Abstract

The recent financial crisis has drawn the attention towards Islamic finance. Islamic banks have demonstrated not only a great resilience to financial instability but they also still maintain the rapid growth. The main characteristic of Islamic financial system is a prohibition of interest that is perceived as highly unethical in Muslim world. Interest is replaced by *Profit and Loss Sharing* principle in which a bank plays role of a business partner rather than a creditor. Fundamental differences in banking strategy between Islamic and conventional banks are apparent, however, their implications for overall bank performance are still the subject of discussions. This thesis empirically investigates efficiency and stability of banking sector in the Middle East region where both banking systems coexist alongside and where the largest concentration of Islamic assets is currently held. The efficiency was measured independently by two frontier techniques, namely Data Envelopment Analysis and Stochastic Frontier Analysis. Thereafter a regression analysis was performed to examine determinants of bank efficiency and to investigate the impact of the crisis on both types of banks. The results indicate that Islamic banks are more resilient to financial instability but their operation is more cost demanding compared to traditional banks.