

An analysis of the Pakistani banking industry's performance in relation to Islamic ...

An analysis of the Pakistani banking industry's performance in relation to Islamic and conventional banking

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Received on: 15-07-2022

Accepted on: 20-08-2022

Abstract

Islamic banking upholds the financial laws of Sharia. Here, transactions are carried out honestly, without the use of *riba*, and with an emphasis on furthering Islamic economic goals and objectives. On the other hand, conventional banks follow regulations that were created by humans, with the set interest rate acting as the primary activity. This research analyses the performance of Islamic and conventional banks in Pakistan from 2020 to 2022. The performance of two conventional banks (MCB and HBL) and two Islamic banks (Meezan and Dubai Islamic) in Pakistan from 2020 to 2022 will be examined and assessed in this study. Financial ratio analysis for liquidity, profitability, solvency, and activity analysis of the designated institutions from both categories were performed to evaluate total performance. According to the findings, conventional banks in Pakistan would be more profitable than Islamic banks from 2020 to 2022. In the remaining ratios of current, cash, debt to asset, and asset turnover, Islamic banks outperform conventional banks in Pakistan.

Keywords: Financial comparison, Islamic banking, conventional banking

Introduction

"Islamic banking was started in 1963 in a small village of Egypt," claims Metwally (1997). This was carried out experimentally to confirm its viability in a real-world setting. The deposits exploded in three years, proving that this experiment was successful. Political pressure to abandon the project existed, and it was finally abandoned. Nevertheless, the experiment was a success in showing how orderly Islamic banking might be. The success of this endeavour prepared the ground for Islamic banking to have a clear market. As a result, Islamic banking emerged in the 1970s at a respectable rate. Many Islamic banks have their roots in Arab and Asian nations. Initially, the majority of these Islamic banks were located in Muslim-majority nations. Islamic banks began on a small scale and are currently active in at

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least 60 nations. Even non-Muslim nations with sizable Muslim minorities, such the United Kingdom, France, and Germany, among others, have them in operation.

According to Ariss (2010), Islamic banking has grown significantly since 1975 and is now widely recognised as a valuable source of funding. In Asia and the Arabian Gulf, Islamic banks have prospered. Furthermore, a significant number of financial institutions have changed their various activities from traditional procedures by setting up Islamic windows or well-established Islamic Banks. The repeated boom-bust cycles of recession that have been seen in a number of states and areas over recent decades, according to Parsa (2020), have also drawn attention to the traditional banking and financial institutions' susceptibility to the financial crisis. Instead, it was found by Ihak and Hesse (2010), Hasan and Dridi (2011), Kenourgios et al. (2016), and Rashid et al. (2017) that Islamic banks have stronger resistance to such destruction due to their larger capitalization and ample liquid assets. This has, among other things, accelerated the spread of Islamic banking around the world, particularly in Asia and the Middle East.

The Pakistani government and financial authorities still struggle to adapt to the quickly changing global trade and economic conditions despite the country's present rules and regulations. The global banking crisis, international fraud, and natural calamities are to blame for these difficulties the government is experiencing. Pakistan's economy is being severely harmed by the outbreak (COVID 19). Hassan et al. (2020) discovered a noteworthy association between bank risk and financing liquidity risk in Pakistani Islamic and conventional banks. The authors emphasised how both Islamic and Western systems operate. There are rules established by people in traditional banks. But Shariah law is followed by Islamic banks. The goal of both systems is to boost sales. Traditional banks lend money via compound interest. An Islamic bank adheres to the concept of profit and loss sharing, however while making loans there is a defined income. Musharakah or Mudharabah, among other things, are the basis for how an Islamic bank shares losses. Similar to how conventional and Islamic banking systems help the corporate world run the economy efficiently, they both fulfil all necessary tasks, but they operate differently and have different beliefs.

Numerous professionals and specialists in other countries prefer to desire instruction in addition to effort in the Islamic financial system because of the efficient instruments of the Islamic banking system. Additionally, the top banks in the world are now required to open and run their financial systems in accordance with Islamic principles. They adhere to the Sharia Law of Islam in this respect. Additionally, because Islamic banking operates in the global real economy, it is devoid of speculation and gaming. As a result of its involvement in debt financing and the fact that the bulk of its transactions are driven by market speculation, conventional banking is consistently more risky than Islamic banking. Ultimately, this serves as the quintessential illustration of Islamic banking's superiority over conventional banking (Mahmood, 2020). Banks are not allowed to merge Islamic and conventional banking activities in Pakistan since they are separate from one another. In Pakistan, the Sharia Advisory Board is in charge of Islamic banking, whereas the State Bank of Pakistan is in charge of conventional banking.

The board is in responsibility of identifying needs, launching new Islamically compliant goods and services, and maximising their utilisation. Pakistan has five fully sharia compliant Islamic banks in addition to twelve conventional and Islamic banking windows. In Pakistan,

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conventional banks known as Islamic windows continue to run more than 268 Islamic branches. The current Islamic banks are made up of more than 524 divisions. This shows that more than 50% of Pakistan's Islamic Banking branches are found inside of regular banking locations. Given the positive commercial trend of sharia-compliant Islamic windows, it is now fairly evident that conventional banking is attempting to incorporate the Islamic Banking model into its banking regulations. This research compares Islamic and conventional banking in Pakistan with a view to estimating and measuring the financial performance of both sectors in terms of profitability (2020 to 2022).

In order to examine the activities of banks using various financial rates, two different banking systems were statistically analysed. Supervisory authorities are evaluated based on five criteria: capital adequacy, asset quality, management quality, profits, and liquidity. This framework, which is a grading system, serves as the foundation for the assessment. In terms of return on assets (ROA) and return on equity, it also contrasts and compares the profitability of Islamic and conventional banks (ROE).

Literature

Inadequacy of the performance criterion for Islamic banks was examined by Badreldin (2009). The study then put Islamic banks to the test by applying a commonly utilised return on equity (ROE) analysis tool. Additionally, conventional banks employ this technology. The findings suggested that Islamic banks will succeed using the aforementioned recognised model. This technology would also provide significantly enhanced analysis and comparison within Islamic banking. The study also showed that a significant portion of previously calculated efficacy of Islamic banks was inaccurate and needed to be enhanced for accuracy. The investigation found that the inaccurate measuring techniques were to blame for the unreliability.

Mrad and Mateev (2020) looked at the effectiveness and profitability of conventional banking and Islamic banking in the United Arab Emirates using correlation, evocative, and multiple regression analysis. In the United Arab Emirates, they discovered a significant cost-effectiveness gap between conventional banking and Islamic banking. In comparable banks, the most important appropriateness indicators of a bank's cost-effectiveness are dominant. The cost competence of regular banks was greatly impacted by risk-taking, while this impact is insufficient for Islamic banks. They discovered that there is no appreciable difference in the bank's output between conventional and Islamic banking. Only in traditional banks do money acceptance procedures have a substantial influence on a bank's success. Islamic profitability, however, reacts to risk-taking more quickly. In order to improve both banks' financial performance and market position, compliance standing, and risk assessment, they proposed that since Islamic and conventional banks are subject to different rules and laws, the establishment and application of regulations must also differ for each type of bank.

According to Bitar et al investigation 's from 2019, there are differences between conventional and Islamic banks' efficiency propositions. Similar to this, several research have backed the idea that Islamic banks are more capable based on four key factors. First, because the mark-up financing contracts used by Islamic banks are asset-backed and related to the actual economy, they are less vulnerable to losses caused by speculative activity. Second, Islamic banks provide Investment Account Holders reasonable returns in an effort to keep their current depositors and attract new ones. Investment Account Holders will withdraw

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money and invest elsewhere if return rates are not competitive. Likewise, according to Farooq & Zaheer (2015), pressure may discipline Islamic banks and improve their competence. Thirdly, Bitar et al. (2019) addressed how Islamic banks' management capacity has significantly increased to overcome gaps connected to restrictions imposed by Shari'a legislation.

Johne et al. (2014) report that Islamic banks have increased their investments in staff development and in enhancing public understanding of Islamic financial products. A better reputation, a good banking experience, and increased demand for their products are the results of these studies. Finally, Bitar et al. (2019) explore how macroeconomic conditions make Islamic banks more effective than conventional banks. For instance, Bitar et al. (2017) imply that pressure on Islamic banks is caused by oil income, rapid economic expansion through private banking sectors, opening of the banking sector to global competition, and recently approved financial reforms. To ensure effective resource allocation and boost production, this pressure may be translated into new financial products, increased spending on research and development, as well as employee training.

Ali et al. (2019) consistently used efficiency ratios to conduct comparative evaluations of both banking sectors. From the Islamic republic of Pakistan, they grabbed five Islamic and five conventional banks. Additionally, they showed that Islamic Banking has functioned more skillfully. In order to meet the expectations of the customer and sustain proactive services, they also recommended that the Islamic industry concentrate on the creation of new goods and technical innovations. Although there is no significant difference in terms of profitability between both, their analysis found that the Islamic banking sector has a superior structure than commercial banks since it is less riskier than a commercial bank. Similar to this, Arshed & Kalim (2020) evaluated the market for Islamic banking deposits in their study. Because resources enable banks to achieve long-term capital structure portfolios, the role of the bank as an intermediary provides appropriate deployment of surplus capital while maintaining deposit accessibility. Moreover, Islamic banks must adhere to Shari'ah regulations, in contrast to regular banks. The experts came to the further conclusion that the global Islamic banking deposit market is strong, stable, and convergent. Therefore, banks must affirm their relationship with price while developing a plan to attract deposits. The effect of fixed capital creation, net financing, and Islamic banking products on growth was also shown by them.

According to the research, capital accumulation and Islamic financial investment are positively correlated with economic growth over the long term. Ijarah, one of the Islamic banking products, helps to encourage economic growth, but Musharkah and Murabaha decline and have an adverse effect on it. Ijarah was the product that had flawless long-term and short-term favourable relationships. Saeed et al. (2020) investigated the differences between Islamic and conventional risk-taking mindsets when it comes to capitalization. An significant development in the financial sector is the formation of an Islamic banking system that complies with Shariah rules. Islamic institutions have maintained fast development despite growing hardships and a decline in faith in international financial systems. In contrast, Kamarudin & Kassim (2020) found that clients are happier with traditional banks in terms of consistency, responsiveness, reassurance, and empathy, with the exception of tangibility, where they are happier with Islamic banks. Additionally, consumers who have been dealing with the bank for more than a year regard each aspect of staff professionalism

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as crucial to guaranteeing their loyalty to the institution. Results of this study show that Conventional Banking's market share is growing quickly.

Methodology

The design of this research study was done in a way that would enable a comparison of the effectiveness and profitability of Islamic banks in Pakistan with those of conventional banks. The focus of this study is on all Pakistani banks, including those Islamic and conventional banks that operate within the same framework of economic, political, and social constraints. With the use of the random sample procedure, two conventional banks (MCB and HBL) and two Islamic banks (Meezan Bank and Dubai Islamic) have been chosen. Due to the fact that MCB and HBL are the two largest conventional banks in Pakistan and hence best reflect the whole population of conventional banks, two conventional banks from the conventional banking industry have been chosen at random. While Meezan Bank and Dubai Islamic Bank—considered to be the banks that rely on Shariah principles the most—are also chosen using a random selection technique from the Islamic Banking Sector, reflecting the whole population of Islamic Banks.

In the current study, financial parameters were assessed using SPSS software to determine profitability in Islamic and conventional banks. As a result, the following variables were employed in the investigation. Two (2) dependent and five (5) independent variables have been assigned to these variables.

3.1 Dependent Variable

- a) Returns on equity
- b) Returns on Assets.

3.2 Independent Variables

- a) Capital Adequacy Ratio = Total Equity / Total Assets
- b) Asset Quality Ratio = Provision Loan Losses / Total Loan
- c) Earning-Quality-Ratio = Operating Cost / Total Revenue
- d) Liquidity-Quality-Ratio = Liquid Assets / Total Deposit

Analysis

The Correlation About Islamic Banks

The results show that there is a weakly negative association between (ROE) & (ROA) as dependent variables and a variety of independent factors, such as (CAR) capital adequacy ratio and (AQR) assets quality ratio. The correlation has been applied to Islamic banks. Although there is a perfect inverse connection between the independent variable (EQR) earning quality ratio and the dependent variables (ROE and ROA), raising the earning quality ratio may reduce profitability. In the final analysis, the liquid quality ratio (LQR), an independent variable, and the dependent variables of profitability (ROE and ROA), which indicates that profitability may grow with an increase in the liquid equality ratio. Following table 1. is given below for presenting details of the above discussion.

Table 1 Correlation Analysis

CORRELATION	ROE	ROA	CAR	EQR	AQR	LQR
ROE	1.000					
ROA	0.914	1.000				
CAR	(0.311)	(0.364)	1.000			
EQR	(0.859)	(0.926)	0.338	1.000		

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AQR	(0.299)	(0.281)	(0.241)	0.245	1.000	
LQR	0.3343	0.3649	0.141	(0.344)	(0.290)	1.000

The Correlation Regarding Conventional Banks

The connection has also been used with conventional banks. The findings showed that (ROE) and (ROA) as dependent variables have a significant negative connection with (EQR) earning quality ratio as an independent variable, which indicates that an increase in earning quality ratio will reduce the profitability of traditional banks. However, there is only a very slight positive correlation between the independent variables (CAR) and LQR and the dependent profitability indicators (ROE and ROA). It implies that increasing the independent variables would cause profitability to marginally rise. Last but not least, the study's dependent variables and the number of independent variables (LQR) and (AQR) have a weakly negative association, indicating that there is an inverse link between the two of them and that raising the independent variable may lower the profitability ratio. Details of the previous conversation are presented in the table 2. below.

Table 2. Correlation Analysis

CORRELATION	ROE	ROA	CAR	EQR	AQR	LQR
ROE	1.0000					
ROA	0.6842	1.0000				
CAR	0.0609	0.0712	1.0000			
EQR	(0.7416)	(0.6167)	(0.0572)	1.0000		
AQR	(0.0654)	(0.2051)	(0.0279)	0.2079	1.0000	
LQR	(0.0842)	0.1107	0.2919	0.2197	(0.2921)	1.0000

The combined ROA's R-square value is 0.573, indicating that SS and all other variables account for 57% of the variation in ROA, with other factors accounting for the remaining 43%. The combined ROE's R-square value is 0.607, meaning that all variables, including SS, account for 61% of the variation in ROE and that the remaining 39% is due to other factors. The ROA in Islamic banks has a R square value of 0.718, indicating that all predictors contribute to 72% of the variance in ROA and that the remaining 28% of the variation is due to other variables. The ROA in commercial banks has an R-square of 0.541, which accounts for a 54% variance in ROA caused by the independent variables employed in the estimation. The R-square of 0.858 for ROE in Islamic banks explains 86% of the variation in ROE as a result of the included variables in the model. The R-square of 0.549 for ROE in commercial banks indicates a 55% variance in ROE attributable to the independent variables in the estimation.

TABLE 3. R SQUARE AND MODELING TEST ANALYSIS

Models	R	R Square	R Square Adjusted	Std. Error of estimate
<i>Combined Sample - ROA</i>	0.757 ^a	0.573	0.555	0.652
<i>Combined Sample - ROE</i>	0.779 ^a	0.607	0.590	0.623
<i>Islamic Banks - ROA</i>	0.847 ^a	0.718	0.587	0.462
<i>Conventional Banks ROA</i>	0.735 ^a	0.541	0.517	0.662

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Islamic Banks - ROE	0.926 ^a	0.858	0.792	0.458
Conventional Banks ROE	0.741 ^a	0.549	0.527	0.639

Conclusion

For the purposes of this study, we excluded conventional banks and assessed the performance of both conventional and Islamic banks. The Islamic banking system developed its own set of regulations and standards, which exclude bank rates and artificial market movements. The study's goal is critical in light of the fact that each financial system has its own reality. In Pakistan's current financial climate, both systems are experiencing ups and downs. The study's most noteworthy result is not simply which banking system in Pakistan has the highest performance when financial indicators and regression analysis are compared. Furthermore, this research allows investors to carefully assess and evaluate which strategy is best for them.

The two different banking systems' approaches and tactics for expanding their market share and raising shareholders' wealth and worth vary. The historical context of both techniques and their practical elements were primarily stressed in this study. After discussing the various facets and dimensions, It is also stated that traditional banks recognise the significance of the Islamic banking system. As a result, they are transforming existing conventional branches into Islamic banks and creating a slew of new branches based on the Islamic banking concept. Decisions of this sort may provide significant evidence that the Islamic banking model has triumphed over the traditional banking sector in Pakistan. The Islamic banking system is more widely accepted, therefore it is becoming much more widespread in Pakistan. Furthermore, bank clients' behaviour is abruptly changing for the better, strengthening their confidence and faith in Islamic banks in comparison to traditional banks. As a result, the banking regulators must consider these consumers' behaviour while deciding whether or not to open the Islamic banks' window.

We separated the correlation analysis findings into two tables and applied a stationary test to ensure that the time series values were accurate. We have calculated the Islamic bank correlation test in the first phase and we conduct the correlation on the traditional Bank at the second step. We discovered both a negative and positive correlation between profitability and independent factors, however regression analysis revealed that the independent variable (EQR) had the strongest and most persistent negative correlation with profitability. In order to attain sustainability generally and specifically for long-term perspectives, banks must consider and maintain all of these ratios. In order to pinpoint the areas that have been missed, Islamic banks' performance should be compared to those of Islamic banks in other countries. It is suggested that future researchers conduct the same examination with a large sample of banks to validate the findings of this study. Give the bankers a plan of action as well so they may improve the institutions' financial performance and address any policy flaws.

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