

Performance Evaluation of Islamic and Conventional Banks in Pakistan

Sundas Ayub, Nadeem Sohail and Raheel Mumtaz

Government College University, Faisalabad, Pakistan

Abstract: The study underneath provided a new confirmation sequentially to evaluate the performance of Islamic and Conventional Banks in Pakistan. The time span used for the study was elaborated from 2001 to 2007. For assessment, statistics were composed from five conventional banks of Pakistan i.e MCB, NBP, UBL, HBL and Allied Bank and one Islamic bank was also used to collect data for the said purpose i.e Al-Baraka Islamic Bank. There were following variables used in this research to compose statistics i.e Net investment, Advances Net, Operating Fixed assets, Borrowing from Financial Institutions, Deposits and other Accounts, Administrative Expenditures, Profit and Number of Employees. The tests used to follow up the subjected research purpose were ADF and correlogram. The above tests were used to find out whether data was stationary or not. In this regard, it was found that data was stationary at the level. The method of multiple regressions was exercised for subjected analysis. There was found a positive insignificant impact of Al-Baraka Islamic bank. In this regard, it was concluded that Al-Baraka was less profitable as compared to five conventional banks.

Key words: Performance Evaluation of Banks

INTRODUCTION

The Italian word “banco” (means "desk/bench) is the word from which the word “Bank” is derived. The word “Bank” can also be defined as a financial institution that is licensed by the government. It is also defined as an institution which dealt with money or credit. Banking is one of those businesses which are most vulnerable in this world. The Banking system plays very keen part in the financial system of any country. Banks play a role of custodian in there purpose i.e they are the custodian of the assets of the general masses. Banks also plays a momentous function in an existing world that mostly dealt with capital and wealth. They manipulate and smooth the progress of many diverse but integrated monetary activities which are following i.e Capital mobilization, scarcity eradication, fabrication and allocation of municipal funding etc. In this regard, it can be concluded that Banks play very significant and useful part in the overall monetary development relates to any country [1]. There are following two main categories of banking (1) Conventional banking (2) Islamic banking.

Conventional Banking: Conventional banks play a very significant role in the development of financial system. Following are the main functions that the Conventional Banks play in different ways i.e easy relocation of capital from those businesses which have easy excess to the businesses that have need of supplementary capital to run the business and it’s relating activities. The Banks are used as a business to make capital. In Conventional banking, purely economic intermediation model is used. In this model, banks commonly borrow capital from savers and then this capital is lent by the enterprises. The main source of turnover for Banks is the differentiation in the rate of interest and the rate at which they lent. The usefulness of the Banking system is also in the way that they provide their services i.e they corporate through the letters of credit and guarantees. The low-cost finances are the source of there profit which they get through the way of demand deposits. When we talk about Commercial banks, they are prohibited from buying and selling. It is also pertinent here to describe that their shareholding is sternly confined to a small fraction of their net value. Therefore in Commercial Banks, the system that is used to fabricate derivative deposits is the fractional reserve

system. This is the system that allows these Banks to manipulate their low-cost reserves. There are also some flaws in the process of bank lending due to which it is subject to a number of tribulations that shows there inefficiency. Those that Borrow, typically distinguish more about their personal maneuver than those which lend. When Banks play the part of lenders then they face this information disproportionately. When we compare Islamic Banks with the Banks that have a Conventional Banking system, it is concluded that their base is base on interest. When we talk about Conventional Banking system, it is concluded that there is no concept of Halal and Haram in any case. It is also pertinent here that there is unequal distribution of wealth etc. in the case of view of Modern banking system. Therefore, these banks confer loan at encoded interest rate [2].

Islamic Banking: While in Islamic banking system, the base is Islamic Shariah. It is practically applied through Islamic economics. Its purpose is same as Conventional Banking system i.e to make business but only in the light of rules of Shariah. There is a constricted concept of Interest free banking as denoted by a number of Banks which avoid interest in some way or other. Following are the main purposes of Islamic Banking system i.e 1. To keep away from transactions which are based on or correlate to interest (disallowed in the Islamic Shariah). 2. To keep away from unethical practices. 3. To take part in actively achieving the intention of an Islamic financial system. "Riba" is prohibited in Islamic Shariah. But it is pertinent here to describe that Islamic Shariah does not disallow all the increase in the assets. It only disallows the predetermined raise over principal credit. During the period of last 10 years, the slow Banking sector of government becomes very active and reactive to meet the demands of modern world. In Pakistan, from partition to next 30 years, the dilemma of eradicating "Riba" was underestimated and was mishandled. In Pakistan, the steps for implementing Islamic Shariah in the Banking sector and monetary institutions set up in 1977-78, in the period of General Zia-ul-Haq. That's why in Pakistan, Banks working with Islamic Shariah were started with Great Spirit and with honesty. But this has vanished with the passage of time because dilemma of eradicating "Riba" has not been reviewed in the Banking sector of Pakistan and the same case is of economy of Pakistan. There is only the show off of Islamic Banking system [3]. The concept of effectual Islamisation is urged by the religious organization which becomes a big class of public representatives. While on the other way, the conventional

banking system of Pakistan was facing tremendous pressure from the side of IMF and others [2]. In this regard, deposit accounts and also government securities in some way reference a return of interest when we talk about it in terms of a fixed rate instead of presences of PLS. Loans are given with different rates of interest by the Banks which provide the services to their clients depending on their economic footing and on the type of the scheme. Furthermore regardless of their forename, there is a return that is found on PLS deposits which restrains a significant constituent of interest. It is because the Banking systems are permitted to pay out their PLS deposits that is in the form of government securities i.e interest-bearing. It is fairly enquired that the Banks which use Islamic Shariah as approach of investment, which work not worth mentioning task in the economics of Pakistan. It is also discussable that Islamic investment also stands on mechanism that relates with interest. In this system interest work as a fundamental characteristic in their system of interest-free profits [3]. It is also pertinent here to describe that the future is bright for Islamic Banks and Mudaraba Banks in Pakistan. There are some Banks that are already in Islamic banking field focusing on Islamic Shariah. In these Banks some are following; MCB, Faysal Bank, Al-Meezan banks and ABAMCO Limited. Pak-Kuwait Investment Company Limited is the only Islamic Insurance Company in Pakistan. It is premiere joint venture financial institutions in Pakistan [1]. It is cited that Pakistan's banking quarter show a successful story in the as how reorganization of Banks and privatization of Banks can change a segment towards economic growth significantly. The competitive pressure is also increased in the Banking sector when there is the use of unification and acquisition. It is pertinent here to describe that in Pakistan, the doors are opened for foreign commercial banks at large. It is also important to mention here that some foreign banks are there which are in a search of acquiring some smaller Banks i.e such banks which have a wide spread local office set of connections. Similarly, there is also some Pakistan's Banks which are in a search to buy out foreign banking maneuver in Pakistan. It poses that there is a challenging and competitive environment in the banking sector of Pakistan which help out in providing more facilities and services to their customers.

Review of Literature: Iqbal [4] sought out a comparison in the ways i.e whether the Islamic banks work in better way or conventional banks. In this research the data is pull together from 1990 to 1998. In this research, the

researcher tested different hypotheses and widespread observation relevant to Islamic banking system. To check the performance of Islamic banking system, there were two methods which were used in the research for analysis i.e analytical trends and ratio analysis. In this regard for the purpose of better research different benchmarks were used and some were developed for different ratios for the first time. As the research was result orienting so at the end it was concluded that Islamic banking system was improving reasonably for the passage of time.

Iqbal [5] conducted a typical research to analyze the usefulness and performance of Islamic banking system. The researcher also makes comparison of Islamic banking system and their services and Conventional banking system and their services. In this research the method used for the said purpose is ratio method. The researcher conducted a survey which presents the overall progress of the Islamic banking system. It also includes the growth of Islamic banking system and performance of Islamic banking system over the period set for comparison. In this research he used the relevant ratio of 1000 top Conventional banks. He used it as a standard for subjected comparison. At the end of research it was concluded that in term of growth as well as performance there were a significant deviations in case of Islamic banks in contrast of Conventional banks.

Yudistira [6] analyzed and researched 18 Islamic banks in the view of their performance for the duration of 1997 to 2000. In this research the method used for the said purpose is based on efficiency measurement. This was termed as parametric approach in such case of study. In this approach Data Envelopment Analysis is employed for analysis. This approach of Islamic banking system, it analyze the technical and scale efficiencies of those Banks. Following variables were used for analysis i.e BA (Bank Assets), FA (Fixed Assets), SC (Staff Cost), TD (Total Deposits), OI (Other Income), Loan and LA (Liquid Assets). At the end of research it was concluded that during the global crisis (1998 to 1999) performance of Islamic banks was uneconomically. But it was pertinent to describe that Islamic banks had shown better credit performance when they were as compared to conventional banks.

Arby [7] conducted a typical research to analyze the commercial banks in Pakistan with reference to their structure and performance. In this research the commercial Banks selected for the said purpose should be under the scaffold of industrial association. In this research, the methods used for the said purpose were following; (A) Lorenz curve, (B) Gini co-efficient, (C) Herfindahl index

and (D) Concentration Ratio. At the end of research it was concluded that allocation of banking commerce is exceedingly twisted in Pakistan. But it was pertinent to describe that the productivity of Banks which were owned by the government, were extremely depreciated as shown by the performance analysis of the said category of Banks.

Kamaruddin *et al.* [9] conducted a typical research to analyze the comparison of the performance of Islamic and Conventional banks. The analysis was based on investigation that wholly enquired the expansion Islamic banking in his paper. It also described new point of view on the performance assessment of Islamic banking businesses in Malaysia. It was the first research project in which the researcher analyzed both CPE (cost and profit efficiency) of those Banks which fully worked out in the way of Islamic Shariah and active stand by and reactive operations of domestic and foreign banks in Malaysia. In this research, the method used for the said purpose was DEA (Data Envelopment Analysis). Data Envelopment Analysis was the modus operandi which provided numerous efficiency determinants i.e (A) Allocative, (B) Pure technical and (C) Scale efficiency. These factors prescribe the CPE (cost and profit efficiency) degree of differences amid banks. At the end of research it was concluded that Islamic banks operators are comparatively well-organized.

Weill [10] conducted a typical research to analyze the comparison of the selling supremacy of Islamic and as well as conventional banks. To study the said purpose and to study the selling supremacy, the researcher subtracts indices on a model of banks. He gathered the information to conclude the required results from 17 countries. The countries choose for the said purpose was such in which Islamic and conventional banks coexist from the time period 2000 to 2007. It was shown by the Null hypothesis that there was market power which was superior for Islamic banks. At the end of research it was concluded that learner indices show non significant differentiation between Banks which follow Islamic Shariah and conventional banks all the way through their comparison. But it was pertinent here to describe that when control variables, regression of Lerner indices were included which suggested that Banks which follow Islamic Shariah have a lower market power than other Banks working with conventional banking system. It was also important here that the lower market power of Banks which follow Islamic Shariah could be better described by their different working norms and incentives given by the Banks in different ways.

Charles (2009) conducted a typical research to analyze that in the global financial market, whether Islamic finance works as a more viable alternative? In this research, the researcher came to know that in this industry of monetary services, Islamic finance has become the fastest growing banking sector. It was pertinent to describe here that as the ratio of incomes had been increased and middle class was expanded in the oil rich Islamic countries, the Islamic finance and the services of Islamic Banking system broke the all previous records of their history. The Banks which follows Islamic Shariah prohibits various types of financing and different types of interest paid by the costumers. It was also important that in the Banks which follows Islamic Shariah as there was the system of proper risk sharing which results safer way of financing than western system of financing. Islamic system also protects markets from economic downfall.

Research Methodology: The data collected for analysis was secondary data which was collected from 5 conventional banks namely HBL, UBL, MCB, Allied Bank and NBP and from 1 Islamic bank Al-Baraka Islamic bank. Data about 7 variables were collected from time period 2001-2007 which includes Advances Net, Deposits and other Accounts, Administrative Expenditures, Investment Net, Operating Fixed Assets, Borrowings from Financial Institutions.

Methodology: The data collected for analysis was secondary data which was collected from 5 conventional banks namely HBL, UBL, MCB, Allied Bank and NBP and from 1 Islamic bank Al-Baraka Islamic bank. The data about 7 variables were collected from time period 2001-2007 which includes Advances Net, Deposits and other Accounts, Administrative Expenditures, Investment Net, Operating Fixed Assets, Borrowings from Financial Institutions. The OLS technique used for analysis because the method of OLS has some very attractive statistical properties that have made it most powerful method for regression analysis. For graphical analysis correlograms used to check weather data was stationary or not. All the data was stationary at 1st difference. For non graphical analysis the Unit Root Test and Augmented Dickey-Fuller Test used. They indicate that model was co integrated.

Regression Analysis: In this study Multiple Regression Model used for analysis.

The general forms of model that include more than one independent variables are;

$$Y_i = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \dots + \beta_k X_k + \mu_i$$

Model: Numerous econometric models were used to estimate the performance of Islamic and conventional banks. On the basis of a review of alternative theoretical approaches, it was concluded that a Statistical techniques including Regression analysis were used as a methodology which was the most suitable for the task for the performance estimation

To estimate the relationship between the Profit and Investment Net, Advances Net, Operating Fixed Assets and Borrowings from Financial Institution, Deposits and other Accounts, Administrative Expenses, Number of Employees regression equation for this model:

Regression equation of this model is given below;

$$Y_i = \beta_1 + \beta_2 X_1 + \beta_3 X_2 + \beta_4 X_3 + \dots + \beta_8 X_7 + \mu_i$$

Where;

Y_i = A dependent variable denoting the Profit (Millions)

X_1 = An Independent variable denoting the Investment Net

X_2 = An Independent variable denoting the Advances Net

X_3 = An Independent variable denoting the Operating Fixed Assets

X_4 = An Independent variable denoting the Borrowings from Financial Institution

X_5 = An Independent variable denoting the Deposits and other Accounts

X_6 = An Independent variable denoting the Administrative Expenses

X_7 = An Independent variable denoting the Number of Employees

μ_i = Error Term

β_1 is the intercept and $\beta_2 + \dots + \beta_8$ are regression coefficients.

RESULTS

Results of Regression on Bank Related Variables and Profit:

To estimate the relationship between Advances Net, Deposits and other Accounts, Administrative Expenditures, Investment Net, Operating Fixed Assets, Borrowings from Financial Institutions and number of employees and also introduce the dummy variable of Islamic bank following regression model was regressed

$$Y_i = \beta_1 + \beta_2 X_1 + \beta_3 X_2 + \beta_4 X_3 + \dots + \beta_8 X_7 + \mu_i$$

Following regression equation is estimated

$$\text{Profit} = -119657 + 0.114834X_1 - 0.676124X_2 - 0.042436X_3 + 0.043860X_4 + 135.7491X_5 + 0.161600X_7 - 0.095758X_8 + 1132814$$

Test statistics of Multiple Regression Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1196657.	1553608.	-0.770244	0.4466
ADVA	0.114834	0.022972	4.998801*	0.0000
AEXP	-0.676124	0.280861	-2.407328**	0.0218
DAOA	-0.042436	0.020592	-2.060754**	0.0473
INV	0.043860	0.026117	1.679383***	0.1025
NOEM	135.7491	183.2922	0.740616	0.4642
OFA	0.161600	0.165158	0.978455	0.3350
BFFI	-0.095758	0.054597	-1.753902***	0.0887
DISL	1132814.	1809714.	0.625963	0.5356
R-squared	0.844174	F-statistic		22.34684
Durbin-Watson stat	1.477332	Prob(F-statistic)		0.000000

For data analysis E-Views (version 5.1) was used

* Showed significant at 1% level of significance

** Showed significant 5% level of significance

*** Showed significant 10% level of significance

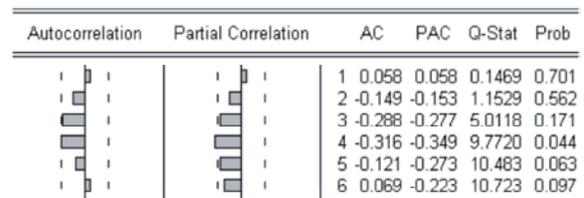
The results revealed that only three out of the eight factors were insignificant in determining the bank's performance.

All variables included in this regression model explained one by one;

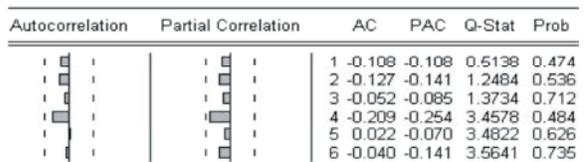
Coefficient of advances net had significant positive effects on profits and was significant at 1% level of significance. This means there was a positive relationship between advances net and profit. Coefficient of administrative expenses had negative impact on profit and was significant at 5% level of significance. There was a negative relationship between administrative expense and profit. Coefficient of deposits and other accounts had negative impact on profit and was significant at 5% level of significance. There was a negative relationship between deposits and other accounts and profit. Coefficient of investment net had positive impact on profit and was significant at 10% level of significance. There was a positive relationship between investment net and profit. Coefficient of number of employees had insignificant positive impact on profit. Coefficient of operating fixed assets had insignificant positive impact on profit. Coefficient of borrowing from financial institution had negative impact on profit and was significant at 10% level of significance. There was a negative relationship between borrowing from financial institutions and profit. Coefficient of DISL had insignificant positive impact on profit. R square value showed that 84.41% variation in profit due to these given independent variables while remaining 15.59% variation in profit due to others variables which were not included in the model. F statistic showed that model is significant.

Correlograms: All the correlograms show that data is stationary at 1st difference.

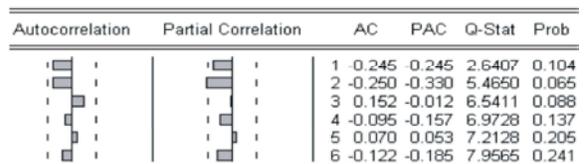
Correlogram of Net Advances



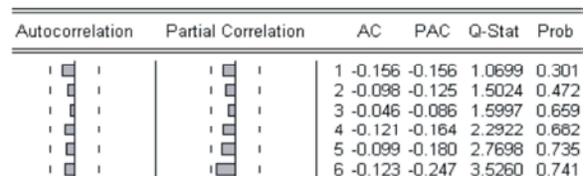
Correlogram of Administrative Expenditures



Correlogram of Borrowing from Financial Institutions



Correlogram of Deposits and other Accounts



Correlogram of Numbers of Employees

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob
		1 -0.156	-0.156	1.0699	0.301
		2 -0.098	-0.125	1.5024	0.472
		3 -0.046	-0.086	1.5997	0.659
		4 -0.121	-0.164	2.2922	0.682
		5 -0.099	-0.180	2.7698	0.735
		6 -0.123	-0.247	3.5260	0.741

Correlogram of Operating Fixed Assets

Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob
		1 -0.156	-0.156	1.0699	0.301
		2 -0.098	-0.125	1.5024	0.472
		3 -0.046	-0.086	1.5997	0.659
		4 -0.121	-0.164	2.2922	0.682
		5 -0.099	-0.180	2.7698	0.735
		6 -0.123	-0.247	3.5260	0.741

Correlogram of Profit

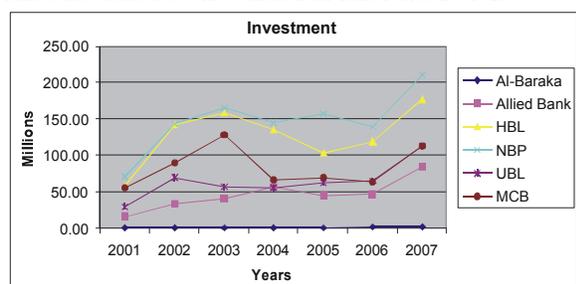
Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob
		1 -0.156	-0.156	1.0699	0.301
		2 -0.098	-0.125	1.5024	0.472
		3 -0.046	-0.086	1.5997	0.659
		4 -0.121	-0.164	2.2922	0.682
		5 -0.099	-0.180	2.7698	0.735
		6 -0.123	-0.247	3.5260	0.741
		7 0.648	0.589	25.278	0.001

Correlogram of Investment

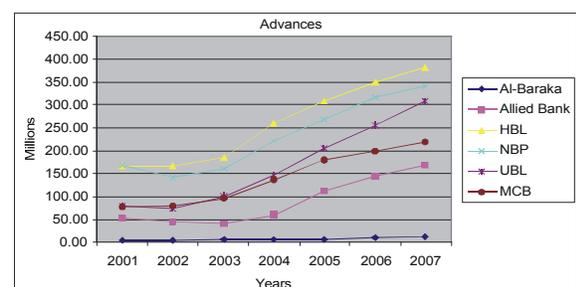
Autocorrelation	Partial Correlation	AC	PAC	Q-Stat	Prob
		1 -0.156	-0.156	1.0699	0.301
		2 -0.098	-0.125	1.5024	0.472
		3 -0.046	-0.086	1.5997	0.659
		4 -0.121	-0.164	2.2922	0.682
		5 -0.099	-0.180	2.7698	0.735
		6 -0.123	-0.247	3.5260	0.741
		7 0.648	0.589	25.278	0.001

Time Series Graphs:

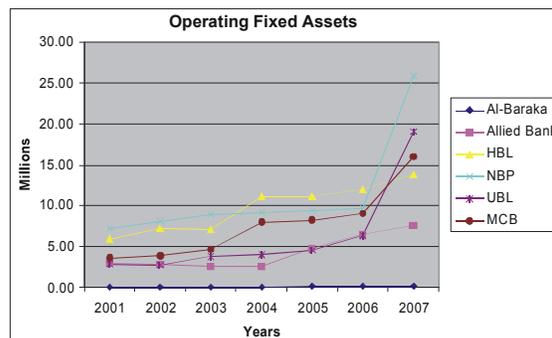
Time Series trend of Net Investment from Time Period 2001- 2007



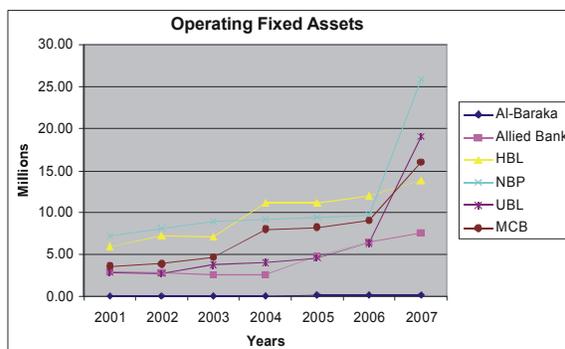
Time Series trend of Advances from Time Period 2001- 2007



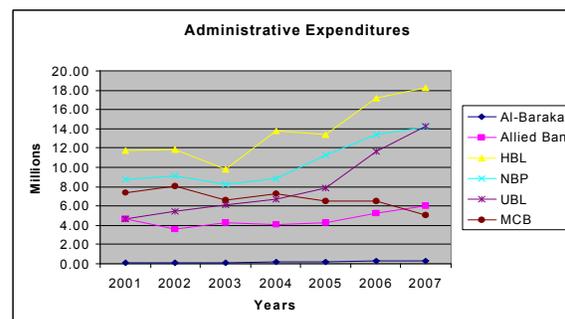
Time Series trend of Operating Fixed Assets from Time Period 2001- 2007



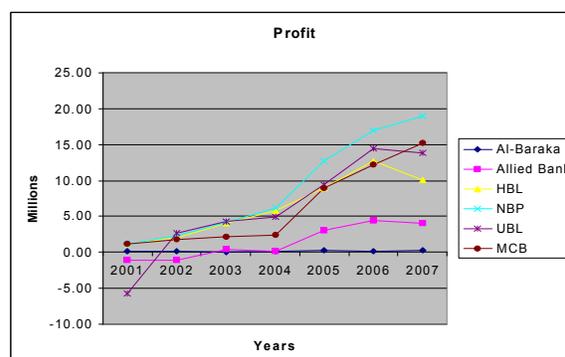
Time series trend of Borrowing from Financial Institutions from Time Period 2001- 2007



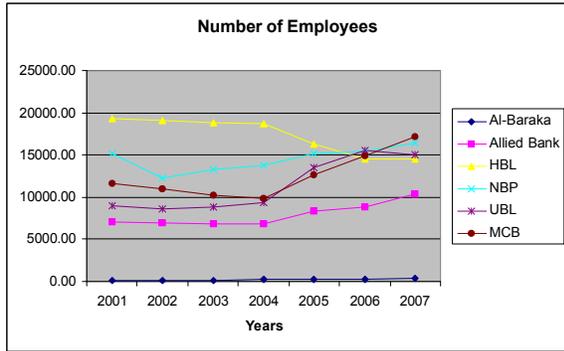
Time series trend of Administrative Expenditures from Time Period 2001- 2007



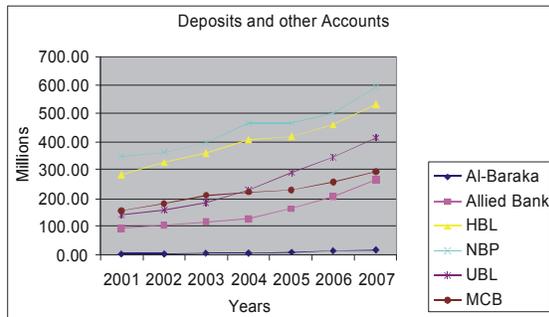
Time Series trend of Profit from Time Period 2001- 2007



Time series trend of Number of Employees from Time Period 2001- 2007



Time series trend of Deposits and other Accounts from Time Period 2001-2007



All the above graphs show that the performance of Al-Baraka Islamic bank is low as compared to Conventional Banks.

CONCLUSION

Banks play a considerable part in the determining and proceeding in the today's modern societies. Economy is totally based on the keen role of Banking system of both Conventional banking and Islamic Shariah banks. To seek out the said performance this study is launched. The purpose of the study is to assess the performance of banking sector including both systems i.e Conventional banking system and Islamic banking system. To accommodate the above study time series data of Al-Baraka Islamic Bank from the period of 2001 to 2007 is used as the Al-Baraka Islamic Bank is one of the Islamic Banks in Pakistan. The methodology used for performance assessment modus operandi is significant to gauge the intensification and expansion of any banking system. The measures showed that the competence and aptitude of both bank system i.e both Conventional banking and Islamic Shariah banks have increased. It is also come to know that estimated regression model show the influence of different factors i.e (A) Advances Net,

(B) Investment Net, (C) Deposits, (D) other Accounts, (E) Administrative Expenditures and (F) Borrowings from Banks had noteworthy influence on bank's profitability. While on the other hand, when we talk about number of Employees and Operating Fixed Assets, then there is not worth mentioning impact on profit. Whereas DISL i.e a Dummy Variable is created for Islamic bank system to show not worth mentioning optimistic impact on that Islamic bank's profit. At the end of research it has come to know that Al-Baraka Bank is less cost-effective in the comparison with 5 conventional banks of Pakistan. The result shows the long history and experience of conventional banks of Pakistan in the banking business. It also shows that these conventional banks grasp overlook in the financial sector. It also has its large contribution on the whole monetary resources of the Pakistan.

On the other hand Islamic Banks are started few years later so they have to take time to get experience. So the research depicts that in the regard of estimated regression, the Al-Baraka Banks has not worth mentioning positive impact as compare to conventional banks.

REFERENCES

1. Khan, M., 2004. Banking Industry of Pakistan: Performances and Constrains. [Online] Available from: <http://www.mediamonitors.net/biopakby muhkhhan.html>. (Accessed 25 July 2009).
2. Dar, A.H. and M.M. Akram, 2008. Islamic Economics. Publisher Ilmi Kitab Khana.
3. Zaidi, S.A., 2005. Issues in Pakistan's Economy. Published by Ameena Saiyid, Oxford University Press.
4. Iqbal, M., 2001. Islamic and Conventional Banking in the Nineties: A Comparative Study. Islamic Economics Studies, 8, No. 2, April, 2001.
5. Iqbal, M., 2002. Islamic and Conventional Banking in the 1990: A Comparative Analysis. Unpublished MA Dissertation, Department of Economics and Social Science, University of Norway.
6. Yudistira, D., 2003. Efficiency in Islamic Banking: an Empirical Analysis of 18 Banks. Department of Economics, Loughborough University.
7. Arby, M.F., 2003. Structure and Performing Of Conventional Banks in Pakistan. Munich Personal RePEc Archive (MPRA). MPRA paper no. 4983. [Online] Available from: http://mpra.ub.uni-muenchen.de/4983/1/MPRA_paper_4983.pdf. (Accessed 5 September 2009).

8. Kamaruddin, Hisham, B. Safa. Samaun, M. Mohd and Rohani, 2008. Assessing Production Efficiency of Islamic banks and Conventional bank Islamic Window in Malaysia. MARA University of Technology.
9. Welli, L., 2009. Do Islamic Banks Have Greater Market Power? Working Paper 2009-02, Institute de Finance de Straboug. [Online] Available from: <http://ifs.u-strasbg.fr/large/puplications/2009/2009-02.pdf>. (Accessed 15 October2009).
10. Charles, A.R., 2009. Islamic Finance a viable Alternative in the Global Financing Market. Social Science Research Network. Viewed 5 October 2009, Available from: <http://ssrn.com/abstract=1332793>.