

## **COMPARISON BETWEEN ISLAMIC BANKING AND CONVENTIONAL BANKING IN PAKISTAN**

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### **Abstract**

The study is conducted to analyze the financial performance comparison between conventional and Islamic banks in Pakistan for five years i.e. 2014-2018. For the study purpose, five banks have been selected from the conventional banking sector and five from the Islamic banking sector. The comparison has been made on the basis of the average value of different ratios to analyze their profitability, liquidity, efficiency, and risk of solvency. The financial data is taken from the financial reports of these banks. The comparison shows that the performance and profitability of conventional banks are better as compared to Islamic banks. Islamic banks required more focus on achieving more customer's deposit and lending portfolio so that they can remain competitive against conventional banks. This approach will be helpful to achieve the overall socio-economic objectives of Islamic banks. Islamic banks also need to develop new and innovative products to satisfy consumer needs and overall profitability and growth in comparison with conventional banks.

**Key Words:** Financial Ratios, Financial Performance, Comparison, Islamic banking, Conventional Banking.

## **1. Introduction**

The economic performance of a country depends upon the financial sector and the banking sector is considered as the backbone of the financial sector. It not only provides innovative solutions for the general public for business growth such as short term & long term borrowing but also creates opportunities for productive investments for economic growth (Hussein, 2016). In most of the countries worldwide, two types of banking system prevail. One is called conventional banking that provides the deposit, financing and investment opportunities based on interest. The second one is called Islamic banking, in which all the above-mentioned facilities are based on Islamic and "Shariah Compliant" framework and policies (Latif, 2016).

The study provides insights into the performance comparison of conventional and Islamic banks. For this purpose, data is collected from the financial statements of five conventional banks as well as five Islamic banks. Ratio analysis is used for the year 2014 to 2018 to analyze the financial performance of the above-mentioned banks in terms of profitability, liquidity, and growth. The results revealed that the financial performance of conventional banks is quite better as compared to Islamic banks in Pakistan (Asad, 2018). There are multiple factors associated with it such as strong customer base, large branch network, better customer services, and Customer-focused products and so on. The conclusion provides an overall review of the study followed by suggestions to improve the performance and efficiency in the Pakistani banking sector (Rashid, Analyzing performance determinants: Conventional versus Islamic banks in Pakistan. , 2016).

### **1.1 Research Aim:**

The research aim is to analyze the comparative performance of conventional and Islamic banks in Pakistan from the year 2014-2018.

### **1.2 Research Objectives**

Following are the research objectives of this study:

- To make the comparison of Islamic and conventional banks in Pakistan
- To analyze the ratios of Islamic and conventional banks for performance check
- To compare the performance of Islamic and conventional banks in terms of efficiency, liquidity and overall efficiency

### **1.3 Research Question:**

Is the performance of Islamic banks is better than conventional banks in Pakistan or not?

## **2. Literature review**

The literature review section will provide information about the overview of the banking sector in Pakistan and some general differences between Islamic and conventional banks. It also provides insights about the previous studies related to the same topic i.e. comparison of Islamic and conventional banks in terms of performance, profitability, and efficiency. Let's discuss this information in detail:

### **2.1 Overview of Pakistani Banking Sector**

State bank of Pakistan was established in 1<sup>st</sup> July 1948 and act as a central bank to provide guidelines and supervision of the banking sector in Pakistan. It also provides licensing facility to local, foreign and Islamic banks to operate their business activities Pakistani financial sector. Banking sector of Pakistan is divided into different categories on the basis of different categories of banks (Hussain, 2016). Currently, there are 34 conventional commercial banks, five public sector banks, seven foreign banks, and five full-fledged Islamic banks. The State bank of Pakistan established a commission for financial sector transformation in the year 2003, which led the foundation of the Islamic banking sector in Pakistan. The idea was initiated to cater to the needs of a large segment of customer who wants interest free products and services for themselves as well as their businesses (Ahmad, 2017).

### **2.2 The difference between Islamic and Conventional Banking**

Although Islamic and conventional banks are providing their products and services to all segments of the financial sector still there is a basic difference between Islamic and conventional bank which is "Shariah Board". All Islamic banks are bound to work and operate according to guidelines and framework issued by "Shariah Board" (Nobanee, 2016). The Shariah Board act as regulatory authority for Islamic bank that provides guidelines about investment, financing, deposit and other related banking services. In Islamic banking, all stakeholders work on risk sharing mechanism and there is no guaranteed profit or returns. On the other hand in conventional banking, all the banking operations are based on pre-determined profit and interest rate decided at the start of the relationship (Abedifar, 2015). The creditors already know about the profit rate and interest amount that will be earned from the debtor within a given time frame. The money is considered as a commodity and conventional banks work on the strategy of profit maximization with risk-free investment opportunities (Abdelsalam, 2016).

### **2.3 Modes of Islamic banking**

Islamic banks offer different types of banking facilities to cater to the needs of individuals and businesses in both the assets and liabilities side. They accept the deposit of their customer for both current and savings account (Waemustafa, 2015). The current account operates with the concept of "Qarz e Hasna" whereas saving accounts are based on the Islamic concepts of "Musharika" and "Mudarba". Similarly, on the assets side, Islamic banks offer a different type of financing such as Murabaha, Diminishing Musharika, Baimuajjal, Salam and Ijarah. All these financing facilities are based on partnership and risk sharing mechanism designed by the scholars of Shariah Board to ensure "interest-free banking" (Aldoseri, 2016).

### **2.4 Findings from the Literature**

Comparison of conventional banks and Islamic banks in terms of profitability, efficiency and risk assessment in different countries is very often in literature. Similarly, the use of ratio analysis is also a well-known and commonly used technique to compare the profitability and liquidity of

different organization, especially in the banking sector. The study conducted by (Wahab, 2016) revealed that credit performance of Islamic and conventional banks is different from each other but their profitability and liquidity has no significant differences.

(Khan, 2017) Conducted a study to analyze the growth of financing and other related assets in comparison with the conventional banks in the UAE. According to the information disclosed by them, Islamic banking is showing a quarterly growth of 6.4 percent in the quarterly report present by Central bank of UAE. The values of financing have risen up from AED 1,225 billion to AED 1,276 billion by the end of March 2018. They also provided the breakdown of financing facilities in which “Diminishing Musharaka” financing is at the top with a total percentage of 37.5% followed by Murabaha 16.9% and Ijarah 13.2%. Oil and gas, construction and manufacturing were the top three sectors of the economy, in which maximum financing facility is provided. The research also revealed that Islamic banks are also able to better customer base with an average growth of 1.2% as compared to last quarter and it will continue with the same pace till the end of the year 2018.

(Al-Deehani, 2015) Conducted the research to investigate the performance of conventional banks in comparison with the conventional private banks in Pakistan. For that purpose, they have selected five banks from the conventional banking sector and five from the Islamic banking sector. Total 9 ratios were calculated including profitability ratios, liquidity ratios, and efficiency ratios. The results showed that ROA (Return on Assets) and ROE (Return on Equity) of conventional banks is quite better as compared to Islamic banks because of strong customer base and strategies of higher management towards profit maximization. The value of earning per share is also a sign of better profitability which was significantly high in a conventional bank in comparison with an Islamic bank. Another research was conducted by (Abrar, 2018) related to analyze the performance of conventional and Islamic banks for the year 2010 to 2014. They selected the, and ANOVA to measure the significance of ratios and profitability comparisons. Their study revealed that profitability margins are quite higher in Islamic banks because of the higher profit rate with a recovery rate of almost 95%. The research also has shown that people are willing to take less risk, that’s why they prefer conventional banks, but still, there is a huge market and growth potential for Islamic banks to enhance their customer base and profitability through innovative products.

A research contribution made by (Rahman, 2015) about the performance analysis and profitability comparison between Islamic and conventional banks in Pakistan showed that conventional banks are better in terms of profitability and growth efficiency. The reason which was described in the conclusion of their research is because of the strong brand name, innovative products, deeper market penetration, and huge competition. They also added that huge competition led towards fewer profit margins but still provide more opportunities for the conventional banks to acquire huge customer base to offer them investment and financing opportunities and earn income from interest-based framework. As the profit rates and interest, the amount is calculated at the start of the contract, so there is minimum or no element of risk for the bank to lose its earnings (Aman, 2016).

### **3. Methodology**

The research methodology consists of techniques and framework through which a researcher can identify, analyze and interpret the information about the research topic. Research methodology provides insights to the reader about the reliability and validity of the information given in the research. The methodology of this research work includes the population, sample size, data collection method, and theoretical framework. Let's discuss each of these above-mentioned items in detail:

### 3.1 Population

The population of this research work is according to the research topic i.e. conventional and Islamic banks of Pakistan.

### 3.2 Sample Size

Total ten banks were selected from the overall banking sector of Pakistan. Five banks from conventional banking sector which include Soneri Bank Limited, Bank Alfalah, Bank Al Habib Limited, Faysal Bank Limited and Standard Chartered Bank Pakistan Limited. Another five banks from Islamic banking sector include Meezan Bank Limited, Dubai Islamic Bank Limited, Al Baraka Bank Limited, Bank Islami Pakistan Limited, and MCB-Islamic Bank Limited.

### 3.3 Data Collection Method

The data required for this research include the financial statements for the year 2014 to 2018 of the selected banks which is downloaded from their official websites. The hard copies of financial statements were also taken from the Pakistan Stock Exchange to get better information and insights about the policies of selected banks. The reports from the State bank of Pakistan and related articles were also studied from different online resources, library resources, books, and journals.

### 3.4 Theoretical Analysis

The theoretical framework of research provides a particular and unique technique through which research can analyze and determine the results. In this research topic, ratio analysis technique is used to make the comparison of conventional and Islamic banks performance, efficiency and profitability. Financial ratios are excellent predictors to analyze profitability and to determine risk and solvency (Daly, 2017).

### 3.5 Financial ratios:

There are four types of ratios which are used to measure the efficiency, effectiveness, and profitability of the selected conventional and Islamic banks. Let's discuss each category of ratios one by one:

#### 3.5.1 Profitability Ratios:

As the name suggests, profitability ratios are used to measure the overall profitability of the bank. The profitability ratio includes ROA (Return on Assets) and ROE (Return on Equity). ROA determines how much a bank earn against one dollar spent against is assets. The ROE describes the profitability or earning of a bank against one dollar spent on equity. Formulas of ROA and ROE are as follows:

**ROA** = Net profit / total assets

**ROE** = Net profit/total shareholder's equity

The following tables show the values of ROA and ROE of selected Islamic and conventional banks in Pakistan:

**Table 1: Return on Assets**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	2.8%	2.8%	3.4%	4.5%	5.7%
<b>Conventional Banks</b>	4.3%	5.2%	5.9%	6.5%	7.2%

**Table 2: Return on Equity**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	36.3%	28.3%	38.6%	42.4%	43.6%
<b>Conventional Banks</b>	53.5%	54.3%	55.2%	56.7%	57.4%

### 3.5.2 Liquidity Ratios:

Liquidity ratios are those ratios that measure the organizational capacity to manage their short term needs such as operating expenses. In other areas of the world, in the banking sector, some of the banks face liquidity issues due to huge withdrawals from customer's accounts and more risk-taking an appetite. In Pakistan, there is a very strong check and balance of State bank of Pakistan. All scheduled banks have to deposit at least 40% of the bank's capital as a guarantee to State bank of Pakistan. Due to this reason, not a single bank is defaulted or liquidated in the history of 71 years (Aziz, 2016).

The liquidity ratio can be calculated through the current ratio and loan to deposit ratio. The current ratio describes the bank's capability to manage its current liabilities with current assets. The higher value of the current ratio indicates that the company is liable to pay its current liabilities with effective utilization of current asset. Loan to deposit ratio also measures the liquidity of bank in comparison with its loans against its assets. The formulas of current ratio and loan to asset ratio are given below:

**Current Ratio** = Current assets / current liabilities

**Loan to Asset Ratio** = Loans / total assets

The following tables show the values of the current ratio and loan to asset ratio of selected Islamic and conventional banks in Pakistan:

**Table 3: Current ratio**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	4.47%	4.24%	5.28%	4.86%	5.67%
<b>Conventional Banks</b>	4.37%	4.83%	4.69%	5.12%	4.93%

**Table 4: Loan to deposit ratio**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	204.20%	206.34%	205.96%	208.56%	210.26%
<b>Conventional Banks</b>	216.25%	218.46%	212.78%	219.82%	220.31%

### 3.5.3 Risk and Solvency Ratios:

The risk and solvency ratios describe the organization's capability to meet long term solvency and going concern of the organization. In the case of the banking sector, these ratios measure a bank's ability to manage the financing to the debtors by the utilization of its assets and owner's equity. For this purpose, two types of ratios are calculated. The first one is called debt to equity ratio and the second one is a debt to assets ratio. The debt to equity ratios refers to analyze the bank's financial leverage in terms of its liabilities against its shareholder's equity. Another ratio is a debt to assets ratio, which is calculated by dividing the total liabilities of the bank against its total assets. The lower value of these ratios is a positive sign, which indicates that the bank has the ability to pay its liabilities and will continue its identity as a going concern. The formulas of these two ratios are as follows:

**Debt to Equity Ratio** = Total liabilities / total shareholder's equity

**Debt to Asset Ratio** = Total liabilities / total assets

The following tables show the values of debt to equity ratio and debt to asset ratio of selected Islamic and conventional banks in Pakistan:

**Table 5: Current ratio**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	44.4%	45.2%	47.4%	52.7%	54.6%
<b>Conventional Banks</b>	54.3%	56.2%	57.8%	58.6%	58.9%

**Table 6: Loan to deposit ratio**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	324.56%	326.92%	327.63%	345.21%	352.20%
<b>Conventional Banks</b>	360.21%	362.28%	365.45%	367.12%	368.56%

**3.5.4 Efficiency Ratios:**

The efficiency ratios indicate how effectively an organization is managing its assets to generate sales, effective utilization of receivables and to measure the growth of the firm. The higher value of efficiency ratios indicates that a bank’s overall performance is good, and management is effectively utilizing its resources. These ratios include income to expense ratio and asset ratio. These ratios measure the bank’s overall efficiency to manage the operating expenses against total income, as well as effective utilization of assets to generate revenues. The formulas of these ratios are given below:

**Income to Expense Ratio** = Total income / total operating expenses

**Asset Utilization Ratio** = Total revenue / total assets

The following tables show the values of income to expense ratio and asset utilization ratio of selected Islamic and conventional banks in Pakistan:

**Table 7: Income to expense ratio**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	15.4%	12.4%	16.8%	17.4%	18.5%
<b>Conventional Banks</b>	16.5%	17.2%	18.6%	19.6%	21.2%

**Table 8: Asset utilization ratio**

Details	2014	2015	2016	2017	2018
<b>Islamic Banks</b>	24.26%	26.56%	27.51%	28.63%	29.32%
<b>Conventional Banks</b>	27.35%	28.63%	33.23%	34.56%	36.78%

**4. Results**

The results of the above-mentioned ratios revealed that the profitability and efficiency of conventional banks is quite higher than Islamic banks in Pakistan. The risk and solvency ratios indicate that conventional banks have more risk appetite as compared to Islamic banks. The values of these ratios are quite consistent in the last five years from 2014 to 2018. Profitability and efficiency are showing positive trends and is expected to grow at the same pace in the upcoming years.

### **5. Conclusion**

The overall conclusion of the research shows that conventional banks are showing better performance and efficiency as compared to Islamic banks. All banks are utilizing their assets more effectively to manage their short term and long term liabilities. The risk and solvency ratios indicate that conventional banking has more risk appetite and they have abilities to manage their debts more effectively. Islamic banks have less profitability because of the investment and financing guidelines issued by Shariah-compliant funds. The Shariah board provides guidelines about investment and lending options as per Islamic rules and regulations.

### **6. Recommendations**

There are the following recommendations for the improvement of profitability and efficiency of Islamic banks:

- The Islamic banks should provide customized solutions to their customers including investment, lending and deposit options in the light of Shariah Board.
- The profitability of Islamic banks can be enhanced by diversifying the portfolio of Islamic banks and increasing customer base.

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