Factors Affecting the Rapid Growth of Islamic Banking System: A Comparative Ratio Analysis of Selected Banks of Pakistan

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Abstract:

Banking industry acts as mean of support of contemporary trade and business, stand-in as a link, to endow with a key foundation of monetary intermediation. Thus, evaluation of its competence is fundamental in framework of a well-organized and spirited financial system. There is various conduct of measuring competence of banks. Private Banks in Pakistan appeared as capable on both borders, i.e., procedural competence and allocative one, in comparison to their analogue, the public and foreign banks. As the race in banking sector is being paid strong, these banks could do with to diminish their set expenditures. This study analyzed the Return on Equity (ROE), Return on Assets (ROA) and Financing to Deposit Ratio (FDR) for Islamic Banks and Advance to Deposit Ratio (ADR) for Conventional Banks. The study comprises of three periods, Pre-Crises, During Crises and Post Crises. After the crises period, Islamic banking system continue to rise and still got very difficult for conventional banking system to revitalize. But they start opening their Islamic Banking Window where they deal with Islamic Finances. MCB opened its MIB(Muslim Islamic Bank) and Aetbaar for Allied Bank.

Keywords Ratio Analysis, Islamic Banking, Conventional Banking, Finance to Deposit Ratio (FDR), Advance to Deposit Ratio (ADR).

Introduction

Based on Islamic way of life, Muslims carry out social actions not for wholesome monetary returns, but moderately to get Allah's praise and stay away from Allah's annoyance(El-Halaby, S., & Hussainey, K. 2015).Developing and evolutionary economies, Pakistan alike, endow with an inimitable prospect to learn the blow of generalization and nonintervention on the effectiveness and presentation of the banking area. Pakistan is too in the route of constructing a well-built banking podium. In order to appeal the opposition; Islamic Banks (IBs) & Conventional Banks (CBs) are in direct competition and such competencies proven as an instrument for appealing further competition. It is previously discussed on top of that how alliance and procurement have transport in banking area of Pakistan. It is culminated by the analyst on the base of "Debt to Equity Ratio" that M&A has an encouraging blow on the act of the banks (Irfan Shakoor, M., Nawaz, M., Zulqarnain Asab, M., & Khan, W. A. (2014).It advocates the truth that banks in Pakistan require to perk up their inputs efficiency e.g. deposits and assets. Private Banks in Pakistan emerged as competent on both borders, i.e., practical effectiveness and allocative one, related to their correspondents; the national and overseas banks (Mukherjee, A., Nath, P., & Pal, M. N. (2002).

Bank plays a key role as financial liaison for the developments of economy. In Pakistan due to non-existence of deficit market banks plays a noteworthy part in finance channelizing from saver to borrower (Vong and Chan, 2009). Bank plays a fundamental role for the economic expansion by contributing economic assets to public and private sector. In banking sector the determinants of effectiveness is well researched. The profitability dimension varies from study to study. The gainful commercial banking sector has the capability to put up with peril and conquer the confrontations. Greater part of the countries has financial system planted on banking system. The importance of the profitability of the banks can be cherished at together micro and macro economy phases. When prosperity is premeditated by return on assets it is positively exaggerated by bank size and working effectiveness. The act of banking sector is resolute by profitability. The microeconomic factors and the peripheral factors both have a noteworthy brunt on effectiveness of banking sector of Pakistan (Sehrish Gul 2011). These can be more abridged by converting over to internet banking mechanism that is assumed to be cost-effective service release means for monetary corporations like banks.

Islamic economics is a financial organization by means of the endeavor to accomplish the philosophy of Holy Quran as opposed to receiving utmost return on monetary possessions. Effectiveness of monetary service firms and the tactic organism come next by them is for the most part reflected from side to side the knowledge concise in their balance sheets and profit and loss financial records. Till the end of 1980s, Pakistan's banking area was profoundly synchronized in the majority of the areas of actions. "The actions of financial sector in Pakistan were principally directed by the government as a way to put into practice its growth plan"[Hardy and di Patti, 2001). The financial system of Pakistan is conquered by the commercial banks. The formation of banking system in Pakistan undergoes momentous variations subsequent to 1997 when the banking administration method was associated with global paramount proceedings. Privatization of public sector banks and the continuing course of joining/consolidation carried noticeable variations in the possession, composition, and application in the banking sector. In banking requisites, the stimulus of effectiveness are sound pragmatic and analyzed but the description of effectiveness vary in lots of studies. In past, researchers have tested to come across the reasons of prosperity for banking sector, a few researchers measured merely the banking distinctiveness, while others incorporated the financial composition and macroeconomic aspects as well (Javaid, S., Anwar, J., Zaman, K., & Ghafoor, A., 2011).

Islamic banking is now in performance of an imperative responsibility in financing and adding to diverse economic and social aspects in the country in fulfillment with the doctrine of Islamic Shari'ah in Islamic banking exercises.

Six IBs are there in Pakistan operating efficiently.

There names & launching year is mentioned below:

1. AlBaraka Islamic Bank Pakistan (1991)
2. Meezan Bank Limited (2002)
3. BankIslami Pakistan Limited (2003)
4. Dubai Islamic Bank Pakistan Limited (2005)
5. Emirates Global Islamic Bank Limited (2007)
6. Burj Bank Limited (2007)

According to Islamic Shari'ah the IBs are vault to practice guidelines of Allah Almighty on each and every one dealing, principally concerning exchange of money for money. Though, this does not indicate that Islam hinders several augment on code arithmetic. In Islam, profit is the accepted recompense for assets.

Review of Literature

The total assets yield; the banks should perk up and also expand their finance by the means of producing more earnings in return on their assets in order to improve their return on equity. A banking crisis can be generated by limitation in banking system marked by unrelenting illiquidity, insolvency, undercapitalization, far above the ground level of non-performing loans and fragile business supremacy, surrounded by others. Banking crisis more often than not commence with failure of the bank to gather its monetary constraints to its stakeholders. This, in most cases, expedite runs on banks, the banks and their clientele employ in enormous credit evoke and disengagements which from time to time demand Central Bank liquidity hold up to the exaggerated banks. Regardless of the reason, though, bank strengthening is carry out to fortify the banking system, hold globalization, perk up vigorous competition, develop economies of scale, take on highly developed technologies, elevate efficiency and get better profitability.

Ultimately, the task is to strengthen the intermediation task of banks and make it sure that they are efficient enough to execute their vital role of boosting economic growth, which then is related to improve economic performance and social welfare.

To produce more profit the banks could do with a good authoritarian setting that will allow the banks to make bigger their span of business but severely surrounded by the financial service industry. With a fine guideline and management corporate governance will be augment, pointless cost and operating cost will be cut down and the profit will amplify(Adegbaju, A. A., & Olokoyo, F. O., 2008).Sarker (1999) described more that Islamic products have diverse risk characteristics in the case of Bangladesh; and the outcomes shown diverse prudential guidelines

Definitely, consolidation amongst banks, mounting antagonism and constant novelty to endow with financial services, all add to an increasing attention in a comprehensive decisive assessment of Islamic banks. Attention is paid principally on the fundamentals to interest-free financing. The issues of practicality of IBs and their aptitude to muster saving, group risks and smooth the progress of business did not get adequate exposure in the offered literature. Financial institutions in general and banks in particular are exposed to a range of risks, whereby the degree of these risks depends on the portfolio uniqueness of individual banks. In comparing the asset eminence ratios for equal-sized commercial and Islamic Banks, we examine a noteworthy disparity in the ratio of loan-loss reserve to gross loans. Commercial banks in our illustration are apt to encompass further credit loss reserve – relative to the entire loans – than IBs. Since high performing banks are inclined to hold back their credit threat, they tend to have lesser loan loss stipulation ratio (Hassan, M. K., & Bashir, A. H. M., 2003,). Banks working under extra open institutional scheme are further liable to attain elevated competence levels according to the institutional control variables. On the whole, it explores that economic autonomy is a main component of the setting within which financial institutions function. Further financial/banking autonomy seems to be connected with superior competence ranks in European banking. Moreover, while scheming for institutional growth, our outcome exposes a tough connection linking the eminence of institutions and bank effectiveness. The financial autonomy complement of the economic freedom indexes captures the "better autonomy in financial and banking markets from government power (Chortareas, G. E., Girardone, C., & Ventouri, A. (2013).IBs are predicted in belief to set immoral and social accountability in their business representation. Hence the key purpose of Sharia is to offer the wellbeing and fairness to community for their faith, existence, assets and affluence evenly.

Policy makers across the world are bounded due to extensive banking crises and Major changes in banking constitution and competitiveness through the question raised regarding proper role, constitution, and regulation of banking. In addition, consolidation of banking in many countries formed fewer, superior, extra compound banks with greater than before shares of national banking systems. Mounting globalization of banking and financial markets also intended that foreign banks played ever more important roles in lots of countries, making the world's financial markets more linked than ever previous to. Banking systems with fewer emphases on nontraditional banking as calculated by noninterest income were further liable to have the central bank as a decision-making power (Barth, J. R., Dopico, L. G., Nolle, D. E., & Wilcox, J. A. (2002).Both governments and banks are usually incredibly reliant on domestic economic doings, which affects tax revenues and the requirement for financial services. The more well-defined aspect of banking is the financial autonomy to banks in a region/countries based on liberated political system comprised of sound government policies formulation and execution with due consideration of the governance excellence. The indexes of "Economic Freedom" is used by banking sector extensively as an explanatory variable (Demirguc-Kunt et al., 2004).

The correlation involving financial autonomy & bank competence states that as minor constraints are there for banks & financial institutions regarding the control & functioning of their business; the more valuable they are supposed to execute which leads to efficient allocation of resources (Chortareas, G. E., Girardone, C., & Ventouri, A., 2013).The higher losses are supposed to be faced by better-capitalized banks in the absence of insolvency and such a situation leads to get access to the financial support preservation in the midst of market improbability concerning their asset values. The banks are allows to cover transitory cash-flow shortfalls due to the buffer of liquid assets funding disruptions and also allows to cover transitory bank size while intervening through government involvement especially in case of large banks(Huang, R., & Ratnovski, L., 2009).Illustrate their obedience with Sharia as well as serving the humanity is the key purpose of every Islamic enterprise according to Islam (Baydoun and Willett, 2000).

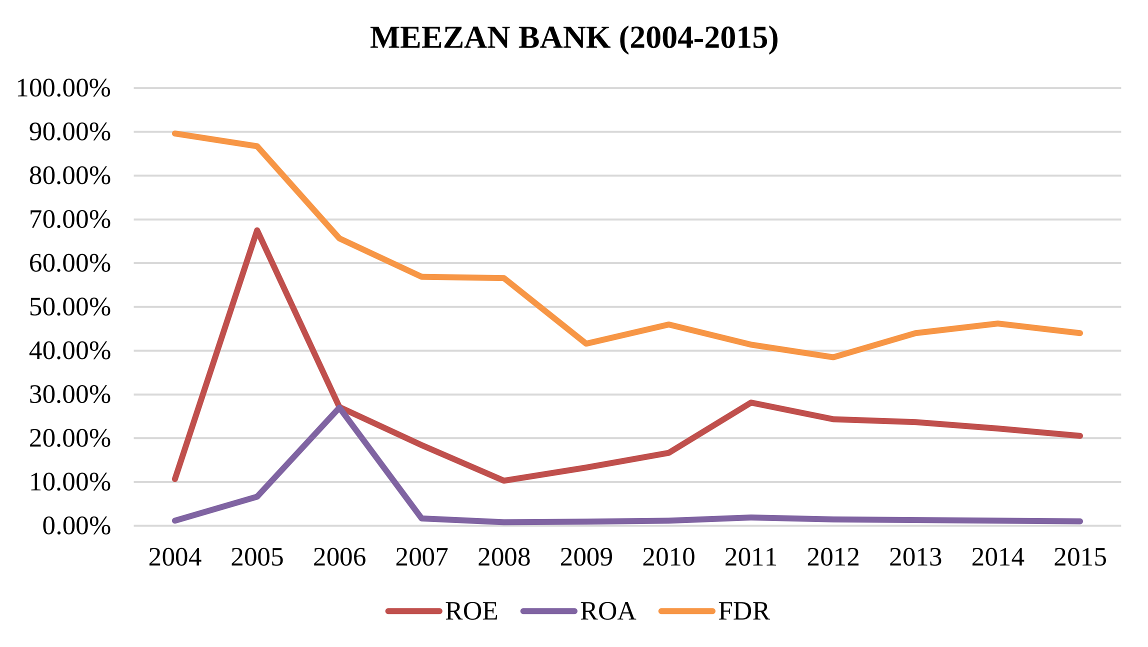
Bank concentration is pessimistically linked with limits on bank actions, but the affiliation connecting bank absorption and other financial sector guiding principle indicators is frail –even though commonly of the probable indication (Demirguc-Kunt, A., & Levine, R. (2000, October).

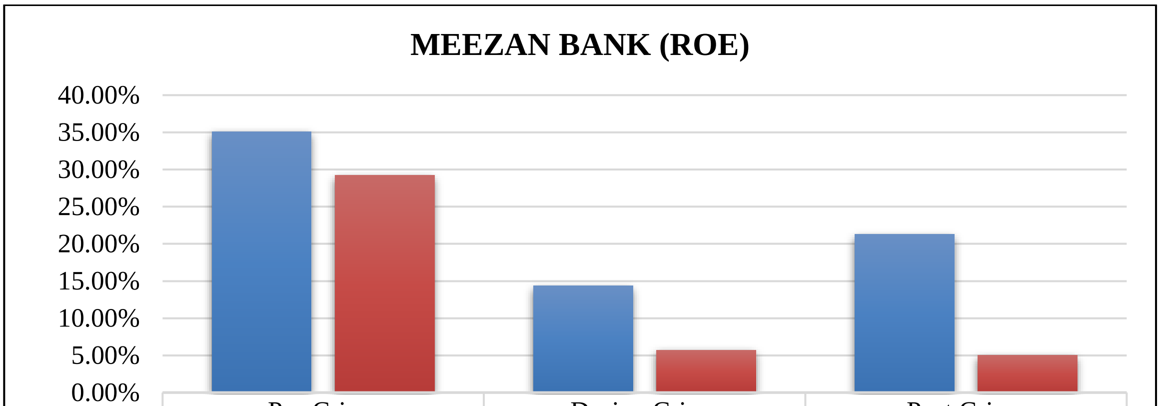
In the banking system of the rising economies (Bunda,Desquilbet, 2008), the capital sufficiency gauge is validated as a constructive power over the liquidity and the inflation rate, which increases banks' liability to nominal standards of loans, is directly connected to liquidity. Concealed vulnerabilities have been exposed by the all-purpose need of liquidity and we are witnessing an historical era of worldwide financial manner reorganization (Munteanu, I., 2012).

Data Analysis

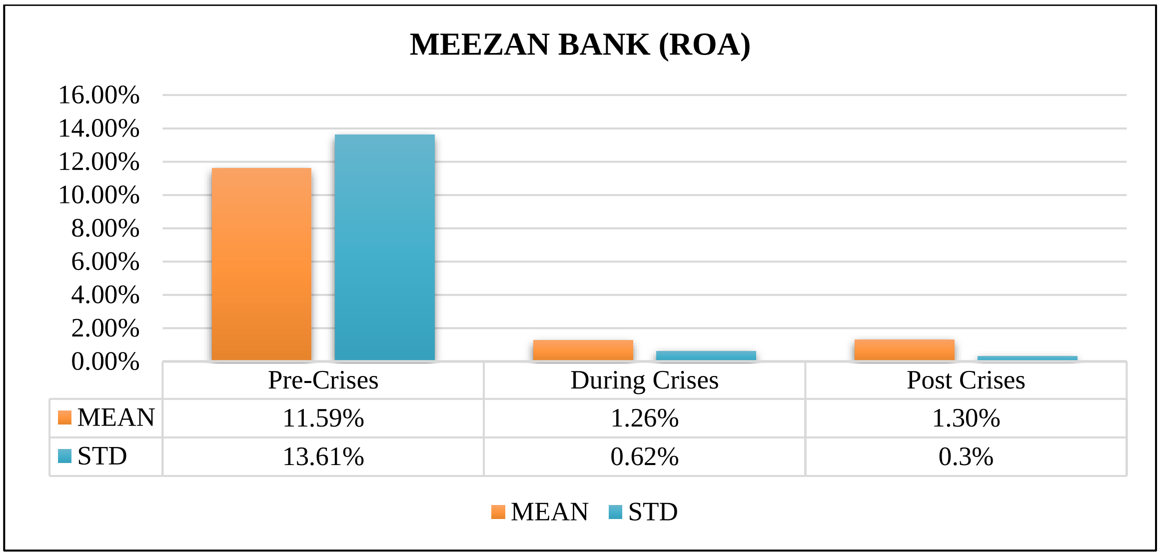
Meezan Bank Analysis (2004-2015)

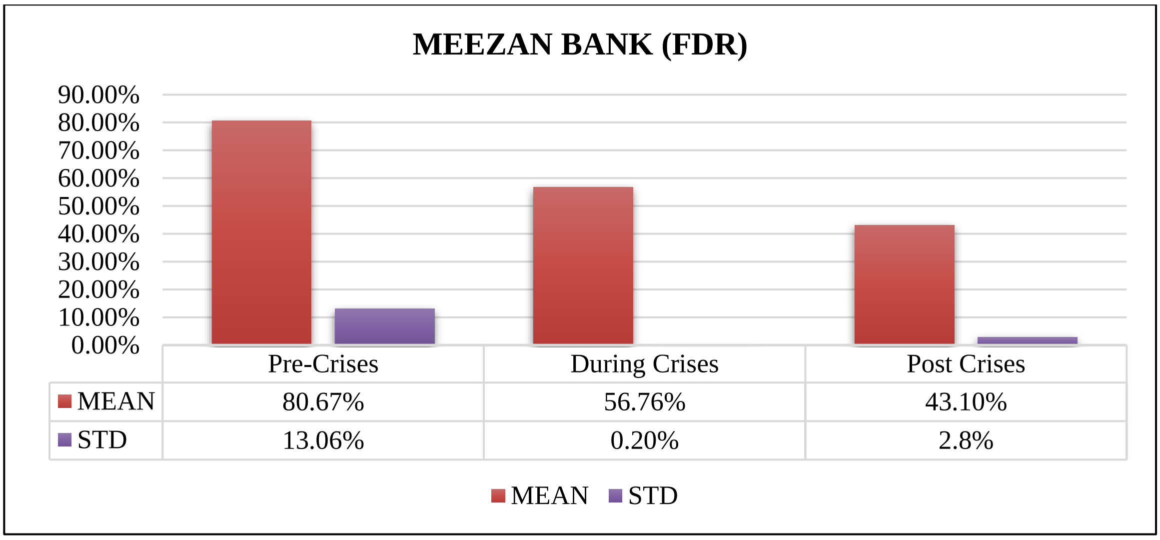
The learning shows the ROE (Return on Equity), ROA (Return on Assets) and FDR (Financing to Deposit Ratio) of Meezan Bank from 2004 to 2015. As the graph affirmed the ROE is the maximum in 2005 (68%) and lowest in 2008(10%). ROA was 27% in 2006 which is the utmost stage in the on the whole phase and at the lowest of 11% in 2004, though, FDR is at peak in 2004 of 90% and lowest in 2012 of 39%.





	Pre-Crises	During Crises	Post Crises
MEAN	35.11%	14.35%	21.27%
STD	29.23%	5.72%	5.0%

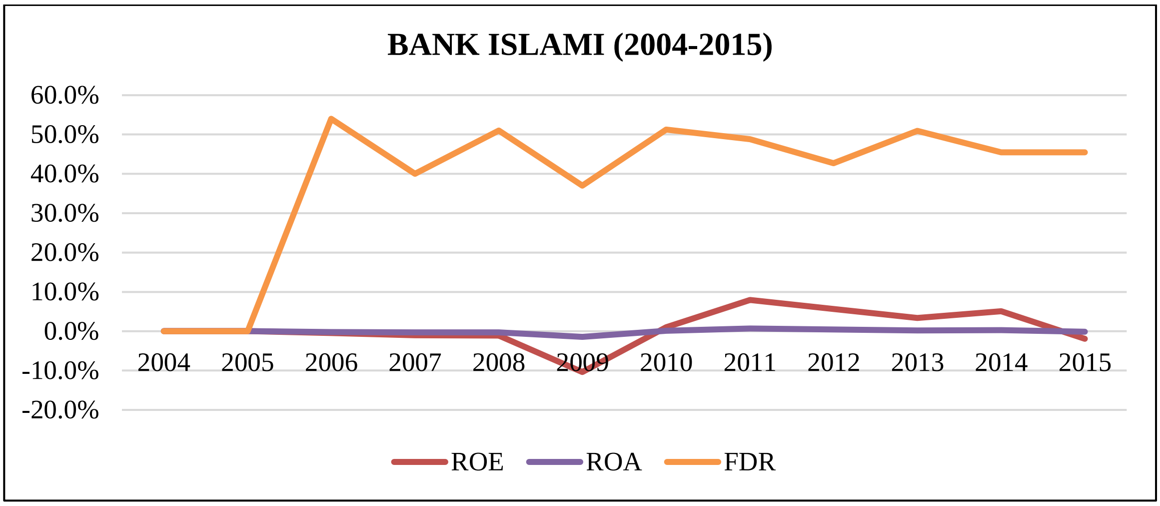


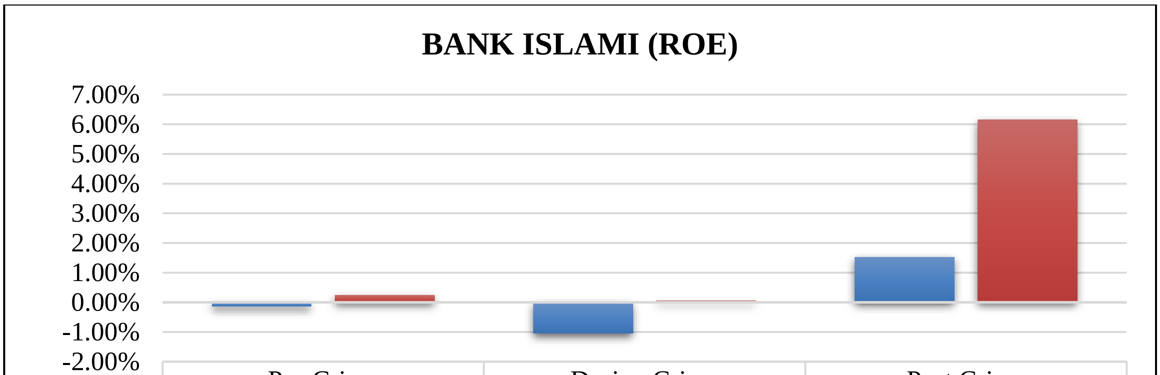


Meezan`s average ROE before crises was around 35% and it was reduced to 14% in crises and then revive to 22% after crises. The ROE`s dispersion was around 30% before crises, 5.72% during the crises and 5% even after the crises. ROA of Meezan `s was lie somewhere in 11% in pre crises on an average, and reduced to less than 2% after that in crises and even after crises, and its deviation was even less than 1% in crises and after crises which was more than 13% before crises but as far as FDR is concerned its central point was at very high point at before crises, which was around 81% and then reduced to 56% and 43% in crises and post crises respectively.

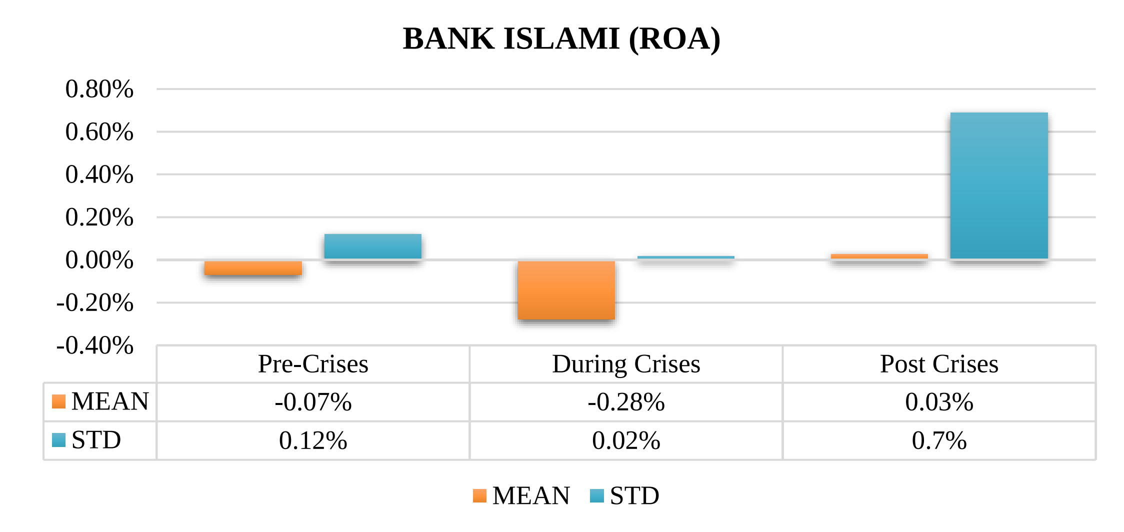
Bank Islami Analysis

The study explores the ROE (Return on Equity), ROA (Return on Assets) and FDR (Financing to Deposit Ratio) of Bank Islami from 2004 to 2015. As the graph confirmed the ROE is the top in 2008 (8%) and lowest in 2009(-10%) with the exception of first two years. ROA of Bank Islami did not nurture to the noteworthy mark systematic out the period and it remained to 2% greatest in the period, however, FDR is the maximum in 2006 of 54% and lowest in 2009 of 39%.

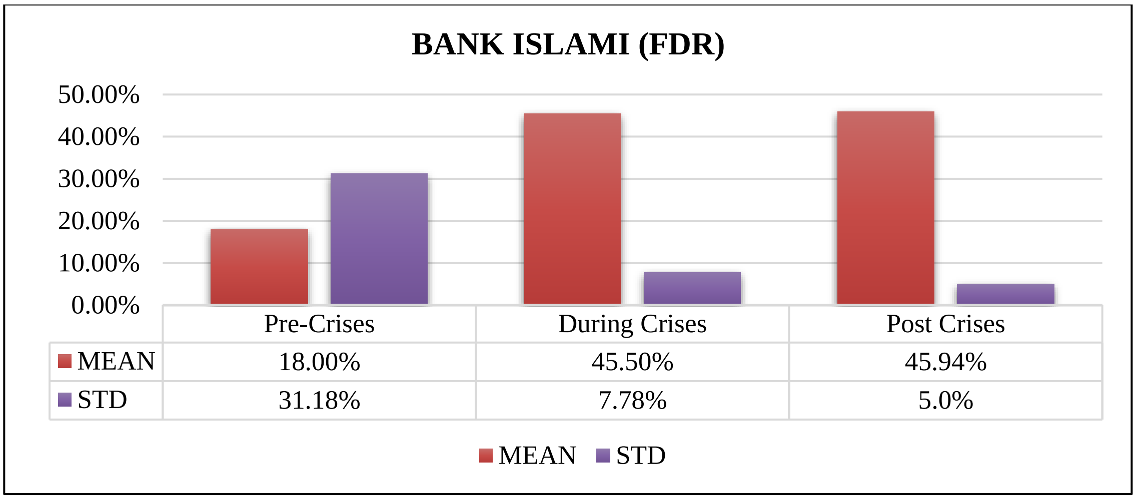




	Pre-Crises	During Crises	Post Crises
MEAN	-0.14%	-1.04%	1.53%
STD	0.24%	0.05%	6.2%



	Pre-Crises	During Crises	Post Crises
MEAN	-0.07%	-0.28%	0.03%
STD	0.12%	0.02%	0.7%

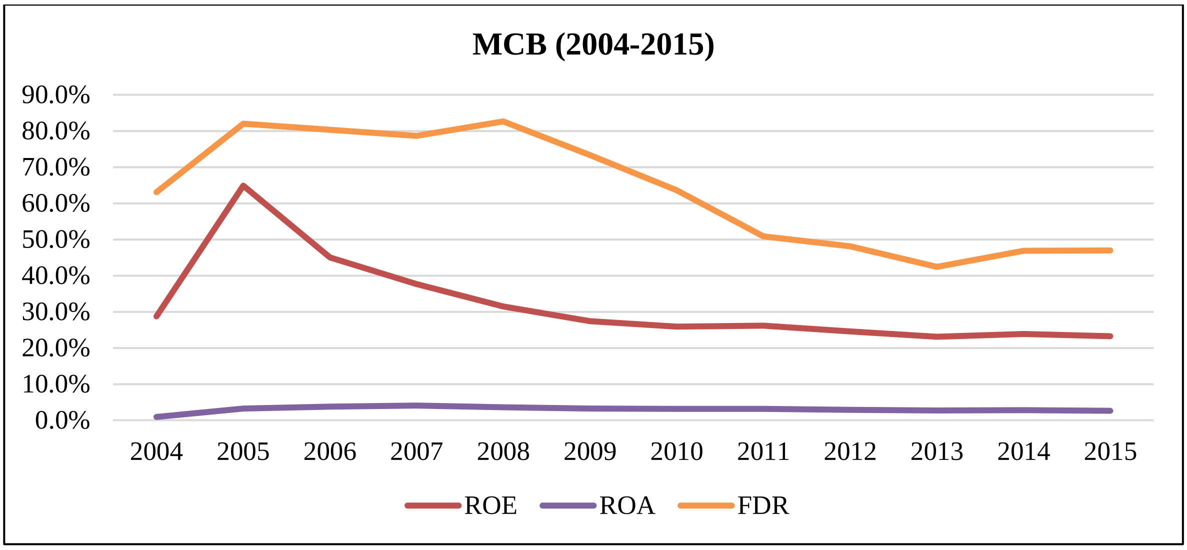


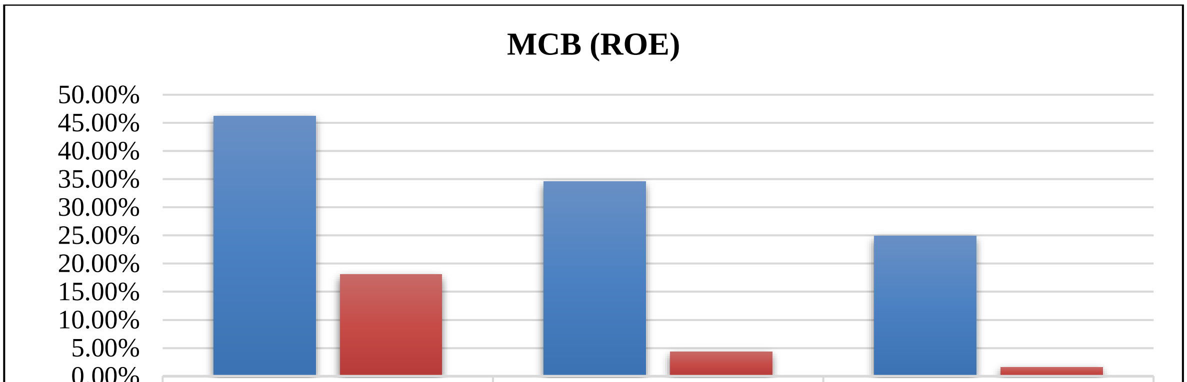
	Pre-Crises	During Crises	Post Crises
MEAN	18.00%	45.50%	45.94%
STD	31.18%	7.78%	5.0%

Bank Islami`s average ROE before crises was negative because it was not fully operational before crises and it was more negative in crises and then revive to 1.5% after crises. The ROE`s dispersion was less than 1% before crises and during the crises and 6% even after the crises. ROA of Bank Islami `s was also negative before and during crises and even after crises it was just rose to less than 1%, and its deviation was even less than 1% in all the periods for ROA. FDR was having its central point somewhere 18% in pre crises period, then it rose to 45% in crises and after crises. Before crises its FDR deviated for more than 31% and then less than 10% in after periods.

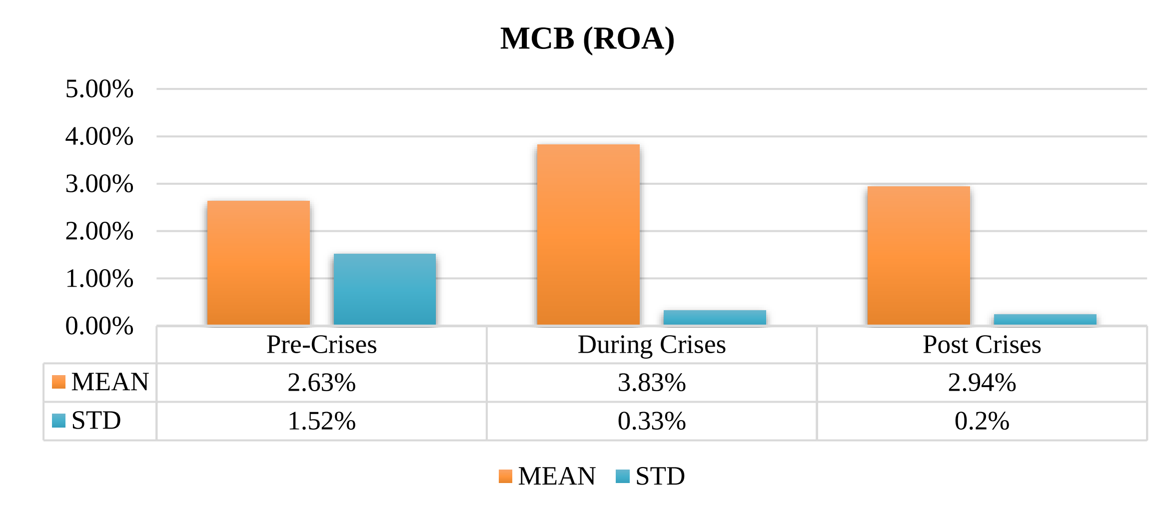
MCB Analysis

The learning explores the ROE (Return on Equity), ROA (Return on Assets) and ADR (Advances to Deposit Ratio) of MCB from 2004 to 2015. As the graph declared that the ROE is the maximum in 2005 (65%) and lowest in 2013 and 2015(23%). ROA was remained steady to 3-4% all the way through the phase, however, FDR is maximum in 2005 of 82% and lowest in 2012 of 42%.

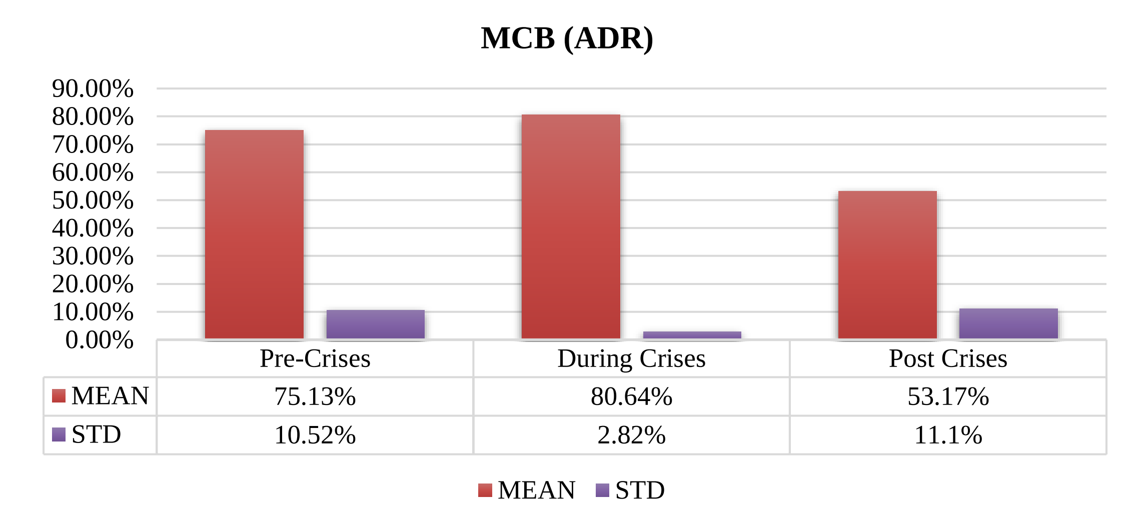




	Pre-Crises	During Crises	Post Crises
MEAN	46.20%	34.58%	24.88%
STD	18.10%	4.36%	1.6%



	Pre-Crises	During Crises	Post Crises
MEAN	2.63%	3.83%	2.94%
STD	1.52%	0.33%	0.2%

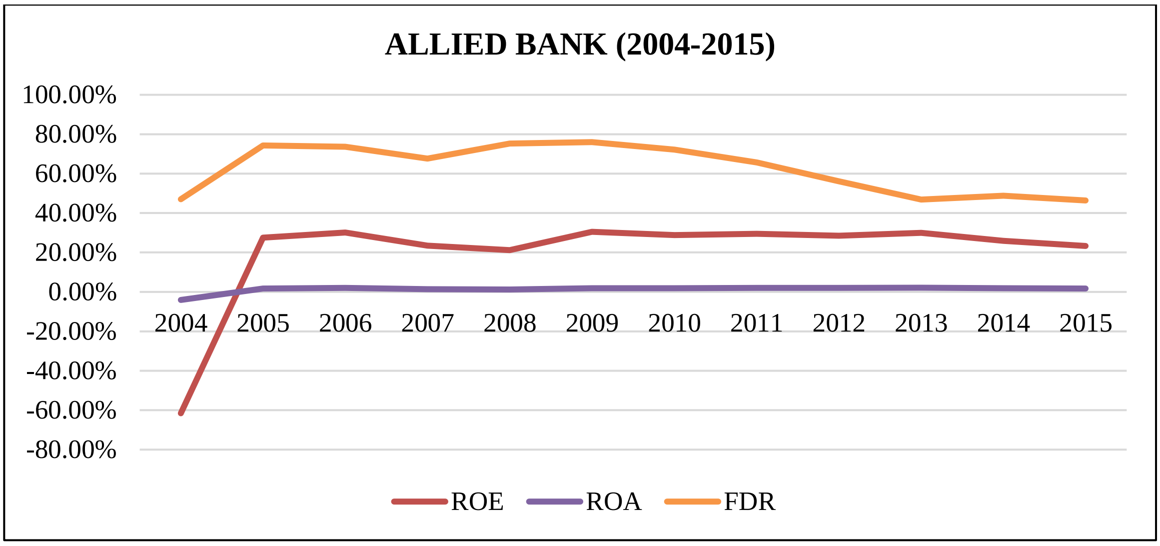


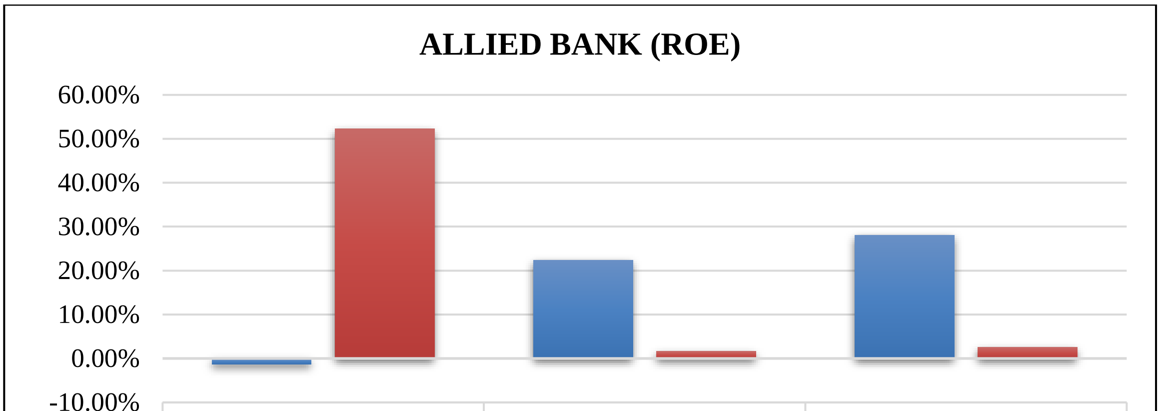
	Pre-Crises	During Crises	Post Crises
MEAN	75.13%	80.64%	53.17%
STD	10.52%	2.82%	11.1%

MCB`s average ROE before crises was around 46% and it was reduced to 34% in crises and then to 24% after crises. The ROE`s dispersion was around 18% before crises, 4.36% during the crises and less than 2% even after the crises. ROA of MCB `s was lie somewhere below 5% and its deviation was even less than 2%throughout the analysis period, but as far as ADR is concerned its central point was at very high point at before crises, which was around 75% and then further increased to 81% and then reduced 53% in crises and post crises respectively.

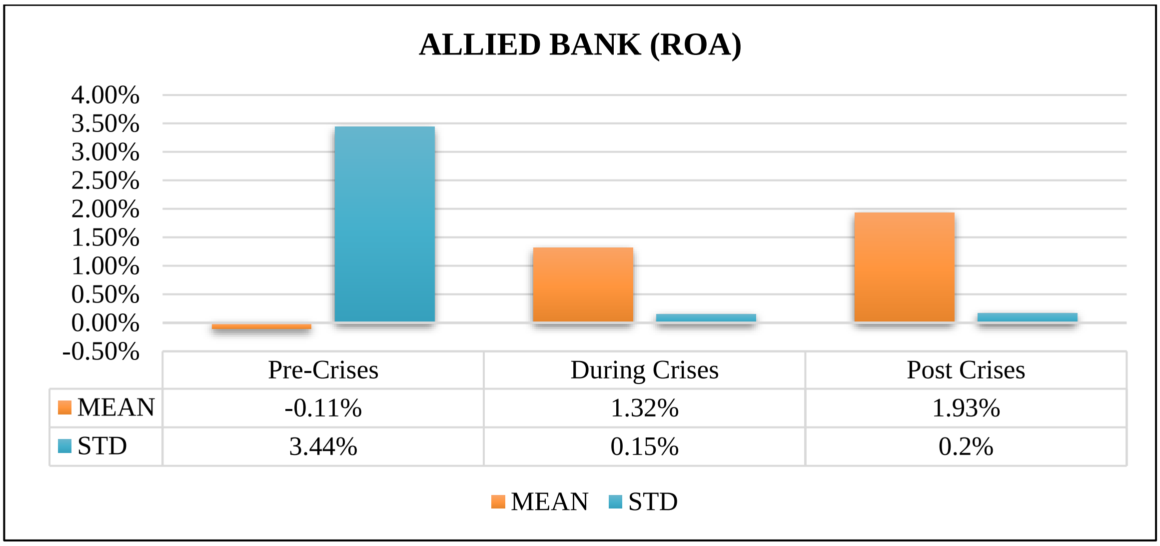
Allied Bank Analysis

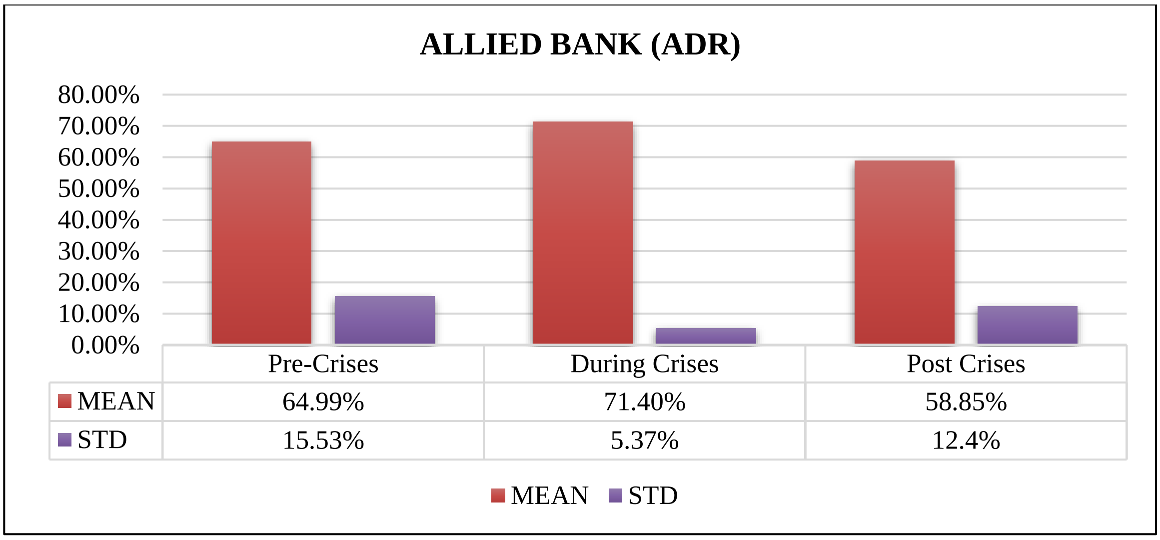
The learning explores the ROE (Return on Equity), ROA (Return on Assets) and ADR (Advances to Deposit Ratio) of Allied Bank from 2004 to 2015. ROE is the minimum of (-62%) in 2004 and it rose to 23% in 12 years' phase. ROA is steady of 1% all the way through the phase while ADR is 76% (highest) in 2009 and 47% the lowest in 2013.



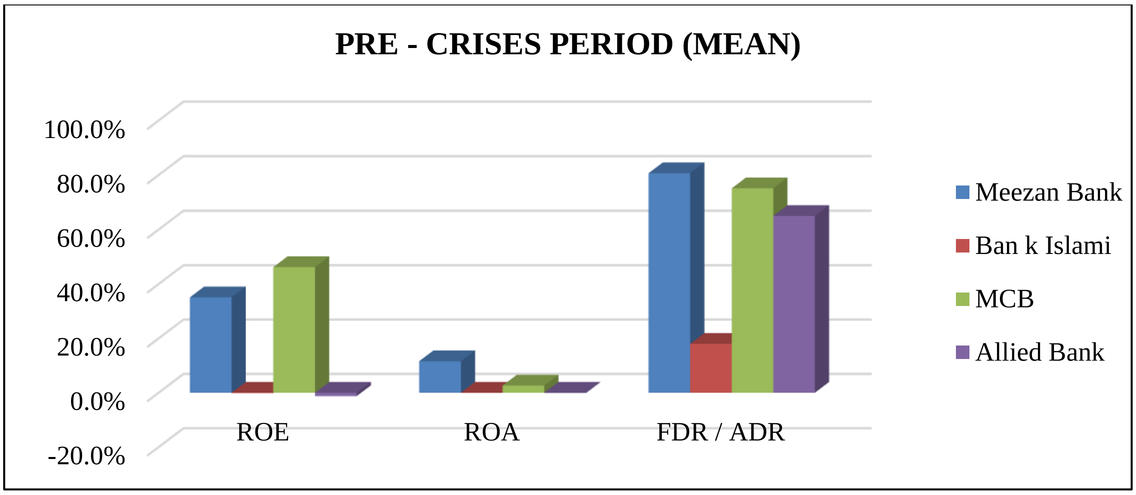


	Pre-Crises	During Crises	Post Crises
MEAN	-1.25%	22.35%	28.05%
STD	52.24%	1.63%	2.6%



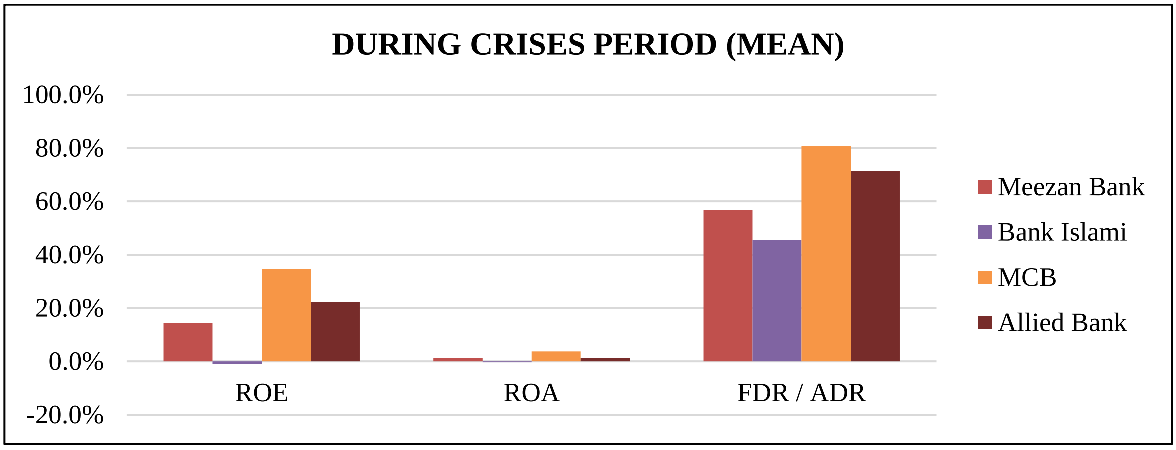


Allied`s average ROE before crises was negative and it was revived to 22% in crises and then increased to 28% after crises. The ROE`s dispersion was around 50% before crises, and less than 5% in other periods. ROA of Allied `s was also negative in pre crises on an average, and less than 2 % in other periods. and its deviation was even less than 1% in crises and after crises which was more than 13% before crises but as far as ADR is concerned its central point was at very high point at before crises, which was around 65% and then even increased to 71% and then reduced to 59% in crises and post crises respectively.



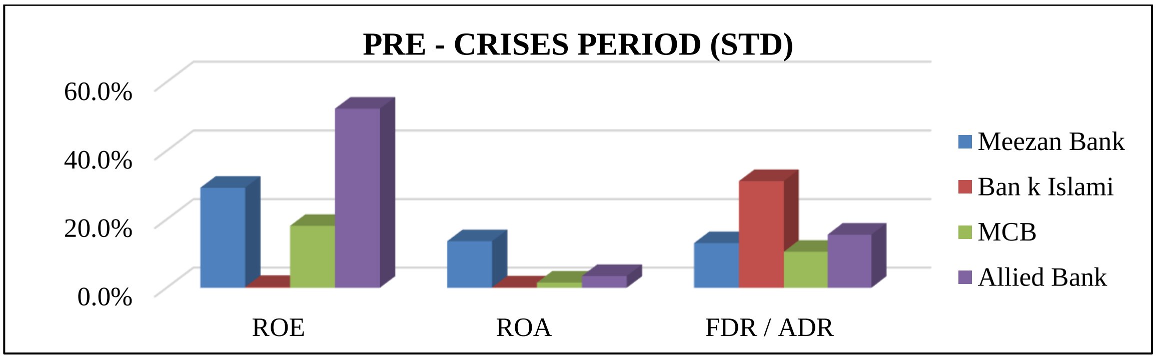
CONSOLIDATED ANALYSIS (MEAN)

In pre-crises period, the MCB`s mean ROE is at the maximum and Bank Islami`s is at the lowest, Mean ROA of Meezan Bank was at its peak and Allied and Bank Islami`s mean ROA having negative point and Meezan Bank had the best Mean FDR following MCB for Mean ADR.



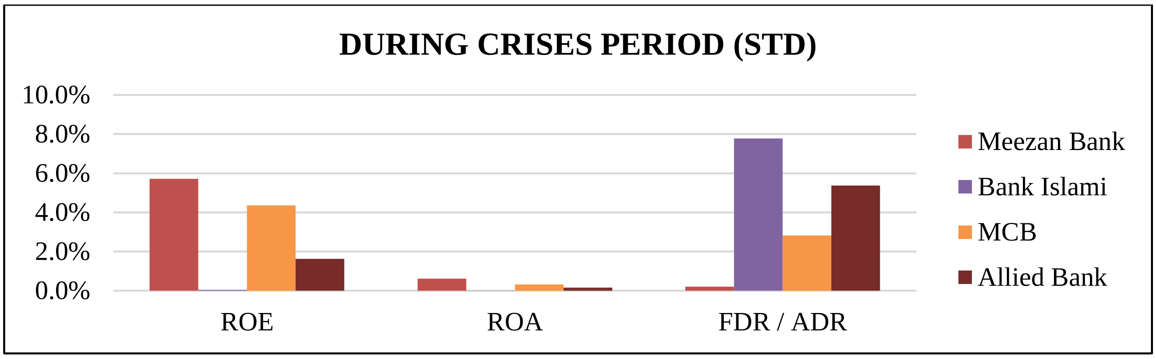
During Crises, the MCB`s mean ROE is at the maximum and Bank Islami`s is at the lowest, Mean ROA of all the banks were almost the same during crises and MCB had the maximum ADR during crises.

After Crises, the Allied`s mean ROE is at the maximum and Bank Islami`s is at the lowest, Mean ROA of all the banks were almost the same even after the crises but Allied Bank had the best Mean ADR following MCB for Mean ADR.

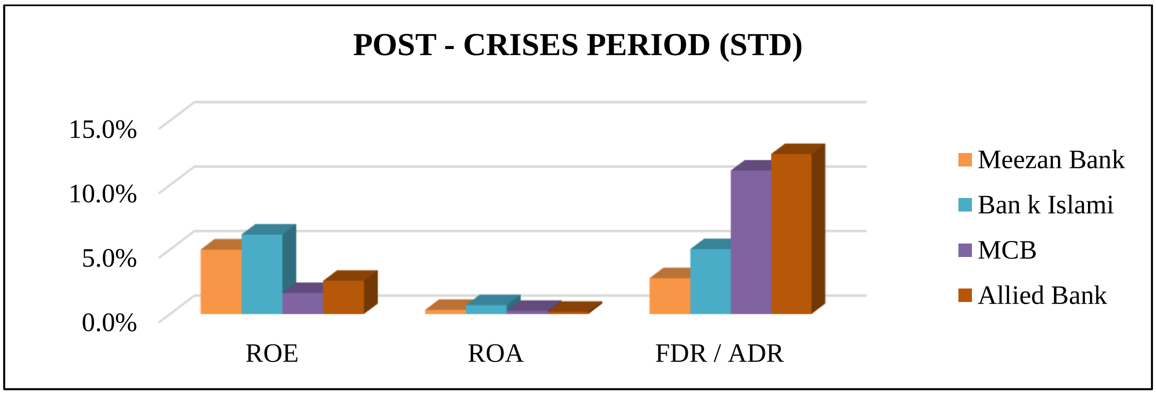


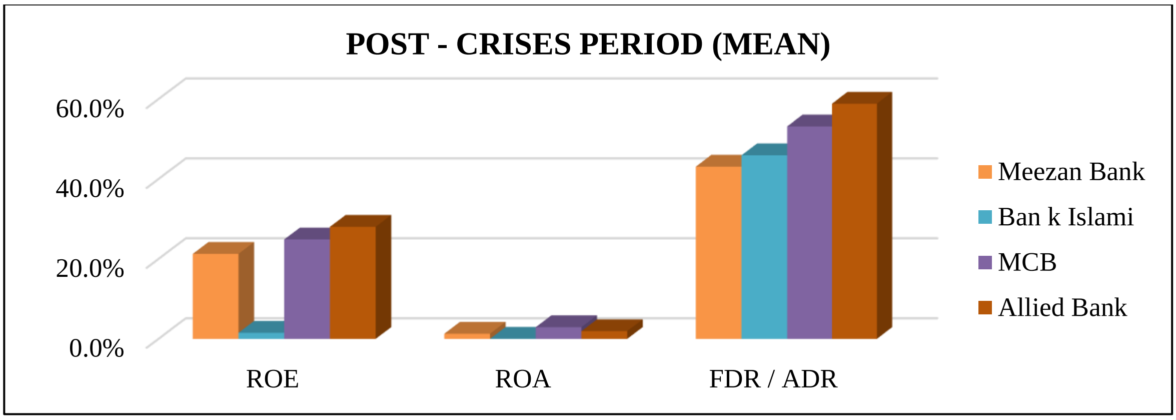
CONSOLIDATED ANALYSIS (STANDARD DEVIATION)

The maximum dispersion in Pre-crises period for ROE is Allied`s, for ROA Meezan Bank had the maximum dispersion and for FDR/ADR Bank Islami had the maximum.



During Crises, the maximum dispersion in for ROE was Meezan`s, for ROA the dispersion was almost the same and for FDR/ADR Bank Islami had the maximum. After the crises, the maximum dispersion in for ROE was Bank Islami`s, for ROA the dispersion was almost the same and for FDR/ADR Allied Bank had the maximum.





Conclusion

The study revolves around the analysis of Return on Equity (ROE), Return on Assets (ROA) and Financing to Deposit Ratio (FDR) for Islamic Banks and Advance to Deposit Ratio (ADR) for Conventional Banks. The study comprises of three periods, Pre-Crises, During Crises and Post Crises. The pre Crises period are way good for conventional banking system because there were not so many banks which were operating in Pakistan on Islamic principles, Meezan Bank was started 5 years ago and Bank Islamic was not fully operational, so the reason behind the success for conventional banking was that those were massively operational.

The main reason of the downfall of conventional banking system and the rise of Islamic Banking system was actually the World Economic Crises, which was mainly because of Circular Debts and lending securities not backed by any sort of assets which further leads to default the complete chain of the system. The rise of the Islamic Banking system was mainly because it always follows the asset backed financing, and at the time of default, it would be recovered, so during crises the overall productivity of the Conventional banking system had fallen and it gave an edge to Islamic Conventional Banking system to rise.

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