A Piece of Education on Comparative Performance Study of Islamic Banking system and Commercial Banking system in Pakistan

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Abstract

Purpose of the study: Islamic banking has been explained in numeral ways. This study is shown to find out the difference among the two parts of banking, the first one is Islamic banking and the second one is conventional banking system of Pakistan with respect to liquidity, efficiency, and profitability. The secondary data from banks of each banking subdivision is taken for valuation. Proportion analysis is used to define the characteristics of study respondents and regression analysis is used to study the difference in term of significant factors that affect client trust of Islamic banks and commercial banks.

Methodology: The secondary data from banks of each banking area is taken for calculation. Ratio analysis is used to conclude the characteristics of study respondents and regression analysis is applied to examine the difference in term of significant factors that influence customer trust of Islamic banks and commercial banks. Five Islamic banks and five commercial banks has been taken as sample under population of all the banks

Main Findings: The results of the study show that there is important difference among the both kinds of banking for the variables under study. Furthermore, influence of return on asset is more on client trust for the study period (2015– 2019) for the Islamic bank as compared to the conventional banking. The study also inspects the important factors that are significant for development of Islamic banking.

Application of this study: This study contributes toward the financial area for policymakers in order to build the best policies of the banking system. New banks can get advantage form this study in order to achieve their goals this thing will ultimately lead toward the success.

Keywords: Banking system, Islamic banks, Conventional Banks, Cash to deposit of Islamic banks and cash to deposit of conventional banks

1. INTRODUCTION

Islam has banned interest, so the Islamic banking system contains products that do not include interest and are in accordance with the principles of Shari'ah, which is why it is also known interest-free banking. The system is evolving over time as demand for free interest products increases. Many clients are show interest in banks in an Islamic method, and various profitable banks are also launching Islamic banking products that break away from the traditional bank. There are also clients of many non-Muslim Islamic banks. Islamic banking is also a lot of in some non-Muslim countries. According to a State Bank of Pakistan report, there are above 300 Islamic finance organizations functioning in about 75 countries. (Salman, Nawaz et al.,2018).

Islamic banking has been described in different methods. The OIC General Secretariat is defined as follows: An Islamic bank is a commercial institute whose position, guidelines and regulations clearly express its obligation to the collection and payment of interest on Islamic Shariah principles and anything else. - His Operations (Ali and Sarkar, 1995) Islamic banks have been growing quickly since 1971. "In one year, with a growth rate of 15%, Islamic banks have assets of $65 billion. But, it accounts for less than 1% of the world's bank assets. (Wilson, 1995) In the past it has been argued that Riba states to interest or usury, but now there is an agreement among Muslim scholars that the term covers all kinds of interests, only not "too much" interest. (Siddiqi. 2004).

The first Islamic bank was established in Egypt in 1963, while in Pakistan, Islamic banking emerged in the 1970s (Ariff 1988). Islamic banking was re-launched in Pakistan in 2002. And now, there are many complete Islamic banks operating in Pakistan (such as Faysal Bank, Meezan Bank and Islami Bank, Islamic Bank of Dubai, etc.).

The present international commercial disaster is the result of Riba-based economies. Countries that had significant markets and led the world were also affected by the economic downturn to such an extent that interest rates have now come down to zero. These countries are showing great interest in Islamic banking because it is not based on interest rates.
Instead of asset-based banking as opposed to traditional money-based banking (Ayub and Muhammad 2012).

Many scholars have explained that Islamic banks are more well-organized and commercial than traditional banks. Some scholars have concluded that Islamic banks suffer from surplus liquidity. The main purpose of this research peace is to find out whether there is any difference between the profitability, efficiency and liquidity of Islamic banks and traditional banks in Pakistan.

2. LITERATURE REVIEW

There are a lot of investigates published recently which study the modifications among the performance of Islamic and conventional banking in different parts of the world (Abdul-Majid, Saal, & Battisti 2010; Saif-Alyousfi, Saha, & Md-Rus, 2017; Salman, Nawaz et al., 2018). This part of investigation contain theoretical literature as well as empirical literature.

Background of Islamic banking: The Islamic monetary system is built on a commercial law recognized as fiqh al-mu'amalat. Fiqh refers to the rules of learning, while muamalat refer to economic transactions in this particular sense. This law considers issues of fairness, equality and social impartiality in all business dealings, and encourages business, look after property privileges and in accordance with the divine law of Allah and His last Messenger Muhammad (Peace Be Upon Him). Emphasizes the definition of contractual obligations.(Pesendorfer, Lehner et al.,2016).

Modern Islamic banking:
Islamic banking began with modest revenue and loss-splitting accounts, Islamic savings and investment products, but now as Islamic bonds (sukuk) and hedge funds, which are bringing the Islamic Republic's key products to market. Are flourishing Islamic prohibitions are now based on the principles of profit and loss partnership (Mudarabah), partnership or joint ventures (Musharakah), sale agreement (Salam), financial lease agreement (Ijarah) and interest-free loans (Qard-e-Hasna)), Markup trading (Murabaha) (Pesendorfer, Lehner et al.,2016).

3. DIFFERENT ISLAMIC BANKING PRODUCTS THAT ARE COMMONLY USED IN PAKISTAN

Ijarah: This product is mainly used for the buying of automobiles such as automobiles, delivery trucks, etc. The bank buys the car for the customer and the customer pays the monthly rent. Chhapra (Butt et al.,2018).
Mudarabah: This product is used to finance a business. The bank provides finance and the company provides labor. If there is a loss, the bank will bear it as long as there is no intention to do so. (Salman, Nawaz et al.,2018).
Murabaha: Agreement to sell goods with markup on the price of goods. The customer instructs the bank to buying product from a third party. (Salman, Nawaz et al., 2018)
Musharakah: It is a partnership agreement among a bank and a customer in which mutually partners invest in a project in ratio. They distribute the profits or losses in such a way that the share in the partnership is the share of the loss in which they have invested, but the benefit is shared in a predetermined proportion by joint consent. (Salman, Nawaz et al., 2018)
Empirical studies.
Different investigators have applied different ways to measure variables. Proportion study is the most accurate way used in this regard. Different investigators have come up with a lot of outcomes. Here is an analysis of more than twenty investigators on the act of Islamic and traditional banking. The way of proportion analysis is used in a study comparing Islamic and traditional banking in Pakistan. (Salman, Nawaz et al., 2018).

A Pakistani scholar (Salman, Nawaz etc. 2018) deliberate the presentation of Islamic banks in Pakistan and compared the profit, arbitration and liquidity proportions of one Islamic bank (Meezan Bank) and 8 traditional banks in Pakistan and for this 3 Ratio used cost effectiveness; Return on capital, return on assets and profit-to-expense ratio. It found that traditional banks were more profitable than Islamic banks and that the rate of return on assets was almost twice that of traditional banks.

Three Malaysian scholars (Abdul Majid, Mohammad Nor et al., 2005) compared the two types of banking and compared the effectiveness of traditional Islamic banking in Malaysia. They examined two types of statistics. Parametric and non-parametric to measure the incompetence of two types of banks.

Laxman et al., (2008) the author studies the act of Islamic banks in Pakistan. He nominated two major Islamic banks in Pakistan, Meezan and Al-Barka Islamic Bank and calculated the ROA and ROE ratio for both. The outcomes showed that the profitability of these two banks was better than the banking industry average. Even Meezan Bank showed better outcomes than others.

A case study was conducted on Bank Muamlat Indonesia (an Islamic bank) to associate its risk, integrity, profitability and liquidity with traditional Indonesian banks. The author (Salim, 2010) used proportions for the reasons stated and applied various statistical tests to the data attained. The outcomes show that there is no significant difference between the profits of BMI and interest-based banks, but the outcomes show that the Islamic bank has a relatively lower amount than in this case.

According to one more study by Haroon and Ahmed (2000) in Malaysia, about the effects of traditional interest rates and interest rates on payments in Islamic banks, clients are showed by a more profitable theory. This study dispels the general impression that Islamic banks are more liquid than traditional banks.

Abdul Majid, Saal, and Battisti, (2009) deliberate the "the impact of Islamic banking on the cost efficiency and productivity change of Malaysian commercial banks" was showed which concluded that the Islamic banks are less well-organized than the conventional banks as they need more input to produce the desire outputs.

Abdul Majid, Saal and Battisti, (2009) studied the "impact of Islamic banking on the cost performance and productivity change of Malaysian profitable banks", concluding that Islamic banks are inferior to traditional banks. Are efficient, as they require more input to get the desired results.

Haron, (1996) stated that it was possible to know the act of Islamic banks working in two dissimilar areas. Competitive and monopolistic. The writer applied various mathematical methods to determine the data obtained from banks. There is no alteration in the profits of Islamic banks operating in a monopoly atmosphere. The result is that the greater the number of shareholders and the wealth of the company, the greater the profit of bank depositors operating in a competitive market.
A study by Bader, Badar, etc., (2008) found that mutually Islamic and traditional banks are not as much of well-organized as their potential and both need improvement. Data from 1990 to 2005 were taken from forty-three Islamic and thirty-seven traditional banks. The data envelope examination model was used to examine the performance of these banks and T tests were performed to catch out if there was any alteration. The outcomes show that there is no important difference in the performance of Islamic and traditional complements.

4. METHODOLOGY

Here banking system is categorical variable with two groups:
Conventional banking
Islamic banking
The features of the following three variables of the both groups is measured by one ration analysis.

- Profitability
- Efficiency
- Liquidity

The statistical model is constructed on the following equation to predict the differences of financial act among Islamic banks (IB) and conventional banks (CB) with respect to CTD.

$$CTDIB=\beta b1ROAIB+\beta b2ROEIB+\beta b3RODIB+\beta b4OPMIB+\beta b5OLAIB+\beta b6ATOIB+\beta b7CTAI+e \quad (1)$$

$$CTDCB=\beta b1ROACB+\beta b2ROECB+\beta b3RODCB+\beta b4OPMCB+\beta b5OLACB+\beta b6ATOCB+\beta b7CTACB+e \quad (2)$$

Where dependent variables are:

CTDIB = Cash to Deposit of Islamic banks;

CTDCB = Cash to Deposit of conventional banks.

Independent variables are:

ROAIB = Return on Asset of Islamic banks, ROEIB = Return on Equity of Islamic banks RODIB = Return on Deposits of Islamic banks, OPMIB = Operating Profit Margin of Islamic banks, OIAIB = Operating Income to Assets of Islamic banks, ATOIB = Asset Turnover of Islamic banks, CTAIB = Cash to Assets of Islamic banks, ROACB = Return on Asset of conventional banks, ROECB = Return on Equity of conventional banks, RODCB = Return on Deposits of conventional banks, OPMCB = Operating Profit Margin of conventional banksOIACB = Operating Income to Assets of conventional banks, ATOCB = Asset Turnover of conventional banks, CTACB = Cash to Assets of conventional banks

e = Error term

β = Beta

Hypothesis:

H0. There is significant factor that actuate on customer trust of both banking system. i.e. Islamic banks and conventional banks of Pakistan.

H1. There is no significant factor that actuate on customer trust of both banking system.

i.e. Islamic banks and conventional banks of Pakistan.

Financial Ratios:

Profitability, Efficiency and Liquidity Ratios of two banks (Islamic and conventional) is calculated and then compared. The following ratios were calculated:

Return on Assets (ROA)=Net profit after Taxes + Interest Expense ÷ Average Total Assets ROA measures the success a bank has in using its assets to earn profit. Total assets are financed by the creditors, depositors and the shareholders. Interest (profit in the case of Islamic bank) is the income earned on the money provided by the creditors and depositors and net income is the profit available to be distributed to the shareholders.

Return on Equity (ROE)= Net Income ÷ Average Common Stock Holders Equity**.** This ratio is the relationship between the net income the common shareholders' investment in the bank.

Return on Deposit (ROD) = Net Income ÷ Total Customer Deposits**.** This is the relationship of the profits earned on the usage of money provided by the depositors. Operating Profit Margin =Operating Income ÷ Markup Earned**.**
Operating Income to Assets = Operating Income ÷ Total Assets. This is the net return after provisions earned on the total (current and fixed) assets of the bank. Asset Turnover = Revenue ÷Total Assets.

Cash to Assets= Cash ÷ Total Assets. This ratio calculates the proportion of cash in the assets of the bank.

Population and sample: Our population contains all the Islamic banks (in the category of Islamic banking of out independent variable) and all the conventional banks (in the Conventional banking categorical variable "Banking System") in Pakistan.
The following four banks are selected for the assessment as sample.

Islamic banks:

- Meezan Pakistan Ltd
- Bank Islamic Limited
- Bank Alfalah
- Burj Bank
- Al baraka Bank Pakistan

Conventional bank:

- Standard Chartered Bank (Pakistan) Ltd
- MCB Bank Limited Pakistan
- Habib Ban
- United Bank
- National bank of Pakistan

Data source:

Data type is secondary, the data is collected from the financial statements of the above-mentioned banks. Most of the

statements were taken from the official websites of these banks.

Data analysis and discussion

5. COMMERIAL BANKS

Regression Analysis:

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      panel variable:  years (unbalanced)
       time variable:  id, 1 to 5
               delta:  1 unit

xtreg ctd cta ato roe1 oia opm rod roa

ındom-effects GLS regression                    Number of obs     =         24
:oup variable: years                            Number of groups  =          5

·sq:                                            Obs per group:
    within  = 0.9655                                          min =          4
    between = 0.2823                                          avg =        4.8
    overall = 0.9599                                          max =          5

                                                Wald chi2(7)      =     382.97
)rr(u_i, X)   = 0 (assumed)                     Prob > chi2       =     0.0000
```

ctd	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
cta	.8164941	.0624028	13.08	0.000	.6941869	.9388013
ato	8.511266	12.31673	0.69	0.490	-15.62908	32.65161
roe1	.3760181	4.472681	0.08	0.933	-8.390276	9.142312
oia	7.935949	11.1515	0.71	0.477	-13.9206	29.7925
opm	-.0333162	.7042302	-0.05	0.962	-1.413582	1.34695
rod	6.294529	9.645336	0.65	0.514	-12.60998	25.19904
roa	-7.828096	19.61689	-0.40	0.690	-46.2765	30.6203
_cons	-.9588385	1.119469	-0.86	0.392	-3.152958	1.23528
sigma_u	0					
sigma_e	.6186297					
rho	0	(fraction of variance due to u_i)				

Source: Author Self calculation upon the base of secondary data.

Result's Discussion

In the above table simple regression analysis has been done by using ratios of five different commercial banks. CTA's is independent variable. Where, Asset's turnover ratio is significant at level five and remaining p values and there coefficients are insignificant. And cash to asset is significant but remaining results of ratios are insignificant because other factor than ratios are affecting the bank like economic, social and political.

Fixed Effect:

r(198);

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. xtreg ctd cta ato roe1 oia opm rod roa, fe

Fixed-effects (within) regression               Number of obs      =        24
Group variable: years                           Number of groups   =         5

R-sq:                                           Obs per group:
     within  = 0.9669                                         min =         4
     between = 0.1550                                         avg =       4.8
     overall = 0.9580                                         max =         5

                                                F(7,12)            =     50.00
corr(u_i, Xb)  = -0.0636                        Prob > F           =    0.0000
```

ctd	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
cta	.81201	.0660957	12.29	0.000	.6679999	.9560202
ato	5.134815	18.6855	0.27	0.788	-35.5774	45.84703
roe1	2.602618	5.361062	0.49	0.636	-9.078133	14.28337
oia	7.736455	12.06554	0.64	0.533	-18.5521	34.02501
opm	-.3104992	.7771662	-0.40	0.697	-2.003799	1.382801
rod	-1.116441	11.62254	-0.10	0.925	-26.43977	24.20689
roa	-6.492055	20.8895	-0.31	0.761	-52.00637	39.02226
_cons	-.6123535	1.722282	-0.36	0.728	-4.364884	3.140177
sigma_u	.26259564					
sigma_e	.6186297					
rho	.15267368	(fraction of variance due to u_i)				

```
F test that all u_i=0: F(4, 12) = 0.65                     Prob > F = 0.6369
```

Source: Author Self calculation upon the base of secondary data.

Result's Discussion

In above table regression analysis through fixed effect has been carried out by using ratios of five different commercial banks. By using stata software did the houseman test.Where CTA's is independent variable. Cash to asset is significant but remaining results of ratios are insignificant because other factor than ratios are affecting the bank like economic, social and political.

Random Effect:

rho	.15267368	(fraction of variance due to u_i)

F test that all u_i=0: F(4, 12) = 0.65 Prob > F = 0.6369

. xtreg ctd cta ato roe1 oia opm rod roa, re

Random-effects GLS regression — Number of obs = 24
Group variable: years — Number of groups = 5

R-sq:
- within = 0.9655
- between = 0.2823
- overall = 0.9599

Obs per group:
- min = 4
- avg = 4.8
- max = 5

Wald chi2(7) = 382.97
corr(u_i, X) = 0 (assumed) — Prob > chi2 = 0.0000

ctd	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
cta	.8164941	.0624028	13.08	0.000	.6941869	.9388013
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_cons	-.9588385	1.119469	-0.86	0.392	-3.152958	1.23528

sigma_u	0	
sigma_e	.6186297	
rho	0	(fraction of variance due to u_i)

Source: Author Self calculation upon the base of secondary data.

Result's Discussion

In above table regression analysis through random effect has been carried out by using ratios of five different commercial banks. By using stata software did the lagrangian multiplier test. Where, CTA's is independent variable. Cash to asset is significant but remaining results of ratios are insignificant because other factor than ratios are effecting the bank like economic, social and political.

Islamic Bank

Regression.

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. xtreg ctd opm rod ato cta roe1 roa1 oia1

Random-effects GLS regression                   Number of obs     =        16
Group variable: years                           Number of groups  =         5

R-sq:                                           Obs per group:
     within  = 0.6127                                         min =         3
     between = 0.3462                                         avg =       3.2
     overall = 0.5215                                         max =         4

                                                Wald chi2(7)      =      8.72
corr(u_i, X)   = 0 (assumed)                    Prob > chi2       =    0.2734
```

ctd	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
opm	36.89442	34.35283	1.07	0.283	-30.4359	104.2247
rod	9.195507	6.854492	1.34	0.180	-4.239051	22.63007
ato	146.2755	89.17565	1.64	0.101	-28.5056	321.0565
cta	-122.9254	56.75655	-2.17	0.030	-234.1662	-11.68459
roe1	-2.198369	6.782914	-0.32	0.746	-15.49264	11.0959
roa1	4.049295	406.448	0.01	0.992	-792.5742	800.6727
oia1	165.1427	83.72834	1.97	0.049	1.038178	329.2472
_cons	-17.74762	14.31572	-1.24	0.215	-45.80592	10.31068
sigma_u	0					
sigma_e	2.8556718					
rho	0	(fraction of variance due to u_i)				

Source: Author Self calculation upon the base of secondary data.

Result's Discussion:

In above table simple regression analysis carried out by using ratios of five different Islamic banks. Where, CTA's is independent variable. Asset's turnover ratio is significant at level five and remaining p values and there coefficients are insignificant. Cash to asset is significant, Results of other ratios are also significant except return on equity and return on asset but remaining results of ratios are insignificant because other factor than ratios are effecting the bank like economic, social and political.

Fixed Effect.

```
. xtreg ctd opm rod ato cta roe1 roa1 oia1, fe

Fixed-effects (within) regression               Number of obs      =        16
Group variable: years                           Number of groups   =         5

R-sq:                                           Obs per group:
     within  = 0.7016                                         min =         3
     between = 0.1182                                         avg =       3.2
     overall = 0.4578                                         max =         4

                                                F(7,4)             =      1.34
corr(u_i, Xb)  = -0.4768                        Prob > F           =    0.4087

------------------------------------------------------------------------------
         ctd |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
         opm |   50.97213   39.71679     1.28   0.269    -59.29935    161.2436
         rod |    13.3113   10.34588     1.29   0.268    -15.41348    42.03608
         ato |   277.6562   188.9726     1.47   0.216    -247.0159    802.3284
         cta |  -156.2875   86.28373    -1.81   0.144    -395.8495    83.27455
        roe1 |  -.5164437   12.53073    -0.04   0.969    -35.30733    34.27444
        roa1 |    -368.421   590.8622    -0.62   0.567    -2008.917    1272.075
        oia1 |    153.3341   191.7054     0.80   0.469    -378.9253    685.5935
       _cons |   -25.41177   22.90203    -1.11   0.329    -88.99801    38.17447
-------------+----------------------------------------------------------------
     sigma_u |   2.1283257
     sigma_e |   2.8556718
         rho |    .35710696   (fraction of variance due to u_i)
------------------------------------------------------------------------------
F test that all u_i=0: F(4, 4) = 1.05                     Prob > F = 0.4822
```

Source: Author Self calculation upon the base of secondary data.

Result's Discussion:

In above table regression analysis through fixed effect has been carried out by using ratios of five different Islamic banks. By using stata software did the houseman test. Where, CTA's is independent variable. Asset's turnover ratio is significant at level five and remaining p values and there coefficients are insignificant. Cash to asset is significant, Results of other ratios are also significant except return on equity and return on asset but remaining results of ratios are insignificant because other factor than ratios are effecting the bank like economic, social and political.

Random Effect:

```
F test that all u_i=0: F(4, 4) = 1.05                     Prob > F = 0.4822

. xtreg ctd opm rod ato cta roe1 roa1 oia1, re

Random-effects GLS regression                   Number of obs     =        16
Group variable: years                           Number of groups  =         5

R-sq:                                           Obs per group:
     within  = 0.6127                                         min =         3
     between = 0.3462                                         avg =       3.2
     overall = 0.5215                                         max =         4

                                                Wald chi2(7)      =      8.72
corr(u_i, X)   = 0 (assumed)                    Prob > chi2       =    0.2734
```

ctd	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
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rho	0	(fraction of variance due to u_i)				

Source: Author Self calculation upon the base of secondary data.

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In above table regression analysis through fixed effect has been carried out by using ratios of five different Islamic banks. By using stata software did the lagrangian multiplier test. Where, CTA's is independent variable. Asset's turnover ratio is significant at level five and remaining p values and there coefficients are insignificant. Cash to asset is significant, Results of other ratios are also significant except return on equity and return on asset but remaining results of ratios are insignificant because other factor than ratios are effecting the bank like economic, social and political.

6. CONCLUSION

This research is carried out in order to know which banking system is better either Islamic banking system or conventional banking no doubt many research has been carried out upon this area but no any significant piece of reach is available in literature under these variables (CTDIB & CTDCB as Dependent variable, whereas ROAIB, RODIM, OIAIB, ROEIB, ATOCB are independent variables). Five Islamic banks and five conventional banks has been taken as sample among population (all banks of Pakistan). Data is secondary and gathered from Financial statement and time Spain for the data is 2015-2019. Regression, fixed effect and random effect has been implemented results of the study different many preceding findings as the analysis show that there is significant difference between the both types of banking for the variables under study. Moreover, influence of return on asset is more on customer trust for the study

period (2015– 2019) for the Islamic bank as compared to the conventional banking. The study also examines the significant factors that are important for growth of Islamic banking so in this way our results supported to H1, There is no significant factor that actuate on customer trust of both banking system .i.e. Islamic banks and conventional banks of Pakistan.

7. LIMITATION AND STUDY FORWARD

The one of the possible limitation of this study can be fewer banks as sample size under the population of Islamic banking system and conventional banking system. For future researchers authors can enhance the sample size and can cover other variable that is not taken in this study.

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