Analysis of the Performance of Islamic and Conventional Banks in Pakistan

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Abstract

Broadly speaking, there are two types of banking systems in the world, Islamic, and Conventional, Banking System. Conventional banking is an interest-based system while Islamic banking is an interest-free banking system. The prime aim of any bank is to earn maximum profit from its various products and services. The banks provide various kinds of products and services to the customers for the satisfaction of their financial needs. During the process, banks create assets and sometimes incur some expenses too. The assets and liabilities of the banks actually determine the viability as well as the profitability of the banks. It is in this context, that this study has tried to know as to which banking system is more viable and profitable. A sample of four banks, two from Islamic and two from conventional banks, has been selected and applied the Financial Ratios. The findings suggest that Islamic banks are as profitable as conventional banks although Islamic banks are infant in the banking industry of Pakistan. The Liquidity and Solvency Ratios suggested that Islamic banks are better than conventional because Islamic banks maintain lower debt and more equity in capital structure which decreases the risk of default. Islamic banks are more efficient in cost but less efficient in profit and revenue as compared to conventional banks.

Keywords: Banking, Islamic Banking, Pakistan

Introduction

Islamic finance is an old terminology and has been in use since the advent of Islam. In ancient times people used to keep their valuables, precious commodities and articles in the custody of trustworthy persons who were known for their honesty and integrity. In Arabia, Muhammad (pbuh) was considered the most honest person in Makkah and was

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commonly known as *Ameen* and that is why people in the area used to keep their valuables with him for safety purpose.

The emergence of the Islamic finance system in the present day world is a recent phenomenon in which, besides other financial institutions, Islamic Banking plays an important role. They provide all those services and facilities to the customers that have been provided by all other conventional banks but within the framework set by the Shari'ah of Islam. Islamic banks too accept deposits and then lend the money so collected to the people on the basis of Shari'ah compliant modes of finance.

Dubai Islamic bank is generally considered to be the first Islamic bank, started its operation in 1975 with a product of profit and loss sharing account. People deposited their money in the bank and the bank usually invested the money in some other businesses for earning profit. The banks as well as the depositors were supposed to be partners both in profit and loss. Later, by introducing some other innovative products the Islamic banking sector became able to provide an alternative to the interest based banking system. The main objective of this paper is to compare the two emerging Islamic banks with conventional banks of similar size regarding their profitability and future competition in Pakistan.

Literature Review

Awan (2009) is of the opinion that the performance of Islamic banks in Pakistan is much better than conventional banks. During 2006 to 2008, the market share of Islamic banks increased from 2.5 percent to 5 percent showing a 100 percent growth. He pointed out that the State Bank of Pakistan (SBP) has granted permission to conventional banks to open Islamic branches and windows that put too much pressure and burden on newly established Islamic banks to compete with them.

The idea of Islamic banking is flourishing day by day not only in the Muslim world but also in the western and non-Muslim countries. Schmith (2005) writes that the prospects for the growth of Islamic banks is high because 1.5 billion Muslims in the world need an alternative to interest based banking system. Besides, Islamic banking has also attracted non-Muslims and got popularity in Europe and America with a growth rate of 15 to 20 percent each year.

In Pakistan, the market share of the Islamic banks in the banking industry is 3.2 percent with 170 branches and 23,000 borrowers, while there are 7,700 branches of the conventional banks with five million borrowers (Akhtar, 2007). He is of the opinion that if Islamic banks improve their services and provide innovative quality products to the

customers, they will be able to compete with conventional banks by increasing the market share up-to 15 percent in near future.

However, there are some difficulties facing the customers of Islamic banks. Khattak and Rahman (2010) reported that the customers of Islamic banks are less satisfied comparatively to conventional banks. There are two main reasons, according to them. First, people are not fully aware about the different products offering by the Islamic banks and secondly, Islamic banks do not provide highly efficient products as conventional banks do. Moreover, people are a little bit reluctant to invest in Islamic banking sector due to, one, they are accustomed to conventional banking and secondly a low experience of the Islamic banks in the banking industry.

Regarding the performance of Islamic banks, Jaffar and Manarvi (2011) reported that the performance of the Islamic banks is better than conventional banks. They took a sample of five conventional banks and five Islamic banks to measure the performance. They applied CAMEL methodology to test the performance. CAMEL is one of the standard tests for checking the financial health of the banks. Their study found that Islamic banks performed better than conventional banks in terms of adequate capital while conventional banks did well in terms of management quality. However, in terms of management quality and earnings ability, the conventional banks excelled. Moreover, in terms of profitability and liquidity there was no major difference between the Islamic banks and conventional banks (Samad, 2004). He is of the opinion that the concept of Islamic banking is new but still is performing as better as conventional banks.

Bader, *et al;* (2008) also found that there is no big difference between Islamic banks and conventional banks in utilizing its resources. They argued that Islamic banks are better than conventional banks in profit efficiency than conventional but in cost and revenue side conventional banks are performing better. Using six financial ratios (FRA), Islamic banks are less cost effective and more profit and revenue effective than conventional banks (Johnes, *et al;* 2008). On the other hand, using Data Envelopment Analysis (DEA), they found that total efficiency in conventional banks is significantly higher than Islamic banks.

Data and Methodology
There are six Islamic commercial banks and more than twenty conventional banks operating in Pakistan. A sample of four banks (two from Islamic and two from conventional banks) has been selected for this

study. The data from 2006 to 2009 has been collected from the State Bank of Pakistan.

Comparative analysis technique is applied to compare operations and products of both Islamic banks and conventional banks. To measure the profitability and earning capacity of the conventional banks and Islamic banks, the study applied the Ratio Analysis technique. To measure the performance of the banks, we applied Financial Ratios. Liquidity ratio has been applied in this study to compare the ability of banks to pay their shot term liquidities. Moreover, the profitability and earning ratio has also been applied for comparing the ability of banks to generate earnings as compared to their expenses. For comparing the ability of the banks to meet their long term liabilities, Solvency Ratio technique has been adopted.

Results, Discussion and Suggestions

Analysis of Profitability Ratio

The four ratios to measure the profitability are Return on Assets (ROA), Profit Margin (PM), Return on Equity (ROE) and Earnings per Share (EPS). Profitability ratio simply indicates how much revenue or profit has been generated in a specific period of time.

The Return on Assets and Profit Margin of Islamic banks are 0.0124 and 0.0435 compared to 0.0815 and 1.568 of the conventional banks. The ratios show that assets of conventional banks generate more profit than Islamic banks. The Return on Equity and Earnings per Share for Islamic banks are 0.0445 and 0.6131 while for conventional banks the figures are -0.0969 and -2.17 respectively.

These ratios indicate that the capital and dividends of the share holders of Islamic banks are higher than the share holders of conventional banks. Collectively, Islamic banks are less profitable than conventional due to two reasons. First, Islamic banks are newly established banks having less expertise in the banking sector and the common people are not fully aware of the interest free banking system. Secondly, Islamic banks have faced huge financial crisis in its initial stage.

Table 1 Analysis of Financial Ratios of Islamic and Conventional Banks						
	Islamic Banks			Conventional Banks		
	BankIslami	Dubai Islamic	Averages	Atlas Bank	KASB Bank	Averages
Ratios	4 years average	4 years average	Average of two Banks	4 years average	4 years average	Average of two Banks
Profitability Ratio						
ROA	0.0053	0.0195	0.0124	0.0261	0.1369	0.0815
ROE	0.0289	0.0601	0.0445	-0.1521	-0.0417	-0.0969
PM	0.0995	0.7707	0.4351	0.273	2.8646	1.568
EPS	0.0889	0.9275	0.5131	-1.66	-2.74	-2.2
Liquidity Ratio						
Deposit to total Assets	0.6498	0.7135	0.6816	0.6694	7.5933	4.1314
Current Ratio	31.079	23.218	27.149	4.0428	1.6109	2.8268
Quick/Acid Test Ratio	5.887	6.2548	6.0709	0.671	0.075	0.373
Solvency Ratio						
Debt Ratio	0.7064	0.762	0.7342	0.8479	7.29155	4.0697
Debt to Equity Ratio	1.2595	2.2827	1.7711	3.9503	1.19677	2.5735
Long Term Debt to Equity	0.6866	0.7444	0.7155	0.7127	4.87855	2.7956

Analysis of Liquidity Ratio
The first ratio to find the liquidity is deposits to total assets ratio. These are 0.6816 and 4.1314 for Islamic banks and conventional banks respectively as shown in table 1a and table 1b. It indicates high liquidity for Islamic banks that mean highly convertible assets for cash on face value. The second ratio to find liquidity for banks is the Current Ratio (CR). The ratio is 27.19 for Islamic banks while for conventional banks it is 2.8268. It shows that the current assets of the Islamic banks are more than its current liabilities as compared to conventional banks. Another ratio to find the liquidity is Quick Ratio or Acid Test Ratio which also depicts high liquidity for Islamic banks.

Analysis of Solvency Ratio
The solvency ratio shows the difference between assets and liabilities of the banks. If assets of the banks are more than its liabilities, the bank is able to pay full its creditors or otherwise. In other words, it means that how much assets is financed with equity and how much with debt.

The debt ratio for Islamic banks is 0.7342 while for conventional banks it is 4.0697. It indicates that Islamic banks have low debt than conventional banks. In other words it means that Islamic banks have more assets than liabilities indicating lower cost of financing.

The second ratio to find solvency is Debt to Equity Ratio. This ratio also indicates lower debt for Islamic banks and higher for conventional banks. The third ratio for solvency is Long Term Debt

Equity Ratio that again shows a better position of the Islamic banks than conventional.

By and large, Islamic banks are financed more with equity and less with debt as compared to conventional banks and that is the reason that the assets of Islamic banks are more than the liabilities. All the above tests and techniques indicate that Islamic banks are more profitable than conventional banks. Islamic banks can further improve their operations by taking certain steps. For example, still huge population has not been provided banking facilities; therefore, Islamic banks should open their branches in areas where people need them. Secondly, Islamic banks should adopt and initiate a policy for spreading the awareness among the masses about the Islamic banking facilities, benefits and products. Moreover, Islamic banks should use their resources more efficiently and more effectively than before.

Conclusion
Islamic banks started their operations very recently but still their position in the banking industry is very satisfactory. Islamic banks have performed better than conventional banks in recent financial crisis. They are as profitable as other conventional banks. One of the reasons that Islamic banks are better than conventional is that Islamic banks are financed more with equity and less with debt as compared to conventional banks.

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Appendix

Table 1 Financial Indicators of BankIslami				
BANKISLAMI	2006	2007	2008	2009
Sales	100010	602060	1468690	2193891
Net income/loss	8354	37023	52930	478939
Deposits	1778008	9934282	12477955	27987378
Accounts receivables	1695848	7066555	7267366	12891554
Total current assets	3034070	8499721	9442779	8109069
Total assets	4024674	14447473	19088600	34286771
Share holder equity	2000000	3200000	52796798	52796798
Current liabilities	73830	154998	599585	641768
Long term debt	1947957	10447749	13297194	28904710
Total liabilities	2021787	10602747	13896779	29546478
Total no of shares	194174.757	197530.86	7282316.9	8994343.78
No of branches	10	36	102	102
Net assets	2002887	3844726	5191821	4740293
Share price	10.3	16.2	7.25	5.87

Note: the data given in all the table represents Million Rupees except share prices and no: of branches

Table 2 Financial Indicators of Dubai Islamic Bank				
DUBAI ISLAMIC	2006	2007	2008	2009
Sales	156811	1119716	2723796	3647145
Net income/loss	411502	369169	181822	226737
Deposits	4322621	16114461	25458910	27980906
Accounts receivables	2534285	4384971	7622976	7845074
Total current assets	3254118	6377396	10314548	10777338
Total assets	8434280	21308247	32050073	35368894

Share holder equity	3917480	5126230	6017780	6776030
Current liabilities	283529	347904	283188	404493
Long term debt	4620320	16605004	2670075	28924136
Total liabilities	4903849	16952908	26983946	29328629
No of branches	10	16	22	25
Net assets	3530431	4355339	5066127	6040265

Table 3 Financial Indicators of ATLAS Bank

ATLAS BANK	2006	2007	2008	2009
Sales	892583	1338459	2975768	3387928
Net income/loss	10591	321371	1010559	1695559
Deposits	8842946	15322671	18646412	26173680
Accounts receivables	7337781	10209983	3156355	5699517
Total current assets	7938860	11711317	4774180	7276610
Total assets	17020586	22984261	28967027	30869506
Share holder equity	3125916	5001466	5001466	5001466
Current liabilities	4076107	1593523	5579167	1208989
Long term debt	9946189	16206498	19730916	27178457
Total liabilities	14022296	17800021	25310083	28387446
Total no of shares	214103.8356	294203.8824	1506465.663	1453914.535
Net assets	2998290	5184240	3656944	2482060
Share price	14.6	17	3.32	3.44

Table 4 Financial Indicators of KASB Bank				
KASB BANK	2006	2007	2008	2009
Sales	1790347	449232	24973	13620
Net income/loss	135687	151003	17489	140918

Deposits	21275570	33131773	3784000	3457000
Accounts receivables	8199275	2865851	2128921	280638
Total current assets	10504357	3122576	2143693	303243
Total assets	26538735	3122576	491153	307094
Share holder equity	2162059	1371103	9964934	9078238
Current liabilities	23651272	1493612	556308	5459000
Long term debt	758666	5037470	5006790	2358000
Total liabilities	24409938	1997359	1056987	7817000
Total no of shares	133049.7846	67876.38614	536903.7716	966798.5091
Net assets	2128797	1271103	483942	299277
Share price	16.25	20.2	18.56	9.39