

## **CHAPTER 1**

### **INTRODUCTION**

#### **1.1 Background**

Economies that enjoy a healthy and profitable banking sector are capable to confront negative financial shocks and enhance the stability of a financial system as a whole (Anbar and Alper 2011). Hence, it is crucial to seek for deep understanding for factor might affect bank performance. Banks are financial institutions authorized to collect deposits and give credit. Banks may also provide other financial services. for instance, currency exchange, wealth management, and safe deposit boxes. Banks mainly can be divided into two main categories IBs and CBs (Lewis and Algaud, 2001).

Islamic banks operate the same basic functions as banks working under the conventional one. But, Islamic banking refers to the banking system which works according to Sharia, which prohibits charging any extra money for money that is borrowed (Kamarulzaman and Madun, 2013). It is built on profit-loss sharing where all financial transactions must be backed by real. Furthermore, IBs do not allow investments in any prohibited activities mentioned in the Quran, such as alcohol and pork products. As a matter of fact, IBs are younger and enjoy less experience compared with conventional one's asset (Ahmed, Hassan, and Rayfield, 2018; Iqbal and Mirakhor, 2007; Ulaiman et al., 2018). The Islamic finance industry has achieved significant progress of having a wider acceptance in the global level,

particularly in the last four decades (Nour Aldeen, Ali Shah, & Herianingrum, 2019).

Allah SWT says in holy Quaran:

الذين يأكلون الربوا لا يقومون إلا كما يقوم الذي يتخبطه الشيطان من المس ذلك انهم قالو انما البيع  
مثل الربا واحل الله البيع وحرم الربا فمن جاء موعظة من ربه فانتهى فله ما سلف وامره إلى الله ومن  
عاد فأولئك أصحاب النار هم فيها خالدون \*يحمق الله الربوا ويربى الصدقات والله لا يحب كل كفار  
اثيم

Those who devour interest will not stand except as stands one whom the Satan by his touch has driven to madness. That is because they say: “trade is like interest”, but Allah has permitted trade and has forbidden interest ... Allah will deprive interest of all blessing, but will give increase for deeds of charity: for He does not love any ungrateful sinner (2:275-276).

Another evidence from holy Quran:

لا تأكلوا لربوا اضعافا مضاعفة واتقوا الله لعلمكم تفلحون

O you who believe! Devour not interest doubled and multiplied; but fear Allah, that you may prosper. Fear the Fire, which is prepared for the disbelievers (3:130-131).

Rassulallah said:

اجتنبوا السبع الموبقات ,قالو وما هن يا رسول الله؟ قال : الشرك بالله والسحر وقتل النفس التي حرم الله  
إلا بالحق واكل الربا واكل مال اليتيم والتولي يوم الزحف وقذف المحصنات المؤمنات الغافلات ؟

Avoid the seven destructive sins: associating partners with Allah, sorcery, killing a soul which Allah has forbidden- except through due course of the law, devouring interest, devouring the wealth of orphans, fleeing when the armies meet, and slandering chaste, believing and innocent women (Bukhari and Muslim).

Interest considered as one of the dangerous weapons to exploit poor people and needy as well. When a major wealth portion is centralized in a few men's hands, subsequently asking for interest when they want to help poor people, in this case, the poor will become me poorer and the rich will be richer. As a result, few has

everything and a lot have nothing. And hence jealous, envy, murder, etc. appear among the abovementioned classes (Zakir Hossain, 2009).

The unfortunate class-struggle starts from this certain point. societies and nations fall into extreme insecurity. Eventually, the gross ethics of human collapse and the culture, economy society, state management, etc. fall into a ruined nation (Zakir Hossain, 2009). Studies on Islamic banking performance record that it is not a minor system for its conventional counterparts (Nevine and Abdel, 2017). Islamic banking, the same as any other banking system, should be seen as an evolving system that has shown great progress. Recent research has also shown that Islamic banking is an effective way of financial intermediation. Furthermore, Islamic banking should not be observed as a religious act: rather, it is a different way of financial intermediation and previous performance confirms that it is an attractive way of financing (Nevine and Abdel, 2017).

Financial performance mainly could be categorized into five categories as follows (liquidity risk, profitability, risk management, efficiency, capital adequacy) (Khan et al., 2017), (Sukmana and Febriyati, 2016), (Sobhy and Megeid, 2017). Recently, much research has concentrated on Islamic and conventional banks' performance comparison in many countries. For instance, Pakistan (Khan et al., 2017; Akhtar et al., 2011), Egypt (Sobhy and Megeid, 2017), Indonesia (Sukmana and Febriyati, 2016) and Rosly and Bakar (2003) examined the case of Malaysia. But there is dearth in researches in the Syrian context. To the best of the author knowledge, this topic has yet to be explored. It remains unclear which banking system performing better in the country.

Nevertheless, some studies focus on MENA region have excluded Syria from their sample for instance, (El-Chaarani, 2019). Moreover, Ghenimi & Omri, (2015) and Mahdi & Abbes (2018), due to the vilonet coflice impact on the banking sector. To the best of our knowledge, this topic has yet to be explored. It remains unclear how do IBs and CBs function in the country? This study is an attempt to offer an alluded picture of IBs and CBs performance in the country. Moreover, indicate the macro and micro factors impact asset quality in the Syrian commercial banks, as it has been generally agreed that macroeconomic and microeconomics conditions affect credit risk.

The in-hand study will investigate whether Islamic bank's performance better, worse or same with their counterparts the conventional ones.

Banking history in Syria can be divided into three phases as the following banks were started in Syria during the Ottoman occupation period when the Empire Bank was established in 1856. The main functions of these banks were issuing banknotes. In May 1874), it became the trustee of the empire funds and a repository for all state revenues. Lately, many banks were established in the late 19th century. (Horani and Hassani, 2011).After Ottoman Empire Syrian Bank was established to manage the state funds. While the general directorate was in Paris. In 1924 renamed to Bank of Syria and Lebanon. During this era (SociétéGénérale) established a range of banks. The Italian bank in 1919 and small financing institutions in Damascus and Aleppo which were particularly focusing on agriculture funds (Sharf and Abo Arraj, 1993).

After Syrian independence in 1946, economic chaos was recorded in the country, resulting from the dependence of the French occupation. Syrian Exchange Center was established in 1952 which was responsible for exchange rate stability. Followed by the dissolution of the Bank of Syria and Lebanon in 1953 fundamental pillars were set for the central bank of Syria (Sharf and Abo Arraj, 1993). Laws, regulations and acts during 1952-1962 led to the growth of Syrian's GDP. Hence, the need for new banks were observed. After the entry of socialism thought. in 1963, all banks were condensed into 5 banks. Again in 1966, those 5 banks were merged to form one bank namely Syrian commercial bank which was responsible for the internal and external business operations (Aljashy, 2015). The Industrial, Agricultural and Real Estate Banks was established to raise and provide necessary services for each related sector (Horani and Hassani, 2011). Due to inability of national banks to meet the financial needs, in 2001 private banks allowed to operate in Syria. This was followed by another announcement allowing IBs to start up in 2005.

The objectives of allowing private sector in banking was to build an efficient and effective monetary policy to maintain the stability of the Syrian pound exchange rate, low and stable inflation rate, contributing to the creation of a proper environment for investment and supporting the economic growth (Central bank of Syria, 2019). IBs consist of 21.43% and the conventional one 78.57% from the entire Syrian banking system. Total branches for Islamic banks' 30 branches whereas it is 205 for conventional banks. Nowadays, Syria has been thriving in

performing a dual banking system and has appeared as a nation to have 3 full-fledged IBs functioning alongside conventional counterparts.

**Table 1.1**  
**Private Banking Sector in Syria**

No	Banks' Name	Acronym	Started at	Number of Branches
<b>Islamic banks</b>				
1	Chan Bank	CHB	23-May.-2007	8
2	Syrian Islamic International Bank	SIIB	15-Oct.-2007	23
3	AL-Baraka Bank	BBSY	06-Jun.-2010	9
<b>Conventional banks</b>				
4	BanqueBemo Saudi Fransi	BBSF	04-Jan.-2004	41
5	Bank of Syria and Overseas	BSO	06-Jan.-2004	27
6	International Bank for Trade and Finance	IBTF	06-Jun.-2004	30
7	Bank Audi Syria	BASY	28-Oct.-2005	27
8	Byblos Bank Syria	BBS	05-Dec.-2005	11
9	Arab Bank Syria	ARBS	02-Jan.-2006	17
10	Syria Gulf Bank	SGB	13-june.-2007	12
11	Sharq Bank Syria	SHRQ	3-May.-2008	4
12	Bank of Jordan Syria	BOJS	28-Nov.-2008	13
13	Fransa bank Syria	FSBS	15-Jan.-2010	8
14	Qatar National Bank	QNB	15-Nov.-2010	15

(Source: Websites of banks in Syria)

This research extends previous studies by analyzing and comparing the performance of conventional and Islamic banks during the Syrian conflict. The private banking sector has been in exist since 2004, it is quite the time to examine and evaluate its performance and coexistence in the country, particularly in the violent political crisis, which was erupted a decade ago. As this is one of the pioneering studies in the Syrian context, this study reveals vital information for both the private banking sector and the central bank by providing a piece of remarkable information to set future prospects in the country. Moreover, depositors and investors might not only interested in *shariah* complaint banking system but comparing its profitability and performance to evaluate the opportunity cost.

Furthermore, the study develops the exist literature concerning IBs and CBs. The in-hand study will enhance the stockholder and central bank awareness about long-term financial and economic stability in Syria.

This research employed both macro and microeconomics variables. For t-test analysis we compared 5 different variables namely: CAR representing the capital adequacy(Siddiqui, 2008); OER reflects a bank efficiency (Hayset al.,2009); ROA reflects the profitability of an entity(Schmidlin, 2014); NPF addresses the doubtful loans and the management efficiency (Bessis, 2015); FDR; shows the given finance, hence, will reflect the availability of the cash to meet clients requirements (Sukmana and Kholid, 2013). In addition to macroeconomic variables such as exchange rate EX which represent a nation's currency against other countries currencies (Habib, 2015). Moreover, the GDP growth which represent the economics outputs of a nation (Piazzesi and Wei, 2006). Based on the literature, this paper extends the previous studies by looking to the industry level for Islamic banks as well as conventional banks on their financial performance during the Syrian conflict. This is crucial especially for the Islamic banking regulator to develop Islamic banking in Syria, Islamic bank has been started working in 2006 to complement the conventional banks in Syria. As such, it is timely to look at their performance. To the best of the authors' study, there has been no study conducted to compare both mentioned industries in Syria, it is remarkable to the central bank as the monetary authority. One objective of this study is to illustrate the difference in performance between both types of banks during the Syrian crisis. Moreover, this study is vital for Syrian Central Bank as to further observation if Islamic banks can

serve as a channel of monetary policy during the current economics' situation during the Syrian conflict. Furthermore, the study develops a database of Islamic banks, which is particularly useful because no previous study has included Islamic banks industry in Syria

## 1.2 Banks Performance

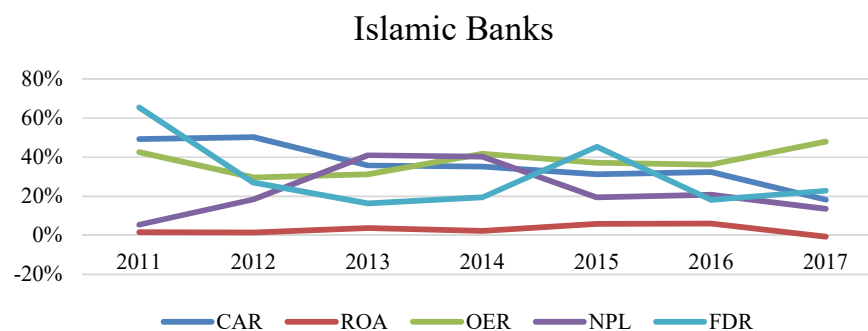
This study focuses on the financial ratios of two types of banks (Islamic and conventional). Data adopted are the Capital Adequacy Ratio (CAR), Return on Assets (ROA), Operational Cost/Operational Revenue (OER), Non Performing Loan (NPL) / Non Performing Financing (NPF) as well as Loan to Deposit Ratio (LDR) / Financing to Deposit Ratio (FDR). The definition of the variables used in the study will be described in detail below: Capital Adequacy Ratio (CAR) is defined as the ratio that indicates the ability of bank's capital in business development and accommodating the possible risk of losses resulting from operational activities of the bank. Assessment on this aspect is done as to determine whether the bank has adequate capital to support their needs. Return on Assets (ROA) is the ratio used to measure the bank's ability to make profit. This ratio is related to earnings before taxes in the last 12 months against the average volume of business in the same period. ROA also describes asset turnover. Operational Cost-depreciation/Operational Revenue (OER) is often called the efficiency ratio and is used to measure the ability of bank management in controlling operating expenses to operating income. The smaller the ratio, the more efficient the bank's operational costs. Thus, the possibility of a bank to be in error is smaller, and the bank's



performance is better. NPF and NPL in Islamic banks and conventional financial ratios are related to credit risk and financing. Non Performing Financing shows the ability of bank management to manage the troubled financing granted by banks. As such, the higher ratio, the lower the quality of the bank's credit. Credit and financing in this case are loans and financings granted to third parties excluding loans to other banks. Credit or financing problems are classified as substandard, special mention and jammed. Loan to Deposit Ratio (LDR) / Financing to Deposit Ratio (FDR) is the ratio of the financing granted by banks to the third party funds which are successfully deployed by banks. FDR ratio is analogous to the Loan to Deposit Ratio (LDR) of the conventional banks; which is the ratio used to measure the level of bank liquidity and shows the bank's ability to meet the demand for credit by using the total assets owned by banks.

### 1.3 An Over View on The Financial Performance

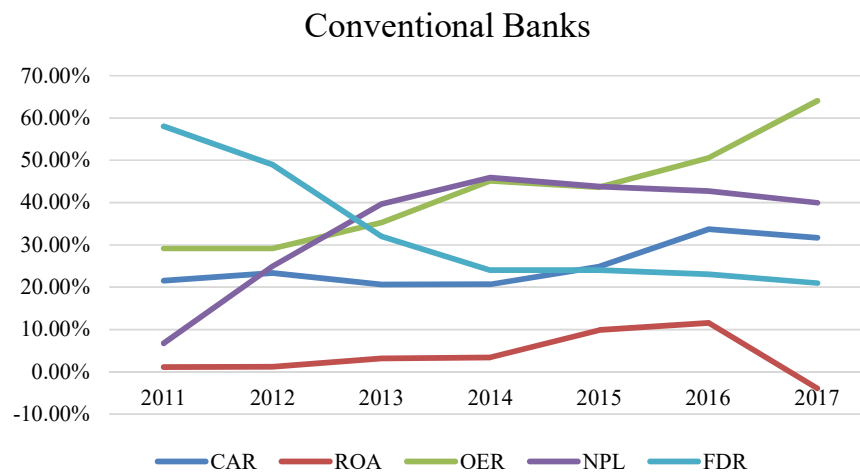
This section will provide an aluded picture about employed financial ration in both Islamic and conventional banks alike.



**Figure 1.1**  
**Financial Ratios (Islamic banks)**

**Table 1.2**  
Average Financial Ratios Islamic Banks

Islamic Banks	CAR	ROA	OER	NPL	FDR
2011	49%	2%	42%	5%	65%
2012	50%	1%	29%	18%	27%
2013	36%	4%	31%	41%	16%
2014	35%	2%	42%	40%	19%
2015	31%	6%	37%	19%	45%
2016	32%	6%	36%	21%	18%
2017	18%	-1%	48%	14%	23%



**Figure 1.2**  
Financial Ratios (Islamic banks)

**Table 1.3**  
Average Financial Ratios Islamic Banks

Conventional banks	CAR	ROA	OER	NPL	FDR
2011	21.57%	1.15%	29.13%	6.79%	58.00%
2012	23.38%	1.21%	29.12%	24.96%	49.00%
2013	20.60%	3.23%	35.25%	39.65%	32.00%
2014	20.69%	3.43%	45.15%	45.92%	24.00%
2015	24.88%	9.90%	43.66%	43.77%	24.00%
2016	33.70%	11.57%	50.53%	42.75%	23.00%
2017	31.74%	-3.90%	64.03%	39.97%	21.00%

Basel I and Basel II standards set the ratio of capital adequacy at a minimum of 8%, while Basel III standards set capital adequacy at 10.5%. In the case of the Syrian Arab Republic, all the banks operating in Syria must achieve Basel II at 8%. And the result above shows that the means for both Islamic and conventional banks fulfill the requirements with means 48% for conventional banks and 36% for its counterparts, consequently the conventional banks more solvent with more capital than banks. Thus, conventional banks have a greater ability to cope with risks and unexpected events.

The fact that banks achieve greater capital adequacy ratio will help them to have a greater position to increase their collateral commitment, reduce unexpected risks and help them face asset losses. This result can be justified by the fact that private banks have observed that conventional banks have increased their capital to reach the minimum capital.. conventional banks and Islamic banks have also done so, but considering the capital after the increase, conventional banks have increased their capital more than Islamic banks in aggregate. The authority has set the capital for Islamic banks at 15 billion while for conventional banks 102 billion. To be noted, neither Islamic banks nor conventional banks have achieved the required capital except Qatar National Bank (QNB), which its capital has been raised to reach 15 billion.

In view of the financial statements of conventional and Islamic banks operating in Syria, we note that most of these profits are due to the revaluation of the foreign currencies. Private banks are distancing themselves from the financial crisis. Most of these banks are reluctant to lend. According to the final data for

2013, all banks are profitable, after the profits are reserved in the foreign centers as well as the re-evaluation of the structural foreign currency. In some of the banks, the structural positions of foreign exchange and unrealized gains were revalued only in the exchange market due to the rise in foreign exchange rates against the Syrian pound to ten times since the outbreak of the Syrian conflict. As a result, the assets of the 14 private banks grew by 15.4 percent in 2013, The bank's total assets exceeded 890.9 billion Syrian pounds in the same year, compared to more than 772.14 billion in 2012.

It is natural for conventional banks to be better in terms of quality of profits, since the main source of income in conventional banks have not been affected as it is in their Islamic counterparts, but the reason for the emergence of this result (higher value of OER) is due to the interest paid by conventional banks steadily to customers deposits, which did not decrease relatively with the decline in given finance. It is suggested that the conventional banks reduce the duration of the deposits and make them for short-term, resulting in a decrease in interest paid and thus will improve (OER) ratio.

Syria's banks have benefited from a boom in lending after the state put an end to its monopoly on the banking sector 10 years ago. The banks have also taken advantage of poor access to banking services in a country of 20 million people. By that time it was a golden opportunity for the private banks to invest in the Syrian market, only to be stymied again by the conflict in 2011. This high percentage of NPF/NPL due to the current condition effects on business in various cities in Syria. That prompted the managers to use various tools and legal and illegal procedures

(dialogue and persuasion) have been worked intensively to encourage non-performing loans to carry out settlement and rescheduling of non-performing loans. which contributed to raising the level of collection, which during the last quarter of 2018 (business 2 business Sy, 2019). In 2011 credit losses at conventional banks accounted for the second largest share of total expenses at 29%. It also ranked second in the Islamic banks at 26%. furthermore, the ratio of these two items grew exponentially after 2011.

A review on Islamic banks financial reports, it was obvious that Islamic banks deposits' growth rates in higher than the conventional ones.

#### **1.4 Research Question**

This research will address the following main research question: Which types of banks are having better financial performance?

The main research question shall be answered with the help of finding. This research answers two main questiones:

*RQ1.* Does any difference exist between IBs and CBs performance in Syria?

*RQ2.* What are the major factors influence the quality of the asset (NPF) in both Islamic and conventional banks alike?

#### **1.5 Research Aims and Objectives**

This research extends previous studies by analyzing and comparing the performance of Islamic and conventional banks during Syrian conflict. Private banking sector have been in exist since 2004, it is quite the time to examine and

evaluate its performance and coexistence in the country, particularly in the violent political crisis, which was erupted a decade ago. As this is one of the pioneering studies in the Syrian context.

### **1.6 Benefits of The Research**

The role of CBs and IBs is crucial for depositors, investors, banks as a business institution and economic policymakers. After two decades of conventional and IBs in Syria, it is high the time to examine and evaluate their coexistence in the country and to stay aware which performed efficiently during the economic and social changes particularly during the conflict in Syria.

Both types of banks experienced losses and tried to polish their returns through the revaluation of foreign currencies. This study stresses on portraying a real picture of banks operating in Syria during the violent political conflict and gives recommendations base on research results.

This study reveals vital information for both private banking sector and central bank by providing a remarkable information to set future prospects in the country. Moreover, depositors and investors might not only interested in *shariah*' complaint banking system, but comparing its profitability and performance to evaluate the opportunity cost.

### **1.6.1 Theoretical Benefits**

As this is one of the pioneering studies in the Syrian context. Furthermore, the study develops a database of IBs, which is particularly useful because no previous study has focused on IBs in Syria. This study will enhance the literature of Islamic banks especially during the abnormal circumstances.

### **1.6.2 Practical Benefits**

This research extends previous studies by analyzing and comparing the performance of Islamic and conventional banks during the Syrian civil war. Private banks started in Syria since 2004. It is quite a time to examine its performance because Syria is getting out of conflict era and it is important to analyze its solvency position for future prospects.

This study is a pioneering attempt for analyzing the banking sector in Syria, therefore, it has significance for academicians, researchers and policymakers in planning works for future directions.

## **1.7 Scope of The Research**

This research will concern the entail banking sector in Syria Islamic conventional one. Which comprises of 11 conventional banks and 3 Islamic, Over the time period 2011-2017. 2011 Syrian crisis has been started. Hence, this research will concern the performance of these banks during the political crisis and evaluate its performance from a comparative perspective.

### **1.8 Research Limitations**

The study encountered some obstacles related to the non-uniformity of the names of items in the financial statements for the studied banks. Additionally, the significant difference achieved during the period under study that's due to the working environment under the crisis. To solve the problem of standardizing the names of the items in the financial statements, we approached specialists and doctors who have more than 10-year working experience in banks.

### **1.9 Thesis Outlines**

This research shall begin with having a brief review of literature concerning Islamic and conventional banks proceeded by the methods used in this study, followed by the result and analysis ending with the conclusion. The sequence of this study is as follows: after this background a brief literature review concerning Islamic and conventional banks performance. After this, the methods used in this research, followed by the result and analysis ending with the conclusion.