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Performance of Islamic Banking and Conventional Banking in Pakistan: *A Comparative Study*

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ABSTRACT

Islamic banking and finance in Pakistan started in 1977-78 with the elimination of *interest* in compliance with the Principles of Islamic Shari'ah in Islamic banking practices. Since then, amendments in financial system to allow the issuance of new interest-free instrument of corporate financing, promulgation of ordinance to permit the establishment of Mudaraba companies and floatation of Mudaraba Certificates, constitution of Commission for Transformation of Financial System (CTFS), and the establishments of Islamic Banking Department by the State Bank of Pakistan are some of the key steps taken place by the governments.

The aim of this study is to examine and to evaluate the performance of the first Islamic bank in Pakistan, i.e. Meezan Bank Limited (MBL) in comparison with that of a group of 5 Pakistani conventional banks. The study evaluates performance of the Islamic bank (MBL) in profitability, liquidity, risk, and efficiency for the period of 2003-2007. Financial ratios (12 in total) such as Return on Asset (ROA), Return on Equity (ROE), Loan to Deposit ratio (LDR), Loan to Assets ratio (LAR), Debt to Equity ratio (DER), Asset Utilization (AU), and Income to Expense ratio (IER) are used to assess banking performances. T-test and F-test are used in determining the significance of the differential performance of the two groups of banks. The study found that MBL is less profitable, more solvent (less risky), and also less efficient comparing to the average of the 5 conventional banks. However, there was no significant difference in liquidity between the two sets of banks. The reasons are due to the facts that conventional banks in Pakistan have longer history and experience in doing banking business and hold dominating position in the financial sector with its large share in the overall financial assets of Pakistan, as compared to Islamic banks, which in true sense, started only a few years back with all letter and spirit.

Albeit, the study found that MBL is less profitable, more solvent (less risky), and less efficient during 2003-2007, however, it is improving considerably over time indicating convergence with the performance of the conventional banks.

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Chapter 01

INTRODUCTION

1.1. INTRODUCTION TO THE STUDY

Rising and stiff competition, consolidation among banks, globalization, deregulation, liberalization, and continuous innovation to provide Isalmically acceptable financial services have given rise to the interest of all the concerned and interested parties in detailed critical evaluation of Islamic banks[1].

Whether these are depositors, investors, bank managers, or regulators, performance evaluation of banks is important for all parties. In a highly competitive financial market bank performance provides signal to depositor-investors whether to invest or withdraw funds from the bank. Depositors may also be interested in evaluating the performance of the bank as they are not entitled to fixed returns and the nominal values of their deposits are not guaranteed. Managers are keen to know the outcomes of previous management decisions as well as to evaluate whether to improve loan service or deposit service or both to improve its finance. Being responsible for safety and the soundness of the banking system and preserving public confidence bank regulators monitor banks' performance to identify banks that are experiencing severe problems. Persistent monitoring of performance is important as existing problems may remain unnoticed and can lead to financial failure in the future otherwise [Samad & Hassan (2000), and Hassan & Bashir (2003)].

Although, Islamic banking in Pakistan started around three decades ago with an initiative of elimination of interest from the operations of specialized institution and commercial banks in 1977-78, but the serious efforts have been the part of recent past only when in January 2000, State Bank of Pakistan (SBP) constituted a Commission for Transformation of Financial System (CTFS) to introduce Shari'ah compliant modes of financing, and, on 15 September 2003, when the State Bank of Pakistan (SBP) established the Islamic Banking Department. As a result of these staid efforts, Islamic banking is now playing an important role in financing and contributing to different economic and social sectors in the country in compliance with the principles of Islamic Shari'ah in Islamic banking practices.

To give a real boost to Islamic banking operations in Pakistan, in an historic initiative, in January 2002, Meezan Bank Limited was granted first *Islamic Banking License* by the State Bank of Pakistan to operate as first full-fledged Islamic bank in Pakistan.

Islamic banks in Pakistan are only six in total and majority of these Islamic banks started their operations only recently except Meezan Bank Limited which is in operation for last

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[1] Conventional banking is quite old and has been focused both extensively and intensively by the existing literature as compared to the modern Islamic banking, which started only four decades before and still lacks that level of intensive and extensive literature. That is why, the center of discussion and focus of this study is more on Islamic baking than conventional banking.

more than six years. On the contrary, conventional commercial banks in Pakistan are comparatively quite large in size and number, and majority of these banks is operating in Pakistan for last more than a decade.

Existing literature on Islamic banking unleashes various studies made on performance measurement of Islamic banks [*for example see*, Bashir (2000), Hassan & Bashir (2003), Samad & Hassan (2000), Rosly & Abu-Bakar (2003), Samad (1999), Samad (2004), Sufian (2007), Saleh & Rami (2006)]. However, studies on assessing financial performance of Islamic bank(s) and conventional bank(s) in different countries have been captured by the existing literature on Islamic banking and finance but we could not detect any studies published on comparative analysis of financial performance of Islamic bank(s) and conventional bank(s) of Pakistan.

The aim of the study is to examine and analyze the experience with Islamic banking of the first Islamic bank, Meezan Bank Limited (MBL), in order to evaluate the Islamic bank's performance in comparison with the group of 5 conventional banks in Pakistan. Since MBL is the only old, somewhat large and experienced domestic private Islamic bank in Pakistan, it will give us some room to generalize our results with regards to performance evaluation of Islamic banks in Pakistan. The study will also provide us some insight about the performance of Islamic banking in comparison to conventional banking in the country.

Another prime reason for selecting MBL as Islamic bank is the data availability and the fact that it is the only domestic private Islamic bank that has age of more than five years. This also stems reason for selecting latest five years (2003 to 2007) to perform our analysis. Since MBL is the private bank, all five conventional banks selected for the study do also belong to private sector. Moreover, these 5 conventional have been selected on merit in that these banks, at large, duly represent private banking sector of Pakistan. Government owned banks and privatized banks have not been made part of this group due to the fact that most of government owned banks and all privatized banks are pretty old and quite large in size as compared to the private sector banks in Pakistan. Reason for not selecting foreign bank, whether Islamic or conventional, is to focus on financial performance of domestic banks only.

Among different tools and techniques different authors used as performance measure, financial ratios found to be quite commonly used in the literature. For the study, we used financial ratios to measure and compare Islamic bank and conventional banks performances in the profitability, liquidity, risk & solvency, and efficiency. T-test and F-test are used to determine the significance of the results.

1.2. LIMITATIONS OF THE STUDY

There are thirty-five banks in total operating as commercial banks[2] in Pakistan including six full-fledged Islamic banks. Out of these six Islamic banks, five are private banks and

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[2] For more details on total banks of all types in Pakistan, please refer to the section "Islamic Banking Sector".

one is a foreign bank. Among all Islamic banks, Meezan Bank Limited (MBL) is the only old, somewhat big and experienced domestic and private Islamic bank in Pakistan operating last for more than six years. Almost all of rest of the Islamic banks in the country started their operations only recently except Albaraka Islamic Bank (AIB) which is a foreign bank operating in the country as branches of AlBaraka Islamic Bank Bahrain since 1991 (Source: AIB). Being foreign bank, we did not select AIB as Islamic bank for our study because the study is aimed at comparing performance of Islamic bank and conventional banks of Pakistan. Another reason for *not* selecting AIB is that it is very small in size[3].

We had a wide and open range of conventional banks to from a group for the study but time, data availability, and some other reasons have been the major limitations that restricted us to the selection of only 5 conventional banks to compare financial performance with Islamic bank (MBL).

1.3. STUDY LAYOUT

Having discussed about the parties interested in performance evaluation of the banks, aim of the study, tools used to measure performance, and limitations of the study, the study continues with Introduction to Islamic banking in chapter 02 followed by banking sector in Pakistan coupled with Islamic banking sector in Pakistan in chapter 03. Review of some of the studies on standalone performance evaluation of the Islamic banks as well as on comparative financial performance of Islamic banking vis-à-vis conventional banking is covered in literature review (chapter 04). Data and Methodology used for the study are discussed in detail in chapter 05 while empirical results and conclusion constitute chapter 06 and 07 respectively. The study ends up with references, website & weblinks, and appendices.

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[3] Size is measured both in terms of value of total assets and the number of branches operating in Pakistan.

Chapter 02

INTRODUCTION TO ISLAMIC BANKING

2.1. BACKGROUND STUDY

After its first introduction on experimental basis in a small town of Egypt in 1963, many Islamic Banks, both with letter and spirit, were established in the Middle Eastern and Asian regions. The growth of Islamic banking has been increasing ever since, not only in terms of number of countries it is operating in but also in term of areas of finance it has ventured in (El Gamal, 2006). In three decades, Islamic banks have grown in number as well as in size world wide and are being practiced on even more intensive scale. Some countries like Sudan and Iran, have converted their entire banking system to Islamic banking. In other countries where conventional banking is still dominating the Islamic Banking is operating alongside. Today, Islamic banks are operating in more than sixty countries (Aggarwal and Yousaf 2000). Islamic Banking and Finance is growing at between 10%-15% per annum and is boasting global assets in excess of $1Trillion. A recent survey indicated that there are more than 160 Islamic financial institutions existing world wide (Dar 2003).

Gradual and steady spread of the Islamic banks over time over the world is a lucid manifestation of success and the symbolic growth rate is the hallmark of this emerging market. Being fastest growing segment of the credit market in Muslim countries, market share of Islamic banks in Muslim countries has risen from 2% in the late 1970s to about 15 percent today (Aggarwal and Yousaf 2000). Islamic banking is getting popularity, warm welcome, and appreciation also by non-Muslims in Muslim and non-Muslim countries. According to Yudistira (2003), although, most of the Islamic banks are within Middle Eastern and/or Emerging countries, many universal banks in developed countries have started to spigot huge demand of Islamic financial products. This also confirms that Islamic banking is as viable and efficient as the conventional banking is.

Where the financial liberalization and deregulation have created new challenges and new realities for Islamic banks, the globalization effect has also put these institutions in cutthroat competition with traditional financial institutions in well developed financial markets. It has become indispensable for Islamic banks to be innovative in designing Islamically acceptable instruments to grapple with the unremitting innovations in financial markets and to compete in local and global deposit markets. Moreover, for fund mobilization and utilization, Islamic banks must seek investment opportunities and avenues that offer competitive rates of return at acceptable degrees of risk. In order to maximize the value of the bank, management of the bank should carefully consider interactions between different performance measures.

Islamic finance refers to the means by which corporations in the Muslim world, including banks and other lending institutions, raise capital in accordance with Shari'ah[4], or Islamic law. It is also referred to the types of investments that are permissible under this form of law. A unique form of socially responsible investment[5], Islam makes no division between the spiritual and the secular, hence its reach into the domain of financial matters (Ross 2007[6]).

2.2. ISLAMIC BANKING AND FINANCE DEFINED

Islamic banking has been defined as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by Islamic Shari'ah. Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic banking, the more general term is expected not only to avoid interest-based transactions, prohibited in the Islamic Shari'ah, but also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy (Source: SBP).

Islamic banking is the system of banking consistent with principles of Islamic law (Shari'ah) and guided by Islamic economics. Islamic economics is referred to that body of knowledge which helps realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances (Chapra 1996). A key element of Islamic economics is distribution of equitable rewards to the different factors of production. Islamic economic system seeks system of Redistributive justice where concentration of wealth in a few hands is countered and flow of money into the economy is fluent. Islamic banking is, therefore, seen as a lynchpin to achieving the economic and social goals of the Islamic economic system. (Source: Bank Alfalah).

As system of Islamic banking is grounded in Islamic principles and all the undertakings of the banks follow Islamic morals so it could be said that financial transactions within Islamic banking are a culturally-distinct form of ethical investing. Two basic principles behind Islamic banking are the *sharing of profit and loss* and, significantly, *the prohibition of Usury*, the collection and payment of interest, also commonly called *Riba* in Islamic discourse. Although collecting and paying interest is not permitted under Islamic law, revenue-sharing arrangements are generally permitted.

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[4] "Way to the water." The "way" of Islam in accord with the Qur'an and Sunna, Iijma' and Qiyas. Sharia is the law of Islam (Source: Islamic Dictionary).
[5] An investment that is considered socially responsible because of the nature of the business the company conducts. Common themes for socially responsible investments include avoiding investment in companies that produce or sell addictive substances (like alcohol, gambling and tobacco) and seeking out companies engaged in environmental sustainability and alternative energy/clean technology efforts. Socially responsible investments can be made in individual companies or through a socially conscious mutual fund or exchange-traded fund (ETF).
[6] http://www.investopedia.com/articles/07/islamic_investing.asp

The thrust of Islamic banking is founded on the desire to submit to the Divine Instructions on all transactions, particularly those involving exchange of money for money. However, it would be quite unfair to limit Islamic banking to elimination of *Riba* only. *Riba* is but one of the major undesirable elements of an economic transaction, the others being *Gharar* (risk or uncertainty) and *Qimar* (speculation). While elimination of these objectionable aspects in a transaction is indeed a critical aim of Islamic banking, it is by no means its ultimate objective.

According to some, usury or excessive and exploitative charging of interest; while according to others, interest per se – is forbidden by the Qur'an. For example:

*"And that which you give in gift (loan) (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allâh; but that which you give in Zakât (sadaqa - charity etc.) seeking Allâh's Countenance, then those, they shall have manifold increase. **Sura Ar-Rum (30:39)**."*

*"That they took riba (usury), though they were forbidden and that they devoured men's substance wrongfully – We have prepared for those among men who reject faith a grievous punishment. **Sura An-Nisa (4:161)**."*

It has been argued in vain for long in some circles that the prohibition in Islam is that of excessive interest only or that it is the interest on consumptive loans that has been forbidden and as such loans extended for commercial purposes are entitled to an excess over the principle amount lent. Such tendentious arguing fails to give due understanding to versus **278 & 279 of Surah Albaqra** (quoted below);

"O ye who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury) (from now onwords) if you are (really) believers. (2:278)."

"And if you do not do it, take notice of war from Allah and His messenger! But if you repent, you shall have your capital sums. (2:279)."

However, this does not mean that Islam prohibits any gain on principle sums. In Islam, profit is the recognized reward for capital. When capital employed in permissible business yields profit that profit (excess over capital) becomes the rightful and just claim of the owner of the capital. As a corollary, the risk of loss also rests exclusively with the capital and no other factor of production is expected to incur it. Another important element of Islamic finance is that profit or reward can only be claimed in the instance where either risk of loss has been assumed or effort has been expended. Profit is therefore received by the provider of capital and wages/remuneration by labor/manager.

A depositor in an Islamic bank can therefore make earnings on his or her deposit in several ways:

o Through return on his capital when that capital is employed in a business venture.

- o Through sharing of profit when his capital is par of capital is employed in a partnership, and finally,

- o Through rental earnings on an asset that has been partially financed buy his capital.

2.3. HISTORICAL PERSPECTIVE OF ISLAMIC BANKING: *A GLANCE*

As with all things Islamic, the origination of Islamic finance goes back to the time of Prophet Muhammad *(Peace be upon Him)*. The Qur'an and the example of Prophet Muhammad *(Peace be upon Him)* provide direct behavioral guide and represent bedrock of Islamic faith to over one billion Muslims globally. The Prophet Muhammad *(Peace be upon Him)* happened to be a businessman serving as a trader for Khadija *(May Allah be pleased with Her)*. The Prophetic example was the very epitome of fair-trade. Refraining from usury, ensuring transparency in transactions, and total honesty entitled him Al-Amin (The trustworthy) in pre-Islamic Arabia (Sufyan[7]).

In Muslim communities, limited banking activity, such as acceptance of deposits, goes back to the time of the Prophet Muhammad *(Peace be upon Him)*. At that time people deposited money with the Prophet Muhammad *(Peace be upon Him) or* with Abu Bakr Sedique *(May Allah be pleased with Him)*, the first Khalif of Islam.

In order to avoid manifestation of Islamic fundamentalism which was anathema to the political regime, the first modern experiment with Islamic banking was undertaken in Egypt under cover without projecting an Islamic image. Ahmad El Najjar made pioneering effort and established a Savings Bank based on *profit-sharing* in Egyptian town of Mit Ghamr in l963. There were nine such banks in the country by 1967. These banks, which neither received nor paid any interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi l988). These banks were functioning essentially as saving-investment institutions rather than as commercial banks. Although its charter made no reference to Islam or Shari'ah (Islamic law), Nasir Social Bank, established in Egypt in l97l, was declared an interest-free commercial bank (Arif 1988).

In the seventies, because of changes that took place in the political climate of many Muslim countries, there was no longer any strong need to establish Islamic financial institutions under cover. Both with letter and spirit, a number of Islamic banks were established in the Middle East, e.g., the Dubai Islamic Bank (l975), the Faisal Islamic Bank of Egypt (l977), the Faisal Islamic Bank of Sudan (l977), and the Bahrain Islamic Bank (l979), to mention a few.

A number of banks were also established in the Asia-Pacific region in response to these winds of change, e.g., The Philippine Amanah Bank (PAB) was established in l973 as a specialized banking institution by Presidential Decree without reference to its Islamic character in the bank's charter. The PAB is not strictly an Islamic bank; nevertheless,

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[7] Ismail, Gulam Sufyan, "Islamic finance explained", "http://www.nzibo.com/IB2/IFExplained.pdf"

efforts are underway to convert the PAB into a full-fledged Islamic bank (Mastura 1988). Its interest-based operations continue to coexist with the Islamic modes of financing. PAB operates two 'windows' for deposit transactions, i.e., conventional and Islamic (Arif 1988). Islamic banking was introduced in Malaysia in 1983, but not without antecedents. Muslim Pilgrims Savings Corporation (MPSC) was the first (non-bank) Islamic financial institution in Malaysia setup in 1963 for people to save for performing hajj (pilgrimage to Mecca and Medina). MPSC was evolved into the Pilgrims Management and Fund Board in 1969, which is now popularly known as the Tabung Haji. The success of the Tabung Haji also provided the main thrust for establishing Bank Islam Malaysia Berhad (BIMB), which represents a full-fledged Islamic (commercial) bank in Malaysia. Bank Islam Malaysia Berhad (BIMB) was setup in July 1983 with paid-up capital of RM 80million (Arif 1988 and BIMB).

The Organization of Islamic Countries (OIC), established Islamic Development Bank (IDB) in December 1973 with the purpose to foster economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah i.e., Islamic Law. The IDB not only provides fee-based financial services but also provides financial assistance on profit-sharing bases to its member countries (Source: IDB).

Reference should also be made to some Islamic financial institutions established in countries where Muslims are a minority. There was a proliferation of interest-free savings and loan societies in India during the seventies (Siddiqi 1988). The Islamic Banking System (now called Islamic Finance House), established in Luxembourg in 1978, represents the first attempt at Islamic banking in the Western world. There is also an Islamic Bank International of Denmark, in Copenhagen, and the Islamic Investment Company has been set up in Melbourne, Australia (Arif 1988). In the late 20th century, a number of Islamic banks were created, to cater to this particular banking market.

From a humble beginning in a small village in Egypt in the late 60s, it has now spread to the four corners of the world. By normal standards in a time span that is less than half a century it cold have hardly been expected to establish foothold in Islamic world, let alone make its presence felt in Muslim-minority countries. Yet such has been its phenomenal rate of growth that not only is taking firm roots in its homestead, but is also attracting genuine interest among standard barriers of conventional banking and in swathes of land where Muslims are a small minority only.

2.4. DIFFERENCE BETWEEN ISLAMIC BANKING AND CONVEMNTIONAL BANKING: *AN OVERVIEW*

Like conventional bank, Islamic bank is an intermediary and trustee of money of other people but the difference is that it shares profit and loss with its depositors. This difference that introduces the element of mutuality in Islamic banking makes its depositors as customers with some ownership of right in it (Dar and Presley 2000).

Islamic banking and conventional banking differs in that while the conventional banking follows conventional interest-based principle, the Islamic banking is based on interest-free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries (Arif 1988). Rationale behind prohibition of interest and the importance of PLS in Islamic banking has been discussed in many Islamic economics studies[8]. Moreover, Islamic PLS principle creates the relationship of financial trust and partnership between borrower, lender, and intermediary (Yudistira 2003).

Islamic finance is a financial system with the aim to fulfill the teaching of Holy Qur'an as opposed to reaping maximum return on financial assets. Conformity to norms of Islamic ethics is the main concern of Islamic financial system. These norms of Islamic ethics as enunciated by the Shari'ah govern all transactions in an Islamic financial system. At a fundamental level, an Islamic financial system can be described as a "Fair" and a "Free" system where "Fairness" is the primary objective; however, it also circumscribes the "freedom" of the participants in the system. Though, in Islam participants are free to enter into transactions but this basic norm of freedom doest not imply rampant freedom to contract and is constrained by other norms, such as, the prohibition of *Riba and Gharar*.

An Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment as compared to a conventional bank which is basically a borrower and lender of funds. Difference between the two banking systems also lies in terms of governance structure. Islamic banks must obey a different set of rules – those of the Holy Qur'an – and meet the expectations of Muslim community by providing Islamically-acceptable financing modes (Suleiman 2001).

Islamic banks are similar to those of non-Islamic banks in that both offer similar (financial) services and play a pivotal role in the economic development of their societies. But they are different in that Islamic banks, unlike non-Islamic banks, are bound to follow Islamic Shari'ah in their operations. For instance, according to Islamic Shari'ah exploitative contracts based on Riba (usury or interest) or unfair contracts that involve risk or speculation are unforeseeable.

According to Siddique (1985), Islamic banks compared with non-Islamic banks seek a "just" and "equitable distribution of resources". Islamic bank is based on Islamic *Faith* and its operations must be within the boundaries of Islamic Law or the Shari'ah. There are four rules that govern investment behavior (Suleiman 2001):

a. the absence of interest-based *(RIBA)* transactions;
b. the avoidance of economic activities involving speculation *(GHARAR)*;
c. the introduction of an Islamic tax, *ZAKAT*;
d. the discouragement of the production of goods and services which contradict the value pattern of Islam *(HARAM)*.

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[8] See for example, Chapra (2000), and Dar and Presley (2000).

CHAPTER 03

BANKING SECTOR IN PAKISTAN

3.1. AN OVERVIEW

Financial Sector Development and Economic Development are inter-related. Well functioning and efficient financial sector plays pivotal role in the growth of the economy as well as in improving the living standards of its population. Banks in Pakistan share 95 percent of the financial sector, therefore good health of banks and economic growth and development of Pakistan are directly related to each other (Ishrat Hussin 2005).

Pakistani banking system is comprised of 53 banks[9]. *Thirty* commercial banks, *four* specialized banks, *six* Islamic banks, *seven* development financial institutions and *six* micro-finance banks make up this total. The banking sector of Pakistan is composed of government owned banks (9), private banks (22), privatized banks (4), foreign banks (5), development institutions (7), non-member banks (4), and small and medium enterprises (2). Of the total system assets, four largest commercial banks make up 44.2 percent, while eight second-tier banks account for a further 35 percent indicating moderate concentration (Source: Dailytimes).

Banks of Pakistan have been involved basically in catering to the needs of the government organizations, subsidizing the fiscal deficit, engaging in trade financing, and serving a few large corporations. Small and medium enterprises, housing sector and the agricultural sectors which create most of the growth and employment in Pakistan were deprived of lending. Moreover, financial system of Pakistan was also under political influence in that there was utmost political intervention in lending decisions and in the appointment of managers (Ishrat Hussain 2005).

According to Patti & Hardy (2005), over the past 15 years, liberalization, the entry of private banks, the privatization of public-sector banks, and the tightening of prudential regulations have transformed the Pakistani banking system. Presently, nearly 80 percent of the system assets are controlled by the private sector, as opposed to the early 1990s when this share was only 10 percent whereas 90 percent of the system assets were controlled by the government at that time. Moreover, total financial assets have reached $175 billion which constitute 110% of GDP. The banking system amounts to 95% of the total assets of financial institutions and shares 40% of total stock market capitalization. Deposit base has mounted to $60 billion and advances to $47 billion. Growing financial intermediation process has contributed significantly towards banks aggregate profitability to increase to $1.8 billion. Present foreign stake comes to 47% of the total paid-up capital of all the financial institutions regulated by State Bank of Pakistan (Shamshad 2007, and SBP).

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[9] List of banks in Pakistan is available at: http://www.pakistaneconomist.com/database2/pakbanks.asp

3.2. ISLAMIC BANKING SECTOR

Let us begin with the view of Quaid-e-Azam Muhammad Ali Jinnah (the founder of Pakistan) on Islamic Banking he expressed on the occasion of the Opening Ceremony of The State Bank of Pakistan on July 1, 1948[10]:

> "We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice. We will thereby be fulfilling our mission as Muslims and giving to humanity the message of peace which alone can save it and secure the welfare, happiness and prosperity of mankind"

Islamic banking in Pakistan started in 1977-78, which included the elimination of interest from the operation of specialized institution and commercial banks. On June 26, 1980, amendments were made in the corporate and financial system to allow the issuance of new interest-free instrument of corporate financing named, Participation Term Certificate (PTC). In the same time, with the aim of rising risk based capital, Ordinance was introduced to permit the establishment of Mudaraba companies and floatation of Mudaraba Certificates. July 1, 1985, all commercial banks in Pak Rupee were made interest free which was mark-up technique with or without buy-back agreement. However, in November 1991, Federal Shariat Court (FSC) declared it un-Islamic (Source: IIFM).

In January 2000, in the State Bank of Pakistan, a Commission for Transformation of Financial System (CTFS) was constituted to introduce Shari'ah compliant modes of financing. CTFS was held responsible primarily for creating legal infrastructure conducive for working of Islamic financial system, launching a massive education and training programs for bankers and their clients, to create awareness for the general public about the Islamic financial system and also to deal with major products of banks and financial institutions, both for assets and liabilities side (Source: IIFM).

In September 2001, Government of Pakistan decided to make shift to interest free economy in a gradual and phased manner without causing any disruptions. It was also agreed that State Bank Pakistan would consider for establishing subsidiaries by the commercial banks for the purpose of carrying out Shari'ah compliant transactions, specifying branches by the commercial banks exclusively dealing in Islamic products and, creating new full-fledged commercial banks to carry out utterly banking business based on proposed Islamic financial products (Source: IIFM).

In January 2002, Meezan Bank Limited was granted first *Islamic Banking License* by State Bank of Pakistan.

On 15 September 2003, The State Bank of Pakistan (SBP) established the Islamic Banking Department with the mission to promote and regulate Islamic Banking Industry in line with best international practices ensuring Shari'ah Compliance and transparency and the with the vision of making Islamic banking the banking of first choice for the

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[10] *Source: Meezen Bank Annual Report. 2007*

providers and users of financial Services. The foremost task of the department is to promote and develop the Shari'ah Compliant Islamic Banking as a parallel and compatible banking system in the country. Department is comprised of three divisions: Policy Division, Shari'ah Compliance Division, and Business Support Division. A Shari'ah Board comprised of experts to guide the Islamic banking industry is also in place at SBP. Risk Management, Corporate Governance, Prudential Regulations, and Accounting & Shari'ah Standards etc., are the key areas SBP is working on to regulate and supervise the Islamic Banking Sector. Currently, Islamic Banking Sector is operating under the existing laws & regulations for conventional banks (Source: SBP).

Presently, there are six full-fledged Islamic banks operating in Pakistan. These banks with their year of incorporation are:

- o AlBaraka Islamic Bank Pakistan (1991)
- o Meezan Bank Limited (2002 – restructured as Islamic bank)
- o BankIslami Pakistan Limited (2003)
- o Dubai Islamic Bank Pakistan Limited (2005)
- o Emirates Global Islamic Bank Limited (2007)
- o Dawood Islamic Bank Limited (2007)

Among the banks listed above, Albaraka Islamic Bank (AIB) is the only foreign Islamic bank operating in Pakistan as branches of AlBaraka Islamic Bank Bahrain since 1991, and Meezan Bank Limited (MBL) has the honor of being the first domestic commercial bank offered full-fledged Islamic banking license by SBP in January 2002.

The market share of Islamic banking assets in the overall banking system rose to 4.3% as of December 31, 2007 compared with 3.0% in preceding year. Islamic banking deposits, financing and investment stood at 4.1%, 4.3% and 2.6% respectively as compared to 2.79%, 2.88% & 0.94% a year earlier. Year on Year (YoY) growth for total assets, deposits and financing & investment was 75%, 78%, 91% respectively. Branch network during the same period reached 289 from 150 branches, showing 93% increase in year 2007. It is hoped that by the end of this financial year the share of assets of Islamic banking to overall industry will cross 5.0%. We may safely say that Islamic banking industry is growing with healthy signs of financial inclusion. Meezan Bank is leading Islamic bank while the Bank Alfalah is on the top among IBDs of conventional banks (Source: SBP).

There is massive demand for Islamic financial services and the growth of Islamic Banking in Pakistan has been commendable during the last two years. However, the lack of infrastructure support & lack of professional Islamic Bankers has constrained the growth.

CHAPTER 04

LITERATURE REVIEW

In 1963, Islamic banking came into existence on an experiment basis on a small scale in a small town of Egypt. The success of this experiment opened the doors for a separate and distinct market for Islamic banking and finance and as a result, in 1970s Islamic banking came into existence at a moderate scale and a number of full-fledge Islamic banks was introduced in Arabic and Asian countries. Most of these Islamic banks were in Islamic countries. Having started on a small scale, Islamic banks and non-banking financial institutions are now in operation even on more intensive scale. Today, Islamic banks are operating in more than sixty countries with assets base of over $166 billion and a marked annual growth rate of 10%-15%. In the credit market, market share of Islamic banks in Muslim countries has risen from 2% in the late 1970s to about 15 percent today (Aggarwal and Yousaf 2000). These facts and figures certify that Islamic banking is as viable and efficient as the conventional banking.

To adhere to the teachings of Islamic Law (Shari'ah) – avoid paying and receiving Riba, avoid Gharar, investing in profit-sharing ventures, avoid investing in such business that are unethical and impermissible, and making socially responsible investments – are the distinguishing points as well as goals of all Islamic banks. How well these Islamic financial institutions have performed and to what extent they have been successful in achieving these goals have been the question marks for the scholars, researchers, and the stakeholders[11].

Where Islamic banking, on the one side, is being regarded as a fastest growing market, on the other side, it is not free from issues, problems, and challenges. Numerous studies have been performed since the inception of the modern Islamic banking and finance. Conceptual issues underlying interest free financing (Ahmad 1981, Karsen 1982) have been the prime focus of these previous studies on Islamic banks. It is hard to find enough coverage in the existing literature on the issues of viability of Islamic banks and ability to mobilize saving, pool risk and facilitate transactions (Hassan & Bashir 2003). However, there are few studies that have focused on policy implications of eliminating interest payments [see for example, Khan (1986) and Khan & Mirakhor (1987)].

Although the phenomenon of Islamic Banking and finance has emerged in recent years and despite the considerable development of Islamic banking sector, the studies focusing on the efficiency of the Islamic banks are still limited in number [see, for example, Yudistira (2003) and Sufian (2007)]. Most of the studies that have been conducted, generally evaluate the performance of Islamic banks with regards to the relationship between profitability and bank characteristics. Bashir (2000) and, Hassan & Bashir (2003) employ bank level data and perform regression analysis to determine the underlying determinants of Islamic performance. Samad & Hassan (2000) and Kader & Asarpota (2007) apply financial ratio analysis to assess the performance of the Malaysian Islamic

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[11] Stakeholders: current account holders creditors, Musharka financing partners, Mudarabah investment account holders, managers, employees, Islamic community, regulatory agencies. See (Suleiman 1999).

bank and UAE Islamic banks respectively. Similarly, to measure efficiency of Islamic banks in Bangladesh, Sarker (1999) utilizes Banking efficiency model and claims that Islamic banks can stay alive even within a traditional banking architecture in which Profit-and-Loss Sharing (PLS) modes of financing are less dominated. Sarkar (1999) further claims that Islamic financial products have different risk characteristics and consequently different prudential regulations should be in place.

Samad and Hassan (2000) evaluate *intertemporal* and *interbank* performance in profitability, liquidity, risk and solvency, and community involvement of an Islamic bank (Bank Islamic Maalysia Berhad (BIMB) over 14years for the period 1984-1997. The study is intertemporal in that it compares the performance of BIMB between the two time period 1984-1989 and 1990-1997. This is not a new method (Elyasiani 1994). To evaluate interbank performance, the study compares BIMB with two conventional banks (one smaller and one larger than BIMB) as well as with 8 conventional banks. Using financial ratios to measure these performance and F-test and T-test to determine their significance, the results show that BIMB make statistically significance improvement in profitability during 1984-1997, however, this improvement when compared with conventional banks is lagging behind due to several reasons. This result is consistent with that of Samad (1999) and Hassan (1999). The study also reveals that BIMB is relatively less risky and more solvent as compared to conventional banks. These results also conform to risk-return profile that is BIMB is comparatively less profitable and less risky. Performance evaluation of BIMB indicates that it is more liquid as compared to the group of 8 conventional banks. Results of the primary data gathered by surveying 40% to 70% bankers identify that lack of knowledgeable bankers in selecting, evaluating and managing profitable project is a significant cause why Musharka and Mudarabah are not popular in Malaysia.

Abdus Samad (2004) in his paper examines the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks during the post Gulf War period 1991-2001. Using nine financial ratios in measuring the performances with respect to (a) profitability, (b) liquidity risk, and (c) credit risk, and applying Student's t-test to these financial ratios, the paper concludes that there exists a significant difference in credit performance between the two sets of banks. However, the study finds no major difference in profitability and liquidity performances between Islamic banks and conventional banks.

Kader and Asarpota (2007) utilize bank level data to evaluate the performance of the UAE Islamic banks. Balance sheets and income statements of 3 Islamic banks and 5 conventional banks in the time period 2000 to 2004 are used to compile data for the study. Financial ratios are applied to examine the performance of the Islamic banks in profitability, liquidity, risk and solvency, and efficiency. The results of the study show that in comparison with UAE conventional banks, Islamic banks of UAE are relatively more profitable, less liquid, less risky, and more efficient. They conclude that there are two important implications associated with this finding: First, attributes of the Islamic profit-and-loss sharing banking paradigm are likely to be associated as a key reason for the rapid growth in Islamic banking in UAE. Second, UAE Islamic banks should be

regulated and supervised in a different way as the UAE Islamic banks in practice are different from UAE conventional banks.

Saleh and Rami (2006) in order to evaluate the Islamic banks' performance in Jordon, examine and analyze the experience with Islamic banking for the first and second Islamic bank, Jordan Islamic Bank for Finance and Investment (JIBFI), and Islamic International Arab Bank (IIAB) in Jordon. The study also highlights the domestic as well as global challenges being faced by this sector. Conducting profit maximization, capital structure, and liquidity tests as performance evaluation methodology, the paper finds several interesting results. First, the efficiency and ability of both banks have increased and both banks have expanded their investment and activities. Second, both banks have played an important role in financing projects in Jordan. Third, these banks have focused on the short-term investment. Fourth, Bank for Finance and Investment (JIBFI) is found to have high profitability. Finally, the study concludes that Islamic banks have high growth in the credit facilities and in profitability.

Bashir (2000) examines the determinants of Islamic banks' performance across eight Middle Eastern countries between 1993 and 1998. Using cross-country bank-level data on income statements and balance sheets of 14 Islamic banks in eight Middle Eastern countries for each year in the 1993-1998, the study closely examines the relationships between profitability and the banking characteristics. After controlling for economic and financial structure indicators such as – macroeconomic environment, financial market structure, and taxation – the study shows some very important and interesting results. First, the profitability measures of the Islamic banks react positively to the increases in capital and loan ratios, which is intuitive and consistent with previous studies. Second, the study highlights the empirical role that adequate capital ratios and loan portfolios play in explaining the performance of Islamic banks. Third, the results indicate that customer and short-term funding, non-interest earning assets, and overhead are also important for promoting banks' profits. Fourth, the results reveal that foreign-owned banks are more profitable than their domestic counterparts. Fifth, keeping other things constant, there is evidence that implicit and explicit taxes affect the bank performance measures negatively. Sixth, favorable macroeconomic conditions have positive effect on performance measures of the bank. Finally, the results of the study show that stock markets are complementary to bank financing.

A similar study performed by Hassan and Bashir (2003) analyzes how the performance of the Islamic banks is affected by bank characteristics and the overall financial environment. They utilize cross-country bank level data on Islamic banks in 21 countries for each year in 1994-2001 to closely examine the performance indicators of Islamic banks. In general, they find their analysis of determinants of Islamic banks profitability consistent with previous findings. The study indicate that controlling for macroeconomic environment, financial market structure, and taxation, the high capital and loan-to-asset ratios lead to higher profitability. Everything remaining equal, the regression result of the study reveals that there is negative effect of implicit and explicit taxes on the bank performance measures, while there is positive impact of favorable macroeconomic conditions on bank performance measures. That is, favorable macroeconomic environment appears to kindle higher profit margins. Results also show surprisingly a

strong positive correlation between profitability and overhead. That is in the Islamic banking market expense preference behavior appears to hold. They also find in their study that size of the banking system has negative impact on the profitability except *net on interest margin.*

Yudistira (2003) in his study makes an empirical analysis on efficiency and provides new evidences on the performance of 18 Islamic banks over the period 1997-2000. Panel data set for this time period is extracted from non-consolidated balance sheets and income statements of these Islamic banks with specific purpose of seeing the impact of recent financial crises on efficiency of Islamic banks. This study is different from previous studies in that it utilizes non-parametric approach, Data Envelopment Analysis (DAE) to analyze the technical efficiency, pure technical efficiency, and scale efficiency of Islamic banks. Being in line with the principle of Islamic financial system, the intermediation approach is used to specify input-output variables of Islamic banks. The study finds several results. First, the overall efficiency results indicate that there is a small (at just over 10%) inefficiency across 18 Islamic banks, which is considerable as compared to many conventional counterparts. Similarly, global crisis in 1998-1999 badly affected the performance of Islamic banks; however, they performed better afterwards. Second, the results show that small and medium sized Islamic banks faced diseconomies of scale which suggests that M&A should be encouraged. Moreover, as compared to their non-listed counterparts, publicly listed Islamic banks are found to be less efficient. Lastly, Country specific factors mainly determined the efficiency differences across sample data. Furthermore,

Sufian (2007) performs a similar study to provide new evidence on the relative efficiency between the domestic and foreign banks Islamic banking operation in Malaysia during the period of 2001-2004. Non-parametric Data Envelopment Analysis (DEA) methodology has been utilized to distinguish between three different types of efficiency: technical, pure technical and scale efficiencies. The study also used intermediation approach to specify input-output variables of Islamic banks. A series of parametric and non-parametric tests were performed to examine whether the domestic and foreign banks were drawn from the same population, as most of the most of the results could not reject the null hypothesis at 5% level of significance. Finally, Spearman Rho Rank-Order and the Parametric Pearson correlation coefficients were employed to examine the association between the efficiency scores derived from the DEA results with the traditional accounting ratios. Several results are drawn form the study. The results from the DEA show that efficiency of Malaysian Islamic banks recovered slightly in years 2003 and 2004 after declining in year 2002. The domestic Islamic banks are found marginally more efficient than foreign Islamic banks. The study examines that operating at the wrong scale of operations has been the main reason for the Malaysian Islamic banks inefficiency. The dominance of scale in determining the technical efficiency of Malaysian Islamic banks is further confirmed from the results of the correlation coefficients. The results of the study also indicate that profitability is significantly and positively correlated to all efficiency measures.

CHAPTER 05

DATA AND METHODOLOGY

The study is aimed at comparative financial performance of Islamic banking vis-à-vis conventional banking in Pakistan. Specifically, study makes comparison of Meezan Bank Limited (Islamic bank) and a group of 5 conventional banks performances each year in 2003-2007. Data for each year have been compiled from the income statements and balance sheets of these two sets of banks. In the bank performance study, this type of inter-bank analysis is pretty common (Sabi 1966). In today's competitive financial market, one can better understand the performance of a bank by an analysis of inter-bank comparison.

Various indexes have been provided by financial management theories for measuring bank's performance. Using accounting ratios is one of them. To measure performance, financial ratios have been used quite commonly and extensively in the literature. For example, bank regulators use financial ratios to evaluate bank's performance (Samad & Hassan 2000), Patnam (1983), Meister and Elyasiani (1988), Spindler (1991), Akkas (1994), Sabi (1996), and Samad (1999), Ali & Rami (2006) gave employed ratios for evaluating a bank's performance.

In order to see how Islamic bank has performed in comparison with the conventional banks over 5 years, the study uses 12 financial ratios for the bank's performance. These ratios are broadly categorized into four groups: (a) profitability ratios; (b) liquidity ratios; (c) risk and solvency ratios; and (d) efficiency ratios. Since there are five conventional banks in a group to compare with one conventional bank, so we first calculated ratio of each bank in that group and then calculated average of those five ratios to compare that average ratio with one ratio of Islamic bank in each year[12].

5.1. PROFITABILITY RATIOS

Generally, accounting profits are the difference between revenues and costs. Profitability is considered to be the most difficult attributes of a firm to conceptualize and to measure (Ross, Westerfield, and Jaffe 2005). These ratios are used to assess the ability of the business to generate earnings in comparison with its all expenses and other relevant costs during a specific time period. More specifically, these ratios indicate firm's profitability after taking account of all expenses and income taxes, the efficiency of operations, firm pricing policies, profitability on assets and to shareholders of the firm (Van Horne 2005). Profitability ratios are generally considered to be the basic bank financial ratio in order to evaluate how well bank is performing in terms of profit. For the most part, if a profitability ratio is relatively higher as compared to the competitor(s), industry averages,

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[12] For example, we calculated ROA for each conventional bank in the group in the year 2003 and then calculated an average ROA ratio by adding up those 5 ROA ratios and dividing by 5 to compare this average ROA ratio with ROA of Islamic bank of that year. We calculated each ratio for group of 5 conventional banks in each year in similar manner.

guidelines, or previous years' same ratios, then it is taken as indicator of better performance of the bank. Study applies these criteria to judge the profitability of the two banks: *Return on assets (ROA), Return on Equity (ROE), and Profit Expense Ratio (PER).*

5.1.1. Return on assets (ROA)

Return on assets indicates the profitability on the assets of the firm after all expenses and taxes (Van Horne 2005). It is a common measure of managerial performance (Ross, Westerfield, Jaffe 2005). It measures how much the firm is earning after tax for each dollar invested in the assets of the firm. That is, it measures net earnings per unit of a given asset, moreover, how bank can convert its assets into earnings (Samad & Hassan 2000). Generally, a higher ratio means better managerial performance and efficient utilization of the assets of the firm and lower ratio is the indicator of inefficient use of assets. ROA can be increased by firms either by increasing profit margins or asset turnover but they can't do it simultaneously because of competition and trade-off between turnover and margin. ROA is calculated as under:

$$ROA = \frac{Net\ profit\ after\ tax}{Total\ Assets}$$

5.1.2. Return on Equity (ROE)

Return on equity indicates the profitability to shareholders of the firm after all expenses and taxes (Van Horne 2005). It measures how much the firm is earning after tax for each dollar invested in the firm. In other words, ROE is net earnings per dollar equity capital. (Samad & Hassan 2000). It is also an indicator of measuring managerial efficiency [(Ross 1994), Sabi (1996), Hassan (1999), and Samad (1998). By and large, higher ROE means better managerial performance; however, a higher return on equity may be due to debt (financial leverage) or higher return on assets. Financial leverage creates an important difference between ROA and ROE in that financial leverage always magnifies ROE. This will always be the case as long as the ROA (gross) is greater the interest rate on debt (Ross, Westerfiled, Jaffe 2005). Usually, there is higher ROE for high growth companies. ROE is calculated as under:

$$ROE = \frac{Net\ profit\ after\ tax}{Shareholders'\ Equity}$$

5.1.3. Profit to Expenses Ratio (PER)

It measures the operating profitability of the bank with regards to its total operating expenses. In our study, operating profit is defined as earnings before taxes and operating expenses means total non-interest expenses. The ratio measures the amount of operating profit earned for each dollar of operating expense. The ratio indicates to what extent bank is efficient in controlling its operating expenses. A higher PER means bank is cost efficient and is making higher profits (Samad & Hassan 2000). PER is calculated as under:

$$PER = \frac{Profit\ before\ tax}{Operating\ Expenses}$$

5.2. LIQUIDITY RATIOS

Liquidity ratios indicate the ability of the firm to meet recurring financial obligations. Liquidity is important for the firm to avoid defaulting on its financial obligations and, thus, to avoid experiencing financial distress (Ross, Westerfield, Jaffe 2005). These ratios measure ability of the firm to meet its short term obligations, maintain cash position, and collect receivables. In general sense, the higher liquidity ratios mean bank has larger margin of safety and ability to cover its short term obligations. Because saving accounts and transaction deposits can be withdrawn at any time, there is high liquidity risk for both the banks and other depository institutions. Banks can get into liquidity problem especially when withdrawals exceed new deposit significantly over a short period of time (Samad & Hassan 2000). Measures of liquidity are: *Loan to Deposit Ratio (LDR), Cash & Portfolio Investment to Deposit Ratio (CPID), and Loan to Asset Ratio (LAR).*

5.2.1. Loan to Deposit Ratio (LDR)

Loan to deposit is the most important ratio to measure the liquidity condition of the bank. Here, loan means the *advances* for the conventional banks and *financings* for the Islamic banks. Because Islamic banks are prohibited to extend loans and earn interest *(Riba)* and restricted to follow Islamic Shari'ah Principles while conducting their banking business operations so the only way the Islamic banks can utilize their deposits is to provide financings through different Islamic financial products. Bank with Low LDR is considered to have excessive liquidity, potentially lower profits, and hence less risk as compared to the bank with high LDR. However, high LDR indicates that a bank has taken more financial stress by making excessive loans and also shows risk that to meet depositors' claims bank may have to sell some loans at loss. LDR is calculated as under:

$$LDR = \frac{Loan}{Deposits}$$

5.2.2. Cash & Portfolio Investment to Deposit Ratio (CPIDR)

Another measure of liquidity of the bank is the cash and portfolio investments to deposit ratio. The higher the ratio the better is the liquidity position of the bank, therefore, the more is the confidence and trust of the depositors in the bank as compared to the bank with lower CPIDR. This ratio serves two purposes. First, it boosts the trust of the depositors in the bank as the depositors know that bank is not only having enough cash but also made some investments in securities portfolio and supposedly earning some positive returns on those portfolio investments. Secondly, they feel confident that in need of cash bank may sell these portfolio investments at any time in the secondary market which is readily available for this purpose. CPIDR is calculated as under:

$$CPIDR = \frac{Cash\ \&\ Portfolio\ Investments}{Deposits}$$

5.2.3. Loan to Asset Ratio (LAR)

Like LDR, loan to assets ratio (LAR) is also another important ratio that measures the liquidity condition of the bank. Whereas LDR is a ratio in which liquidity of the bank is measured in terms of its deposits, LAR measures liquidity of the bank in terms of its total assets. That is, it gauges the percentage of total assets the bank has invested in loans (or financings). The higher is the ratio the less the liquidity is of the bank. Similar to LDR, the bank with low LAR is also considered to be more liquid as compared to the bank with higher LAR. However, high LAR is an indication of potentially higher profitability and hence more risk. LAR is calculated as under:

$$LAR = \frac{Loan}{Total\ Assets}$$

5.3. RISK AND SOLVENCY RATIOS

This is a class of ratios that measures the risk and solvency of the firm. These ratios are also referred to as gearing, debt or financial leverage ratios. The extent to which a firm relies on debt financing rather equity is related with financial leverage. These ratios determine the probability that the firm default on its debt contacts. The more the debt a firm has the higher is the chance that firm will become unable to fulfill its contractual obligations. In other words, higher levels of debt can lead to higher probability of bankruptcy and financial distress. Although, debt is an important form of financing that provided significant tax advantage, it may create conflict of interest between the creditors and the shareholders (Ross, Wedsterfield, and Jaffe 2005). If the amount of assets is greater than amount of its all types of liabilities, the bank is considered to be solvent.

"Deposits" constitute major liability for any type of bank whether Islamic or conventional. Borrowed money in either form[13] stands second among total liabilities for almost all banks except all Islamic banks which are prohibited by Islamic Shari'ah from taking or giving any kind of interest-based debts[14]. To gauge risk and solvency of the bank, measures usually used are: *Debt-Equity Ratio (DER), Debt to Total Assets Ratio (DTAR), and Equity Multiplier (EM).*

5.3.1. Debt-Equity Ratio (DER)

It is one of the tools to measure the extent to which firm uses debt. It measures ability of the bank capital to absorb financial shocks. In case, creditors default in paying back their loans or the asset values decrease bank capital provides shield against those loan losses.

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[13] Either by issuing debt or borrowing from other financial institutions.
[14] A form of debt which is non-interest based called "Qard-e-Hasan" is permitted under Islamic Sharia (*See badralislami.com for definition).*

A bank with lower DER is considered better as compared to the bank with higher DER. DER is calculated as under:

$$DER = \frac{Total\ Debt}{Shareholders'\ Equity}$$

5.3.2. Debt to Total Assets Ratio (DTAR)

It measures the amount of total debt firm used to finance its total assets. It is an indicator of financial strength of the bank. It provides information about the solvency and the ability of the firm to obtain additional financing for potentially attractive investment opportunities. Higher DTAR means bank has financed most of its assets through debt as compared to the equity financing. Moreover, higher DTAR indicates that bank is involved in more risky business. DTAR is calculated as under:

$$DTAR = \frac{Total\ Debt}{Total\ Assets}$$

5.3.3. Equity Multiplier (EM)

How many times the total assets are of the shareholders' equity is measure by equity multiplier. In other words, it indicates the amount of assets per dollar of shareholders' equity. Higher value of EM means that bank has used more debt to convert into assets with share capital. Generally, the higher is the EM the greater is the risk for a bank. EM is calculated as under:

$$EM = \frac{Total\ Assets}{Total\ Shareholders'\ Equity}$$

5.4. EFFICIENCY RATIOS

These ratios measure how effectively and efficiently the firm is managing and controlling its assets. These ratios indicate the overall effectiveness of the firm in utilizing its assets to generate sales, quality of receivables and how successful the firm is in its collections, the promptness of payment to suppliers by the firm, effectiveness of the inventory management practices, and efficiency of firm in controlling its expenses. Higher value of these ratios is taken as good indicator which means firm is doing well. Ratios used to measure efficiency of the bank are: *Asset Utilization (AU), Income to Expense Ratio (IER), and Operating efficiency (OE).*

5.4.1. Asset Utilization (AU)

How effectively the bank is utilizing all of its assets is measured by assets utilization ratio. The bank is presumably said to using its assets effectively in generating total revenues if the AU ratio is high. If the ratio of AU is low, the bank is not using its assets to their

capacity and should either increase total revenues or dispose of some of the assets (Ross, Westerfield, and Jaffe 2005). Total revenue of the bank in this study is defined as *net spread before provision* plus all *other income*. AU is calculated as under:

$$AU = \frac{Total\ Revenue}{Total\ Assets}$$

5.4.3. Income Expense Ratio (IER)

Income to expense is the ratio that measures amount of income earned per dollar of operating expense. This is the most commonly and widely used ratio in the banking sector to assess the managerial efficiency in generating total income vis-à-vis controlling its operating expenses. High IER is preferred over lower one as this indicates the ability and efficiency of the bank in generating more total income in comparison to its total operating expenses. Total income in the study is defined as *net spread earned before provisions* plus *all other income* while the *Other Expenses* in the income statement are treated as *total operating expense* for the study. IER is calculated as under:

$$IER = \frac{Total\ Income}{Total\ Operating\ Expenses}$$

5.4.2. Operating Efficiency (OE)

Unlike IER, which measures the amount of income earned per dollar of operating expense, OE is the ratio that measures the amount of operating expense per dollar of operating revenue. It measures managerial efficiency in generating operating revenues and controlling its operating expenses. In other words, how efficient is the bank in its operations. Lower OE is preferred over higher OE as lower OE indicates that operating expenses are lower than operating revenues. Operating revenue in this study is defined as *net spread earned before provisions* plus *fee, brokerage, commission, and forex income*. *Other expenses* is defined same as we defined in the previous ratio. OE is calculated as under:

$$OE = \frac{Total\ Operating\ Expenses}{Total\ Operating\ Revenue}$$

CHAPTER 06

EMPIRICAL RESULTS

6.1. PROFITABILITY RATIOS

6.1.1 Return on Assets (ROA)

The result indicates several important points of comparison of ROA between Islamic bank and conventional banks. First, ROA of conventional banks has been greater than Islamic over time except year 2007 in which Islamic bank ROA (1.43%) slightly surpassed conventional banks ROA (1.38%). Second, ROA decreased drastically to 1.14% from 1.93% (40% decreases) and from 2.18% to 1.35% (38% decrease) during 2003-2004 for Islamic bank and conventional banks respectively. Third, after having drastic decrease in 2003-2004, conventional banks recovered their ROA in 2004-2005. But this recovery was not only small but also temporarily. Since 2005, ROA of conventional banks is consistently on decreasing trend. Islamic bank has similar story as of conventional banks but with one difference i-e ROA of Islamic bank seems to be more fluctuating in that it increased in 2004-2005 from 1.14% to 1.37%, but again decreased to 1.30% in 2006 and ended up at 1.43% in 2007 with an increase of 0.13%. Finally, on average, ROA of conventional banks (1.59%) is higher than average ROA of Islamic bank (1.49%); however, statistically there is no difference between the two means at 5% significance level (see Table-6.13).

Financial results of 2008 of Islamic bank and conventional banks will reveal whether this declining trend of conventional banks ROA would continue and ROA of Islamic bank would increase or decrease. Nevertheless, banking sector in Pakistan is growing significantly but considering the last 4 years trend in ROA, both types of banks are experiencing difficulties in profitability.
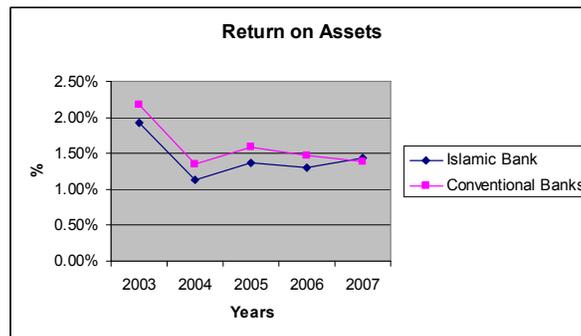
Figure-6.1

Table-6.1

	2003	2004	2005	2006	2007	*Mean*	*S.D*
Islamic Bank	1.93%	1.14%	1.37%	1.30%	1.43%	*1.49%*	*0.00296*
Conventional Banks	2.18%	1.35%	1.59%	1.47%	1.38%	*1.59%*	*0.0034*

6.1.2 Return on Equity (ROE)

Similar to ROA, from the study of ROE of both conventional banks and Islamic bank, we underpin some important points to consider. The result shows that conventional banks ROE is consistently higher than Islamic bank ROE during 2003-2007. In year 2003, the difference was huge which decreased considerably during 2004-2007. The difference is 17.6% in 2003, which has plummeted to 2.5% in 2007. This momentous decrease in difference of two ROEs is essentially due to overall increasing trend in ROE of Islamic bank and decreasing trend in ROE of conventional banks. This gives us an important insight. ROE of Islamic bank followed conventional banks ROE in terms of increase and decrease during 2003-2007, however, in the years when ROE of the two banks increased, increase in ROE of Islamic bank has been more than increase in ROE of conventional banks (30% increase for Islamic bank as compared to 12% increase for conventional banks in 2004-2005), and decrease in ROE of Islamic bank has been less than decrease in ROE conventional banks (8.5% decrease for Islamic bank as compared to 15% decrease for conventional banks in 2005-2006). ROE of Islamic bank increased from 12.23% in 2003 to 16.88% in 2007, whereas, ROE of conventional banks decreased from 29.83% to 19.38% in 2007. Analysis of the last five years financial statements further highlighted that overall profits base has increased more than equity base in Islamic bank resulted into an increase in ROE over time. On the contrary, for some of the conventional in a group of 5 conventional banks, equity base increased and profits base decreased which stood the main cause of overall reduction in ROE during 2003-2007. Nevertheless, ROE of Islamic bank has improved; ROE of Islamic bank is lagging behind the conventional banks as yet. An average ROE of the Islamic bank is 13.27%, whereas the average ROE of conventional banks for the same periods is 22.76%. The difference of the two means is strongly significant (see Table-6.13).
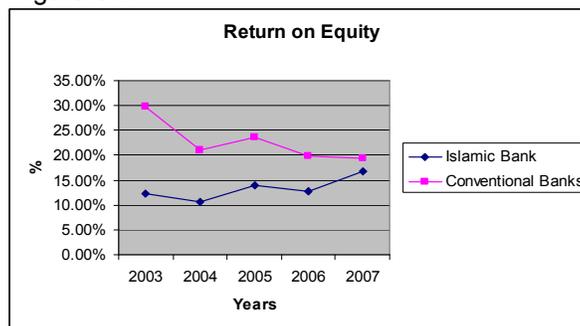
Figure-6.2

Table-6.2

	2003	**2004**	**2005**	**2006**	**2007**	*Mean*	*S.D*
Islamic Bank	12.23%	10.69%	13.87%	12.69%	16.88%	*13.27%*	*0.02317*
Conventional Banks	29.83%	21.04%	23.60%	19.95%	19.38%	*22.76%*	*0.04271*

6.1.3. Profit Expense Ratio (PER)

Another measure of profitability, PER, is supporting the conventional banks to be more profitable in terms of expenses as compared to the Islamic bank over the time period of 2003-2007. The analysis of PER of Islamic bank and conventional banks indicates that conventional banks have generated consistently higher profits for every one rupee[15] of expense spent during 2003-2007 but with decreasing trend as compared to Islamic bank during the same time period. After the decrease in 2003-2004, PER of conventional increased in 2005, but again it decreased afterwards with no sign to rise again. PER of conventional banks was 1.91 in 2003 which decreased by 57% from 1.91 in 2003 to 0.82 in 2007. This decrease in PER of conventional banks is far greater than decrease in PER of Islamic bank during the same time period. PER of Islamic bank decreased to 0.72 in 2007 from 0.94 in 2003 accounting for only 23% decrease. Further analysis of financial statements of the 5 conventional banks included in the study revealed the fact that expenses of these conventional banks have increased during 2005-2007, however, for some banks profits did not increase much and for others even decreased during the same time period, which resulted into decrease in PER of the group of conventional banks. Mean PER of the Islamic bank is 0.77 which is less than conventional banks mean PER of 1.34. This difference in the two means is statically different at 5% significance level (see Table-6.13).
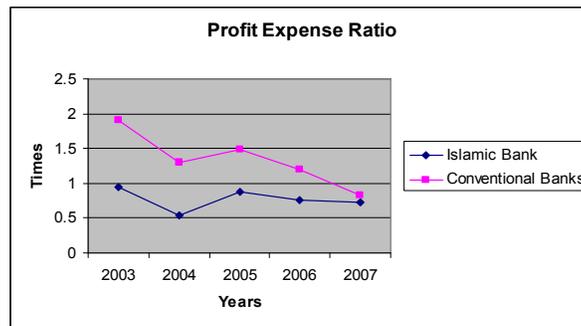
Figure-6.3

Table-6.3

	2003	2004	2005	2006	2007	*Mean*	*S.D*
Islamic Bank	0.94	0.54	0.88	0.76	0.72	*0.77*	*0.155306*
Conventional Banks	1.91	1.3	1.48	1.2	0.82	*1.34*	*0.398773*

Nonetheless, overall all results of profitability measures go in favor of conventional banks. The results indicate that conventional banks are *more profitable* compared with Islamic bank, however, Islamic banks are consistently improving and performing better in making good returns on investment (assets), satisfying their shareholders in offering competitive or even better returns, and also managing their operating expenses.

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[15] "Rupee" (also referred to as PKR) is the name of Pakistani currency.

6.2. LIQUIDITY RATIOS

6.2.1. Loan to Deposit Ratio (LDR)

High loan to deposit ratio for Islamic bank compared with conventional banks during 2003-2006 indicates that Islamic bank has been comparatively less liquid. However, in 2007, Islamic bank LDR (63.35%) decreased below conventional banks (70.89%) turning Islamic bank into comparatively better liquidity position. LDR of Islamic bank decreased from 95.36% in 2003 to 63.35% in 2007. This overall declining trend in LDR of Islamic bank indicates the tendency of comparatively more increase in deposits than loans (financings) and further emphasizes improved liquidity position of Islamic bank. Compared with Islamic bank, LDR of conventional banks has been reasonably lower and floating between approximately 70% and 77%. Conventional bank LDR was 73.85% in 2003 which decreased to 70.89% in 2007. Although Mean LDR of Islamic bank 82.70% is higher than Mean LDR of conventional banks 73.55% but statistically there is no difference between the two means at 5% level of significance (see Table-6.13).
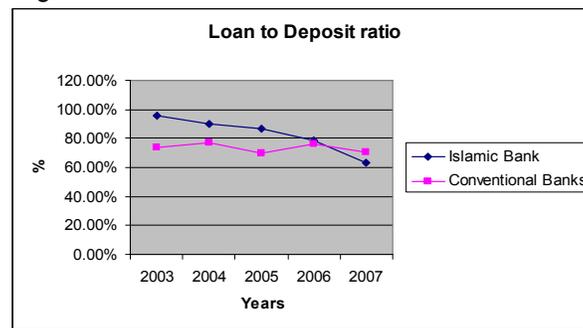
Figure-6.4

Table-6.4

	2003	**2004**	**2005**	**2006**	**2007**	*Mean*	*S.D*
Islamic Bank	95.36%	89.61%	86.70%	78.47%	63.35%	*82.70%*	*0.12413*
Conventional Banks	73.85%	76.66%	69.90%	76.44%	70.89%	*73.55%*	*0.03103*

6.2.2. Cash & Portfolio Investments to Deposits & Borrowings Ratio (CPIDBR)

After decrease in ratio of cash & portfolio investment to deposits & borrowings of both Islamic bank and conventional bank during 2003 and 2005 from 25.77% to 21.60% and 39.88% to 29.12% respectively, CPIDBR increased to 28.39% for Islamic bank and 36.90% for conventional banks in 2007. However, decrease in CPIDBR was more than increase for both sets of banks. Since 2005, an increasing trend in CPIDBR indicates that liquidity position of both Islamic bank and conventional banks is improving over time. Higher CPIDBR of conventional banks supports that conventional banks are more liquid as compared to Islamic bank. Table-5.5 shows that mean CPIDBR of Islamic bank (24. 56%) is lesser and statistically different from mean CPIDBR of conventional banks (34.11%) at 5% significance level (see Table-6.13).

Figure-6.5

Cash & Portfolio Invesment to Deposit & Borrowing
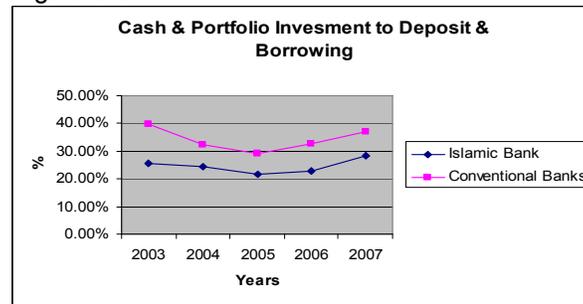
Table-6.5

	2003	**2004**	**2005**	**2006**	**2007**	*Mean*	*S.D*
Islamic Bank	25.77%	24.37%	21.60%	22.65%	28.39%	*24.56%*	*0.02673*
Conventional Banks	39.88%	32.12%	29.12%	32.52%	36.90%	*34.11%*	*0.04256*

6.2.3. Loan to Asset Ratio (LAR)

Whereas loan to deposit ratio shows that liquidity position of Islamic bank is getting better, loan to asset ratio shows somewhat different results. Figure 6 shows that LAR of Islamic bank is on increasing trend whereas LAR of conventional banks is swinging between 59% and 64%. This increasing trend of Islamic bank LAR is palpable evidence of more financial stress which Islamic bank is taking by making excessive loans and holding less liquid assets. However, this is an indication of potential betterment in profitability and also conforms to our results drawn from profitability ratios of Islamic bank. LAR of Islamic bank increased to 66.63% in 2007 from 51.47% in 2003 while LAR of conventional banks increased from 59.57 % in 2003 to 59.78 % in 2007. Further analysis of LAR indicated that Murabaha has been the most famous and mostly used mode of financing followed by Ijara, export refinance under Islamic scheme, and Dimishing Musharaka and standing second, third, and fourth respectively in a row.

Overall result indicates that Islamic bank is as liquid as the conventional banks are. Table-5.6 shows that the average LAR of conventional banks is slightly higher than that of Islamic bank; however, the difference is not statistically significant at 5% significance level (see Table-6.13).
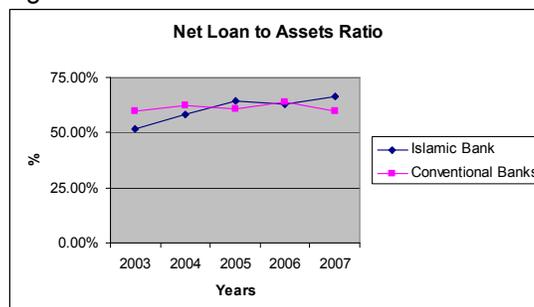
Figure-6.6

Net Loan to Assets Ratio

30

Table-6.6

	2003	2004	2005	2006	2007	*Mean*	*S.D*
Islamic Bank	51.47%	58.21%	64.35%	62.65%	66.63%	*60.66%*	*0.05993*
Conventional Banks	59.57%	62.44%	60.63%	63.99%	59.78%	*61.28%*	*0.01890*

Overall results of all liquidity measures show that Islamic bank and conventional banks are similar to each other except in terms of CPIDBR in which conventional banks are found to be more liquid than Islamic bank. Moreover, the study found that Murabaha, Ijara, export refinance under Islamic scheme, and Dimishing Musharaka have been the most famous and mostly used mode of financing.

6.3. RISK AND SOLVENCY RATIOS

6.3.1. Debt to Equity Ratio (DER)

Debt to equity ratio of Islamic bank increased to 10.77*times* in 2007 from 5.35*times* in 2003 showing an overall increasing trend as compared to conventional banks DER which increased from 14. 76*times* in 2003 to 17.29*times* in 2004 but followed a downward trend afterwards and ended at 13.49times in 2007. Noticeably, decrease in DER of conventional banks is more than increase in DER of Islamic bank. These results demonstrate that conventional banks are more *risky* as compared to Islamic bank. "Deposits" constitute major liability for any type of banks whether Islamic or conventional. Borrowed money stands second among total liabilities for almost all conventional banks except all Islamic banks which are prohibited by Islamic Shari'ah from taking or giving interest-based debts. Increasing trend in DER for Islamic bank indicates that deposits base of Islamic bank is increasing more than its equity base. We observed from our further analysis of the financial statements of the group of five conventional banks that for conventional banks DER to follow decreasing trend is partly due to more reliance on equity financing as compared to debt and less deposits base. Higher DER during 2003-2007 in figure 7 points out the conventional banks to be more risky than Islamic bank. Average DER of Islamic bank is 8.48*times* as compared to 15.37 of the conventional banks. This difference in means is statistically different at 5% level of significance (see Table-6.13).
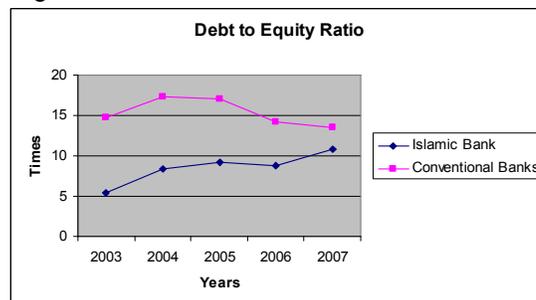
Figure-6.7

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Table-6.7

	2003	**2004**	**2005**	**2006**	**2007**	*Mean*	*S.D*
Islamic Bank	5.35	8.39	9.14	8.75	10.77	*8.48*	*1.97216*
Conventional Banks	14.76	17.29	17.06	14.23	13.49	*15.37*	*1.71381*

6.3.2. Debt to Total Assets Ratio (DTAR)

The results of debt to total assets ratio conform to our results of DER. The results show that DTAR of the conventional banks is consistently higher than Islamic bank making once again conventional banks to be more *risky* and less solvent than Islamic bank. However, Islamic bank DTAR has increased considerably during 2003-2007. It was 84.25% in 2003 which climbed to 91.51% in 2007 getting quite closer to conventional banks DTAR of 91.51%. Though, DTAR of conventional banks was high but it stayed pretty stable and fell in range of 92% to 94% over five years. The comparison of means of DTAR for risk measure for both Islamic bank and conventional banks in Table-5.8 reveals that the average DTAR of Islamic bank is 89% whereas the average DTAR of conventional banks is 92. 78%. The difference of the two means is statistically different as 5% significance level (see Table-6.13).
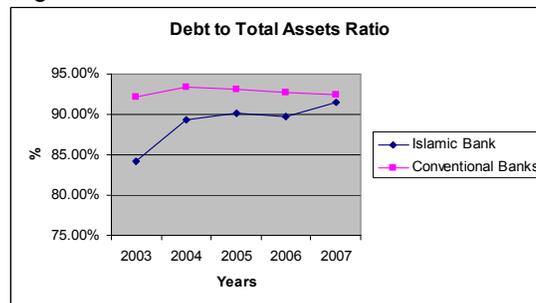
Figure-6.8

Table-6.8

	2003	**2004**	**2005**	**2006**	**2007**	*Mean*	*S.D*
Islamic Bank	84.25%	89.35%	90.14%	89.74%	91.51%	*89.00%*	*0.02776*
Conventional Banks	92.22%	93.39%	93.12%	92.67%	92.48%	*92.78%*	*0.00475*

6.3.3. Equity Multiplier (EM)

The analysis of another measure of risk, equity multiplier, further proves conventional banks to be more *risky* and less solvent as compared to Islamic bank. The results are consistent with our results found in DER and DTAR for both sorts of banks. EM of Islamic bank increased to 11.77*times* in 2007 from 6.35*times* in 2003. Not surprisingly, conventional banks EM is exhibiting similar behavior as of DER which further verifies that relative to debt, equity base is increasing more in conventional banks. Increasing

from 15.79*times* in 2003 to 18.29*times* and 18.07 *times* in 2004 and 2005 respectively, EM of conventional banks decreased to 14.49*time* in 2007. Table-5.9 shows mean values for two sets of banks. The difference between the two means is statistically significant at 5% significance level (see Table-6.13).
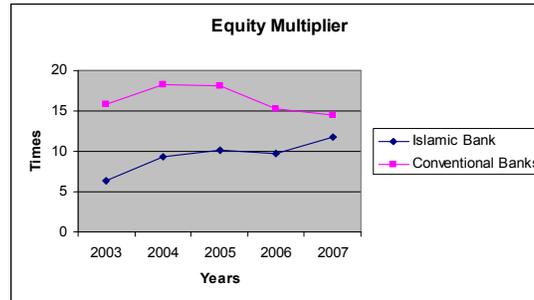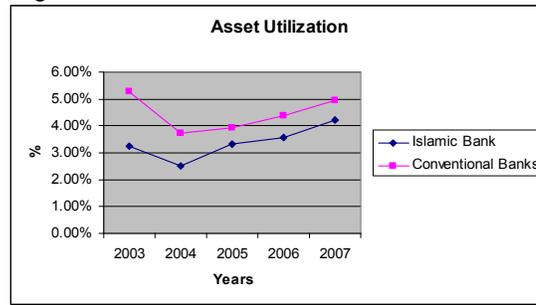
Figure-6.9

Table-6.9

	2003	2004	2005	2006	2007	Mean	S.D
Islamic Bank	6.35	9.39	10.14	9.75	11.77	*9.48*	*1.97216*
Conventional Banks	15.79	18.29	18.07	15.23	14.49	*16.37*	*1.71367*

Overall, analysis of the results of all risk and solvency measures, DER, DTAR, and EM, indicate conventional banks to be more risky and less solvent than Islamic bank. As we observed in LDR that deposits base of Islamic bank is increasing rapidly over time and deposits make the largest component of total liabilities of the bank, that is why, we observe DER, DTAR, and EM of Islamic bank on the rising trend.

6.4. EFFICIENCY RATIOS

6.4.1. Asset Utilization (AU)

The behavior of the two lines in figure-6.10 reveals some useful information about AU of both banks. Having drastic decrease in 2003, AU of conventional banks showed an upward trend and increased from 2.50% in 2004 to 4. 94% in 2007 but remained below 5.29% that was in 2003. On the contrary, AU ratio of Islamic bank not only mapped the trend in the same direction and increased from 2.5% in 2004 to 4.22% in 2007 but also surpassed AU ratio of 3.26% that was in 2003. Apparently, this result indicates that Islamic bank is doing relatively better in terms of trend than conventional banks. However, AU ratio of conventional banks is consistently higher during 2003-2007 than Islamic bank and an average of AU ratio of conventional banks (4.46%) is higher and, at 5% significance level, statistically different from average AU ratio of Islamic bank (3.38%). This proves that conventional banks are comparatively more efficient in utilization of the assets in generating total income (revenue) than that of Islamic bank. (see Table-6.13)

Figure-6.10

Table-6.10

	2003	2004	2005	2006	2007	Mean	S.D
Islamic Bank	3.26%	2.50%	3.33%	3.57%	4.22%	3.38%	0.00619
Conventional Banks	5.29%	3.73%	3.95%	4.37%	4.94%	4.46%	0.00656

6.4.2. Income to expense Ratio (IER)

Figure-6.11 exhibits the behavior of income to expense ratio for both conventional banks and Islamic bank. The results show that IER of conventional banks is higher than that of Islamic bank during the 5-year period, which proves once more that conventional banks are more efficient in managing their expenses. Compared with Islamic bank, conventional banks are generating more income for every 1 rupee of expense spent. However, the results also show that since 2005 this ratio is decreasing for conventional banks while it is on the increasing trend for Islamic bank. Further analysis of financial statement reveals that the decreasing trend is due to increase in expenses and decrease in income of some banks in the group of 5conventional banks, and for Islamic bank IER to increase since 2005 is due to increase in income which is more than increase in expenses, causing the IER to rise.

IER of Islamic bank decreased from 1.42*times* in 2003 to 1.2 *times* in 2004 but increased afterwards and stayed at 1.61*times* in 2006 and 2007. IER of conventional bank decreased to 2.07*times* in 2004 from 2.78*times* in 2003 and having increased again to 2.27*times* in 2005 it decreased thereafter. IER in 2007 is 2.04*times*. Mean IER of Islamic bank is 1.45*times* which is less than mean IER of 2.26*times* for conventional banks shows that both means are strongly different from each other at 1% significance level (see Table-6.13).
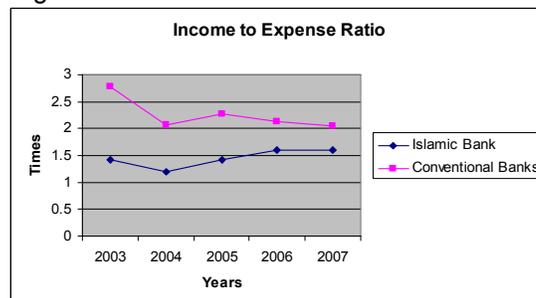
Figure-6.11

Table-6.11

	2003	2004	2005	2006	2007	Mean	S.D
Islamic Bank	1.42	1.2	1.42	1.61	1.61	*1.45*	*0.16991*
Conventional Banks	2.78	2.07	2.27	2.12	2.04	*2.26*	*0.30599*

6.4.3. Operating Efficiency (OE)

As another measure of efficiency, OE ratio, measured by dividing operating expenses by operating revenues, further strengthens our previous two results that conventional banks are also more efficient than Islamic bank in managing their operating expenses and generating more operating revenues. Difference in performance was huge in 2003 which, however, reduced drastically resulting into convergence of OER for both banks in 2007. In 2003 the difference in ratios of two sets of banks was 48.50%, which reduced to 3.51% in 2007. Learning by doing has drastically decreased this difference over 5 years which evidently supports our results of previous two efficiency measures and our argument that Islamic bank is improving considerably in managing its operations. OER of Islamic bank was 103.39% in 2003 which followed a decreasing trend thereafter and resulted into decrease in ratio to 62.23% in 2007. Ratio of OE for conventional banks increased to 58.72% in 2007 from 54.95% in 2003 showing an upward trend and increasing inefficiency on the part of conventional banks. Average of OER of 78.78% is higher and statistically different at 5% significance level than average OER 53.51% of conventional banks (see Table-6.13).
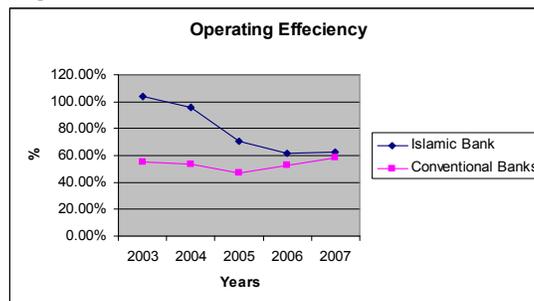
Figure-6.12

Table-6.12

	2003	2004	2005	2006	2007	Mean	S.D
Islamic Bank	103.39%	95.94%	70.37%	61.99%	62.23%	*78.78%*	*0.19536*
Conventional Banks	54.95%	53.51%	47.43%	52.95%	58.72%	*53.51%*	*0.04076*

An overall analysis of all efficiency measures reveals that Islamic bank is less efficient in asset utilization, income generation and managing its expenses. However, the results also show the Islamic bank is improving overtime considerably in these efficiency measures.

TABLE–6.13

Comparison of Mezaan Bank Ltd. (Islamic Bank)

with 5 Conventional Banks' Financial Ratios

Performance Measure	Islamic Bank		Conventional Banks		T-test	F-test
	Mean	S.D	Mean	S.D		
Profitability						
ROA	1.43%	0.00296	1.49%	0.0034	0.45192	0.79644
ROE	13.27%	0.02317	22.76%	0.04271	0.0024****	0.263059
PER	0.77	0.155306	1.34	0.398773	0.017198***	0.098444*
Liquidity						
LDR	82.70%	0.12413	73.55%	0.03103	0.14852	0.01986***
CPIDBR	24.56%	0.2673	34.11%	0.4256	0.0028****	0.38803
LAR	60.66%	0.05993	61.28%	0.0189	0.83068	0.04605**
Risk and Solvency						
DER	8.48	1.97216	15.37	1.71381	0.00036****	0.79022
DTAR	89.00%	0.02776	92.78%	0.00475	0.01705***	0.00474****
EM	9.48%	1.97216	16.37%	1.71367	0.00036****	0.78926
Efficiency						
AU	3.38%	0.00619	4.46%	0.00656	0.02782**	0.90979
IER	1.45	0.016991	2.26	0.30599	0.00084****	0.27904
OE	78.78%	0.19536	53.51%	0.04076	0.0221***	0.01015***

**** Difference in means: Significant at 1%
*** Difference in means: Significant at 2.5%
** Difference in means: Significant at 5%
*Difference in means: Significant at 10%

CHAPTER 7

CONCLUSION

Examination of the empirical analysis makes it possible for us to shed some light on our findings and draw some conclusions. First, our analysis of profitability measures indicates that conventional banks are more profitable and are significantly different from Islamic bank in Return on Equity (ROE) and Profit Expense Ratio (PER). However, conventional banks are not significantly different from their counterpart in terms of Return on Asset (ROA). Further analysis of ROE and PER reveals that Islamic bank is getting closer to conventional banks in an upward trend; it is not inconceivable that in the near future that Islamic bank might outperform the conventional banks. Moreover, in a separate study of one to one comparison of each of conventional bank in the group with Islamic bank reveals that Islamic bank (MBL) outperforms some of the conventional banks in the selected group. Overall, ROE is found rising for Islamic bank and plummeting for the conventional banks during 2003-2007 mainly due to the difference in equity base and profit level of the banks. Net Profits of Islamic bank are found to increase more rapidly than its equity base causing ROE to increase, whereas, the opposite happened within the group of conventional banks causing ROE to fall over time. Same reasoning stands true for the reason of conventional banks' PER which is found decreasing during 2003-2007, however our analysis of Islamic bank PER less than that of conventional banks shows that even though PER performance convergence did occur, the Ratio is still lagging behind that of conventional banks. Analysis of efficiency measures further strengthens our finding.

Examination of the liquidity measures, Loan Deposit Ratio (LDR) and Loan Asset Ratio (LAR), of the two sets of banks shows that Islamic bank liquidity is not different from that of the conventional banks. However, conventional banks are found to be more liquid than Islamic bank in terms of Cash & Portfolio Investments to Deposits & Borrowings Ratio (CPIDBR). Findings also show that while LDR of the conventional banks is stable and falling over particular range, LDR of Islamic bank is decreasing over time. This decreasing trend is due to increase in its deposits base which can be considered a positive and a good sign for the Islamic bank in that Islamic banking is making inroads into the society. Moreover, this shows that level of trust and confidence of the people is increasing in Islamic banks with the passage of time and also a manifestation of a positive attitude of the people for considering Islamic financial products as alternate and viable financing options. Further analysis of LAR indicated that Murabaha has been the most famous and mostly used mode of financing followed by Ijara, Export refinance under Islamic scheme, and Dimishing Musharaka standing second, third, and fourth respectively.

Having found Islamic bank to be less profitable than its counterparts, what we expect when it comes to risk and solvency measures is according to the basic rule of finance "the higher the expected return the higher the risk". Our findings of profitability and risk & solvency perfectly fit in this risk-return profile and allow us to conclude that conventional banks are more profitable, also more risky and less solvent than Islamic bank. Analysis of

the results of all the risk and solvency measures, Debt Equity Ratio (DER), Debt to Total Assets ratio (DTAR), and Equity Multiplier (EM), indicates conventional banks to be more risky and less solvent than Islamic bank. As we observed in LDR that deposit base of Islamic bank is increasing rapidly over time and since deposits make the largest component of total liabilities of the bank, we also observe DER, DTAR and EM of Islamic bank on the rising trend. The difference in these performance measures is statistically significant which suggests that these two sets of banks do not fall in the same risk class. This confirms that product of Islamic banking is a viable investment class providing unique risk structure for interested investors.

Like in profitability, and risk & solvency measures, conventional banks are found to be statistically different and more efficient in terms of utilization of their assets, in generating income, and managing their expenses as compared to Islamic bank. Although, all efficiency measures, Asset Utility (AU), Income Expense Ratio (IER), and Operating Efficiency (OE) suggest that Islamic bank are significantly less efficient but increasingly converging towards that of conventional banks, during 2003-2007. This gives us some insight regarding Islamic bank's improvement in generating income, utilization of assets, and effective management in controlling expenses.

Our findings on the performance measurements of Islamic banking in Pakistan are different and at times mixed in comparison to the results drawn from the similar studies done in different parts of the world. For example, Kader and Asarpota (2007) found in their study that UAE Islamic banks are relatively more profitable, less liquid, less risky, and more efficient as compared to the UAE conventional banks. Samad & Hassan (2000) revealed in their study that BIMB (Bank Islam Malaysia Berhad) is less profitable, relatively less risky and more solvent as compared to conventional banks of Malaysia. Abdus Samad (2004) in his paper examined the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks and concluded that there exists a significant difference in credit risk performance between the two sets of banks. However, he did not find any major difference in profitability and liquidity performances between Islamic banks and conventional banks.

The difference in results is largely due to the fact that Islamic banking has longer history in these countries as compared to Pakistan where full-fledged Islamic banking started merely few years back. Moreover, conventional banking has a longer history, deeper roots, vast experience of learning from the financial markets mechanisms, and larger share in the Pakistan financial sector. Considering these facts of the matter, we don't find the results of our study surprising. However, the way Islamic banking sector is improving and growing in Pakistan, we expect Islamic banking of Pakistan to be equally or even better in performance than conventional banking in the foreseeable future.

Finally, for future studies, as the time passes, when there will be more Islamic banks to study and longer time period, a similar study would generate better insight on the issue of performance comparison and provide solid evidence one way or another. By then, we would gladly join the discussion again.

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APPENDICES

APPENDIX-A

ISLAMIC MODES OF FINANCING

Islamic legal principles that regulate the conduct and content of commercial transactions in Islamic banking data back to the early days of Islam in Arabia. These were the elaborated efforts of the Muslim scholars of middle ages that lead to the establishment of fundamental principles of finance and commerce. Prohibition of Riba is the most important of these principles (Aggarwal & Yousaf 2000).

Islamic banks and monetary authorities of several countries have developed alternative "Interest-free" financing techniques. Broadly defined, following are the basic financing alternatives or modes of financing that adhere to Islamic principles and can be applied to contemporary financial scenarios.

     i.   Musharaka *(Joint Ventrure)*
    ii.   Mudarabah,
   iii.   Murabaha *(cost-plus pricing)*
    iv.   Salam
     v.   Istisna
    vi.   Ijara *(leasing)*

These alternate financing techniques have been based on the following two basic principles*:*

1) THE PROFIT AND LOSS SHARING (PLS) PRINCIPLE

2) THE MARK-UP PRINCIPLE.

Islamic banks base Musharaka and Mudarabah financing arrangements on the PLS principle while Murabaha, Salam, Istisna, and Ijara on the Mark-up principle. (Aggarwal & Yousaf 2000). Dar (2003) classifies four types of financing acted as alternative of interest; *interment-based, sale-based, rent-based, and service-based*.

1. PROFIT AND LOSS SHARING PRINCIPLE

How do Islamic banks operate when paying and receiving of interest is prohibited? Answer to this question lies in the understanding of the difference between the expressions "rate of interest" and "rate of return". Rate of interest is strictly prohibited and forbidden in Islam, but Islam not only permits but also encourages trade. In the interest-free system sought by adherents to Muslim principles, people are able to earn a return on their money only by subjecting themselves to the risk involved in profit sharing. Given the fact that interest rates are forbidden in financial transactions, banks are expected to operate only on the basis of Profit and Loss Sharing (PLS) arrangements or other acceptable modes of financing (Suleiman 2001). In the Islamic legal and economic literatures, the PLS principle is generally accepted as the basis of financial transactions.

Under PLS principle, bank bears loss if the project fails and may earn return on the invested funds provided bank shares in the risk of the investment (Aggarwal & Yousaf 2000). Following two instruments are utilized by the Islamic banks based on PLS principle:
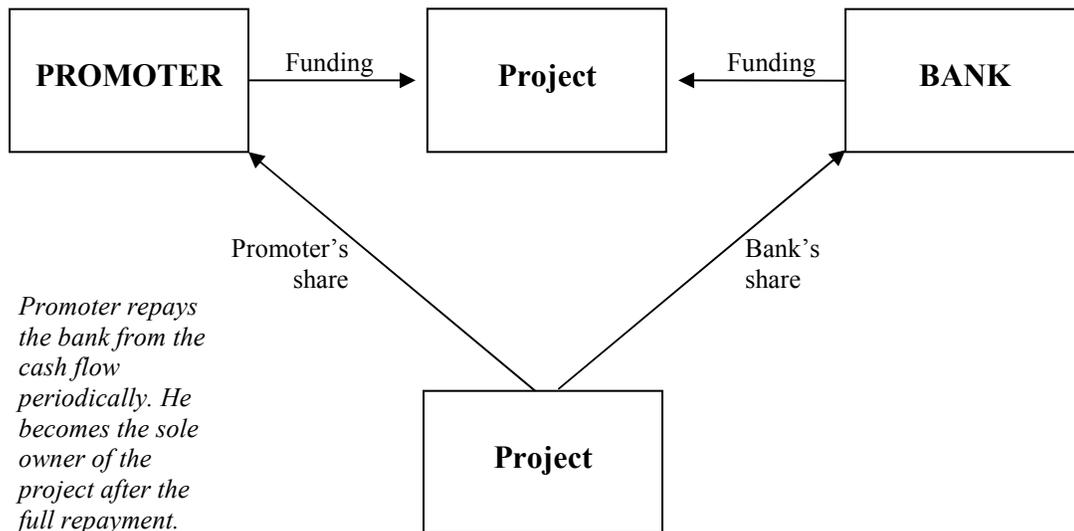
a. Musharka (Joint Venture),   b. Mudarabah

a. Musharka *(Joint Venture)*

In the eyes of Shari'ah, Musharka is the most desired form of financing. It satisfies all the essential elements promoted by Shari'ah such as the absence of interest, the presence of risk, the spirit of profits and loss sharing, and the direct linking of capital investment to underlying assets based transactions.

Musharka is similar to joint venture partnership where profits and losses are shard between the partners. Musharka is a contractual relationship formed through mutual consent of the parties for sharing profits and losses in a joint venture. Assets in the venture are jointly owned in proportion to each partner's contribution (source: MCB). Losses are shared in proportion to the capital contributed by each partner while the proportions of profits are negotiated freely, usually, on a pre-agreed ratio. Musharka is akin to western style general partnership and closer to traditional equity stake with rights of control (Aggarwal & Yousaf 2000). Bank sometimes participates in the execution of the projects by providing managerial expertise (Naser). Figure A-1 illustrates the elements.

Figure A-1

Promoter repays the bank from the cash flow periodically. He becomes the sole owner of the project after the full repayment.

b. Mudarabah

In Islamic finance, Mudarabah stands alongside Musharka as preferred financing method. Mudarabah" is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who

is called "rabb-ul-mal", while the management and work is an exclusive responsibility of the other, who is called "mudarib" (Mufti Muhammad Taqi Usmani, 1998).

Mudarabah can also be defined as a contract between at least two parties whereby one party, the financier *(Sahib al-mal or Rabb-ul-mal)*, entrusts funds to another party, the entrepreneur (Mudarib), to undertake an activity or venture (Suleiman 2001).

It is similar to Musharka in that it is also a form of partnership but it differs from Musharka in that under mudarbaha financing Islamic bank (the financier) contributes capital with no control over the business venture and right to participate in the managerial decision, and the *entrepreneur* brings efforts/expertise and exercises complete control over the management of the business venture. Mudabarbah is akin to western style limited partnership where one or more of the parties contribute capital and the remaining parties bring their efforts/expertise to the business venture (Rajesh, Tarik 2000).

Proportions for sharing profits are decided upfront. Profits are shared on the basis of pre-arranged and agreed on ratio (usually according to a negotiated percentage of ownership). For instance, it is agreed between the parties that 60% of the total profit earned is paid to the parties who invested the capital *(Rabb-ul-maal)* whilst 40% share for those bringing purely their efforts/expertise (Mudarib) to the business venture.

In case of loss, the Islamic bank earns no return or negative return on its investment and the entrepreneur receives no compensation for his or her effort (Aggarwal & Yousaf 2000). This distribution effectively treats human capital with equally financial capital (Suleiman 2001).

Musharka and Mudarabah: a glance at comparison

Musharka and Mudarbah instruments are thought of as equity investments. Modarabah financing is more akin to a limited partnersip whereas Musharka financing is closely related with traditional equity stake with rights to control (Aggarwal and Yousaf 2000).

2. MARK-UP PRINCIPLE

Roots of the mark-up principle can be found in commercial trade activities. In exchange for a negotiated profit margin, the bank finances the purchase of assets (Aggarwal and Yousaf 2000). Islamic financial instruments based on this principle included: *i) Murabaha, ii) Salam, iii) Istisna, iv) Ijarah*

i)- MURABAHA

Murabaha is a non-participatory mode of Islamic financing where the bank sells the asset required by its client to the client on *cost-plus* basis. Under this financing arrangement, bank purchases an asset on behalf of an entrepreneur and resells the asset to the entrepreneur at a predetermined price that includes the original cost and added, negotiated profit margin (Aggarwal and Yousaf 2000). Asset is first purchased by the bank so bank incurs the risk of any loss or damage to the asset as long as asset remains under its ownership. Ownership remains with the bank until all payments are made. Upon

sale of the asset, this is an obligation of the Islamic bank to inform the client the original cost incurred in the purchase of the asset and the profit margin incorporated in the sale price (source MCB).

Payment is made in the future either in installments or in lump sum. Payment of the sale price by the client may be deferred but in that case it would become **Muajjal**. The selling price once agreed can not be changed even when the client fails to pay on the agreed date. Murabaha is the classic Islamic financial instrument for trade financing, dating to ninth century Arabia (Aggarwal & Yousef 2000).

ii)- Salam

It is an advance payment commodity sales contract where the delivery of the commodity is deferred (Salman 2004)[16]. Payment is received in advance by the seller for the goods to be delivered to the buyer after an interval of time. The seller receives in advance fully paid price of the goods at the time of the contract undertaking to deliver the goods specified by the buyer at a future date (source: Bank Alfalah). Commodity due at a stipulated future date specified in the contract becomes *receivable* of the bank when bank signs to buy a commodity on *salam* and pays out the price. Because of Shari'ah restriction of "do not sell what is not in your possession", in need of cash, bank cannot exit the *salam* contract before maturity by selling it to a third party. Thus secondary market for trade in *salam* contracts cannot exist[17]. Also, it may not an active market even if the commodity becomes available. This results into primary or direct liquidity risk associated with this source of financing (Salman 2004).

iii)- ISTISNA

It is a manufacture to order contract for yet to be manufactured good on advance payment of price either in installments or in full (Salman 2004). It is a manufacture of a specific product against precise specifications by a manufacturer for delivery to buyer. It is necessary that the price of the product and product specifications are fully agreed upon by the manufacturer and the buyer, and that the material required for manufacture is arranged by the manufacturer (source: Bank Alfalah). This financing instrument is similar to that of *salam* in terms of primary liquidity risk that arises is similar way as in *salam*. However, liquidity risk in *istisna* is lower than *salam*. Whereas in *salam* full upfront payment is mandatory, under *istisna* contract bank is permitted to provide funds in installments or even to defer the whole amount to a future date thus maintaining its liquid assets in the duration of the contract (Salman 2004).

iii)- IJARA and IJARA WA-IQTINA (Islamic Leasing)

Ijara is simply referred to as "Islamic leasing". A contract in which bank first owns an asset which it leases to its customer. Or the bank gets a tangible asset on lease from a third party and subleases it to the customer (Salman 2004). It is standard hire-only

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[16] Cited by Salman (2004), Jurists have identified specific conditions for validity of is contract which can be found elsewhere, for example see Usmani (1998).

[17] *Salam* was an exception to this general principle of trade. So *salam* on *salam* cannot be permitted (Salman 2004).

contract. Under this agreement, a client may take on rent, property, vehicle or any other real asset belonging to the bank. For example, a car can be leased at a pre-determined fixed cost per month. The bank transfers the right of use the asset to the client, while retaining the ownership of the asset. The client pays periodic rent to the bank for the use of the asset. Basis for the rental can be fixed as well as floating. Any change in rental can be made through mutual consent (Bank Alfalah).

The Ijara contract is similar to a western conventional *"operating lease"* contract where in Islamic Bank is the lessor and the client is the lessee. Like in operating lease, Islamic bank under Ijara contract leases an asset to the client for agreed on lease payment for a stipulated time period but with *no* option of ownership for the lessee. The maintenance and the insurance is the responsibility of the lessor.

Ijara Wa-Iqtina is similar to the western (conventional) financial or capital lease. Like in financial lease, Islamic bank under *Ijara Wa-Iqtina* contract purchases the asset such as building, equipment, or even an entire project and leases it to the client for agreed on lease rental payment for a stipulated time period, together with the client agreement to make lease rental payments towards the purchase of the asset from the lessor (Salman 2004). This contract is similar to Ijara but with *an* option of ownership of the asset for the lessee at the termination of the lease period. To avoid any speculation lease payments must be agreed on in advance.

APPENDIX-B

MEEZAN BANK LIMITED: AN INTRODUCTION

Meezan Bank Limited a publicly listed company was incorporated on *January 27, 1997* and started operations as an investment bank in August that year. In ***January, 2002*** in an historic initiative, Meezan Bank was granted the nations first full-fledged commercial banking license as a dedicated Islamic Bank, by the State Bank of Pakistan.

Meezan Bank, has now clearly established itself as the largest Islamic Bank in Pakistan with a large network of branches in all major cities of the country. The banking sector is showing a significant paradigm shift away from traditional means of business, and is catering to an increasingly astute and demanding financial consumer who is also becoming keenly aware of Islamic Banking. Meezan Bank bears the critical responsibility of leading the way forward in establishing a stable and dynamic Islamic Banking system replete with dynamic and cutting-edge products and services.

During the first five years of its operation as an Islamic commercial bank (from 2002 to 2007), offering universal banking services to customers, Meezan Bank has been one of the fastest growing banks in the history of the banking sector. Average growth in deposits has been 60% per annum during this period while the branch network grew from 4 to 100. The bank has established a strong and credible management team comprised of experienced professionals, that have achieved a strong balance sheet with excellent operating profitability and strong ratios that places the Bank at the top of the industry.

The Bank has been assigned a long-term entity rating of A+ and a short-term entity rating of A-1.

The Banks main shareholders are leading financial institutions of the Region namely, Noor Financial Investment Company, Kuwait, a leading investment banking entity based in Kuwait; Pak-Kuwait Investment Company, a AAA rated financial entity in the country; the Islamic Development Bank of Jeddah, and Shamil Bank of Bahrain–a leading Islamic Bank in Bahrain. The established position, reputation, strength and stability, of these institutions add significant value to the Bank through Board representation and applied synergies.

The Bank has an internationally renowned, very high caliber and pro-active Shari'ah Supervisory Board Chaired by Justice (Retd.) Maulana Muhammad Taqi Usmani, an internationally renowned figure in the field of Shari'ah, particularly Islamic Finance. He holds the position of Deputy Chairman at the Islamic Fiqh Academy, Jeddah and in his long and illustrious career has also served as a Judge in the Shariat Appellate Bench, Supreme Court of Pakistan. The Board also includes Sheikh Essam M. Ishaq (Bahrain), Dr. Abdul Sattar Abu Ghuddah (Saudi Arabia) and Dr. Imran Usmani who is also the resident Shari'ah advisor of the Bank. Dr. Imran is assisted by a team of professionals (otherwise referred to as the Product Development and who strictly monitors the regular transactions of the Bank.

At Meezan Bank, we strive to find commonalties with the conventional banking system with absolutely no compromise on Shari'ah rulings. The bank has developed an extraordinary research and development capability by combining investment bankers, commercial bankers, Shari'ah scholars and legal experts to develop innovative, viable, and competitive value propositions that not only meet the requirements of today's complex financial world, but do so with the world-class service excellence which our customers demand, all within the bounds of Shari'ah.

Meezan Bank has built a strong Information Technology and customer knowledge-based focus that continues to use state of the art technology and systems. The Bank's Corporate and Investment Banking business unit is geared towards nurturing and developing a long-term relationship with clients by understanding their unique financing requirements and by providing Shari'ah compliant financing solutions through corporate banking and structured finance.

(Source: Meezan Bank Limited)