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Performance of Islamic and conventional banks: A meta-frontier approach

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Abstract
This study conducts a stochastic frontier analysis of and adopts meta-frontier approach towards Malaysian banks' data and finds that conventional banks are more cost efficient than Islamic ones. The primary factors contributing to the differences in efficiency between the two banks are the wide disparity from their respective best banks and technological constraints. While few Islamic banks use technologies that are similar and close to the industry's standard, many others have diverse technologies. The latter can be attributed to differences in organisational structure and operational processes. By contrast, conventional banks are closer in terms of structure and processes to their best bank and adopt technologies that are almost similar to those used in the industry. These findings show that a different treatment is required in terms of the policy, regulations, and management for both bank types, a key implication for policy makers, bank regulators, and industry players.

Keywords
Meta-frontiers; Islamic banks; bank efficiency

JEL Code
G20; G21; Z12

1.0 Introduction

An increased number of countries have both Islamic and conventional banks. Starting with United Arab Emirates with the establishment of Dubai Islamic bank in 1975 (Iqbal and Molyneux 2005), Islamic banking operation has expanded rapidly to other countries and not exclusively to majority Muslim populations such as Philippines, Singapore, China, Kenya, Germany, Denmark, and the United Kingdom (The World Bank 2014). The Islamic banking assets have been growing rapidly for several decades and they have increased more than double from USD386 billion in 2006 to USD939 billion in 2010 (Mohieldin 2012). Thus, understanding the fundamental similarities and differences between Islamic and conventional banks' performance and efficiency is important for bank regulators, monetary authorities, policy makers, practitioners, and researchers to benchmark the institutions' performance, make strategic decisions, and prepare for the growing domestic and international competition. Islamic banking operations differ from those of conventional banking fundamentally because of the former's compliance with *Shariah*, the Muslim legal code. Many studies comparing the efficiency of both banks assume that Islamic banks operate using single frontier technology (e.g. El-Gamal and Inanoglu 2005; Mokhtar et al. 2006; Al-Jarrah and Molyneux 2007; Abdul-Majid et al. 2011a). This, however, questions the extent to which Islamic and conventional banks can be compared. Some researchers have argued that assuming the same technology for all banks can be a misspecification if the banks have different technologies (e.g. Lozano-Vivas 1998; Dietsch and Lozano-vivas 2000; Lozano-vivas et al. 2002; Chaffai et al. 2001). With this study, we attempt to address this question by providing empirical evidence on whether Islamic and conventional banks operate under common cost frontiers (or single frontier technology). We estimate the efficiency scores of Islamic and conventional banks possibly operating with different technologies and thus, under a different frontier. To do so, we use a meta-frontier to calculate the efficiency scores and technology gaps for these banks.