



A Study on Comparative Performance of Conventional and Islamic Banking in Pakistan

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Abstract

The primary reason behind conducting this research was to uncover the variances amidst the two different banking groups (conventional and Islamic) grounded on their fiscal fallouts analysis in the context of Pakistan during 2015-2018. Three Shariah banks and three non-Shariah banks have been selected for their comparative performance assessment. The comparison has been made between them grounded on the ratio analysis technique where average values of the selected ratios were used for the deduction of outcomes by applying a t-test. The resulted outcomes reflect that Non-Shariah banks left behind their counterparts in terms of efficiency. Moreover, the empirical fallouts of this study resulted that in terms of liquidity both the banking systems dominated each other with a 1:1 ratio. Additionally, the empirical fallouts again disclosed that the two different banking groups dominated each other with a 1:1 ratio concerning the quality of assets. Overall, with respect to efficiency non-Islamic banks proved dominant over non-conventional banks, whereas about liquidity and asset quality the performance of both the banking systems was somehow balanced where each of them dominated one another with a 1:1 ratio. The author believes that this study will be productive for a large number of investors in their investment decision-making.

Key Words: Islamic banking, Conventional banking, Efficiency, Liquidity, Assets Quality, Pakistan, Bank Performance.

Introduction

A nation's fiscal performance is mostly reliant on its finance area. In utilization of investors' financial resources into useful activities in order to contribute in the economic development, the role of banking sector can be significant. Shariah and non-Shariah banks both are part of Pakistan's banking sector. Conventional banking is prohibited as it is non-Sharia compliant, while Islamic banking is not prohibited as this banking system works under the umbrella of Sharia principles and laws.

In 2002, Islamic banking system took place in Pakistan when Meezan bank limited came into being. Shariah banking report revealed that in Pakistan five full-grown Sharia Compliant banks are working as of June, 30, 2019.



Islamic banking services are offered by a large number of non-Shariah compliant banks (conventional banks) in addition to their own services. The deposits and assets of Islamic banks covered 15.9% and 14.4% market segment of the whole banking industry (Islamic Banking Bulletin June 30, 2019). There are 2,913 branches of Islamic Banks in Pakistan as on June, 30, 2019.

The concentration of this study is to relatively evaluate the monetary performance of the two different banking groups during 2015 to 2018. The relative performance evaluation is conducted for 4 years based on various financial ratios. This research is net worthy as per the keen interest of investors in monetary performance of the two different banking structures. Most of the investors need to have sound information about monetary performance of banks to decide about their investment policy.

Mostly, two major categories of banking structures are there, around which banking industry is centered. The first one is Islamic banking, which is also called Shariah complaint banking, while the other one is conventional banking, which is also called non-shariah complaint banking. In the process of customer satisfaction there exists rivalry amidst these two groups of banking. A clear dissimilarity can be observed between them in respect with the laws that govern the conducts of the two banking systems, but there exists some similarities as well between the two. For instance, both of them provide services to keep the investors' funds safe, a creditor to their clients and regime etc. Equity financing is the primary motive of non-conventional banking despite of debt financing. The dealings of conventional banking involve interest, while the dealings of Islamic banks are grounded on the distribution of loss and income sharing between the concerned authorities. All in all, Islamic banking operations are consistent with Shariah codes, whereas non-Islamic banking processes are built on manmade' philosophies.

Non-conventional banking footing is centered on Shariah codes and all its conducts must be inside the circle of Shariah codes and conducts.

Following are the central Shariah codes and conducts of Islamic Banking:

- Interest (riba) free dealings.
- Risk sharing between bank and entrepreneur
- Negligence of commercial events containing coercion.
- Negligence of commercial activities.
- Following the concept of Islamic tax (zakat)
- Discourage the manufacturing of products that are inconsistent with Islamic standards.

While the fundamental ground of conventional banking is the saver and borrower association between the bank and investor and between the bank and borrower. Interest is considered as a rental charge over the loan, which reflects an investment's opportunity cost.

Three conventional banks to be examined consist of Muslim Commercial Bank limited (MCB), Habib Bank limited (HBL) and JS bank limited along with the three Islamic banks to be examined include Dubai Islamic Bank limited (DIB), Al- Baraka Islamic Bank limited (AIB) and Meezan Bank limited (MBL).

Objectives of the study

This study is primarily aimed on the relative performance evaluation of both Shariah and non-Shariah banks in Pakistan during 2015-2018. For attaining this wide-ranging objective, the subsequent explicit sub-objectives are designed;



1. To examine liquidity of chosen Islamic and non-Islamic Banks.
2. To investigate efficiency of chosen Islamic and non-Islamic Banks.
3. To consider quality of assets of chosen Islamic and non-Islamic Banks.

Literature Review

A comparative performance assessment study of the two different groups of banks was held in Bahrain during 1991 to 2001 by Samad (2004). He concluded that both banking systems are different in respect with credit performance. However, with respect to liquidity and profitability the two groups of banks are not considerably altered from one another. A relative performance study on Shariah and non-Shariah banks was made in Bahrain by Samad (2004) for the time span of 1991 to 2001. He did not catch any chief distinctions amidst the two banking systems concerning liquidity as well as profitability; rather he observed a significant variation between them concerning credit performance.

A research conducted by Majid *et al.* (2005) during the time span of 1993-2000, where he found that non-Islamic banks are lagging behind than their counterparts in terms of efficiency. Moreover, Mohd Zamil (2007) found in his study that non-Islamic banks are doing better in terms of efficiency than their opponents during 2000-2004. Another study was arranged by Ali (2005) in Bangladesh on the relative efficiency of Shariah and non-Shariah banks, where it was concluded by him that the efficiency degree of Shariah complaint banks is superior to their counterparts.

A contrastive research on the monetary performance assessment amidst the two different groups of banks namely Shariah and non-Shariah banks were conducted in UAE by Kader *et al.* (2007). According to their results, in terms of liquidity and profitability there were no chief variations between Shariah and non-Shariah banks. A study based on the contrastive performance assessment amidst the two different banking groups was held by Ali (2009) by adopting accounting ratios in Pakistan during 2004 to 2008. He concluded that profitability, liquidity and asset quality of Islamic banking is superior in contrast with their counterparts.

Conventional and non-conventional banks' working as well as management efficiency was examined in Malaysia by Samad (2009). According to him, non-conventional banks are dominant in respect with operation's management and a little variation was experienced in terms of productive effectiveness.

A study conducted by Shahid *et al.* (2010) to investigate the comparative efficiency between Shariah and non-Shariah banks in Pakistan, where he concluded that Shariah banks are lagging behind than their counterparts in terms of technical efficiency. A research held on relative performance assessment of the two banking systems by adopting CAMEL model during 2005 to 2009 by Jaffer and Monarvi (2011). They found non-conventional banks were performing inferior than their rivals with respect to earning ability and liquidity management.

A research was held on relative performance assessment of the two banking systems by adopting accounting ratios by Zia-ur-Rehman (2011). The results of the study revealed that due to high working expenses and poor management Islamic banks' performance is inefficient.

A study by Sadaqat, Ali and Farhan (2011) was held in Pakistan on the relative performance amidst the two different banking groups namely Shariah and non-Shariah banks. They examined that liquidity uncertainty is among the chief challenges faced by non-conventional banks. Moreover, they added that during worldwide financial crises non-conventional banks dominated their opponents in respect with progress, efficiency, liquidity and earnings.



A contrastive study amidst Shariah and non-Shariah banks in a number of nations was conducted by Faizulayev (2011). To assess the influence of profitability elements, it was determined by him that non-Shariah banks varies from Shariah compliant banks in respect with earnings, capital adequacy, asset quality, liquidity, and the liquidity level of interest free banks is inferior in contrast with non-Shariah banks.

A research on the relative performance assessment of the two different banking groups was held in Bangladesh by adopting ratio analysis during 2004 -2008 by Safiullah (2010). He found that non-conventional banks are lagging behind from their opponents in respect with productivity and efficiency. Ali *et al.* (2013) done a research which resulted that commercial banks' customers satisfaction is high than that of Islamic banks' customers.

A study was held by Beck *et al.* (2013) in 22 nations on 510 banks. They concluded that Islamic banks' asset quality is superior in contrast with their counterparts. According to a study of (Islam 2010), creditors ignore Islamic banks due to worst liquidity management and non-obedient Shariah banking.

According to a study held by Abbas *et al.* (2016) resulted that non-conventional banks' monetary performance is recorded fairly low in Pakistan. But according to Siddiqui (2008) Islamic banks in Pakistan is performing superior with respect to resources and capital management.

According to a study organized by (Miah & Uddin, 2017), non-Islamic banks are performing better in terms of efficiency than their Islamic counterparts. Alghfais (2017) investigated that Shariah banks are lagging behind by 20% than non-Islamic banks in terms of efficiency. According to (Beck, Kunt & Merrouche, 2013) the complex nature of Shariah banking products influence the growing operating expenses.

A study was conducted by Sheikhothman Fahed (2009) with the aim of assessing assets and liabilities' management of Shariah and non-Shariah banks, by analyzing their profitability and liquidity elements. According to him, liabilities and assets of Shariah and non-Shariah banks are having tight correlation due to closeness of return on equity ratios.

Methodology

This study is conducted on the basic motive of making contrastive performance assessment amidst Shariah and non-Shariah banks through financial ratios. Three Shariah compliant banks and three non-Shariah compliant banks are chosen as a sample for their comparative study. Three types of ratios including efficiency, liquidity and assets quality are chosen for their comparative assessment.

This research is primarily comparative study in which two different banking systems namely Shariah and non-Shariah banks are compared based on secondary data, in order to get results about the latest trends between the two. As per the quantitative nature of the study the researcher collected secondary data from the State Bank of Pakistan (SBP) website of all the chosen banks as a sample for this study for the time span of 2015-2018 and analyzed the data through statistical test (t-test).

Empirical Results

Efficiency Ratios

The efficiency ratios are further sub-divided into ROA, ROE, EPS, Spread and IR, which are discussed below one by one in detail.



Return on Assets (ROA)

The statistical fallouts reflect that ROA of non-Islamic banks showed continuous downward trend during the selected piece of time which shows the inefficiency of non-Islamic banks' management. Moreover, non-conventional banks' ROA shows continuous upward trend except the only year 2016 which shows higher efficiency as compare to their counterparts. However, on the basis of their means non-Shariah banks' ROA 0.92% is healthier than non-conventional banks' ROA 0.49%. Though, significant statistical variance amidst the two groups of banks is not recorded at 5% level of significance. (The results are presented in Index and Chart 1).

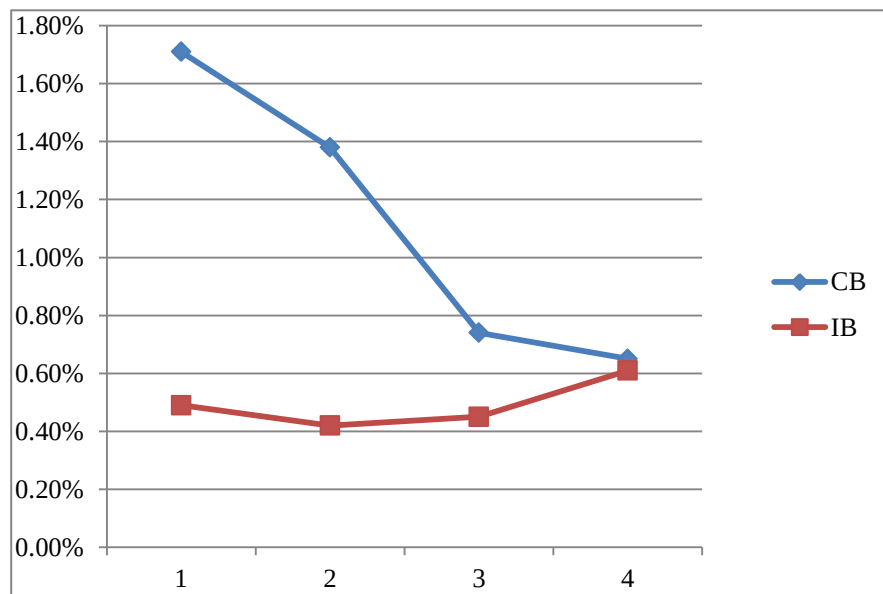


Chart 1: Contrastive examination of return on assets of conventional and non-conventional banks

Index 1: Return on Assets

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	1.71%	1.38%	0.74%	0.65%	0.92%	0.00001584333333333333	1.5656
IB	0.49%	0.42%	0.45%	0.61%	0.49%	1.0433333333333333E-06	

Return on Equity (ROE)

The empirical results of the two banks indicate some important points of comparison to be considered. According to the results, the ROE of conventional banks is significantly higher 20.42% in 2015 than Islamic Banks 9.50% leading by a massive difference of 10.92%. After then conventional banks faced up with a continuous decline in the successive years which is ended on 8.62% at the end of 2018 from 20.42% in 2015 recording a significant decrease of 11.8%. Furthermore, non-conventional banks' ROE is decreased by 1.02% in 2016 and 0.04% in 2017 respectively, but in 2018 ROE of Islamic Banks recorded a considerable rise of 1.84% as it ended on 11.34 %. Moreover, the empirical results further reveals that non-conventional banks' ROE surpassed the ROE of non-Shariah banks with a considerable difference of 2.72% in 2018. Though, significant statistical variance (2.3%) amidst the two groups of banks is not recorded at 5% level of significance. (The results are presented in Index and Chart 2).

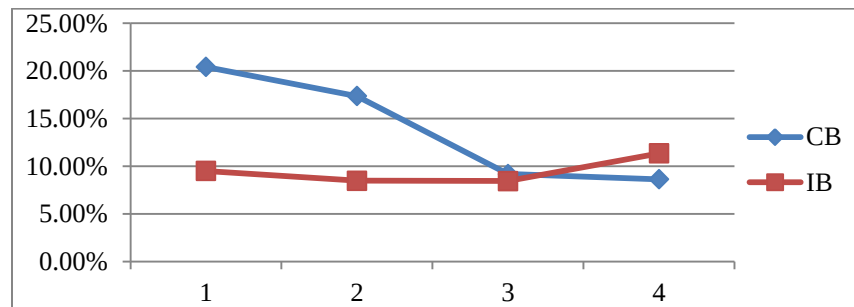


Chart 2: Contrastive scrutiny of return on equity of conventional and non-conventional banks

Index 2: Return on Equity

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	20.42%	17.36%	9.19%	8.62%	11.72%	0.0023910	0.6700
IB	9.50%	8.48%	8.44%	11.34%	9.42%	0.0002765	

Earnings per Share (EPS)

The empirical outcomes reflect that non-Islamic banks EPS 16.34% enormously dominating the EPS of Islamic banks 1.96% with a huge difference of 14.38% during 2015. However, in 2016 EPS of conventional banks lowered down with a margin of 1.87% from 16.34% to 14.47%, whereas Islamic banks' EPS moved up with a little difference of 0.13% from 1.96% to 2.09% during the same year. Again in the succeeding year the EPS of conventional banks significantly goes down with a large decrease of 6.08% from 14.47% to 8.39%, whereas in the same year Islamic banks' EPS again moved up with a little rise of 0.14% from 2.09% to 2.23%. finally, in 2018 the EPS of conventional banks showed a little of 0.48% by moving up from 8.39% to 8.87%, while Islamic banks continued its upward trend by moving up to 3.21% from 2.23% recording a difference of 0.98%. Overall, their average results indicate that there exists a significant statistical variance of 8.07% amidst the two groups of banks at 5% level of significance. (The results are presented in Index and Chart 3).

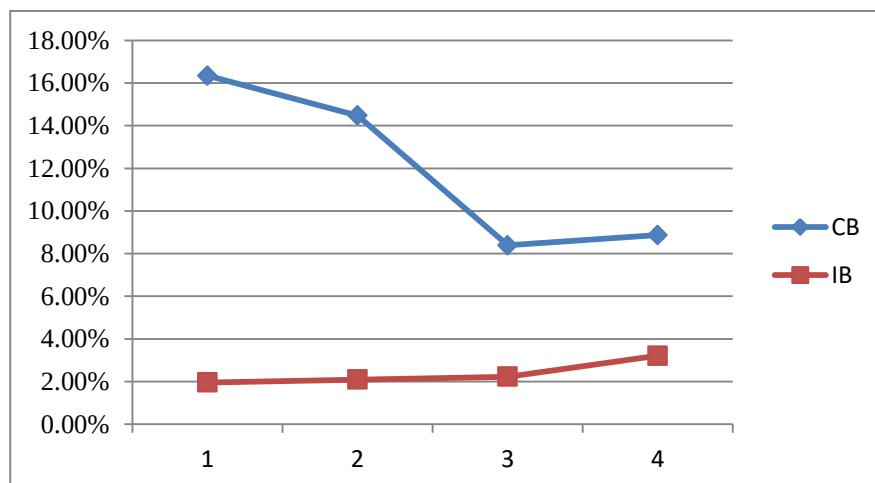


Chart 3: Contrastive examination of earnings per share of conventional and non-conventional banks



Index 3: Earning Per Share

Years	2015	2016	2017	2018		Mean	Variance	T value
CB	16.34%	14.47%	8.39%	8.87%		10.58%	0.0011426133333333	3.7319
IB	1.96%	2.09%	2.23%	3.21%		2.51%	0.000037239999999999	

Spread Ratio

The empirical results of the two banking systems reveal that there no significant variance (1.75%) exists amid non-Shariah banks 50.96% and interest free banks 49.21% during 2015. In 2016, a significant rise is recorded in both banking systems' spread, as non-Shariah banks recorded a rise of 2.55% by moving up from 50.96% to 53.51%, whereas a spread of Islamic banks moved up to 49.21% to 52.97% with a rise of 3.76%. In 2017, a significant reduction of 5.95% is recorded in the spread of conventional banks by lowering down to 47.56% from 53.51%, while the spread of Islamic banks significantly moved up with a rise of 3.91% from 52.97% to 56.88%. In 2018, the spread of both the banks has lowered down, as non-Shariah banks faced up with a reduction of 3.24%, while 1.9% decrease is recorded in case of interest free banks. However, their average outcomes displayed that interest free banks (54.94%) are dominating their counterparts 48.46% with a clear difference of 6.48%. Additionally, the results reflect that significant statistical variance amidst the two groups of banks exists at 5% level of significance. (The results are presented in Index and Chart 4).

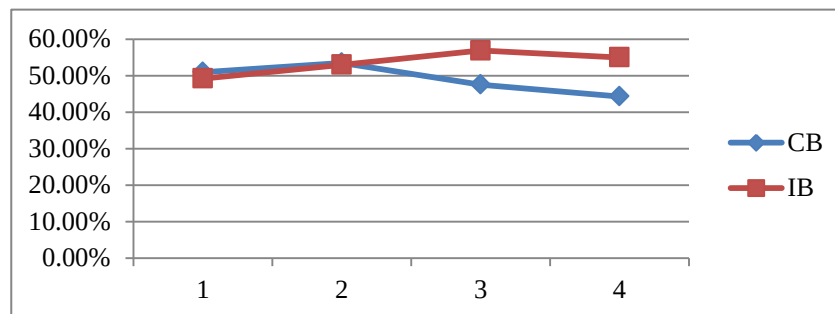


Chart 4: Contrastive spread examination of conventional and non-conventional Banks

Index 4: Spread

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	50.96%	53.51%	47.56%	44.32%	48.46%	0.0021726	1.8350
IB	49.21%	52.97%	56.88%	54.98%	54.94%	0.0003823	

Interest Ratio (IR)

The empirical results of both banking systems signifies that non-Islamic banks' 49% IR are lagging behind than the IR of interest free banks 50.66% with a margin of 1.66% during 2015. In 2016, the IR of both the banks faced a significant decline as conventional banks recorded a decrease of 2.67% by lowering down to 46.33% from 49%, while Islamic banks recorded a decrease of 3.66% by moving down to 47% from 50.66%. In 2017, conventional banks outperformed as their IR moved up with a momentous margin of 5.67% from 46.33% to 52%, whereas Islamic banks continued their downward trend by further going down with a margin of 4% from 47% to 43%. In 2018, both the banks showed upward move in their IR, as the IR of conventional banks moved up with momentous difference of 4% from 52% to 56% while the IR of Islamic banks moved up with a considerable difference of 1.66% from 43% to 44.66%. Although, their mean results expressed that there exist significant statistical variance (6.55%) amidst the two groups of bank at 5% level of significance. (The results are presented in Index and Chart 5).

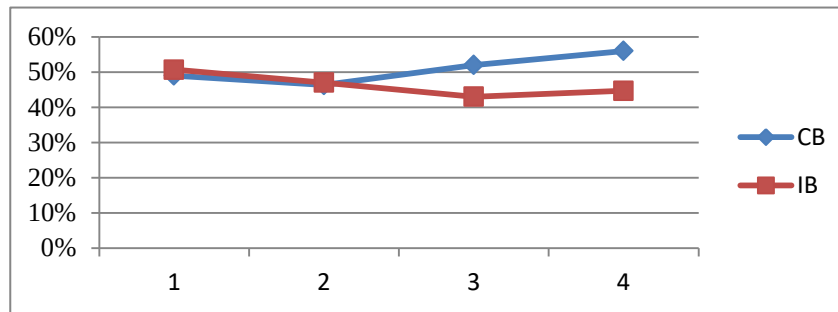


Chart 5: Contrastive examination of interest ratio of conventional and non-conventional bank

Index 5: Interest Ratio

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	49%	46.33%	52%	56%	51.44%	0.00236096	1.7836
IB	50.66%	47%	43%	44.66%	44.89%	0.00040385	

Liquidity Ratios

The liquidity ratios are further subdivided into ITA and ATA, which are discussed below one by one in detail.

Investment to Total Assets Ratio (ITA)

The tabulated figures display a continuous decrease of ITA in case of both the banking systems in the selected four years' time period which is inversely proportional to their liquidity. In addition to that, the declining rate of non-Shariah banks is far larger than Shariah complaint banks. However, the ratio of non-Shariah banks is still much healthier than their rivals. Since, the average outcomes showed that ITA of conventional banks 49.75% are dominating Islamic banks 18.53% with a large margin of 31.22%. Moreover, the results reflect that significant statistical variance amidst the two groups of banks exists at 5% level of significance. (The results are presented in Index and Chart 6).

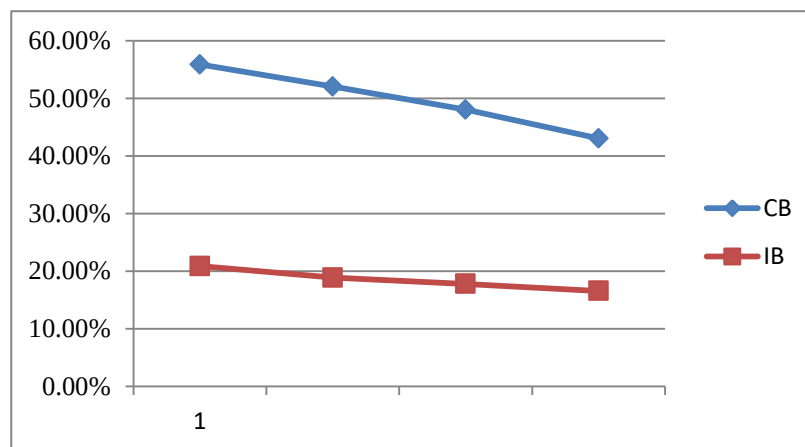


Chart 6: Contrastive examination of investment to total assets of conventional and non-conventional banks



Index 6: Investment to Total Assets (ITA)

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	55.87%	52.03%	48.04%	43.04%	49.75%	0.00302003	16.8024
IB	20.88%	18.88%	17.78%	16.57%	18.53%	0.000334969	

Advances to Total Assets Ratio (ATA)

The tabulated values shows a continuous upward trend in ATA of both the banking systems which is directly proportional to their liquidity, but the results signify that interest free banks are highly liquid as compare to their counterparts based on their higher ATA ratio. As their average fallouts displayed that non-Shariah banks' 37.14% mean ATA is significantly lagging behind than non-conventional banks' 57.29% mean ATA with a large difference of 20.15%. (The results are presented in Index and Chart 7).

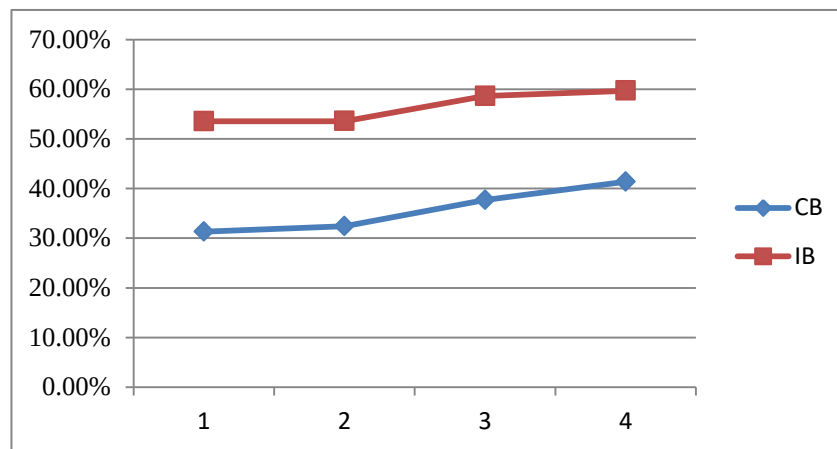


Chart 7: Contrastive examination of advances to total assets ratio of conventional and non-conventional banks

Index 7: Advances to total Assets (ATA)

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	31.29%	32.38%	37.69%	41.35%	37.14%	0.00203421	-21.9952
IB	53.54%	53.56%	58.63%	59.67%	57.29%	0.00106864	

Assets Quality Ratios

Assets Quality ratios are further sub-divided into NPLA and PNPLA, which are discussed below one by one in detail.

Non-performing Loans to Gross Advances Ratio (NPLA)

The empirical results signify that the NPLA for conventional banks is fluctuating throughout the selected time span. Moreover, interest free banks are doing superior in terms of NPLA except the only year 2016. Hence, based on these results non-Islamic banks are carrying out effectively in respect with NPLA than their counterparts during the selected four years. Consequently, the average outcomes reveal that non-Islamic banks' 6.22% mean NPLA is dominating the NPLA of Islamic banks 4.48% with insignificant variance of 1.74% at 5% level of significance. (The results are presented in Index and Chart 8).

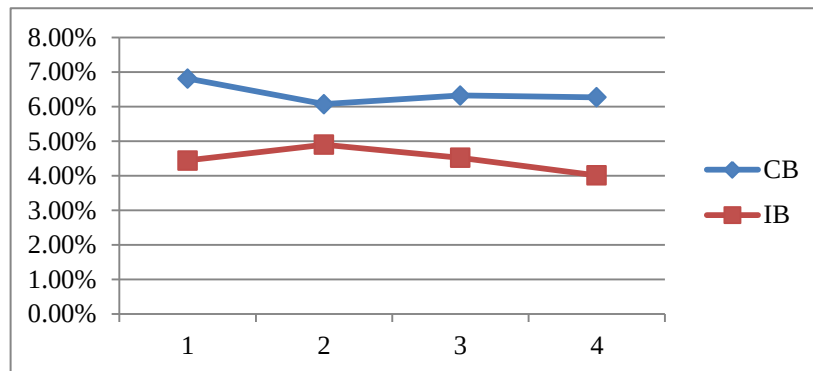


Chart 8: Contrastive examination of non-performing loans to gross advances ratio of conventional and non-conventional banks

Index 8: Non- Performing Loans to gross advances (NPLA)

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	6.81%	6.07%	6.32%	6.27%	6.22%	1.75000000000001E-06	5.5181
IB	4.44%	4.90%	4.52%	4.01%	4.48%	0.00001994333333333334	

Provisions against non-performing to Gross Advances Ratio (PNPLA)

The empirical outcomes of both the banking systems expressed that the PNPLA of conventional banks 6.08% are leading the PNPLA of Islamic banks 3.71% with a considerable margin of 2.37% during 2015. In 2016, the PNPLA of both the banks faced a little decline, as the PNPLA of conventional banks recorded a decline of 0.77% by lowering down to 5.31% from 6.08%, while the PNPLA recorded a decline of 0.22% by going down to 3.49% from 3.71%. In 2017, the PNPLA of conventional banks gets recovered and showed a little increase of 0.58% by moving up from 5.31% to 5.89%, while Islamic banks continued their downward trend by further moving down to 3.11% from 3.49% recording a decline of 0.38%. In 2018, again a little decline 0.81% is recorded in the PNPLA of conventional banks by getting down to 5.08% from 5.89%, whereas Islamic banks consecutively continued their downward trend by further getting down to 3.07% from 3.11% recording a little decline of 0.04%. Since, the average fallouts showed that non-Islamic banks' 5.43% mean PNPLA is superior than non-conventional banks' 3.22% mean PNPLA with an insignificant statistical variance of 2.21% at 5% level of significance. (The results are presented in Index and Chart 9).

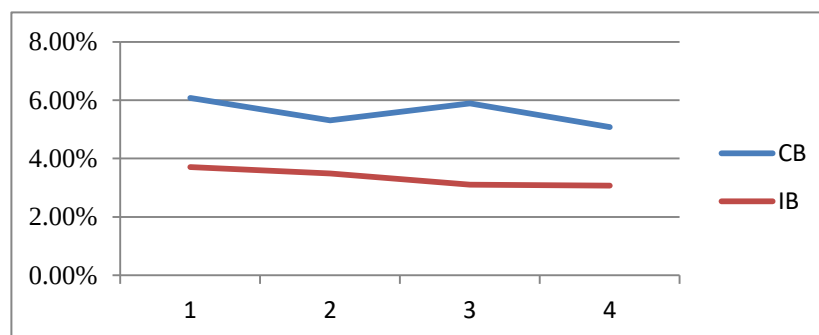


Chart 9: Contrastive examination of provisions against non-performing loans to gross advances of conventional and non-conventional banks



Index 9: Provisions against non-performing Loans to Gross Advances

Years	2015	2016	2017	2018	Mean	Variance	T value
CB	6.08%	5.31%	5.89%	5.08%	5.43%	0.00001742333333333333	7.5070
IB	3.71%	3.49%	3.11%	3.07%	3.22%	5.373333333333333E-06	

Conclusion

This study is primarily aimed to explore the changes amidst the two different banking setups. The empirical findings expressed that non-Shariah banks are leading their opponents concerning efficiency with respect to (ROA), (ROE), (EPS) and (IR). Moreover, no major change is recorded between them in respect with ROA and ROE. However, non-Shariah banks significantly dominated their opponents with respect to EPS and IR with mean differences of 8.07% and 6.55% respectively. Furthermore, Shariah compliant banks with only one efficiency measure (spread) are significantly ahead of conventional banks with a mean difference of 6.48%.

The liquidity of both the banking systems was analyzed by ITA and ATA. The empirical fallouts of ITA reflects that non-Shariah banks led their opponents with a mean difference of 31.22%, while the ATA results disclosed that Shariah compliant banks led their opponents with a mean difference of 20.15%.

Assets quality of the banking systems was investigated by two financial measures, namely NPLA and PNPLA. The NPLA findings directed that non-conventional banks led their opponents, while in terms of PNPLA fallouts showed that non-Islamic banks left behind their rivals with a considerable difference of 2.21%.

To sum up, based on the empirical findings of this study non-Islamic banks proved dominant with respect to efficiency than non-conventional banks. Moreover, with respect to liquidity and assets quality both the banking systems dominated each other with 1:1 ratio. Thus, investors can base their investment decisions on this study's findings whether to choose Islamic banks or conventional banks for their investment.

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