A Study of Performance Comparison between Conventional and Islamic Banking in Pakistan

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Abstract

Islamic banking is operating on the Sharia principles of finance. Here, the transactions are Riba free and avoid unethical practices, participate actively to achieve goals and objectives of Islamic Economy. On the other hand, conventional banks are operating on the man-made principles where the predetermined rate of interest is the core activity. This research study analyses the performance of Islamic versus conventional banks in Pakistan over the period of 2008-2010. The aim of this study is to examine and to evaluate the performance of the two Islamic banks (Meezan and Dubai Islamic) and two conventional banks (MCB and HBL) in Pakistan for the year 2008 to 2010. Pakistan has been chosen as a focal point for the study since both types of banks are performing in the market and there has been no such study previously in the country. This research study investigates whether Islamic banks are performing well in Pakistan compared to the conventional banks. Financial ratio analysis for liquidity, profitability, solvency and activity analysis of the mentioned banks from both categories was performed to test the overall performance. The result indicates that conventional banks are more profitable than Islamic banks in Pakistan for year 2008 to 2010. Islamic banks in Pakistan have better current, cash, debt to asset and asset turnover ratio while conventional banks have good performance in other remaining ratios. Although in some ratios performance of Islamic banks are also good but according to overall results conventional banks of Pakistan are more efficient than Islamic banks for year 2008 to 2010.

Key Words: Performance, Islamic Banking,

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A country's economic growth, among several other factors, is based on the financial sector's performance especially financial institutions working in that country. One of them is the banking sector. This sector can perform important role in the overall country's economic performance. In Pakistan, the banking sector has always shown notable results in the past and in the same way the trend is going on. By keeping in mind the importance of banking field in Pakistan and the performance showed by this sector in both the past and in present situation, this topic was selected for research thesis where I am going to examine and compare the performance of the two main pillars of the banking sector conventional and Islamic banks operating within the country.

Van Horne, James and Wachowicz, John (2005) told that, "A bank is a corporation registered with either the central bank or the federal government of the country. They provide the services of deposits, withdrawals, interest dealing, making loans, discount notes, investments in financial securities etc depending on bank's type."

Islamic banking is operating on the Shariah principles of finance. Here, the transactions are riba free and ignore unethical works, perform according to Islamic laws and regulations to achieve objectives and goals of Islamic Economy. Islamic banking is based on the risk-sharing concept between the investor and entrepreneur, profit maximization theory based on Shariah restrictions, and entering into partnership form of business is the main operation of the Islamic banks.

On the other hand, conventional banks are operating on the manmade principles where the predetermined rate of interest is the core activity. In conventional banking, there is no risk sharing concept between the buyer and seller but assurance of fixed interest rate, profit maximization theory without any restriction, and lending and receiving money is the main operation of the conventional banks.

Literature Review

Islamic banking attributes to a banking system or enterprise that is persistent with Islamic laws and principles (Sharia). The practical applications of these principles must conform to Islamic laws and help develop Islamic economies. Islamic law prohibits the earning of interest on lending money, therefore, Islamic banks must not accept or pay interest during their daily business. But Conventional banking does not conform to Islamic principles. In conventional banking, interest is earned by lending money. It is based on relationship between the debtor and creditor i.e. a person deposits the money into the bank and/or borrows the money from bank. Interest is earned on deposits and lending by respective parties.

According to Metwally (1997) "Islamic banking was introduced in 1963 in a wee town of Egypt". This was done on an experimental basis to validate its feasibility in a live environment. This experiment was a success as the deposits surged in three years. There was some political pressure to discard the project and ultimately the project was discontinued. Nonetheless, the project successfully demonstrated that the Islamic banking could be organized. The progress of this attempt paved the way for an unequivocal market for Islamic banking. This resulted in Islamic banking coming into being in 1970s at a reasonable ratio. A number of Islamic banks were originated in Arabic and Asian countries. Initially, almost all of these Islamic banks were in Muslim countries. After starting on a measured scale, Islamic banks are now functioning in at least sixty countries. They are even operational in non-Muslim countries that have significant Muslim minority such as United Kingdom, France and Germany etc.

A study by Samad and Hassan (2000) assessed inter-temporal and interbank performance of an Islamic bank. The subject of the study was Bank Islam Malaysia Berhad (BIMB). They examined banking features such as liquidity, profitability, risk and solvency, and community involvement of BIMB. They measured these aspects for 1984 to 1997 using financial ratios. The study concluded that BIMB was relatively more liquid and less risky compared to a group of 8 conventional banks and yet not popular among Malaysians. The study found reasons for the unpopularity of loans lend under profit sharing and joint venture profit sharing schemes in Malaysia; 40% to 70% bankers surveyed indicated that major reason was the scarcity of knowledgeable and competent bankers in selecting and managing profitable projects.

A study conducted by Bashir (2000) scrutinized the elements of Islamic banks' effectiveness across 8 Middle Eastern nations. The study utilized bank-level data across all nations on balance sheets and income statements of 14 Islamic banks on yearly basis between 1993 and 1998 inclusive. The study found the relationships between profitability and internal as well as external banking characteristics. The study showed how the banks performed under different controlled environments for macroeconomics, taxation and market structure. The study displayed following important results:

i. Islamic banks' profit showed a direct link between capital and loan. The acceptable capital ratios and loan portfolio were crucial for the bank's profitability. This finding was uniform with formal researches.

ii. The study signified the contribution of following factors for banks' profitability: customer and short-term funding, non interest earning assets and overhead in promoting banks' profits.
iii. The study revealed that foreign-owned banks were more lucrative than indigenous ones.
iv. The study alluded that taxation played an imperative contribution in the performance measures.
v. The study indicated that welcoming macroeconomic circumstances had affirmative development on performance capacities of banks.
vi. Finally, study suggested that the stock markets were complimentary to the bank funding.

A similar study performed by Bashir and Hassan (2003) analyzed how banks' attributes and general financial climate altered the effectiveness of the Islamic banks. They utilized bank level data across multiple nations on Islamic banks in 21 nations. They assessed the efficiency signals of Islamic banks for 7 years i.e. 1994 to 2001. In general, this study complemented the previous study conducted by Bashir (2000), mentioned earlier. This study, however, revealed a healthy affirmative relationship between profitability and expenses. The huge profits attained by Islamic banks may be allocated to higher salaries. It emerged that expense preference behavior hold in Islamic banks. It was discovered that the capacity of banking setup had unfavorable effect on profitability except net on interest margin.

Yudistira (2004) scrutinized impinge of financial breaking point on productiveness of Islamic banks. He established that:

i. There was a minor inefficiency a crossed these banks. However, it was noteworthy in comparison to conventional banks.
ii. These Islamic banks exhibited poorly during the global crisis in 1997 – 1999. Nevertheless, they exhibited better figures after words.
iii. Smaller and medium sized Islamic banks faced diseconomies of scale.
iv. Publicly listed Islamic banks were not as productive as non public Islamic banks.
v. There were country specific aspects that decided the efficiency differences in sample data.

Alkassim (2005) investigated the moneymaking of conventional and Islamic banking in the Gulf Cooperation Council (GCC) for 1997 to 2004 era. His dissertation explored if internal bank attributes can shed some light on the differences in moneymaking between Islamic and Conventional banking. Furthermore, a regression analysis was employed on a cross section of banks to quiz the effectiveness of the said variables on banks' performance. The study suggested that the traditional banks in GCC had exceeded asset quality as compared to their Islamic counterparts. Nevertheless, Islamic banks were better capitalized. Moreover, empirical outcomes in Islamic banks indicated that lending money without charging interest advocated profitability.

Furthermore, Sufian (2006) carried out a resembling research to supply fresh conclusions on comparable efficiency between indigenous and alien banks. The study looked at the Islamic banking affairs in Malaysia for the period of 2001 to 2004. The study focused on to differentiate among three kinds of efficiencies: scale, technical, and put technical. The research had utilized Non-parametric Data Envelopment Analysis (DEA) methodology for examining differences.

Ahmad and Hassan (2007) explored main operational distinctions between traditional and Islamic Banks in Bangladesh. They conducted the study to analyze distinctions for period 1994 – 2001. They discerned that it was not fair to ascertain a comparison between Traditional and Islamic banks because the later operated within conventional banking law, even though they do business differently. The study proposed that Islamic Banks should have a distinctive inter-bank money market for their operations. The study further proposed that Islamic banks should establish a subordinate financial market and consequently should have an independent regulatory authority.

Moin (2008) conducted a study to analyze the effectiveness of the pioneering bank in Islamic banking sector in Pakistan: Meezan Bank Limited (MBL). The study examined MBL in contrast with five traditional banks in Pakistan. Study analyzed following aspects: profitability, risk, liquidity and efficiency for 2003 to 2007. The researched concluded that MBL was more solvent, less profitable, and less efficient as compared to the median of 5 traditional banks. However, there was no major distinction in liquidity between both streams of banks.

Badreldin (2009) analyzed deficiency of performance criterion for Islamic Banks. The study then applied a currently used return on equity (ROE) Analysis Tool to test the applicability and usefulness of Islamic banks. This tool is used in conventional banks as well. The outcomes proposed that aforementioned accepted model would be a success for Islamic banks. Additionally, this tool would present considerably improved examination and comparison within the Islamic banking. The study also indicated that considerable amount of formerly gauged effectiveness of Islamic Banks was unreliable and should be improved for preciseness. The study noted that the reason for the unreliability was the flawed methods use for measurements.

Suyanto (2009) conducted a study to analyze inter-bank effectiveness of Bank Muamalat Indonesia (BMI). The analysis focused on following aspects: liquidity, profitability and solvency, risk, and community involvement. The study gathered the data for 2000 to 2004 in order to apply the financial ratios to determine performance and effectiveness of BMI. The study noted following results in comparison to conventional banks.

i. BMI was relatively more profitable
ii. BMI was more committed to the community development
iii. BMI was less liquid
iv. BMI didn’t show any difference in risk performance

Research Objectives

i. To conduct a comparative analysis of Islamic Banks and Conventional Banks in Pakistan
ii. To find out whether the Islamic or conventional banks are operating efficiently

Research Questions

i. Islamic bank’s performance is better than the conventional banks in Pakistan? Or
ii. Conventional bank’s performance is better than the Islamic banks in Pakistan?
iii. Islamic banks are more efficient in performance than conventional banks in Pakistan? Or
iv. Conventional banks are more efficient in performance than Islamic banks in Pakistan?

Research Design

The design for this research study has been done in such a manner that it can provide help for the comparison of performance and profitability of Islamic banks with conventional banks of Pakistan. . The area of this study is related with entire Pakistani banks where selected Islamic and Conventional banks are doing their jobs according to the same rules and regulation of the economic, political and social work frame.

Research Methodology

a. Type of the study

It is a comparative analysis research study regarding the conventional and Islamic banks in Pakistan.

b. Population of the study

The population of this research study is based on the entire Islamic and conventional banking sector in Pakistan where the conclusion will be generalized.

c. Sample of the study

Two Islamic banks (Meezan bank and Dubai Islamic) and two conventional banks (MCB and HBL) have been selected with the help of random sampling method.

Two conventional banks MCB and HBL have been selected through random sampling from the conventional banking sector because these are the biggest conventional banks of Pakistan representing the whole population of conventional banks. While Meezan Bank and Dubai Islamic bank, which are considered the banks mostly based on Shar'iah Principles, are also selected through random sampling method from the Islamic Banking Sector representing the whole population of Islamic Banks.

d. Sources of Data Collection

The methodology, which I adopted to collect data for writing this research dissertation, consists on both primary as well as secondary sources. Sample frame is for 3 years in this study.

Analysis Tool

The main objectives of this research study are to conduct a comparative analysis of conventional and Islamic banks for financial performance comparison of Islamic banks with conventional banks. In order to find out the performance comparison between Islamic and conventional banking in Pakistan, a comparative research is conducted.

Most of the data has been gathered from the balance sheet and income statements of the sampled banks. As this is a comparative research study and is related to the comparison of the financial performance between Islamic and conventional banking in Pakistan. Therefore data of the banks is analyzed by using the financial ratio analysis tool because only the financial ratio analysis tool can relate two pieces of financial data and measure the financial performance of the banks accurately. Similarly; only through financial ratio analysis tool, one accounting figure can be easily measured and compared with another accounting figure.

Yearly comparison of both Islamic and conventional banks can be properly done by using ratios. Ratios can be used in order to check the any company’s performance. By doing ratio analysis a company’s present and future performance can by properly measured. Additionally, financial ratio analysis is helpful for doing analysis of financial statements that can give useful information to shareholders, debentures-holders, creditors, bankers and other outsiders. Shareholders, creditors take more interest in ratio analysis of a company.

According to the objectives of my research and the benefits of the financial ratio analysis tool, the financial ratio analysis technique has been selected for the financial performance analysis of the sampled banks. Likewise, many authors had used financial ratio analysis mentioned in the literature review.

According to Samad and Hassan (2000) “inter-temporal and interbank profitability of Bank Islam Malaysia Berhad (BIMB)” has been evaluated by using financial ratio analysis tool.

Rosley and Abu Bakar (2003) analyzed the profitability ratios to determine the relative profitability of Islamic Banking Scheme (IBS) which provides Islamic services in Malaysia.

Saleh and Rami (2006) also used the financial ratios to evaluate the Jordanian exposure with Islamic banking.

Many other authors for example Sabi (1996), Samad and Hassan (2000) had also used ratio analysis to examine and analyze the performance of the bank.

Followings are the ratios that are used in this study.

Financial Ratio analysis

Financial ratios can be used in order to know the any company's performance. It is just like a tool, which is used to calculate and compare the data in financial statements of companies. The outsider and business itself are interested in these ratios. Financial ratios are basically divided into following kinds.

i. Profitability ratio
ii. Liquidity ratios
iii. Leverage/solvency ratio
iv. Activity ratio

Profitability ratios

Van Horne, James and Wachowicz, John (2005) defined in his book *"Fundamentals of Financial Management",* Chapter # 6: Financial Statements Analysis, "It is an important and frequently used tool of the financial ratio analyses". These ratios measure how much an organization can earns relative to its sales generated. Over all performance and efficiency of any organization can be measured through these ratios. Through these ratios organizations can check their profit margin in its sales. Shareholders are normally more interested in profitability ratio. Followings are the different kinds of profitability ratio.

i. Interest profit margin
ii. Net profit margin
iii. Return on assets
iv. Return on equity
v. Return on advances

Liquidity ratios

Van Horne, James and Wachowicz, John (2005), defined in his book *"Fundamentals of Financial Management",* Chapter # 6: Financial Statements Analysis," "Liquidity ratios are used to measure a company's ability that how quickly it can obtain cash for its needs. We can get this ratio by dividing total cash on short-term borrowings. It shows how many times short-term liabilities are covered by cash. If the value is greater than 1.00, it means fully covered". Following are the main liquidity ratios used in this study.

i. Current ratio
ii. Cash ratio
iii. Networking capital
iv. Advances to deposits ratio

Solvency ratios

Van Horne, James and Wachowicz, John (2005), defined these ratios in his book *"Fundamentals of Financial Management",* Chapter # 6: Financial Statements Analysis, "Measures the degree to which the business relies on debt financing". Through these ratios we can measures the ability of any company to meet its all debt obligations. Basically it can be found through these ratios whether a company owns more than it owes. Higher ratio means company is more solvent.

Followings are the main Solvency ratios.

i. Leverage ratio
ii. Debt to assets ratio
iii. Debt to equity ratio

Activity ratio

Van Horne, James and Wachowicz, John (2005), defined in his book *"Fundamentals of Financial Management",* Chapter # 6: Financial Statements Analysis, "Activity ratios are sometimes called efficiency ratios. Activity ratios are concerned with how efficiently the assets of the firm are managed. Activity ratios measure how efficiently a company uses its assets". Normally companies try to convert their production into sales quickly because through this way they can get higher revenue. Asset turn over ratio is one of the examples of activity ratio.

Findings, Recommendations and Conclusion

Findings

Profitability Ratio

We start from profitability ratios that have five kinds like interest profit margin, net profit margin, and return on assets (ROA), return on equity (ROE), return on advance.

1. The interest profit margin of MCB and HBL is higher than Meezan and Dubai Islamic banks for year 2008 to 2010. So it means that Conventional banks have higher interest profit margin rate than Islamic banks in Pakistan for the year 2008 to 2010.Normally people do less investment in Islamic banks because they get less profit in Islamic banks than conventional banks. Another cause is less awareness of Islamic products among peoples so they avoid doing investments in Islamic banks.
2. Both conventional banks have higher net profit margin ratio than both Islamic banks of Pakistan for the year 2008 to 2010.Some people are risk avoiders so they do not want to do investments in Islamic banks because products are based on risk sharing system.
3. Generally higher ROA indicate that the firm efficiently utilizes its assets. So result shows that ROE of Islamic banks has been lower than conventional banks of Pakistan for the year 2008 to 2010.
4. As return on equity of Islamic banks is consistently lower than ROE of conventional banks during three years. So again conventional banks performed better as compared to Islamic banks of Pakistan for the year 2008 to 2010.
5. Performances of conventional banks in return on advances are good as compared to Islamic banks of Pakistan for the year 2008 to 2010.

Thus overall result shows that Islamic banks are less profitable than conventional banks in Pakistan for the year 2008 to 2010.

Liquidity ratio:

Liquidity ratios show the following results:

1. Current ratio of Meezan and Dubai Islamic bank is higher than current ratio of MCB and HBL for the year 2008 to 2010. So Islamic banks performed better in this ratio than conventional banks because by having higher current ratio a bank can cover its short-term obligation quickly and efficiently.
2. Cash ratios of the conventional banks are lower than Islamic banks of Pakistan for the year 2008 to 2010.

3. Networking capital ratio of HBL is better than other banks for all the three years
4. For advances to deposits ratio, performance of Conventional banks is better as compared to Islamic banks of Pakistan for the year 2008 to 2010.

Thus overall result shows that Islamic banks performed better as compared to conventional banks in current and cash ratio, while conventional banks have better performance in networking capital and loan to deposit ratio.

Solvency ratio:

Solvency ratios indicate the following results:

1. Both conventional banks (MCB and HBL) have lower leverage ratio than Meezan bank so it means conventional banks are in good position according to this ratio in Pakistan for the year 2008 to 2010.
2. Dubai Islamic bank has performed better than the rest of the three banks for the year 2008 to 2010, as it has the lowest debt to asset ratio than other banks.
3. Conventional banks have better debt to equity ratio than Islamic bank in Pakistan for year 2008 to 2010.

Activity Ratio

In order to check how quickly and efficiently a bank can generate revenue by utilizing its total assets, asset turnover ratio is calculated Overall result shows that both MCB and Dubai Islamic banks have good performance for this ratio in Pakistan for the year 2008 to 2010. It shows that both conventional and Islamic banks have good performance for this ratio.

Recommendations

In today's business market the Islamic banks are new and having the different methods that are in a starting stage and period but its knowledge curve will increase rapidly with good experiences and time in market.

1. The Islamic bank should aim the suitable unattached market to make out wider their depositions bases very well as to large their financing service.

2. There should be a start of a course related to articulated marketing and education program to inform and tech the people very well about Islamic banks and different types of finance ,that are being ready to use.
3. To acquire gradually and hiring the skillful employees, not just anyone is full of courage by the Islamic values but in proper training and experience in finance and banking.
4. For the useful purpose and capability of additional liquidity available with Islamic banks, a well-developed secondary market should be developed.
5. For the bright future of both conventional and Islamic banks they must try to improve its activities in order to overcome its weaknesses.

Conclusion

Thus the result is different in almost all countries because of this fact that Islamic banking has long history in some countries in comparison with Pakistan where few years back the Islamic banking was fully and simply started. While on the other side the conventional banking has a very long history, great learning experience from the process of financial banking.

Both Meezan and Dubai Islamic bank have lower profit margin ratios than conventional banks (HBL and MCB), which shows that Islamic banks are less profitable in Pakistan for the year 2008 to 2010. Liquidity ratio of Islamic banks performed better as compared to conventional banks in current and cash ratio, while conventional banks have better performance in networking capital and loan to deposit ratio. In Solvency ratios the Islamic banks performed well only in debt to asset ratio, while conventional banks are in a good position in case of leverage and debt to equity ratio. Both conventional and Islamic banks have good performance for activity ratio in Pakistan for the year 2008 to 2010.

Overall conclusion is that Islamic banks have good performance in current, cash, debt to asset and asset turnover ratio while conventional banks performed better in other ratios hence an end of the judgment is that the both conventional and Islamic banks performing super jobs in their own ways. In few performance ratios the Islamic banks performing their services and jobs very well but studying the overall result the conventional banks of Pakistan performing their jobs more efficiently than Islamic banks for the year 2008-2010.

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