THE CONVENTIONAL AND ISLAMIC BANKING: A SOCIO-ECONOMIC PERSPECTIVE

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Abstract

A banking sector has always been conceptualized as a reflector of economic progress of any country. In a developing country like Pakistan, economic progress of any sector is also linked with multiple facets of social progress. In Pakistan, two parallel modes of banking systems (conventional and Islamic) offers two different paths to investors and lenders to achieve their financial goals. The profitability of these two different banking systems could determine the extent to which investors and lenders could benefit from achieving their social and economic up gradation. Primarily, this study aims at evaluating the financial performance of conventional and Islamic banks operating in Pakistan. This research endeavor mainly focuses on assessing the viability and profitability of both banking systems (conventional and Islamic) in terms of how efficiently these banks are fulfilling the customers' and investors' needs to facilitate them in uplifting their economic and social status. In this regard, a sample of this research study constitute ten banks representing five banks from conventional banking system whereas, as remaining five relates to Islamic banking sector. In order to achieve study objectives, the financial statements of selected banks covering the period of 2010-2015 were analyzed. The financial performance of selected banks was measured through efficiency, liquidity and leverage ratios. This study concluded that the degree of liquidity is higher and riskiness is lower for Islamic banks as compared to

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conventional banks whereas, conventional banks reported higher profitability then Islamic banks. The significance of this study is embedded in providing useful insight in terms of identifying that how both banking systems are responding to investors and lenders' expectations and contributing towards economic development of a country.

Keywords: *Conventional and Islamic Banking, Social and Economical Perspective, Social Progress, Development of the Country*

Introduction

In contemporary era, banking sector is conceptualized as springboard to monitor and facilitate economic progress of any country. Generally, economic progress of any country has been referred as a key driver to uplift social status, whereas, financial stability of any society has been considered as a prerequisite to perform better at economic and social fronts. The bank as a financial intermediary is works between investors and lenders through engaging in multiple financial activities to offer them economic benefits and social inclusion. Primarily, in developing countries like Pakistan, financial markets are not generally well established; therefore, the role of financial intermediary might emerge as stronger (Beck et al., 2013). The investors perceive that the banks could help them in earning reasonable profit without bearing unnecessary risk. On the other hand, lenders perceive banks as their major source of borrowings. A bank acts as a financial intermediary who deals with deposits, advances and other related services. Overall, in Pakistan, banking sector has attracted considerable attention from lenders as well as investors. The choice of availing the product and services of conventional or Islamic banks depends on the well functioning of these two different modes of banking (Usman & Khan, 2012). Notably, there is ample empirical research concerning conventional banking due to its old history, Whereas, the Islamic banking embarked functioning in recent times and suffers from adequate empirical research.

Although, the main purpose of Islamic banking is of similar nature as of conventional banking to do the business, however, its conduct of business is governed by the Islamic shari'ah, in the light of Islamic laws. The Islamic banking focuses on avoiding interest based transactions to enforce objectives of Islamic financial system. In Pakistan, the Islamic banking system was initiated in 1977-1978 in the regime of General Zia-ul-Haq. To strengthen this banking system, in year 2000, State Bank of Pakistan (SBP) commenced a "Commission for Transformation of Financial System (CTFS)" to embark shari'ah modes of financing and in 2003 established an Islamic banking department. Currently, the significant role of Islamic banking is endorsed by economic and social sectors of the country.

The basic rationale of this study is embedded in making comparison between conventional and Islamic banks from multiple aspects to facilitate investors and lenders to make effective investment decisions. The findings drawn from this study could help in understanding the basic phenomenon pertinent to the financial performance achieved by both banking systems during the time frame of 2010-2015.

Literature Review

The extant literature on conventional and Islamic banking reports verity of studies focused on different aspects of these two different modes of banking systems. The magnitude of literature on conventional banking is quite rich carried out across globe in various contexts. However, the empirical research concerning Islamic banking is generally embedded in the context of Muslim countries and is relatively limited. The financial stability of banks could be viewed as reflector of socio-economic well being of their investors and lenders. In this section, some of the relevant research concerning both modes of banking systems (conventional and Islamic) has been reviewed.

Iqbal (2001 & 2004), compared Islamic and conventional banking with the sample of twelve banks in his study. These studies were focused on some key dimensions, for instance total equity, total investment, total revenue, total assets and total deposits to measure annual growth rates during 1990 to 1998. Based on various ratios, such as profitability ratio, return on asset ratio, return on equity ratio, and capital assets ratio, along with liquidity ratio, deployment ratio, and cost/income ratio, , he reported that the return on assets (ROA) as well as return on equity (ROE) ratios for the Islamic banks indicated substantially higher profitability than the conventional banks. He further reported the depositors of conventional banks might expose to lesser degree of risk then the depositors of Islamic banks, consequently, the customers of Islamic banks might demand higher rate of return in relation to bearing extra risks. In the similar vein, Saifullah (2010), did the performance comparison between Islamic and conventional banks in Bangladesh within a time frame of 2004 to 2008. He applauded the better performance of conventional banks than Islamic banks with respect to profitability, liquidity and efficient contribution towards economy.

Arif and Ayub (1998 & 2002) stated that the conventional mode of financing system is focused and rely only on interest rate, whereas, the Islamic mode of financial system offers loan excluding any interest and focus on covering administrative cost. It is further reported that although market imperfection appeared beneficial for Islamic banks (Arif & Ayub, 2002), however, Islamic banks' performance is not up to par in terms of assets, liabilities and liquidity concentrations and efficiency in operational activities (Hassoune , 2002). According to Awan (2009), in Pakistani context Islamic banks are performing better than conventional banks. It was evident that during 2006-2008, there was growth of 2.5 percent to 5 percent in market share of Islamic banks (Hassoune, 2002). Notably, since State Bank of Pakistan (SBP) instructed conventional banks to open Islamic branches, that led towards mounting pressure on newly activated Islamic banks to compete with conventional banks (Hassoune , 2002).

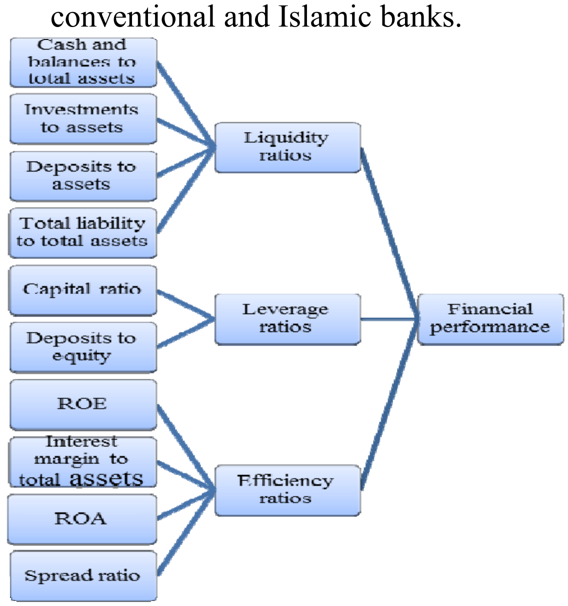
In terms of comparing the size of both banking systems, Akhtar (2007) stated that there are 170 branches of Islamic banks with 23,000 borrowers, constituting the market share of 3.2 percent, whereas, conventional banks are comprises of 7,700 branches incorporating five million borrowers in Pakistan. This reflects that if Islamic banks enhance their various services and offer novel quality products to the customers, they could perform better by increasing competition with conventional banks that might results in increase market share of up-to 15 percent in coming future (Akhtar, 2007). While making performance comparison between Islamic and conventional banks based on CAMEL methodology, Jaffar and Manarvi (2011) reported that the Islamic banks performed better in comparison to conventional banks concerning adequate capital, on the other hand, conventional banks performed better with respect to management quality. However, no significant difference was reported in terms of profitability and liquidity between the Islamic banks and conventional banks. While highlighting the significance of Islamic banks, Schmith (2005), stressed that the notion of Islamic banking is getting popularity not only in the context of Muslim world but also western and non-Muslim countries are also adopting it. He added that the future prospects for the rise of Islamic banking system appear notable, as 1.5 billion Muslim populations around the world require substitute of interest based banking system (Schmith, 2005).

In order to highlight the variations between Islamic and conventional banking systems, Hanif (2011) asserted that the Islamic banking imposes certain restrictions drawn from Islamic principles and laws, therefore, a number of large businesses would not perceive Islamic banking as convenient. Keeping in view the study objectives and extant literature, this research study focuses on assessing the financial performance of conventional and Islamic banks from multiple financial perspectives. These study findings could help in understanding the financial performance of both banking systems in recent times and areas of concerns that need to be improved for better financial results.

Research Methodology

This research is descriptive in nature. In order to achieve the research objectives, the sample of this research study constitute ten banks representing five banks from conventional banking system whereas, as remaining five relates to Islamic banking sector. The five conventional banks under study include National Bank of Pakistan (NBP), Allied Bank of Pakistan (ABL), United Bank Limited (UBL), Habit Bank Limited (HBL) and Muslim Commercial Bank (MCB).The five Islamic banks understudy include Dubai Islamic bank, BURJ bank, Meezan bank, Bank Albaraka and Bank Islami. Pertinent to comparing the financial performance of both types of banks, data were taken from the financial statements of all ten banks under study covering the period of 2010-2015. In terms of measuring the financial performance, initially the various financial ratios were calculated for each bank in both groups for period of six years and later on the average values were computed on yearly basis. Findings drawn from the study were summarized and represented through descriptive statistics.

Figure: 1. The key ratios applied for assessing the financial performance of conventional and Islamic banks.

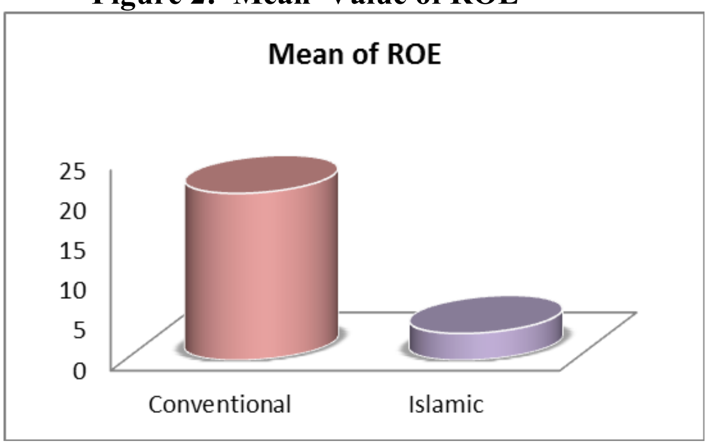


Data Analysis and Findings

The financial performance of each bank in both groups was measured from the perspectives of efficiency, liquidity, and leverage ratios. In this regard, efficiency of banks was analyzed by mean of four key ratios, namely, Return on Equity (ROE), Net Interest Margin to Total Assets Ratio, Return on Assets (ROA), and Spread Ratio. ROE ratio was computed to determine the efficiency of stockholders' investment in generating net income. Net Interest Margin to Total Assets ratio was aimed at measuring the capacity of earnings of entire business through utilizing all of its assets. ROA ratio was computed to indicate the ability of the banks' earnings on its total assets. Finally, spread ratio was utilized to indicate a gap between the interest rate charged by banks on its loans and the rate they pay on their deposits.

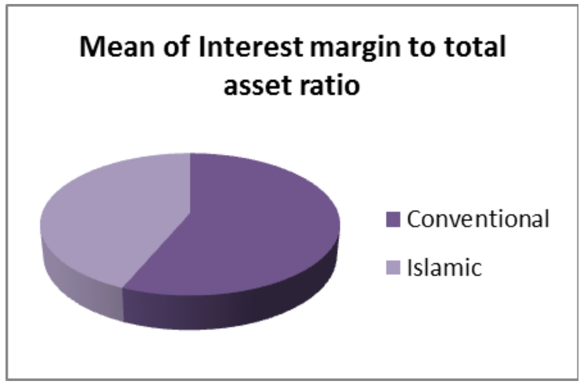
The study findings revealed that the ROE ratios of conventional and Islamic banks are 624.25 and 100.25 respectively. This corroborates that the conventional banks are generating higher income in comparison to Islamic banks during a period of 2010-2015, as shown by the Figure: 2.

Figure 2: Mean Value of ROE



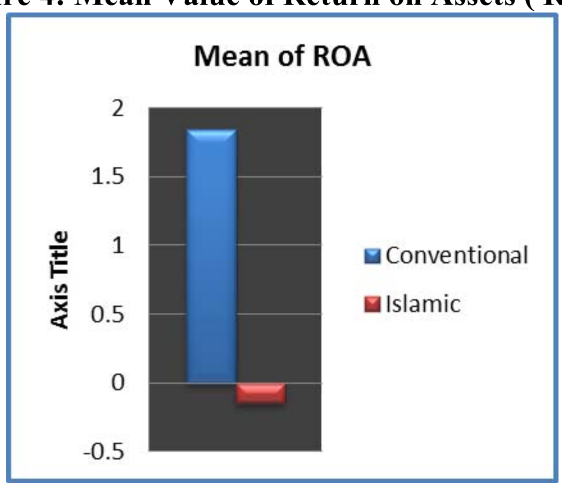
The findings drawn from the data indicated that the interest margin to total assets ratio of both Islamic and conventional banks are 125.52 and 97.05 respectively, as shown in Figure.3. This inequality between both types of banks reflects that the Islamic banks reported less degree of efficiency in utilizing their assets relative to conventional banks.

Figure 3: Mean value of interest margin to total assets ratio



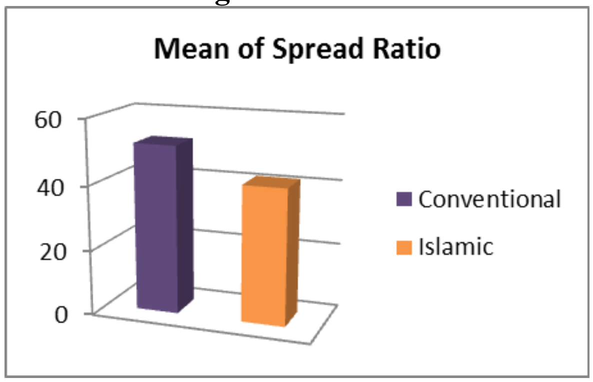
While the return on assets ratios were computed at 1.845 and -0.146 for conventional and Islamic banks respectively, as shown in Figure 4. These results refers that Islamic banks have not shown higher efficiency relative to conventional banks in utilizing their assets to generate more income.

Figure 4: Mean Value of Return on Assets (ROA)



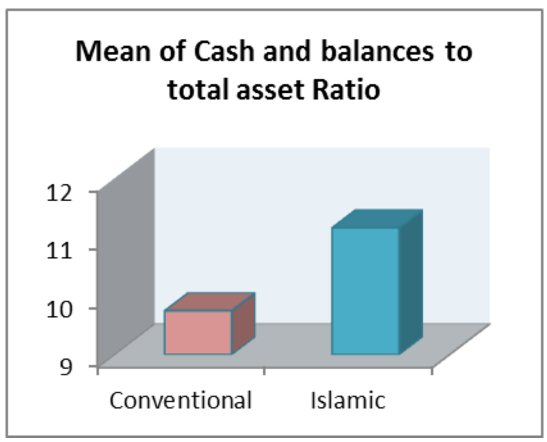
The results drawn concerning spread ratios shown the values of 51.77 and 41.66 for conventional and Islamic banks respectively, as presented in Figure 5.These findings refers that there is a significant variation of spread ratio between conventional and Islamic banks.

Figure: 5



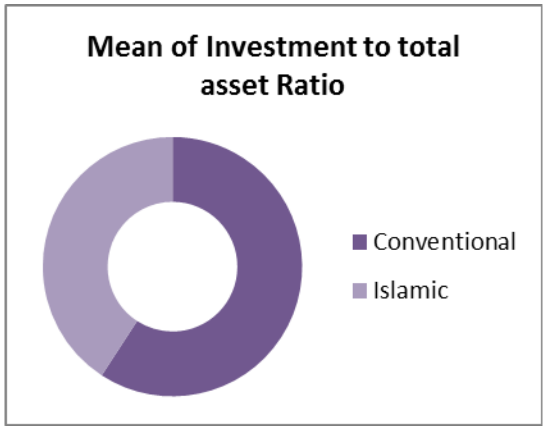
Pertinent to measuring the liquidity of banks, various ratios were computed. In this regard, the ratio of cash and balances to total assets were computed at 9.7486 and 11.1575 for conventional and Islamic banks respectively, as shown in the Figure 6. These results indicate slightly high liquidity for Islamic banks and corroborate that the Islamic banks comparatively have more convertible assets than conventional banks to meet their short term financial needs.

Figure 6: Mean value of cash and balances to total asset ratio



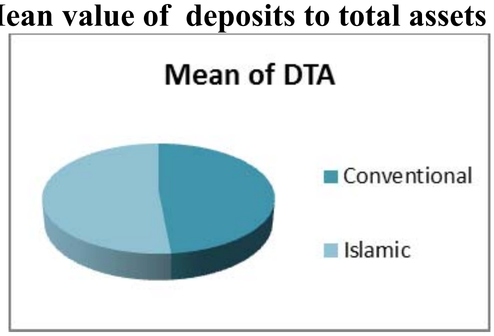
With regard to measuring the liquidity of banks from the perspective of investment to total assets, the said ratios were computed at 42.527 and 29.321 for conventional and Islamic banks respectively, as shown in Figure 7. These results indicate that the conventional banks have higher liquidity with respect to total assets.

Figure7: Mean value of investment to total assets ratio



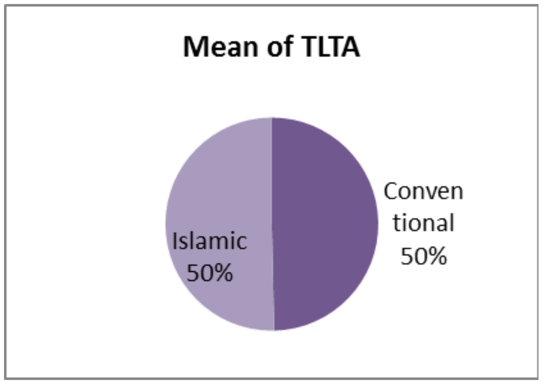
The third ratio which was used to measure the liquidity of banks pertinent to deposits to total assets were computed at 78.279 and 83.116 for conventional and Islamic banks respectively, as presented in Fig.8. These results revealed slight minor difference between conventional and Islamic banks to maintain their deposits concerning total assets.

Figure 8: Mean value of deposits to total assets ratio



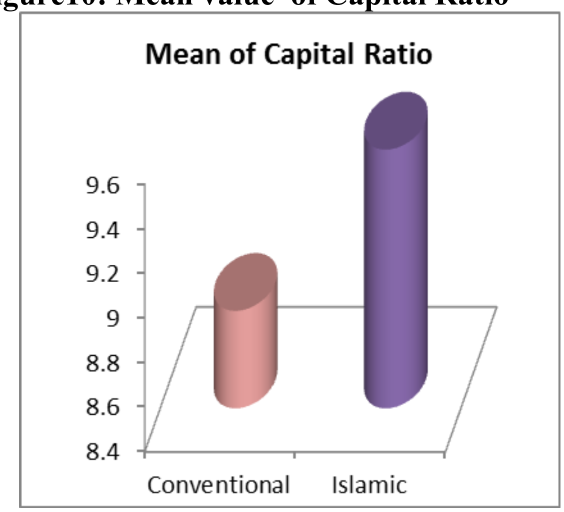
Finally, the liquidity of banks was measured with respect to the proportion of liabilities to total assets. In this regard, the ratio of total liabilities to total assets was reported at 89.195 for conventional banks and 90.437 for Islamic banks, as presented in Figure 9. These results reflect that conventional as well as Islamic banks have adopted similar policies in maintaining their liquidity from this dimension.

Figure 9: Mean value of total liabilities to total assets



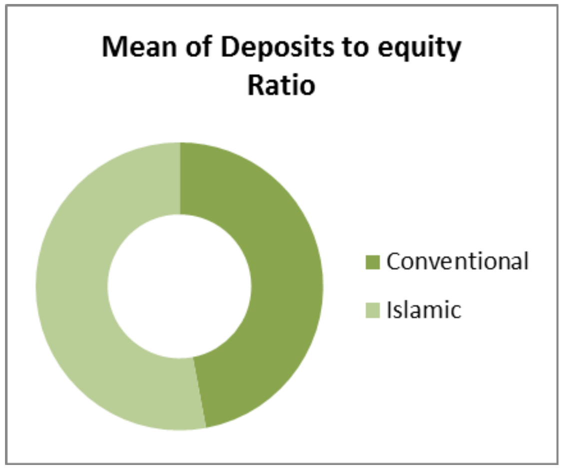
The degree of leverage of conventional and Islamic banks was measured from two aspects. In this regard, the capital ratio was reported at 8.837 and 9.560 for conventional and Islamic banks respectively, as presented in Figure: 10. These findings depict that the proportion of equity in relation to total assets is slightly more for Islamic banks relative to conventional banks.

Figure10: Mean value of Capital Ratio



Another ratio which was used is deposits to equity ratio which shows the result of 9.225 for conventional banks and 10.387 for Islamic banks respectively, as presented in Figure11. These findings reflect a slight difference between the deposits generated in banks and equity of both types of banks. It also reflects that the depositors are attracted towards Islamic banking in past few years.

Figure 11: Mean value of deposits to equity ratio



In order to provide a comprehensive view regarding the various dimensions of the financial performance of conventional as well as Islamic banks for the period covering 2010-2015, the descriptive statistics of efficiency, leverage, and liquidity are summarized in Table 1.

Table 1: Summary of Descriptive Statistics of Efficiency, Liquidity, and Leverage Ratios.

Categories of Ratios	**Types of Ratios**	**Conventional Banks**			**Islamic Banks**		
		Sum	**Mean**	**S.D**	**Sum**	**Mean**	**S.D**
Efficiency Ratios	Return on Equity	624.25	20.808	4.674	100.25	3.341	11.612
	Interest Margin to Total Assets	125.52	4.184	0.99718	97.05	3.235	0.970036
	Return on Assets	55.36	1.84533	0.5749	0.82	-0.146	1.0732
	Spread Ratios	1553.3	51.7766	1.4058	1249.82	41.6606	1.7652
Liquidity Ratios	Cash & Balances to Total Assets	292.46	9.7486	2.9215	334.71	11.157	4.3545

	Investment to Assets	1275.82	42.527	1.8225	879.63	29.321	1.9342
	Deposits to Assets	2348.39	78.279	0.677	2493.5	83.116	0.826
	Liabilities to Total Assets	2675.87	89.1956	2.075	2713.13	90.437	4.552
Leverage Ratios	Capital Ratio	265.13	8.837	0.3339	286.81	9.560	0.8291
	Deposits to Equity	276.76	9.225	0.343	311.61	10.387	0.756

Conclusion

This study concludes that conventional and Islamic banks' performance is varied across different financial parameters during the time frame of 2010-2015. This study corroborates that conventional banks are efficiently utilizing their assets and equity through generating more earnings than Islamic banks. Whereas, on liquidity side, Islamic banks' performance is better than conventional banks in terms of maintaining higher cash and balances in proportion to total assets. However, conventional banks performed better in terms of maintaining higher investment and deposits in relation to total assets. Moreover, conventional banks have more liabilities in relation to total assets than Islamic banks. These findings also indicate the high riskiness of conventional banks than Islamic banks. The leverage ratios were computed to explore the methods of financing of both conventional and Islamic banks to meet their financial obligation. This study found that conventional and Islamic banks do not differ more in terms of their degree of leverage. Overall, this study concludes that the Islamic banks reported higher degree of liquidity and less riskiness as compared to conventional banks because they are largely financed by equity and less by the debt as compared to conventional banks. Notably, the efficiency of conventional banks reported higher relative to Islamic banks.

This study offers useful insight pertinent to determine that how well these two different types of banking systems are efficiently generating income for their investors and providing required funding to their borrowers. The better performance of banks offers financial gains to their concerned parties that might leads towards upgrading their economic and social status. Overall, this study reflects that conventional and Islamic banks construct two distinct modes of modern banking system in Pakistan, therefore, the better financial performance of both types of banks is not only pivotal for their depositors, lenders, and owners only, but it is also imperative for the socio-economic development of our country. It is of note that although, this study offers useful insight pertinent to financial status of conventional and Islamic banking systems, however, this study is only confined to five conventional and five Islamic banks, and only focuses on the limited time frame of 2010-2015.This suggest that future studies might involve larger sample size with extended coverage of time period.

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