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THE EFFECT OF CONVERSION OF CONVENTIONAL BANKS TO ISLAMIC BANKS: EVIDENCE FROM GCC COUNTRIES

Ahmad Al-Harbi
Ministry of Economy & Planning, Saudi Arabia
Email: atalharbi@yahoo.com.au

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Abstract

The conversion from conventional to Islamic banking is one of the important topics in the Islamic finance industry due to non-existence of comprehensive framework for the conversion process contributing to several problems for the converted banks. Thus, the main purpose of this paper is to investigate the effect of conversion from conventional to Islamic banking on the converted banks' operations. In addition, this paper will shed some light on the motivation behind the conversion and the process of conversion as well as providing answers to some of the problems that could hinder the conversion process. The analytical method used is ratio analysis (t-test) on the data extracted from BankScope database of five banks operating in the Gulf Cooperation Council (GCC) countries. The findings show that conversion helped to improve the performance and financial position of the converted banks, leading to sharp increases in assets, deposits, equity, and net income. Despite these benefits, however, the converted banks' profitability, efficiency, asset quality, liquidity, and risk indicators do not improve. This dichotomy may be due in part to the management's inability to utilize the banks' funds more efficiently to bring performance in line with increases in assets, deposits, equity, and net income. The findings indicate that the conversion methods play an important role in the conversion process because choosing the wrong method could slow or rescind the conversion. Thus, this study suggests that the conversion method and banks' management competencies must be taken into account prior to conversion.

JEL classification: G21; F37; P120
Keywords: *Conversion, Profitability, Efficiency, Asset Quality, Liquidity, Risk, Management*.

1. Introduction

The topic of bank conversion, which is the recent trend in Islamic banking development has gained momentum in the recent years especially in the GCC countries. Islamic banks in the GCC countries accounts for 41% of the total Shariah-compliant assets in the world (Alharbi, 2015).

In the past few years, a number of banks around the world have converted to Islamic finance model. The conversion has been implemented in three ways; first, converting fully to Islamic finance form; second, open Islamic branches; and third, offer Islamic products. Table 2 lists some of the banks that have fully converted to Islamic banking.

In the full-fledged model, converting a financial institution involves specifying a plan for the conversion process with a fixed cutoff date for converting all the banks business. This approach is adopted by Dubai Bank, Emirates Islamic Bank, Kuwait International Bank (formerly Kuwait Real Estate Bank), and Sharjah Islamic Bank (formerly Sharjah National Bank). The advantage of this approach is that the conversion process will be accomplished in a short period. However, this approach is characterized by high risk, since the bank could face liquidity problems or severe financial hardship, which would expose the bank to lawsuits from stakeholders. In addition, other drawbacks to this approach are

higher operating cost, low performance due to the lack of proper new-hire employee training, and low morale among employees (Al-Atyat 2007).

The partial transformation approach is implemented by establishing or converting a branch to operate according to Shariah principles, and then converting other branches until the entire bank is converted. There are two main benefits of this method. First, partial transformation offers more security than complete conversion; if the first conversion experiment fails, the negative ramifications are limited to only one branch. Another benefit of partial transformation is that it allows the bank's management to acquire the necessary expertise in the transformation process, which helps reduce errors and problems in the future.

However, there are two notable disadvantages of the method. First, it is difficult for the converted branches to be independent from the bank's conventional activities, thus making it difficult for the converted branch to convince the community its seriousness to implement the Shariah principles because some of the activities will usually conflict with those principles. Second, any losses suffered by the converted branches could cause the conventional bank to have second thoughts about the transformation process. Moreover, this could give a negative impression to the bank's management about the transformation process in general, which could end the conversion experiment quickly.

It should be noted that partial transformation is also often adopted by banks that want to profit from a wider customer base but do not intend to convert all operations. Banks that have this objective sometimes establish Islamic windows or offer isolated Islamic financial products. This strategy is adopted by HSBC bank, which created HSBC Amanah in 1998 to provide Islamic financial solutions to Muslims in non-Muslim countries as well as in Islamic countries.

Under the gradual transformation strategy, the bank prepares a comprehensive and integrated conversion plan for all departments and branches that will be implemented in intervals. Each interval has a specific deadline and required standards. Bank Al-Jazira in Saudi Arabia adopted this approach.

According to Adam (2005, p. 43), most Shariah scholars recommend the full-fledged conversion due to concerns that partial or gradual transformations may signal a lack of intention to convert all the bank's activities. Adam further notes that, the AAOIFI Shariah Board Standard 6 is instructive:

If the bank did not decide to an immediate and comprehensive conversion and decided to adopt a gradual or partial conversion, then it is not regarded as a converted bank and may not be granted a license as an Islamic bank unless the conversion is completed. The shareholders are required to accelerate the process of conversion in order to free themselves from the sin of impermissible activities. (p. 43)

On the other hand, Al-Atyat (2007) argues that gradual transformation is the best method to convert a conventional bank to Islamic banking because it avoids the drawbacks of the other two approaches.

The bank conversion process requires that the converted bank dispose of any interest on the bank's capital, form a supervisory board, develop a new IT system, reform its contracts, convert its loan books, change its charter, and train existing and new employees. All of these issues reflect that a conversion decision is indeed a strategic decision for the bank.

Despite the importance of this topic, few empirical articles have addressed this issue as many of the studies

concentrated on the reasons behind the conversion as indicated in the literature review section. Thus, this paper will attempt to address this gap, empirical study the effect of conversion on converted banks and provide a framework for the transformation process. In addition, the study will list the obstacles of the conversion process and how to resolve it as well as providing a blueprint for the conversion process.

2. The Motivation of Conversion

The motives for establishing an Islamic bank or converting an existing bank vary from one institution to another. In general, these decisions are based on profitability, cultural and religious beliefs and principles, and politics.

Evidences indicate that Islamic banks have been remarkably successful with respect to profitability. A field study on a number of Saudi banks that converted to Islamic banking reveals that 82% of banks converted are able to maintain their existing customers who preferred Shariah-compliant banking products (Mustafa 2006). Furthermore, 47% of the banks in the field study disclosed that their main conversion motivation was to attract new customers who preferred a bank with exclusively Islamic products. Finally, the study shows that 24% of the banks converted because they expected a high rate of return on Islamic banking investments. In addition, Alani and Yaaecob (2012) found a statistical significance between the trend of conversion to Islamic banking and profitability. In another study on all banks in Jordan, Al-Atyat (2007) shows that profitability was among the most important factor in a bank's decision to convert. Al-Atyat (2007) also argues that troubled conventional banks which suffer from declining profitability often choose to convert to Islamic banking to avoid bankruptcy.

It is against Islamic law to deal in *riba* because the practice is considered a sin. Mustafa (2006) shows that 65% of the sample banks declared that their main impetus for conversion was the belief that *riba* is a sin. Moreover, Abu Homera and Al-Souissi (2010) in a study of two Libyan banks found that the main reason behind their conviction to convert to Islamic banking was that *riba* is one of the greatest sins in Islam.

The third motivation for conversion is political. Islamic parties consider Islamic economic as a tool to control the economy. The influence of Islamic parties/governments led Iran, Pakistan and Sudan to fully Islamize their financial system in 1980s. And the recent Arab turmoil in 2011 led to the rise of political Islam in the MENA region which gave a boost to the Islamic finance industry. For example, Libya is developing a blueprint to Islamize its financial system (Stela and Abdulsalam 2016) and Oman established a dual banking system.

3. Literature Review

The empirical and theoretical work related to the conversion of conventional banks to Islamic banking operations is scarce. According to the best of our knowledge, there is only one similar empirical study conducted by Al-Atyat (2007) on banks in Jordan[1]. The study aimed to clarify the major requirements and difficulties encountered during the transformation process from conventional to Islamic banking. The researcher used a questionnaire and SPSS program to conduct this study. The dependent variables of the study are the clarity of Shariah ruling relating to conventional banks operations, willingness of banks' management to adhere to Shariah principles, expectation of additional profit after conversion, availability of Islamic financial markets, availability of qualified human resources, availability of laws and legislation that govern the conversion process and the success of Islamic banks. The dependent variable was the

[1] These studies are conducted in Arabic

possibility of Jordan's conventional banks to convert to Islamic banking. Al-Atyat (20017) found that all the factors except willingness of banks' management to adhere to Shariah principles had a positive effect of the conversion decision.

Al-Atyat (2007) also did a minor analysis using financial ratios (ROA, ROE, investment to deposit ratio, quick ratio, sales to total assets ratio) on the performance of some converted banks (four banks in GCC countries). He found that the performance of Bank Al-Jazira, Sharjah Islamic Bank, Emirates Islamic Bank and Kuwait International Bank improved after conversion.
However, the minor analysis done by Al-Atyat (2007) was not sufficient to come with reliable results about the effect of conversion on the converted banks due to limited number of financial ratios and the short period of the study 2002 to 2006.

In a more recent study, Hasan (2016) investigated the conversion of Export Import Bank of Bangladesh and First Security Islami Bank Limited for the period of 2000-2015 (Bangladesh). Hasan found that ROA, ROE, internal growth rate, sustainable growth rate and investment as a percentage of age of total deposits has improved after conversion. However, the cost of fund increased for the First Security Bank after conversion and this attributed to the increased remuneration on deposits.

Other recent studies such as Arshad *et al.* (2016), Shafii *et al*. (2016a; 2016b), Ababneh (2016) and Ahmed and Khan (2017) addressed the issues related to conversion from conventional banking to Islamic banking. All of these studies are theoretical except for Al-Atyat (2007) and Hasan (2016). Arshad *et al.* (2016) discussed the concept of the conversion process and highlighted the challenges and obstacles facing the transformation process. In the same vein, Shafii *et al*. (2016b) investigated the factors influencing the success of the transformation process from conventional banking to the Islamic banking and the motivations for this process. On the other hand, Shafii *et al*. (2016a) examined the factors influencing the conversion process in the context of Libya and proposed a conceptual framework to examine these factors.

As can be seen the above studies are mainly limited to one country, its analysis was not comprehensive and concentrated on the reasons behind the conversion. In the other hand, this study will focus on the obstacles facing converted banks, draw a blueprint for the conversion process and conduct through analysis of the converted banks.

4. The Conversion process

The bank conversion process requires that the converted bank dispose of any interest on the bank’s capital, form a supervisory board, develop a new IT system, reform its contracts, convert its loan books, change its charter, and train existing and new employees. Accordingly, these issues make conversion a strategic decision for a bank.

A conventional bank seeking to convert to Islamic banking must follow some principles to achieve success. However, these principles which are discussed below should not be seen as a rigid template because all banks have unique situations. The most important principles of conversion are listed in Table 1.

5. Issues Related to the Conversion Process

It should be noted that not all the money from conventional banks is *haram* money (unlawfully earned money). Some money is considered *halal* money (money gained by engaging in legal and Shariah- compliant activities), such as the

bank's capital, customer's deposits, and bank profits earned from lawful, non-interest operations such as currency exchange and fees from money transactions. Money considered *haram* if it is gained from interest on loans or from fixed- income bonds. When converting its operations, a bank must purify all its business from *haram* money. This is a complex process, thus some of the common issues faced in the conversion process are discussed below.

5.1 Eliminating Interest Profit

The bank must eliminate shareholder capital or equity which the bank earned through interest- bearing loans before the conversion. Scholars disagree on how banks should treat this money. Some scholars believe that the banks should purify and cleanse its business from all interest taken in the past. This perspective comes from Islamic Law (*fatawa*) from the year 2003, which was issued by the *fatawa* committee of Kuwait's Ministry of *Awqaf* and Islamic Affairs (Al-Tbtabai 2003):

It is permissible for a *riba* bank to convert to an Islamic bank that conducts its business in accordance with Islamic *shariah* on the condition that the Islamic bank's capital must be free from all *riba* (past, present, and future), and all of its transactions must be in accordance with the provisions of Islamic *shariah*, and the bank must establish a *shariah* supervisory board to oversee all of its activities. (p. 7)

A second perspective is that the converting bank must return interest-based profits to the clients or give to charity. This perspective was adopted by Sudan when the country Islamized its entire financial system. Several prominent banks have taken this approach as well, including National Bank of Sharjah in the UAE and Bank Al-Jazira in Saudi Arabia.

A third perspective is that banks may keep the interest-based profits. Saudi Scholar and a member of Shariah committees of several banks, Abdullah Al-Manea (1996) explains this perspective:

According to some scholars and some of their authenticators that the one how possesses *haram* money by its descriptive not origin, such as money earned through usury, which does not have a certain individuals and it is commingle with its halal money which been earned by his effort, and if he sincerely repented all the money he possesses will belong to him as his repentance will pardons the past deeds. (p. 34)

Scholars supporting the third perspective draw their opinion from the Quranic passage Al-Baqara 2:275: "but *Allah* hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for *Allah* (to judge)." Other scholars, especially followers of *al-medhhab* Al-Hanbali (cited in Al-Tbtabai 2003), opine that if the bank is unable to determine how much of their surplus came from *haram* activities, half of the bank's overall surplus must be given to charity.

5. 2 Transferring Client Accounts from the Conventional Bank

Clients who have savings and term-deposit accounts with the bank have a few options when the bank converts. Clients may keep their deposits with the understanding that they will now operate on the basis of a profit–loss sharing (*mudarabah*) contract. Clients also have the option to withdraw their deposits. For customers who reject both options, the bank must fulfill the contract until the date of conversion or to the end of the contract if the bank is required to do so by law (Adam 2005, p. 45; Hassan 2002). In this latter case, the bank is still considered Shariah-compliant because the interest is being paid out of necessity (*darurah*; Adam 2005, p. 45).

Table 1 Conversion Framework

Necessary Measures	Process
1. The success of the conversion process requires a bold and firm decision from the highest authority of the financial institution (Al-Ghamdi 2002). Al-Ghamdi argues that this decision will bring a full range of advantages that consequently lead to a successful conversion.	a. unite the efforts of all bank employees toward one shared goal; b. create a catalyst for creativity and innovation, as it will be a motivation to find alternative mechanisms and programs to support the bank's new orientation; c. eliminate confusing environments in which employees find themselves working in two separate divisions; d. improve the bank's credibility with its customers and clients; and e. encourage employees to better understand Islamic financial practices.
2. The bank must prepare a strategic plan for conversion with a clear vision and specific stages. The plan should include several elements.	a. The bank must prepare a specific timeline for the conversion process to be approved by the board of directors and all concerned parties (Adam 2005, p. 44; Al-Sharif 2003; Hassan 2002; Mustafa 2006). Also, the conversion process should commit to the targeted deadline to maintain credibility with its clients (Al-Sharif 2003). b. The bank must obtain legal authorization from its shareholders and the regulatory authorities (Adam 2005; Al-Beltaji 2009; Hassan 2002). c. The bank must completely and effectively separate the Islamic and conventional branches and bank headquarters. This requires that the Islamic branches have accounting and financial independence from the bank headquarters and other branches (Al-Sharif 2003; Mustafa 2006). d. The bank must establish an independent Islamic department or committee to oversee, develop, and regulate the Islamic branches and to coordinate the conversion process and assign staff responsibilities (Adam 2005; Mustafa 2006). e. The bank must redraft the conventional financial contracts and develop new contracts and products in accordance with *shariah* requirements (Adam 2005; Hassan 2002; Mustafa 2006). f. The bank's management should be fully convinced of and committed to the conversion process (Mustafa 2006). g. The converted bank must solve three key problems. i. Any existing profit that came from interest must be distributed among shareholders, returned to the people who paid it, or given to charity (Al-Tbtabai 2003; Hassan 2002). ii. The bank must convert the loan books (Adam 2005; Hassan 2002), assess which account holders can continue to be clients, and convert other liability accounts (Adam 2005; Hassan 2002). iii. Finally, the bank must assess its unfunded business activities for compliance with the new model (Adam 2005).
3. The bank must form a Shariah supervisory committee (Adam 2005; Al-Beltaji 2009; Al-Sharif 2003; Hassan 2002; Mustafa 2006). Shariah scholars with reliable knowledge and experience in the field of Islamic banking must be appointed to establish the legitimacy of the contracts adopted by the converted branches. The Shariah committee should oversee the converted branches and scrutinize all of	

its contracts from all aspects of Islamic law.	
4. The bank must restructure in accordance with its new activities and functions; the bank's charter should also be updated (Adam 2005; Hassan 2002).	
5. The bank must tackle all necessary human-resource issues and concerns (Adam 2005; Al-Beltaji 2009; Hassan 2002; Mustafa 2006). Due to the differences between Islamic and conventional banking, personnel must be trained in Islamic banking services and products.	
6. Once the plan is in place and the new Islamic bank is operating, the management must coordinate activities between the branches to ensure integration (Al-Martan 2003; Mustafa 2006). Coordination also facilitates employee understanding of the nature of Islamic banking and helps develop mechanisms to achieve coexistence between the two systems and resolve any disagreements that may arise.	To avoid problems among staff, managers must work hard to build trust with employees, and certain fair practices should be instituted, such as giving priority to existing conventional-bank staff for new positions in the Islamic branch when possible (Al-Martan 2006). Potential marketing conflicts between the conventional and Islamic branches should be avoided by holding regular administrative meetings with representatives from both
Continue Table 1	
	branches and agreeing on strategies that mutually benefit both branches as opposed to creating competition (Nasser 1996)
7. The converted bank must keep books that comply with AAOIFI standards (Adam 2005; Hassan 2002)	
An IT system must be put in place (Adam 2005; Al-Martan 2003; Hassan 2002)	
8. Some physical facilities will have to be changed, such as nameplates, the bank's logo, and marketing materials (Adam 2005).	
9. The converted bank must make the transition gradually (Mustafa 2006). The experiences of other banks that have already converted have shown that the transition from conventional to Islamic banking cannot be done successfully overnight. The nature of the banking business involves multilateral parties, including individuals, national and international institutions, and regulatory bodies. These relationships create many obligations that the bank must honor to maintain its business and reputation. In addition, a gradual implementation will allow the bank to train its employees on Islamic banking practices and to inform the bank's customers about the conversion process.	
10. The converted bank should create a program to raise awareness about Shariah banking principles and products among its employees and customers. Sharjah Bank, for example, organized regular seminars for its employees and clients to create awareness about Islamic banking, explain its role in the economy, and elucidate the effects of *riba* (Hassan 2002).	
11. Once the conventional financial institution announces its decision to convert to Islamic financing, it must continue with the process as announced to avoid damaging the bank's reputation (Mustafa 2006).	

This applies to savings and term-deposit accounts because new accounts will not generate interest. The same requirements apply to all liability cases under which the bank has to pay back funds with interest.

5. 3 Dealing with Outstanding Loans

At the time of conversion, the bank will have many interest-bearing loans in progress. An Islamic bank is not allowed to earn interest, but the bank cannot legally force the borrowers to pay back the loans before their maturity. Some banks have addressed this through the Shariah principle of *darurah*; that is, the bank uses the interest collected on loans to pay interest that it owes on the deposits that it was obligated to keep by law (Hassan 2002). If the bank earns more interest than it has to pay, the surplus should be given to charity (Adam 2005, p. 45). Another strategy is that the bank can come to an agreement with the client in which the bank drops all interest charges and only collects the principal until the date of maturity.

Newly created Islamic banks have come up with other ideas for addressing outstanding loans. For instance, a bank can purchase an asset or part of an asset from the debtor, such as real-estate or equipment, and this partially or fully pays off the loan for the client. In this case, the borrower might have the option to rent the asset to the bank for a given time period at a specified amount, or the borrower can sell the asset through an *ijarah muntahia bittamleek* contract (Adam 2005, p. 46; Hassan 2002). If the bank rents the asset, the bank can rent the asset to a third party to earn profit (Hassan 2002). This is often done with real- estate or vehicles, such as cars and airplanes.

In another option, the bank can offer the debtor a *musharakah* (partnership) in any investment project owned by the debtor. In this agreement, the debt is cleared and the bank takes a share of the ownership of the new partnership equal to the amount of the unpaid loan (Hassan 2002). The bank can rent (*ijarah*) its shares in a given investment project to the debtor according to an *ijarah* scheme, an *ijarah muntahia bittamleek* scheme, or any other Shariah-compliant model agreed to by both parties. Any losses will be divided among all parties as specified in the contract. Another option suggested by Hassan (2002) is that the bank and the debtor form a partnership for a new project; the debtor's share of the profit used to repay the debt, the bank can finance new investment projects or business activities for the debtor and the debtor's profits from these activities used to repay the debt (Hassan 2002). According to Hassan (2002), this option is usually used when the debtor does not have any assets that the bank can use or sell to repay the debt, the debtor does not have any existing projects that the bank can partner on, the debtor is not willing to participate in either of the previous solutions, or some combination thereof. This model is most suitable for repaying loans to the government and large companies with diverse debt portfolios.

Regarding government debt, the bank can also participate in government service projects, some of the revenue will be directed to repaying the debt, and the remaining amount will be divided between the government and the bank according to an agreement between both parties (Hassan 2002). As an example, the bank could manage service projects such as water systems, airports, and other systems for an agreed-upon fee.

In some cases, clients were able to overdraft their accounts though converted banks' needs to address this problem. One way to address this issue is to treat the outstanding loan balance at the time of the bank's conversion as the principal for a new, non-interest loan (Hassan 2002). This is the same as the third strategy mentioned in this section. Another way to treat the outstanding loan balance is use the balance as a basis for a *mudarabah* contract between the bank (*rabb al-mal*) and the borrower (*mudarib*; Adam 2005, p. 46; Hassan 2002). In this type of agreement, the borrower can combine his or her money with the money taken from the bank to finance an investment project or a special business activity. When creating this agreement, the bank should conduct a feasibility study and clearly define the financing limit and the profit ratio (i.e., the percentages of the profit to be distributed to the bank and the borrower from the new venture).

5.3 Addressing the Bank's Unfunded Activities

Not all conventional banking activities violate Shariah principles because some activities do not utilize interest. Such activities include remittances, guarantees, letters of credit, foreign exchanges, traveler's checks, and real estate management services, and although these services are technically in harmony with Shariah principles, any such activities used by the converted Islamic bank must be processed through Shariah-based contracts (Adam 2005, p. 47). For example, the letter of credit issued by the converted bank can be based on *musharakah*, *mudarabak* or *wakalah* contracts.

Table 2 Conventional banks under conversion to full-fledged Islamic banks 2017

Bank name	Country	Established	Started	Converted
Export Import Bank of Banglade	Bangladesh	August 3, 1999	NA	July 1, 2004
First Security Islami Bank Limited	Bangladesh	August 3, 1999	NA	January 1, 2004
Albaraka Bank Egypt	Egypt	1980	1984	2010
United Bank	Egypt	2006	2006	In progress
Kuwait International Bank	Kuwait	May12, 1973	2004	January 1, 2007
Bank of Kuwait & Middle East	Kuwait	January 1971	June 2008	January 1, 2010
Public Islamic Bank Berhad	Malaysia	July 5, 1973	2007	2007
Industrial Development Bank	Jordan	1965	2009	2010
Meezan Bank	Pakistan	1997	NA	2002
Bank Al-Jazira	Saudi Arabia	1975	1998	2005
National Commercial Bank	Saudi Arabia	December 26, 1953	1988	January 27, 2009
Dubai Bank	UAE	September 2002	2006	2007
Emirates Islamic Bank PJSC	UAE	1976	March 10, 2004	October 9, 2004
Sharjah Islamic Bank	UAE	1975	2001	2002

Source: Constructed by the author using Bankscope database, banks websites, central banks and newspaper articles

6. Methodology and Data

To capture the effects of bank conversion on bank performance, a ratio analysis (*t*-test) and data on financial position and operating performance was performed on a sample of five banks: Sharjah Islamic Bank, Emirates Islamic Bank, Bank Al-Jazira, Kuwait International Bank, and Dubai Bank. The data was obtained from BankScope database. The author relies on the quality of Bankscope data provided by Bureau van Dijk which use universal format to compare banks globally.

All banks in our sample are located in the Gulf Cooperation Council (GCC) countries. Specifically, the selection of United Arab Emirates (Sharjah Islamic Bank, Emirates Islamic Bank, and Dubai Bank), Kuwait (Kuwait International Bank), and Saudi Arabia (Bank Al-Jazira) is attributed to data availability. These five banks are chosen because the start and end dates of their conversion are known and have sufficient number of years before and after conversion to be compared on key indicators (Kuwait International Bank is an exception because it has only been Islamic since 2007). In addition, those banks were troubled banks due to declining profitability or not showing improvement prior to the conversion. Finally, the sample period was chosen to avoid the effect of world financial crisis on the result of the study.

This study compares the mean financial ratios before and after the conversion. A paired sample *t* test is used:

H_o: $\mu 1 - \mu 2 = 0$ (there is no difference between the means before and after conversion).

H_A: $\mu 1 - \mu 2 \neq 0$ (there is a difference between the means before and after conversion).

Formula for single sample *t* test:

$$t = \frac{\underline{d}}{s_{\underline{d}}}$$

Where $\underline{d}$ = mean difference and $s_{\underline{d}}$ = standard error of the mean difference.

$\alpha = 0.10$

This study uses nine financial ratios, which fall into five general categories: profitability, efficiency, asset quality, liquidity, and risk. These ratios are defined in Table 3.

Table 3 Financial ratios used to capture the conversion effect on the converted banks

General category	Name of financial ratio	Equation
Profitability	Return on assets (ROA)	Net income / total assets
	Return on equity (ROE)	Net income / equity
Efficiency	Net interest margin (NIM)	Net interest revenue / earning assets
	Overhead to total assets (OHA)	Overhead / total assets
Asset quality	Loan to total assets (LOA)	Total loans / total assets
	Loans to deposits (LOD)	Loans / customer deposits
Liquidity	Liquid assets to deposit & short-term funding (LAD)	Liquid assets / deposit &short-term funding
Risk	Deposits to assets (DTA)	Customer deposits / total assets
	Equity to deposits (ETD)	Equity / customer deposits

1) Sharjah Islamic Bank, UAE

On March 18, 2001, the management of National Bank of Sharjah passed a vote to convert to an Islamic bank in 2002 (Al-Sheikh 2002). The conversion took 6 months, ending on June 30, 2002[2]. The bank changed its name to Sharjah Islamic Bank. During the conversion period, some important events took place. In 2001, the Sharjah government's holding in the bank was reduced from 42% (at the end of 2000) to 27% (at the end of 2001) through the sale of a significant number of government-owned shares to Kuwait Finance House, which is one of the largest Islamic banks in the world. According to bank officials, the sale was intended to help increase the bank's performance.

[2] It can be said that National Bank of Sharjah is the first bank in the world that converted entirely to Islamic banking

The bank's financial position and operating performance improves after the conversion, as its assets, equity, net income, and deposit and short-term funding increased, see Table 4, Figure 1 and Figure 2. The financial-ratio analysis for the periods before and after conversion show some interesting changes as well. The means for the profitability ratios (ROA and ROE) show that the bank is better off before conversion, with a significance level of 1% (*t*-test is 4.72 and 8.87 respectively; Table 5). However, the profitability ratios decrease before conversion and then improve slightly (see Figure 3). The drop in the ROE ratio from 2005 to 2008 is related to the shares issued by the bank. Therefore, it can be said that the conversion helped the bank sustain its profitability.

Table 4 Financial positions before and after conversion for Sharjah Islamic Bank

Average (AED, in millions)	Assets	Loans	Deposits	Equity	Net income
Before (1994–2000)	1186.94	848.04	853.59	276.97	56.46
After (2002–2008)	7979.79	5519.31	5219.28	2104.99	171.10

urce: Constructed by the author

Table 5 t-test results of Sharjah Islamic Bank

	ROA	ROE	NIM	OHA	LOA	LOD	LAD	DTA	ETD
M (before)	4.52	20.21	3.86	1.60	71.41	102.49	34.33	70.36	32.25
SD	0.98	2.19	0.87	0.36	8.24	17.33	11.34	5.80	8.50
M (after)	2.45	9.44	3.18	1.82	77.78	120.38	17.08	63.42	42.78
SD	0.63	2.35	0.51	0.13	11.67	17.85	9.06	6.32	14.51
t-test	4.72	8.87	1.78	−1.56	−1.18	−2.19	3.14	2.14	−1.66

The efficiency ratios do not demonstrate any significant improvement after conversion (Table 5 and Figure 4). The overhead to total assets (OHA) ratio increases from 1998 to 2002, and thereafter the ratio remain5 consistently higher. A *t*-test for equality of means indicates that NIM is slightly lower after the conversion; specifically, the results of the *t*-test (1.78) show a significance level close to 10%. Still, this ratio decreases before the bank's conversion but get more stable after the conversion. In general, it can be said that conversion does not have a significant impact on the bank's efficiency. Regarding asset quality, the relevant ratio does not improve after conversion. The loan- to-total-assets (LOA) ratio does not change, as indicated by an equality of means test.

Also, the average value of loan-to-deposit (LOD) ratio after conversion is higher, as shown by the *t*-test result (significant at 10 per cent level). This indicates that the asset quality of Sharjah bank drops after the conversion (Table 4 and Figure 5). Furthermore, the bank's liquidity decreases after conversion (Table 5 and Figure 6). In addition, the deposit-to-asset (DTA) ratio decreases after conversion, indicating that the bank's risk increased; this result is significant at the 10% level. On the other hand, there is no significant change in the equity-to-deposit (ETD) ratio after conversion (Table 5 and Figure 7). Furthermore, when adding controls for the effect of the financial crisis by dropping year 2008 from the *t* test, the analysis does not change.

Generally, the results indicate that the bank's conversion help it achieve positive results. Deposits, assets, equity, and net income all increase significantly after the bank's conversion. However, it appears that the bank's management does not utilize the increase of assets and equity efficiently; for instance, although the bank's net income increases, the increase is not proportionate to the increase in the assets and equity of the business. This can be observed by the bank's efficiency ratios and by the increase in the risk ratios. The increase of the bank's overhead can be explained by the conversion costs

incurred by the bank and some new expenses, such as the costs to establish the Shariah board.

2) Emirates Islamic Bank, UAE

Emirates Islamic Bank was originally established as a conventional bank known as the Middle East Bank in 1976. In March 2004 the bank's owners passed a resolution to convert to a Shariah-compliant banking model. The entire process was completed by October 9, 2004, and the bank changed its name to Emirates Islamic Bank. The bank profits before conversion were not improving. The present analysis begins from 2001 data because 2000 data are not available. The majority of the bank's shares are held by Emirates Bank (now Emirates NBD, which was established in 2007 from the merger of Emirates Bank International and the National Bank of Dubai). The bank's financial position and operating performance improve significantly after its conversion (Table 6 and Figure 8).

Table 6 Financial positions before and after conversion for Emirates Islamic Bank

Average (AED, in millions)	Assets	Loans	Deposits	Equity	Net income
Before (2001–2003)	2,227.30	680.50	1,262.13	745.33	76.27
After (2005–2008)	4,885.53	9,372.15	1,153.35	1,206.65	213.55

Source: Constructed by the author

The profitability-ratios analysis (Table 7 and Figure 10) shows mixed results. In particular, ROE improves and ROA drops, although only ROA's change is significant. The bank's net- interest margin (NIM) drops significantly after conversion; this is shown by the *t*-test results in Table 6 and Figure 11. By comparison, the OHA ratio improves (although this change is not significant). The two indicators for asset quality (LOA and LOD) do not show any improvement, and the results are significant in the case of LOA (Table 6 and Figure 12). In addition, the liquidity of the bank drops in the period after the conversion, as shown (significant at the 1% level) in Table 5 and Figure 13. Furthermore, in 2008, the bank's liquidity drops again, but the outcome of the *t*-test does not change.

The results with respect to the bank's risk and solvency indicators are mixed. The DTA ratio improves significantly after conversion, moving from a mean of 56.57% in the pre conversion years to 79.40% in the post conversion years. In contrast, the bank's ETD ratio suffers a severe drop in its mean value after conversion, plummeting from 60% to 13.1%. Table 7 and Figure 14 indicate this.

Similar to the management of Sharjah Islamic Bank, the management of Emirates Islamic Bank does not utilize the bank's resources to generate a higher income in proportion to the increase of the bank's assets and equity. Another indication of poor management is the increase in the bank's risks, however this increase does not translate into higher profits.

Table 7 t-test results of Emirates Islamic Bank

	ROA	ROE	NIM	OHA	LOA	LOD	LAD	DTA	ETD
M (before)	3.45	10.24	3.54	2.63	29.74	51.90	109.26	56.57	60.00
SD	0.46	0.19	0.47	0.89	17.54	29.00	34.00	1.96	10.56
M (after)	1.52	16.36	1.64	1.74	59.93	75.56	8.07	79.40	13.16
SD	0.38	5.85	0.38	0.35	10.20	13.00	2.71	5.83	7.20
t-test	6.15	−1.77	6.00	1.87	−2.90	−1.48	6.13	−6.38	7.04

3) Bank Al-Jazira, Saudi Arabia

Bank Al-Jazira was incorporated on October 9, 1976, following the takeover of National Bank of Pakistan's Saudi Arabia branch. Al-Jazira commenced operations on June 21, 1979. The bank increased its capital in 1992 and 1994, which resulted in the dilution of National Bank of Pakistan's shareholding. Beginning in 1992, the bank started to restructure, and as a result the bank became profitable in 1997. In 1998, Bank Al-Jazira's board of directors made a strategic decision to Islamize its banking activities. The bank set the conversion time frame at 6 years.

Bank Al-Jazira established a Shariah board as parts of its core structure to oversee the bank's operations and ensure that it complied with Shariah principles. The bank succeeded in converting all of its branches in 2002. In 2007, the bank increased its capital which came entirely from the bank's profits. The bank did not change its name to include the word Islamic in its name because the country's legal authority does not allow banks to do this.

The analyses show that the conversion improves Bank Al-Jazira's financial position and operating performance as assets, equity, net income, deposits, and short-term funding all increase (Table 8 and Figure 15). In addition, bank profitability increases significantly after conversion as indicated by the *t*-test results (Table 7 and Figure 17).

Table 8 Financial positions before and after conversion for Bank Al-Jazira

Average (SR, in millions)	Assets	Loans	Deposits	Equity	Net income
Before (1994–1997)	4,226.08	1,085.90	2,039.50	417.60	1.00
After (2005–2008)	19,741.35	9,548.60	4,188.68	603.53	968.45

Source: Constructed by the author

The results of the efficiency analysis are inconclusive (Table 9 and Figure 18). On the one hand, the mean NIM value is higher after the conversion. This indicates that the bank is more efficient in generating income from its main activities. On the other hand, the OHA ratio increases after conversion, which reveals a lower efficiency. Perhaps the increase in overhead might have been related to the costs related to the conversion process in general, the establishment of Shariah board, or the bank's expanded activities. Similar to the efficiency results, the findings for asset quality are mixed (Table 9 and Figure 18). The mean LOA ratio after conversion is higher than the mean before conversion. In contrast, the mean loan-to-deposit (LOD) ratio does not show any significant changes between the two periods. Furthermore, the bank became less liquid after conversion, as indicated by the *t*-tests (Table 9). The risk ratios show a decrease in the bank's risk, as both of the risk variables (DTA and ETA) improve after conversion, but only the DTA finding is significant. This is shown in Table 8 and Figure 21.

Table 9 t-test results of Bank Al-Jazira

	ROA	ROE	NIM	OHA	LOA	LOD	LAD	DTA	ETD
M (before)	−0.01	−5.52	1.41	1.80	26.04	65.27	79.00	40.26	24.26
SD	0.56	15.23	0.50	0.37	6.06	16.50	9.00	4.39	11.83
M (after)	5.82	24.33	3.00	2.90	47.37	64.22	45.30	73.58	29.93
SD	5.00	17.86	0.58	0.46	6.28	6.17	19.51	3.21	6.83
t-test	−2.32	−2.54	−4.14	−3.72	−4.89	0.12	3.13	−12.25	−0.83

From these figures, it can be surmised that, in addition to the bank's management, conversion plays an important role in improving Bank Al-Jazira's performance.

4) Dubai Bank, UAE

Dubai Bank which is also located in the UAE was established in 2002. In mid-2006 the bank's board decided to convert its operations and aimed to launch its first Islamic operations at the beginning of 2007. The bank's assets, loans, and deposits and net income increased sharply after conversion, as indicated by Table 10, Figure 22 and Figure 23.

Table 10 Financial positions before and after conversion for Dubai Bank

Average (AED, in millions)	Assets	Loans	Deposits	Equity	Net income
Before (2002–2005)	2,207.18	969.23	1,606.40	366.25	7.70
After (2007–2008)	14,705.40	11,894.10	11,352.85	2,007.70	218.45

Source: Constructed by the author

The results of the analysis show that the bank's financial indicators reveal problems in the years before conversion. This might have been the reason behind the bank's decision to convert. The conversion positively impacts Dubai Bank's profitability and efficiency while adversely impacts its liquidity and asset quality (however, these results are not significant). The risk and solvency of the bank show some improvement, as the mean DTA ratio increased, but again these results are not significant. Generally, conversion boosts the bank's performance. Dubai Bank is small, and its loan losses increased after 2009, which led the government to intervene and bail out the bank in 2011. Later that year, the government ordered Emirates NBD, UAE's biggest lender, to take over Dubai Bank (Simeon & Hall 2011).

Dubai Bank's losses are due to its exposure in Dubai Holdings which controls 70% of the bank's shares. Dubai Holdings was hit hard by the financial crisis and sunk the bank heavily into debt. This problem ultimately led the bank to default on its financial commitments.

Table 11 t-test results of Dubai Bank

	)A	)E	M	HA	)A	)D	\D	[A	`D
M (before)	.64	.00	)7	[1	.80	.43	.62	.66	.45
SD	)8	.42	)1	36	.80	.32	.14	.52	.92
M (after)	58	.89	34	)0	.43	3.00	.57	.90	.81
SD	50	34	)7	)3	.45	)2	.36	[5	42
t-test	.06	.13	.35	54	.85	.00	)7	.89	72

5) Kuwait International Bank, Kuwait

Kuwait International Bank was incorporated as Kuwait Real Estate Bank in 1973 as a bank specializing in real estate financing. The bank served individual and company real estate investors. In an extraordinary general-assembly shareholder meeting held on October 25, 2003, the bank decided to convert to Islamic bank. The bank obtained initial approval from the central bank of Kuwait in 2004, began the conversion process in 2005, and completed it in 2006. On December 3, 2006, the central bank of Kuwait approved the conversion of the bank to Islamic banking. At a general-assembly shareholder meeting on December 25, 2006, the bank approved an amendment to the memorandum and articles of the bank so that all of its activities would comply with Shariah principles. Additionally, the meeting approved changing the bank's name to Kuwait International Bank. Since 2007, the bank has operated as an Islamic bank. The bank profitability decreased sharply in 1998 and was struggling to improve its profitability since then.

The bank's assets, loans, equity, and deposits increase after conversion (Table 12 and Figure 29). In 2008, the bank's assets

soar 45.8%, from 789.86 million Kuwaiti dinars to 1,151.24 million Kuwaiti dinars. The net income shows a drop in 2005 and 2006, before it begins to increase in 2007. Similarly, the ROA, ROE, NIM, LOD, and DTA means all improve in the period after the conversion. However, the LOA, LAD, and ETD means are lower in the post-conversion period. None of these results are statistically significant (Table 13, Figure 33 and Figure 35). Overall, conversion has a positive impact on Kuwait Real Estate Bank.

Table 12 Financial positions before and after conversion for Kuwait International Bank

Average (KWD, in millions)	Assets	Loans	Deposits	Equity	Net income
Before (1994–2003)	512.03	301.71	345.93	85.32	6.92
After (2007–2008)	1,015.35	646.85	835.45	161.35	18.90

Source: Constructed by the author

Table 13 t-test results of Kuwait International Bank

	ROA	ROE	NIM	OHA	LOA	LOD	LAD	DTA	ETD
M (before)	1.35	7.68	2.53	1.35	56.12	125.01	53.30	45.30	41.83
SD	1.02	5.35	0.81	0.24	18.94	41.98	30.13	12.63	17.05
M (after)	1.86	11.71	3.25	1.55	63.51	106.61	34.35	59.62	26.72
SD	0.05	0.44	0.69	0.01	4.21	9.23	6.63	1.21	1.16
t-test	−0.68	−1.02	−1.17	−1.10	−0.53	0.60	0.85	−1.54	1.21

Table 2 above indicates that the trend of bank conversion is increasing in Islamic countries, especially in the Middle East. This could lead to higher competition among Islamic banks. Thus, Islamic banks needs to increase its efficiency to stay competitive not among themselves but with conventional banks that offer Islamic financial solutions. The analysis, generally speaking, showed that conversion has positive and significant influences on banks' operations.

7. Conclusion

In the analysis of the five banks, the conversion generally has positive and significant influences on converted banks' financial position. Specifically, three of the banks experienced increases in their net incomes and assets after conversion. The declines in the profitability ratios of Sharjah Islamic Bank (ROA and ROE) and Emirates Islamic Bank (ROA) might have been related to the managers' inabilities to utilize bank funds efficiently to achieve more profits, assets, and equity. In contrast, Bank Al-Jazira's conversion to Islamic banking had a significant and positive impact on its performance. This dichotomy may be due in part to those banks' management inability to utilize the banks resources more efficiently to bring performance in line with increases in assets, deposits, equity, and net income. This can be seen in Bank Al-Jazira case, where the bank changed its management, as indicated by the bank, prior to its conversion[3].

Al-Atyat's (2007) study indicated that the availability of qualified human resources is the most influential variable in the decision making of the conversion process. Thus, the converted banks need to consider replacing its management by people whom are capable to achieve the banks goals, especially those bank facing difficulties prior to the conversion.

[3] The banking sector in GCC countries is highly concentrated, thus those banks must be profitable as indicated by many studies (relation between concentration and profitability). It can be concluded that the lower profitability in any bank in those countries could be mainly related to that bank management.

Moreover, the method of conversion could be another cause of some banks failure to improve its profitability after conversion. It appears that the gradual process is the best approach to converting conventional banks to Shariah-compliant banks. A gradual approach not only allows for a smooth conversion but also gives employees time to become familiar with Islamic banking operations. This eventually leads to better performance for the converted bank. This is proven by the case of Bank Al-Jazira which adopted the gradual transformation approach leading to a successful conversion to Islamic banking. It should be noted that, the outcome of this study is not conclusive due to data limitation. Consequently, more studies should be conducted on the effect of conversion on the converted banks taken into account the effect of bank specific variables. Another limitation of this study is due to the fact that it did not include data beyond 2008.

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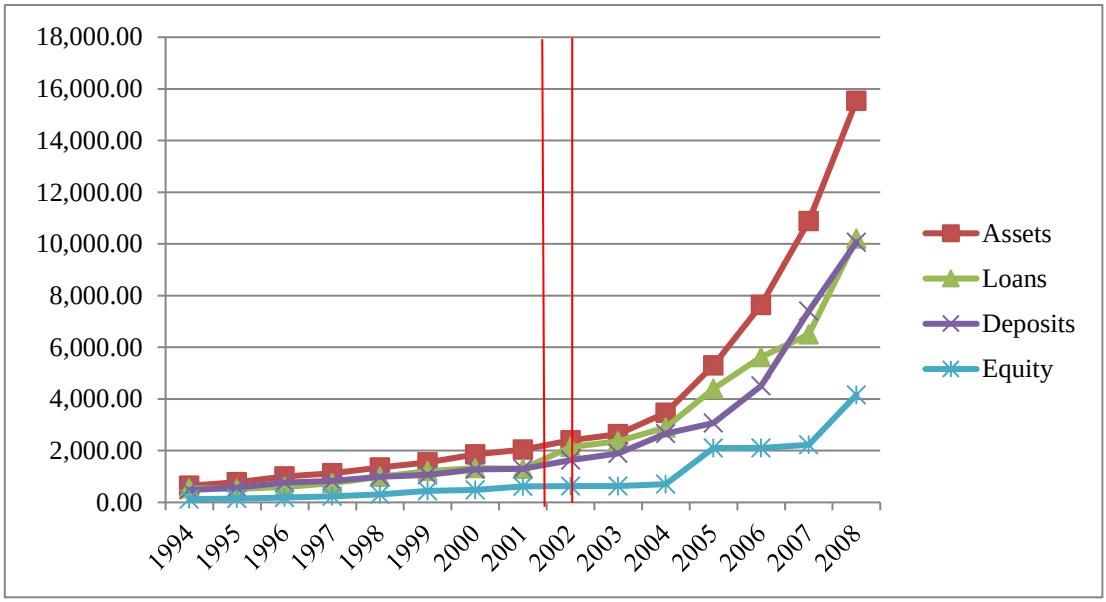
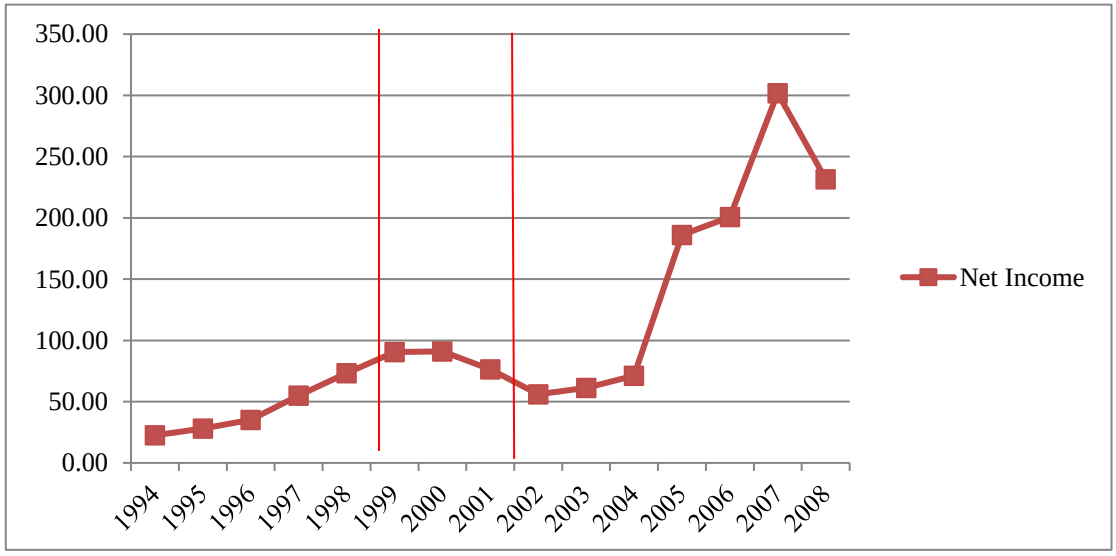
APPENDIX

Figure 1: Financial position of Sharjah Islamic Bank (AED, figures in millions)



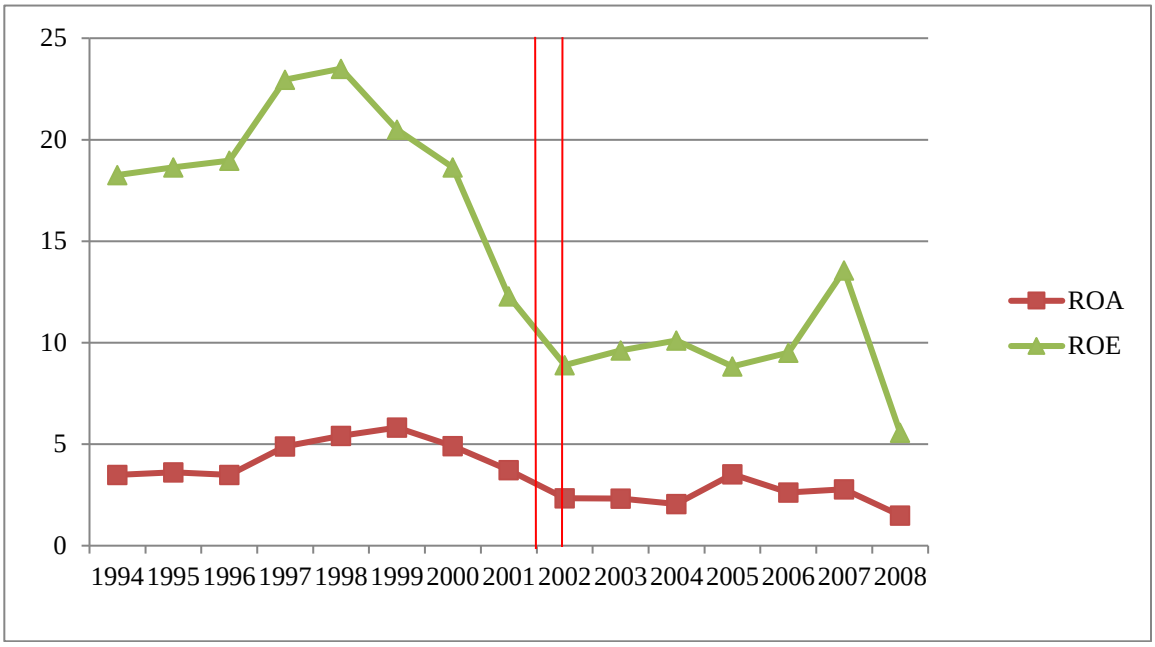
Source: Constructed by the author

Figure 2: Net income of Sharjah Islamic Bank (AED, figures in millions)



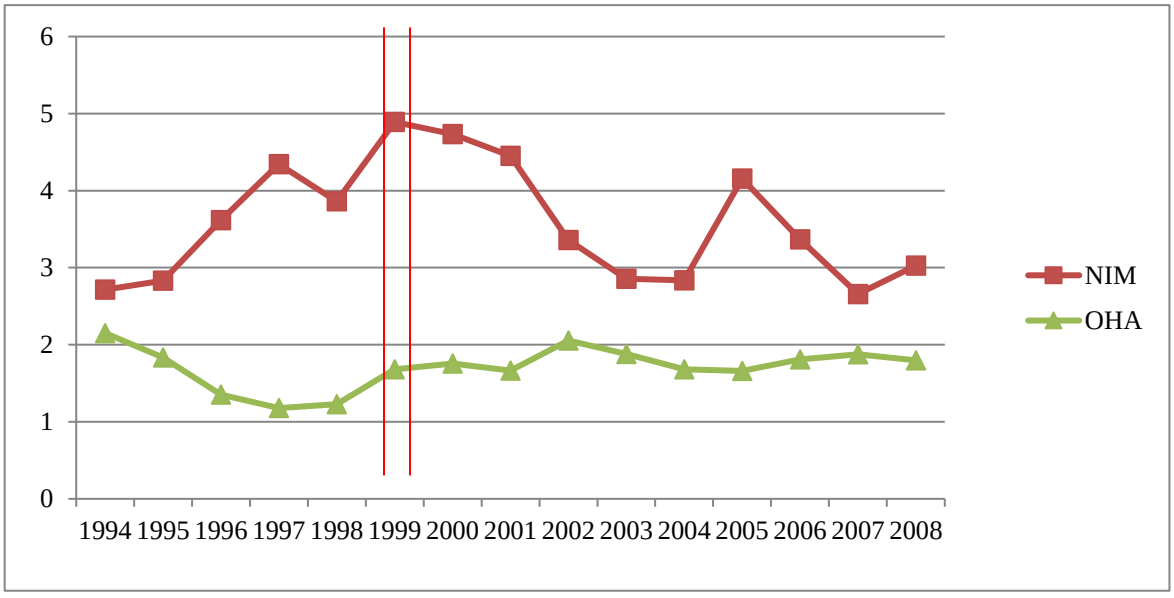
Source: Constructed by the author

Figure 3: Profitability ratios for Sharjah Islamic Bank



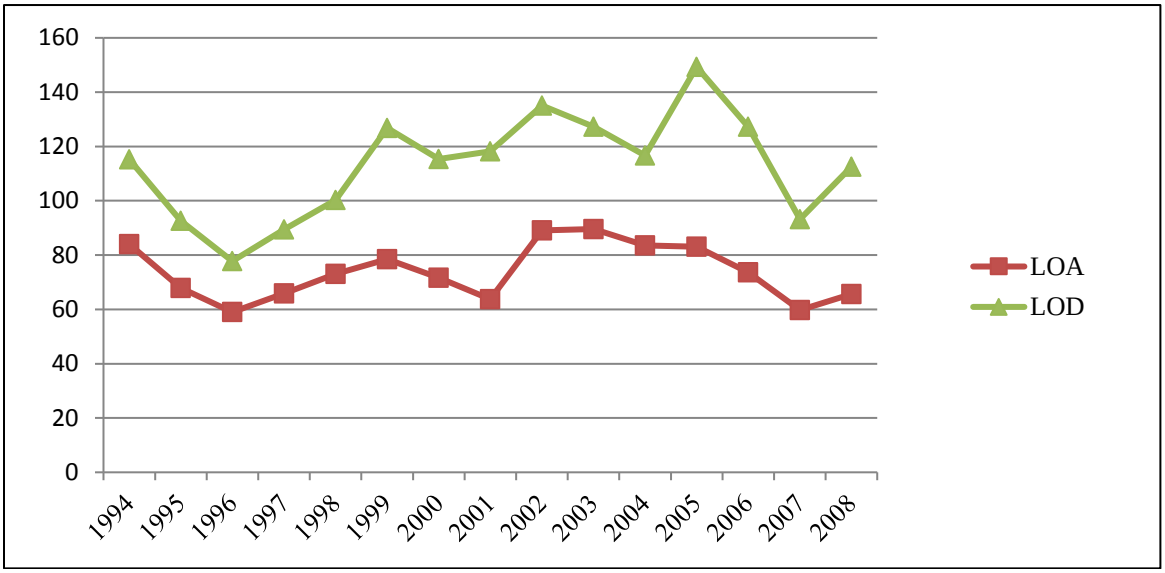
Source: Constructed by the author

Figure 4: Efficiency ratios for Sharjah Islamic Bank



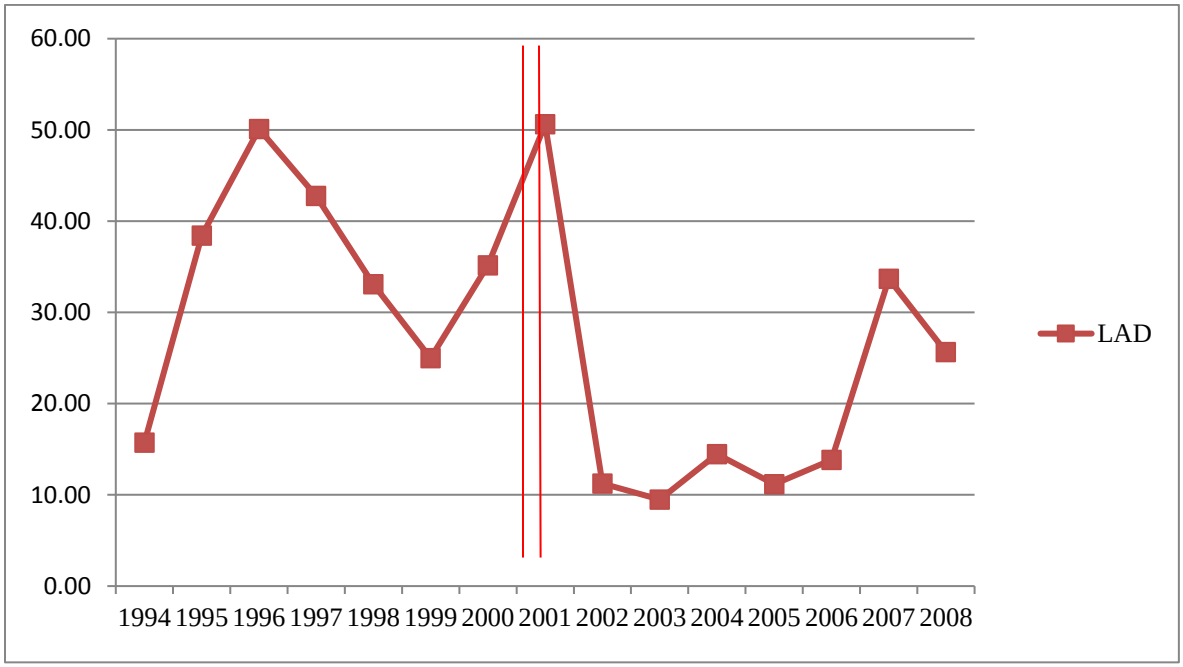
Source: Constructed by the author

Figure 5: Asset-quality indicators for Sharjah Islamic Bank



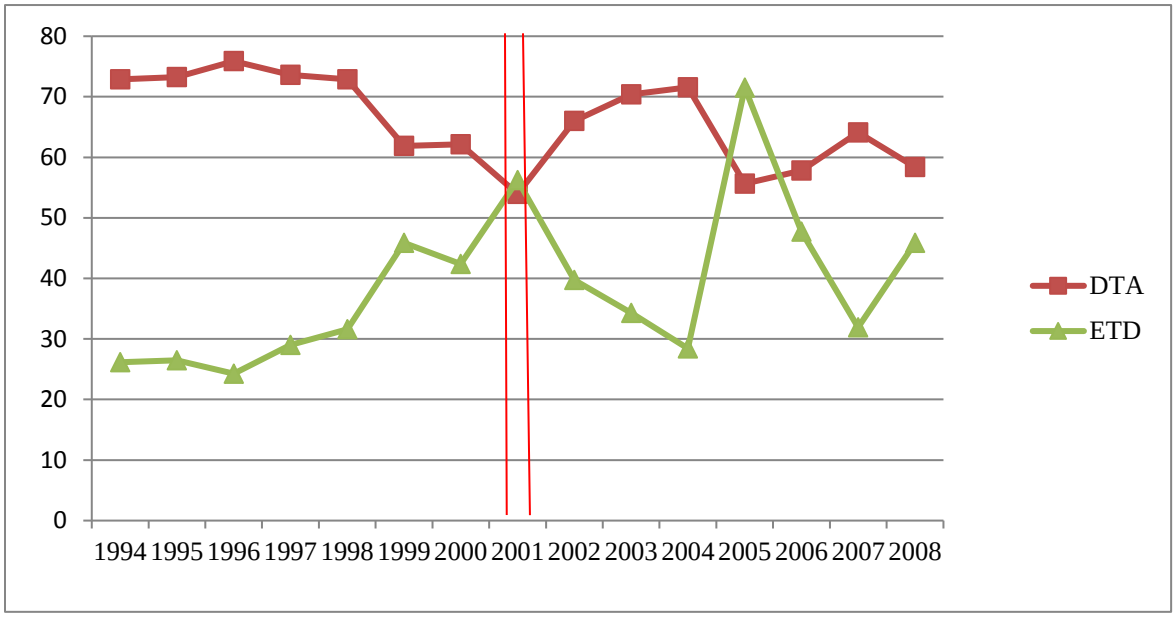
Source: Constructed by the author

Figure 6: Liquidity ratio for Sharjah Islamic Bank



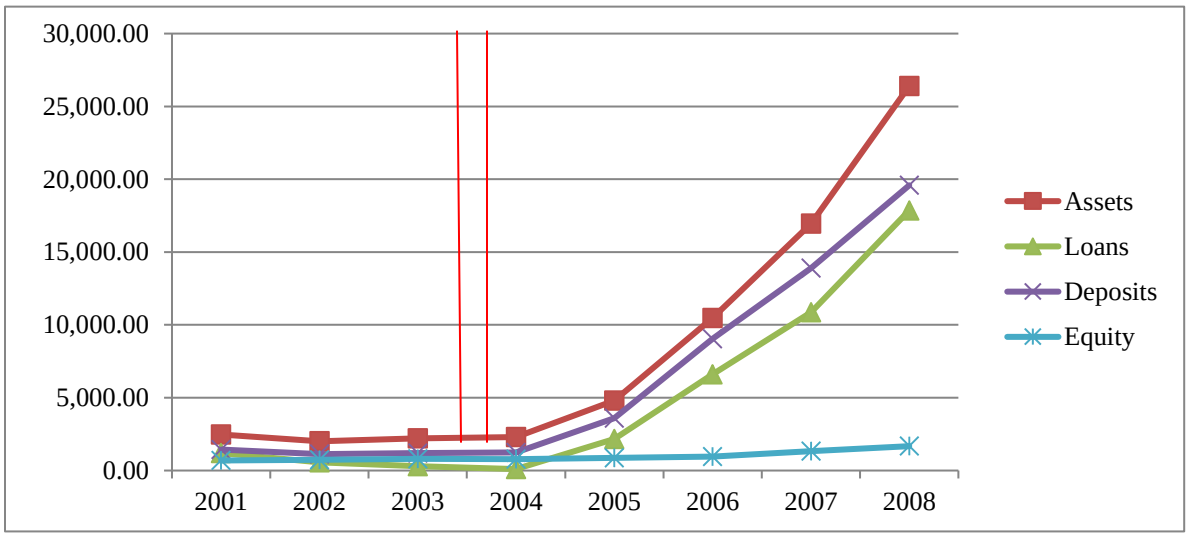
Source: Constructed by the author

Figure 7: Risk ratios for Sharjah Islamic Bank



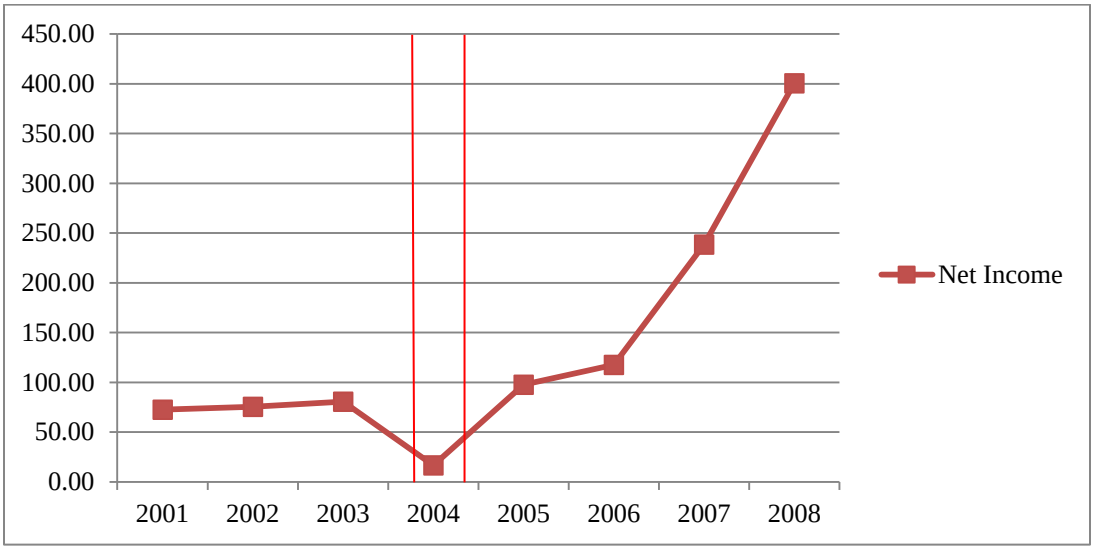
Source: Constructed by the author

Figure 8: Financial position of Emirates Islamic Bank (AED, figures in millions)



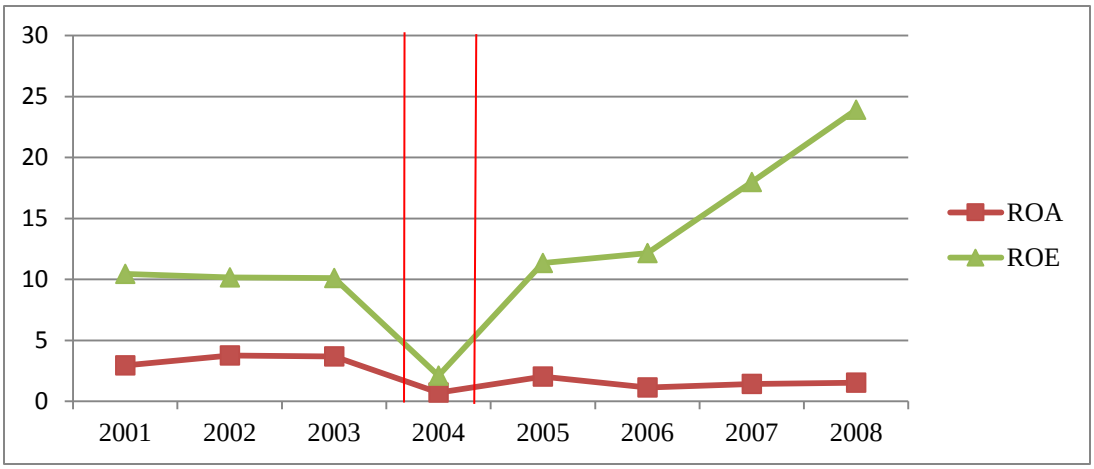
Source: Constructed by the author

Figure 9: Net income of Emirates Islamic Bank (AED, figures in millions)



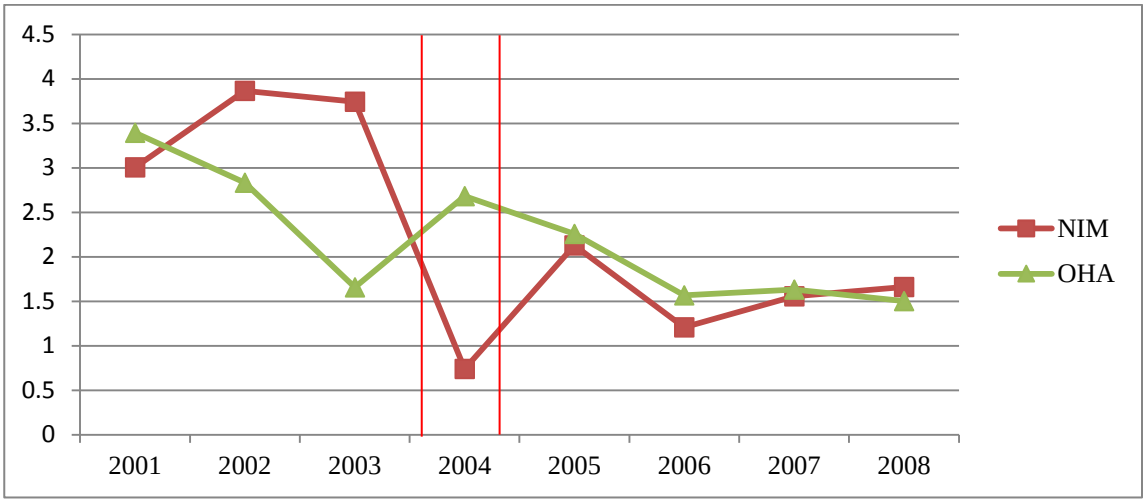
Source: Constructed by the author

Figure 10: Profitability ratios for Emirates Islamic Bank



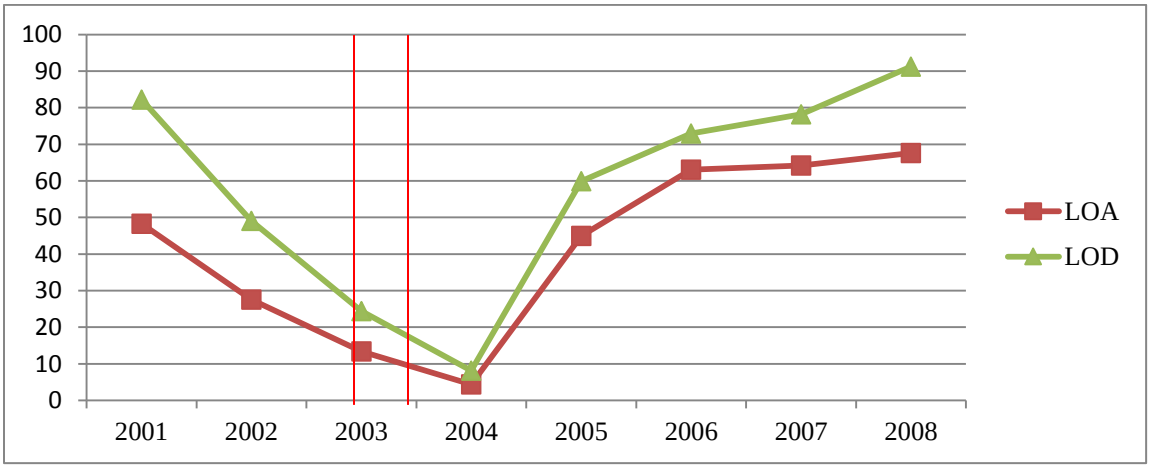
Source: Constructed by the author

Figure 11: Efficiency ratios for Emirates Islamic Bank



Source: Constructed by the author

Figure 12: Asset-quality indicators for Emirates Islamic Bank

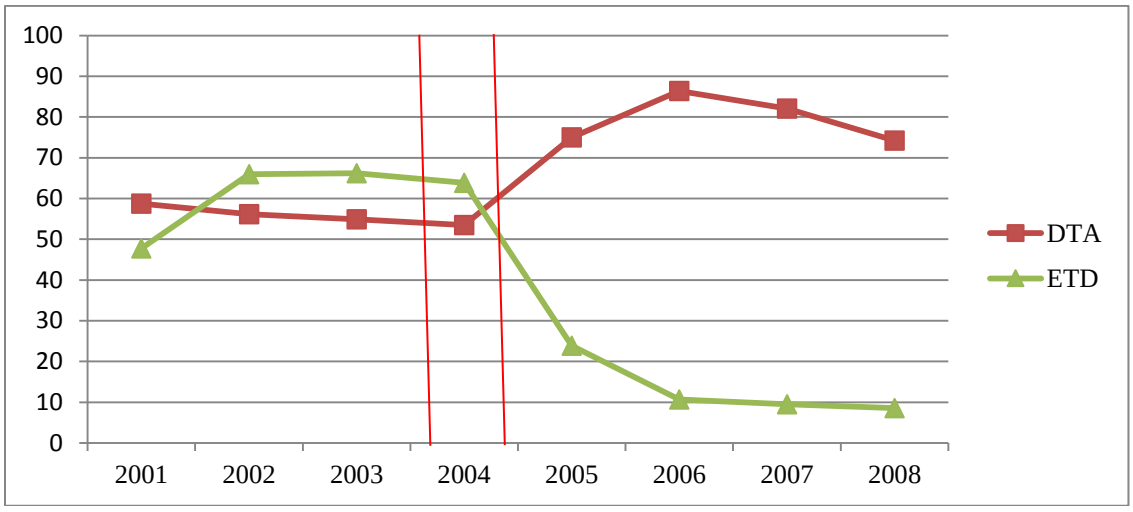


Source: Constructed by the author

Figure 13: Liquidity ratio for Emirates Islamic Bank

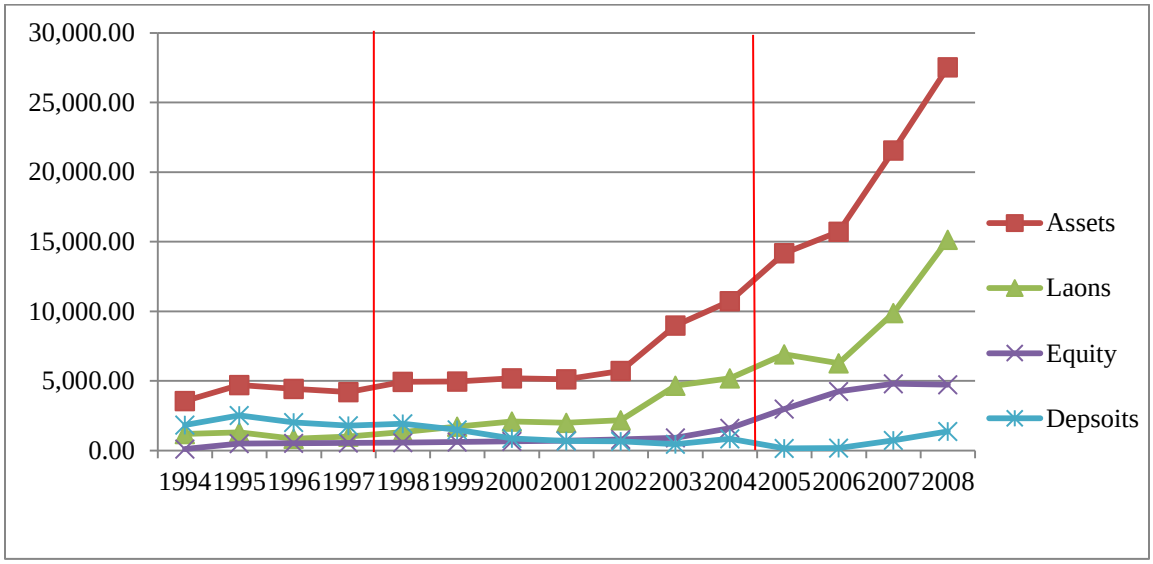
Source: Constructed by the author

Figure 14: Risk ratios for Emirates Islamic Bank



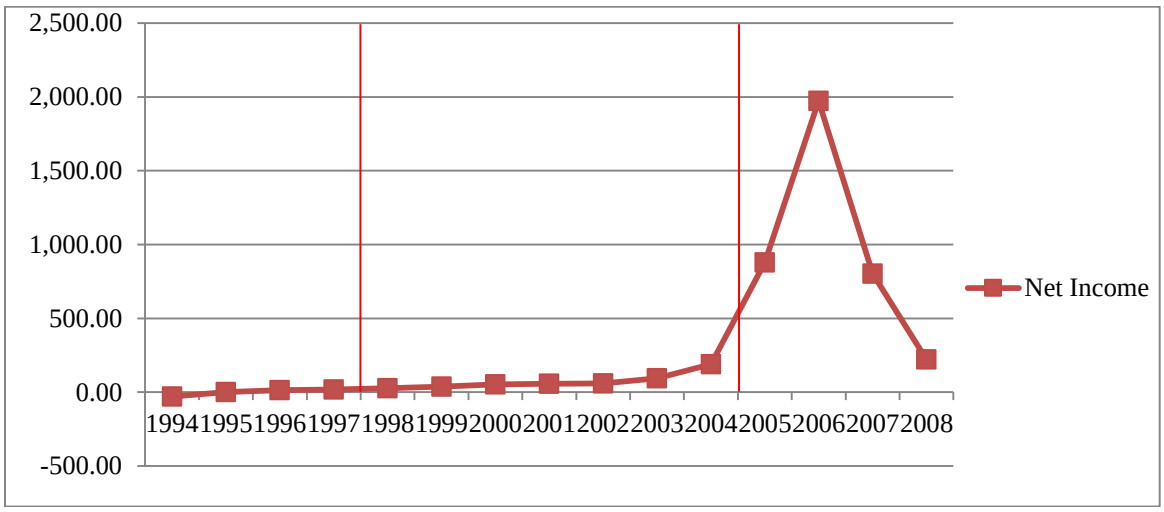
Source: Constructed by the author.

Figure 15: Financial position of Bank Al-Jazira (SR, figures in millions)



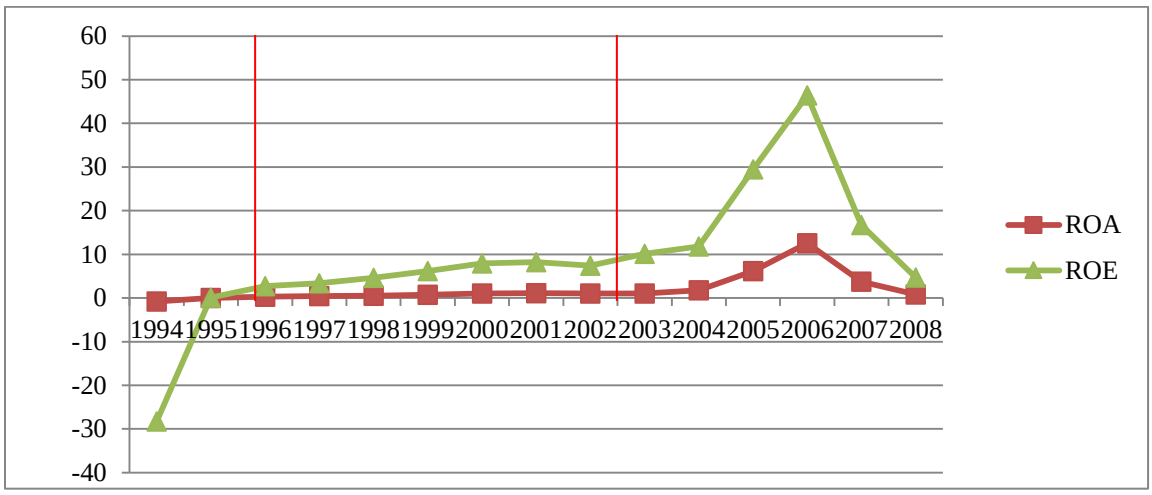
Source: Constructed by the author

Figure 16: Net income of Bank Al-Jazira (SR, figures in millions)



Source: Constructed by the author

Figure 17: Profitability ratios for Bank Al-Jazira

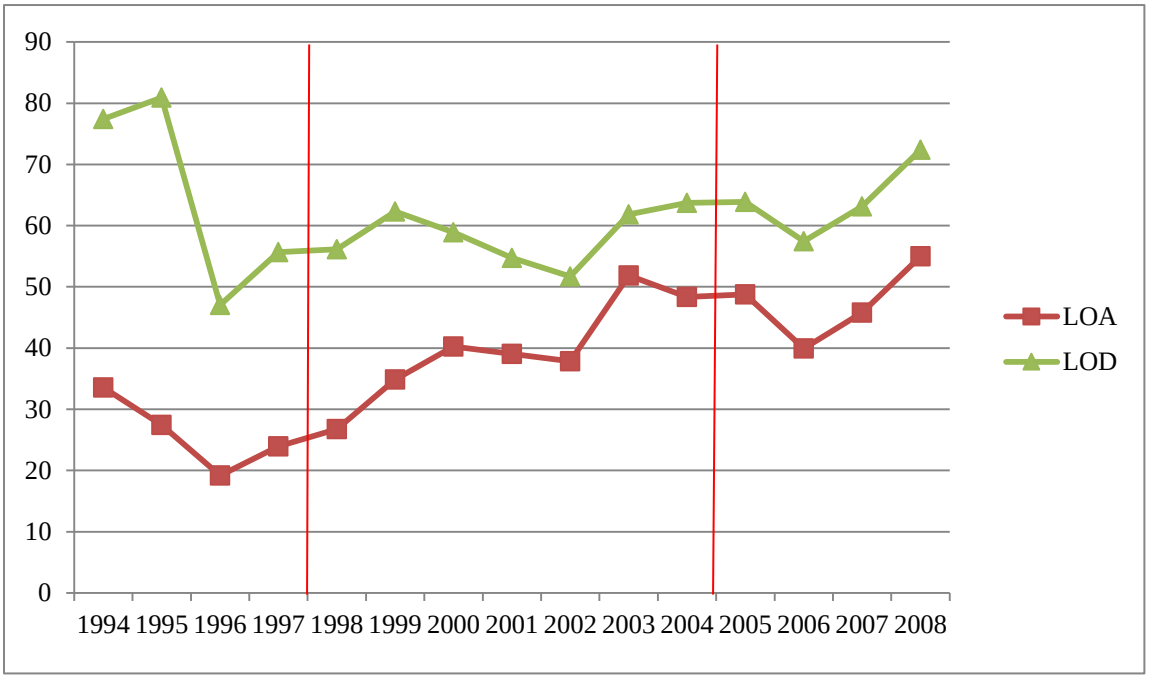


Source: Constructed by the author

Figure 18: Efficiency ratios for Bank Al-Jazira

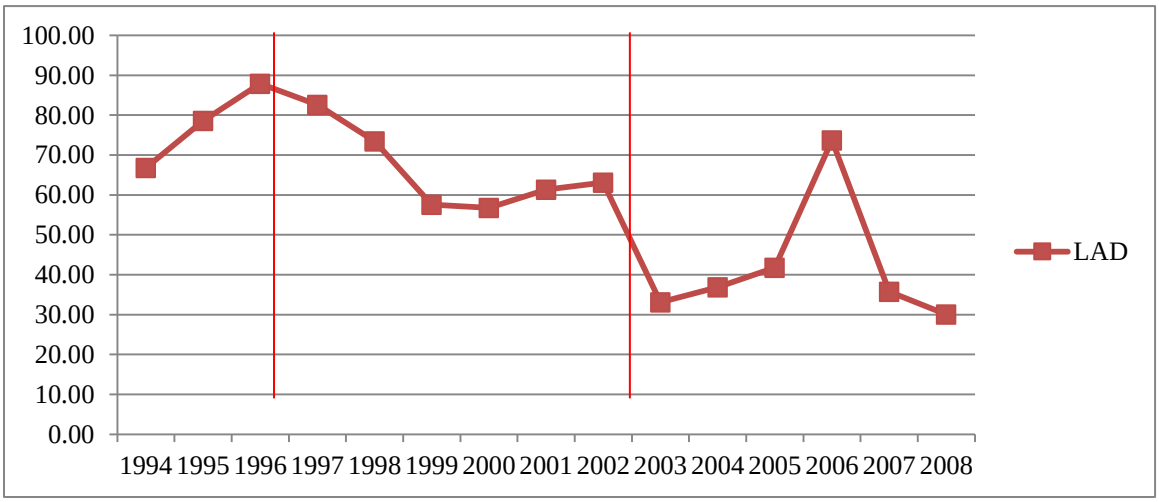
Source: Constructed by the author

Figure 19: Asset-quality indicators for Bank Al-Jazira



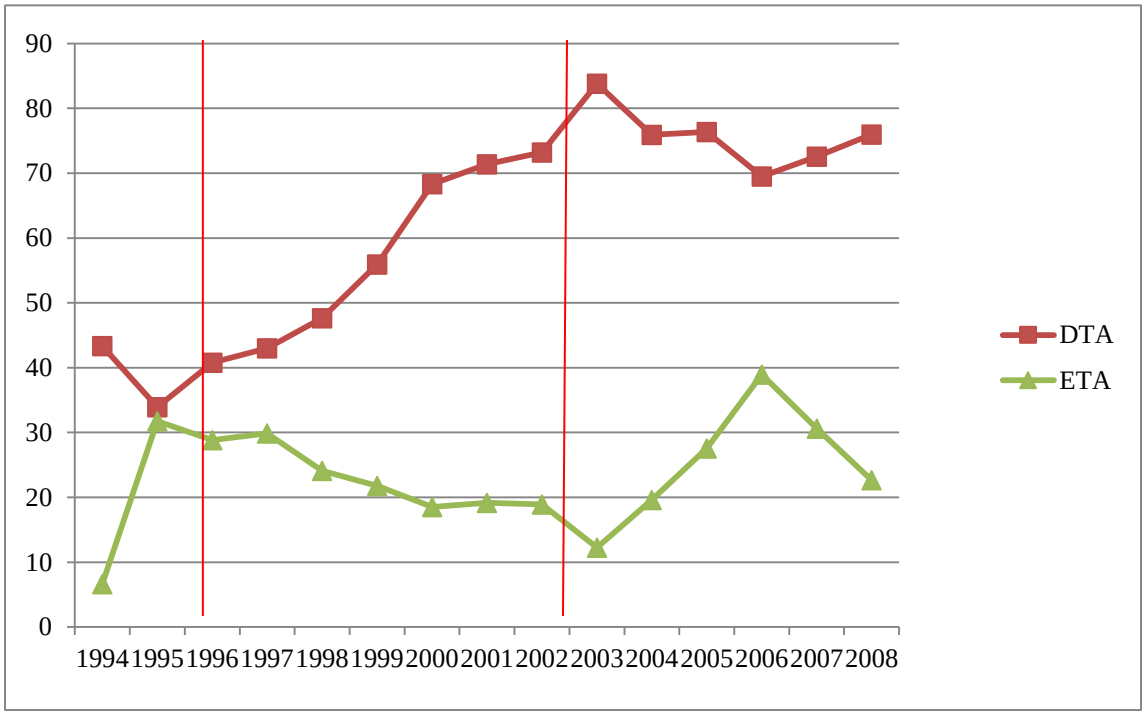
Source: Constructed by the author

Figure 20: Liquidity ratio for Bank Al-Jazira



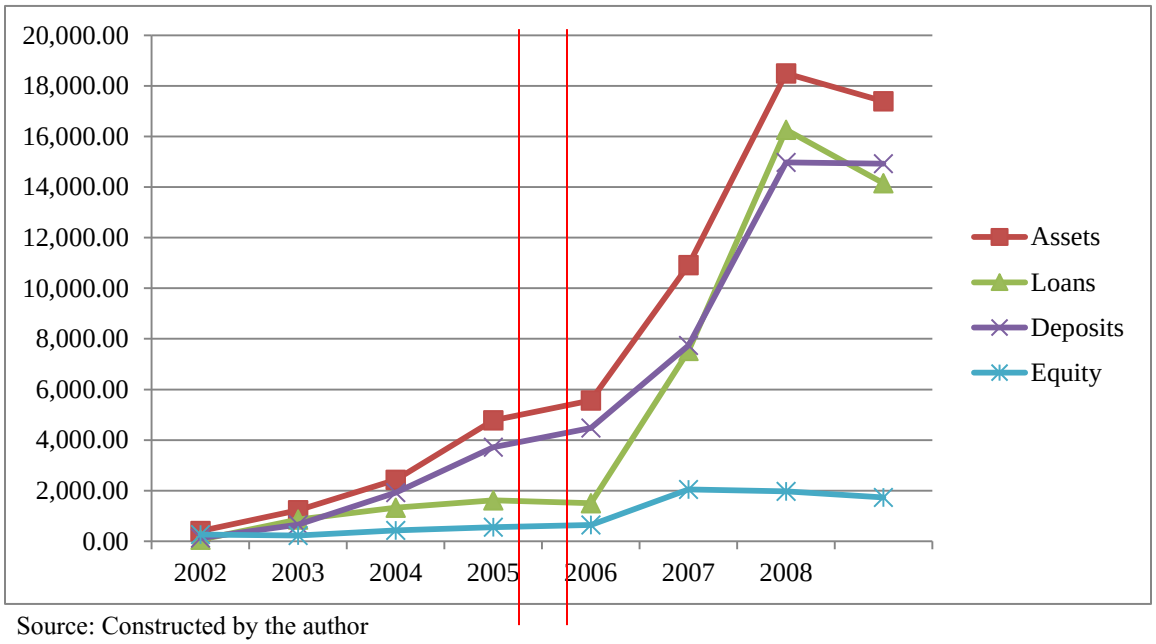
Source: Constructed by the author

Figure 21: Risk ratios of Bank Al-Jazira



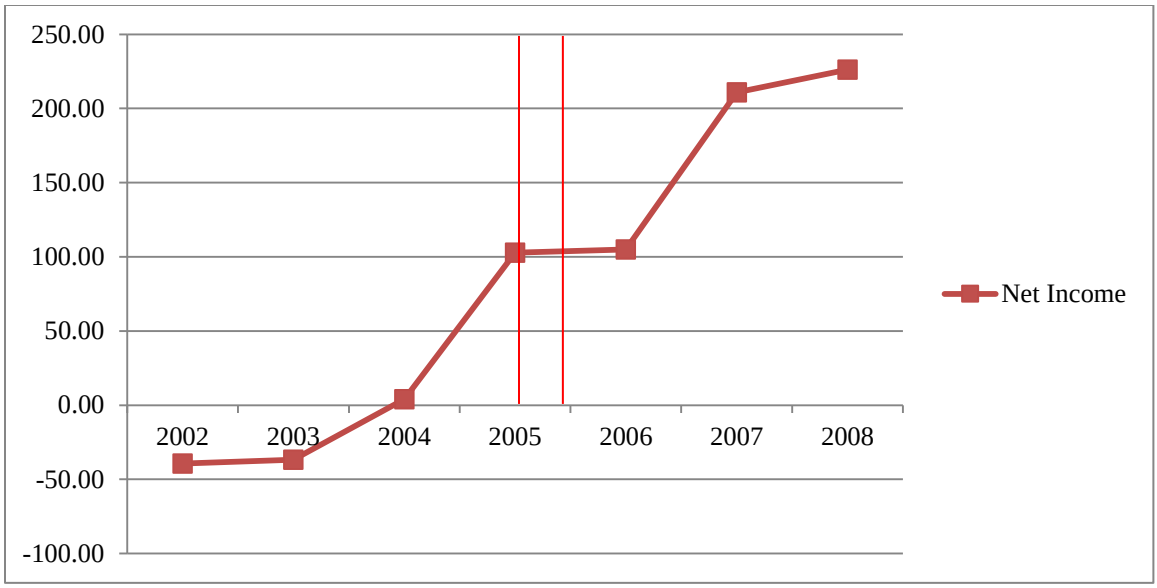
Source: Constructed by the author

Figure 22: Financial position of Dubai Bank (AED, figures in millions)



Source: Constructed by the author

Figure 23: Net income of Dubai Bank (AED, figures in millions)

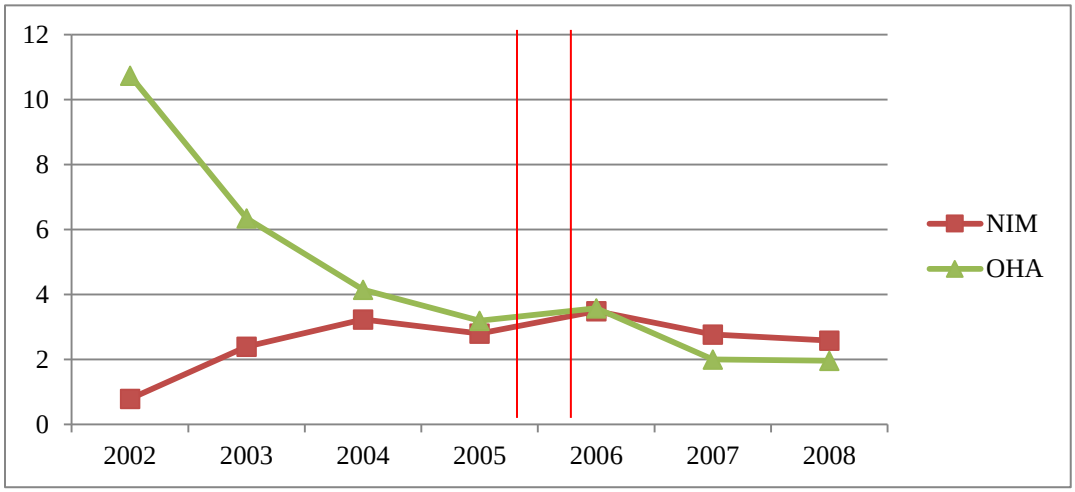


Source: Constructed by the author

Figure 24: Profitability ratios for Dubai Bank

Source: Constructed by the author

Figure 25: Efficiency ratios for Dubai Bank

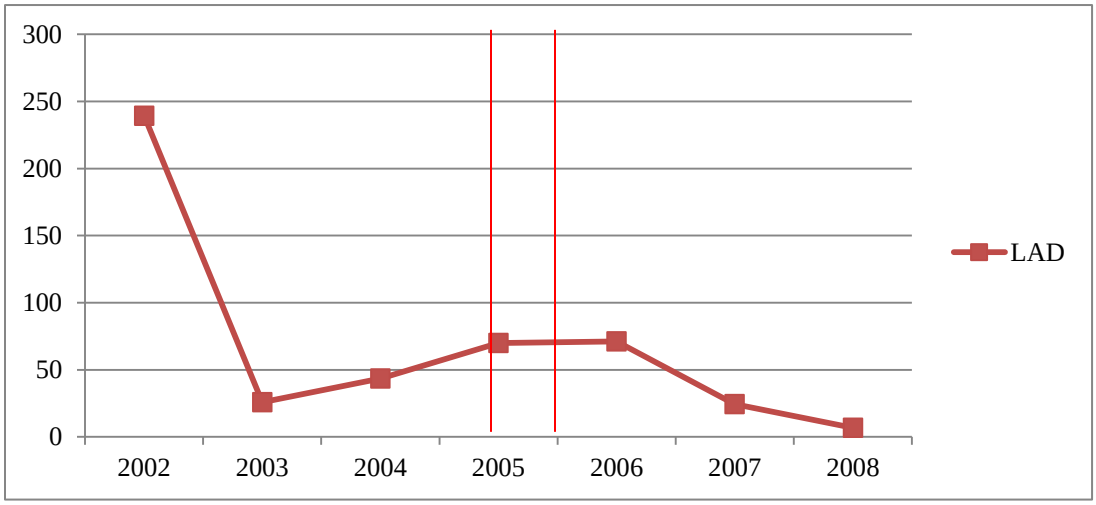


Source: Constructed by the author

Figure 26: Asset-quality indicators for Dubai Bank

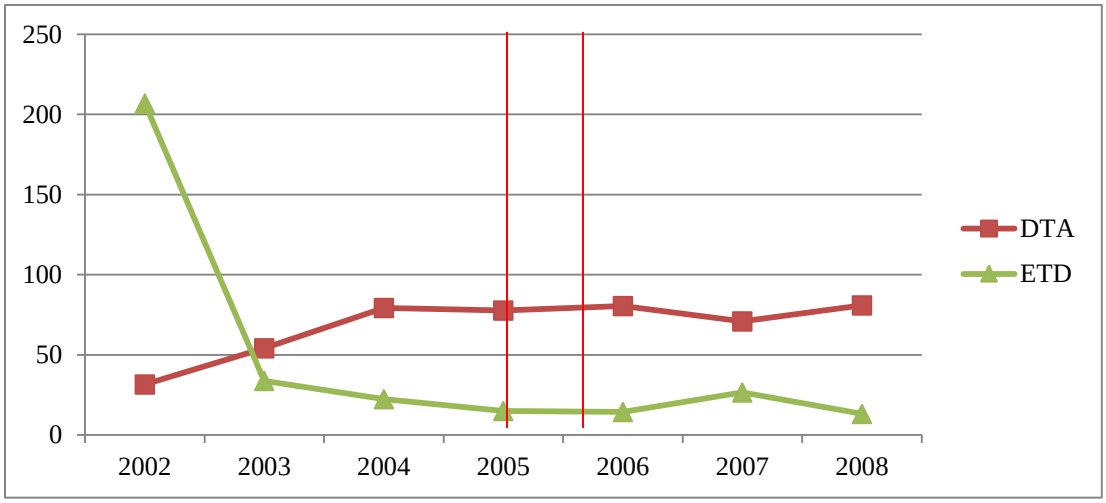
Source: Constructed by the author.

Figure 27: Liquidity ratio for Dubai Bank



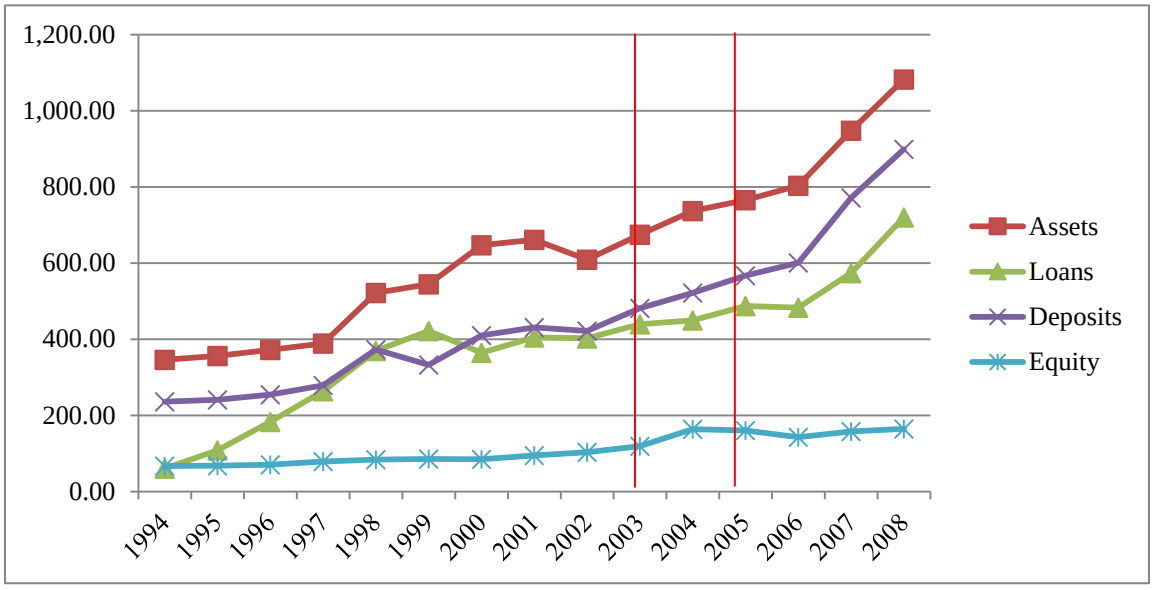
Source: Constructed by the author

Figure 28: Risk ratios for Dubai Bank



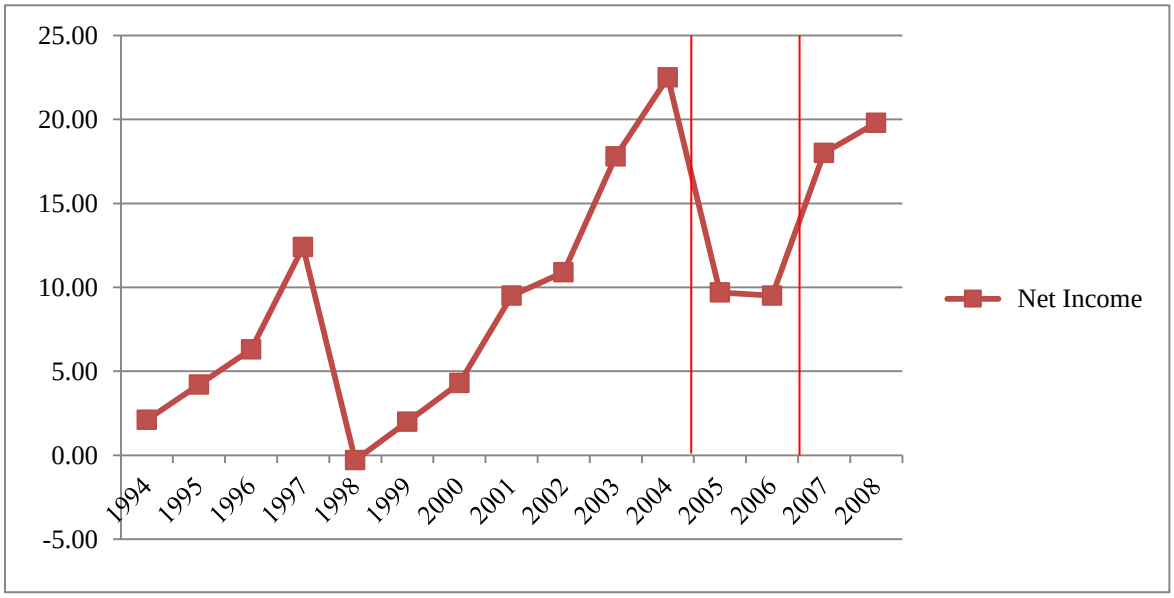
Source: Constructed by the author

Figure 29: Financial position of Kuwait International Bank (KWD, figures in millions)



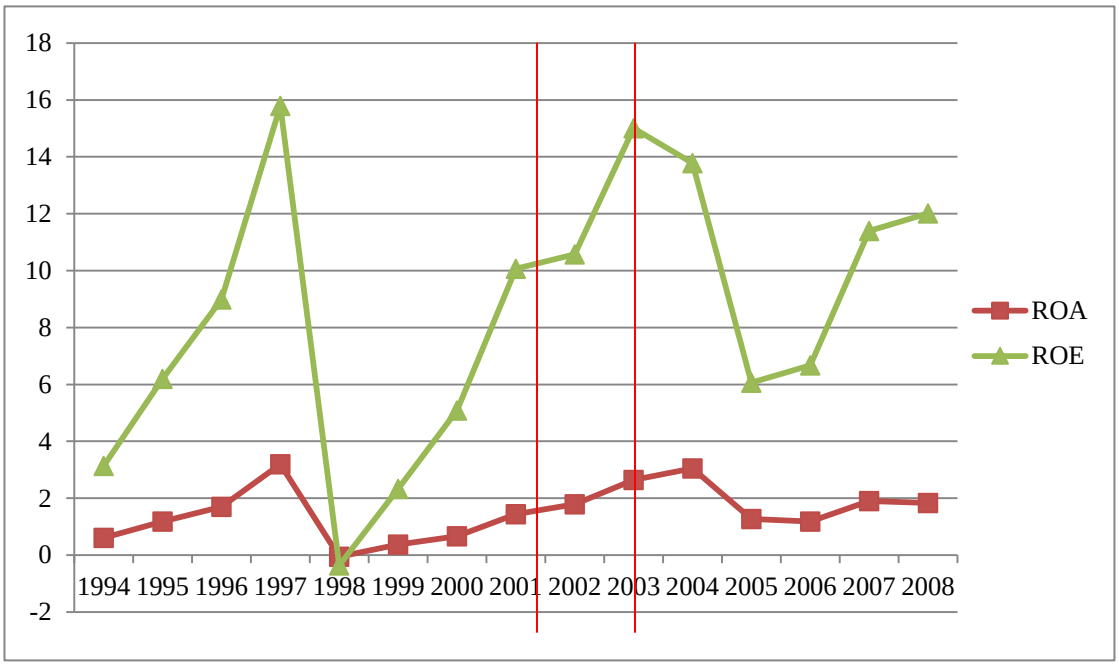
Source: Constructed by the author.

Figure 30: Net income of Kuwait International Bank (KWD, figures in millions)



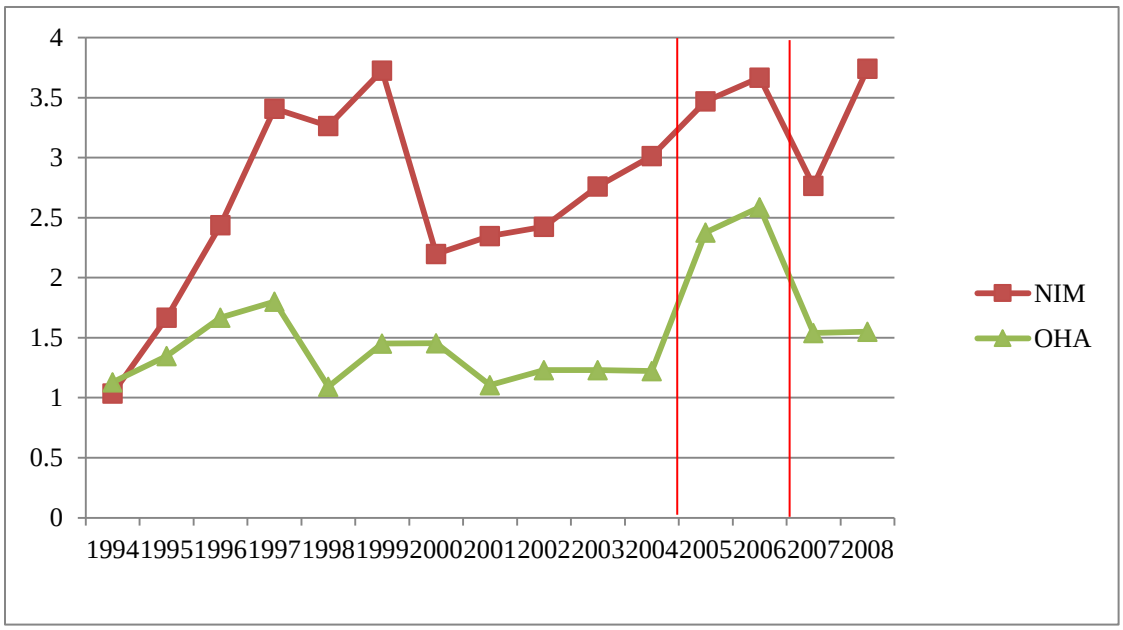
Source: Constructed by the author

Figure 31: Profitability ratios for Kuwait International Bank



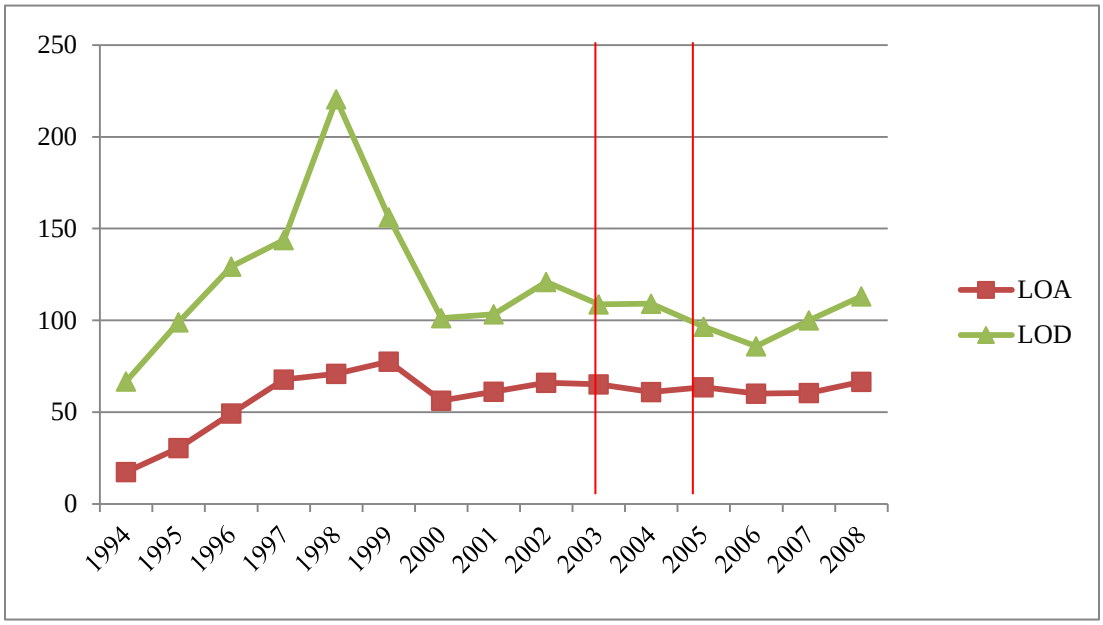
Source: Constructed by the author

Figure 32: Efficiency ratios for Kuwait International Bank



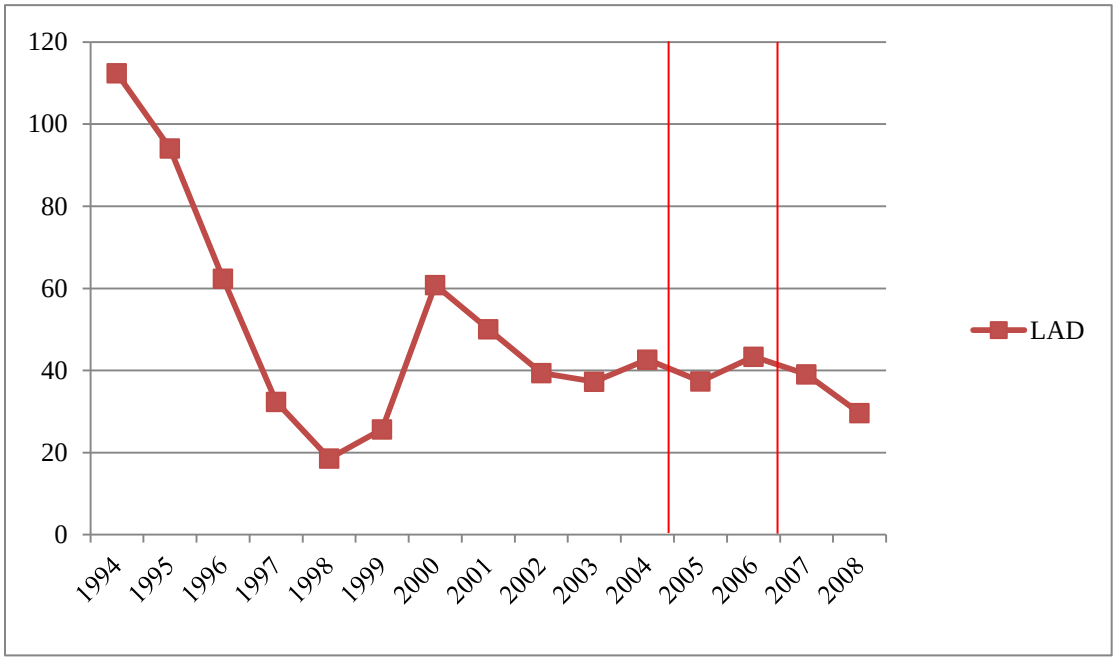
Source: Constructed by the author

Figure 33: Asset-quality indicators of Kuwait International Bank



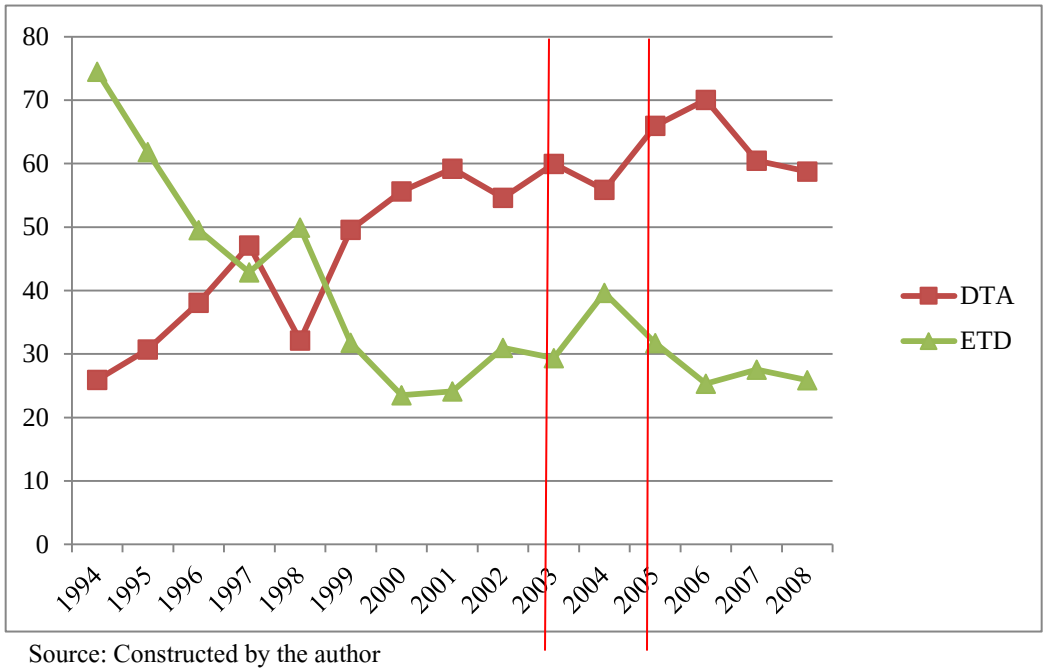
Source: Constructed by the author

Figure 34: Liquidity ratio for Kuwait International Bank



Source: Constructed by the author

Figure 35: Risk ratios of Kuwait International Bank



Source: Constructed by the author