Financial Crisis and Omani Commercial Banks: A Performance Review

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Abstract

Purpose – To evaluate the financial performance of the local commercial banks in Sultanate of Oman in the context of the global financial crisis.

Design/Methodology/approach - The paper examines the financial performance of the seven local commercial banks using the CAGR (Compound Annual Growth Rate) approach. The analysis is done by calculating the CAGR of gross loans, customer deposits, fee income, operating profit, net worth, net profit and net interest income during the period from 2005 to 2009.

Findings – The analysis reveals that the performance of the banks are influenced by the orientation and strategy of the management. Some banks are strong in their marketing potential while some are effective in taking care of shareholders' interest by enhancing income and operating profit. However, some banks show their dominance in efficiency or effective cost management. The effect of global financial crisis on the Omani commercial banks has not been significant except for National Bank of Oman (NBO). The study reveals that the local commercial banks show a high degree of resilience and stability.

Research limitations/implications – The study would help the bank managers to assess the resilience, competitiveness and stability of the banking system in Oman and sources of vulnerabilities. The results also reflect the operational orientation of the managers. This research is based on the financial data of the seven banks for only five years due to non-availability of financial information.

Practical implications – The financial performance evaluation would help in establishing the competitiveness and sustainability of the various local commercial banks in Oman. The analysis brings to the forefront the strengths and weaknesses of the various banks and enables the individual banks to identify improvement goals. The findings thus serve as a platform to formulate policies that will help promote effective financial system.

Originality/value - This paper provides an in-depth analysis of the financial performance of local commercial banks which form the backbone of the financial services industry in Oman. The paper helps to assess the health and resilience of the commercial banks in Oman especially during the periods of financial crisis.

Keywords – Banking, financial performance evaluation, Compound Annual Growth Rate, Oman.

Paper type – Research paper.

1. Introduction

Oman's financial system is dominated by banks which account for more than 90 percent of total assets and liabilities of the financial sector as a whole. In Oman, the banking industry has been witnessing significant growth in recent years, mainly due to sustained increase in oil prices, efforts to diversify the economy, implementation of large industrial, real estate and infrastructure projects and growing emphasis on the private sector. Total assets of the commercial banks, which were 4.9bn Rials at the end of 2004, rose to 14.2bn Rials at the end of 2009, indicating an annual average growth of about 38 percent during the last five years. Bank credit constituted bulk of the bank's assets which remained by and large stable in the range of 65-70 percent of the total assets.

The banks play a vital role in the development of the economy. A sound and resilient financial system is an essential precondition to promote sustainable economic development in an open and oil dependent economy like Oman. If competitive and efficient financial systems can promote economic growth, it can also be susceptible to the risks thrown up by the economic forces. Similarly, many of the sources of risk and vulnerability in a financial system could be traced to the performance of the local as well as global economy. However, some of the sources of risk could be entirely internal to specific banks, which may differ widely from bank to bank.

In view of the above, the paper attempts to evaluate the financial performance of the local commercial banks during the period from 2005 to 2009, to assess their financial performance in the context of the global financial crisis.

2. Financial system in Oman

The institutional framework of the financial sector in the Sultanate of Oman comprises the Central Bank of Oman (CBO), commercial banks, specialized banks, non-bank finance and leasing companies and money exchange establishments dealing solely in money exchange business and a few authorised to engage in remittance transactions as well. The Omani banking system has been going through several rounds of mergers since the 1990s with a few bank exits and new entrants, and as at the end of 2009, the number of commercial banks stand at 17, of which 7 are locally incorporated and 10 are branches of foreign banks. The locally incorporated commercial banks are Bank Muscat (BM), National Bank of Oman (NBO), Oman International Bank (OIB), Oman Arab Bank (OAB), Bank Dhofar (BD), Bank Sohar (BS) and Al Ahli Bank (AB).

2.1 Soundness of banking system in Oman

In pursuance of its commitment to adopt global best practices in banking regulation and supervision, the CBO was in the forefront to mandate implementation of Basel II capital adequacy framework since January 2007. The minimum capital requirement for new local banks was raised from 50mn Rials to 100mn Rials and for foreign banks from 10mn Rials to 20mn Rials.

2.2 Impact of global financial crisis on Oman

The global monetary and financial conditions changed dramatically during the course of 2008. After a phase of high economic growth and bullish asset prices, the global economy encountered sharp corrections in asset prices, which in turn led to growing concerns about the health of the financial systems and deceleration in economic growth.

Oman's monetary and financial sector environment in 2008 was characterised by high growth in money and credit, which reflected the pressures of fast expansion in aggregate demand in an economy witnessing strong economic growth. After September 2008, however, the global credit squeeze intensified, limiting the access of local banks to international markets for funds. Sharp downward correction in oil prices commencing from the last quarter of the year, and significant deceleration in global demand conditions and the influence of intensifying economic slowdown and rising unemployment started to gradually affect the economic outlook in Oman till the end of 2009.

In view of the above scenario, there is a need to assess the impact of the global financial crisis on the financial performance of the local commercial banks to evaluate their resilience.

3. Review of literature

Compared with the analysis of monetary and macroeconomic stability, the analysis of financial stability is still in its infancy. There is yet to be widely accepted model or analytical framework for assessing or measuring it (Schinasi, 2005). Financial indicators that could alert policy makers and managers to potential problems in the real economy have only begun to be developed.

Sundarrajan et al. (2002) in their analysis observed that financial soundness indicators (FSIs) are indicators compiled to monitor the health and soundness of financial institutions ad markets, and of their corporate and household counterparts. FSIs include both aggregated information on financial institutions and indicators that are representative of markets in which financial institutions operate. Knight (2006) expresses that FSIs aim to predict banking and currency crises. FSIs can be arrived at by using past information on key aspects of soundness such as capital, earnings, asset quality, etc.

The increasing competition in the national and international banking markets, the change over towards monetary unions and the new technological innovations herald major changes in banking environment, and challenge all banks to make timely preparations in order to enter into new competitive financial environment. Karafolas and Mantakas (1996) in their study of the cost structure and the scale economies in the Greek banking system use variables such as size of assets, capital, labor and technological progress. Spathis et al. (2002) investigated the effectiveness of Greek banks based on their assets size. They used in their study a multi-criteria methodology to classify Greek banks according to the return and operation factors, and to show the differences of the banks profitability and efficiency between small and large banks. Many researchers have focussed on asset and liability management in the banking sector (Richard and Moloney, 2003; Ruth, 2001; Canddy, 2000). The literature suggests that risk management issues and its implications must be concentrated on by the banking industry. Presely (1992) concluded from his study that there is a need for greater risk management in relation to more effective portfolio management, and this requires a greater emphasis upon the nature of risk and return in bank asset structure, and greater diversification of assets in order to spread and reduce the bank's risks.

Arzu, Tekas and Gunay (2005) discussed the asset and liability management in financial crisis. They argued that an efficient asset-liability management requires maximizing bank's profit as well as controlling and lowering various risks, and their study showed how shifts in market perceptions can create trouble during crisis.

Several researchers have studied the impact of financial indicators such as Capital on the financial performance. Capital refers principally to funds contributed by the bank's owners, consisting mainly of stock, reserves and those earnings that are retained in the bank. Diamond and Rajan (2000) show that the benefit of capital in reducing the bank's expected bankruptcy cost. Mehran and Thakor (2009) show theoretically that higher capital leads to a higher survival probability for the bank in dynamic setting. Boot, Greenbaum, and Thakor (1993) show that banks with higher amounts of financial capital have a greater capacity to withstand financial shocks and honor 'illusory promises' like loan commitments which in turn can facilitate the development of their reputational capital which in turn would enhance the market share and profitability especially during times of stress and crisis.

Jahangir, Shill and Hque (2007) stated that the traditional measure of profitability through stockholders' equity is quite different in banking industry from any other sector of business, where loan-to-deposit ratio works as a very good indicator of bank's profitability as it depicts the status of asset-liability management of banks. But banks' risk is not only associated with this asset liability management but also related to growth opportunity. Smooth growth ensures higher future returns to holders and there lies the profitability which means not only current profits but future returns as well. So, market size and market concentration index along with return to equity and loan-to-deposit ratio grab the attention of analyzing the bank's profitability.

Most developing countries have been taking different plans and strategies to their financial sectors. The financial sector in Arab countries has started recently as part of their overall economic plans and growth. However, there is an increasing attempt to develop money capital markets in Arab world. Commercial banks are the most dominant financial institutions in any country. Therefore, local financial institutions and foreign ones have greater opportunity in economic development in the Arab countries. Islam (2003) discussed the development and performance of domestic and foreign banks in Arab gulf countries, and showed that local and foreign banks in these countries have performed well over the past several years. Moreover, he added that banks in these economies are well capitalized and the banking sector is well developed with intense competition among the banks.

In the light of the above literature, this study attempts to evaluate the performance of the Omani commercial banks during the period from 2005 to 2009 in order to assess their competitiveness and growth and to establish the effect of the financial crisis on the banking system.

The rest of the paper is organized as follows: Section 4 describes the variables used in this study and the methodology applied. Section 5 deals with the findings and its discussion. Section 6 presents the conclusion followed by section 7 and 8 which deal with the implications and scope for further research respectively.

4. Methodology

The main objective of this paper is to assess the financial performance of commercial banks in Oman. The focus has been to assess the growth in the financial parameters. Analysis based on growth is done by calculating the CAGR (Compound Annual Growth Rate) of gross loans, customer deposits, fee income, operating profit, net worth, net profit and net interest income during the period from 2005 to 2009. The study has been done among the seven leading local commercial banks which include Bank Muscat (BM), National Bank of Oman (NBO), Bank Dhofar (BD), Oman International Bank (OIB), Oman Arab Bank (OAB), Ahli bank (AB) and Bank Sohar (BS). Ahli Bank (AB) used to be a specialized bank till January 2008 after which it changed to become a commercial bank. Bank Sohar (BS) is a new bank and started its operations in 2007.

The data for the study was sourced from the published financial statements of the banks, their web-sites, Central Bank of Oman reports and other published reports.

5. Findings

The CAGR for the various banks has been calculated for the period 2005 to 2009 except for Oman Arab Bank (OAB) and Bank Sohar. The CAGR measures for OAB have been calculated by excluding data for 2005 due to non-availability. Bank Sohar started its operations in 2007 and hence the data available for the following periods have been considered. The CAGR values calculated for the following seven growth parameters are as follows

Table 1. CAGR values of the Financial Indicators

Growth parameters / Banks	Gross loans	Customer Deposits	Fee Income	Operating Profit	Net Worth	Net Profit	Net Interest Income
BM	22.29	18.90	24.66	28.91	19.98	10.16	17.44
NBO	17.58	15.39	24.56	17.43	8.31	0.75	13.42
BD	19.54	19.49	17.77	19.28	20.77	12.33	15.07
OIB	3.22	2.06	7.82	0.26	8.41	-0.46	-0.41
OAB	13.60	15.29	21.40	13.09	14.57	11.17	9.00
BS	37.68	50.17	7.39	60.83	28.53	-	82.12
AB	27.10	60.68	52.58	12.02	23.85	14.10	13.74

Gross loans are the loans and advances including the impairment provision. They are by far the largest asset item for a bank. Table 1 lists the Compound Annual Growth Rate (CAGR) of gross loans for the seven banks considered. The new commercial banks – Bank Sohar (37.6%) and Ahli Bank (27.1%) – seem to perform better than the others in this parameter. Among the other five main banks, Bank Muscat (22.2%) has the highest growth in gross loans followed by Bank Dhofar (19.5%), NBO (17.5%), OAB (13.6%) and OIB (3.2%) in that order.
Customer deposits are the principal liability of any bank. It represents financial claims held by businesses, households, and governments against the bank. The growth in customer deposits again is the best for Ahli Bank (60.68%) and Bank Sohar (50.1%). Bank Dhofar (19.4%) tops the table among the five main banks followed closely by Bank Muscat (18.9%) and then NBO (15.3%) and OAB (15.29%) are at almost the same level. OIB's growth (2%) has been the least.
The fee and commission income is what the bank earns from a diverse range of services it provides to its customers. The growth in fee income is found to be highest for Ahli Bank (52.58%). Bank Muscat (24.6%) and NBO (24.5%) are in the second and third position respectively. OAB follows with 21.4% growth and next comes Bank Dhofar with 17.7%. Bank Sohar has the least growth of 7.3% on this measure.
Considering the CAGR for operating profit of the seven banks, it is interesting to note that though Bank Sohar (60.8%) had the minimum growth in fee income, its growth in operating profit is the highest. This can be due to high growth in net interest income. Bank Muscat (28.9%) comes next followed by Bank Dhofar (19.2%), NBO (17.4%), OAB (13%), Ahli Bank (12%) and OIB (0.26%) in that order.
Net worth is the owner's investment in the institution. Hence, here net worth has been considered equal to the total equity. As market interest rates change, the value of both a financial institution's assets and liabilities will change, resulting in a change in its net worth. The net worth of Bank Sohar (28.5%) and Ahli Bank (23.8%) are the highest indicating high growth of equity as part of the assets. Out of the five main banks, Bank Dhofar (20.7%) has the highest growth in net worth followed closely by Bank Muscat (19.9%) and OAB (14.57%). OIB (8.4%) and NBO (8.3%) have the least growth.
Growth in net profit was the highest for Ahli Bank (14%), followed by Bank Dhofar (12.3%), OAB (11.1%), Bank Muscat (10.1%). NBO's CAGR of net profit was 0.75% only due to the impairment provisions as per the Central Bank of Oman directives (Singh and Karra, 2010) towards exposure to Dubai world and the banks in Bahrain. OIB's growth rate was negative and the value for Bank Sohar could not be determined due to losses.
The CAGR of net interest income for the seven banks shows that net interest income growth was substantial for Bank Sohar (82.1%) followed by Bank Muscat (17.4%), Bank Dhofar (15%), Ahli Bank (13.7%), NBO (13.4%), OAB (9%) and lastly OIB (-0.4%).

6. Discussion

The results of the analysis show that the growth of the financial indicators has been quite high for the two new commercial banks – Bank Sohar (BS) and Ahli Bank (AB). This may be attributed to their new entrance into commercial banking. However, their performance cannot be compared to the five main banks namely Bank Muscat (BM), National Bank of Oman (NBO), Bank Dhofar (BD), Oman International Bank (OIB) and Oman Arab Bank (OAB) which have been operational for many years in Oman.
The performance ranking of the five banks on each of the growth parameters are as follows:

Table 2. Summary of the Growth Parameters of the five main Banks

Parameters	Evaluation criteria	Bank Muscat	NBO	Bank Dhofar	OIB	OAB
Growth parameters						
Gross loans	CAGR('05-'09)	1	3	2	5	4
Customer Deposits	CAGR('05-'09)	2	3	1	5	4
Fee Income	CAGR('05-'09)	1	2	4	5	3
Operating Profit	CAGR('05-'09)	1	3	2	5	4
Net Worth	CAGR('05-'09)	2	5	1	4	3
Net Profit	CAGR('05-'09)	3	4	1	5	2
Net Interest Income	CAGR('05-'09)	1	3	2	5	4
Total Score		**11**	**23**	**13**	**34**	**24**

On comparing the growth in the financial indicators it can be seen that out of the five main banks, Bank Muscat and Bank Dhofar put up promising performance.

Bank Muscat puts up consistently superior performance in almost all parameter except net profit, customer deposits and net worth. It is interesting to note that though Bank Muscat ranks first on growth in operating profit, it stands third on the growth of net profit. This could be attributed to higher depreciation and amortisation/impairment provision on account of higher fixed assets like building and branches. Lower growth in net profit, in turn, explains for the lower net worth values. It can also be noted that the growth in customer deposits is second indicating that there is some deficiency in marketing for deposits. This could be an area for improvement. However, the leveraging function of the bank is appreciable as it ranks first in growth of gross loans in spite of lower growth in deposits and net worth. The marketing function for loan disbursements is found to be more effective here. It can be concluded that the financial crisis did not have much effect on the performance of Bank Muscat.

Bank Dhofar puts up a promising performance in the growth of deposits, net worth and net profit. In terms of growth of operating profit it ranks second, however the growth in net profit is the best among all the five main banks. This could be attributed to the bank's better control on costs when compared to Bank Muscat. Bank Dhofar also has been successful in getting more deposits, though it lags behind in disbursement of loans resulting in lower growth in Fee income and net interest income thereby affecting the operating profit. The results indicate that the bank has been largely unaffected by direct influence of the financial crisis.

For NBO, all growth parameters are low. Especially the growth in net worth and net profit has been disappointing due to the impairment provisions as per the Central Bank of Oman directives towards exposure to Dubai World and the banks in Bahrain (Singh and Karra, 2010).

Performance of OAB has been lack lustre except for the growth in the net profit. The performance on net profit could be because of their effective cost management and lower depreciation and amortisation costs on fixed assets or buildings. OIB has put up the worst performance on almost all the financial indicators calling for an immediate revamp of its orientation, operations and management. The financial crisis does not seem to have affected OAB and OIB much.

7. Conclusion

The resilience of the banking system and individual banks is of utmost importance to a developing country like Oman where banks are the primary financiers for the infrastructure and other growth projects. The financial performance of the banks take additional importance in the context of vision 2020 of the Oman of private sector especially the commercial banks towards diversification of Oman's economy. The analysis reveals that the banks' performance is influenced by the orientation and strategy of the management. Some banks are strong in their marketing potential while some are effective in enhancing income and hence operating profit. However, some banks show their dominance in efficiency or effective cost management.

The direct effect of global financial crisis on the Omani commercial banks has been minimal except for National Bank of Oman (NBO). The study reveals that the local commercial banks show a high degree of resilience and stability. The findings also offer practical help to managers by providing directions for improvement.

8. Implications

a. The analysis can help the managers of the various commercial banks to assess the gap in the various parameters and hence enables the identification of weaknesses to overcome and the strengths to build on.
b. The study can be a source of help to the bank managers in strategy formulation to improve their financial performance and formulate policies that will promote effective financial system.

9. Future scope of research

a. In the future studies, analysis can be conducted to compare performance of large and small banks in Oman. This would help to establish the factors that influence the competitiveness of larger banks from the smaller banks and hence enable better grasp of factors that contribute to the success.
b. Islamic banking is just going to begin in Oman from the first or second quarter of 2012. A comparative study in the future on the performance of the traditional commercial banks, commercial banks offering Islamic banking products and exclusively Islamic banks can be taken up to learn about the factors critical for growth and performance.
c. The performance of the Omani commercial banks can be compared with the banks in the other GCC countries to assess their competitiveness and for formulating new strategies for improvements.

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