

# Comparative Financial Performance of existing Islamic Banks and Contemporary Conventional Banks in Pakistan

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**Abstract.** The banking system in Pakistan is flourishing these days. The conventional banking is in practice in Pakistan since long time and majority of the current consumers are involved in. As a Muslim, many people don't believe on conventional banking and therefore, they do not use banking services to avoid from interest. For them, the alternate system is Islamic banking, where interest-free services can be offered and they can get involved into banks. The objective of the study is to analyze the financial performance of Islamic and conventional banking industry in Pakistan. For this purpose, five Islamic & five conventional banks are selected and their financial data has been collected from year 2005 to 2009. Return on Assets (ROA) is used as a proxy and it is measured with other explanatory variables to measure the financial performance of banking industry. Descriptive Statistics, Correlation Matrix and F-Statistics are used to analyze the impact of explanatory variables. The study gives a different image of financial intermediation for Islamic banking system in Pakistan. However, there is some difference in the operational activities of Islamic and conventional banks. Their financial performance indicators are similar which are used to calculate the profitability of the banks. In the light of the analysis, it is concluded that Islamic banking system is much superior to the conventional banks. Similarly, they have the capacity to increase their market share by generating new activities in Pakistan.

**Key Words:** Financial Performance, Islamic banks, Conventional banks, Return on Assets

## 1. Introduction

The concept of Islamic banking was accelerated in 1940's. By 1970's this concept reached to its climax particularly in middle east and generally in all over the Islamic world. With the passage of time all the Muslim countries made Islamic banks a major tool to their economy. In no time this concept flourished in Africa, North America, Asia and Europe as well. At the moment, in almost 70 countries, about 300 Islamic financial institutions are working efficiently with capital investments worth \$500-800bn. By 2010, the market value of Islamic financial institutions was of \$4 trillion. In Middle East, Islamic banking system has been a wonderful addition in economy sector. Bahrain is at the top of the list regarding Islamic banking in the whole world whereas Malaysia is second in ranking by their remarkable and memorable policies in the sector of Islamic banking. As far as Pakistan is concerned, Islamic banking share in total banking sector is 7% and it rapidly growing with the passage of time. Currently, following six Islamic banks are operating in Pakistan. Al-Baraka Islamic Bank Pakistan (established in 1991), Meezan Bank Limited (established in 2002), Bank Islami Pakistan Limited (established in 2003), Dubai Islamic Bank Pakistan Limited (established in 2005), Dawood Islamic Bank Limited (established in 2007) and Emirates Global Islamic Bank Limited (established in 2007)

## 2. Literature Review

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A significant role was played initially in Islamic banking sector by Malaysia which also introduced dual banking and innovate the higher purchase known as *al-ijara-wa-iqtana* (El-Din, S. Abdullah, 2007). Vaihekoskia (2009) discovered that systematic liquidity risk is a market wide systematic risk because it can cover all types of liquidity risk. According to Uddin (2009), there exists inverse relationship between liquidity and stock return. Liquidity position also affects the financial performance of the banks. Ismail (2010) concluded that there is a room for the development of Islamic banking and there is sudden need to revise the policies and principles in order to communicate the masses about the strong and powerful liquidity management. There should be equal amount of capital both Islamic as well as conventional banks despite of the fact that there is a great difference between the two (Kahf, M., 2002). Munawar Iqbal (2004) concluded that Islamic banks are superior to the conventional banks in terms of the ROA and ROE, after taking 12 banks as a sample whose growth rate and ratio analysis were studied keeping in view the international standards.

About twenty banking systems working in Saudi Arabia, Pakistan, Qatar, Sudan, Egypt and Gambia were studied by Cihal Hassee in 2008 covering 520 observations for Islamic banks and 3248 observation for 397 conventional banks and conclusion were made in favor of Islamic banking system in terms of their financially stronger position. No doubt, the concept of Islamic banking has up-heaved the world of banks and has proved it a valuable platform for the investors in the economy sector yet there is not sufficient study and research on Islamic banking (Yudistira, 2003 and Sufian, 2007), and that insufficient study just discusses the features and profitability of Islamic banking. Sufian (2007) differentiated the efficiency of both the Islamic and the conventional banks during 2004 through Non Parametric Data Envelopment Analysis (DEA) method in order to describe the kinds of efficiency i.e., Technical, pure technical and scale. He also used intermediation approach, spearman who presented Rank Order and Parametric Pearson correlation coefficients in order to show the impacts of DAE results with the ordinary accounting methods. The consequences are in favor of domestic Islamic banks in term of profitability particularly Malaysian Islamic banks recovered in 2003 and are further technically sound as declared in correlation coefficient analysis.

### 3. Data and Methodology

Five Islamic banks, Al-Baraka Islamic Bank, Meezan Bank, Bank Islami, Dubai Islamic Bank, Dawood Islamic Bank and five contemporary conventional banks, Silk Bank, JS Bank, Arif Habib Bank, KASB Bank and Atlas Bank were selected and their data has been collected from 2005 to 2009. Return on Assets (ROA) is used as a proxy to measure the financial performance of banking industry. Explanatory variables are Total Loans/Total Assets, Deposits/Total Assets, Total Expenses/Total Assets, Non-Interest Expenses/Total Expenses and Total Equity/Total Assets. Multiple regression Model is used to compare this financial performance. Descriptive Statistics, Correlation Matrix and F-Statistics are used to analyze the impact of explanatory variables.

#### 3.1. Research Model

$$ROA = \beta_0 + \beta_1 T. Assets + \beta_2 T. Equity/T. Assets + \beta_3 T. Liability/T. Assets + \beta_4 Deposits/T. Assets + \beta_5 Total Expense/T. Assets + \beta_6 Non-Interest Exp/Total Exp + \varepsilon$$

### 4. Results and Discussion

#### 4.1. Descriptive Statistics

In Table 4.1, Mean, Median, Maximum, Minimum and Standard deviation of both banks is calculated. ROA as explained variable is compared with other explanatory variables. While comparing ROA of both Islamic and conventional banks, Mean, Median and Standard deviation of conventional banks is higher than the Islamic banks which show that conventional bank system is much better than the Islamic banking system. The range of conventional banks is also 25% higher than Islamic banks. That means ROA shows to be higher for the conventional banks. Whereas, TE/TA is higher for Islamic banking system, which indicates that Islamic banking system is more capitalized than the conventional bank. Similarly TL/TA of conventional banks is higher than the Islamic banks. Expenses in conventional banks expressed lower standard deviation that means they have more stable expenses as compared to Islamic banks.

Table: 4.1. Collective Sample (Conventional and Islamic Banks)

Averages	ROA	Total Assets	TE/TA	TL/TA	Deposits/TA	Total Exp./TA	NIExp/T. Exp.
Mean	0.0180	33,427,397	0.1959	0.8056	0.4718	0.0361	0.0449
Median	0.0100	26,538,735	0.1580	0.8420	0.4900	0.0330	0.0340
Maximum	0.0720	124,000,000	0.5400	0.9750	0.7100	0.0940	0.3400
Minimum	-	4,024,674	0.0260	0.4600	0.1350	-	-
Std. Dev.	0.0187	24,463,845	0.1394	0.1392	0.1265	0.0182	0.0516

**Conventional Banks**

Averages	ROA	Total Assets	TE/TA	TL/TA	Deposits/TA	Total Exp./TA	NIExp/T. Exp.
Mean	0.0244	34,482,659	0.1713	0.8310	0.4743	0.0321	0.0501
Median	0.0185	29,918,267	0.1495	0.8515	0.4755	0.0315	0.0345
Maximum	0.0720	68,664,341	0.5400	0.9750	0.7100	0.0710	0.3400
Minimum	-	5,696,379	0.0260	0.4600	0.1350	-	-
Std. Dev.	0.0225	17,983,627	0.1223	0.1218	0.1403	0.0155	0.0699

**Islamic Banks**

Averages	ROA	Total Assets	TE/TA	TL/TA	Deposits/TA	Total Exp./TA	NIExp/T. Exp.
Mean	0.01	34,084,683	0.19	0.81	0.47	0.05	0.04
Median	0.01	26,751,393	0.16	0.84	0.51	0.05	0.04
Maximum	0.05	124,000,000	0.50	0.93	0.60	0.09	0.09
Minimum	0.00	4,024,674	0.07	0.50	0.24	0.01	0.01
Std. Dev.	0.01	28,703,068	0.12	0.12	0.11	0.02	0.02

**4.2. Correlation Matrix Analysis**

In Islamic banks, TL/TA has a positive significance impact on ROA and negative impact on TE/TA, which shows increase in bank loan, increase in ROA and decrease in the total equity of the banks. Deposits to total assets has positive significant impact on TA, TL/TA, and ROA, while negative significant correlation with TE/TA which shows increase in the total asset and bank loans which results decrease in the ROA. There is positive significant correlation of total expense on ROA, TE/TA, and deposits that shows increase in expenses increase in the profitability of the banks that suggests the banks to create more activities to generate the profit. At the end Non-Interest Expenses to total expense has positive impact on ROA. Staff salaries is the major overhead expenses of the banks that create activities other than huge portion of bank expense paid interest to the deposit holder of the bank. Similarly in conventional banks, TL/TA positively correlate with the ROA while negatively correlate significant ROA by TE/TA, that show when size of the loan increases which results in increase in ROA, and decrease in equity share of the banks. Deposits to assets ratio shows positive significant impact on ROA, TL/TA, and total assets while negative significant impact on Total equity, that show increase in deposits boosts up the lending capacity of the banks, resultantly increase in the total assets. At the end increase in expenses of the conventional banks, increases growth of the banks by generating more activities of the banks and high rate of deposits, resultantly low interest income.

Table: 4.2. Collective Sample (Conventional and Islamic Banks)

	ROA	Total Assets	TE/TA	TL/TA	Deposits/TA	Total Exp./TA	NIExp/T. Exp.
ROA	1.00						
Total Assets	0.22	1.00					
TE/TA	(0.24)	(0.67)	1.00				
TL/TA	0.24	0.67	(0.487)	1.00			
Deposits/TA	0.14	0.16	(0.41)	0.41	1.00		
Total Exp/TA	0.15	(0.14)	0.23	(0.23)	0.06	1.00	
N.I. Exp/T. E	0.46	(0.01)	(0.04)	0.05	0.08	0.25	1.00

**Conventional Banks**

	ROA	Total Assets	TE/TA	TL/TA	Deposits/TA	Total Exp./TA	NIExp/T. Exp.
ROA	1.00						

Total Assets	0.53	1.00					
TE/TA	(0.42)	(0.76)	1.00				
TL/TA	0.43	0.76	(0.423)	1.00			
Deposits/TA	0.23	0.38	(0.50)	0.50	1.00		
Total Exp/TA	0.09	0.18	(0.12)	0.12	0.40	1.00	
N.I. Exp/T.E	0.45	0.08	(0.17)	0.19	0.15	0.12	1.00

#### Islamic Banks

	ROA	Total Assets	TE/TA	TL/TA	Deposits/TA	Total Exp./TA	NIExp/T. Exp.
ROA	1.00						
Total Assets	(0.0774)	1.00					
TE/TA	0.191	(0.521)	1.00				
TL/TA	(0.0141)	0.570	(0.383)	1.00			
Deposits/TA	0.001	0.156	(0.017)	0.680	1.00		
Total Exp/TA	0.619	(0.269)	0.400	(0.228)	(0.158)	1.00	
N.I. Exp/T.E	0.618	(0.252)	0.386	(0.227)	(0.153)	0.998	1.00

### 4.3. Regression Analysis

Collectively, in Pakistani banking industry, increase in equity and loans results high return on assets. Moreover total expense and deposits have a positive insignificant relation with ROA, and non interest expenses have positively significant impact on ROA, that shows the cost of technology used in banks like ATM and other modern tools increase the financial performance. These variables have overall 45.82% impact on ROA and the highest coefficient is total assets which is 0.0007. In conventional banks, ROA shows the negative significant relation with total assets and total expenses. The negative regression directs conventional banks to control their expenses. However Ben Naceur (2003) shows that increase in expenses increases the profitability of the banks by generating more activities. Total assets show the negative coefficient with ROA but it gives insignificant impact on explanatory variable. Total assets, total loan/assets and non interest expenses/total expenses show insignificant impact and total equity/total assets, deposits/total assets, total expenses/total assets show the significant impact on ROA. Overall regression results are consistent as are correlation matrix and these variables influenced 41.56% on ROA. Whereas, in Islamic banks total loan to total assets show positive and significant relation with explanatory variable ROA. Deposits to total assets and total expenses to total assets have insignificant impact on ROA, while total equity to total assets and total loans to total assets show that size of the banks and non interest expenses to total expenses have significant impact on ROA. Overall regression results are consistent as are correlation matrix and these variable influenced 54.37% on ROA.

Table: 4.3.1. Regression Analysis

		Constant	Total Assets	TE/TA	TL/TA	Deposits/ TA	Total Exp./TA	NIExp./ T.Exp.
Collective banks (ROA)		-4.398	0.5692	0.1124	0.0098	0.1852	-4.79	1.1128
	P-value	0.0000	0.0007	0.0001	0.0048	0.1427	0.1633	0.0011
Conventional banks (ROA)		2.2213	-0.1897	0.0699	0.0013	0.9754	-13.998	0.3467
	P-value	0.0027	0.1508	0.0023	0.7365	0.0000	0.0001	0.7897
Islamic banks (ROA)		-8.945	1.2162	0.1267	0.0241	3.9723	3.994	0.9768
	P-value	0.0000	0.0001	0.0000	0.0000	0.1633	0.4453	0.0326

Table: 4.3.2. Regression Analysis

Collective banks (ROA)	R-Squared	0.4582
	R-Squared (adjusted)	0.437
	f-test Value	26.52
	Prob. (F-statistic)	0.0001
Conventional banks (ROA)	R-Squared	0.4156
	R-Squared (adjusted)	0.3846

	f-test Value	17.65
	Prob. (F-statistic)	0.0000
Islamic banks (ROA)	R-Squared	0.5437
	R-Squared (adjusted)	0.5197
	f-test Value	19.59
	Prob. (F-statistic)	0.0000

## 5. Conclusion

The study indicates the relationship between banks characteristics and different performance indicators like ROA, ROE and NIM. The results of financial comparisons of Islamic and conventional banks are consistent with the previous studies like Hassan and Bashir (2004), Faisal A. Alkassim (2005) and Ben Naceur (2003). The variable used in this study reacted differently on the financial performance of Islamic and conventional banks. Total assets show the size of the bank and show negative relationship on financial performance for conventional banks and positive on Islamic banks. That means the banks which have larger assets show less profitability, resultantly weak financial performance. Total equity represents the internal capital structure of the banks, shows positive relation both for conventional and Islamic banks. Total loans show positive relation both for Islamic and conventional banks that indicates that increase in loan increases the financial performance. Conventional banks deposits ratio is less than Islamic banks which means that deposits of Islamic banks increase the profitability more than the conventional banks. Total expenses of Islamic banks have positive impact on the financial performance which means that by increasing expenses, they generate more activities to get more profit while expenses of conventional banks give negative impact on the financial performance. Non Interest expenses for both types of banks have positive impact that shows increase in the financial performance. However, there is some difference in the operational activities of Islamic and conventional banks. Finally, it is concluded that Islamic banking system is much superior to the conventional banking system. They have the capacity to increase their market share by generating new activities in Pakistan.

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