

# Development of islamic banking in the uae essay sample

[Literature](#), [Russian Literature](#)



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Though overall economic performance in 2008 was the worst since the Great Depression, there is significant variation in the effect of this Global Crisis on each of the Islamic Banks and Conventional Banks. This paper aims at studying the performance and profitability of “ Abu Dhabi Islamic Bank (ADIB)” during and after the crisis of 2008, then, it will be compared with the financial status of “ Abu Dhabi Commercial Bank (ADCB)” for the same period. The ratios and charts in this paper are calculated and formulated based on financial reports released by both banks on annual and quarterly basis. Return on Assets and Return on Equity were used as the proxies for the profitability. However, it is concluded from this study that ADIB as an Islamic bank was less affected by the economic crisis of 2008 than ADCB conventional bank. Introduction

Banking Industry is one of the most important industries that supports the development of a country. Like some other financial institutions and capital markets, banks are the institutions which are significantly needed by the real sectors in doing their business. An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the

liabilities side, it mobilizes funds on the basis of a Mudarabah or Wakalah (agent) contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank and which are guaranteed. On the assets side, it advances funds on a profit-and-loss sharing or a debt-creating basis, in accordance with the principles of the Sharīah. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and date-to-maturity of each deposit.

Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank. Commercial banking is based on a pure financial intermediation model, whereby banks mainly borrow from savers and then lend to enterprises or individuals. They make their profit from the margin between the borrowing and lending rates of interest. They also provide banking services, like letters of credit and guarantees. A proportion of their profit comes from the low-cost funds that they obtain through demand deposits. Commercial banks are prohibited from trading and their shareholding is severely restricted to a small proportion of their net worth. As the consequence, there are many parties which have the interests to require their banking industry running well.

For the government, well organized banking industry would be favorable since it could show that monetary system, banking and payment system in that country are well run. For the business parties, the well-run banking

industry will ease the transactions they make with their counterparties including financial scheme when required. For the management of banks themselves, the sound bank management for each bank would become positive points to fulfill the responsibilities to the stockholders. The selection of ADIB and ADCB was based on their well reputation and performance in UAE. In other words, these two banks were noted as two of the successful banks in UAE. Islamic Banks and Conventional Banks

Islamic banking is considered as an alternative of banking institutions that are resistant to shocks in macroeconomic conditions or financial market. Based on the data from World Bank (2011), after the world economic crisis period, it was claimed that the Islamic banks had a relatively better recovery compared to conventional banking institutions as indicated by the relatively low non-performing financing (NPF) ratio and there was no occurrence of negative spread in their operations. The data also indicates that Islamic banks were relatively more capable of channeling funds to the production sector with the financing to deposit ratio (FDR) returning to the level over 100%, while conventional banks' loan to deposit ratio (LDR) dropped below 50%. Million \$

Throughout the recent global financial crisis, the Islamic banking industry in UAE has also demonstrated resilience, evidenced by relatively high growth performance of this industry and a fairly stable level of NPF. However, there are two factors considered protecting the Islamic banks from the direct impact of shocks in the global financial system example the exposure of Islamic banking financing was still more geared to the domestic economy.

Despite of its severe impact, the global financial crisis has triggered an increasingly attention questioning the resilience of Islamic banks and their relationship with financial stability. Comparison of performance 2005 - 2010

In this study, the period chosen is between 2005 & 2010. The ratios are calculated on annual basis and quarterly bases using the balance sheets and the income statements of both banks ADIB & ADCB taking into consideration that the bank financial reports are published quarterly and annually with each reporting being compared to that achieved in the same period of the previous year.

Before the crisis, the net profit of ADCB was much higher than the net profit of ADIB. During the crisis, the net profit of ADCB went below zero (complete loss), while ADIB could sustain a little amount of profit although it was also affected by the crisis

Table 1: (Data collected from both bank's balance sheet) Net Profit

Million AED

Using Abu Dhabi Islamic Bank's and Abu Dhabi Commercial Bank's balance sheet and income statement, the return of assets (ROA), return on equity (ROE), and net income growth are calculated.

Figure 1: Return on Assets (Annual)

Noting that the return on assets (ROA) is calculated as an indicator of how profitable a company is relative to its total assets, it can be seen that in

ADCB, the curve of the ROA went straight down during the crisis reaching below zero after the crisis of 2008 while the curve of ADIB went a bit high during the crisis then slightly down after the crisis and did not go below zero. After the crisis, both banks started to recover. ADIB was recovering more rapidly than ADCB as it shows in the above curve of the annual chart.

Reason:

Because of the net loss on hedge of net investment in foreign operations, the net income went (151, 138) below zero causing a great loss. Knowing that the return on assets is calculated by dividing the net income over the total assets, the loss in the net income was reflected on the return on asset.

Figure 2: Return on Assets (Quarter)

Notice the curve in the quarter chart, ADCB was affected by the crisis during the first quarter of 2008 which caused its ROA to go down before it tries to recover and then fall again and stay in weak performance till the third quarter of 2010 when it sharply increased again, while ADIB's performance was good during the first three quarters of 2008 before it was affected after the crisis, it tried to recover in the beginning of 2009, but again failed in the fourth quarter of 2009, and again recovered rapidly in the first three quarters of 2010 to fall again in the last quarter of 2010. The performance of ADIB is already fluctuating all over the quarters (2008 - 2011) that means the change in its trend is not because of the crisis, while that of ADCB shows changes during the crisis period.

Reason:

Although the operating income, specifically net income from Murabaha, Mudaraba, Ijara and other Islamic financing is considered high during the last quarter of 2009 in ADIB, the operating expenses also increased horribly 81.24% compared to the same period of 2008. That caused the net income to decrease by 90.83% compared to the same period of 2008. This massive decrease caused the ROA of ADIB to go below zero in the last quarter of 2009. ADCB's performance in the second quarter of 2010 was crucial. In order to recover, ADCB increased its interest income and decreased its staff expenses and depreciation causing the net profit to increase as it shows in the third and fourth quarter of 2010 in the chart above. Figure 3: Return on Equity (annually)

One of the most important profitability metrics is return on equity. ROE reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. ADIB was performing well during the crisis period; the profitability even was higher during the crisis 2008. After crisis, and specifically in 2009, the profitability of ADIB was affected but could directly be maintained. Due to Share of results of associates of 14,798 in 2010 compared to (3,219) in 2009 with an increase rate of 559.70%!!! The performance of ADCB went roughly down during the crisis and even after the crisis till it increased its interest income and decreased the staff expenses.

Reason:

This Huge increase in the share of results of associates in ADIB is due to the

large investments of conventional banks in Islamic financial institutions because they found refuge to the shock they faced. This was reflected on the net income and alternatively on the ROE rate. ADCB noticed that the Islamic financial Institutions are less affected by the crisis due to absence of interest in their operations. So, they started a segment of Islamic finance including Murabaha, Mudaraba, Musharaka, Ijara and other Islamic services.

#### Figure 4: Return on Equity (Quarterly)

Since ROE indicates how well a company is being managed to allow profit on its shareholder's money, and since it is a reliable indicator of a company's future earnings, the chart above shows the great profits on its shareholder's money that ADIB achieved during the crisis. After crisis, the profits on shareholder's money decreased, to recover again in the third quarter of 2009 and strictly decline in the fourth quarter of 2009 to rapidly recover during the first three quarters of 2010, and unfortunately decline again in the fourth quarter of 2010. ADCB has little profit on shareholder's money and sometimes it had losses all through the studied period.

#### Reason:

In the fourth quarter of 2009, Provision for impairment in the operating expenses of ADIB increased from (459, 680) in 2008 to (1, 448, 819) in 2009 with 215. 17% increase. This increase in the operating expenses decreased the net income, and alternatively, decreased the ROE below zero. In the first three quarters of 2010 ADIB's performance nourished, declined and improved its best performance in the third quarter of 2011. ADCB finding its refuge in the Islamic banking and increasing its interest income helped



improve its performance during the last quarter of 2010 and then the three quarters of 2011.

#### Figure 5: Net Income Growth (annually)

The net income of ADIB decreased slightly after the crisis and then it could recover and increase its net income starting 2009 and continuing to grow in 2010 rapidly. The net income of ADCB decreased during the crisis and continued to decrease after the crisis as a consequence of the crisis.

#### Reason:

After the crisis, the provision for impairment at the operating expenses decreased from (1, 448, 819) in 2009 to become (749, 212) in 2010. On the other hand, the distribution to depositors and sukuk holders increased from (977, 968) in 2009 to be (1, 045, 006) in 2010. This increase lead to the increase in the net income and alternatively reflected on its growth as it shows in the above chart. ADCB suffered severely after crisis the same as all conventional banks. Despite their trials to increase the interest income and decrease the staff expenses, that plan could not recover the crisis and was not considered as a good remedy to relief.

#### Figure 6: Net Income Growth (quarterly)

On quarterly basis, the net income shows huge growth at ADCD in the third quarter of 2010. Reviewing the balance sheet that for the third quarter of 2010, the following observations were made: 1- The net income from Islamic financing increased from 31, 272 in 2009 to 139, 980 in 2010 with a growth

of 347. 62%.. 2- The increase in the interest income and decrease in the interest expenses also affected the net income. 3- The increase in net profit from 390, 615 in 2009 to become 3, 045, 111 in 2010 appears clearly in the net income growth on quarterly basis.

On the other hand, ADIB could maintain the stability in its growth all through the period after recovering from the crisis consequences in 2009.

### Conclusion

In General, it can be concluded that, net income and assets and liabilities management are the most important factors that determine the bank's profitability. The result of this research has shown that the ROA and ROE calculated on annual basis and quarterly shown can provide indication of the bank's performance and profitability. During the crisis of 2008 ADCB as a conventional bank was more affected than ADIB the Islamic financial institution. With the review of the balance sheets and income statements and the available annual and quarter reports, it was concluded that the conventional investments with interest rates were affected severely by the crisis, while the Islamic financial institution was less affected due to the prohibition of interest (Riba) by Shariaa'.

After the crisis, the conventional bank ADCB found that Islamic financing can be a good assistant to help it function properly again. So they introduced the Islamic financing to their products and services. Taking this action, ADCB - and other conventional banks as well - started to compete with the Islamic financial institution ADIB and other Islamic financial institutions. Opening this

Islamic financial service, they took a share in the market reducing the share of ADIB. On the other hand, investors trust in the Islamic financial operation increased and most of them shifted to the Islamic banking to avoid the interest on their loans. Finally, I hope that this research could serve as a good study on the effect of the interest on the financial situation and the importance of Islamic operations in saving the economic stability.

## References

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[ 2 ]. ADIB annual reports (2005, 2006, 2007, 2008, 2009, 2010) [ 3 ]. ADCB annual reports (2005, 2006, 2007, 2008, 2009, 2010) [ 4 ]. Data collected from ADIB & ADCB quarterly reports for the period 2008 - 2010