

THE IMPACT OF CONSOLIDATION ON ISLAMIC FINANCIAL SERVICES INDUSTRY

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*Small asset size of Islamic Financial Institutions (IFIs) is often cited an obstacle for further growth. Looking at the motivating factors behind consolidation wave in conventional financial markets, this paper argues that IFIs can also benefit from consolidation in several ways. Expanding the **scale** of operations is not sufficient but it is essential that IFIs expand the **scope** of their products and services to meet the challenges of domestic and international markets. An increase in scale and scope through consolidation can provide IFIs necessary threshold to justify building a solid infrastructure for new services on both sides of the balance sheet. In addition to benefits of expanding scope, consolidation can bring benefits to IFIs through **diversification** and through enhanced management quality as well as efficiency gains from prudent risk taking, monitoring and management. The paper concludes by discussing policy implication for policy-makers and the managers before embarking on the wave of consolidation.*

1. INTRODUCTION

The issues of optimal structure of a banking system or the optimal size of a financial institution have been discussed extensively in recent years among academics and practitioners. This discussion gains attention every time a financial crisis brews or a financial institution fails, or a merger is proposed. The literature on the impact of consolidation on financial services is extensive and several arguments in favor of or against consolidation have been put forward. Several empirical studies have been conducted, especially to understand the causes and effects of an elevated activity of consolidations which occurred towards the end of the last decade. The subject has been of interest to diverse group of policy makers including the ones responsible for ensuring market discipline through competition, promotion of efficiency and stability of the financial sector, and prevention of

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contagion and spillovers. Despite considerable research on consolidation of financial services industry, much is yet to be understood, partly due to the dynamic nature and increasing complexity of the industry.

Whereas numerous studies have been conducted to understand and explain the effects of consolidation in conventional financial markets, it has received little or no attention in the literature dealing Islamic financial services industry.¹ This paper is one of the first serious attempts to explore the impact of consolidation on Islamic financial services industry and on Islamic Financial Institutions (IFIs). The paper identifies the areas where the market and IFIs may benefit from the consolidation which can enable them to turn current high growth into long-term sustainable growth. Given the challenges facing IFIs and current state of affairs, there could be several convincing reasons to argue in favor of consolidation. This paper focuses on two aspects, i.e. benefits arising out of economies of scope and benefits from enhanced risk management through diversification. These two areas make a strong case for thinking seriously about consolidation. The paper concludes that there are definitely merits in expanding the size of Islamic financial institutions through consolidation. The paper also reviews policy implications of consolidation for decision makers including management of IFIs and regulators and supervisors.

Section 2 briefly reviews consolidation trend in global financial markets. Section 3 summarizes arguments why the size of financial institutions matters. Section 4 discusses the case of consolidation of IFIs, and finally, Section 5 discusses policy implications.

2. CONSOLIDATION TREND IN GLOBAL FINANCIAL MARKETS²

The financial services industry in major industrial countries experienced a trend towards consolidation through mergers and acquisitions in the last two decades. This move towards consolidation started in the 1980s in the US but at a much later stage in Europe where the trend developed at a relatively slow pace until 1996. Consolidation trend in both the US and Europe reached its peak during the last three years of the 1990s.³ Data in **Table 1** testifies the universal trend of consolidation activity in the banking and the non-banking financial industry in major industrial economies during the 1990s.⁴ Over this period, acquisitions of banking firms accounted for 60 percent of all financial consolidations and 70 percent of the total value of consolidated institutions. Interestingly, the largest number of mergers and acquisitions in the financial sector occurred within national

¹ Al-Omar and Iqbal (1998) provided some of earlier statistics on the size of Islamic banks and argued to increase the size.

² For a comprehensive discussion of consolidation in financial services, please see Group of Ten (2001).

³ Carletti (2002).

⁴ Amel, Barnes, Panetta and Salleo (2004).

borders.⁵ In the US, the consolidation movement saw the number of commercial banking organizations fall from 12,463 to 7,926 between 1979 and 1997. The clean-up was concentrated among the smallest institutions and as a result in this period the number of large banks (with total assets in excess of \$ 100 billion) actually increased from three to six while the number of medium-sized banks (with total assets in the range \$100 million to \$100 billion) remained relatively stable, falling from 2,446 to 2,284. The number of small banks (with total assets below \$100 million) was the target and their number fell from 10,014 to 5,636.⁶

Table 1. Consolidations, Mergers and Acquisitions in the main industrial countries

	1990-1995				1996-2001			
	Banks		Non-Bank Financials		Banks		Non-Bank Financials	
	No.	Size (\$ bil)	No.	Size (\$ bil)	No.	Size (\$ bil)	No.	Size (\$ bil)
Australia	53	2	60	1	91	13	155	9
Belgium	21	1	28	1	34	28	24	4
Canada	52	2	85	1	112	15	167	12
France	148	12	145	11	96	45	89	8
Germany	123	2	72	3	229	69	104	1
Italy	147	19	71	1	138	80	54	4
Japan	29	44	15	1	236	119	207	4
Netherlands	36	11	49	0	4	6	42	6
Spain	66	6	19	0	67	31	44	2
Sweden	44	3	33	1	38	17	37	2
Switzerland	81	3	21	0	43	24	30	1
United Kingdom	140	33	169	6	279	114	330	36
United State	1,691	157	375	23	1,796	755	742	191
Total	2,631	295	1,142	50	3,183	1,317	2,025	279
Euro Area	655	60	435	16	700	303	457	30
World	3,363	340	1,589	59	4,781	1,495	3,668	319

Source: Amel, Barnes, Panetta and Salleo (2004).

As result of this consolidation wave, the number of banking firms decreased in almost every industrial country and the concentration of the banking industry, as measured by the percentage of a country's deposits controlled by the largest banks, tended to increase. If other banking activity, such as off-balance sheet activities, were included in the size measure, the increase in banking concentration would be even greater. As a consequence, several industrial countries reached a situation of high banking sector concentration or faced a further deterioration of an already concentrated sector (e.g. Australia, Belgium, Canada, France, the Netherlands and Sweden), while the banking sectors of a few other countries (Germany and the United States) remained relatively un-concentrated.⁷

Many factors are cited as stimulants for this wave of consolidation. Among the critical forces encouraging consolidation are financial deregulations, globalization

⁵ Group of Ten (2001).

⁶ Danthine (2001).

⁷ See Group of Ten (2001).

of financial and real markets, advancements in technology, excess capacity or financial distress in the market, and increased shareholder pressure for financial performance. The barriers to entry decreased with the deregulation and globalization of financial markets resulting in increased competition for financial firms. Deregulation in the US changed the rules of the game with the end of prohibition of interstate banking and by removing separation between commercial and investment banking.⁸ In case of Europe, economic, financial and monetary union, and introduction of the euro accelerated the speed of financial market integration and encouraged cross-border activity, partly through consolidation. The 1980s and 1990s also brought technology revolution, especially in the area of telecommunication and computing power which put further pressure on the financial industry to compete globally. Increased competition among banks forced them to seek ways to cut costs and to increase market share which ultimately led to a trend of consolidation through mergers to create synergies or through acquisitions of inefficiently small, poorly managed and insufficiently diversified financial institution.

3. WHY DOES SIZE MATTER?

The question of why financial institutions wish to expand and increase their size through consolidations has been discussed extensively. There are several arguments in favor of extending the size of a financial institution. The objective to maximize shareholders' value is obvious but other stakeholders including managers and government can also affect consolidation decisions to pursue private objectives.⁹ One of the earlier and more conventional arguments for consolidation has been potential for efficiency gains through cost savings due to economies of scale, organizational efficiency, reduced cost of funding, and economizing of capital. For instance, economies of scale in commercial banking can be achieved if banks with similar operations find it beneficial to eliminate overlapping branches and consolidate back office operations including systems and technology, administration and marketing functions. There is also evidence of productivity gains from the wider use of new information technology where the initial setup costs are too large compared to small scale operation of smaller institutions.¹⁰

It is also argued that large financial institutions are able to enjoy revenue enhancements through economies of scope offering a larger menu of products to the same customer base. Scope economies can also be significant because combining different product lines (such as banking and insurance products or combining commercial and investment banking lines) may increase the relationship

⁸ In US, Glass-Steagall Act of 1934 which prohibited combination of banking, securities and insurance business was repealed by Financial Services Modernization Act of 1999.

⁹ Berger, Demsetz, Strahan (1999).

¹⁰ Hawkins (2001).

value of banking at a much lower average marketing costs.¹¹ More recently, increasing globalization and complexity of financial markets have created opportunities for large financial institutions to create value through efficient risk management. Application of portfolio theory to banking can lead to better diversification opportunities in the deposit base, investments and loans. A well-diversified bank has better expected return-risk trade-offs resulting in lower variability of profits and higher security for depositors. Diversification can potentially not only reduce the probability of failure at individual institutional level but can also enhance stability of financial and payment system.

With increased size, the market share of the financial institution enlarges which enhances its market power. With the ability to dominate markets, a large sized financial institution may be motivated to extract monopoly rents through its market-making position. Similarly, it has also been argued that through consolidation some institutions may try to increase the value of their access to the government's financial safety net including deposit insurance, discount window access, and payments system guarantees. If financial market participants perceive very large organizations to be "too big to fail", i.e. an explicit or implicit government guarantees which will protect debt holders or shareholders, there may be incentives to increase size through consolidation in order to lower the cost of funding and increase the value of shares.¹²

Finally, several other miscellaneous reasons have been cited as plausible motivation behind desire to increase the size of a financial institution. These include hidden agenda to expand private managerial benefits¹³, an implicit defense against takeovers, shopping spree in search of under-valued institutions after an economic crises, or preemptive take-over during an upswing of the business cycle.¹⁴

4. ISLAMIC FINANCIAL INSTITUTIONS (IFIs) AND CONSOLIDATION

As a result of continuing high demand for financial products compatible with *shari'ah*, number of financial institutions offering Islamic products have grown in large numbers all over the globe. Although, Islamic financial institutions (IFIs)

¹¹ Danthine (2001).

¹² Saunders and Wilson (1999) look at international comparisons over a 100-year period which shows how changes in the structure and strength of safety net guarantees may affect financial institution risk-taking, and by extension, the motive to consolidate to increase the value of access to the safety net.

¹³ Berger, Demsetz, and Strahan (1999). One of managerial objectives may be empire-building where managers may be able to pursue their own objectives in increasing the size decisions, particularly in banking where corporate control may be relatively weak.

¹⁴ Danthine (2001) thinks that in the absence of any rational motives, race for size can only be explained by the private motivations of managers to enhance their compensation packages or their aspiration to rule over ever bigger institutions.

have grown in numbers, but the average size of their assets is still small as compared to average size of assets of a bank in the conventional system. It is worth noting that as of 2001, not a single Islamic bank was on the list of the top 100 banks in the world. According to the same estimates, more than sixty percent of the IFIs were below the minimum assets size of \$500 million considered for an efficient conventional bank and aggregate assets of all Islamic banks are less than of any bank on the list of the top 60 banks in the world. Finally, the size of assets of the largest Islamic bank amounted to a meager 1 percent of the assets of the largest bank in the world.¹⁵ Table 2 shows the number of IFIs' and their respective sizes of assets and capital as of end of the 1990s. It clearly indicates wide dispersion of financial institutions with relatively small size of assets.

Table - 2: Islamic Financial Institutions (IFIs)

Region	No. of IFIs	Average Capital (US\$ Million)	Average Assets (US\$ Million)
South Asia	51	17	770
Africa	35	6	45
South East Asia	31	5	75
Middle East	47	116	2204
Europe and Americas	9	70	101
Asia and Australia	3	3	6
Total	176	42	839

Source: Kahf (1999).

Table 3 lists the assets and the capital of top 10 Islamic commercial banks as of 2006. This does not show any noticeable difference from the data by the end of the 1990s. It is also worth noticing that the disparity and margin between the top and the bottom tier of this list is considerable.

Table – 3: Islamic Banks Assets and Capital as of 2006 (US\$ million)

	Islamic Commercial Banks	Total Assets	Total Equity and Reserves
1	Al Rajhi Bank (Saudi Arabia)	28,057	3,636
2	ABC Islamic Bank (Bahrain)	22,441	2,072
3	Kuwait Finance House (Kuwait)	21,953	1,479
4	Dubai Islamic Bank (UAE)	17,548	1,845
5	Al Baraka Banking Group (Bahrain)	7,639	708
6	Bank Al Jazira (Saudi Arabia)	4,094	538
7	Bank Islam Malaysia (Malaysia)	3,969	554
8	Bank Muamalat Malaysia (Malaysia)	3,813	202
9	Qatar Islamic Bank (Qatar)	3,035	500
10	Sharjah Islamic Bank (UAE)	2,081	515

Source: Islamic Banks and Financial Institutions Information System (IBIS).

¹⁵ Iqbal (2001).

A study of 45 Islamic banks conducted by Iqbal and Molyneux (2005) shows that the majority of Islamic assets are concentrated in the GCC and Middle East region (60 percent). A rough estimate of the average assets size shown in Table 4 also indicates relative small size of assets of leading Islamic banks.

Table – 4: Islamic Banks by Geographic Region as of 2002

Region	No. of Banks	Total Assets (US\$ mil)	Average Asset Size
South and South-East Asia	22	9,730	442
GCC	26	55,900	2,150
Other Middle East	15	6,180	412
Africa	4	N/A	N/A
Rest of the world	2	134	67

Source: Iqbal and Molyneux (2005).

Before the question of achieving potential efficiency gains through consolidation for IFIs is raised, it is worth surveying the studies conducted to examine the performance and efficiency of Islamic banks.¹⁶ Several studies have been undertaken to evaluate the cost and production efficiency of Islamic financial institutions in different countries where Islamic finance is practiced. Majority of such studies have measured efficiency using accounting ratios and comparing the same with the ratios of conventional banks of similar size and location. Metwally (1997) compared the performance of 15 interest-free banks with 15 conventional banks for structural difference between the two groups of banks in terms of liquidity, leverage, credit risk, profit and efficiency. The study found that although profitability and efficiency differences are not statistically significant between the two types of banks, Islamic banks tend to be more conservative in utilizing funds for lending and were disadvantaged in terms of investment opportunities. Similar findings of constraining investment opportunities were observed by Samad and Hassan (1999) who looked at the inter-bank performance of Bank Islam Malaysia Berhad (BIMB) in terms of profitability, liquidity, risk and solvency as well as community involvement for the period 1984-1997 and concluded that the average profit of Islamic banks was significantly lower than the conventional banks mainly due to limited investment opportunity set for Islamic banks.

Based on data from 1993 to 2000, Majid, Nor, and Said (2003) concluded that there was no statistically significant difference in the level of efficiency between Islamic and conventional banks operating in Malaysia. This study does however find a linkage between inefficiency and the bank size. The bank size not only influenced inefficiency, it also did so in a non-linear fashion. Increasing size initially provides some scale economies before diseconomies of scale set in once a critical size was reached thus suggesting a U-shaped average cost function. In a

¹⁶ Typical measure of efficiency is the ability to convert inputs (staff costs, fixed assets and total deposits) into outputs (total loans, liquid assets and other income).

comparative study of conventional and Islamic banking, Iqbal (2000) measured the efficiency of 12 IFIs by comparing their trends and profitability ratios with a “control group” of 12 conventional banks of similar size from the same countries. Islamic banks included in the sample accounted for more than 75 percent of the total assets as well as total capital of the whole Islamic banking industry and were accordingly a reasonable proxy representative of the entire sector. The study finds that during the 1990-1997, Islamic banks achieved higher rates of growth of total investments, total assets, total equity and total deposits than their conventional counterparts. More importantly, the study finds that IFIs also turned out to be more cost effective and made a better use of their resources than the banks in the control group, as indicated by significantly higher deployment ratios.¹⁷

Hussein (2003) estimated operational efficiency of 17 Sudanese Islamic banks from 1990-2000 and found that Islamic banks did not create inefficiency *per se* but there were wide efficiency differences across domestic Islamic banks. However, despite the small size of the foreign banks, they were found to be more efficient than the state-owned and joint-ownership banks. Finally, a more recent study by Yudistira (2004) analyzed the size efficiency relationship by grouping 18 Islamic banks by total assets. Banks with more than \$600 million of assets were categorized as large size and banks below this level were categorized as small-to-medium size. The overall efficiency results for the period 1997-2000 suggested that low levels of inefficiency (around 10 percent) across all banks was observed but the results were defended by arguing that such inefficiencies are within the industry norms when compared to many conventional banks. Interestingly, the study finds that the largest degrees of scale inefficiencies come from large size Islamic banks.

In general, studies have found Islamic banks to be performing efficiently when compared with similar conventional financial institutions in similar market conditions. By international standards, average size of an IFI is relatively small but despite this fact, it is surprising that no study has been able to provide a convincing evidence of inefficiencies in Islamic banks. There could be two possible explanations for why Islamic banks are found efficient irrespective of small size. First, most of the studies have been performed as a relative comparison with conventional banks in the same geographical region; thus ignoring the impact of systematic inefficiencies. A more realistic analysis should include comparison of efficiencies against international benchmarks, comparison with foreign banks, controlling for any protection against competition, and taking into account the quality of standards, and other macro-economic variables such as capital movement. Further, most of the studies were performed during a period of high growth resulting from high demand for Islamic financial services. During the periods of high growth and demand, institutions are often subject to low degrees of market pressures and competition. When institutions are entering in a niche market like Islamic finance, some level of inefficiency is compensated by abnormal profit

¹⁷ Iqbal (2000).

margins. These margins erode fast as more players enter the market and it becomes more competitive.

A second reason could be that undertaking an empirical study to review the performance of IFIs or to understand the efficiency of financial services is a challenge itself due to low degree of transparency and quality of information disclosure of IFIs. For instance, many Islamic banks do not provide sufficient details as to the division of equity and deposits, and access to transaction level data is extremely difficult. When it comes to deposits, it is hard to get reliable and detailed breakdown of the deposit types offered by IFIs because of common practice to club different types of deposits together. Similarly, details on the assets side are often not very transparent. The above mentioned factors imply that the results from efficiency studies are to be taken with caution and one can not conclude with high degree of confidence that there is no further potential for efficiency gains.

There is no doubt that Islamic financial markets have experienced significant growth in the last two decades but researchers are contemplating how this rapid growth can be sustained given the structure of the institutions and the markets. Challenges imposed by globalization and growing participation by conventional banks offering Islamic products in the market are to be taken seriously by IFIs. To maintain a sizeable market share, IFIs need to keep up with the demands of changing landscape of financial markets. Several studies have identified many impediments to further growth of IFIs. The list is fairly exhaustive but three factors are critical.¹⁸ First, IFIs need to expand the array of financial instruments through financial engineering on both assets and liabilities side. Such financial instruments should enable an IFI to enhance liquidity and provide better portfolio and risk management opportunities for itself and for its clients. Second, IFIs need to realize the importance of proper risk management by developing a risk culture, by offering tools for risk-mitigating and risk-trading, and by providing inter-temporal risk smoothing for individual and institutional investors. Third, no one can deny the significance of enhancing governance and transparency, improving standards, and fostering integration with international financial markets.

IFIs have been slow in overcoming obstacles in achieving sustainable growth, especially in the area of financial engineering and innovations.¹⁹ Compared to the enormous financial innovations experienced by conventional markets in the last two decades, the level of innovations by IFIs is negligible. Progress in the area of providing risk-sharing and risk-transferring instruments is dismal as well. Whereas credit is due to IFIs for expanding the market size, further growth may not come that easy. Absence of innovation, risk-mitigation and capacity to integrate with global financial markets can certainly be linked to lack of economies of scale and

¹⁸ Iqbal and Mirakhor (1999) and Iqbal and Mirakhor (2002).

¹⁹ For a discussion of financial engineering, see Iqbal (1999).

scope due to average small size of IFIs. Factors stimulating consolidation of financial services as discussed in **Section 3** may be applicable to IFIs who can qualify for similar prescription of consolidation.

Large number of scattered small IFIs can certainly benefit from the economies of scale and scope.²⁰ Empirical studies on consolidation in conventional literature tend to conclude that economies of scale are applicable up to a certain threshold of size beyond which the economies start to diminish. This may be the case with some of IFIs as observed by few studies. Even if there is no compelling argument in favor of consolidation of IFIs on mere grounds of achieving scale economies, this paper argues that two other arguments should not be ignored. These are benefiting from the economies of scopes and benefiting from the risk diversification which are discussed further in detail below.

4.1. IFIs and Economies of Scope

The necessity for expanding the scope of Islamic financial services can be better understood by first reviewing the nature of financial intermediation in Islamic financial system. The nature of financial intermediation performed by IFIs is different from conventional banking system due to very fundamental differences in the nature of the contractual relationship between the depositors (investors) and borrowers (entrepreneurs). Financial intermediation in Islamic financial system requires a closer relationship and monitoring between the principal (investors) and its agent (financial intermediary) and between the financial intermediary and the users of the fund. There are other characteristics of the system which make the role of financial intermediary special.

Prohibition of interest by Islam closes the door for the debt markets and debt trading in the financial system. Although, equity mode of investment and financing is encouraged but an organized market for trading equities securities fully compatible with shari'ah does not exist as of this time. There are several structural and operational issues which need to be resolved before a robust and fully-functional efficient market for equity securities is developed.²¹ In absence of efficient equity markets, financial intermediary becomes the main source of capital in the financial system. Non-availability or limited application of derivatives markets further increases the burden of financial intermediaries to also provide risk-sharing and risk-mitigation functionality. These factors put additional responsibilities on the financial intermediary to play a very vital and critical role in the financial system. As a result, the emergent financial system is by design heavily

²⁰ Whereas the focus of most of empirical studies on efficiency of Islamic banks has been efficiency and economies of scale, there is no study which has analyzed the economies of scope.

²¹ For a discussion of design of a financial system based on Islamic principles, see Iqbal (2004). Maintenance of interest-bearing margin accounts and restrictions on short-selling are some of the constraints for equity markets.

pivotal on the financial intermediary very similar to a financial system dominated by bank-like institutions or an ‘insiders’ financial system as prevalent in Germany and Japan.²²

Table 5 shows the distribution of assets by different product types used by IFIs. The data clearly reflects that IFIs are practicing traditional instruments on the assets side and this composition has not changed significantly over the period. On an average, as a mode of financing, *murābahah* has been the first choice of IFIs, followed by *ijārah* and *istiṣnāʿ*-based assets and the rest in terms of *muḍārbah* and *mushārahah*. Bulk of the financing is undertaken in the form of trade-financing activities and contrary to what the system promotes, equity- and partnership-based assets are seriously lagging. Predominantly, the transactions on the assets side consist of customized or tailor-made transactions between the bank and its client. There is no organized market to securitize the bank’s assets and to trade the securities in the market, thus severely limiting the liquidity of the financial institutions. This limited set of asset choices is a major impediment to further growth of Islamic financial services industry.

Table - 5: Asset Composition of Select Islamic Banks

	1999	2000	2001	2002
<i>Murābahah</i> & Deferred Sales	80.1%	83.0%	86.7%	84.3%
<i>Istiṣnāʿ</i> ^c	10.8%	8.7%	7.5%	7.0%
<i>Ijārah</i> (Leasing & Hire Purchase)	2.5%	2.4%	1.9%	2.9%
<i>Muḍārbah</i> (partnership)	1.6%	1.6%	1.2%	3.1%
<i>Mushārahah</i> (equity participation)	0.9%	0.8%	1.3%	1.2%
<i>Qarḍ Ḥasan</i>	0.2%	0.3%	0.4%	0.5%
Other	0.2%	0.2%	0.5%	3.0%

Source: Islamic Banks and Financial Institutions Information System (IBIS).

IFIs need to expand the scope of financial services to meet the challenges of growth and globalization. Changing global financial landscape expects financial intermediary to go beyond its traditional core banking role and instead demands an expanded role of financial intermediaries. Distinction between traditional

²² Iqbal (2004). Studies have shown that a financial system dominated by strong financial intermediary is not necessarily going to be an inefficient one. Allen and Gale (1999) point out that Japan has sophisticated financial markets, but for most of the past fifty years, a concentrated banking system has played the dominant role in allocating resources and has contributed to economic development. The emerging concept of a financial system to be viewed as set of financial services argues that it does not matter if the system is bank-based or market-based but the important issue is which institutions and how well they perform a particular function or financial service. Therefore, it is the overall level and quality of financial services that improves the efficient allocation of resources and economic growth. For further details see Levine (2002).

commercial banking and investment banking is getting blurred and there is global trend of mixing financial services with non-banking services in an efficient fashion. Although this trend is prevalent in major industrial economies, it has not been embraced by many of emerging markets where Islamic finance is practiced. For example, a recent study, which ranked several countries in the Middle East region (where Islamic finance is dominant) according to their level of financial development, finds that throughout the region, countries fared poorly on indicators for a strong institutional environment and for the development of non-bank financial sector.²³

With increased sophistication of financial systems, institutional investors have grown significantly and have become an integral part of the modern financial system. For instance, contractual savings with defined benefits like insurance and pension funds have grown considerably and make heavy use of assets management business. In a financial system where securities markets are under-developed which is the case of Islamic financial markets as identified earlier, financial intermediary will have to take on the task of providing broader set of services including non-bank financial services. In addition, majority of IFIs are not adequately equipped for providing typical investment banking services such as facilitating development of capital markets, underwriting, guarantees, market research, and fee-based advisory services. It is critical that contracts like *ju'āla*, *Wikala*, and *Kifala* which can expand investment banking functionality are further developed, recognized, and operationalized to fully exploit the capabilities of IFIs.²⁴ It is, therefore, essential that IFIs expand the scope of its products and services to fill this gap in the financial system.

For further growth, it is essential that the role of intermediation in Islamic financial services industry is extended beyond its traditional set-up and there is need to broaden the scope and range of financial services offered like a 'financial products-supermarket.'²⁵ In this role, an IFI ought to serve as a one-stop shop to cater to different types of customers and clients ranging from private individuals, institutions, high-net-worth individuals and corporations for their investment, borrowing, risk management, and wealth management needs.²⁶ Introduction of new products and services is resource intensive and requires solid infrastructure for successful completion at each phase starting with solid market research, product

²³ Creane, Goyal, Mobarak and Sab (2003).

²⁴ Iqbal (2004) is of the view that contracts like *ju'āla*, *Wikala*, and *Kifala* are currently underutilized.

²⁵ Iqbal (2004).

²⁶ Ceechetti (1999) calls such supermarket a 'all-in-bank'. For example, an institution like this will serve retail customers, manage portfolios for individuals, and provide various services for corporate customers. At the same time, like a broker, the financial products supermarket will be a retail firm that handles asset allocation together with payments and settlement services.

design, development, placement and finally proper accounting. Investment needed to develop supporting infrastructure is of significant cost. By expanding the size of the institution through consolidation, development of infrastructure for product development can be made affordable.

The nature of financial intermediation and the style of financial products and services offered by an IFI make it a hybrid between commercial and investment banking similar to a universal bank. Universal banking is known to benefit from the economies of scope due to its close relationship, established client base, and access to private information gained through relationship. By expanding the scope of services, IFIs can spread the fixed cost in terms of both physical and human capital of managing a client relationship over a wider set of products leading to more efficient usage of resources.²⁷ Through consolidation, IFIs can use their branch networks and all their other existing delivery channels to distribute additional products at low marginal cost.²⁸ As universal banks, IFIs can also capitalize on good reputation established in one product or service to market other products and services with relatively less effort.²⁹ Finally, expanded scope of IFIs can benefit consumers as well who may save on searching and monitoring costs by purchasing a bundle of financial services from a single provider instead of acquiring them separately from different providers.³⁰

With current state of the affairs of Islamic financial industry—marred by small sized institutions—the above mentioned challenges, i.e. expanding scope of financial services simply can not be met. Consolidation can lead to efficiencies due to economies of scale but these efficiencies are known to be exhaustive beyond certain size as supported by empirical studies. On the other hand, the potential gains in efficiencies due to economies of scope can have long lasting impact on growth through diversified sources of value creation as a result of expanded products and services; and thus may result in stable profitability gains. With enhanced scope of services, IFIs can also achieve increased market power to compete with foreign banks or those conventional banks who offer Islamic financial products and services. Therefore, there are reasonable grounds to argue that IFIs can benefit from economies of scope through consolidation.

4.2. IFIs and Risk Diversification

While the effects of consolidation on the efficiency of financial institutions have been the subject of vast literature, evidence on the effects of consolidation on financial firms' attitude towards risk are more limited. Studies on consolidation effects have treated risk/return trade off as one of the contributing factors to

²⁷ Steinherr and Huveneers (1990) in Santos (1998).

²⁸ Llewellyn (1996).

²⁹ Rajan (1996) refers such benefits to spillovers in reputation where universal banks can use the reputation gained in offering one service to recommend their clients other services.

³⁰ Santos (1998).

improvement of efficiency. Increasing complexity of financial systems and growing significance of value-added contribution of risk management for the financial institution and its clients have led to the realization that the effects of size or consolidation on financial firm's risk-taking and risk-management practices are to be given more attention. Indeed recent studies contend that the failure to properly correct for the risk dimension has led to significant underestimates of the optimal bank scale.³¹

A larger sized financial intermediary can benefit by managing its risks better and can prepare itself to meet unexpected volatility. Benefits from managing risks come through expanded set of diversification of opportunities; value created from effectively managing financial risks, and from improved capital utilization. A greater scale, a more diverse mix of financial services provided, or an increased geographical spread of risks usually implies the potential for improved diversification, so the same protection against financial distress can be attained with fewer resources.³² Larger size may allow a financial firm to increase its resilience to shocks by attaining higher profits through a lower variability of profits as a result of enhanced diversification opportunities.³³ Finally, large financial institutions have used their diversification advantage to operate with lower capital ratios and pursue riskier activities.³⁴

The banking literature tends to presume that diversification and size go hand in hand and this is supported by some empirical evidence as well. Hughes *et al.* (1998) found that the benefits from consolidation increase through improved profitability and production efficiency, and lower insolvency risk when consolidation widens the geographical spread of the bank.³⁵ Another study looked directly at the diversification gains from improvements in the risk/expected return tradeoff by examining the tradeoffs among expected profit, variability of profit, profit inefficiency, and insolvency risk for large US banking organizations in the early 1990s. The study found that when organizations are larger in a way that geographically diversifies, especially via interstate banking that diversifies macroeconomic risk, efficiency tends to be higher and insolvency risk tends to be lower.³⁶

The risk profile of IFIs is distinctively different from the risk profile of a conventional commercial bank. As opposed to a conventional deposit-taking financial intermediary, an IFI's exposures are of special nature of contract between depositors (investors) and the financial intermediary and due to the type of

³¹ Danthine (2001).

³² Demsetz and Strahan (1997).

³³ De Nicoló (2003).

³⁴ Demsetz and Strahan (1997).

³⁵ Danthine (2001).

³⁶ Hughes et al., (1999)

instruments used on the assets side which exclude fixed-income securities.³⁷ Unlike a depositor of a conventional commercial bank, a depositor of an IFI is treated as an investor who instead of earning a pre-determined interest rate, shares profits and losses of the bank's investments. Absence of debt securities changes the composition of the asset side as well which is heavily concentrated in asset-backed securities linked to trade-related obligations. An additional dimension of complexity comes into picture due to non-availability of hedging instruments or derivatives.

Credit risk or counter-party risk of an IFI stems from risk inherent in some instruments, especially in the sale or trade finance instruments such as deferred payment and delivery contracts combined with a mark-up (*murābahah*) financing. Furthermore, IFIs are particularly vulnerable to liquidity risk given the constraints they face in using conventional money market instruments, considered not to be shari'ah compliant. The quality of management and operational processes raises high operational risks for IFIs as well. Several studies have identified specific risks in the area of governance, transparency and harmonization of standards which needs special attention.

Consolidation of IFIs can lead to better risk management through diversification, enhanced quality of management, reduced operational risk and lower systematic risk. Diversification benefits can come from both geographical and product diversification. On the liabilities side, depositor-base in the form of investment accounts can lead to diversification as a result of geographical expansion. At present, IFIs heavily rely on maintaining good relationships with the depositors to earn depositors' loyalty. However, this relationship can be put to a test during a distress or changing market conditions when depositors tend to change loyalties and shift to large financial institutions which are perceived to be safer.

This risk of losing depositors raises a more serious exposure termed as 'displacement risk'.³⁸ Displacement risk refers to a situation where, in order to remain competitive, an IFI pays its investment depositors a rate of return higher than what should be payable under the "actual" terms of the investment contract by foregoing part or all of its equity-holders' profits which may adversely affect its own capital. An IFI engages in such self-imposed practice to induce investment account holders not to withdraw their funds to invest them elsewhere. Through geographical diversification of deposit base, an IFI can reduce its exposure to displacement or withdrawal risks. With the changing face of the banking business and introduction of internet based banking, achieving a high degree of geographical diversity on the liabilities side is conceivable and should be encouraged.

Diversification has benefits for IFIs on the assets side as well. Diversification on the asset side can reduce the variance of the returns that accrue to claimholders

³⁷ For further details, see El-Hawary, Grais, and Iqbal (2004) and Khan and Ahmed (2001).

³⁸ AAOIFI (1999).

of the financial intermediary; this is beneficial when depositors are risk-averse or if there are bankruptcy costs.³⁹ Geographical spread of products can further help an IFI improve its credit risk by selecting the best credit quality of borrowers and avoiding weak credit quality. Further diversification benefits can come from a more diverse mix offered by extending the scope of products and services as discussed earlier.

Data in **Table 3** which shows assets composition of IFIs clearly indicates that IFIs' asset side is concentrated in handful of products and is convincingly not diversified. In terms of sector allocation, average financing activities of IFIs have been primarily trade oriented (32 percent) followed by sectors like industry (17 percent), real estate (16 percent), services (12 percent), agriculture (6 percent) and others (17 percent).⁴⁰ Due to the small size, IFIs often concentrate on few select sectors and avoid direct competition. For example, an IFI may specialize in agriculture sector financing whereas another might do the same in the construction sector without attempting to diversify to other sectors. This practice makes IFIs vulnerable to cyclical shocks in a particular sector. Dependency on few select sectors or lack of diversification increases an IFI's exposure to new entrants in the same sector, especially by foreign conventional banks who are better equipped to meet these challenges. With increased size through consolidation, IFIs can break sector level concentration and get immunity to exposures by benefiting from less perfectly correlated risks.

Consolidation can also lead to enhanced management quality of IFIs. It is not surprising that Hassan and Bashir (2004) found a negative correlation between big size and level of profitability in select Islamic banks. This counter-intuitive finding can be attributed to deteriorating capacity, ability, and quality to manage large scale institutions ultimately introducing inefficiencies and lower profitability. Different nature of financial instruments requires different skills and training. Professionals trained in conventional banking are abundant in supply but availability of a professional with deep understanding of the principles of Islamic finance and *shari'ah* to some extent is scarce. This shortage of professionals exposes IFIs to management and operational risk. According to a study using a survey methodology, 40 to 70 percent of bankers surveyed indicated that the lack of knowledgeable bankers in selecting, evaluating and managing profitable projects is a significant reason for Islamic banks in Malaysia not to engage in equity-financing projects.⁴¹

Operational risk which arises due to failure of systems, processes and procedures is another risk high on IFIs' scorecard. A survey conducted by Khan and Ahmed (2001) found that the operational risk was ranked second by the

³⁹ Cerasi (1996).

⁴⁰ Kahf (1999).

⁴¹ Samad and Hassan (1999).

Islamic bankers when asked to rank what risks they perceived. Weak internal control processes may present operational risks and expose an IFI to potential losses. For instance, an internal control problem cost the Dubai Islamic Bank US\$50 million in 1998, when a bank official did not conform to the bank's credit terms. This also resulted in a run on deposits in the magnitude of US\$138 million, seven percent of the bank's total deposits, in just one day.⁴² Due to small size, an IFI is often unable to afford high cost management information systems or the technology to assess and monitor risk on timely fashion. With weak management and lack of proper risk monitoring systems, IFIs' exposure is definitely high and one way to reduce this exposure would be to join forces through consolidation to achieve a threshold of scale to afford an infrastructure of robust technology and be able to retain high quality managers through competitive compensation. After consolidation, managerial efficiency of IFIs can improve; as with increased scale, institutions will be able to afford and implement a formal management training programs. Efficiency in managing risk can also be achieved through improved technology and risk monitoring models and systems necessary to stay competitive in the market.

There are several indirect benefits which an IFI may enjoy as a result of a well-diversified portfolio, and the perception of a well-managed institution. An institution can lower its cost of funding because markets tend to view such institutions as safer and of lower risk due to better risk diversification. At present, IFIs are forced to invest in assets of short maturity due to limited opportunities for longer maturity assets. A cursory view of data on the asset maturities collected from six Islamic banks as of 2003 show that 54 percent of their assets had a maturity of less than one year and 39 percent of less than 6 months.⁴³ IFIs tend to not to invest in longer maturity due to lack of liquidity of medium- to long-term assets. However, with diversification, IFIs will be able to extend maturity frontier and will be able to add value to their clients.

Diversification and risk management are closely associated with the degree of market incompleteness. In case of high market incompleteness, financial intermediaries are in better position to provide diversification and risk management for the client because the responsibility of risk diversification shifts from the investors to financial intermediary. Financial intermediaries are considered to be better in providing inter-temporal risk management.⁴⁴ Keeping in view the nature of financial intermediation in Islamic financial system, it is time that IFIs pay due attention to risk management aspect of the intermediation. This can be achieved by developing close relationship with the borrowers to promote close monitoring and

⁴² Warde (2000).

⁴³ Data were collected from the 2003 annual reports of the following banks: Kuwait Finance House, Al-Baraka, Al-Tawfeek, Dubai Islamic Bank, Al Rajhi, and National Bank of Sharjah.

⁴⁴ Allen and Gale (1999).

by collaborating with the borrowers to develop risk culture to reduce exposure of the clients which indirectly will reduce intermediary's exposure.⁴⁵ Monitoring becomes vital in cases where IFIs invest in equity-based instruments and a small size institution may not be equipped to conduct thorough monitoring due to limited resources. However, a large size institution may develop processes, systems and adequate training to undertake effective monitoring.

Preceding discussion can be summarized to argue that IFIs can benefit from consolidation in several ways. Expanding the scale of operations is not sufficient and it is essential that IFIs expand the scope of their products and services to meet the challenges of domestic and international markets and to sustain current levels of growth. An increase in scale and scope through consolidation can provide IFIs necessary threshold to justify building a solid infrastructure for new services on both sides of the balance sheet. There is no question that consolidation can bring benefits to IFIs through diversifications and through enhanced management quality as well as efficiency gains from prudent risk taking, monitoring and management.

Consolidation does not come without any costs. The following **section** discusses the impact and effects of consolidation of financial services on policy making.

5. POLICY IMPLICATIONS

Empirical studies on assessing the effects of consolidation have yielded mixed results. Empirical analysis has fallen short of finding a comprehensive evidence of gains in profitability and expected increase in profitability after consolidation appears to be illusory.⁴⁶ Consolidation has also been unable to deliver the claims of increased efficiency due to economies of scale. However, there are several other arguments in favor of consolidation which are applicable and relevant to emerging or developing markets such as Islamic financial services as discussed in **Section 4**. The restructuring of financial services industry is a challenge for financial service providers and for regulators. These challenges have direct implications on the decision- and policy-making of the management of the financial services providers and the regulators and the supervisors.

The management of IFIs interested in pursuing a policy of expansion through consolidation needs to avoid certain pitfalls and to factor in the following issues in their ultimate decision-making process:

- (a) Policy of consolidation should be part of a strategic plan and not just for the sake of empire building. Management should have clear vision of the objectives to be achieved through consolidation. Consolidation decision

⁴⁵ Iqbal (2003).

⁴⁶ Marcus (2000) points out that banks profitability has fallen in 12 countries despite a wave of consolidation. A study by the US Federal Reserve concluded that 50 percent of mergers by big banks in the United States of America eroded returns, whereas only 17 percent produced positive returns.

should take into account the changing legal, economic and financial environment and how it will impact the future of the consolidated institution.

- (b) Benefits of consolidations are directly related to overall market size. Management should carefully review target market size and the economy size to make an assessment of available capacity. It is conceivable that due to the small size of the economy, large banks may not be able to create enough business to optimally utilize their resources and minimized costs.⁴⁷
- (c) IFIs should be aware of potential difficulties arising in consolidating different systems and management styles and cultures. The increasing number of decision-making centers and structural differences may affect the efficiency of internal control systems. Many conventional banks experienced difficulties in integrating technology and systems after consolidation which resulted in increased level of operational risk after consolidation.
- (d) If IFIs' main motive to consolidate is to benefit from diversification, IFIs will require investing in developing the state of the art risk monitoring and management systems. Some of IFIs' products carry high credit risk and monitoring costs which will require robust internal systems to monitor and manage such risks. Special attention must be paid to prudent management of credit risk to avoid undue concentrations of risks to individual entities, associates, industries, geographical areas, sectors or financial products and services. Management should be ready to bear to the cost of sophisticated risk models and technology.
- (e) IFIs' management should be aware that diversification gains can be easily offset by an increase in risk appetite in *post-consolidation* period. Institutions tend to pursue the policies of undertaking additional risks to extend expected returns which can lead to an increase in overall riskiness of the institution. Management should try to restrain the incentive to take risk and follow a policy of manageable risk.
- (f) IFIs should ensure that they have skillful managers who have experience with the management of large scale institutions. Otherwise, potential benefits from consolidation can not be realized and on the contrary, the level of operational risk may increase.

From the regulators' point of view, typical areas of concern associated with consolidation are (i) the possibility that increased moral hazard may lead large financial institutions to being "too big to fail", to liquidate, or to discipline effectively; (ii) reduction in competition that may provide disincentive to firms to improve efficiency; and (iii) an increase in systemic risk due to a highly

⁴⁷ Hussein (2003) makes this observation based on the study of Sudanese Islamic banks.

concentrated industry.⁴⁸ These concerns would be equally relevant to any consolidation movement in Islamic financial services industry. Regulation and supervision of IFIs which pose diverse set of challenges for the policy-makers can raise more specific concerns. Embedding banking and non-banking financial services under one roof by an IFI without any well-defined segregation makes the task of regulation and supervision more complex. Whereas policy makers may like to encourage consolidation of IFIs to achieve benefits from economies of scale and scope, and from diversification, they should also be watchful of the issues which may be applicable to IFIs such as following:

- (a) Systemic financial risk which is most likely to be transmitted to the real economy through the wholesale activities of financial institutions and markets is of concern to regulators in every country.⁴⁹ Systemic risks may increase after consolidation as a result of a higher level of interdependencies, or through excessive concentration of risk, or due to elevated risk-taking incentive of the individual financial institution. Consolidation of IFIs can develop interdependencies as consolidated financial institutions become large and complex. On the assets' side, IFIs may change portfolio composition by investing in other financial or non-financial institutions (such as leasing companies) through *musharakah* (equity) and *muqarbah* (trust financing), which can lead to a complex network of interdependencies. A high degree of interdependency would suggest the potential for higher systemic risks.⁵⁰ Supervisors should have a system to monitor and to detect excessive levels of interdependencies.
- (b) Low degree of disclosure and transparency in Islamic financial services industry can make supervision less effective. Any prudent supervision would be incomplete without reliable data on key financial services and products at the institutional level. A reduction in number of financial institutions through consolidation can have positive impact on bank supervision of IFIs as dealing with less number of institutions will streamline the collection and analysis of data including institutions' interdependencies. Enhanced monitoring and evaluation of individual service provider's data, in combination with data on financial markets, and domestic and international macroeconomic variables, might yield valuable

⁴⁸ De Nicoló (2003).

⁴⁹ Systemic risk is defined here as the risk that credit or liquidity problems of one or more financial market participants creates substantial credit or liquidity problems for participants elsewhere in the financial system.

⁵⁰ Group of Ten (2001) observes increased interdependencies between large and complex banking organizations in the US, Japan, and Europe subsequent to consolidations. These interdependencies include inter- bank loans, market activities such as OTC derivatives, and payment and settlement systems.

insights into risks posed by interdependencies and possibly improve early warning systems for any potential financial crisis.⁵¹

- (c) Financial innovation in pursuit of expanding scope of services may bring additional challenges for regulators such as ensuring that the process of introducing new products is transparent and proper procedures are being followed in terms of product compliance with shari'ah principles. With reduced number of institutions, the regulators' interaction with individual bank's shari'ah board may be at more manageable level which could enhance the effectiveness of compliance and may facilitate development and establishment of standards.
- (d) Policy makers may like to encourage consolidation of IFIs to compete internationally but it may have an effect on competition in domestic financial services. Regulators will have to strike a balance between reduction in competition and the change in the balance of market power after consolidation. Excessive concentration in financial services can lead to exertion of market power and extraction of higher margins and fees, especially in case of emerging markets. Regulators will have to make a judgment on how to maintain distortion free competition in the market to ensure that the consumers receive the highest quality service at the lowest possible costs. What may be the maximum desirable market share for a single IFI will largely depend on the regulator's capacity to manage, the size of the economy and the potential market size for financial services.
- (e) Policy makers in emerging markets should pay attention to the financing needs of small firms who are often neglected when financial institutions grow in size. Advocates of Islamic finance claim that it encourages entrepreneurship and thus contribute to economic development. Increase in size may have negative impact on availability of credit to small businesses and thus may impact development aspect of Islamic finance.
- (f) In order to benefit from diversification, regulators should give consideration to reducing obstacles to the mobility of customers across geographical regions and across financial service providers. For instance, in the case of the Middle East which hosts a large number of IFIs, regulators of different countries will need to collaborate and cooperate to reduce obstacles to the mobility of customers and capital.
- (g) In order to avoid excessive risk concentration by IFIs, supervisors should ensure that the risks of a merged entity should not be more than the risks of the two stand-alone entities and should carefully make assessments of the

⁵¹ Group of Ten (2001).

credit and operational exposures of the merged entity.⁵² To prevent such situation, policy makers will need to closely monitor IFIs' *post-consolidation* risk-taking behavior to detect any potential effect on systemic risk. This may call for establishing a comprehensive monitoring of IFIs' sectors selection, geographic allocation and diversity of financial services at firm as well as system level.

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⁵² De Nicoló (2003) looked at the systemic risk potential in banking by measuring an indicator of joint risk-taking of systematically important banks in sample set of countries and concluded that systemic risk did not decrease with banking system concentration across countries mainly due to the potential of increasing the incentives for financial firms to take on correlated risks, thereby reducing banking system's diversification.

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