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EMPIRICAL EVIDENCE ON COMPARATIVE PERFORMANCE OF CONVENTIONAL AND ISLAMIC BANKING IN PAKISTAN

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ABSTRACT

The banking sector is crucial to the development of every economy. The purpose of this study is to find if there exists a significant difference between the financial performance of Islamic and conventional banks in Pakistan. Islamic banking system has emerged as a new horizon in the international financial system since the 1970s. Pakistan's Islamic banking department was created on September 15, 2003 and assigned a duty for the promotion and development of banking services in compliance with Islamic laws. Several studies have been carried out by scholars to observe problems associated with Islamic banking systems across the globe. This study fills a gap in the empirical literature and analyzes the profitability of Islamic banks and conventional banks over the period of 2006 to 2015. Differential statistics is applied to quantify the difference. Findings which are generalizable to the banking sector only show that there is a significant difference between the profitability of Islamic banks and conventional banks. That is, conventional banks are more profitable than Islamic banks and contributes the most to sustainable development in Pakistan. Policy implications are discussed and future studies may be conducted on multiple countries.

Keyword: Islamic Banking, Conventional Banking, Sustainability, Banking Performance

1. Introduction

Islamic banking system is considered to be a developed segment of the global financial market; with huge prospects considering its rapid growth across the globe (Nizar, 2015).Islamic banks establish themselves in a comparatively short period by capturing a good market share from its competitors. The Islamic banks have gone through tremendous growth in last two decades. The existence of Islamic banks in some Muslim states is 5%, 12% and 30% in Malaysia, Kingdom of Saudi Arabia and Kuwait respectively. It is expected that in the next 8 to 10 years, Islamic Banking Institutes will become a part of at least 40-50% of the total savings of world's Muslims. Islamic banks are showing emphasis on domestic markets whereas western conventional institutions like Merrill Lynch International set high net values (Marimuthu, Jing, Gie, Mun & Ping, 2010).

The importance of banking is paramount in an economy. Nowadays the banking industry consist of conventional banking (CB) and Islamic banking (IB) in Muslim countries. Conventional banks accept deposits and avail loans by charging interest (*riba*) while Islamic banking denounces *riba* and exhibits mainly a profit and loss sharing system. Islam strictly forbids the charging of interest (*riba*) based transactions as evident in this verse *"And because of their charging riba while they were prohibited from it.*" (Quran, An-Nisaa 4:161). Conventional banks (which is *riba*-based) channel funds from savers to the borrowers, hence, provide interest-financed loans only (Adeleye et al., 2018). The bank and customer share a debtor-creditor relationship when the customer deposits and borrows. Conventional banks act as financial intermediaries and earn a margin (profit) from interest paid to depositors and interest obtained from borrowers (Adeleye et al., 2018; Onwe et al., 2019).

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They also engage in investing in securities, bonds and shares underwriting. Universal banks provide even more general services than commercial banks (Schildbach, 2012). On the dark side however, bubbles within conventional banking practices led to the global financial crises of 2007-2009 (Adeleye et al., 2018)).

On Islamic banking, the religion of Islam prohibited the charging of interest over 1400 years ago but the *riba*-free banking system has emerged recently. As a result of globalization, modern banking emerged in Muslim countries to facilitate trade with non-Muslim countries. However, Muslim leaders have since recognized the need to establish Islamic banking system to avoid *riba* and to fully comply with Sharia laws. Hence, Muslim countries united to create a *riba*-free financial system by establishing the Islamic Development Bank in 1975 (Islamic Development Bank [IDB], 2017). Following that, the UAE government established its first Islamic bank, the Dubai Islamic Bank in 1975. Many other Muslim countries like, Egypt, and Kuwait followed suit in coming years. Pakistani government, since 1981 permitted all the domestic commercial banks to accept deposits on the basis of profit and loss sharing formula. Presently, there are at least six fully functional Islamic banks in Pakistan.

Like other Muslim countries, Pakistanis have been conscious to always use Halal banking system for their business and personal transactions. Hence, both corporate bodies and individuals are eager to understand Islamic banking systems vis-à-vis conventional practices in order to formulate investment decisions and ensure Sharia compliance strategies. Given this, there is the need to analyze and compare the performance gaps between Islamic and conventional banks so that the investors can make Sharia compliance decision confidently. This study fills that gap in the empirical literature. Therefore, the objectives of this study are to: (1) analyze the performance gap between Islamic banks and conventional banks in Pakistan and (2) access if there exists significant differences in their performance. The research questions are also framed inter alia: (1) is there any significant difference between the financial performance of Islamic and conventional banks (2) which banking system shows a better performance? The rest of the paper is structured as follows: Section summarizes the extant finance literature, Section 3 outlines the empirical methodology, Section 4 discusses the results and Section 5 concludes with policy implications.

1. Brief Literature Review

This literature review comprises different studies conducted across the globe. Studies on religion show that it is a combination of norms, values, and culture and Islam is one of the finest religions. Most of the decisions of the Islamic followers are based on its religious motives which dictates what they should and not do. Religion informs and answers the basic questions of life. 97% of Pakistan's population are Muslims who follow the true teaching of Prophet Muhammad (Peace Be upon Him). Omer (1992) stated that Islam is a religion of humanity, with respect for human rights and obligations. Islam is a complete code of life for every Muslim and influences the everyday dealings of its followers. The Muslims follow the Shariah laws, rules, regulation and principles. Previous studies show that religious motives are significant factors in the adoption of Islamic banking. Dusuki and Abdullah (2007) stated that religion is an important factor in the adoption of Islamic banking. Faizulayer (2011) using capital adequacy, asset quality, management earnings and liquidity compared the profitability of banking sector. They have found the significant difference between Islamic banking and conventional banking. Awan (2009) showed that the performance of Islamic banks seem better compared to those of conventional banks by comparing the vertical growth of both banking structures with the growth of Islamic financial institutions amounting to $1 trillion US dollars with 20 percent annual growth. Similarly, Iqbal (2001) described the performance of Islamic and conventional banks by using ratio and trend analysis. He compared the performance of "control group" of conventional banks with those of Islamic banks and concluded that Islamic banks

perform better than conventional banks. Using 2008 banking data, Hamedian (2013) concluded that Islamic banks showed better performance to conventional banks in terms of profitability using different profitability ratios such as return on equity (ROE) and return on assets (ROA). Furthermore, the efficiencies of Islamic and conventional banks have been analyzed using different models with the *t*-statistics showing no significant difference between Islamic banks and conventional banks in terms of mean efficiencies scores. Other studies establish that performance difference exists between Islamic and commercial banks which also differences in depositors' behavior (Irfan, Naeem & Osama, 2014). On the other hand, Hameed and Bashir (2003) explored that controlling for the structure of financial markets, macroeconomic factors and taxation, results indicate that increase in loan-to-asset and capital-to-asset ratio leads to better financial performance. Their findings showed that foreign-owned banks have higher profitability margins. They also found that banks and stock markets are interrelated.

In Pakistan, the Shariah Board plays an important role in enforcing financial modes and guidelines to banks when they are developing new financial products Metawa and Almossawi (1998), Haseeb, Ramiz, Ghulam and Awais, (2010), Khattak and Rehman (2010) found that religion is a significant factor that influences the decision of customers in choosing Islamic banking. This is because muslins have knowledge about the financial teaching of Islam and are aware that charging of interest in not allowed in Islamic economies which follow follow Shariah rules, regulations, and principles. Islamic banks are designing their products on the basis of financial teachings of Islam and its significant relationship with Islamic banking. Hamid and Nordin (2001) found that financial teachings of Islam are the most significant factors in the adoption of Islamic banking. Similarly, Marimuthu (2010) found that knowledge of financial teaching of Islam has a significant factor in the adoption of Islamic banking. In his study, Hanif (2011) identified the differences between Islamic and conventional banks and showed that the major difference exists in their manner of operations (Bahamanyer, 2013).

Shahidet al. (2010) from the Gulf region added that liquidity risk in Islamic banks is less compared to conventional banks. Likewise, Islamic banks do not depend on external liabilities as much as conventional banks but shows no significant differences between them. He stated that that the internal growth rate of both banks are same but concludes that the major differences depend on certain factors such as bank performance and management style. Azhar et al. (2010) on the other hand, examined this from the customer's satisfaction perspective. They found that conventional banks provide better and quality services to their customers than Islamic banks do. In addition, Alkassim (2005) also found that the financial performance of conventional banks is better than that of Islamic banks. Massoud (2015) pointed out that Islamic banks to provide an attractive alternative for conventional banks to customers. Given the significant gap and inconsistencies regarding the performance differences of these two banking structures in terms of profitability this study fills that gap by empirically investigation if there is any significant differences in the performance abilities of the two banking platforms.

2. Data and Estimation Technique

This study uses a panel data on 16 banks in Pakistan from 2006 to 2015. Out of the 16 banks, 10 are conventional while 6 are Islamic banks. Data is sourced from the annual financial statements of these banks. To achieve the research objectives, the study uses differential statistics to analyze the financial performance of these banks using the measure of banks profitability. Comparative statics was further conducted to know whether Islamic Banks are more efficient than conventional banks. Table 1 shows the list of banks covered in this study.

Table.1 List of Banks

Islamic Banks	Conventional Banks
Alfalah Bank	Allied Bank
Albaraka Bank	Habib Bank
Al Habib Bank	United Bank
Dubai Islamic Bank	Standard Chartered
Meezan Bank	Askri Bank
Muslim Commercial Bank	Faysal Bank
	National Bank
	Silk Bank
	Soneri Bank
	Summit Bank

Source: Authors' Compilations

Profitability has been measure using the formulae of Net Sales/Net Profit. For accurate comparison the data of CBs are taken after deducting the Islamic portion from its profitability. Descriptive statistics is carried out to understand the essential features of the variables used. ADF unit root test is applied to see the stationarity of selected data. To engage the comparative analysis, the study adopts the Welch test and equality of means, median and variance also applied for robustness.

3. Results and Discussions

The results are discussed in this section. But first the correlation analysis and summary statistics of the variables are shown.

Table.2

Banking Type	Profitability(Mean)
Conventional banks	0.692124634
Islamic Banks	0.122760849

Source: Authors' Computations

Simple statistics using mean shows that the conventional banks in Pakistan are more profitable than Islamic banks.

Table.3

Test for Equality of Means Between Series				
Date: 06/09/18 Time: 11:09				
Sample: 2006 2015				
Included observations: 60				
Method		df	Value	Probability
t-test		116	-13.45868	0.0000
Satterthwaite-Welch t-test*		60.20800	-13.45868	0.0000
Anova F-test		(1, 116)	181.1360	0.0000
Welch F-test*		(1, 60.208)	181.1360	0.0000
*Test allows for unequal cell variances				
Analysis of Variance				
Source of Variation		df	Sum of Sq.	Mean Sq.
Between		1	123.8781	123.8781
Within		116	79.33191	0.683896
Total		117	203.2100	1.736838
Category Statistics				
Variable	Count	Mean	Std. Dev	Std. Error of Mean
LNCONVENTIONAL	59	-1.924368	1.158548	0.150830
ISLAMIC	59	0.124842	0.159869	0.020813
All	118	-0.899763	1.317891	0.121322

Source: Authors' Computations

In this table, Welch test has been applied to see is there any significant difference between the profitability of Islamic and conventional banks in Pakistan. Welch test assumes null hypothesis as there is no significant difference between the two series while assuming the alternate hypothesis as the opposite. In the above table alternative hypothesis has been substantiated on the P value= 0.00 which is less than the threshold value of 0.05. It has been established that in Pakistan there is a significant difference between the profitability of Islamic and CB. The assumption of normality has been duly checked.

Table.4

Test for Equality of Medians Between Series					
Date: 06/14/18 Time: 01:09					
Sample: 2006 2015					
Included observations: 60					
Method		Df	Value	Probability	
Wilcoxon/Mann-Whitney			1.740643	0.0817	
Wilcoxon/Mann-Whitney (tie-adj.)			1.740643	0.0817	
Med. Chi-square		1	3.709373	0.0541	
Adj. Med. Chi-square		1	3.036726	0.0814	
Kruskal-Wallis		1	3.039096	0.0813	
Kruskal-Wallis (tie-adj.)		1	3.039096	0.0813	
van der Waerden		1	2.960981	0.0853	
Category Statistics					
Variable	Count	Median	> Overall Median	Mean Rank	Mean Score
CONVENTIONAL_PROFITABILITY	60	0.177830	35	65.46667	0.151684
ISLAMIC_PROFITABILITY	59	0.131472	24	54.44068	-0.154255
All	119	0.145731	59	60.00000	-2.99E-17

Table 2 output shows the test for equality of medians between the Islamic Banks and Conventional banks' profitability. All the tests have P-value greater than 0.05 thus rejecting the null hypothesis of similarity of medians. So, the median of the profitability is different among the series, supporting the findings of other tests.

Table.5

Test for Equality of Variances Between Series
Date: 06/14/18 Time: 01:13
Sample: 2006 2015
Included observations: 60

Method		df	Value	Probability	
F-test		(58, 59)	1531.721	0.0000	
Siegel-Tukey			0.162106	0.8712	
Bartlett		1	342.4261	0.0000	
Levene		(1, 117)	3.524925	0.0629	
Brown-Forsythe		(1, 117)	0.936796	0.3351	
Category Statistics			Mean Abs.	Mean Abs.	Mean Tukey-
Variable	Count	Std. Dev.	Mean Diff.	Median Diff.	Siegel Rank
CONVENTIONAL_PRIFITABILI	60	6.256812	1.588294	0.896354	60.51667
ISLAMIC_PRIFITABILITY	59	0.159869	0.109550	0.109437	59.47458
All	119	4.446323	0.855135	0.506202	60.00000
Bartlett weighted standard deviation: 4.444526					

The table shows the test of variance through the different statistical tests. Siegel-Tukey having low power test assumes null hypothesis of equal variances between the series. The P-value is more than 0.05, shows there is no significant difference between the profitability of Islamic and commercial banks. While the Bartlett test statistics for detection of heteroscedasticity between the series shows a P-value of 0.000 which is less than 0.05 proves that significant difference in profitability between the Islamic and commercial banks exists. Levene's test shows acceptance of null hypothesis of equal variances between Islamic and CB with the P-Value of 0.0629. It shows that conventional banks in Pakistan are more profitable than the Islamic banks. Our results support the findings of Alimshan Faizulayer (2011), Bahamayar Hamedian (2013) contradict with the Haseeb shahid, Ramizurrehman (2008) and Abdul Gafoor Awan (2009). There may be geographical differences in which the studies have been conducted.

4. Conclusion

This study is limited to Pakistan banking sector only and attempts to compare the financial performance of Islamic banks and conventional banks. Using profitability as the measure of financial performance, the profitability ratio is used to measure this difference. Some robustness checks were also carried out to test the efficacy of our findings which reveal that conventional banks make more profits than Islamic banks and that there is a significant difference in profitability in terms of their respective net profit margins. From the data used, conventional banks seem to be more profitable than Islamic banks across all the various tests conducted. Moreover, there is another issue which needs consideration that is increase education and public awareness for spreading the unique characteristics that an Islamic banking system holds and how these distinctive features beneficially fit according to the needs of customers in the financial dealings.

Conventional banks have a large footing in Pakistan but Islamic banks are attaining profit and growth gradually. The IB is in development while the conventional banks are well established. Islamic banks are narrowing the gaps with conventional banks of the country and will be a large sector of our economy like conventional banks nowadays. IB, Islamic products and functions are needed due to Muslim country.

In view of the study outcomes, the following recommendations are made: (1) since Islamic banking exhibit some elements of ethics and moral values in its operations, emphasizing these values will create more public awareness for the benefits of Islamic banking and draw more customers; (2) Islamic banks lack Islamic scholars, hence there is the need for qualified Islamic scholars. ; (3) for penetrating into the conventional market, Islamic banks should collaborate with different Islamic organizations and take the confidence of several religious icons for spreading the use of *riba*-free banking system. For further research, this study may be enhanced by including more countries.

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Appendix

Unit root test unprofitability

Null Hypothesis: Unit root (individual unit root process)

Series: LNPROFITABILITY

Date: 06/11/17 Time: 00:00

Sample: 2006 2015

Exogenous variables: Individual effects

User-specified lags: 1

Total number of observations: 98

Cross-sections included: 13 (3 dropped)

Method	Statistic	Prob.**
ADF - Fisher Chi-square	51.8577	0.0019
ADF - Choi Z-stat	-3.26627	0.0005

** Probabilities for Fisher tests are computed using an asymptotic Chi -square distribution. All other tests assume asymptotic normality.