Comments of

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on

Evaluation of Islamic Banking Performance: 
Criteria, Models and Priorities 

by Zubair Hassan 

This is an excellent overview of the literature on evaluation of performance of Islamic Banks. It begins with a much needed review of technical details of two popular methods for evaluating the performance of banks – the so called DEA and SFA are clearly explained, and the assumptions behind these measures are spelled out. After laying out the required technical apparatus currently used to evaluate banking efficiency in conventional economic literature, they turn to review a number of studies of Islamic Banks which use these performance criteria.

Hasan presents an excellent technical critique of many papers in this field. Instead of going over well trodden ground, I would like to focus on a few elements which are general weaknesses in the literature, in the hope that more attention would be paid to these issues in future studies. These are based on the findings of Hasan and his statements regarding the papers in question. Not all of the criticisms below apply to all papers reviewed by Hasan, but the points made below do generally apply to the majority of the studies reviewed.

1. As Hasan points out, Majid et. al. use a data set on Malaysian bank performance from 1993 to 2000, without making any reference to the East Asian crisis. A large number of interesting issues are thereby swept under the rug. Of great interest would be the post crisis performance of Islamic Banks in comparison with conventional banks, especially since Islamic Economic theorists have often asserted that Islamic banks would have superior stability in crisis environments.

2. In reference to the previous point, it is likely that the data set contains outliers, due to the East Asian crisis. Outliers have a major impact on standard OLS type analyses. Econometricians frequently ignore outliers, or else use inappropriate tools to deal with them. See Chapter 5 of Zaman (1996) for an extended discussion.

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3. There is insufficient historical background, context, and attention to details of the Malaysian context – for example, no allowance is made of the existence of Islamic windows in conventional banks. This is typical problem (not confined to Islamic economics) – the tools of econometrics overpower the thought process. Data combined with high powered number crunching software packages are used to produce undigested results. It would be much better to do a historical analysis and look at basic insights from conventional viewpoints. Elementary graphical and exploratory data analysis often produces useful insights which could be backed up by more sophisticated analyses.

4. There is no sensitivity analysis to alternative assumptions. Sophisticated data analysis depends on making a complex set of assumptions, and it is essential to assess how much of the analysis depends on these assumptions. As Hasan has discussed, the efficiency analyses depend on assumptions about perfect competition, cost minimization, profit maximization, as well as complex technical assumptions about distributions and functional forms of the production function. It is entirely unclear how much of the result depends on these assumptions. There is also no assessment of the extent to which the data set conforms to these assumptions. As Hendry (1996) has often pointed out, major econometric errors result from untested assumptions built into conventional analysis.

5. An essential requirement of science is the replicability of results. Enough information should be provided in the paper so that anyone can replicate the results obtained by the authors. Poor methodology prevents this for two reasons. Quite often, the data sets used are not described or not easily available. Editors of journals should take note, and require authors to make available all relevant data sets whenever possible. Authors should also ensure inclusion of small data sets as part of the paper, and attempt to make larger data sets available to other researchers via internet. An essential requirement for progress in any field is cumulative work. Subsequent researchers must build on previous work. This is only possible if the early researchers provide enough information to allow replication. In absence of this, every researcher starts afresh, and as a result there is no cumulative progress. As the parable goes, if 10 people dig 10 feet holes in separate spots, no one will reach the water, but if all dig at the same spot, then they will easily reach the water.

6. Another difficult with replicating results is that descriptions of what was done by the authors is so vague that it is not at all clear exactly what econometric technique was used. The variables used are not described in sufficient precision to allow reconstruction from the data set. The econometric techniques and computer packages and procedures used are not defined with sufficient accuracy to permit replication. As stated earlier, without replicability, cumulative research is not possible, and this is a strong handicap, especially in a new field like Islamic Economics.
7. Purely technical efficiency measures identical to those used by conventional economists are not suitable for Islamic Banks, since they have different objectives. Profits are relevant, but Islamic Banks were introduced to bring about a social transformation and achieve several humanitarian and developmental objectives envisaged in the Shariah. Low marks on technical efficiency would not be of great concern (provided that viability was maintained) if there was progress on these larger fronts. Almost no attention is paid to this in the studies under review.

8. To evaluate the issues discussed in the previous point, it seems likely that qualitative work will be a better place to start. Hasan cites Ausaf (2003) as a good qualitative example which assesses these larger issues. Once there is some clarity on the directions, it may be possible to work out some more quantitative methods of assessment, which would be more relevant for the Islamic dimension of banking.