

FINANCIAL PERFORMANCE OF ISLAMIC BANKING VS CONVENTIONAL BANKING IN PAKISTAN

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ABSTRACT

Financial sectors play a crucial role for the economy of every country. Banking sectors has largely involved in the rare pecuniary growth of Pakistan. This research study consists to measure the performance of Islamic banking Vs conventional banking with respect to profitability in Pakistan from 2008-2012. On behalf of valuation, data was collected from five (5) islamic and five (5) conventional banks in Pakistan i.e. HBL, UBL, BOP, Allied bank and Alfalah are selected as a conventional banks and MB, BIP, AIBP and DIPB and Burj bank are nominated as a Islamic banks. Various variables are used for the supposed determination such as Total asset, Share capital, Advances Net, Deposits and Other accounts, No of Employees, No of Branches and Net Income. Findings showed that there are two banks which are progressing day by day, from Islamic banking Meezan bank ltd and from conventional banking Habib bank ltd.

Keywords: Financial performance Valuation, Correlogram, Correlation, Regression analysis.

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1. Introduction

1.1 Background of the Study

The Banking sector has played a significant role for the economic development of every country for both past and current time period. Banks sport businesses at domestic, national and international level. Banking sector plays vital role in economy development of Pakistan. There are only two types of banking sector existing in all over the world. These are Islamic and conventional banking sector that consist of several categories and operate in different countries. The first Islamic banks started its operations in the UAE in 1975 which is known as Dubai Islamic Bank. Now there are 120 conventional banks which perform together with 75 Islamic banks to all over the world. Currently above three hundred (300) Islamic financial organizations are performing near about fifty five (55) countries and more than two hundred and fifty (250) Mutual funds pursue the Islamic fundamental laws. The Islamic banking works under the structure of the Islamic religion which is established by the Holy Quran and the Prophet's Sunna. Islamic banking operation is based on Murabahah, Mudaraba and partnership. It means that only those activities are allowed, that follow the principles of Islam.

The Holy Quran says,

“O believes! Don't take doubled and redoubled interest fear from God so that you may flourish.”
(Surah_Al-Imran Verses 130_1)

“And if you don't do it, take notice of war from Allah and His messenger! But if you remorse, you shall have your capital sums. (2:279).”

1.2 History of Banking in Pakistan

Today, we know that Pakistan is a consequential financing center in the subcontinent region. But before the independence Hindus have occupation on whole banking system and they treat the Muslim's in a very bad manner the Muslim's are hopeless due to cruel system of Hindus economy. Loan taken by Muslims is not returned back due to highly interest rate and tuff term and conditions by Hindus. In the light of all above discussed causes, Quaid-e-Azam Muhammad Ali Jinnah felt the immense importance of financial institution that will facilitate the Muslims. The first Islamic bank in Pakistan is AlBaraka Islamic Bank limited which was established in the year of 1991. In Pakistan there are thirty one banks (31) are operating which consists of commercial, Islamic, nationalized schedule and specialized banks, which are six

Islamic banks, eighteen commercial banks, five nationalized scheduled banks and two specialized banks. The Islamic banks which are established in Pakistan, banks with their year a. Abraka Islamic bank Pakistan lmt1991), b. Meezan Bank ltd 2000), c. Faysal Islamic bank limited d. Dubai PAK Islamic Bank ltd 2005), e. Emirate Islamic Bank ltd 2007), f. Burj Islamic Bank ltd 2007). The growth rate of Islamic banking industry has been announced as 12.4% by the State bank of Pakistan during the June in 2009.

1.3 Problem Statement

As we know, Pakistan's economy either agriculture sector, industrial sector Or businesses largely depend on banking system because banks provide finance for their development for this, we measuring that, which sector has much participate in the economic development of Pakistan and why?

1.4 Objectives of the Study

The first objective of the study is a financial comparison among Islamic Vs Conventional Banking sectors from 2008-2012. For this purpose there are used different variables to assess the bank's performance. The second objective is to find out that which banking sector is suitable for Pakistan economy and third objective is to create awareness in the peoples about both banking industries.

1.5 Significance of the Study

Both Islamic and conventional banks have played a vital role for the economic evaluation of Pakistan. The intention of the study gives a full picture to investors, shareholders and clients about financial strength of both banking industries by measuring their financial performances, In spite of that to make aware people that which banking sector has better financial position.

2. Literature Review

This research study consists of comparison between two banking sector that which banking sector better perform as compare to other and these are Islamic banking and conventional banking sector. The data is collected from 2008 to 2012. In this research study there is used various hypothesis and deeply observations in regards to Islamic and conventional banks. There are used three methods of analysis for examining the financial performances of Islamic and conventional banking interview method, Analytical trend and regression analysis. Many studies

are conducted in the past about the potential of Islamic banking such as Manan (1998) Siddique (1983) Ahmed (1984) Iqbal and Mirakhore (1987) and Khan (1987). These researchers have conversed broad scope (extent) of institutional issues including concepts and principles that are subject to explanations. There are many other authors that studied on comparison of Islamic vs. conventional banks about their performances, such as; (M.Shehzad, 2013) He determined the performances of five Pak Conventional Banks with Meezan Bank regarding to profitability, liquidity, and risk and solvency. Twelve Financial Ratios are used to determine bank's working ability. T and F-tests followed to measure the performances of two types banking. He appraised that the five conventional banks have greater profitability and efficient but highly risky as compare to Meezan bank. The objective of this paper was to give the true meaning of development from an Islamic viewpoint. This paper examined the forceful reciprocal actions b/w Islamic banking and economic growth in Pakistan.

(Ayub et al, 2012) They researched the Islamic and conventional banking's performances in Pakistan from 2001 to 2007. For assessment they selected 5 Commercial banks, namely MCB, NBP, UBL, HBL and one Albaraka Islamic bank. Independent variables, Investment Net, Advances, Assets, Borrowings from financial institutions, Deposit, Administrative Expenditures, Profit and Number of Employees. The ADF and Correlogram tool are used in this research. Findings showed that It was concluded Conventional Banks more profitable than Albarak bank.

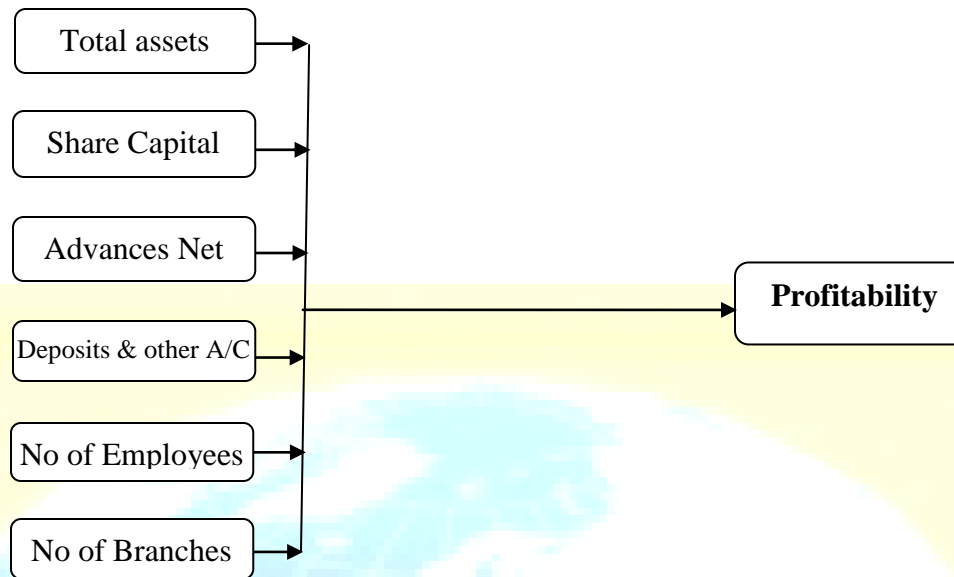
(Sultan, 2011) He has studied on the Technical efficiency performance of different banks in Pakistan before and after their merger. He determined the performances of 6th merger banks, (prime and ABN AMRO, ABN AMRO and Scotland's Royal Bank, Faysal Bank and RBS Saudi pak commercial and silk bank, Standard bank and United Chartered bank, Cres nd Samba Bank). He used the Regression Analysis for the Contribution level of various variables and in the second Phase the DEA analysis are used to evaluate the performances and advantages of Merger's Bank and showed that all banks in merger have improved their performances but it seemed Merger and Acquisition is like a Win-Win situation according to Pakistani's Environment.

(Ahmad, 2010) He interrogated among the services quality and the clients satisfaction of Pakistani Conventional and Islamic banking. He determined the effect of services quality on client's satisfaction by estimating the extent kinship B/W nominated variables. The Data is collected from (720) customer's banks. The SPSS was implemented for data analysis. The

conclusion exhibited that there is a robust positively relationships between the services quality and clients contentment of both Islamic and Conventional banks. (Beck et al, October 2010) They evaluated the comparison between Islamic and Non Islamic Banks also commanding for others banks and country traits. They searched several important distinctions in business tendency, productivity and asset attribute, while Islamic banks looking high cost effectiveness as compare to conventional banks. (Sana-u-Allah Ansari and Atiqa Rehman, 2009) He evaluated the financial performances of Islamic banking and Conventional banking from 2006 to 2009 and giving a truthfully information to Investors, Depositors and Customers about banks. He used a ratio analysis to determine the financial performances of both banking sector in regards to profitability, liquidity and credit risk. He founded that Islamic banks a little risky but high liquid than conventional banking. (Awan, 2009) He analyzed vertical growing of Islamic banking, also examined with Conventional banking. He was selected sixth Islamic, created in Pakistan and sixth conventional banking for the intention of comparisons. Data related to performances and profitability has gathered to primary and secondary origins from 2006-2008. A ratio analysis method was implemented to quantify performance key instruments Islamic & conventional banks. Enactment in addition effectiveness of Islamic banks has superior from nominated conventional banks. (Aggarwal and Yousaf, 2000) Financial instruments used by Islamic banks were examined by Aggarwal and Yousef and their findings showed, Islamic banks provide the facility of long term funding to contractors seeking capital while conventional banks mostly rely on interest.

However this research study is steered to weigh, a financial performances of Islamic banking vs conventional banking regarding Profitability, for the period of 2008-2012. For This purpose there are used different variables Total asset, Share capital, Advances Net, Deposits and Other accounts, No of Employees, No of Branches and Net income are used to determine the bank's performance.

2.2. Theoretical Framework



The above conceptual framework consists of six (6) independent variables and one dependent variable. Total asset, Share Capital, Advances Net, Deposits and Other accounts, No of Employees and No of Branches representing independent variables and profitability is used as dependent variables, while in this research study Net Income is taken as profitability.

3. Research Methodology

3.1. Sources of Data

To meet requirements of the research study there are used variance sources for the collection of data such as interview method is used to collect necessary information from different professional bankers and qualified teachers that make more extensive of this research study.

3.1.1 Secondary data

Secondary data is collected from the following different sources:

- a) Annual reports, b) Banking books, c) Research articles.
- b) State bank of Pakistan, e) Karachi stock exchange.

3.2. Research Questions

Inquire into the phenomena of Islamic Vs Conventional Banking in Pakistan and compare them to each other from conceptual framework point of view? Which banking sector much participates in Pakistan's economy?

3.3 Research Design

This study formulated in a manner, assists in comparing to the financial performances of Islamic and conventional banking. Study area consists of entire Pakistan's banking system.

3.4 Population

The research study consists of whole Islamic and Conventional banking sectors in Pakistan.

3.5 Sampling

The sample which is taken from the population is MB, BIP, AIBP, DIPB and Burj bank ltd from Islamic banking, while HBL, UBL, BOP, Allied bank and Alfalah bank ltd nominated as Conventional banks from commercial banking.

3.6 Research Hypotheses

H1: Conventional Banks are more risky than Islamic Banks.

H2: Islamic banks are more Profitable than conventional banks

H3: Growth rate of Islamic banks has better than Conventional banks.

H4: Efficiency of Islamic banks have greater than conventional banks.

H5: Islamic banks more capitalized as compare to Conventional banks

H6: Conventional banks are more beneficial than Islamic banks for Pakistan.

3.7 Data Analysis Techniques

In this research study there is used different research techniques such as; a) direct interview method, b) comparative analysis technique, c) Correlation and regression analysis are applied to weigh the performance of Islamic & Conventional banking. Out of them the comparative analysis and regression analysis are the best technique to evaluate banking performance.

3.7.1 Correlation

Correlation is mostly mentions toward the connection B/W two variables or statistics. It has naught sort out to thru connectedness, however it forecasts a relationship. This weigh is often followed to examine whether some kind of kinship occurs among the variables and if correlation coefficient range from 0-1 then coefficient value is high, relationship will be strong and if not then vice versa.

3.7.2 Model

Multiple Regression Model (MRM) was used to evaluate financial performances of Islamic and conventional banking. MRM are used as abbreviation of Multiple Regression Model. On the

base of reviews optional hypothetical methodologies, it has founded that an arithmetical methods involving with regression analysis were used as a procedure. Regression equation was applied to estimate the relationship among dependent and independent variables.

Regression Equation of this model

$$Y_t = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \dots + \beta_6 x_6 + \mu$$

α: It is an intercept and shows alpha.

β: It is a transect and $\beta_1 \dots \beta_6$ representing the co-efficient of regression.

Y_t: Indicating the dependent variable Net Income

x₁: Representing an independent variable, Total Assets.

x₂: Representing an independent variable, Share Capital.

x₃: Representing an independent variable, Advances Net.

x₄: Representing an independent variable, Deposit and other accounts.

x₅: Representing an independent, variable, Number of Employees.

x₆: Representing an independent variable, Number of Branches.

μ: It's a residual, unexplainatry things are presented by it.

4. Results & Discussions

4.1 Conventional Banking

Table-1: Correlation of the variables

	Net Income	Total Assets	Share Capital	Advances Net	Deposit & O -A/C	No of Emp	No of Branchs
Net Income	1	.896	.529	.883	.844	.822	.886
Total Assets	.896	1	.527	.894	.965	.801	.850
Share Capital	.529	.527	1	.453	.529	.345	.306
Advances Net	.883	.894	.453	1	.857	.870	.967
Deposit & Other A/C	.844	.965	.529	.857	1	.766	.809
No of Employees	.822	.801	.345	.870	.766	1	.858
No of Branches	.886	.850	.306	.967	.809	.858	1

*. Correlation is significant at the 0.05 ** . Correlation is Significant at the 0.01

The above stated table (Table-1) sums up the outcomes for correlation B/W various variables under the study. Net Income is the dependent variable and remaining are the independent variables. The outcomes for correlation B/W the dependent and independent variables is given which displays the identical correlation. All the correlation values for net income range from 0.529-0.896 and correlation values among other variables extend from 0.306-0.967

Table-4.1.2: Regression Analysis, R, R Square and Adjusted R Square

Model	R	R square	Adjusted R square
1	.956 ^a	.914	.885

Model summary shows sufficient results for our nominated variables, R is equal to 0.956^a, while R square value is .914 that imitates mean (%) of the variation and contribution in the independent variables on dependent variables. Model summary shows significant results for our selected variables. According to results variables are promoting more than 90% in the dependent variables, while Adjusted R square is .885 that represents the model's reliability.

Table- 4.1.3: Regression Coefficients and their Sig

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig
	B	Std.Error	Beta		
1. (Constant)	-1.134E7	2.591E6		-4.3	.000
Total Assets	.018	.008	.657	2.16	.045
Share Capital	.896	.292	.308	3.07	.007
Advances Net	-.065	.028	-.887	-2.3	.033
Deposit and Other A/C	-.008	.009	-.252	-.96	.352
No of Employees	462.760	405.573	.163	1.14	.269
No of Branches	21466.0	6278.637	1.155	63.4	.003

$$\text{Net-Income} = -1.113E7 + 0.657 (T-A) + 0.308 (Sh-C) - 0.887(Adv-N) - 0.252 (D-O a/c) + 0.163 (\text{No-Emp}) + 1.155 (\text{No-Brch}) + \mu$$

The standardized coefficient beta (β) for Total assets is 0.657, Share capital 0.308, Number of employees 0.163 and for Number of branches is 1.155 along with their significances, .045, .007, .269,

.003, While the other variables, Advances net and Deposits & other accounts have negatively influence to dependent variable. Their contribution; -0.887 and -0.252 as beta coefficient respectively and significances are .033 and .352. Each independent variable has a significant (+ve or -ve) impact on the bank's profitability (Net income) excluding deposit and other a/c and number of employees.

4.2 Islamic banking

Table-4.2.1: Correlation of the Variables

	Net Income	Total Assets	Share Capital	Advances Net	Deposit & O A/C	No of Employees	No of Branches
Net Income	1	.940	.386	-.105	.924	.493	.895
Total Assets	.940	1	.528	-.098	.994	.614	.952
Share Capital	.386	.528	1	.153	.506	.332	.427
Advances Net	-.105	-.098	.153	1	-.091	-.052	-.150
Deposit and Other A/C	.924	.994	.506	-.091	1	.601	.945
No of Employees	.493	.614	.332	-.052	.601	1	.548
No of Branches	.895	.952	.427	-.150	.945	.548	1

** . Correlation is significant at 1% * . Correlation is significant at 5%

The above stated table (Table-1) sums up the outcomes for correlation B/W various variables under the study. Net Income is the dependent variable and remaining are the independent variables. The outcomes for correlation B/W the dependent and independent variables are given and show the level relationship. All Correlations values for Net income range from -0.105 to 0.940, while the correlation values among other variables extend from -0.052 to 0.994 both positively and negatively.

Table-4.2.2: Regression Analysis, R, R Square and adjusted R Square

Model	R	R square	Adjusted R square
1	.966 ^a	.933	.911

Model summary shows sufficient results for our nominated variables. R is equal to 0.966^a while R square value is 0.933 that imitates mean (%) of the variation and contribution in the independent variables on dependent variables. Model summary indicates fairly significant results for our selected variables. According to results variables are promoting more than 90% in the dependent variables, while adjusted R square is 0.911 that represents the model's reliability.

Table- 4.2.3: Regression correlation and their sig

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig
	B	Std. Error	Beta		
(Constant)	123821.395	285216.432		.434	.669
Total Assets	.046	.011	2.662	4.104	.001
Share Capital	-.116	.042	-.215	-2.736	.014
Advances Net	.001	.001	.029	.449	.659
Deposit and Other A/C	-.025	.011	-1.295	-2.273	.036
No of Employees	-117.565	55.595	-.167	-2.115	.049
No of Branches	-3100.64	2908.399	-.227	-1.066	.300

$Net\text{-}Income = 123821.395 + 2.662 (T\text{-}A) - 0.215 (Sh\text{-}C) + 0.029(Adv\text{-}N) - 1.295 (D\text{-}O\ a/c) - 0.167 (No\text{-}Emp) - 0.227 (No\text{-}Brch) + \mu$

The standardized coefficient beta (β) for Total Assets and Advances net is 2.662 and 0.029 along with their significances .001, .659, While the other variables, Share capital, Deposits & other accounts, number of employees and number of branches have negatively influence to dependent variable. Their contribution; -0.215, -1.295, -0.1675 and -0.227 as beta coefficient respectively and their significances are .014, .036, .049 and .3. Each independent variable has significant positive/negative (+ve or -ve) impact on the bank's profitability that measures as a net income excluding advances net and number of branches.

4.3 Correlograms

All the Correlograms show that data is stationary at level of 1st difference.

4.3.1 Net Income Correlogram

Date: 01/16/14 Time: 13:59
Sample: 2008 2012
Included observations: 40

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob	
		1	0.331	0.331	4.7312	0.030
		2	0.011	-0.111	4.7368	0.094
		3	0.041	0.084	4.8130	0.186

4.3.2 Total Assets Correlogram

Date: 01/16/14 Time: 13:59
Sample: 2008 2012
Included observations: 40

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob	
		1	0.317	0.317	4.3204	0.038
		2	0.174	0.082	5.6557	0.059
		3	0.030	-0.052	5.6973	0.127

4.3.3 Share Capital Correlogram

Date: 01/15/14 Time: 11:11
Sample: 2008 2012
Included observations: 40

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob	
		1	-0.086	-0.086	0.3185	0.573
		2	-0.078	-0.086	0.5845	0.747
		3	-0.008	-0.022	0.5871	0.899

4.3.4 Advances Net Correlogram

Date: 01/15/14 Time: 11:13
Sample: 2008 2012
Included observations: 40

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob	
		1	-0.493	-0.493	10.456	0.001
		2	0.026	-0.286	10.486	0.005
		3	-0.007	-0.189	10.488	0.015

4.3.5 Deposits and other A/C Correlogram

Date: 01/16/14 Time: 14:01
Sample: 2008 2012
Included observations: 40

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob
		1 -0.177	-0.177	1.3449	0.246
		2 0.078	0.048	1.6131	0.446
		3 0.042	0.066	1.6927	0.639

4.3.6 No of Employees Correlogram

Date: 01/15/14 Time: 11:12
Sample: 2008 2012
Included observations: 40

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob
		1 0.278	0.278	3.3404	0.068
		2 0.045	-0.035	3.4304	0.180
		3 0.049	0.049	3.5385	0.316

4.3.7 No of Branches Correlogram

Date: 01/15/14 Time: 11:08
Sample: 2008 2012
Included observations: 40

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob
		1 0.402	0.402	6.9730	0.008
		2 0.351	0.226	12.422	0.002
		3 0.151	-0.062	13.459	0.004

5. Conclusion

In this research study, individual bank physiognomies (Internal factors) are well-planned to determine of bank profitability in Pakistan. The conclusion exhibited that there is a robust positively relationships between Total Assets, Advances net and net income, While the other variables, Share capital, Deposits & other accounts, number of employees and number of branches have negatively influence to dependent variable (net income) it's for Islamic banking. But according to conventional banking Total assets, Share capital, Number of employees,

Number of branches have positive relationship, while the other variables, Advances net and Deposits & other accounts have negatively influence to dependent variable. By increasing in total assets, indicates that the level of risk is also increase but increase in the chances of huge profitability. But it is not compulsory, that increase in assets always lead to maximize the profitability of a bank sometime creates losses. In this research we funded that HBL is the leading bank while UBL and MBL are rising towards success, while BOP, AIBPL and Burj bank constantly bear losses for three years that created bad impacts for economic development of Pakistan. Findings showed that conventional banking has strong financial position as compare to Islamic banking. The conclusion also revealed that our hypotheses, Islamic banks are more profitable than conventional banks; Efficiency of Islamic banks have greater than conventional banks can't success.

Recommendations

Islamic banks in Pakistan are challenging dual rivalry, i.e, rivalry among themselves and rivalry with conventional banks. Due to that Islamic banking consist in trouble such contentions create a huge problems in the way of progressing of Islamic banking. We noted that Islamic banks are constantly moving towards accomplishment such as Meezan bank limited is rising rapidly and it is very beneficial for Pakistan economy. The government of Pakistan should must take steps for Islamic banking so that they can face the problems that occurs in their progress way.

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