RESEARCH ARTICLE

ASSESSMENT OF ISLAMIC BANKS PROFITABILITY RATIOS-EVIDENCE FROM JORDAN

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ABSTRACT

This study aimed to identify and compare the financial performance of all full-fledged Islamic banks operating in Jordan, in relation to profitability. Data has been retrieved from the financial annual reports for 2011 and 2014. As 2011 was the first full year of two Islamic banks, namely, Jordan Dubai Islamic banks, and Al-Rajhi Islamic Bank. Illustrious profitability ratios analysis had been applied with descriptive and inferential statistics for analyzing the results. Empirical results revealed that Jordanian Islamic banks in the year 2014 were more profitable than the year 2011, except for Islamic International Arab Bank, but with no significant relationship between the means for the relative years in relation to return on assets, return on equity, and profit margin. On behalf of the deviation and coefficient of variance as consistency values also proved that the year 2014 was more consistent than the year 2011, as its values were higher for the year 2011, except for the ROA ratio.

INTRODUCTION

In todays' global and boarder less market, all types of organizations, especially banks, have to adopt innovative strategies to ensure continuous improvement, and in order to do so banks should satisfy the needs of customers and meet their high changing expectations. Due to the importance of their financial system and influence on national economies, banks are highly regulated in most countries, most nations have institutionalized a system known as reserve banking called central banks, under which commercial banks hold liquid assets equal to only a portion of their current liabilities and deposits them in central banks.

Over the last 20 years, interest-free banking attracted a lot of attention, this awareness took place because of the emergence of young Muslim economists (Naqvi, 2011), where Islamic finance proved to be the fastest-growing segment of the global financial system (Lawal, 2010). Islamic economics was described as part of a dynamic, universal way of life that promotes social interaction at the highest possible level (Masruki *et al*., 2011). Swartz (2012) added that the Islamic economic profit sharing authorized strategies would enable the former historical disadvantages of interest, which was basically clear after the world economic crisis in 2008.

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Research Objectives

The study was designed to evaluate and comparatively analyze the financial performance of Jordanian Islamic banks subject to profitability, for the periods 2011 and 2014. The study addressed to contribute in abridging the knowledge gap identified in literature, regarding Islamic banks financial performance, especially profitability, in relation to time, as the year 2011 was the first year after introducing two additional Islamic banks, so the comparison came to see Islamic banks performance after four years of performance in the Jordanian-banking sector.

Significant of the Study

The competitive performance evaluation of Islamic banks for the two periods illustrates the knowledge gap prevailing in literature regarding financial performance evaluation of Jordanian Islamic banks. The research hopes to identify further research issues and questions pertaining to measurement and mitigation of Islamic bank performance, as it helps investors to identify chances and investment opportunity and choose among the banks. Since investments and loans are the largest portion of bank assets, and interest of loans resembles the largest portion of bank revenue and returns (Castelli *et al*., 2006), this study came to evaluate the performance of all the Islamic banks in Jordan, and then compare each bank with the conventional banks.

Literature Review

As known, a failure of a single bank creates an economic confusion, and is regarded as an economy disaster. Bank performance can be studied by either financial or non-financial perspectives, and for any business to continue it must perform in a successful matter, especially profitability (Ranti, 2011). Moin (2008) evaluated the performance of the first Islamic bank in Pakistan and compared it the conventional banks, for the period 2003 – 2007. By using t-test results revealed that, the Islamic bank was less profitable than the other group in a significant relationship. Kadir *et al*. (2013) also examined the financial performance of the banking systems in Malaysia, and t-test showed a positive significant relationship in favor to the conventional banks.

However, Fadzlan (2010) examined the impact entry of foreign Islamic banks on the performance of Malaysian Islamic banks during the period 2001-2007. Ordinary least squares and standard errors were used; results exposed a negative relationship between overhead cost and profitability. After that Hassan *et al*. (2013) examined banking in a group of countries including Jordan, results indicated that foreign Islamic banks on average follow aggressive financing in host countries and enjoy higher net profit margin.

Ahmad and Noor (2010) clarified that the more profitable banks are those that with higher operating expenses to assets, more equity against assets, Akhtar *et al*. (2011) analyzed the trends in progress of Islamic banks in Pakistan and results revealed positive improvement in the financial position over time. Islamic banks in GCC countries over the period 2005-2009 in Zarrouk (2012) were compared before and after the crisis, and results stated that the financial crisis negatively affected the Islamic bank performance. Furthermore, profitability of the Islamic banks also decreased after the crisis, especially in Kuwait, Bahrain, and United Arab Emirates.
El-Galfy and Khiyar (2012) argued that potential Islamic banking practices bring stability at macro in economic development, and as the responsibility of the management is not limited only to shareholders, the study came to test the most used profitability ratios.

Return on Assets (ROA) is considered the most popular ratio to measure financial performance, in the banking industry. ROA shows the ability of management to acquire deposits at reasonable cost and invest them in profitable investments. While Return on Equity (ROE) gives a complete and comprehensive view of the financial performance, by covering profitability, expenditures equity and debt measurement. At the same time, Profit Margin (PM) (also called net profit margin) is the most basic profitability ratio that measures the percentage of net income of an entity to its expenses (Amjad *et al*., 2013). It represents the proportion of income that is left over after all relevant expenses have been adjusted; net profit margin is used to compare profitability of competitors in the same industry.

Islamic Bank Performance

Islam, as a way of life, has always promoted good ethics, integrity, honesty, and proved to be a system that may improve world economy (Paino *et al*., 2011).

Appropriate performance measures depend on the organization, such as profitability, liquidity, asset quality, and risk. Islamic banks products and services have to compete with different or competitive products and services offered by conventional banks or other competitive Islamic banks, and meanwhile stay productive (Abdulrahem *et al*., 2011). In Jordan, there are four Islamic banks. Jordan Islamic Bank " was established in 1978 as the first Islamic bank in Jordan, aimed to carry out all kinds of banking, financing and investment business operations in compliance with Islamic Shariah" (Jordan Islamic Bank Financial Report, 2014).

The second Islamic bank in Jordan was established in 1998 named the Islamic International Arab Bank, "which commenced its banking operations in accordance with Islamic Shariah rules, to meet the growing demand for Islamic banking services and products in the local, Arab and Islamic markets" (Islamic International Arab Bank Financial Report, 2014). While Jordan Dubai Islamic bank was successfully converted and restructured into a fully-fledged Islamic bank in 2009, and started working in the year 2010, as it was previously named Dubai Jordan Bank as a conventional bank. Inorder to reflect the new identity of Shariah compliant and *Halal* institutions and with the fresh injection of capital (Jordan Dubai Islamic Bank Financial Report, 2014). Al Rajhi Bank; as a foreign bank; started operating in Jordan in the year 2011, with 4 branches fully functional in Amman, and 2 in the other cities (www.cbj.gov.jo.). In Jordan and based on an article at Addustour newspaper, and after a study, economists see that there is no need to expand the Islamic banking market, as the demand on such type of banks is low compared with the other 21 conventional banks (Alddustour newspaper, 2012).

MATERIALS AND METHODS

Based on the previous literature, common used ratios had been applied to evaluate and measure financial performance by profitability of the Islamic banks in Jordan. In this study, the descriptive statistics will be presented through frequencies and percentages by summarizing the grouped data using a combination of tabulated description and graphical description. Coefficient of variance was also calculated by using the standard deviation, as if the coefficient of variance decreased it would be an indication of high dispersion of data points around the mean, which leads to consistency, and more homogeneity within the group, which leads to less risk and better performance in banks (Turen, 1995) and Asif Kan *et al*. (2015). The equation is calculated as following:

$$C.V. = \frac{s}{x} * 100$$

Since the main aim of this research was to find the difference between both conventional and Islamic banks, t-test was used in order to determine any significant difference between the two groups mean (Malik and Mullen, 1975), by using the following formula:

$$= \frac{\mu 1 - \mu 2}{\sqrt{\frac{s_1^2 + s_2^2}{n-1}}}$$

Explanation of the Ratio Model

Ratio Analysis is an analytical tool applied by investors and lenders to safeguard their decisions, as it reflects the financial performance of an organization, by examining the financial statements (Ho and Wu, 2006). Financial health and financial position could be known and clarified by the help of financial ratios. In this research, profitability will be used as an evaluating measurement of financial performance. In this research and based on literature review, since Islamic banks performance is based on profit loss sharing, and based on its importance profitability was the financial performance group used to compare all the Islamic banks in Jordan, and compare them with all the banks in the sector, so the research model was as indicated in Figure (1).
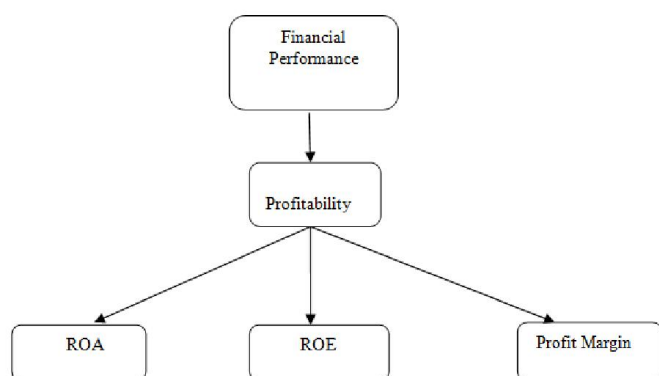

Figure 1.

Profitability Ratios

Profitability became an important issue, which could help banks understand the current conditions of the bank, critical factors that they should consider in making decisions and creating new policies for either recovery or improvement, the ability to earn profit may be measured in term of return on assets, return on equity, and profit margin (Hasan *et al.*, 2013).

There is a significant difference of the financial performance of Jordanian Islamic banks in terms of profitability. The hypothesis was sub-divided into the following hypotheses:

- There is a significant difference of the financial performance of Jordanian Islamic banks in terms of ROA.
- There is a significant difference of the financial performance of Jordanian Islamic banks in terms of ROE.
- There is a significant difference of the financial performance of Jordanian Islamic banks in terms of profit margin.

Then the research came to compare the Islamic banks in individual compared with the conventional banks mean for the years 2011 and 2014.

Data Sampling and Statistics

The data had been retrieved from the annual financial reports of all the Jordanian Islamic banks, for the periods 2011 and 2014. As the year, 2011 was the first full working year of two new Islamic banks in the market. Simple statistics mean standard deviation, coefficient of variance, and t-test was applied for the performance analysis. Table (1) illustrated the Islamic Banks in Jordan, date of establishment, and whether it is registered as a local or foreign bank.

Data Analysis and Discussion

Profitability

Profitability of the selected Islamic banks in this study was measured in terms of ROA, ROE, PM, and discussed respectively.

Return on Assets

Table (2) and Figure (1), reflects the descriptive results and profitability indicator for the period 2011 and 2014. The Islamic banks mean for the period 2014, was higher than the year 2011, as in 2011 both Jordan Dubai Islamic bank and Al-Rajhi bank stated losses in their net income, which caused the ratio to be negative.

Table 1. Islamic Banks in Jordan and Year of Establishment

Bank Name	Jordan Islamic Bank	Islamic International Arab Bank	Jordan Dubai Islamic Bank	Al-Rajhi Bank
Year of Establishment	1978	1997	2009	2011
Type of Bank	Local Bank	Local Bank	Local Bank	Foreign Bank

Table 2. ROA for the year 2011 and 2014

Name of Bank	ROA 2011	ROA 2014
Mean of total Banks in Jordan	0.0072	0.0100
Jordan Islamic Bank	0.0097	0.0126
Islamic International Arab Bank	0.0094	0.0085
Jordan Dubai Bank	-0.0019	0.0029
Al-Rajhi Bank	-0.039	0.0049
Mean of Islamic Banks	-0.0054	0.0072
Standard deviation of Islamic Banks	0.0230	0.0042
Coefficient of variance of Islamic Banks	-4.2366	0.5888
Significance	0.3523	

Significant at a $\alpha < 0.05$ level.

Hypothesis

To evaluate and analyze the financial performance of the Jordanian Islamic banks, and to draw a comprehensive comparison, the following main hypothesis was tested:

The coefficient of variance for the year 2014 was higher even though 2011 revealed losses, but was less risky. However, as noticed there was no significant difference between the two mean, which means that there is no difference in terms of ROA between the Islamic banks.
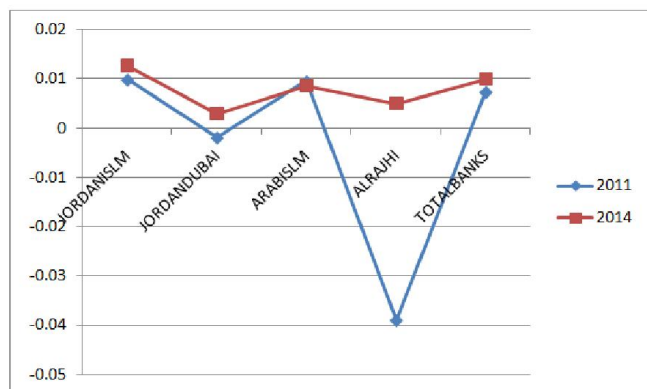
Figure 1. ROA of Islamic Banks and Total Banks in Jordan

Table 3. ROE for the year 2011 and 2014

Name of Bank	ROE 2011	ROE 2014
Mean of All Banks in Jordan	0.0718	0.1061
Jordan Islamic Bank	0.1369	0.1599
Islamic International Arab Bank	0.1180	0.1024
Jordan Dubai Bank	-0.0059	0.0147
Al-Rajhi Bank	-0.1212	0.0479
Mean	0.0319	0.0812
Standard deviation	0.1201	0.0636
Coefficient of variance	3.7618	0.7838
Significance	0.50389	

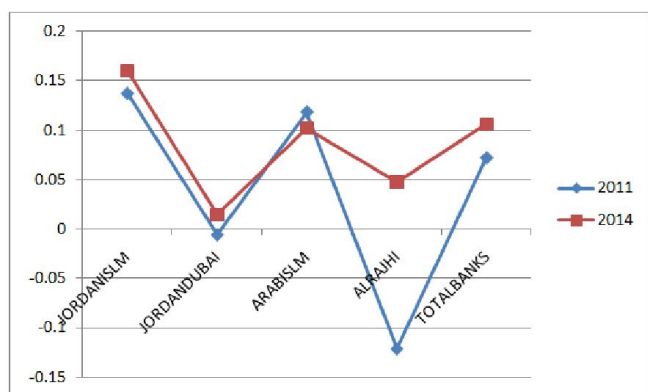Significant at a $\alpha \leq 0.05$ level.

Figure 2. ROE of Islamic Banks and Total Banks in Jordan

Table 4. Profit Margin (PM) for the year 2011 and 2014

Name of Bank	PM 2011	PM 2014
Mean of All Banks in Jordan	0.4600	0.5894
Jordan Islamic Bank	0.7349	0.8719
Islamic International Arab Bank	0.6996	0.5431
Jordan Dubai Bank	-0.0547	0.1235
Al-Rajhi Bank	-1.0662	0.1580
Mean	0.0783	0.4241
Standard deviation	0.8455	0.3539
Coefficient of variance	10.7892	0.8343
Significance	0.4923	

Significant at a $\alpha \leq 0.05$ level.

In comparison with the total bank averages for the periods 2011 and 2014, Jordan Islamic Bank was the only Islamic bank to have a higher ROA than the average of banks for both periods; while Islamic International Arab Bank had a higher mean only for the period 2011.
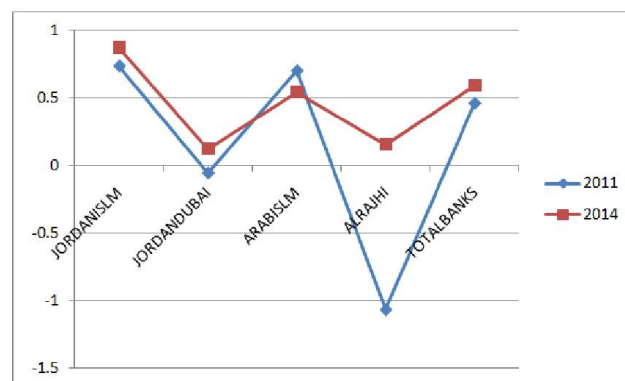

Figure 3. PM of Islamic Banks and Total Banks in Jordan

Return on Equity

The previous scenario for ROE is the same as the ROA. As stated in table (3) and figure (2), the mean for Jordan Islamic Bank was 0.1369 for the year 2011 and 0.1599 for the year 2014. Whereas Islamic International Arab Banks mean was 0.118 and 0.1024, respectively. While the coefficient of variance the year 2011 indicated a riskier performance, but in general results did not show a significant difference between the means.

Profit Margin

Results for the PM ratio in relation to explain the ability of operating expenses to generate net income, seems also consistent with the previous profitability ratios, as both Jordan Islamic Bank and Islamic International Arab Bank of Jordan PM was higher for the period 2011, and for the period 2014, only Jordan Islamic Bank was higher. Results also reveal no significant difference between the two means, and a lower coefficient variable for the period 2014, which means more consistency and less riskiness and higher performance.

Summary

The study identified and compared the financial performance of all full-fledged Islamic banks operating in Jordan, in relation to profitability, then each bank was compared with the mean of the total working banks in Jordan. Data was retrieved from the financial annual reports for 2011 and 2014, familiar profitability ratios analysis were applied with descriptive and inferential statistics for analyzing the results. Empirical results revealed that Jordanian Islamic banks in the year 2014 were more profitable than the year 2011, except for Islamic International Arab Bank, but with no significant relationship between the means for the relative years in relation to return on assets, return on equity, and profit margin. For the deviation and coefficient of variance as consistency values also proved that the year 2014 was more consistent than the year 2011, as its values were higher for the year 2011, except for the ROA ratio. Even though all banks in Jordan profitability ratios increased in the year 2014, especially the new Islamic banks, but it seems that they took part of the Islamic International Arab Bank portion in the market.

Limitations and Recommendations for Future Research

As the target of this paper was to determine of Islamic bank performance based on profitability indicators, a limitation of

the study was based on the limited number of performance ratios. Moreover, a limitation of comparing the Islamic banks with the total of banks occurred, as they may be compared with the conventional banks in addition to the comparison between the local and the foreign Islamic banks.

For that, it is recommended for future studies to investigate other financial performance indicators as liquidity and risk, with various ratios. Another recommendation also is to change the type of banks compared, as conventional and Islamic; or even foreign Islamic banks with local Islamic banks. Based on the research results, it is suggested that Islamic banks should be fully assisted by the central bank of Jordan, so that the stakeholders can make aggressive and profitable steps in comparison with each other and with conventional banks.

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