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Waleed Al-Sultan
University of Wollongong

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FINANCIAL CHARACTERISTICS OF INTEREST-FREE BANKS AND CONVENTIONAL BANKS

A Thesis Submitted in Fulfillment of the Requirements
for the Award of the Degree

DOCTOR OF PHILOSOPHY

from

The University of Wollongong
New South Wales
Australia

by

Waleed Al-Sultan
B.Com (Kuwait)
M.Com (Oklahoma)

DEPARTMENT OF ACCOUNTING AND FINANCE
1999

DECLARATION

I hereby certify that this thesis has not been submitted previously as part of the requirements of another degree and that it is the result of my own independent research.

Waleed Al-Sultan

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DEDICATION

To my mother, Mrs Fatemah, a living courage to my life, my father Saud Al-Sultan, a partner in heart and intellect, and my good brother Khalid Al-Sultan.

ABSTRACT

Many countries all over the world currently experience what became known as “Dual Banking” where interest-free Islamic banks operate side by side with conventional banks. Islamic banks conduct normal business as any conventional bank but do not pay or receive interest. They operate on profit/loss sharing principle. By this, is meant both the supplier of the funds and the borrower share the risks; both prosper when returns are favorable and suffer together when returns are poor.

The literature on Islamic banking and finance though recent is growing fast. Western scholars have begun to show an interest and make substantial contributions. The interdisciplinary nature of the literature offers a challenge.

However, there are still numerous questions to be answered, many problems to be solved and a number of challenges to be faced. In particular, empirical work is needed to assess the differences in financial characteristics of interest-free and conventional banks. Also, nothing much has been written about the loan market in a dual banking system. Moreover, very little is known about the attitudes of clients towards Islamic vis-a-vis traditional banks. Furthermore, research on the performance of Islamic banks in individual countries has not received much attention.

This thesis is an interdisciplinary study which attempts to make a (very) modest contribution towards filling the gap in the literature.

In particular, this study tests for structural differences between the financial characteristics of Islamic and traditional banks. This testing is done through the use of discriminant analysis applied to a sample of 48 Middle Eastern banks, 12 of which are interest-free banks. The analysis covers 20 financial ratios which evaluate liquidity, leverage, performance, credit risk, probability and efficiency.

This study also tries to model the decision, of a client facing a dual banking system, to deal with a traditional or an Islamic bank. This is done using logit and probit regression analysis.

A simultaneous equations model is developed and tested using time series data for 18 conventional banks and 12 Islamic banks to examine the performance of the commercial loan market within a dual-banking system.

Moreover, this thesis tries to test if the transactions of Islamic banks are really free of all traces of “usury interest”. A case study of the Kuwait Finance House is conducted. This involves in-depth analysis of the activities, products and financial statements of this company.

The clients’ perceptions of Islamic banking are also examined. This is done through the application of factor analysis to survey results collected by the researcher

on Kuwaitis' attitudes to Kuwait Finance House, the oldest and largest financial institution operating in Kuwait.

The analysis of the evolution of Islamic banks suggest that these banks use the same tools and procedures as traditional (i.e. interest-based) banks in those areas where there is no conflict between banking operations and Islamic principles. Islamic banks have devised (and are still devising) new instruments to enable them to achieve their objectives in accordance with Islamic Laws.

The simultaneous equations regression analysis suggests that the price of loans charged by Islamic banks does not exert any significant influence on the demand for commercial loans of the customers of conventional banks. However, the demand for funds offered by Islamic banks is positively correlated with the rates of interest charged by conventional banks operating within the dual banking system.

The logit and probit regression results suggest that the more people adhere to Islamic teachings, the higher the proportion of clients which deals with Islamic banks. The results also suggest that, age, income and occupation, are important factors in deciding which banking system to choose.

An analysis of those activities and tools of finance of Kuwait Finance House (KFH), the only Islamic Bank currently operating in Kuwait, suggests that this company is not a mere bank. It acts as a financier, contractor, lessor, developer and agent.

The consumers' survey suggests that 49.3 percent of the respondents borrowed funds from KFH at some time during the last five years, but only 34.5% of the respondents held some type of deposit account with KFH during the time of the survey. The survey also suggests that 51.7 per cent of the respondents prefer to deal with traditional banks rather than KFH.

Application of principal component analysis to survey results suggests that variables which motivate customers to deal with KFH rather than traditional banks can be condensed into five factors, namely: religion, traditional services, terms of borrowing, community development and convenience religion. Those respondents who prefer to deal with traditional banks rather than KFH expressed doubts about the interest-free nature of transactions of KFH; fear that their deposits with KFH may not be guaranteed by the Kuwaiti Central Bank, dissatisfaction with current restrictions of the application of the profit/loss sharing principle, particularly in the area of personal loans, belief that the transactions of the two type of banks are very similar and feeling each type of bank provide same traditional services.

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