

PERFORMANCE OF ISLAMIC FINANCIAL INSTITUTIONS: VIABLE OPTION IN CANADA?

Raef Gouiaa^{*}, Pierre-Richard Gaspard^{**}

^{*} University of Quebec in Outaouais, Gatineau, Quebec, Canada

^{**} CPA auditor, MBA, Government of Canada, Canada

How to cite: Gouiaa, R., & Gaspard, P.-R. (2021). **Received:** 15.04.2021
Performance of Islamic financial institutions: Viable **Accepted:** 21.04.2021
option in Canada? In S. Hundal, A. Kostyuk, & **Keywords:** Islamic
D. Govorun (Eds.), *Corporate governance: A search for Finance, Traditional
emerging trends in the pandemic times* (pp. 38–41). Banks, Performance, Risk,
<https://doi.org/10.22495/cgsetpt5> Regulation, Islamic Banks
JEL Classification: G21,
G23, G28, G29, G32
DOI: 10.22495/cgsetpt5

Copyright © 2021 The Authors

Abstract

The North American financial system is one of the only alternatives available to individuals and businesses to be able to deal with all matters relating to savings and investment. By analyzing the two economic crises (1929 & 2008), it's possible to see how fragile the financial system can be at times. In the 1920s, individuals increasingly bought shares using debt (Marks, 2018). Indeed, it was possible to be able to buy shares by putting up only 10% of the total value and using debt to finance the remaining 90% (Marks, 2018). Economists are unable to attribute a specific cause to this crisis, but the bank loans that were the basis of debts (of individuals and companies) clearly contributed to the fall of the stock market. Investors started selling their shares when they learned how much corporate shares were financed by borrowing at the margin. As investors sold some of their shares because of this news, the Dow Jones had fallen by about 13% on October 28 1929 (Amadeo, 2020). This decline caused other investors to panic and sell their shares for fear of the Dow Jones' decline. All these problems brought a loss in value of about 30 billion in 1929, which is equivalent to a loss of about 400 billion if we discount the value of the currency (Amadeo, 2020).

With regard to the second economic crisis (2008), it demonstrated that the market is not immune to a collapse, particularly due to the bad decisions of the country's major banks. During this crisis, loans had been made to individuals who were not necessarily able to repay the loans in question. These loans were subsequently sold to other banks, creating a domino effect on the entire U.S. market that ended in a global economic

crisis. Bank managers made loans to individuals who could not afford to repay the amounts (Vitez, 2017). This kind of dysfunctional behaviour changed the way individuals handled their money. A study that was done in 2011 analyzing the change in consumer behavior during the economic crisis showed a radical change in the habits of individuals since that event. The conclusion of this research proved that consumers were simpler in their consumption and that even the richest individuals tend to spend less even if they do not need to (Voinea & Filip, 2011). Despite the fact that the crisis has been over for several years, collateral damage on individual behavior is still being felt.

All these events have made consumers more conscientious about managing their money and consumption. Many individuals see traditional finance as the only way to properly secure their future savings. Islamic finance (IF) has been growing rapidly in recent years. The sector has grown by about 8.3% since last year and has a total value of 1.7 trillion (Research and Market, 2019). This increase in popularity is mainly due to the fact that, in some countries, Islamic finance is the only option available. It is noticeable that popularity has not only increased in Islamic countries but in others as well. Currently, there are more than 300 Islamic institutions in the world including countries such as the United States and France (Lipka, 2017). There is a growing number of countries adopting Islamic finance, but the concept remains almost unknown in Canada and other developed countries. In most countries, Islamic finance coexists with conventional banking systems, this is noticeable in countries such as Indonesia, Malaysia, Pakistan, and the United Arab Emirates (El Qorchi, 2005).

In addition to its growing popularity, it has a growing number of Muslim and non-Muslim investors investing in Islamic finance. The fundamentals of Islamic finance in terms of risk management and general principles are making more and more people interested in investing in this sector. According to an analysis of Islamic financial markets, their popularity has increased because of the potential for growth and profitability (Hassan & Girard, 2011). There are several financial indexes that include companies that comply with Islamic guidelines. Companies that are listed on the stock exchange in America must comply with IFRS (International Financial Reporting Standards) which are regulated by the IASB (International Accounting Standards Board). The equivalent is present for Islamic finance. Indeed, in addition to having accounting guidelines to be respected such as IFRS, companies must ensure that they comply with the rules that are set up by the Sharia. In this sense, the Sharia Board is in charge of the supervision and certification of certain products regarding the respect of Sharia rules (Trustnet, 2020). The management of companies then becomes more complex, because it is often necessary to make changes in policies to be able to comply with the rules. Despite this, investments are considered less risky for investors because there are many more laws that must be respected. Islamic finance could be an alternative during economic crises.

Research by Salim and Mahmoud (2016) explains why Islamic finance should be considered during economic crises. The conclusion of this research revolved around the fact that Islamic finance is less risky compared to its counterpart.

The aspect of risk and interest rates are always important to investors and individuals when making financial decisions. Interest rates cause consumers to change their consumption habits (Maverick, 2020). In fact, one of the fundamental differences between these two types of systems is the use of interest. In the Islamic finance system, making interest available to individuals or using interest is not present in Islamic banks (Chong & Liu, 2009). Other alternatives are then made available in order to be able to create value in these banks.

The Canadian financial market is considered to be very conservative and has been using the same practices for a long time. The economies of some countries such as England have adopted a strategy of including Islamic finance in their market and this has produced very satisfactory results. Considering that Islamic finance has been growing in recent years, this type of practice could be relevant to the Canadian market.

The objective of this research is to analyze whether the performance of Islamic financial institutions is comparable to traditional banks. To make this comparison, several tools will be used. The comparison of performance between financial institutions is made using the different relevant financial ratios used in the banking sector. The two main ratios used were return on assets (ROA) and return on equity (ROE), as in most research, these ratios are considered to be the best indicators of profitability among banks. The University of New England made a tool to evaluate the efficiency of the banks. With the data envelopment analysis (DEA) model, it will be possible to analyze the efficiency score of each bank of the sample. Comparison of the efficiency of conventional and Islamic banks will be important to determine because they do not operate in the same way and their primary source of income is different. The correlations will also be used to see which elements have a positive correlation with the main performance indicators (ROA & ROE).

The results revealed that Islamic banks tended to perform better than conventional banks. Performance ratios were in most cases higher for Islamic banks. This observation was confirmed with the use of the DEA model, which measures efficiency and effectiveness at the bank level. The results show that although some Islamic banks had significantly fewer assets than conventional banks, they were still able to use resources more efficiently. This confirmed that Islamic finance is an option for Canada and that with government support it will be possible to have a stronger economy overall. When we talk about efficiency and performance, we must also take into consideration the risk that is closely linked to it. Islamic banks are often considered to be less risky than traditional banks due to the fact that their revenues are very diversified. This risk comparison between traditional and Islamic banks

will be included in the secondary objectives of the research. Overall, these results likely going to be useful for investors, the banks, the government and other users of the information of banking information.

REFERENCES

1. Amadeo, K. (2020, September 2). Stock market crash of 1929 facts, causes, and impact. *The Balance*. Retrieved from <https://www.thebalance.com/stock-market-crash-of-1929-causes-effects-and-facts-3305891>
2. Chong, B. S., & Liu, M.-H. (2009). Islamic banking: Interest-free or interest-based? *Pacific-Basin Finance Journal*, 17(1), 125–144. <https://doi.org/10.1016/j.pacfin.2007.12.003>
3. El Qorchi, M. (2005). Islamic finance gears up. *Finance and Development*. Retrieved from <https://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm>
4. Hassan, M. K., & Girard, E. (2011). *Faith-based ethical investing: The case of Dow Jones Islamic indexes* (Networks Financial Institute Working Paper No. 2011-WP-05). <https://doi.org/10.2139/ssrn.1808853>
5. Lipka, M. (2017, August 9). Muslims and Islam: Key findings in the U.S. and around the world. *Pew Research Center*. Retrieved from www.pewresearch.org/fact-tank/2017/08/09/muslims-and-islam-key-findings-in-the-u-s-and-around-the-world/
6. Marks, J. (2018, April 13). What caused the stock market crash of 1929? *History*. Retrieved from www.history.com/news/what-caused-the-stock-market-crash-of-1929
7. Maverick, J. B. (2020, March 26). Do changes in interest rates affect consumer spending? *Investopedia*. Retrieved from www.investopedia.com/ask/answers/071715/how-do-changes-interest-rates-affect-spending-habits-economy.asp
8. Research and Market. (2019). Global Islamic finance markets report 2019: Islamic banking is the largest sector, contributing to 71%, or USD 1.72 trillion. *Globe Newswire*. Retrieved from www.globenewswire.com/news-release/2019/03/20/1758003/0/en/Global-Islamic-Finance-Markets-Report-2019-Islamic-Banking-is-the-Largest-Sector-Contributing-to-71-or-USD-1-72-Trillion.html
9. Salim, B. F., & Mahmoud, M. H. (2016). Islamic finance: Is it a time to be considered as an alternative during financial crisis times? A comparative study in Gulf Cooperation Council. *International Journal of Economics and Financial Issues*, 6(3), 1123–1131. Retrieved from <https://dergipark.org.tr/tr/pub/ijefi/issue/32012/353804?publisher=http-www-cag-edu-tr-ilhan-ozturk>
10. Trustnet. (2020). *Implications on risk & return*. Retrieved from www.trustnet.com/Education/ShariahLaw.aspx?ms=3
11. Vitez, O. (2017). Factors that lead to an economic crisis. *Small Business*. Retrieved from www.smallbusiness.chron.com/factors-lead-economic-crisis-4004.html
12. Voinea, L., & Filip, A. (2011). Analyzing the main changes in new consumer buying behavior during economic crisis. *International Journal of Economic Practices and Theories*, 1(1), 14–19. Retrieved from https://www.academia.edu/31563450/Analyzing_the_Main_Changes_in_New_Consumer_Buying_Behavior_during_Economic_Crisis