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COST AND REVENUE EFFICIENCY OF ISLAMIC BANKING OPERATIONS OF TANZANIA COMMERCIAL BANKS

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ABSTRACT

The objective of this study was to assess effects of cost and revenue efficiency of Islamic banking operation of Tanzanian commercial banks. The study found the Tanzanian commercial banking's economic efficiency of all banks were not stable over the years and, their stochastic frontier performance was not 100% efficient. Based on empirical analysis the study also found deposit and trade financing were significantly influence economic performance. To further improve and maintain stability of the commercial banking economic performance, commercial banks management should use economic performance measurement techniques banks are encouraged to develop human resource for better management efficiency and employee proficiency on the other hand, Tanzanian commercial banks should maintain sufficient liquidity because; the present findings indicate overwhelming liquidity than the required.

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1. INTRODUCTION

Banking industry is favorable to the economic perform of the country because the activity of the banks increases the mobilization of the saving, improve the efficiency of the resources allowance, and stimulate the technological innovation Goaied, (2015).The role of the banking system in a contemporary economy is of great significance to the development process and thus, it is often considered as the heart of every prosperous economy (Usman, 2003). This study attempts to work with effects of Islamic bank operation to the economic Performance of Tanzanian commercial banks. In this case, the present study will describe the background of the study, the statement of the research problem, objectives of the study, research hypothesis, the scope of the study, significance of the study, organisation of the study and conclusion of the chapter.

1.1 Background of the Study

Banks have very important role as financial institutions especially in developing countries. Since commercial banks involve with financial services or operations to improve performance (Usman, 2003), performance ultimately improves the financial institution as whole, nation and world's financial system Islamic bank division operations cannot be evaded in the economic performance.

1.2 Islamic Banking in the world

Islamic banking is a banking system or banking activity that is consistent with the principles of the shari'ah (Islamic rulings) and its practical application through the development of Islamic economics (IIBI, 2017). The origin of Islamic banking dates back to the very beginning of Islam in the seventh century. In the middle Ages from 5th to 15th century, trade and business activity in the Muslim world relied on Islamic banking principles, and these ideas spread throughout the Mediterranean and the Baltic States, perhaps providing some of the basis for western banking principles. In the 1960s to the 1970s, Islamic banking resurfaced in the modern world (Investopedia). Since it has been growing continuously all over the world. Global conventional banks like Standard Chartered Bank, Deutsche Bank, Citibank, etc. have also set up separate windows / divisions to structure Islamic financial products and are offering Islamic banking services to their Muslim clients and even to those non-Muslim clients who are interested in profit and loss sharing financial instruments. UK, France, China, Singapore and many other countries have developed special regulatory to facilitate the working of Islamic banking (Nazim, 2008).

1.3 Islamic Bank Operation in Tanzania

In Tanzania Amana Bank is the first full-fledged Islamic bank to have acquired a commercial bank license from the BOT. Many other banks have established Islamic windows such as NBC, PBZ and KCB (BOT, 2015). BOT provides licenses to establish Islamic banking into different models such as Islamic windows or full-fledged Islamic banks in Tanzania reasonably; Islamic banking can only be sufficiently accommodated if country's police and laws are united. This can be done if the principles of Islamic banking and the existing principles of conventional banking are matched. These information serve as idea upon which the researcher builds the purpose to conduct this study with the aim of finding out effect of Islamic banking operations on economic performance of Tanzanian commercial bank (Abdul Gafoor A.L.M, 1995). Deposits from savers are an important source of financial strength for the Islamic banks. They use it to increase their capacity for financing operations and thereby increase profit for the shareholders.

Islamic Banks raise funds generally based on Amanah or Wadiah arrangements, on Mudarabah and on Wakalah for Fund Management .There are two main bases of mobilization of deposits by Islamic banks that are Current account deposits and Savings deposits. Banks may also get permanent or redeemable equity capital through investment deposits that practically take the form of a running partnership between the depositors. Depositors in Islamic finance can be compared with investors / shareholders in companies, who earn dividends when the investment makes a profit or lose part of their capital invested. The contractual agreement between depositors and Islamic banks does not pre-determine any rates of return, it only sets the ratio according to which profits and losses are distributed between the parties to the deposit contract (Daudi v, 2016). The Islamic banking lending have two-tier mudarabah and musharakah model. Mudarabah model as the basis of a riba-free banking. . The bank would act as the capital partner in mudarabah accounts with the depositor on one side and the entrepreneur on the other side. Another profit-sharing form of finance musharakah, the "real and ideal instruments of financing in Sharia's". This model would be supplemented by a number of fixed-return models—mark-up (murabaha), leasing (ijara), cash advances for the purchase of agricultural produce (salam) and cash advances for the manufacture of assets (istisna`), etc. In practice, the fixed-return models, in particular murabaha model, became the industry staples, not supplements, as they bear results most similar to the interest-based finance models. Assets managed under these products for exceed those in "profit-loss-sharing modes" such as mudarabah and musharakah (Human, 2015).

1.4 Economic performance

Economic performance are those issues dealing with amount and value of money, debty. Wealth and investment. Profit is one of the most significant components in measuring economic performance based on deposit and financing. Economic performance is a subjective calculates of how well a firm can use assets from its primary mode of production and generate revenues. This term is also used as a general measure of a firm's overall economic health over a given period of time, and can be used to compare related firms across the same industry or to compare industries or sectors in aggregation To calculate economic performance, the following events should be taken in aggregation line items such as loans and advances, deposits, total interest income, profit income in Islamic total interest expense and other costs. Economic performance encompasses change in number or value of loan granted and profit level. Lending is risky to most banks because repayment of loans cannot often be fully guaranteed. According to Brown et al., (2006), implicit contracts between lenders and borrowers, thus, banking relationships can motivate high effort and timely repayments. Foluso (1998), confirm that long-term relationships are a powerful disciplinary device. As only a good reputation leads to attractive credit offers from the current lender, borrowers have strong incentives to repay. The context of this study are the effects of Islamic bank operations in the economic performance of Tanzanian commercial banks "stochastic frontier Model" will be taken into consideration to measure the bank's performance on objective number one and Ordinary list square for objective two and three on Islamic banking operation. Due to the limitation of time the study will be covering for five years' time panel data.

2. THEORETICAL REVIEW

The study was based on the agency theory and Islamic banking theory

2.1 Agency Theory

The origin of Agency theory is Alchian & Demsetz (1972) and developed by Jensen & Meckling (1976). Agency theory re-establishes the importance of incentives and self interest in organizational thinking (Perrow, 1986). In agency theory information is regarded as a commodity which has a cost and can be purchased to makes it possible for organizations to invest in formal information systems such as budgeting, MBO and Board of Directors and Informal systems include managerial supervision. All these investment is geared to control agent opportunism. Agency theory extends organizational thinking by pushing the ramifications of outcome uncertainty to the implications of creating risk. This implies therefore that outcome uncertainty coupled with differences in willingness to accept risk is likely to influence the contracts between principal and agent. Jensen and Meckling (1976) defined Agency theory as the relationship between shareholders who they termed as the principals and the company executives and managers who they see as the agents. Agency theory is an appreciation of the contractual view of the firm. Agency problem therefore arises in the need to separate the suppliers of finance from the management of the firm. The principal-agent relationship is beneficial in that it creates room for the shareholders to specialize as risk bearers, the principal, who hires and retains the agent who is endowed with specific talents, knowledge and capabilities to increase the value of the asset through efficient allocation of resources (Melyoki, 2005). In this principal-agent relationship the agent only enjoys a part of the outcomes of his efforts (Denise and McConnell, 2003).

The theory is based on the assumption of goal conflict between the principal and the agent (Jensen and Meckling, 1976). Due to the human opportunistic behaviour, the agent may make decisions that are incongruent to the best interest of the principals (Padilla, 2002). Agency theory therefore calls for close monitoring of the agents due to the prospect that they serve their own interest rather than of those of the owner principal.

The monitoring results to agency costs that are meant to align the interests of the shareholders to that of the executive and reduce internal inefficiencies. According to Jensen and Meckling (1976) the agency cost comprises of three different components: monitoring costs, bonding cost and residual cost. Monitoring costs are meant to cushion the principal from the devious behavior of the agent. Bonding cost are meant to encourage the agent to make decisions that are beneficial to the principal while residual loss is the cost borne by the principal when the monitoring cost and bonding cost fail to contain the devious behaviour of the executive. The delegation of management rights by the principal to the agent creates a situation where the agent has more information about the outcomes of his efforts (Hart, 1995). The ensuing information asymmetry where the agent has more information on the outcomes than the principal implies that the principal cannot fully measure the outcomes of the agents (Melyoki, 2005). This therefore means agency costs can only be minimized but not eliminated (Hart, 1995).Agency problems exhibit itself in two forms: the failure of managerial competence and the failure of managerial integrity (Moldoveanu & Martin, 2001). Failure of managerial competence arises from ignorant mistakes made in executing managerial responsibilities. These can occur due a situation where the principal cannot adequately ascertain the agent's ability to execute the responsibilities for which he is hired or paid for. On the other hand, failure of managerial integrity arises from moral hazards and relates to the wilful behaviour on the part of the managers that reduces the value of firm's asset (Melyoki, 2005).

The monitoring solution by shareholders, especially major ones constitutes an important mechanism for encouraging managers not to deviate from shareholders interest. In cases where ownership is fragmented, the board of directors is viewed as an alternative mechanism (Jensen, 1993 and Denise, 2001).Agency theory has a basic conclusion that value of a firm cannot be maximized as managers normally hold executive power which allows them to expropriate value for their own interest (Turnbull,1997).However despite the claim that the conflicts between the principal and the agent cannot be eliminated Agency theory provides a broad analytical framework to examine how managers can optimally invest for organizations. Banking industry is no exception, it faces agency problems as any other industry. Bank operate in similar manner, one side principal (shareholder) and other side is agency consist of CEO, director of finance and other managers who are in charge of day to day activities. These two parties work close but with different interest whereby shareholders aim to wealth maximization while managers are interested in profit maximization which cause agency problem. The problem can be minimized but not eliminated, causing shareholder to incur additional cost called agency cost such as incentive structures to bank staff.

2.2 Theory of Islamic banking

The earliest writings on the subject of Islamic banking and finance date back to the forties of the twentieth century by Siddiqi. The theory of Islamic banking is based on the idea that interest is strictly forbidden in Islam, and that Islamic teachings provide the required guidance on which to base the working of banks (Hassan and Lewis, 2007). According to Ahmad (2006), the theory of Islamic banking is based essentially on the premise that interest, which is strictly forbidden in Islam, is neither a necessary nor a desirable basis for the conduct of banking operations, and that Islamic teachings provide a better foundation for organizing the working of banks. The basic postulate that has guided all theoretical work on Islamic banking is that while interest is forbidden in Islam, trade and profit is permissible. The basic principle in Islamic law is that exploitative contracts or unfair contracts that involve risk or speculation are impermissible (Hassan and Lewis, 2007).

Theoretical work on Islamic banking encompasses several aspects related to both the operating procedures of Islamic banks and the possible socioeconomic consequences of the adoption of the new system (Ahmad, 2006). Islam seeks to establish a society based upon fairness and justice (Holy Qur'an 2:239). Thus, the concept of Islamic banking has proceeded on the basis that guidance for all institutionalized developments in an Islamic society should be derived from the principles of Shari'ah .The form and content of Islamic banking practices have, therefore, to be derived from the teachings of Islam (Ahmad, 2006). For instance, if a loan provides the lender with a fixed return irrespective of the outcome of the borrower's venture. It is much fairer to have a sharing of the profits and losses. Fairness in this context has two dimensions: the supplier of capital possesses a right to reward, but this reward should be commensurate with the risk and effort involved and thus be governed by the return on the individual project for which funds are supplied (Hassan and Lewis, 2007).

3. EMPIRICAL STUDIES

Empirical literatures study worked with theoretical concepts to show a relation between effects of Islamic bank operations on the economic performance. Based on their views it seems these components have interactions. Each component is important to each other to sustain the operation of the business. Mohamad et al. (2008) in their comparison study of Asia, Africa and Middle East by using Stochastic Frontier Approach proved overall performance results of all banks shows that a bank on average is better in creating profits than exploiting its resources. Their result also proves that cost efficiency is less stable than profit efficiency over the years, but the overall test shows there is no significant difference between cost and profit efficiency of conventional against Islamic banks, irrespective of size, age and location of banks in both streams. Overall, the Middle East and Turkey Islamic banks attained the highest cost efficiency whilst Islamic banks in Africa scored the lowest cost efficiency and the score of Asian banks reported to be highest profit efficiency. The score of large conventional banks shows the highest profit efficiency where the score of small conventional banks and African conventional banks shows the lowest profit efficiency.

Idialu and Yomere (2010) examined efficiency of Nigeria banks by using the Stochastic Frontier Analysis and confirmed that there is inefficiency in the Nigerian banking system that ranged from 0 to 19 per cent of total cost. The study also developed the inefficiency rank of individual banks. Jiang and Yao (2011) in their study on bank efficiency in China by utilising the one-step SFA concentrate the ownership, selection effect and dynamic effects of governance changes on bank performance. Their result shows there is an improvement of bank efficiency from 1995-2008. The efficiencies in term of average cost and profit were approximately 74% and 63% respectively. Their result also confirms joint stock commercial banks and city commercial banks did better than state-owned commercial banks. These results advocate the low percentage of revenue efficiency is caused by increasing number of foreign banks. Mustafa (2013) explored the effects of Islamic banks on economic depending amongst Kenyan Muslims. The research adopted a descriptive research design and a sample of 384 Muslims was used. Questionnaires were used to collect data. The regression model was used to establish the relationship between the variables. The study established that lack of access to financial information service affected the growth of Islamic banking. In addition, the study established that government policies, regulations, and technological changes affected the growth of the financial institutions. Further, the study found out that customers encounter problems of raising capital, accessing finance and accessing credit and recommended that there should be increased support for learning visits to improve the information flow, the government should come up with policies on training of business owners.

Ahmednoor (2015) evaluated the effects of Islamic banking products on the profitability of Islamic banks in Kenya. Annual financial statements of two Kenyan fully-fledged Islamic banks from 2008 to 2011 were obtained from the CBK and Banks annual report. The data was analyzed using linear regressions method to measure the performance. The study made use of secondary data, which was obtained basically from published annual reports of the selected banks and data collection form for individual product data for items not appearing on the financial statements. The study findings established a strong positive relationship between product size amount and economic performance of Islamic bank in Kenya.

3.1 Study area

This study was conducted in Tanzania. The research mainly covered the commercial banks on economic performance and focus on the banking sector in particularly commercial banks, because of their business intention of profit maximisation, ownership of the business, size of the assets in the banking sector, and valuable contribution as financial intermediate in the financial system. Three commercial banks such as PBZ, NBC and KCB in Tanzania and data collected for five years.

3.2 Research design

Research design is the conceptual structure within which research is conducted. It constitutes the plan for the collection, measurement and analysis of data such the design includes an outline of what researcher will do from writing the research hypothesis and its operational implications to the final analysis of data. The study used descriptive study design.

4. DATA ANALYSIS

4.1 Stochastic Frontier Efficiency

This part present stochastic frontier analysis in the form of Cost Efficiency and Revenue Efficiency.

4.1.1 Cost efficiency Analysis

Figure 1 below presents trend of Cost Efficiency scores for each bank (i.e, PBZ, NBC and KCB) for each year.

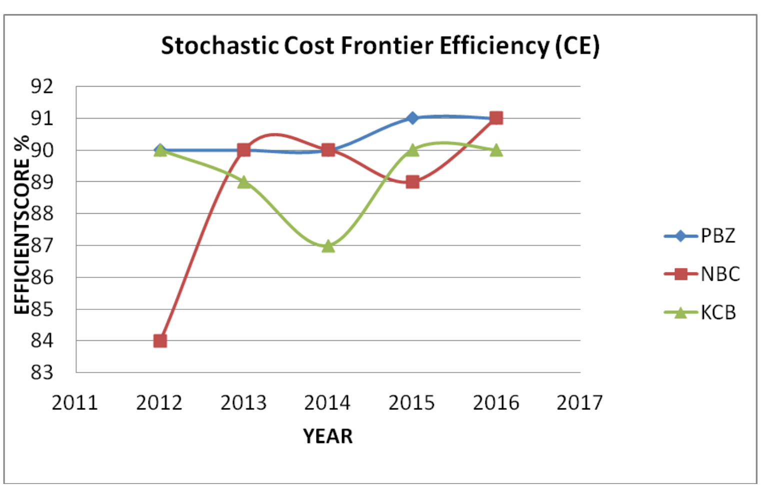

Figure 1.
Stochastic Cost Frontier (CE)

The figure 1 shows the cost efficiency where PBZ increasing over the year from 2012 to 2016 consistent from 90 to 91 and constant CE in 2015 and 2016 this is due the reducing interest payments to depositor and constant in last two year is due to the government dynamic of Tanzania while cost efficiency of NBC were not stable increases from 2012 to 2013 then it was declining in 2014 and 2015. In 2016, it is realized to have rapid increase, declining of CE caused by exchange rate, inflation rate of rate and interest rates charged and KCB is also have unstable cost efficiency in 2012 to 2014 declines then in 2015 increased and finally declined slowly in 2016, the declining caused by exchange rate, inflation rate of rate, interest rates charged and government dynamic of Kenya. Generally the figure shows CE of NBC and KCB were not stable and declining in several time and PBZ shows increasing this is because PBZ is local bank can enable to minimize in common cost like hiring building, employing local human capital and some government tax not involved which is not possible to NBC and KCB as foreign bank incurred hiring building cost , human capital employed demand high salary especially foreigner staff and tax imposed as foreign investor this caused to increase of management cost .Overall inflation rate increases the rise up cost of operating business and loss resulted to customer's default of interest payment to cover normal cost.

4.1.2 Stochastic Revenue Frontier Efficiency (RE)

Figure 2 below presents trend of Revenue Efficiency scores for each bank (i.e, PBZ, NBC and KCB) for each year.

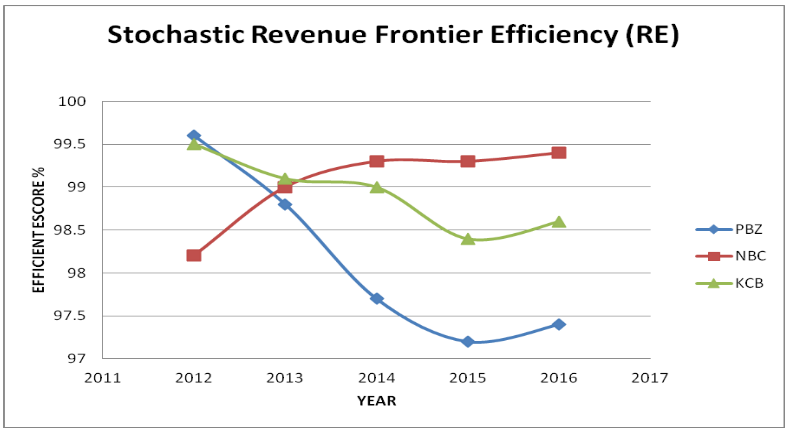

Figure 2.
Stochastic Revenue Frontier (RE)

Figure 2 shows Revenue Efficiency of three commercial bank for Five years from 2012 to 2016. PBZ and KCB revenue efficiency decline from 2012 to 2015 and slowly start to increase in 2016 this is due Operational expenses increases may be caused by difficulties of management of business resource allocation due to expansion of business activities and increasing real interest rate lead the borrower decline as we know the main income of bank is return from borrower. NBC increase over the year consistent from 2012 to 2016 due to increasing lending interest rates, fulfilment of product provided to the customer demanded is reason of maximize revenue and advanced way of offering service to the local and foreign customer in terms of ATM machine VISA CARD, internet banking etc In general, RE are not stable to those banks except NBC increases from 2012 to 2016 This is in line with Md Baten and Kamil's (2011) observation that shows variation of profit efficiency at increasing amount and inefficiency decline. The top RE in our observation NBC and least RE is PBZ.

4.1.3 Stochastic average Cost and Revenue Frontier Efficiency (CE & RE)

Figure 3 below presents trend of average Cost and Revenue Efficiency scores for each bank (i.e, PBZ, NBC and KCB)

Figure 3
Stochastic average Cost and Revenue Frontier Efficiency (CE & RE)

From the above figure, average Cost Efficiency and average revenue efficiency of each bank from 2012 to 2016 overall revenue efficiency is higher than average cost in each bank and PBZ is recognize as higher cost efficiency than NBC and KCB and NBC is recognize as highest revenue efficiency than PBZ and KCB. Cost Efficiency occur due to minimization of costs on operating of commercial banks and the failure of borrowers to pay back due amounts that included interest rates and principal and on time lead to cost maximization and bank performance hence decline the cost efficiency and . Revenue Efficiency occur by maximize revenue through fulfilment of product provided to the customer demanded at reasonable cost.

4.1.4 Stochastic average Cost and Revenue Frontier Efficiency (CE & RE)

Figure 4 below presents trend of average Cost and Revenue Efficiency scores for each bank (i.e, PBZ, NBC and KCB) for each year

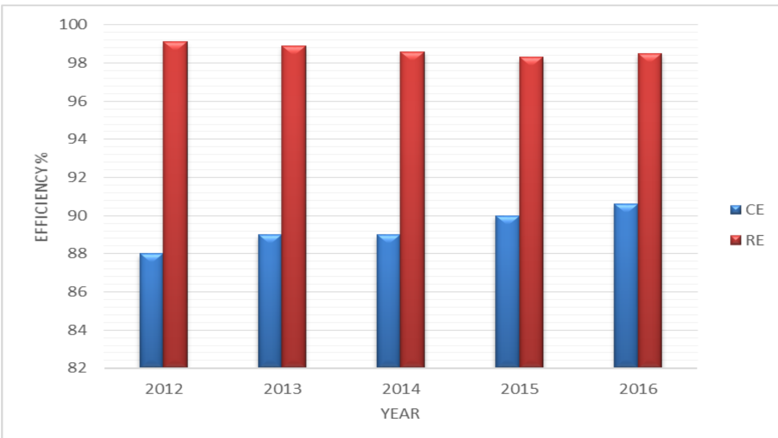

Figure 4.
Stochastic average Cost and Revenue Frontier Efficiency (CE & RE)

From the above figure 4, average Cost Efficiency and average revenue of each year between 2012 and 2016. Cost Efficiency increased every year from 2012 to 2016 while average revenue efficiency were decreasing slowly from 2013 to 2015 and start to increase in 2016. Cost Efficiency increase due to minimization costs of operating commercial banks and awareness of customer on their product provided and the average revenue efficiency decline due the failure of borrowers to pay back due amounts that included interest rates and principal and on time. This was possibly due to the persistent increase of inflation rates. Moreover, most of the commercial banks try to provide new products and improve their services such as ATM machines, SIM banking and internet banking to win competition but become useless because many customers are not aware of their services. This is because the service charges are high which discourage customers to use them. This in turn increases the cost to the commercial banks and causes a decline the revenue Efficiency

5. CONCLUSION

Apparently, banking industry performance is represented by values of completed outcome and efficiency**.** Thus, banking performance depicts potency of inter-banking financial system (by value), their regulators as well as stakeholders. To improve banking efficiency in the 1990s, liberalisation was adopted in the Tanzanian financial sector. Liberalization introduced new technologies, new products and global operations and these made banking sector to face competitive challenges. With this, the research focus on contribution of Islamic windows to the economic performance of Tanzania commercial bank, banking performance continues providing a view on the cost minimisation and revenue/performance maximisation. After the financial liberalization (in the 1990s), Tanzania passed a financial institution act and several regulations (as mentioned during 2006, 2008, 2011, 2012 and 2013) to aid and recover financial loses. Nevertheless, banks still face huge operational challenges that need to be tackled. Despite the existence of banking research in Tanzania, none scaled performance through financial and economic estimates. Accordingly, the present study incorporates economic measurements to examine the performance of three banks (between 2012 and 2016) in Tanzania. In fact, the present study achieves its objectives after assessing performance (intensity and impact) of Tanzanian commercial banks and applied methods include stochastic frontier. Highlight pin-point instability of economic. Generally, the present study discovered that Islamic windows had higher economic performance in Tanzanian commercial banks economic efficiency and all signs of banking achievements. Based on empirical analysis results, economic performance (by value) that is deposit and equity, financing were significantly influenced by independent variables (except trade finance).

5.1 Recommendations and Policy Implication

This section consists of suggestions aimed for commercial banks (as a whole), commercial banks supervision and other stakeholders. It offers best ways to improve economic performance.

Observing the Tanzanian commercial banking performances, signs of improvements were present although economic efficiency of all banks were not stable over the years and, their stochastic frontier performance was not 100% efficient. The banks had opportunity to improve their economic performances to minimize complexity and inefficiency. To further improve the commercial banking economic performance, commercial banks management should use economic performance measurement techniques. In reality, most Tanzanian commercial banks use economic measurement to evaluating levels and trends of performance. Despite their function as financial institutions, economic measures of performance are also better estimates than merely to base on financial measures. Economic measurements do not indicate performance through cost minimisation and/or, revenue and profit maximisation. Comparatively, economic measures offer earlier indication of inefficient components (e.g. equity, deposits and capital in resources utilisation) by using an estimated value. In fact, the present study encourages the use of stochastic frontier efficiency measurements to evaluate economic efficiency of the commercial banks. This is because; stochastic frontier contains error component(s) and other variables. It also provides capability of realizing inefficiency earlier especially in an unstable financial environment. Hence, it aids stakeholders to make the best economic decisions and also aids bank management to make better Cost and Revenue Efficiency comparisons.

Additionally, banks are encouraged to develop human resource for better management efficiency and employee proficiency. Proficiency of employees and management is precious to improve efficiency of the commercial banks. This is done to gain competitive advantages, reducing bank costs and, increase revenue and profit. Therefore, Tanzanian commercial banks and their supervisors should have the best human resource strategy and knowledge management execution to improve the banking financial and economic performances. Such strategy is effective through quarterly seminars or workshops to state new current and future challenges and, how banks can tackle them to maintain and improve performance. This strategy should be continued/ evaluated with monthly internal meeting and discussions for future plans and success. Employment procedures (e.g. educated, faithful, trustworthy and committed) are another aspect for consideration. Importantly, the human resource should consider historical background of the employees and not only focus on educational background or/and interviews, political and family relationships. In fact, it is imperative that Central Bank set criteria and oversee commercial bank employment. On the other hand, Tanzanian commercial banks should maintain sufficient liquidity because; the present findings indicate overwhelming liquidity than the required. Excess liquidity can indicate inefficiency because more deposits are collected but, not utilised properly (investments or loan provision). Failure to allocate deposits decreases bank returns.

Moreover, Tanzanian commercial banks should occupy technological products and build customer awareness. By introducing technological products such as mobile bank and internet banking, commercial banks become efficient and effective but they must be offered only if commercial banks have already increased customer awareness. As observed, poor customer awareness decreases banking performances. Therefore, commercial banks in Tanzania should not only deploy technological products, but also build customer awareness by offering clear knowledge on access, how to use and benefit of using their services. The implementation of free or very low charge on services (in the beginning of service), is another mode to improve customer awareness. Tanzanian commercial banks must diversify their products and services. Most commercial banks conduct common businesses such as accepting deposits and providing loan. Most banks do not deal with product security and market derivatives. By expanding their services, commercial banks not only increase profit, cost and revenue efficiently but also effectively, especially in the present of excellent management/supervision on combined-products. It is strongly emphasised that commercial banks reconsider diversification of large loans to reduce borrowing and lending costs. It is recommended that commercial bank reduce interest rate charges. Apparently, after the 2008 financial crises, Tanzanian commercial banks seemed to increase their borrowing interest rates and reduce deposit rates to cover operational costs. Indefinitely such a move compromises banking efficiency. Tanzanian commercial banks should standardize rates according to current economy, for which it should not exceed 8% for borrowers and not less than 5% for depositors to encourage use of their services (increase banking transactions). Tanzanian banks are also recommended to implement Islamic banking products, which are fair with profit charges. It indefinitely attracts more customers to formal banking activities rather than using home or street financial activities.

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