Difference Between Islamic Banks and Commercial Banks Performance In Pakistan

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Abstract
Researcher could find the difference between the performance of Islamic and commercial banks. Banks are the financial or large sector of our economy. Banks play a very important role in our economic development. Islamic and Commercial banks are two broad sectors of our banking system. Islamic banks conduct banking on Islamic laws but commercial banks conduct banking on manmade laws. Researcher fined the difference between the performance of Islamic and commercial banks on the base of profitability. Profitability checked by return on asset (ROA) or return on equity (ROE). Researcher fined that there is a clear difference between the Islamic and commercial banks performance on the base of profitability in terms of ROA or ROE. Researcher also fined that if differences in performance exist between Islamic and commercial banks also affect this difference on depositors’ behavior.

Key Words: Islamic Banking, Commercial Banking, Comparison.
Introduction

As the banking sector is the most growing sector in the Pakistan. There are many types of banks operating in Pakistan, Conventional and Islamic banks. Commercial banks are those financial instructions which accept and advancing loan on interest basis. They perform different functions as leasing, agency function etc. They have different types of accounts, locker facility for customers. Commercial banking is based on manmade rules and focus on interest financing. Islamic banks perform functions as commercial banks but they follow the rules of Islamic Shariah board. Islamic banking is the interest free banking. They follow the Islamic modes of finance Mudarabah, Musharaka, Ijarah etc.

In Islamic banking Islamic rules are following. Islamic banking started in Pakistan to minimize and eliminate the interest. Meezan bank limited is first and largest Islamic bank in Pakistan. State bank of Pakistan also allow banks to conduct banking on the basis of Islam. State bank of Pakistan established a commission for transformation of financial system (CTFs) which made Shariah compliant modes which help banks to conduct banking according to the Islamic rules.

Conventional banks rely on Manmade principles and focuses on maximization of profit. The fundamental function of conventional banking is lending money and takes it back with high interest including profit. Conventional banks are in large number than Islamic banks that don’t share profit and loss with customers. State bank of Pakistan made an Islamic banking department in 15 September 2003 under this Islamic banking play his role in financing and other economic and social sector. State bank of Pakistan in January 2002 give license to Meezan bank limited for operating as a first Islamic and largest bank in Pakistan. Islamic banking growth increasing day to day not only in terms of countries in which it is operating but also in financing fields or areas. Some countries convert their banking systems all in Islamic bases, for example, Sudan and Iran, large number of Islamic banks established e.g. Faisal Islamic Bank of Egypt (1977), Dubai Islamic bank (1975), Bahrain Islamic Bank (1979) and Faisal Islamic Bank of Sudan (1977) etc. Islamic banks share profit and loss with its customers and depositors. This sharing gives more strong ground to Islamic Banking.

Islamic Banking working base on interest free banking. But conventional banks base on Interest-based techniques and principles. Islamic banking prohibits Riba whereas conventional banking doesn’t. In 1970, Pakistan started interest-free financing through few Islamic interest-free products. Islamic banks work same like conventional banks but without interest.

Islamic Shariah laws restrict the interest charged on payments. Conventional banks charge interest and made relationship with customers as debtor and lender. Islamic banking use some principle like Mudarbah (Speculation), Musharaka (full partnership), Murabaha (Markup financing), Istisna (Manufacturing contracts), Ijarah (Lease financing) and Qarz-e-hasna (benevolent loans). Under the Mudarba products of Islamic banking, banks provide loan and customer invest his efforts.

Under Musharaka product of Islamic banking profit and losses equally shared among all investors. Under the Murabaha product of Islamic banking is same like conventional banking leasing contracts. In Murabaha, bank purchase commodity or good on the behalf of the client and sell it to the client with payment and profit margin like fee. In Ijarah, bank kept ownership of the investment good and give it to the client in rents for a fee.

Qarz-e-hasna is a type of lending in which bank give money to those people who are suffering from critical financial situation. Pakistani government tries to establish Islamic banking at national level. Struggle of islamization can’t produce required output regarding minimizing Riba from society. The objective of Shariah councils is to protect islamicity to establish Islamic banking. Global financial crisis push Islamic
banking and there concern with financial stability. Some Islamic or conventional banks both rely on leverage. Degree of stability is low in Islamic banks than conventional banks. Islamic banks allocate a large number of shares of their assets to generate financing than conventional banks. Islamic banks face competitive conditions as compare to the conventional banks. The growth of any economy depends on the banking sector of that economy.

Objective of the Study

Research has the following two main objectives

1. To make clear the differences between the operations of Islamic and non-Islamic banks in Pakistan
2. How it affect the depositors.

Research Question

Current study will answer:

1. Is there any difference between commercial and Islamic bank performance?
2. If exist then what are the differences?
3. How it influence the depositors?

Literature Review

Wasiuzzaman (2013) under the title of “Comparative study of the performance of Islamic and conventional banks: the case of Malaysia”. They found that the bank size and board size values of conventional banks and return on average assets, was hugely compared to Islamic banks.

The other variables like asset quality, liquidity, capital adequacy and operational efficiency and board independence were higher for the Islamic banks. They found that there is significant differences between two bank types were found for all variables, except for the board independence and profitability. All variables except for type of bank, liquidity and board characteristics were found to be highly significant in affecting profitability.

Rohaya and Hazli (2013) under the title of “Comparison on Stability Between Islamic and Conventional Banks in Malaysia” they found that variables that have been identified as the significant factors towards the risk (e.g. probability to defaults) for Islamic banks were the total assets, herfindahl index, real GDP cost income ratio, market share and inflation while conventional bank stability were influence by cost income ratio, loan asset ratio, market share, income diversity, total assets, Herfindahl Index, and real GDP.

Alani, Yaacob and Hamdan (2013) under the title of “The Comparison of Financial Analysis Tools in Conventional and Islamic Banking: Evidence from Kuwait” They found that the Islamic banks’ earnings processes are not consistent with the traditional banks and they said they have need commensurable analytical tools. They argue that some financial tools are not perfect or compatible if used in Islamic banks. They found here is a less use of researches, writings and books on financial analysis of Islamic banks. They argue that there is a lack of integration between Islamic banks.

Abdal-Majeed, Al-smadi, Hamad andAlmsafir (2013) under the title of “Islamic banking vs conventional banking, during the global financial crisis: Malaysia as a case” argue that Islamic Banking performs better than the Conventional Banking, so they found that it can be concluded, the Islamic Banking system is able to sustain, survive, and can compete with the conventional banking system.
Liaqat Ali, Azmat Ali, Hamza khwaja (2013) under the title of “Comparison of Islamic and Conventional Banking on the Basis of Riba and Services” they argue that customers of both conventional banks and Islamic banking are satisfied with facilities that are offered by both banks but the customers of conventional banks are much satisfied than the customers of the Islamic banks.

Muhammad Shehzad Moin (2013) under the title of “Financial Performance of Islamic Banking and Conventional Banking in Pakistan” they argue that conventional banks in Pakistan have large experience and history in performing banking business and hold the promenading position in financial sector with large share in overall financial assets of the Pakistan, as compared to the Islamic banks.

K.K. Siraj and Sudarsanan (2012) under the title of “Comparative Study on Performance of Islamic Banks and Conventional Banks in GCC region” they argue that the similarity in growth of chosen the performance indicators of Islamic banks and of the conventional Banks in GCC region. They found that Islamic banks reported higher AAG rate of the operating profit.

Jaffarand Manarvi (2011) under the title of “Performance comparison of Islamic and Conventional banks in Pakistan” they argue that Islamic banks performed much better in possessing adequate capital and have much better liquidity position as compare to conventional banks, because conventional banks pioneered in earning ability and in management quality. They argue that quality for the both modes of banking was almost the same, but conventional banks recorded slightly minimum loan loss ratio, that shows a improved loan recovery policy however, UNCOL ratio analysis shows nominal better (more good) performance for Islamic banks.

Safiullah (2010) under the title of “Superiority of Conventional Banks & Islamic Banks of Bangladesh: A Comparative Study” they argue that financial performance (solvency and liquidity, business developments, profitability, efficiency and productivity, commitment to economy and community) of both streams of the banks is notable. They found that commitment to productivity and efficiency, community and economy, signifies that the interest-based conventional banks are doing much better performance than the interest-free Islamic banks. They also found that the performance of Interest-free Islamic banks in business development, liquidity, profitability and solvency is more superior to that of interest-based conventional banks. So they found that Islamic banks are much better in financial performance than the conventional banks.

Muneeza, Wisham and Hassan, (2010) under the title of “The Paradox Struggle between the Islamic and conventional Banking Systems” they found that there are several quarrels between Islamic Banking and conventional banking laws. Some of these clashes are due to the application of common law problems in Islamic banking system. They argue Islamic economics has a different premise from the conventional banking.

Azhar, Taseen, Ameer and Naeem (2010) under the title of “Islamic Vs Conventional Banks in Pakistan: A case study of Bahawalpur” they found that the financial position of banks, economic benefits, interest on deposits, latest facilities and interest on deposits, reputation and strong global image are the factors that motivates the customers towards the conventional banks. Financial position of bank, Interest free loan, Shariah and Islamic teaching, knowledge of Islam and religious environment are such factors that are motivates the customers towards Islamic Banks.

Gamaginta and Rokhim (2010) under the title of “The Stability Comparison between Islamic Banks and Conventional Banks: Evidence in Indonesia” they found that Islamic banks have a lower degree of stability as compared to the conventional banks. Some exclusion includes that small Islamic banks have the same degree of stability with the small conventional banks.
Azhar and Afandi (2003) under the title of “Performance of Islamic and mainstream banks in Malaysia” They found that (IBS) Islamic banking scheme banks have recorded maximum return on assets (ROA) as they are well able to utilize the existing overheads that carried by mainstream banks. They also found that there is also inconsistent with and investment margin ratios and with their relatively low asset utilization. They argue that Islamic banking that thrives on interest-like products is less likely to outshine mainstream banks on the efficiency terms.

Iqbal (2001) under the title of “Islamic and conventional banking in the nineties: A comparative study” they argue that it does not lend any support to general belief that the Islamic banks are suffering from the excess liquidity. But their profitability ratios compare favorably with the international standards. The evaluation of the performance of the Islamic banks through number of key ratios’ yields fairly satisfactory results. Kaleem and Isa (2001) under the title of “causal relationship between Islamic and conventional banking instruments in Malaysia”. They found that there is a significant competition between conventional and Islamic TDRs series in the case of merchant banks and finance companies. They argue that the Islamic banking considers the interest rates before the adjusting its deposits returns. They also argue that the conventional TDRs Granger the cause Islamic TDRs in all the categories.

Theoretical Framework

Variables: Variables that are being focused are firstly discussed here.

Profitability:

Profitability shows which banking system doing better. Profitability measured by different ratios. Profitability is an important measure to find which banking system is profitable or not. In profitability use return on asset (ROA), return on equity (ROE) [Saifullah (2010), Abdul-majeed/Asamadi, Hamad and Almair (2013)].

\[ \text{ROA} = \frac{\text{Net profit after tax}}{\text{Total assets}} \times 100 \]

\[ \text{ROE} = \frac{\text{Net profit after tax}}{\text{Total shareholder equity}} \times 100 \]

Methodology

Research Design

Research design of this paper is based on descriptive type of study in which performance of Islamic and commercial banks are examined.

Population and Sample size

All Islamic banks and commercial banks are used as the population in this research of Pakistan. Total 46 banks are registered from SBP in which 5 are Islamic and 41 are commercial. 3 commercial banks and 3 Islamic banks are selected as a sample. In Islamic banks Bank Islamic Pakistan limited, Dubai Islamic bank limited Pakistan, Meezan bank limited and in commercial banks Habib bank limited, United bank limited, Muslim commercial bank these are chosen as sample for this research.
Sampling Technique

Random sampling technique is used i.e. in which all the elements of population have equal chance to be selected as a sample. Samples are being selected randomly.

Data collection method

Secondary data is collected from financial statements of banks from SBP site to find the difference of Islamic banks and commercial banks performance.

Data Analysis

Ratio analysis is used for analyzing the performance of Islamic and commercial banks. In which find difference between every Islamic bank with every commercial bank and get average of these difference.

Table 1

<table>
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<th>Bank Islamic Pakistan Ltd ROA</th>
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<th>MCB ROA</th>
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Discussion

When comparing all Islamic banks ROA to all Commercial banks ROA which are selected for this study show that commercial bank performance is better or highly profitable in terms of return on asset. It doesn't mean that Islamic banks are not profitably work. We can say just in Pakistan commercial banks are more profitably work than Islamic banks because commercials banks have a great hold on our whole economy for many years.

Table 2

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Table 2 continued...

Discussion

When compare all Islamic banks ROE to all commercial banks ROE which are selected for this study results show that the commercial banks performance is more profitable than Islamic banks in term of...
profitability on return on equity. Difference shows that commercial banks are more perform well than Islamic banks.

Conclusion

Results show that the performance of Islamic banks is less profitable than commercial banks. Financial position is determined by the financial statements of the relevant sector. Profitability is a best measure to identify the performance. The results of ratio analysis of profitability made clear that the return on asset or return on equity of Islamic banks is less than the commercial banks. Banks are the financial sector of our economy.

Commercial banks take a big hold in our Pakistani economy it has a higher ability of managerial performance. But Islamic banks are also a prominent sector of our economy and get profit and growth day by day. This difference can also affect the behavior of depositors according to investment decision. Every depositor likes to invest in those banks which give high return on his investment.

Basically Pakistan is an Islamic country the banks of this country follow the Islamic rules and principles in banking and give knowledge to his customers or other people through some network that what is Islamic banking? And which products and functions are performed by Islamic banks as compare to commercial banks. Commercial banks maximize the shareholders wealth largely as compare to Islamic banks.

Commercial banks produce high return on ROA or ROE as compare to Islamic banks. We can’t neglect the Islamic banks and commercial banks both have a big contribution in the economic development of the Pakistani economy day to day. Islamic banking attracts consumers or people to invest money and maximize profits according to Islamic law and within the limits of Islamic law. What is the return on total income is determined by the ratios. In this study find ROA or ROE of commercial banks is higher than Islamic banks. Islamic banking grows rapidly both in size and number day to day.

The day will also come when Islamic banking is come a large sector of our economy like commercial banking and generate higher profits like commercial banks. Islamic banking or Islamic products or function are the need of our economy now days because our economy is too much filled with interest based businesses which are prohibited in Islam.

References


