

# FACTORS INFLUENCING PERFORMANCE OF THE UAE ISLAMIC AND CONVENTIONAL NATIONAL BANKS

Hussein A. Hassan Al-Tamimi, University of Sharjah

## ABSTRACT

*The objective of this study is to investigate some influential differences in UAE's Islamic and conventional national banks during the period 1996-2008. UAE Islamic banks have a small market share, though there is an increasing demand for their services. This gives rise to an examination of the factors that influence the performance of these banks compared with conventional banks. A regression model was used in which ROE and ROA were used alternatively as dependent variables. A set of internal and external factors were considered as independent variables including: GDP per capita, size, financial development indicator (FIR), liquidity, concentration, cost and number of branches. The results indicate that liquidity and concentration were the most significant determinants of conventional national banks' performance. On the other hand, cost and number of branches were the most significant determinants of Islamic banks' performance.*

**JEL:** G20,G21

**KEYWORDS:** Bank performance, UAE Islamic banks, UAE conventional national banks

## INTRODUCTION

The UAE has 47 commercial banks, 22 of which are national banks and the remaining 25 are foreign banks. Among the national banks, there are five Islamic banks as of the end of 2008. The total assets of the national banks have increased from AED 123 billion in 1996 (about US\$ 33.5 billion) to AED 1,041.7 billion (about US\$ 283.7 billion) in 2008. The total assets of Islamic banks have increased from AED 7.1 billion in 1996 (about US\$ 1.9 billion) to AED 182.6 billion (about US\$ 49.6 billion) in 2008. The proportion of UAE Islamic banks' assets has increased from 4.1 percent of the UAE banking sector's total assets and 5.5 percent of the UAE national banks' assets in 1996 to 10.6 percent and 14.9 percent in 2008 respectively (Emirates Banks Association and Orisis database). However, the UAE Islamic banks' market share is still relatively small, given that the UAE is a Muslim country.

The objective of this study is to investigate some factors that influence performance in UAE's Islamic and conventional national banks. Based on the evidence provided above the Islamic banks have a small market share in the UAE banking industry, although the UAE is a Muslim country and the general impression is that people prefer to bank with Islamic banks rather than with conventional national banks.

The paper also compares the relative importance of each factor on bank performance in the two sets of banks. This is intended to help the UAE Islamic and conventional national banks assess and improve their performance to remain competitive. Currently and because of the severe impact of the current financial crisis, there is a high demand for Islamic banking services, which encouraged three UAE conventional national banks to switch to Islamic banks and to offer Islamic banking services including foreign banks such as: Citinank and HSBC. This new development in Islamic banking industry, particularly in UAE, represents the motivation of this study to investigate some factors influencing UAE Islamic banks' performance compared with that of the national conventional national banks. The remainder of the paper is organized as follows. In the following section we discuss the literature related to the bank performance. This section is followed by an exposition of the empirical model and data. The

fourth section is devoted to the discussion of the empirical findings. In the final section a brief summary of the paper and conclusions of the main results is provided.

## **LITERATURE REVIEW**

A large number of empirical studies have been conducted about factors influencing bank performance or determinants of bank performance. However, most of these studies examine developed economies, with far fewer studies examining emerging economies such as UAE's economy.

Delis and Papanikolaou(2009) investigated the determinants of bank efficiency. They found that the banking sectors of almost all sample countries show a gradual improvement in their efficiency levels. The model used shows that a number of determinants like bank size, industry concentration and the investment environment have a positive impact on bank's efficiency.

The determinants of performance of Greek banks during the period of EU financial integration (1990-2002) has been examined by Kosmidou(2008). He used an unbalanced pooled time series dataset of 23 banks. For bank performance measure he used the ratio of return on average assets (ROAA) and for the determinants he classified them into internal and external determinants. The internal set included: the cost to-income ratio, the ratio of equity to total assets, the ratio of bank's loans to customer and short-term funding, the ratio of loan loss reserves to gross loans and the bank's total assets. The external set included: the annual change in GDP, inflation rate, the growth of money supply, the ratio of stock market capitalization to total assets, the ratio of total assets to GDP and concentration. The results showed that ROAA was found to be associated with well-capitalized banks and with lower cost to income ratios. The results also indicated that the impact of size and the growth of GDP was positive, while inflation had a significant negative impact.

Some studies considered satisfaction with banking services as the main determinant of bank performance. An example of such studies was the one conducted by Jham and Khan(2008) in which they demonstrated how adoption of satisfaction variables can lead to better performance, and how customer satisfaction was linked with the performance of the banks.

Wum et al.,(2007) investigated the impact of factors such as: financial development measured by financial interrelation ratio(FIR), the level of monetization measured by M2/ GDP and the level of capitalization, size, age of the bank, business orientation measured by the ratio of non-interest income, and per capita GDP on the Chinese commercial banks. The results indicated that the higher the levels of financial development, the better ROA performance for banks. The results also indicated a positive impact of per capita GDP on bank performance. However, a negative impact of size and business orientation on the ROA was found.

Unal et al.,(2007) conducted a comparative performance analysis between the Turkish state-owned and private commercial banks during the period 1997-2006. They used net profit-loss, return on assets and return on equity as proxies to measure profitability. To measure operating efficiency they used net profit, net assets efficiencies relative to total employment and total number of branches. The findings suggested that state-owned banks are as efficient as private banks.

Chirwa(2003) investigates the relationship between market structure measured by concentration and profitability of commercial banks in Malawi using time series data between 1970 and 1994. He concluded that there was a positive relationship between concentration and performance

Naceur and Goaid (2001) examined the determinants of the Tunisian deposit during the period 1980-1995. The results indicated that the principal determinants of a bank's performance were by order of importance: labor productivity, bank's portfolio composition, capital productivity and bank capitalization.

Banking sector in Saudi Arabia has been examined by Ahmed and Khababa(1999). They used three measures of profitability as dependent variables; ROE, ROA and percentage change in earnings per share. On the other hand, they used four independent variables. These were: business risk measured by dividing the total loans of the bank by its total deposits, market concentration, the market size measured by dividing the deposits of the bank by the total deposits of the commercial banks under study and the size of the bank. The results indicated that the business risk and the bank size were the main determinants of the banks' performance.

Kim and Kim(1997) conducted a comparative study on the structure-profit relationship of commercial banks in Korea and the U.S. To assess the profitability of the sample banks, they used ROA and ROE. These two variables were used as dependent variables. They also used seven independent variables namely: shareholders' equity to total assets, liquid assets to assets , total loans to total deposits, fixed assets to total assets, total borrowed funds to total assets, reserves for loans to total assets and a reciprocal value of total assts They concluded that the banks in Korea lag far behind the U.S. banks in terms of efficiency and profitability. The findings also indicated that the capitalization rate, reserves for loan losses, and the size of the bank were important factors affecting the profitability of the banks in both countries. Zimmerman (1996) examined factors influencing community bank's performance and concluded that the regional conditions and loan portfolio concentration were important factors in community bank's performance.

In Summary it can be concluded that both ROA and ROE have been widely used as measures of banks' performance. Regarding factors affecting bank performance, different factors have been used by researchers such as: shareholders' equity to total assets; liquid assets to assets ; total loans to total deposits; fixed assets to total assets; total borrowed funds to total assets; reserves for loans to total assets ; market concentration; the market size; labor productivity; bank portfolio composition; capital productivity, bank capitalization; financial interrelation ratio(FIR); M2/ GDP; the level of capitalization; age of the bank; per capita GDP, the cost to-income ratio and customer satisfaction.

## **EMPIRICAL MODEL AND DATA**

The model adopted in this study includes some of the common variables used in the earlier studies noted above. For example, in evaluating the overall banks' performance, there are two ratios normally used namely: return on equity (ROE) and return on assets (ROA). These two ratios are considered by Sinkey (2002) as the best measures of a bank's overall performance (See also Ta Ho and ShunWu, 2006 ; Beck et al., 2005. In this study, ROE and ROA are used alternatively with seven independent variables. The following are brief justifications for the use of independent variables.

The first independent variable is economic conditions (ECON) measured by GDP per capita. It is well established in the literature that there is a positive relationship between economic growth and financial development (see for example Wang ,2009, Beck et al., 2008 and Tang, 2006) . The second variable is SIZE measured by total assets. It is expected that there is a positive relationship between bank size and performance, because by increasing the size of banking firm, cost can be reduced and therefore, performance can be improved (Berger et al., 1987 and Shaffer, 1985. The third variable is FIR, which one of the most common measures of financial development (see for example Wum et al., 2007 and Goldsmith, 1969). The fourth variable is liquidity (LIQ) measured by the ratio of total loans to total deposits. In this regard, it is expected that the more the liquidity, the less efficient the commercial banks and vice versa. The fifth variable is concentration (CONT) measured by the percentage of conventional

national banks or Islamic banks' assets to total assets of the UAE commercial banks. There is a positive relationship between concentration and bank performance (see for example Delis and Papanikolaou 2009 and Chiraw, 2003). The sixth variable is cost (COST); the higher the costs, the less efficient the commercial banks are. Finally, the number of branches (BRAN); the more the number of branches, the better the banks' services are, which in turn is expected to affect performance positively. Therefore, the regression model used in this study is as follows:

$$\text{PERF} = f(\text{ECON}, \text{SIZE}, \text{FIR}, \text{LIQ}, \text{CONT}, \text{COST}, \text{BRAN}) \quad (1)$$

Where:

- PERF - represents performance measures for the UAE commercial banks (ROA and ROE);
- ECON - is a measure of economic conditions = GDP per capita;
- SIZE - is a measure of banks' size measured by total assets;
- FIR - is a measure of financial development= total assets/GDP
- LIQ - is a measure of banks' liquidity = ratio of total loans to total deposits;
- CONT - is a measure of banks' concentration;
- COST - is a measure of banks' salaries to total assets
- BARN - is the number of branches

In addition, a dummy variable is used as an independent variable to reflect the bank type (TYPE) of which 0 is allocated to Islamic banks and 1 to conventional banks.

The data used in this study were mainly obtained from three sources: the UAE Central Bank annual reports and statistical bulletins, the UAE commercial banks annual reports published by the Emirates Banks Association and ORISIS database. The data covers the period of 1996-2008.

Using more than one variable to examine the contribution of independent variables to the regression model may suggest a multicollinearity problem among these variables. Before examining the contribution of independent variables to the regression model there is a possibility of a multicollinearity problem among these variables. A multicollinearity test was carried out to assess the degree of correlation among variables. Table (1) provides the correlations among these variables for conventional national and Islamic banks. Using "rule of thumb" test, as suggested by Anderson et. al (1990), which suggests that any correlation coefficient exceeds (.7) indicates a potential problem. An examination of the results of correlations presented below. Table 1 suggests the existence of multicollinearity problem among some of the independent variables. Therefore, GDP per capita (ECON) and SIZE in the case of conventional national banks and FIR in the case of Islamic banks were dropped from the regression model.

## EMPIRICAL FINDINGS

Table 2-a and Table 2-b provide a summary of the regression results of the regression model for conventional national banks by using ROE and ROA as dependent variables. It can be seen from Table 1 that the explanatory power of the adjusted  $R^2$  explained 28.8% of the variation of conventional national banks' performance when ROE is used as dependent variable and 26.5% when ROA is used. In both cases, the estimated coefficient of LIQ was, as expected, positive and statistically significant at the 1 and 5 percent level. This result is expected because the conventional national banks did not face a liquidity problem. As a matter of fact, they did not reach the limit determined by the UAE Central Bank. The ratio of total loans to deposits required by the latter is 1:1, whereas, the average ratio of loans to deposits during the period under review was 82.6 percent. It is worth mentioning here that the average ratio in 2008 was 102 percent. This high ratio might be attributed to the impact of financial crisis on the UAE banking sector.

Table 1: The Correlation Coefficients between Independent Variables

	Islamic Banks						
	ECON	SIZE	FIR	LIQ	CONCN	COST	BRAN
ECON	1.000						
SIZE	.985**	1.000					
FIR	.829**	.892**	1.000				
LIQ	-.274	-.243	-.232	1.000			
CONCN	.787**	.728**	.419	-.402	1.000		
COST	.432	.396	.198	.227	.553	1.000	
BRAN	.961**	.932**	.771**	-.393	.855**	.410	1.000

  

	Conventional National Banks						
	ECON	SIZE	FIR	LIQ	CONCN	COST	BRAN
ECON	1.000						
SIZE	.959**	1.000					
FIR	.829**	.920**	1.000				
LIQ	.871**	.816**	.6851*	1.000			
CONCN	-.328	-.314**	-.571*	.245	1.000		
COST	-.789**	-.847**	-.658	-.534	.385	1.000	
BRAN	.857**	.872**	.703**	.690**	-.233	-.591*	1.000

\*\*Correlation is significant at the 0.01 level (2-tailed), \*Correlation is significant at the 0.05 level (2-tailed)

The results also indicate that the coefficient value of concentration (CONC) and liquidity(LIQ) was as expected positive and statistically significant at 5 percent level. This is consistent with Delis and Papanikolaon(2009) and Chirwa(2003) who found a positive impact of concentration on banks’ performance. The expected positive impact of concentration might be attributed to the high density of branch network. Dean, 2003 indicated in this regard that the UAE banking sector is by far the most over-banked in the region. However, the results of positive impact of concentration on performance is not supported by the negative coefficient value of BRAN (the number of branches) although it is statistically insignificant. As for the remaining two variables in the model, FIR and COST, the estimated coefficient of FIR was unexpectedly negative and statistically insignificant. This is inconsistent with the finding of Wum et al., (2007) who found a positive impact of FIR on banks’ performance.

FIR is one of the most common indicators of financial development suggested by Goldsmith (1969). It is assumed to have a positive impact of financial development on banks’ performance as the ratio reflects the relationship between financial assets and economic activities measured by GDP. If economic activities increase, more demand on banking services is expected which means more profit opportunities for banks. Regarding COST, the estimated coefficient was unexpected positive, but statistically insignificant when ROA is used as a dependent variable and it is as expected negative but it is also statistically insignificant when ROE is used. The coefficient value is expected to be negative because of the inverse relationship between profits and costs.

Regarding Islamic banks, the same procedure has been followed of which ROA and ROE were used alternatively as dependent variables. However, GDP is used instead of FIR because it gives better results.

Table 3 shows a summary of regression results. The explanatory power of the adjusted  $R^2$  explained 53 % of the variation of the Islamic banks’ performance when ROA is used as dependent variable and 62% when ROE used. The selected independent variables better explain the variation of the Islamic banks’ performance compared with that of conventional national banks. The estimated coefficients were as expected negative, but statistically insignificant in the case of LIQ and CONC, whereas it was positive and statistically significant at 1 percent level in the case of BRAN. The estimated coefficient of COST

was unexpected positive and statistically significant at 5 percent level when ROA was used as dependent variable and at 10 percent level when ROE was used as dependent variable.

Table 2: Summary of Regression Results National Conventional National Banks

Panel A: Dependent Variable ROE			
	Coefficient	t	Sig.
(Constant)		-2.049	.080
FIR	-.022	-.037	.971
CONC	1.017	2.732	.029**
LIQ	.950	2.981	.020**
COST	.176	.374	.719
BRAN	-.122	-.348	.738
R	R Square	Adjusted R Square	Standard Error of the Estimate
.841 <sup>a</sup>	.707	.498	.00309
Panel B: Dependent Variable ROA			
	Coefficient	t	Sig.
(Constant)		-2.018	0.083
FIR	0.088	0.151	0.884
CONC	1.036	2.809	0.026**
LIQ	1.011	3.203	0.015**
COST	-0.006	-0.013	.990
BRAN	-0.128	-.367	.725
R	R Square	Adjusted R Square	Standard Error of the Estimate
.844 <sup>a</sup>	.712	.507	0.02043

Panel A of this table shows the regression estimates of the equation:  $ROE = f(FIR, CONC, LIQ, CONT, BRAN)$ . The table reveals the coefficient values, the t-statistics and the significant level. Panel B of this table shows the regression estimates of the equation:  $ROA = f(FIR, CONC, LIQ, CONT, BRAN)$ . \*\*Statistically significant at the 5 percent level, \* Statistically significant at the 10 percent level.

The expected result of liquidity being negatively related to performance of Islamic banks was mainly attributed to the conservative policies of these banks regarding funds allocation. For example, they do not provide credit facilities in the same manner as conventional national banks. It is worth mentioning here that Islamic law considers a loan to be given or taken, free of charge, to meet any contingency. Thus in Islamic banking, the creditor should not take advantage of the borrower. On the other hand, conventional national banking is essentially based on the debtor-creditor relationship between the depositors and the bank on one hand, and between the borrowers and the bank on the other. In the case of conventional banks, interest is considered to be the price of credit, reflecting the opportunity cost of money, but it is forbidden from Islamic point of view. Therefore the incentive to lend is less in the case of Islamic banks compared with that of conventional national banks. Islamic banks provide loans and advances on the basis of profit-sharing. Based on this argument, Islamic banks are expected to keep high liquidity which in turn negatively affects the level of profits or performance. It is also expected that concentration (CONC) is negatively related to performance because of the small market share of Islamic banks.

Finally, a dummy variable is added to the set of independent variables to explore the effect of the type of the bank on bank performance. Six independent variables are used, two were excluded (FIR and Branches) because of the multicollinearity problem. The results of the estimate provided in the Table 4 indicate that independent variables including the dummy variable explain 59.8 percent of the variation in the dependent variable when ROE is used as a dependent variable. The coefficient value is as expected

positive in the case of concentration (CONC) and statistically significant at 5 percent level. This might be true in the case of conventional banks, but it is not regarding Islamic banks because of relatively small market share. The results also indicate a negative coefficient value of the bank type and statistically significant at 10 percent level. This might give an indication that performance of conventional banks might become better if they switch to Islamic banks or vice versa. It should be mentioned that better results have been obtained when ROE is used as a dependent variable rather than ROA, therefore we did not report the results.

Table 3: Summary of Regression Results for Islamic Banks

Panel A: Dependent Variable ROE			
	Coefficient	T	Sig.
(Constant)		-0.363	.727
GDP	-1.535	-1.908	0.098*
LIQ	-0.230	-0.548	0.600
CONC	-1.328	-1.681	0.137
COST	0.857	2.313	0.054*
BRAN	2.769	2.616	0.035**
R	R Square	Adjusted R Square	Standard Error of the Estimate
0.852	0.727	0.531	0.00436
Panel B: Dependent Variable ROA			
	Coefficient	T	Sig.
(Constant)		1.377	0.211
FIR	-0.580	-1.576	0.159
CONC	-0.185	-0.493	0.637
LIQ	-0.768	-0.969	0.365
COST	0.284	0.851	0.423
BRAN	1.762	2.295	0.055*
R	R Square	Adjusted R Square	Standard Error of the Estimate
0.883	0.780	0.622	0.02970

Panel A of this table shows the regression estimates of the equation:  $ROA = f(GDP, LIQ, CONC, COST, BRAN)$ . The table reveals the coefficient values, the t-statistics and the significant level. Panel B shows the regression estimates of the equation:  $ROE = f(FIR, LIQ, CONC, COST, BRAN)$ . \*\*Statistically significant at the 5 percent level, \* Statistically significant at the 10 percent level.

## CONCLUSIONS

The objective of this study is to investigate some influential factors in UAE’s Islamic and conventional national banks during the period 1996-2008. Data were obtained from UAE official sources. Two dependent variables measuring performance were used, the ROA and ROE along with a number of independent variables. For conventional national banks model, the dependent variables were regressed on five independent variables namely, financial development indicator(FIR), liquidity(LIQ), concentration (CONT), cost(COST) branch number( BRAN). The results indicate a positive performance impact on the liquidity of conventional national banks. The same dependent and independent variable were used in the case of Islamic banks model except for FIR which was dropped because of a multicollinearity problem. The results indicate a positive impact of cost and branch number on Islamic banks’ performance and liquidity and concentration in the case of conventional national banks. Among the limitations of this study is the data availability. If a longer data coverage were available (e.g. quarterly or monthly data) better results might be obtained. The other limitation is the lack of a similar

study for countries having the same features of UAE economy. Further research can be conducted by using monthly or quarterly data with different set of dependent and independent variables.

Table 4: Summary of Regression Results for Islamic and Conventional Banks

	Coefficient	T	Sig.
(Constant)		-0.127	.900
GDP	0.568	1.628	0.120
LIQ	-0.366	-0.755	0.459
CONC	0.190	0.970	0.344
COST	5.505	2.291	0.034
BRAN	-0.112	-0.528	0.604
TYPE	-4.897	-1.924	0.069
R	R Square	Adjusted R Square	Standard Error of the Estimate
0.833	0.695	0.598	0.02712

Note: This table shows the regression estimates of the equation:  $ROE = f(GDP, SIZE, LIQ, CONC, COST, TYPE)$ . \*\*Statistically significant at the 5 percent level \* Statistically significant at the 10 percent level.

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## **BIOGRAPHY**

Hussein A. Hassan Al-Tamimi is Associate Professor of Finance. He can be reached at Department of Accounting, Finance and Economics, College of Business Administration. University of Sharjah, P.O.Box 27272, Sharjah, United Arab Emirates, hussein@sharjah.ac.ae Tel. +9716 5050539.