

# PERFORMANCE MEASUREMENT SYSTEM IN ISLAMIC BANK: SOME ISSUES AND CONSIDERATIONS

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## Abstract

*There are various evidences show that business that complied with Islamic laws, i.e. Islamic business has succeeded. Islamic bank is the most prominent model of Islamic business that is acknowledged widely which could be proven by its existence in many countries, whether in Muslim majority countries or non-Muslim majority countries. As Islamic banks grow rapidly, an issue that needs to be addressed is regarding performance measurement in Islamic bank. However, even though there are many studies on Islamic banking, issues of performance measurement in Islamic bank receive very little attention among researchers. In fact, research on performance measurement in service sector is very rare compared to the manufacturing sector. The purpose of this article is to discuss issues on performance measurement in Islamic bank. As a banking system that based on Islamic tenets, Islamic bank is supposed to have certain unique criteria of performance. Some models of performance measurement commonly used in conventional banks will be analyzed to determine whether they are applicable in Islamic banks. Some issues will be discussed as well regarding the establishment of Islamic performance measurement model that can reflect comprehensive effectiveness that meets Islamic requirement of performance.*

**Keywords:** *performance measurement system, Islamic bank, criteria of performance, Islamic performance measurement model*

## Introduction

Islamic banking system has gained momentum worldwide with the existence of many Islamic banks in various countries. According to Moody's, a global rating agency, in 2006 there were 250 Islamic mutual funds with \$300 billion worth of assets under management and 300 Islamic Financial Institutions (IFIs) holding over \$250 billion of deposits (Siddiqi 2006). In addition, \$200 billion in assets is managed by dedicated Muslim "windows" or subsidiaries of conventional banks. However, the total amount (\$750 billion) has been described by Moody's Investors Service as essentially a "conservative estimate". Islamic-structured funds are on track to break the milestone \$1 trillion mark by the end of this decade (Siddiqi 2006). The development of modern Islamic bank can be traced back to The Muslim Brotherhood Movement in the Egypt in 1928 and an Islamic finance pioneer, i.e. Ahmad al-Najjar, who established one of the earlier known Islamic bank in the world (Hegazy 2007). The contribution of Muslim Brotherhood Movement can be seen from its platform that is concerned primarily with social and economic reform, with the emphasis on Islamic values in business practices and its endeavor to abolish economic activities that are not adhering to Islamic law.

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Further, the first Islamic bank in the world, Mit Ghamr Local Savings Bank, was established by Ahmad Al-Najjar in Egypt in 1963. Even though its operation was based on Islamic tenet, the formal mission of Mit Ghamr Local Savings Bank was set under socialism slogan, as Najjar put it, the “objective was to initiate an experiment that operates in accordance with the economic teachings of the Qur’an and the teachings of the Prophet (Sunnah), even if we had to do so under the slogan of social justice or development, as mentioned in the bank’s charter.” (Hegazy 2007). The government approved on Mit Ghamr bank because the Egypt’s’ government adopted socialism during the early 1960,s and it encouraged the establishment of financial institutions that promote public savings behaviors. This coincided with one of main objectives of the Mit Ghamr initiative that encouraged savings among middle- and low-income classes (Hegazy 2007).

By the early 1970s, Islamic banks grew massively in many countries due to the unprecedented oil boom that made the Arab oil producing countries gained vast amount of financial resource, this coincide with the rise of political Islam throughout the Muslim world (Ariff 1988; Hegazy 2007). These circumstances boosted the morale of Islamic movements and increased the demands for the Islamization of the financial system. As a result, some Islamic banks whether they appeared in Islamic banner or just in spirit of Islam, was beginning to flourished in the Middle East, such as the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Sudan (1977), the Faisal Islamic Bank of Egypt (1977), and the Bahrain Islamic Bank (1979) (Ariff 1988). The rise of Islamic banking was also happened in other regions especially those both in the Muslim majority population such as in South East Asia (Indonesia and Malaysia) and also in the non-Muslim majority population such as Philippine, India, Luxemburg, Denmark, and Australia (Ariff 1988; Rizqullah 2006). The logical consequences of the vast growth of Islamic banks are that they face strong competition not only from other Islamic banks but also from the conventional banks (Naser & Moutinho 1997). The increase in the level of competition leads a company need to pay more attention to its performance in areas such as quality of service, flexibility, customization, innovation, and rapid response (Neely 1999). However, such reality should not constitute an excuse for shying away from the proper legal application of Islam, i.e. shariah (Mallat 2003).

Due to the rapid growth of Islamic banking, researches and articles on Islamic banking have been undertaken such as review on the progress in developing Islamic banking (Mirakhor 1997). Unfortunately, there is only very few researches that examine performance measurement and management system in shariah banking. In fact—in more general areas—although several studies have investigated performance measurement in manufacturing company, but there is still little studies about this phenomenon in the non-manufacturing sector such as banks, despite the service sector contributing an important part of gross domestic product and employment in most advanced economies (Hussain & Hoque 2002; Hussain & Islam 2003; Hussain 2005).

This reality is astonishing considering the importance of performance measurement and dynamic discourse about it. Neely (2002) noted that new report and articles on the topic have been appearing at a rate of one every five hours of every working day since 1994. Marr & Neely (2001), as quoted by Marr & Schiuma (2003), found that internet searches on the topic reveal more than 12 million sites dedicated to business performance measurement. Halachmi (2005), by using Google, found 2.6 million entries of performance measurement in 2004.

Limited research of performance measurement in banking is also astonishing because banking is a backbone of an economy system. Banking failures have stronger adverse effects on economic activity than other business failures (Gilbert *et al.* 2000). However, Smith (1998) argued that measurement of performance in service industries is particularly problematical because many of the outputs are intangible and traditional success measures may be deemed inappropriate. In fact, in Islamic perspective, performance measurement is strongly encouraged (Qur'an 59:18), because all human being will be rewarded by God in the hereafter according to their deed during their life in the world (Qur'an 99:6-8; 101:6-9). Therefore, the Prophet Muhammad encouraged Muslim to evaluate themselves at the end of each day: what has he/she done at the day, why has he/she done it, what has he/she omitted, and why has he/she omitted it? Further, the Prophet Muhammad praised the person who constantly performs self-assessment on his/her deeds and ensures that all his/her actions are geared for his/her life after death as the most intelligent person. In a hadith narrated by Imam Tirmizi, Rasulullah s.a.w said:

“The intelligent person is the one who constantly performs self-assessment on his deeds, and ensures that all his actions are geared for his life after death. On the other hand, a careless person is one who follows his wanton desires, but at the same time wishes all good rewards from Allah.”

Hence, a proper performance measurement system for Islamic bank needs to be established to control and to evaluate Islamic bank in order to keep in line with the shariah (Islamic jurisprudence). Some measures and criteria that represent performance in Islamic perspective also need to be crystallized in order to be able to determine the achievement of performance of an Islamic bank. In doing so, Islamic values undoubtedly must be placed as the main source among other sources.

#### **Islamic Bank and Performance Dimensions in Islamic Perspective**

As a bank that rely its operation on Islamic values, Islamic bank is supposed to have certain criteria of performance. Such criteria must refer to the goals of Islamic economic order. Chapra (1992) summarized the goals of Islamic economic order are:

1. Economic well-being within the framework of the moral norms of Islam
  2. Universal brotherhood and justice
  3. Equitable distribution of income
  4. Freedom of the individual within the context of social welfare
- Hence, Islamic bank is not merely a financial institution serving their clients by securing their funds, but it also plays an important role in enhancing social welfare. In other word, according to Choudury & Hussain (2005), Islamic bank, based on the shariah, is one of the development institutions that playing an important role in the economic and moral uplift of the Islamic society or community. Islamic banks should cooperate between themselves and with other national institutions in accordance with the spirit of cooperation upheld by the shariah for the benefit of the community (Choudury & Hussain 2005).

From those Islamic economic goals, it can be determined more clearly performance dimensions of Islamic business. First, Islam allows seeking financial profit for prosperity purpose (Qur'an 62:10). Profit seeking is the main reason for establishment of business organization. Islam acknowledges this purpose. Profit generation makes a business organization maintain its sustainability. Islam only determines the norms that must be obeyed in seeking profit. Hence, it is concluded financial achievement is one of main performance criteria in Islamic business organization.

Second, in doing business, Islam strongly emphasizes the concept of brotherhood and justice (Qur'an 49:13; 5:8). Since business activity is merely an exchange of valuable thing, there should be no winner or loser in business activity. Justice is also one of Islam's missions. Moslem must behave in a just manner in their daily deed. In the context of Islamic bank, it must perform its main function as an intermediary between party that has the financial surplus and party that needs money supply by brotherhood and the spirit of justice. Thus, Islamic bank are also required to identify projects which serve those who have the skills but do not have the money to finance the projects and hence make use of their skills (Al-Harran 1992).

Third, income and wealth must be distributed equitably because all resources are gifts from God to all human being (Qur'an 2:29), it is unacceptable if wealth is only concentrated and circulated among few hands (Qur'an 59:7). It is a major role of Islamic bank to spread out the wealth from the haves to the have not. Finally, the blessing of Islam is to release the human being from—as stated in the Qur'an—the burdens and chain upon them (Qur'an 7:157), i.e. freeing of slaves, feeding during the time of hardship, taking care orphans, and helping the poor who is in need (Qur'an 90:13-16). Islamic bank should play a role in realizing some of these blessing of Islam, e.g. releasing people from poverty through its intermediary function. Through its services, Islamic bank can build productive society that in turn shapes wealthy society.

Hence, performance of Islamic bank is not limited on its internal performance per se, but rather must be linked to performance of society wherein Islamic bank exists. Performance of Islamic bank is good or excellent only if it brings prosperity to society. A good example of a good performance of banking but does not in-line with its society performance is described by Widodo (2008). Taking case in Indonesia, he noted that there is no significant impact of good performance of banks in Indonesia to society's welfare.

In the case, in 2007 the profit of banking grew 23.6% compared to 2006, i.e. Rp.28.3 trillion in 2006 to Rp.35.015 trillion in 2007. Total asset increased from Rp.1,693.85 trillion in 2006 to Rp.1986.5 trillion in 2007. The amount of distributed loans is Rp.792.29 trillion in 2006, and increased to Rp.1,002.01 trillion in 2007 (Widodo 2008). Ironically, the loans were distributed mostly in industry, i.e. 23.28%, compared to fishery and agriculture that received loans only 5.39%. Whereas, the industry sector accommodated only 12.09 million workforce in 2007, compared to agriculture sector that accommodated higher workforce in 2007, i.e. 42.61 million (Widodo 2007). The inequity of loan distribution also happened when agriculture sector compared to property sector. Property sector such as luxurious apartment received Rp.33.069 billion of loan, compared to agriculture sector that only received Rp.11.329 billion of loan (Widodo 2008).

Ideally, performance measurement model for Islamic bank measures should integrate performance both financial and non-financial performance reflecting all those goals of Islamic economic order. It doesn't enough measure performance of Islamic bank per se without link it to its society performance. Therefore, social welfare has to be one of dimension of performance in Islamic bank context. Consequently, a model of performance measurement system that incorporates such dimension needs to be established.

### **Review on Some Conventional Performance Measurement Systems: Islamic Perspective**

This section analyzes further some existing performance measurement model in term of Islamic perspective of performance. We chose budgeting, the Economic Value Added (EVA™), and the Balanced-Score Card as performance measurement models to be analyzed. There are some reasons why we chose those models. First, although budgeting is the oldest model of performance measurement and many critics on it, it is still used in many company, taught in many text book, and still interesting to be researched (see for example: Hansen & Mowen 1998; Riahi-Belkaoui 2002; Stede 2000). Second, since last decade, balanced score-card and EVA™ has become the most popular performance measurement model compare to others model, that marked with many researches and articles on both of them (see for example: Ittner & Larcker 1998; Biddle 1998; Dierks & Patel 1997; Hoque & James 2000).

#### **Budgeting**

The traditional organizational budgeting model was developed in the 1920s to help financial managers control costs in such large organizations as DuPont, General Motors, ICI and Siemens (SAP 2001). Since then, budgeting become the most popular traditional performance measurement tools that had been used long time. Bart (1988), after summarized some literatures, stated that budget is required to “institutionalize” a firm’s goals, monitor the performance and progress of both the business and individual products, and measure the performance of managers. By using budgeting system, performance is simply defined as a financial profitability, i.e. comparing between budgeted costs/revenue with actual costs/revenue as well as comparing actual profit with actual cost which results on ROI.

Along with the increase of evidences of budgeting practice as well as developments of performance perspective, there are many critics from scholars due to its inherent drawbacks, such as susceptible to gamesmanship (Bart 1988); merely focus on financial result and doesn’t necessarily pay sufficient attention to the means by which the result is achieved (Otley 1999). Recently, budgeting tends to be lost its importance, beside due to the rise in the alternatives control; it is also caused by the levels of unpredictability and uncertainty in many business environments (Otley 2003). Indeed, CAM-I Europe group has identified budgeting as the single major obstacle to effective management and recommends that the role of budgeting is down-graded to that of back office financial planning (Otley 2003).

Hence, considering its drawbacks, budgeting is not good performance measurement tool for Islamic bank. From Islamic perspective, the narrow focus of budgeting—by merely emphasis on financial measures—is very inadequate to reflecting the expected comprehensive performance of Islamic bank. As stated earlier, financial performance is only one of dimensions of performance that needs to be achieved by Islamic bank. Indeed, budgeting system give a plenty room of unethical behavior such as telling lie rather than telling the truth (Jensen 2003). Clearly Jensen (2003) narrated the game in budget setting by both superiors and subordinates. Most line managers realize that the process of budget setting is a joke. “They go to a lot of meetings, scope the extent of their problems, submit budgets they know will be unacceptable, and then scramble to redo budgets to reflect the new level of earnings stipulated by senior management” (Jensen 2003).

### **Economic Value-Added (EVA™)**

EVA™ is an overall measure of financial performance that has been developed by Stern Stewart Corporation. It is intended to focus managers' minds on the delivery of shareholder value. EVA™ is calculated as the excess of modified net operating profit after tax over weighted average cost of capital (see Dierks & Patel 1997). Many acknowledge EVA™ as 'the real key to creating wealth' (Fortune 1993) or 'the key to making shareholders rich' (Fortune 1996). However, though EVA™ has been claimed as 'one of three recent performance measurement innovations that should be investigated further by researchers (Ittner & Larcker, 1998), some argued that EVA™ is a little more than a new acronym for old-fashioned residual income that was extensively debated in 1970s (Otley 1999; Biddle *et al.* 1998). Biddle *et al.* (1998) also found that there is no evidence supporting that EVA™ is more closely associated with equity returns or firm values than is net income. Other study found that EVA™ cannot be used as a predictor of performance, but in a compensation system that would lead employees, from top to bottom, to maximize shareholders' wealth (Griffith 2006).

Just like budgeting, EVA™ also emphasizes merely on financial performance dimension. By serving to shareholders' wealth maximization only, EVA™ neglects others stakeholders of company. The emphasizing on shareholders only and neglecting other stakeholders has been criticized by scholars, and of course it is not acceptable in Islamic view.

### **The Balanced-Score Card**

Perhaps The Balanced Score Card (BSC) is the most prominent performance measurement model for the last 75 years. It is a multidimensional performance measurement model that was developed by Robert Kaplan and David Norton in the early 1990s. The most significant strength of BSC is the link of organizational strategy to each performance measures dimension. Those dimensions of performance are financial, customer, internal business process, and learning and growth (Kaplan & Norton, 1996). The performance dimensions are linked each other by cause-effect relationship (Kaplan & Norton 1996:30). The basic logic that explains how the four dimensions related (see the picture of BSC) is:

- (1) In order to succeed financially, a company needs to satisfy its customers so that they will buy its products. Moreover, a company needs to excel business process in order to become efficient.
- (2) In order to maintain the excellence of business process, a company needs to learn what will be needed in the future in term of internal process.
- (3) The result of continuous learning is the increase of customer satisfaction. A company also needs to learn what customers want that must be accommodated into business process.

Although the BSC is relatively better than the other two model of performance measurement, it is not free from critics. Atkinson *et al.* (1997), as quoted by Maltz (2003), noted that the BSC was incomplete because it fails to: (1) adequately highlight the contributions that employees and suppliers make to help the company achieve its objectives, (2) identify the role of the community in defining the environment within which the company works, and (3) identify performance measures to assess stakeholders' contributions. Neely *et al.* (2001) criticized BSC as, "No mention is made in the balanced scorecard of employees. No mention is made of suppliers, alliance partners or intermediaries. And no mention is made of regulators, the local community or pressure groups. Yet all of these parties can have a substantial impact on the performance and success of an organization". Smith (1998) noted that the BSC fails to incorporate the role of "motivated employees", especially in the service sector. Finally,

while The Balanced Scorecard framework provides constructs for multiple measures and overcoming the limitations of single measures, there is no clear provision for very long-term measures; the distinction between means and ends is not well defined, and the model probably needs additional empirical validation (Maltz *et al.* 2003).

In Islamic perspective, the BSC does not cover comprehensive performance of an Islamic bank. The four dimensions of the BSC are not adequate to capture all expected performance dimensions of Islamic bank. There are another stakeholders should be taken into account by Islamic bank in addition to the four dimensions. For example, the BSC is unable to measure the impact of Islamic bank for society, whether it brings positive change to society or not. The equity of loan distribution, and other benefits received by society from Islamic bank existence is beyond of scope of the BSC.

### Discussion

Neely and Adams (nd) argued that there is no one 'holy grail' or best way to view business performance, because business performance itself is a multifacet concept. Besides, there are multiple and seemingly inconsistent business performance frameworks and measurement methodologies exist (Neely and Adams, undated). The variety of performance frameworks indicates that 'performance' itself is an ambiguous term, and it is not clear to whom an organization delivers its performance (Otley 1999). Therefore, some existing performance measurement systems need to be re-evaluated and some issues on performance measurement systems are need to be addressed such as the usefulness of current performance measurement systems, cost and benefit consideration of adoption of certain performance measurement system, factors that lead to introduction of a new performance measurement system, psychological factors that playing an important role in the design and implementation of a new performance measurement system, etc (Norhayati & Siti-Nabiha 2006).

Having analyzed some existing performance measurement models, it can be concluded that Islamic banks need to establish their own performance measurement system that will be valid to capture their performance comprehensively. A Valid performance measurement allows a firm to effectively describe and implement strategy, guide employee behavior, assess managerial effectiveness, and provide the basis for rewards (Malina & Selto 2004).

Another issue in establishing a unique performance measurement model for Islamic bank is how to incorporate the external environment, i.e. society, to the model. As mentioned above, performance of an Islamic bank should be related with performance of society welfare. Therefore the performance of society welfare should be monitored as well as evaluated whether or not it is caused by the existence of Islamic bank. Neely *et al.* (2005) emphasized the importance of appropriate external element to be covered in performance measurement system. Bititci *et al.* (2000) argued that a performance measurement system needs to be sensitive to changes in the external and internal environment of organization. Therefore, an external environment should have an external monitoring system which continuously monitors development and changes in the external environment (Bititci *et al.* 2000).



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