAR	-0.002483	0.024931	-0.099607	0.9210
ASQ	-0.321546	0.049227	-6.531839	0.0000
EFF	0.002693	0.000580	4.646837	0.0000
LQR	-0.003913	0.004437	-0.881837	0.3815
LOGSIZE	-0.011946	0.002507	-4.764496	0.0000
R-squared	0.836817			
Adjusted R-squared	0.805868			
S.E. of regression	0.003613			
F-statistic	27.03898			
Durbin-Watson stat	1.247605			

Table 20: Regression Results with Fixed Effects of ROE Models

Variable	Coefficient	Std.Error	t-Statistic	Prob.
C	1.919062	0.440602	4.355546	0.0001
CAR	-2.096624	0.749330	-2.797998	0.0070
ASQ	-1.611241	0.895238	-1.799792	0.0771
EFF	0.034965	0.012658	2.762213	0.0077
LQR	-0.028832	0.065220	-0.442078	0.6601
LOGSIZE	-0.124974	0.033745	-3.999836	0.0002
R-squared	0.670583			
Adjusted R-squared	0.608108			
S.E. of regression	0.045060			
F-statistic	10.73353			
Durbin-Watson stat	1.437021			

Intercept

According to the tables 19 and 20, the intercept is statically significant at 1% significance level in both ROA and ROE models. The coefficients are equal to 0.15 and 1.92 approximately in ROA and ROE models respectively. That means if the independent variables remain the same then ROA will increase by 0.15 units and ROE by 1.92 units.

Capital Adequacy

CAR is statistically insignificant in the model where ROA is dependent variable, while, it is at 1% significance level in the ROE model. Its coefficient is equal to (-2.096624). In different way, it means if the CAR increase by 1 unit ROE will decrease by 2.096624 units.

Asset Quality

In both models ASQ is statistically significant at 1% and 10% significance level respectively and it is negatively correlated for both models. That means if ASQ increase by 1 unit ROA will decrease by 0.32 units and ROE by 1.61 units. In other words, these results mean that banks managers should avoid the increasing of non-performing loans which leads to increasing in PLL so banks will not generate more profit.

Efficiency

EFF has prob. equal to 0.00 and 0.0077 in ROA and ROE models respectively which means that EFF is statistically significant at 1% significance level for both models. Its coefficients are equal to 0.002693 and 0.034965 for ROA and ROE models respectively. The explanation for that is that when EFF increase ROA will increase by 0.002 units and ROE by 0.03 units. Thus, banks' managers have succeeded to earn more profit comparing to their expenses.

Liquidity

LQR is statistically insignificant for both models.

LOGSIZE

LOGSIZE has prob. equal to 0.0000 in ROA model and 0.0002 in ROE model which means that it is statistically significant at 1% significance level in both models. LOGSIZE affect ROA and ROE negatively. The results mean that when LOGSIZE increase by 1% ROA will decrease by 0.011946 units and ROE by 0.134974 units.

5.4 Diagnostic Testing

On one hand, multicollinearity issue means that there are at least two independent variables which have a strong relationship between each other. According to the correlation tables that we showed above, there are no strong relationships between the variables themselves neither among Islamic Banks neither conventional Banks. On the other hand, the using of white cross-section standard errors and covariance in the regressions will correct automatically the issue of Heteroscedasticity.

Chapter 6

CONCLUSION AND SUGGESTIONS

The performance of banks is commonly said to be of the bases that the countries' economy rely upon; in addition the banks are mostly considered the spine of the economy and the financial sector. Banks pump money to economy and seek to spread it in a convenient and appropriate way, and they are considered financial intermediators. What Bankers seek to create additional gain to their shareholders while what concerns the government is the country's entire economy. Thus, the performance of banks is extremely important and vital for bankers as for the government. The reason of this research was made is to show how significant the performance of banks is. So, this study aims to examine the profitability for both banking systems in the UAE. Therefore this study examined 4 Islamic banks and 7 commercial banks in the UAE during the period of 2005- 2014 and both measurement profitability ratios (ROE and ROA) were applied as dependent variables. On the other hand, Asset Quality, Liquidity, Capital Adequacy, Management Efficiency and Bank Size formed the independent variables.

First, the banks were selected according to their asset size which is the biggest among local banks in UAE. Secondly, the Data were extracted from the balance sheet and income statement which are published at their websites. Thereafter, applying E-views software, some results were found.

From the Islamic banks perspective the findings pointed out that variables ASQ and LQR have impacted ROA and ROE negatively in Islamic Banks and these findings agree with the results found by Hamedian (2013) in his research. In addition, CAR has affected positively on ROA and negatively on ROE, while, LOGSIZE had a positive influence on ROA but was statistically insignificant on ROE. Moreover, EFF was statistically insignificant on Profitability and this result is logical since loans that bear interest are not offered in the Islamic banks basket services. On the other hand, regression tables of conventional banks show that CAR, ASQ, and LOGSIZE have negatively affected the bank's profitability. EFF had a positive impact on profitability, while, LQR was statistically insignificant.

Depending on the above results, Islamic banks managers should be careful about giving loans, loans under Islamic law, in order to decrease the amount of PLL to the minimum so they can reduce the possibility of falling into losses, at the same time, they should adopt an appropriate cash policy in order to use their cash to generate more profit. While, the first recommendation for conventional bank managements is that they should be accurate about the quality of loans they give since the loans are the most important instruments to generate profit in the conventional banks. Secondly, I recommend them to consider the way they are managing their assets, so, they can manage them in beneficial way that can lead to positive impact on profitability. The third point is that they should adopt a benefit cash policy otherwise they will not be able to cover their short term commitment which can lead to the bankruptcy.

To sum up, Islamic banks were good in CAR and LOGSIZE since they were affected ROA positively. In contrast, conventional banks did well in EFF while the same variable was insignificant on the profitability for Islamic banks because of different strategies and policies adopted by both banking systems. Finally, we cannot say that one banking system performed better than the other one since the factors indicate a negative impact on the profitability of both banking systems.

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APPENDIX

Appendix A: Regression Tables

Table 17: Simple Regression Results for Islamic Banks

Dependent Variable: ROA
Method: Panel Least Squares
Date: 01/13/16 Time: 10:59
Sample: 2005 2014
Periods included: 10
Cross-sections included: 4
Total panel (balanced) observations: 40
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.008294	0.010000	-0.829470	0.4126
CAR	0.043649	0.013954	3.128061	0.0036
ASQ	-0.482459	0.067039	-7.196696	0.0000
EFF	9.66E-05	0.000876	0.110326	0.9128
LQR	-0.030863	0.016013	-1.927364	0.0623
LOGSIZE	0.002299	0.001069	2.151077	0.0387
R-squared	0.713507	Mean dependent var		0.014081
Adjusted R-squared	0.671376	S.D. dependent var		0.008961
S.E. of regression	0.005137	Akaike info criterion		-7.567188
Sum squared resid	0.000897	Schwarz criterion		-7.313856
Log likelihood	157.3438	Hannan-Quinn criter.		-7.475591
F-statistic	16.93530	Durbin-Watson stat		1.207259
Prob(F-statistic)	0.000000			

Table 18: Simple Regression Results for Islamic Banks

Dependent Variable: ROE
 Method: Panel Least Squares
 Date: 01/13/16 Time: 11:03
 Sample: 2005 2014
 Periods included: 10
 Cross-sections included: 4
 Total panel (balanced) observations: 40
 White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.102820	0.094048	1.093277	0.2820
CAR	-0.425800	0.081732	-5.209687	0.0000
ASQ	-4.767146	0.559324	-8.523054	0.0000
EFF	-0.000980	0.005949	-0.164732	0.8701
LQR	-0.313694	0.122493	-2.560918	0.0150
LOGSIZE	0.014540	0.009434	1.541205	0.1325
R-squared	0.729054	Mean dependent var		0.107789
Adjusted R-squared	0.689209	S.D. dependent var		0.077893
S.E. of regression	0.043424	Akaike info criterion		-3.298112
Sum squared resid	0.064113	Schwarz criterion		-3.044780
Log likelihood	71.96224	Hannan-Quinn criter.		-3.206515
F-statistic	18.29727	Durbin-Watson stat		1.611016
Prob(F-statistic)	0.000000			

Table 19: Regression Results with Fixed Effect for Conventional Banks

Dependent Variable: ROA
Method: Panel Least Squares
Date: 01/13/16 Time: 11:05
Sample: 2005 2014
Periods included: 10
Cross-sections included: 7
Total panel (balanced) observations: 70
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.154730	0.030326	5.102244	0.0000
CAR	-0.002483	0.024931	-0.099607	0.9210
ASQ	-0.321546	0.049227	-6.531839	0.0000
EFF	0.002693	0.000580	4.646837	0.0000
LQR	-0.003913	0.004437	-0.881837	0.3815
LOGSIZE	-0.011946	0.002507	-4.764496	0.0000

Effects Specification

Cross-section fixed (dummy variables)			
R-squared	0.836817	Mean dependent var	0.020039
Adjusted R-squared	0.805868	S.D. dependent var	0.008199
S.E. of regression	0.003613	Akaike info criterion	-8.253928
Sum squared resid	0.000757	Schwarz criterion	-7.868471
Log likelihood	300.8875	Hannan-Quinn criter.	-8.100820
F-statistic	27.03898	Durbin-Watson stat	1.247605
Prob(F-statistic)	0.000000		

Table 20: Regression Results with Fixed Effect for Conventional Banks

Dependent Variable: ROE
Method: Panel Least Squares
Date: 01/13/16 Time: 11:06
Sample: 2005 2014
Periods included: 10
Cross-sections included: 7
Total panel (balanced) observations: 70
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.919062	0.440602	4.355546	0.0001
CAR	-2.096624	0.749330	-2.797998	0.0070
ASQ	-1.611241	0.895238	-1.799792	0.0771
EFF	0.034965	0.012658	2.762213	0.0077
LQR	-0.028832	0.065220	-0.442078	0.6601
LOGSIZE	-0.134974	0.033745	-3.999836	0.0002

Effects Specification

Cross-section fixed (dummy variables)			
R-squared	0.670583	Mean dependent var	0.152537
Adjusted R-squared	0.608108	S.D. dependent var	0.071979
S.E. of regression	0.045060	Akaike info criterion	-3.206839
Sum squared resid	0.117763	Schwarz criterion	-2.821383
Log likelihood	124.2394	Hannan-Quinn criter.	-3.053732
F-statistic	10.73353	Durbin-Watson stat	1.437021
Prob(F-statistic)	0.000000		