An Evaluation of Islamic Banking at Bank Muscat, Oman

Review of Integrative Business & Economics Research

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ABSTRACT

The main objective of the study is to analyze critically the Islamic banking system of Bank Muscat in Oman. The research is mainly based on secondary data collected from the bank. The data gap is filled by the primary data collected through personal interviews with the office bearers of Bank Muscat in Buraimi, Oman. The study reveals that the Bank Muscat has a special line of Islamic banking products and services. Islamic Banking Management at Bank Muscat is a highly professional body. The Islamic Banking Management extends consultations for planning and provides appropriate solutions to the problems as and when arise. The Islamic Banking Management develops Islamic banking activities in accordance with their business plans and strategic trends. The Bank Muscat provides loans and investment to their personal and business customers in addition to everyday banking transactions. Bank Muscat has the ultra modern banking facilities with best service standards and highly qualified male and female professionals.

Keywords: Islamic, banking, products, services.

1. INTRODUCTION

Islamic banking is a banking system that is consistent with the principles of Sharia and its practical application through the development of Islamic economics. A more appropriate term for 'Islamic banking' is 'Sharia compliant Finance'. There are two basic principles behind Islamic banking are the sharing of profit and loss and, significantly, the prohibition of the collection and payment of interest. Collecting interest is not permitted under Islamic law. Sharia prohibits the fixed or floating payment or acceptance of specific interest or fees (known as *riba*, or usury) for loans of money. Investing in businesses that provide goods or services considered contrary to Islamic principles is *haraam* (sinful and prohibited). Due to lack of Islamic practice these principles have been applied in varying degrees by historical Islamic economies. In the late 20th century a number of Islamic banks formed to apply these principles to private or semi-private commercial institutions within the Muslim community. Having access to banking products which are Shari'a compliant is important for many people in Oman and beyond. This is why Bank Muscat has designed a special line of Islamic products and services, ranging from everyday banking transactions to loans and investment for personal and business customers.

An early market economy and an early form of mercantilism, called "Islamic capitalism", were developed between the eighth and twelfth centuries. The monetary

ISSN: 2304-1013 (Online); 2304-1269 (CDROM); 2414-6722 (Print)

economy of the period was based on the widely circulated currency the gold dinar, and it tied together regions that were previously economically independent.

2. OBJECTIVE

The main objective of the research is to give insight about the Islamic banking system at the Bank Muscat in Oman.

3. METHODOLOGY

The research paper is mainly based on secondary data collected through annual reports and the account books of the bank. The data gap is filled by Primary Data collected through the personal interview with the branch manager Buraimi branch of Bank Muscat. Information is also gathered from other printed sources.

Data Collection and Analysis

The secondary data is collected from the website of Bank Muscat. In order to fill the data gap a face–to-face interview has been conducted. The Unit of measurement of response, which are quantifiable, are standardized. The qualitative response to the question are standardized to bring uniformity and symmetry.

4. LITERATURE REVIEW

There are several researches carried out on financial performance analysis worldwide summary and findings of some of those main researches are mentioned below:

Kablan, S and Yousfi, O (2011) analyzed Efficiency of islamic and conventional banks in countries with islamic banking**.** The study found that they were efficient at 78.9%. The level of efficiency could however vary according to regions. Asia displays the highest score with 84.64%. Indeed, country like Malaysia and Pakistan implemented reforms in order to allow Islamic banks to better cope with the existing financial system. On the contrary countries with Islamic banking system do not necessarily display efficiency scores superior to the average.

Thorsten Beck, Asli Demirgüç-Kunt & Ouarda Merrouche (2010) in his paper **Islamic vs. Conventional Banking** discusses Islamic banking products and interprets them in the context of financial intermediation theory. The study found that many of the conventional products can be redrafted as Shariacompliant products, so that the differences are smaller than expected. Comparing conventional and Islamic banks and controlling for other bank and country characteristics, the authors find few significant differences in business orientation, efficiency, asset quality, or stability.

Hempel and Simonpson (1998) have made a study on bank's financial performance and managerial efficiency in Taiwan. The study found that the higher the ROA, the higher is the financial performance or profitability of the banks.

Samad and Hassan (2000) evaluate Inter-temporal and Interbank Performance in profitability, liquidity, risk and solvency, and community involvement of an Islamic bank (Bank Islamic Malaysia Berhad (BIMB) over 14years for the period 1984-1997. The study is inter-temporal in that it compares the performance of BIMB between the two time period 1984-1989 and 1990-1997. To evaluate interbank performance, the study compares BIMB with two conventional banks (one smaller and one larger than BIMB) as well as with eight conventional banks. Using financial ratios to measure these performance and F-test and T-test to determine their significance, the results show that BIMB make statistically significance improvement in profitability during 1984-1997,

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however, this improvement when compared with conventional banks is lagging behind due to several reasons. The study reveals that BIMB is relatively less risky and more solvent as compared to conventional banks. These results also conform to risk-return profile that is BIMB is comparatively less profitable and less risky. Performance evaluation of BIMB indicates that it is more liquid as compared to the group of eight conventional banks.

Abdus Samad (2004) in his paper examines the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks during the post Gulf War period 1991-2001. Using nine financial ratios in measuring the performances with respect to (a) profitability, (b) liquidity risk, and (c) credit risk, and applying Student's t-test to these financial ratios, the paper concludes that there exists a significant difference in credit performance between the two sets of banks. However, the study finds no major difference in profitability and liquidity performances between Islamic banks and conventional banks.

Ahmad and Hassan (2007) analyzed the asset quality, capital ratios, operational ratios such as net profit margin, net interest income, income to asset ratio, non-interest income to asset ratio and liquidity ratios for seven years from 1994 to 2001. Islamic banks on an average were the preeminent performer in terms of lowest non-performing to gross loan ratio, capital funds to total asset ratio, capital funds to net loans ratio, capital funds to short-term loan ratio, capital funds to liabilities ratio, non-interest expense to average asset ratio and most of the liquidity ratios. Therefore, it can be concluded that Islamic banks are outperforming others in capital adequacy and adequate liquidity. Except Return on Equity Ratio, Islamic Banks were at par with the industry in all other cases.

Saleh and Rami (2006) in order to evaluate the Islamic banks' performance in Jordon examine and analyze the experience with Islamic banking for the first and second Islamic bank, Jordan Islamic Bank for Finance and Investment (JIBFI), and Islamic International Arab Bank (IIAB) in Jordon. The study also highlights the domestic as well as global challenges being faced by this sector. Conducting profit maximization, capital structure, and liquidity tests as performance evaluation methodology, the paper finds several interesting results. First, the efficiency and ability of both banks have increased and both banks have expanded their investment and activities. Second, both banks have played an important role in financing projects in Jordan. Third, these banks have focused on the short-term investment. Fourth, Bank for Finance and Investment (JIBFI) is found to have high profitability. Finally, the study concludes that Islamic banks have high growth in the credit facilities and in profitability.

By going through the literatures it is found that there are many good researches carried out on Islamic Banking but there are no research carried out on the topic An Evaluation of Islamic Banking at Bank Muscat, Oman. Therefore the research work will add knowledge to the existing knowledge.

5. EMPIRICAL INVESTIGATION

Mirza Basheer-ud-Din Mahmood Ahmad was perhaps the first person to discuss Islamic economics in detail in his books *Nizame Nau* (1942) and *Islam ka Iqtisadi Nizaam* (1945). Later work included that of Naeem Siddiqi, Maulana Maududi and Muhammad Hamidullah. The *Iqtisaduna* (Arabic: "Our Economics") is a major work on Islamic economics by a prominent Shia cleric Muhammad Baqir al-Sadr. Written between 1960 and 1961, it is al-Sadr's main work on economics, and still forms much of the basis for modern Islamic banking.

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They have all recognised the need for commercial banks and their perceived "necessary evil," have proposed a banking system based on the concept of Mudarabha - profit and loss sharing.

In the next two decades interest-free banking attracted more attention, partly because of the political interest it created in Pakistan and partly because of the emergence of young Muslim economists. Works specifically devoted to this subject began to appear in this period. The first such work is that of Muhammad Uzair (1955). Another set of works emerged in the late sixties and early seventies. Abdullah al-Araby (1967), Nejatullah Siddiqi (1961, 1969), al-Najjar (1971) and Baqir al-Sadr (1961, 1974) were the main contributors.

Modern Islamic Banking

The early 1970s saw greater institutional involvement. The Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, the First International Conference on Islamic Economics in Mecca in 1976, and the International Economic Conference in London in 1977 were the instrumental as the involvement of institutions and governments led to the application of theory to practice and resulted in the establishment of the first interest-free banks. The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process. Dr. Sami Hassan Homoud, a Jordanian (1976) who made his PhD in Islamic Banking, was the first one to write about Morabaha, and he established the Jordanian Islamic Bank in 1978.

The first modern experiment with Islamic banking was undertaken in Egypt undercover without projecting an Islamic image—for fear of being seen as a manifestation of Islamic fundamentalism that was anathema to the political regime. The pioneering effort, led by Ahmad Elnaggar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967 (Ready 1981), by which time there were nine such banks in country.

Principles

Islamic banking has the same purpose as conventional banking: to make money for the banking institute by lending out capital. But that is not the sole purpose either. Adherence to Islamic law and ensuring fair play is also at the core of Islamic banking. Because Islam forbids simply lending out money at interest, Islamic rules on transactions (known as *Fiqh al-Muamalat*) have been created to prevent this perceived evil. The basic principle of Islamic banking is based on risk-sharing which is a component of trade rather than risk-transfer which is seen in conventional banking. Islamic banking introduces concepts such as profit sharing (*Mudharabah*), safekeeping (*Wadiah*), joint venture (*Musharakah*), cost plus (*Murabahah*), and leasing (*Ijar*)

In an Islamic mortgage transaction, instead of lending the buyer money to purchase the item, a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, the bank's profit cannot be made explicit and therefore there are no additional penalties for late payment. In order to protect itself against default, the bank asks for strict collateral. The goods or land is registered to the name of the buyer from the start of the transaction. This arrangement is called Murabahah.

Another approach is EIjara wa EIqtina, which is similar to real estate leasing. Islamic banks handle loans for vehicles in a similar way (selling the vehicle at a higher-than-market price to the debtor and then retaining ownership of the vehicle until the loan is paid).

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An innovative approach applied by some banks for home loans, called Musharaka al-Mutanaqisa, allows for a floating rate in the form of rental. The bank and borrower form a partnership entity, both providing capital at an agreed percentage to purchase the property. The partnership entity then rents out the property to the borrower and charges rent. The bank and the borrower will then share the proceeds from this rent based on the current equity share of the partnership. At the same time, the borrower in the partnership entity also buys the bank's share of the property at agreed installments until the full equity is transferred to the borrower and the partnership is ended. If default occurs, both the bank and the borrower receive a proportion of the proceeds from the sale of the property based on each party's current equity. This method allows for floating rates according to the current market rate such as the BLR (base lending rate), especially in a dual-banking system like in Malaysia.

There are several other approaches used in business transactions. Islamic banks lend their money to companies by issuing floating rate interest loans. The floating rate of interest is pegged to the company's individual rate of return. Thus the bank's profit on the loan is equal to a certain percentage of the company's profits. Once the principal amount of the loan is repaid, the profit-sharing arrangement is concluded. This practice is called Musharaka.

Further, Mudaraba is venture capital funding of an entrepreneur who provides labor while financing is provided by the bank so that both profit and risk are shared. Such participatory arrangements between capital and labor reflect the Islamic view that the borrower must not bear all the risk/cost of a failure, resulting in a balanced distribution of income and not allowing the lender to monopolize the economy.

Islamic banking is restricted to Islamically acceptable transactions, which exclude those involving alcohol, pork, gambling, etc. The aim of this is to engage in only ethical investing, and moral purchasing. The Islamic Banking and Finance Database provides more information on the subject.

In theory, Islamic banking is an example of full-reserve banking, with banks achieving a 100% reserve ratio. However, in practice, this is not the case, and no examples of 100 per cent reserve banking are known to exist in practice.

Islamic banks have grown recently in the Muslim world but are a very small share of the global banking system. Micro-lending institutions founded by Muslims, notably Grameen Bank, use conventional lending practices and are popular in some Muslim nations, especially Bangladesh, but some do not consider them true Islamic banking. However, Muhammad Yunus, the founder of Grameen Bank and microfinance banking, and other supporters of microfinance, argue that the lack of collateral and lack of excessive interest in micro-lending is consistent with the Islamic prohibition of usury (riba).[34][35]

Fundamentals of Islamic Finance

The term “Islamic banking” refers to a system of banking or banking activity that is consistent with Islamic law (Shariah) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called riba in Islamic discourse. In addition, Islamic law prohibits investing in businesses that are considered unlawful, or haraam (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, which are contrary to Islamic values). Furthermore the Shariah prohibits what is called "Maysir" and "Gharar". Maysir is involved in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future whereas Gharar describes

ISSN: 2304-1013 (Online); 2304-1269 (CDROM); 2414-6722 (Print)

speculative transactions. Both concepts involve excessive risk and are supposed to foster uncertainty and fraudulent behaviour. Therefore the use of all conventional derivate instruments is impossible in Islamic banking.[37] In the late 20th century, a number of Islamic banks were created to cater to this particular banking market.

Riba

The word "riba" means interest, usury, excess, increase or addition, which according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money). The definition of *riba* in classical Islamic jurisprudence was "surplus value without counterpart", or "to ensure equivalency in real value", and that "numerical value was immaterial."

Applying interest was acceptable under some circumstances. Currencies that were based on guarantees by a government to honor the stated value (i.e. fiat currency) or based on other materials such as paper or base metals were allowed to have interest applied to them.When base metal currencies were first introduced in the Islamic world, the question of "paying a debt in a higher number of units of this *fiat* money being *riba*" was not relevant as the jurists only needed to be concerned with the real value of money (determined by weight only) rather than the numerical value. For example, it was acceptable for a loan of 1000 gold dinars to be paid back as 1050 dinars of equal aggregate weight (i.e., the value in terms of weight had to be same because all makes of coins did not carry exactly similar weight).

Usury in Islam

The criticism of usury in Islam was well established during the lifetime of the Islamic prophet Muhammad and reinforced by several verses in the Qur'an dating back to around 600 AD. The original word used for usury in this text was Riba, which literally means “excess or addition”. This was accepted to refer directly to interest on loans so that, according to Islamic economists Choudhury and Malik (1992), by the time of Caliph Umar, the prohibition of interest was a well-established working principle integrated into the Islamic economic system. This interpretation of usury has not been universally accepted or applied in the Islamic world. A school of Islamic thought which emerged in the 19th Century, led by Sir Sayyed, argues for an interpretative differentiation between usury, or consumptional lending, and interest, or lending for commercial investment (Ahmed, 1958). Nevertheless, Choudhury and Malik provide evidence for “a gradual evolution of the institutions of interest-free financial enterprises across the world” (1992: 104). They cite, for instance, the current existence of financial institutions in Iran, Pakistan and Saudi Arabia, the Dar-al-Mal-al-Islami in Geneva and Islamic trust companies in North America.

Mudarabah

"Mudarabah" is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The capital investment comes from the first partner, who is called the "rabb-ul-mal", while the management and work is the exclusive responsibility of the other party, who is called the "mudarib".

The Mudarabah (Profit Sharing) is a contract, with one party providing 100 percent of the capital and the other party providing its specialized knowledge to invest the capital and manage the investment project. Profits generated are shared between the parties according to a pre-agreed ratio. If there is a loss, the first partner "rabb-ul-mal" will lose his capital, and the other party "mudarib" will lose the time and effort invested in the project.

Murabahah

ISSN: 2304-1013 (Online); 2304-1269 (CDROM); 2414-6722 (Print)

This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the default is settled.

This type of transaction is similar to rent-to-own arrangements for furniture or appliances that are common in North American stores. bank does not provide hibah in this type of account.

Islamic Banking at Bank Muscat

Islamic Banking Management is professional and responsible body for extending appropriate solutions and consultations for planning, following-up execution and developing Islamic banking activities in coordination with the relevant bodies in accordance with the strategic trends and business plans planned for the Bank. In addition to developing and offering banking products and services which are Shari'a compliant, following-up implementation by the assistance of pioneer professionals in addition to marketing the same in collaboration with businesses managements related to Bank customers.

All operations of the Bank's Islamic window follow Shari'a guidelines as expressed and outlined by the Shari'a Supervisory Board (SSB). The SSB prepares a report on annual basis to the Shareholders and depositors/investment account holders of the Bank regarding the extent of the Bank's compliance with Shari'a regulations. This report is issued prior to the release of the Bank's published annual accounts. The responsibility for complying with Shari'a guidelines rests with the management of the Bank. The management of the Bank conform Shari'a guidelines and enable necessary controls to ensure compliance.

The Bank has Shari'a Monitoring and Review Department (SMRD) which mainly carry out the following activities:

i. Shari'a compliance review;
ii. Shari'a review;
iii. Advice on issues relating to Shari'a compliance; and
iv. Liaison in matters involving the Shari'a Supervisory Board.

The SMRD have complete and unhindered access to all records, transactions and information from all sources including professional advisers and the Bank's employees. It is the management's responsibility to provide the SMRD and Shari'a Supervisory Board with all the information relating to the Bank's operations and compliance with Shari'a guidelines. The SMRD and Shari'a Supervisory Board don't undertake operational activities of the Bank.The SMRD maintains adequate records of all its correspondence with the Shari'a Supervisory Board and the business and operations team of the Bank.

Shari'a Supervisory Board:

Meethaq Shari'a Board members comprises of five of the most leading scholars in the field of Islamic banking:

i. Sheikh Dr. Ali Qaradaghi
ii. Sheikh Essam Muhammad Ishaq

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iii. Sheikh Dr. Majid Al Kindi
iv. Sheikh Dr. Saeed Mubarak Al-Muharrami
v. Mr. Abdul Kader Thomas

Financing

Meethaq Home Financing

A home is more than just a roof over the head. The Meethaq Home Financing gives the same sense of security and comfort to its customers. Whether the home is already completed or under construction Al Bait Home Financing gives loan for both.

Meethaq Car Financing

Being the pioneer of Islamic Banking in Oman, Bank Muscat gives the perfect package for its customers to drive the car away with Shari'a-compliant car financing product. Meethaq Car Financing is Oman's first Interest Free car financing based on the Islamic financing mode of Murabaha. This product is ideal for individuals looking for car financing while avoiding an interest-based transaction.

Banca Takaful

Takaful basically cultivates a plan to protect a person or his / her loved ones from what lies ahead in the future. The system of Takaful is based on the principles of brotherhood, mutual solidarity and Tabarru, which is encouraged by the Shari'a.

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