

**ISLAMIC BANKING SYSTEM:
GROWTH AND PERFORMANCE IN PERSPECTIVE OF PAKISTAN**

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ABSTRACT

In accordance with the Islamic law, Islamic banking is an activity, govern by Islamic rules and regulations and practically applicable through development of Islamic economics. The Islamic banking system (IBS) reveals encouraging system in the arena of financial system. This is competing with the established interest based conventional system (CBS). The Islamic Banking System (IBS) is becoming vital source of landing for individual and states. Through this system customers are very responsive in nature of availing the services to emerging Islamic Banking System (IBS) which is based on tenets of Islam and consistent with the human-nature that always preferred welfare, justice and transparent approach in their daily life and also justify the legitimate way of spending so has to contribute towards establishment of welfare society. This research highlights the growing trend of the emerging banking system in the Pakistan as well as around the world.

Keywords: Islamic Banking System (IBS), Conventional Banking System (CBS), Malaysian Ringgit (MR)

INTRODUCTION

The Islamic Banking System (IBS) deals with financial transactions in accordance with the teaching of Shariah. The financial system aims to provide mechanism to mobilize the resources and these transfer through different transactions and make proper financial allocation of resources. Such mechanism must be completed in any given time period. This mechanism of mobilization, transfer and allocation of resources has significance to all sectors of an economy to grow at substantial level for the development of the society. In general, the financial resources revolve around household, investors, businesses, banks and firms, the financial activities lead to economic growth. It is an established opinion that the savings transform into deposits by households and onward borrowed through banking system as a financial resource between suppliers and users. The said structure is based on the conventional banking system that has originated over centuries and has been evolving since then (Ahmed, H.

(2006). This financial structure dominates world economics and politics till to date. Whereas; social well-being of people under Islamic Banking System (IBS), which is at its infancy especially due to its limitations and debate over its legal framework through which it operates all over the world. The Muslim world consisting of more than 1 billion population had to relay, on the conventional banking which is not permissible in Islam. Therefore; the emergence of Islamic Banking is a positive interception, especially for those abide by the Islamic ideology. This research paper also highlights the emerging Islamic Banking System IBS in the world. The paper also attempts to assess the financial performance of Islamic banking and its scope along with future prospects in competing with conventional banking system that is in operation since centuries. The paper is divided into three parts, part one reviews background, part two provides a tabular analysis of financial performance parameters. It discusses the logical reason of Islamic banking growth especially in the context of future prospects in relation to customer perceptions. Finally part three details conclusions and recommendations along with selective references.

BACKGROUND

Islamic banking system came into being in Egypt in year 1963; (Ahmed El Najjar) played a pivotal part in bringing Islamic banks into existence and the new system was based on the principles of non-interest based profit sharing as per the philosophy of Shariah. At the beginning, nine banks were operating in Egypt. All those banks were operating without charging interest; instead, all those banks were not charging any interest but rather preferred to lend to industries and trade in direct investments by the depositors / partners.

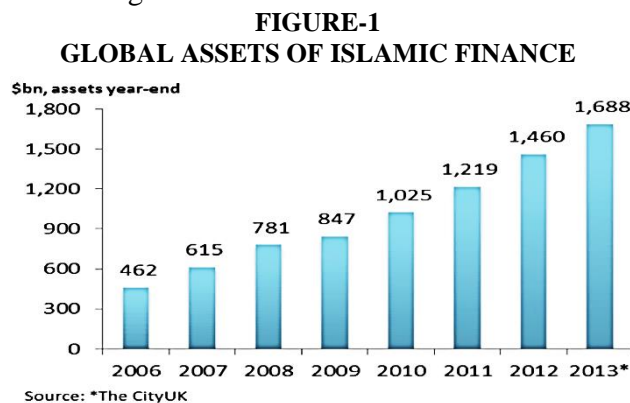
After nearly a decade of their formation, Islamic banks started getting recognition and earning an eminent response and position in the global financial industry. Most banks that came into existence were private initiatives; however, the Iranian government was the first to take the initiative as an state. As per the commandments of Shariah, no bank was allowed to deal in interest or Riba (Usury), (Abdel-Hameed M. Bashir (1993).

In-fact believed that the progress regarding financial institutions commenced in 1980s. The previous effort only dealt with continuation of interest free banking, whereas the real evaluation of the new Islamic Financial System (IBS) surfaced in 1980s. The interest free banking system is a still remains the foremost effective of

Islamic banks as their purpose of existence is the strengthening of financial institution as per Shariah laws. Beside this some vital aspects like protection of agreement of property rights and also risk sharing and safeguarded. Islamic banking widely regarded as an interest free banking in contrast to interest based conventional banking as more commonly practiced worldwide, including among a large number of leading Muslim countries. This is because banking interest is interpreted as Riba, which is prohibited. In Islamic banking, there is no lending as such, there are no lenders and there are no borrowers either, because no loan or debt is being created in Islamic banking; hence there are no debtors either. Instead, Islamic banking is a mode of financing on profit and loss sharing terms, PLS, whereby financiers and clients share risks of financing or investing in underlying assets on equal terms. Since there cannot be proportional risk sharing without proportional ownership, therefore, financiers have to acquire ownership of items prior to extending credit finance, a key stipulation that cannot be circumvented. Likewise, in Islamic banking, there are no interest-based deposits; instead, deposits are lodged on PLS terms given these features, Islamic banking is a system of finance rather than banking as the term banking is commonly understood worldwide; though it is labeled as Islamic banking.

Interest free banking has become ever increasing phenomena within the International Financial System (IFS). The Islamic Finance penetrates in this market and being accepted as intermediation within global and intercontinental financial flows.

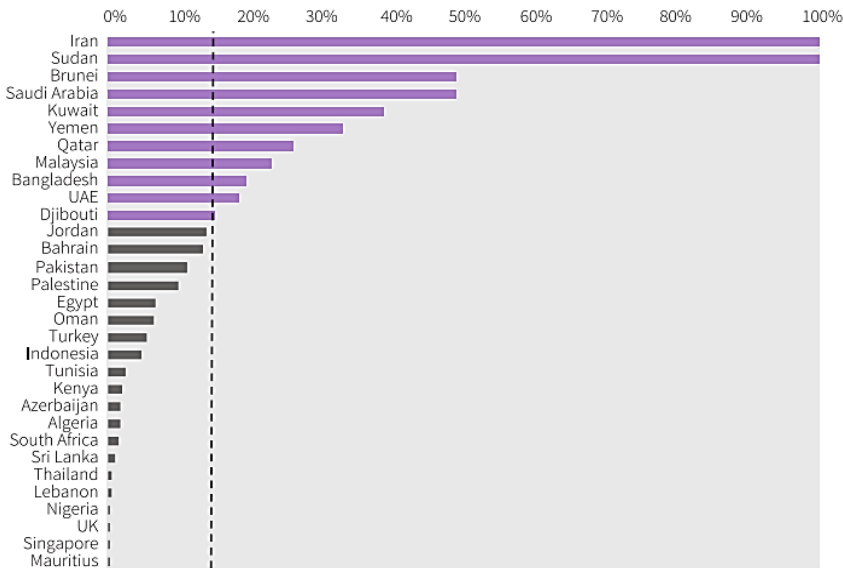
The Figure 1 showing the Global Assets of Islamic Finance over the period with increasing trend.



SOURCE: <https://project-firefly.com/node/18581>

The countries in figure 2 bars indicate those that satisfy the criteria of having a more than 15% share of Islamic banking assets as a proportion of total domestic banking sector asset. Hence, are categorized as systemically important.

FIGURE-2
ISLAMIC BANKING SHARE IN TOTAL BANKING ASSETS BY JURISDICTION (1H2015)



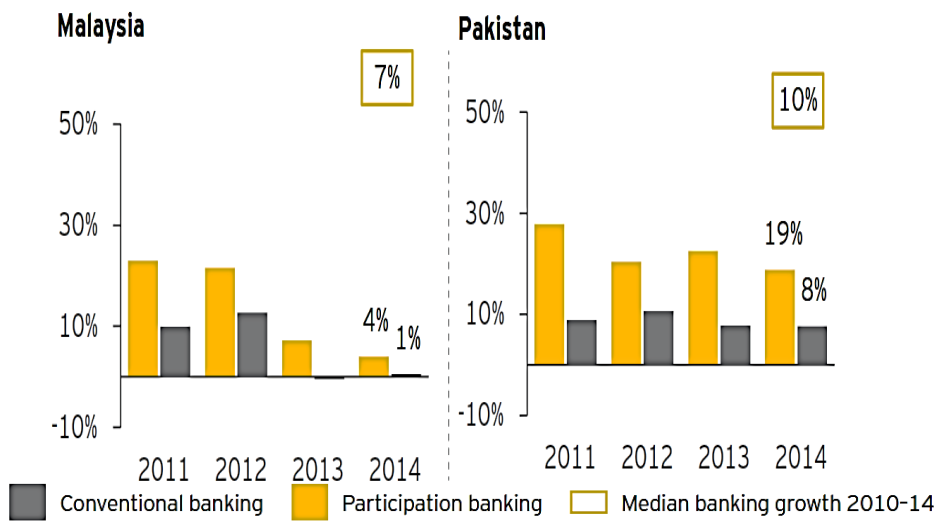
SOURCE: IFSI Stability Report 2016 (final)

The global Islamic finance industry is being dominated by Islamic Banking System through contributing significantly by all the countries like, Iran, Saudi Arabia, Gulf countries, Malaysia even UK. As above figure reflects the share of such countries which are categorized as important as practicing Islamic banking. Presently, the Islamic Banks are relying heavily on profit from demand oriented niche market like Sukuk, which is growing rapidly. The emerging Islamic banks already present in the field facing competition among them besides the arch rival conventional financial institutions by realizing the changing trends within financial market where conventional banks have also opened their Islamic windows in their banks to get and avail emerging opportunity from the market share.

EVALUATING PERFORMANCE

The Islamic Banking nevertheless is growing rapidly but simultaneously facing challenges, issues and problems too. Various attempts have been made in its beginning to modernize Islamic Banking System. Special focus were on conceptual issues like interest free financing (Ahmed 1981, Karsen, 1982) while doing previous research studies on interest free banks. On the contrary, it is not easy to find sufficient work on the viability of Islamic banks issues, risk, facilities of transaction and tendency to mobilize savings. Nonetheless, there few studies on how to eradicate interest payment as policy matter (Khan, 1986 and Khan & Mirakhor, 1987). So far Islamic Banking in Malaysia has progressed remarkably in recent past and still continuing to develop up to considerable level in the Islamic banking sector, however research on the efficacy an efficiency of this banking system still lagging behind (Yudistira, 2003 and Sufian, 2007). It is also worth mentioning that general evaluation approach has been made towards performance of Islamic banks only through profitability and Islamic banks approach to grab market share within financial market.

**FIGURE-3
ASSET GROWTH OF ISLAMIC BANKING IN MALAYSIA
AND PAKISTAN**



SOURCE: Company financial reports, EY universe, EY analysis

The statistically significant and inverse impact of the taxes reveals that repression in term of finance distorting the overall working of Islamic banks. Similarly the opportunity cost of holding reserve has negative effect of the reserve tax because deposits, in Islamic banks are taken as share and have nominal value which not guaranteed and as such holding of reserve have negative effect on Islamic banks in two ways:

- No return on holding of reserve by the banks.
- Such statutory requirement makes unable banks for onward investment.

Therefore; as prudential policy of the central banks the Islamic banks should be exempted from statutory requirement owing to reasons that reserve does not entitle for discount loan or last resort to borrow from the central banks.

The instruments under Islamic Finance have pre-determined mark up in deferred payment due to time value and recognized. Bashir also subscribe this explanation.

Since the conceptual realm is not as flexible as compare to the operational realm of Islamic finance because of financial transaction may have implicit time value of money under built in provision in the instruments of Islamic Finance. According to Bashir, what is difference between modern banking and Islamic banking, which are also offering competitive rates of return and also lending on higher rates too. Sarker 1999 in his Bangladesh model has elaborated that Islamic product with risk involved should have prudential regulation and Islamic banking can also survive conveniently in the interest dominated conventional banking system, where PLS modes of finance are not so recognized and dominating.

ISLAMIC BANKING IN PAKISTAN

As the Holy Quran enshrines in the verses 2:275 allows financial activity under Islamic economic set- up through asset back financing to bring about value addition. Accordingly in line with other countries like Malaysia, practicing and experiencing Islamic banking, likewise Pakistan Islamic banking system is also based on the prohibition of Riba or risk free return and trading. Islamic banking in Pakistan based on risk sharing, involvement physically owning and handling of goods, personal involvement in trading process and leasing and various Islamic modes of financing. Therefore, Islamic banking performance not only to avoid such transactions which bear

interest or Riba not allowed in Shariah. In order to achieve the objectives and goals of newly emerging Islamic banking system in an Islamic economy is also to avoid immoral practices and actively involve towards establishing welfare state and justice in the Islamic economy.

As envisaged in the constitution of Pakistan (1973) which has attached top priority to eliminate interest from economy and banking sector. Subsequently in 1991, Supreme Court of Pakistan has also endorsed such policy standing on the financial system of a Muslim Country. Pakistan started and embarks upon this Banking system and has been experiencing ferocious competition from its peers as well as from conventional banks. For last more than ten years Pakistan is also witnessing positive and unprecedented growth which certainly optimistic and augurs well for this newly emerged financial and banking system in Pakistan.

The Central Bank of Pakistan (SBP) being central regulatory body performing leading role for the development and promotion of this banking system alongside conventional banking system in the country. SBP has been focusing on all the relevant issues of Islamic banking under its newly established Islamic Banking Department at its central office, which has been giving impetus to the ongoing efforts to making this new banking system first choice for the customer.

As we know, Islamic banking system has been working as parallel to the conventional banking system, giving equal and open option and level playing field to all within broad based financial services to perform its due role in the economic development of the country. The trend in the table 2 show that Islamic banking in Pakistan during the year 2003 to 2011 has visible share in net financing, deposits and assets which show upward trend from 1% to 7% in 2011. It is very encouraging to note steady rise from 2003 to 2011. Similarly spread of Islamic banks has increased significantly over the period of years from individuals to financing were extended to textile industry, energy, chemical and pharmaceutical, sugar and cement industries.

TABLE-1
GROWTH OF ISLAMIC BANKING IN PAKISTAN- RS. IN BILLION

Years	Assets		Deposits		Net Financing Investment	
2003	13	1	8	1	10	1
2004	44	2	30	1	30	1
2005	71	2	50	2	48	2
2006	119	3	84	3	73	2
2007	206	4	147	4	138	4
2008	276	5	202	5	186	4
2009	366	6	283	6	226	5
2010	411	6.1	330	6.4	236	4.6
2011	560	7.3	452	7.6	420	7

SOURCE: Extracted from: Islamic Banking Bulletin, Karachi: State Bank of Pakistan, June 2011

TABLE-2
SPREAD OF ISLAMIC BANKING IN PAKISTAN - 2014

Particulars	Number of Branches	Increase in %
Fully Fledged Islamic Banks	497	62
Islamic Branches of Conventional Banks	253	32
Sub-Branches	49	6
Total	799	100

SOURCE: Ahmad, M. F., Hussain, M. S. & Hannan, S.A. (1999).

CUSTOMER OPINION AND PERCEPTIONS

More competition is being witnessed by the Islamic banks amongst them and conventional banks for customers. In order to expand newly emerged banking system, new areas like customer satisfaction and introduction of innovative products to fulfill customers' requirements have been the need of the time, and expectations from the Islamic banks are ever increasing around the world and also in Pakistan too. It is the basic need and requirement to be completed for banks customers as better option for them as compare to the conventional banking products and financing. Therefore; overall satisfaction may be measure through customer's evaluation of different approaches of the service providers (Westbrook, 1981). Consequently, strong competition within the prevailing financial systems has been linked to the customer

satisfaction as important factor and attached due importance as pivotal position (Bartell, 1993; Haron *et.al.*, (11.1994; Chakravarty *et.al.*, 1996; Chitwood, 1996; Kaller 2003). We can say customer satisfaction bring about creditbility and reputation in service environment by the banks (Bontis, Booker and Serenko, 2007). The number of benefits delivered to the clients and customers from the banks, which differentiate these services providers other than goods and have key features like: intangibility, heterogeneity, perishability and reparability (Parasuraman *et.al.*, 1985). Within competitive banking service delivered become essential reference to retain and grab customer acquisition (Galloway and Ho, 1996). It becomes only possible when bank attaches priority to the customers ever increasing improved services (Hanson, 2000). Customer satisfaction is therefore major factor for banks to keep continuing offering quality of services (Spreng and Machoy, 1996; Gefan, 2002; Ibanez *et.al.*, 2006; Saravanan and Rao, 2007).

TABLE-3
CUSTOMER SATISFACTION LEVELS FOR MEEZAN BANK IN %

Questions Asked	Fully Satisfies	Satisfied	Neutral	Dissatisfied	Fully Dissatisfied
Bank provides fast and efficient services Terms and conditions for availing Islamic.	24	41	28	7	-
Product or investments	29	34	22	8	7
Friendliness of bank personnel	43	34	19	4	-
Profit and loss sharing	23	49	25	-	3
Bank policies are according to Islamic Law	41	40	14	-	5
Location of bank	51	37	12	-	-
Variety of products and services offered by the bank	26	25	40	5	7
The quality of service of e-banking provided by the bank	12	39	15	17	17

SURVEY DATA, 2014

While considering various factors that may effects service quality due to political conditions, prevailing environment, socio-culture variations, demographic changes with technological advancement quality of services has not become multi-dimensional approach, having different views by the various researchers (Cronin

et.al., 2000). In order to expand banking operations and their portfolios, the banks have realized the importance of service quality within the banking industry which leads to customer satisfaction in Pakistan (Jamal and Naseer, 2003).

TABLE-4
SATISFACTION AND PERCEPTION LEVELS ABOUT
CONVENTIONAL BANKING IN PAKISTAN

Questions Asked	Fully Satisfies	Satisfied	Neutral	Dissatisfied	Fully Dissatisfied
Bank provides fast and efficient services.	35	25	25	15	-
Ease of obtaining loans (the acceptability of loan terms and Conditions).	23	15	45	15	2
Friendliness of bank personnel	23	20	42	15	-
interest rate/ profit you get on saving account or investments.	10	35	35	20	-
Interest rates on which bank gives you loan	20	22	38	20	-
Location of bank	25	37	21	17	-
Variety of product and services offered by the bank	5	70	17	8	-
The quality of service of e-banking provided by the bank	-	44	30	20	6

SURVEY DATA, 2014

Table 3 and 4 highlights the confidence levels gauged by the customer satisfaction and their perception about Islamic Bank in Pakistan (Meezan Bank) and the conventional banking sector in the country. The data is collected through secondary sources is quoted as referred in this section.

CONCLUSIONS

The articles highlights emergence of Islamic Banking System in the world which also include the finance market in Pakistan and Malaysia. This article is in endeavor to prove the economic attitude of financial affairs with future prospects to compete the centuries old prevailing conventional banking system. The performance evaluation of case study of Bank Al-Meezen being the premier first Islamic in the Pakistan and

Malaysia on the financial performance has been presented to indicate positive upward trend in profit; equity; investment; assets and deposits etc. The indicator confirms that Islamic Banking System (IBS) is expanding significantly performing well on financial fronts. However, some grey area need to be explored and research on the regulatory framework and standardized auditing procedure of the Islamic Banking System (IBS).

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