Evaluating the Financial Performance of Islamic and Conventional Banks of Pakistan: A Comparative Analysis

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Abstract

The objective of this study is to evaluate the comparative financial performance of Islamic and conventional banks. To make an appropriate comparative study profitability and liquidity ratios of Islamic banks (Mezan Bank Ltd, Bank Islamic and Albaraka) and conventional banks (Faysal Bank, KASB and Bank of Khyber) are used during the period from 2007 to 2009. The sampled banks are selected on covenant sampling technique on the basis of almost having equal weight of invested capital and number of existing branches. To make substantially noteworthy results, paired sample t-test is used. The results show that Islamic banks have high growth rate and profitability over the conventional banks. Moreover the Islamic banks have high liquidity power over conventional banks.

Key Words: Financial performance, Islamic & conventional banks, profitability, liquidity

1. Introduction

In 1963, Islamic banking came into existence on an experimental basis on a small scale in a small town of Egypt. The success of this experiment opened the doors for a separate market for Islamic banking and finance and as a result, in 1970s Islamic banking came into existence at a moderate scale and a number of full-fledge Islamic banks was introduced in Arabic and Asian countries later on. Islamic banks and non-banking financial institutions are now in operation even on more intensive scale. Today, Islamic banks are operating in more than sixty countries with assets base on more than $166 billion and a marked annual growth rate of 10%-15%. In the credit market, market share of Islamic banks in Muslim countries has risen from 2% in the late 1970s to about 15 percent today (Rajesh, Aggarwal and Yousaf, 2000).

Islamic banking in Pakistan started around three decades ago with an initiative of elimination of interest from the operations of specialized institution and commercial banks in 1977-78. The serious efforts have been realized in January 2000 when State Bank of Pakistan (SBP) constituted a Commission for Transformation of Financial System (CTFS) to introduce Shari'ah compliant modes of financing, and, on 15 September 2003, when the State Bank of Pakistan (SBP) established an Islamic Banking Department. As a result of these serious efforts, Islamic banking is now playing an important role in financing and contributing to different economic and social sectors in the country in compliance with the principles of Islamic Shari'ah in Islamic banking practices. To give a real boost to Islamic banking operations in Pakistan, is an historic initiative in January 2002, Meezan Bank Limited was granted first Islamic Banking License by the State Bank of Pakistan to operate as first full-fledged Islamic bank in Pakistan.

Like conventional bank, Islamic bank behaves as an intermediary and trustee of money of other people but the difference is that it shares profit and loss with its depositors.

This difference that introduces the element of mutuality in Islamic banking makes its depositors as customers with some ownership of right in it (Dar and Presley 2000). Islamic banking is the system of banking consistent with principles of Islamic law (Shari'ah) and guided by Islamic economics. Islamic economics is referred to that body of knowledge which helps to realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teachings (Chapra, 1996).

According to Islamic Shari'h the Islamic banks are bound to follow instructions of Allah Almight on all transactions, particularly involving exchange of money for money. However, it would be quite unfair to limit Islamic banking to elimination of Riba only. Riba is but one of the major undesirable elements of an economic transaction, the others being Gharar (risk or uncertainty) and Qimar (speculation). While elimination of these objectionable aspects in a transaction is indeed a critical aim of Islamic banking, it is by no means its ultimate objective.

As in Islam the more emphasis is given to Riba free transactions and that emphasis are given in different points of Muslims' holy book Quran, "That they took riba (usury), though they were forbidden and that they devoured men's substance wrongfully – We have prepared for those among men who reject faith a grievous punishment. Sura An-Nisa (4:161)". At another point such type of arguments are passed in sura Bagra "O ye who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury) (from now onwords) if you are (really) believers. (2:278)."

"And if you do not do it, take notice of war from Allah and His messenger! But if you repent, you shall have your capital sums. (2:279)."

However, this does not mean that Islam prohibits any gain on principle sums. In Islam, profit is the recognized reward for capital. When capital employed in permissible business yields profit that profit (excess over capital) becomes the rightful and just claim of the owner of the capital. But, the risk of loss also should be there. Another important element of Islamic finance is that profit or reward can only be claimed in the instance where either risk of loss has been assumed. Profit is therefore received by the provider of capital and wages/remuneration by labor/ manager.

1.1 Difference between Islamic and Conventional Banking

Islamic banking and conventional banking differs in different aspects like,

1. Conventional banking follows conventional (interest-based) principle while the Islamic banking is based on interest free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries. Rationale behind prohibition of interest and the importance of Profit-and-Loss (PLS) sharing in Islamic banking has been discussed in many Islamic economics studies. Moreover, Islamic PLS principle creates the relationship of financial trust and partnership between borrower, lender, and intermediary (Yudistira 2003).
2. Islamic finance is a financial system with the aim to fulfill the teaching of Holy Quran as opposed to getting maximum return on financial assets. Islamic ethical norms are the main concern of Islamic financial system. These norms of Islamic ethics are stated by the Shari'ah govern all transactions in an Islamic financial system. At a basic level, an Islamic financial system can be described as a "Fair" and a "Free" system where "Fairness" is the primary objective.
3. An Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment as compared to a conventional bank which is basically a borrower and lender of funds (Suleiman 2001).

Islamic banks compared with non-Islamic banks seek a "just" and "equitable distribution of resources". Islamic bank is based on Islamic Faith and its operations must be within the boundaries of Islamic Law or the Shari'ah. There are four rules that govern investment behavior (Suleiman 2001).

a. The absence of interest-based (RIBA) transactions;
b. The avoidance of economic activities involving hypothesis (GHARAR);
c. The introduction of an Islamic tax, ZAKAT;
d. The discouragement of the production of goods and services which is prohibited (HARAM) in Islam.

2. Literature Review

Samad (2004) examined the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks during 1991-2001. It has been realized that there exists a significant difference in credit performance between the two sets of banks. However, the study finds no major difference in profitability and liquidity performances between Islamic banks and conventional banks.

Srairi (2010) evaluated the cost and profit efficiency through stochastic frontier approach of 71 commercial banks of Gulf cooperation council countries from 1999 to 2007. The efficiency comparison between Islamic and conventional banks is evaluated across the world and especially the gulf countries. The calculated results revealed that the efficiency of banks at Gulf countries is more convincing than the world. It is also found that the conventional banks are more efficient than Islamic banks. Kaleem and Isa (2003) evaluated the Islamic and conventional deposit returns through an alternative econometric procedure. They further studied the impact of one deposit return on the other deposit return. They stated that Islamic banking industry contributed a significant development in the Muslim countries.

Zainol & Kassim (2010) showed the effects of change in interest rate on the rate of return in Islamic banks and yielding effects on the amount of deposits on Islamic and conventional banks. The calculated results of their study revealed great implications on the risk management of Islamic banks at Malaysia. They showed that there is a significant relationship between Islamic banks' rate of return and interest rate of conventional banks. They argued that when the interest rate rises the Islamic banks have to follow market trend through increasing the deposit rate. Hanif (2011) examined the similarities and differences between Islamic and conventional banking he found that the Islamic banking practicing modern conventional banking with little restriction imposed by the Islamic Sharia. The researcher further argued that it would be wrong to say Islamic banking merely the copy of conventional banking; a big difference exists in the operation of Islamic financial institutions and conventional banking system.

Bley & Kuehn (2003) investigated the relationship of different financial terms and concepts about conventional and Islamic banking among the university students. It was found that the knowledge of the terminologies used in conventional banking was higher than Islamic banking terminologies. It was further argued that religious sincerity is not only source to find the preference for Islamic banking services. It was suggested that educating the understanding of the Islamic products would be compared to the conventional product would lead to better choices for consumer. Viverita (2011) evaluated that Islamic banks observed insignificant cost efficiency at 5% than conventional banks. It was also found that Islamic banks generated more profitability and revenue than Islamic banks.

Haron & Ahmad (2000) assumed that if, there is an effect of conventional theory on the Islamic bank customers then there is a strong relationship between the rate of interest on the deposit at conventional banks with the rate of profit of the deposited amount at Islamic banks. They realized the effect of interest rate on deposited amount at conventional banks and past dividend rates on deposited amounts at Islamic banks through adaptive expectation model in Malaysian banks. They found that according to Muslim customers there is a negative relationship between interest rate of conventional banks with the rate of return offered by the interest free banks.

Ibrahim (2000) argued that as Muslims do consider this universe with dual view (this universe and hereafter) whereas the westerns seculars have materialistic view only. The inception of the conventional accounting systems in the Islamic organizations leads to mismatch the objective of the organizations with procedures used by that corporation. The researcher expressed that conventional accounting system carries western values and materialistic reality of profit whereas the Islamic ideology based on social welfare, justice and equity measures.

Kader & Leong (2009) found that Islamic bank financing are more expensive than conventional loan during diminishing interest rate. They concluded, Islamic banking system also victim of interest rate in-spite of this, the Islamic banks are running their operation on interest free principles. Saleh & Zeitun (2007) evaluated financial performance of two big Islamic banks of Jordan and found that both banks increased their efficiency and ability, expanded investment opportunities. It observed that these Islamic banks emphasized on short term investment, and observed high credit growth and profitability. Iqbal (2001) evaluated the performance of Islamic banks through trend analysis and ratios analysis during the period from 1990 to 1998 and it is found that Islamic banks performed quite well than the conventional banks over the specified period of time.

Akhtar, Ali & Sadaqat (2011) did comparative analysis of Islamic and conventional banks by focusing the importance of size of the firm, networking capital, return on equity, capital adequacy and return on asset with liquidity risk management. It is found that size of the banks and networking capital to net assets having positive but insignificant relationship with liquidity risk. Whereas the capital adequacy in conventional banks and return on asset in Islamic banks having a positive and significant relationship with liquidity risk.

Jaffar & Manarvi (2011) evaluated the performance of Islamic and conventional banks through CAMEL test during the period of 2005 to 2009. The sample of their research is 5 Islamic and 5 conventional banks. It is found that Islamic banks performed better and having high liquidity than the conventional banks, moreover it is realized that conventional banks have pioneer in the management and having a good earning ability.

3. Research Methodology

3.1 Population/ Sample

The objective of this study is to evaluate the comparative financial performance of Islamic and conventional banks. To make an appropriate comparative study three Islamic banks (Mezan Bank Ltd, Bank Islamic and Albaraka) and three conventional banks (Faysal Bank, KASB and Bank of Khyber) are selected on the basis of almost having equal weight of invested capital and number of branches. To get substantiated results, the consolidated financial statements of both Islamic and conventional banks during the period of 2007 to 2009 were used.

3.2 Procedure and Instruments Used

The consolidated financial statements collected from the official website of respective banks and the official website of state bank of Pakistan. To measure the financial performance; profitability and liquidity ratios are used. In order to see how Islamic banks performed in comparison with the conventional banks over the period of 3 years from 2007 to 2009, the yearly profitability and liquidity ratios of Islamic banks are compared with yearly profitability and liquidity ratios of conventional banks. Moreover the combined mean of profitability and liquidity ratios are compared with combined mean of conventional banks. To get the significant differences among the calculated results the paired sample t-test is used.

4. Conclusion and Suggestions

The calculated results revealed that the profitability of the Islamic banks is more worthwhile than conventional banks. The analysis make it clear that Islamic banks are booming rapidly than conventional banks, except year 2007 the mean profitability of conventional banks was much better than Islamic banks but later on 2008 and 2009 the profitability of Islamic banks is better than conventional banks.

Table # 1 Combine mean of Islamic Banks with combine mean of conventional Banks

Banks	ROA (Return on Assets)			ROE (Return on Equity)			EPS (Earning Per Share)			LDR (Loan to Deposit Ratio)			CPIDR (Cash and Portfolio Investment Ratio)			LAR (Loan to Asset Ratio)		
Islamic Banks	Mean %	t	2-tailed Sig.	Mean %	t	2-tailed Sig.	Mean %	t	2-tailed Sig.	Mean %	t	2-tailed Sig.	Mean %	T	2-tailed Sig.	Mean %	t	2-tailed Sig.
	0.08	1.675	0.236 **	4.52	0.562	0.630 **	65.2	1.118	0.380 **	50.4	-0.695	0.559 **	36.4	-1.746	0.559 **	44.6	-2.725	0.112 **
Conv. Banks	-7.9			-6.3			8.6			61.3			60.19			49.3		

Source: Analysis of secondary data
* $P < 0.10$. ** $P < 0.05$

It may be due to worse economic condition of world and the recession period greatly influenced the overall economy and especially the conventional banking of Pakistan. The reason behind the crises can lead as for another research or an open discussion. The liquidity measures indicated that the Islamic banks are more liquid than conventional banks. It provides clear evidence that Islamic banks are in a growing stage and trying to get more benefits from the commitment of the funds. Considering these results we found our study surprising because the Islamic banks were more profitable more liquid than the conventional banks.

By increasing the sample size and time frame of the research, will provide strong empirical results on performance and reveal significant relationship between Islamic and conventional banks.

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