

COMPARISON OF ISLAMIC AND CONVENTIONAL BANKING IN PAKISTAN

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ABSTRACT

Islamic Banking is growing with fast speed all over the world particularly in Pakistan while the conventional banking is surprisingly declining in the countries which are the champion of capitalism and founder of interest-based financial system. Now these developed countries are trying to contain financial crisis by manipulating interest rates and have brought down it near to zero level but have failed to achieve desired results. Dozens of centuries old and strong financial institutions have been wiped out from the financial scene.

In this depressed world financial scenario, Islamic banking has emerged as a strong alternate financial system. It has recorded a phenomenon growth within a short span of time. Now Islamic financial industry has reached \$1 trillion US dollar and is growing about 20 percent annually. Its growth is not restricted to the Muslim societies but Islamic financial products are also gaining popularity among non-Muslim countries. Many global banks have also opened separate windows to serve their Muslim clients. Similarly, about all global agencies like IMF, World Bank, IFC, ADBP, etc, have set up special cell to investigate into this new phenomenon. In this paper, the author has probed how an idea floated by some Muslim economists a few years back has now become a potent reality.

Keeping this objective in mind the author has analyzed the vertical growth of Islamic banking and compared it with its counterpart conventional banking. Six newly formed Islamic banks in Pakistan and six conventional banks of the same size were selected for the purpose of comparison. Data relating to their performance and profitability were collected from primary and secondary sources from 2006 to 2008. The ratio analysis technique was applied to measure the performance of key indicators of both Islamic and conventional banks.

The results of the study are very encouraging because the performance and profitability of Islamic banks are far better than selected conventional banks. Islamic banks outperform conventional banks in assets, deposits, financing, investments, efficiency, and quality of services and recovery of loans. It predicts the bright future of Islamic banking in Pakistan.

1. INTRODUCTION

Islamic banking emerged as a practical reality and started functioning in 1970s. Since then it has been growing continuously all over the world. Presently, Islamic banking industry has reached US\$1.0 trillion US dollars by the end of 2008. International Rating Agency, Standard & Poor estimates that Islamic financial industry has potential to grow to US\$4.0 trillion over medium term. It is surprising to note that global conventional banks like HSBS, Standard Chartered Bank, Deutsche Bank, Citibank, etc, have also set up separate Windows/Divisions to structure Islamic financial products and are offering Islamic banking services to their Muslim clients and even to those non-Muslim clients who are interested in profit and loss sharing (PLS) financial instruments. UK, France, China, Singapore and many other countries have

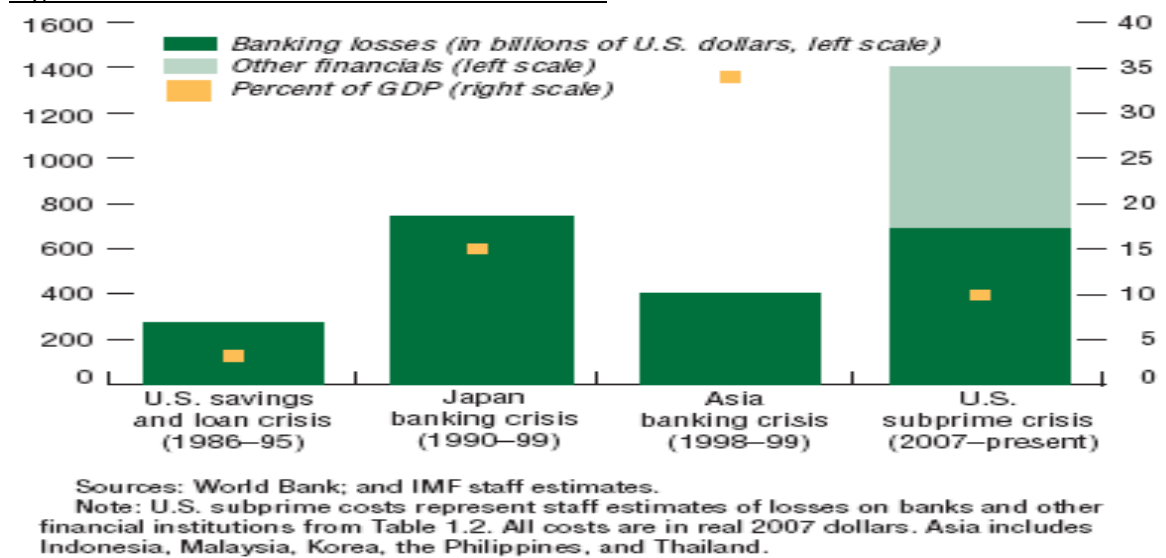
developed special regulatory to facilitate the working of Islamic banking. The speed of the growth of Islamic banking all over the world including Pakistan has been expedited since 2002.

The underlying objective of this study is to investigate the phenomenon that conventional banking, which has been operating for the last three centuries on strong footing, have started tumbling steeply in the last few decades while Islamic banking has been expanding all over the world particularly in Muslim countries with fast speed. The vertical growth of Islamic banking within short span of time has surprised every one including western financial experts and analysts. A massive research activity has been initiated all over the world to probe this phenomenon. Nazim Ali (2008:154) disclosed that 970 books have been published on Islamic Finance recently. As many as 215 books were published in Asia, 190 in Europe, 425 in Middle East and 140 in North America. While 2557 research articles on Islamic finance have been published in research journals”. Out of these, 1187 research papers were published in the European journals, which are nearly half of total published papers. It indicates the growing interest of Europe in Islamic finance. Similarly, 1547 papers were read in different conferences held on Islamic finance in Asia, Europe, Middle East and North America. This small detail shows the growing interest of researchers in Islamic finance.

It is interesting to note that conventional banking has been declining continuously. Even now it is in serious crisis and suffering huge losses. The western countries are also paying huge fiscal cost of conventional banking crisis.

An amazing comparison of four main financial crisis occurred during last two decades in different parts of the world has been given in the Figure 1. The first major crisis was U.S. Savings and Loan crisis, 1986-95, which involved a fiscal cost of \$225 billion to the United States while five percent of GDP losses. The second major banking crisis was occurred in Japan in 1990-99, spreading over a period of a decade and is termed as “mother of all crises”, costing Japanese economy about \$800 billion, about 18 percent of GDP losses. Third major crisis was ensued in East Asian and Latin American countries in 1998-99 that involved fiscal cost about \$400 billion, 10 percent of GDP losses. The fourth biggest financial crisis (generally termed as Sub-prime mortgage loans crisis) was occurred in the United States in 2007 and is still continued in 2009. IMF estimated its fiscal cost around \$1.4 trillion and 10 percent GDP losses in 2007, which was revised to \$2.2 trillion and 16 percent of GDP losses in 2009. This crisis has hit hard to the United States, European countries and slightly Asian countries. It is to be taken as the worst financing crisis since Second World War that has jolted the invulnerability and institutional financial strength of advanced economies.

Figure 1. COMPARISON OF FINANCIAL CRISIS



Source: IMF Financial Stability Report, October, 2008

The root-cause of all above stated financial crisis is the volatility of interest rates. In order to control recent credit crisis started in 2007, the Central Banks of the United States, Britain, Japan, European Union and other advanced countries have scaled down interest rates near to zero and about all Central Banks of the world have pumped trillion of dollars in money markets but even then the crisis is deepening day after day. So far 100 banks have failed in the United States and in other advanced countries and many old and established financial institutions like Northern Rock, Royal Bank of Scotland, Lehman Brothers, Washington Mutual; Goldman Sachs, AIG, etc have been collapsed... In 1984, there were 15,084 banks in the United States but now their number has reduced to about 7000. It means almost half of conventional banks have been wiped out as a result of financial crisis occurred in the United States in different times. Asian Development Bank Report, 2008 written by Claudio Loser, an ex-IMF director, estimates that "The value of global financial assets including stocks, bonds and currencies probably fell by more than \$50 trillion in 2008, equivalent to a year of world gross domestic product (GDP). This brief detail is sufficient to understand the pace of the declining of conventional banking at global level.

2. EVOLUTION OF ISLAMIC BANKING

Before the dawn of Islam, the Makka, the Holy city of Arabian Peninsula, was the centre of world trade and regarded as a safe heaven for investors and business people. Traders caravans used to make two trips-north and south- to and from Makka during the summer and winter. Amid this relative security and local prosperity in trade and business, it was obvious that primitive system deposits and the utilization of money shall appear in pre-Islamic Makka society. Mostly goods are exchanged on bartered basis while payments also made in Dinar and Dirham coins. Dinar coins were in gold while Dirham coins were in silver. The parity between Dinar and Dirham was 1.12.

The business of money changing was common. Similarly, lending money on interest (Riba) was also common in Arabian Peninsula. The Jews of Medina, Banu Nadir, monopolized local business. They lend money to local people and charge high rate of interest. It was their main source of income. They were in majority and wealthy community as compared to other communities while the Quresh tribe of Makka was the men of trade and commerce. They pooled financial resources for carrying out large business ventures and share profit according to proportion of their contribution.(Warde-2006).

However, when Holy prophet (MPBUH) along with his companions migrated to Medina the concentration of business activities were also shifted from Mecca to Medina. The Holy Prophet and his companions were experienced and honest traders and the residents of Medina took full advantage of their presence. Medina was an agrarian city and most of its residents were engaged in agriculture activities. But after the arrival of the Holy Prophet the entity of that city was changed and it was emerged as one of the main business cities of Arab region. (K.Ali, Study of Islamic History, p.59).

The tiny Muslim state was emerged from the city of Medina and was transformed into the big empire of the world due to introduction of pro-poor, equitable and welfare-oriented financial system. The next four to six centuries saw a continuous expansion of Muslim empire and high living standard of its citizens.

The Muslim's love for trade is expressed by Goitein (1967: 55) in these words: "Merchants, craftsmen, and scholars alike would combine journeys undertaken in their personal interests with pilgrimages to holy places. The Muslim pilgrimage, of course, far outstripped in importance those of the other two religions. In the first place, pilgrimage was one of the main religious duties of a Muslim, whereas in Christianity and Judaism it was only a meritorious deed. Secondly, from its very inception, the pilgrimage to Mecca was connected with the great transcontinental trade and remained so throughout the Middle Ages. The standing wish for a Muslim pilgrim was: "May your Hajj be accepted, your sin be forgiven and your merchandise not remain unsold."

2.1 PRELIMINARY ISLAMIC BANKING MODEL

The people having savings or valuable articles, used to keep them under the custody of trusted persons who were known for their trustworthiness and having capability to discharge their obligations promptly whenever demanded. The underlying objective was to keep small savings in the shape of deposits with trusted persons for safekeeping and not for earning profit. This was the early shape of deposit-taking which is one of the functions of modern banking. Similarly, the wealthy people supplied funds to honest and experienced traders to finance their trade ventures and earn profit. The traders used to purchase commodities from the areas where they were abundant and sold where they were scarce and whatever the profit they earned they handed over to the owner of capital after charging their fee and traveling expenses. This was the early model of financing which is the core business of modern banking. This kind of financing is known in Islamic financial literature as “Modarba transaction”.

Now we quote practical examples from the history of Islam to illustrate early Islamic banking model.

2.1.2 EXAMPLES OF PERSONAL BANKING MODEL

(a) The people of Makka used to deposit their money and valuables with the Holy Prophet (PBUH) because he was the most honest and commonly known as Amin (trustworthy) even before the declaration of his prophethood. These deposits and valuables remained under his custody until his emigration from Makka to Medina. Before, his departure, the Holy Prophet handed over these deposits and valuables to his cousin and son-in-law, Hazrat Ali for their onward return to their owners.

(b) Naqvi, (1993:4) states that the safe-keeping of the money was also a common practice in the Arab world. People having savings deposited money with trusted persons and got back in the same form when needed. Zubain Bin Al-Awam, who was a companion of the Holy prophet, enjoyed the reputation of trustworthiness. He was most trusted person regarding safe-keeping of money and had security infrastructure of safekeeping. His practice of receiving deposit was novel and completely different from other people. He received money as a loan but not as deposit. His preference of taking money as loan and not deposit was that he wanted to secure the right of disposing of the money, considering it a loan and not deposit in order to ensure or guarantee for repayment to the owner as the money remaining idle in the form of deposit might be a loss to the owner. But when the deposit is converted into loan it is secured as it becomes the liability of the borrower. At his death total money due from him was amounted to 2,200,000 Dirham, a large sum according to the value of that time. His son, Abdullah Bin Zubair, paid the whole debt of his father and then distributed his father's asset among his family members.

2.2.2 EXAMPLES OF ISLAMIC BUSINESS FINANCING MODEL

(a) As mentioned above that the family of the Holy Prophet, Muhammad (MPUH) was prominent in business circle of of Makkah, His father, Abdullah, was also a leading business figure. But he was died when he was returning from a business trip of Syria at 25 years of age. in the young age. The grandfather of the Holy Prophet, Abu Mutlib, was also a leading businessman of Makka but he was also died when the child was at 8. His uncle, Abu Talib, brought him up and oftenly accompanied him in his business tours. His honest business practice popularized him as a man of high integrity. Khadija bint Khuwailid, a wealthy and noble widow of Macca hired his services for his business. He made handsome profits for her. She was very much happy and impressed by the honesty and dedication of the Holy Prophet and later was married to the Holy Prophet when he was at the age of 25 while she was at 40 in 595 A.D.

This example illustrates the fact that an entrepreneur can avail financing from a wealthy woman for his business venture and form partnership with her.

(b) Hazrat Usman b.Affan, who later became Khalifa, was a wealthy and generous person. He generously supported the Muslims after embracing Islam and provided financial help to every one. He also lent money to Yaqub, a Jewish merchant of Medina, to carry on business with his money during the period of Hazrat Umar b.Khitab, Second Muslim Caliph. (Imamuddin, (1991:178).

These two examples highlight the mode of financing in early period in which one person supplied funds and other used his entrepreneurial skill and charge fee for his expertise including business expenses. The funds were supplied on the basis of good character, sincerity, expertise and honesty of the entrepreneur. No collateral was involved and no personal guarantee was sought before supplying funds for business ventures.

3. EVOLUTION OF CONVENTIONAL BANKING

Early conventional banking had its origins in Italy. The profession grew out of the trade boom of the so-called commercial revolution of the High Middle Ages (1000–1350). By the early modern period, however, banking spread throughout Europe and became complex and increasingly involved in credit transactions. By the late thirteenth and fourteenth centuries there were three types of banks:

1. International merchant banks;
2. Local deposit banks, and
3. Pawn broking establishments.

These categories were not exclusive: the same businessmen sometimes engaged in two or all three types simultaneously. Although the Florentine banking system fell into crisis in the sixteenth century, yet Italians remained active in international banking into the seventeenth century. In the meantime, banking on the Italian model grew in southern Germany and other parts of Europe. The most notable of the firms was the great Fugger Banking Companies of Augsburg named after Hans Fugger, a renowned trader of fourteenth century weaver. These banks were engaged in a range of activities, including speculation in the money market and trade in commodities. The conventional banking system that was originated in Italy moved to Spain and then to Holland, until it settled in England. The commercial activity in England was motivated by a group of Lombardian traders emigrated from Italy in the 14th century A.D. The new comers settled in that part of London which is known today as the famous Lombard Street. With their arrival in London, the most important part of banking operations, the documentary credit and lending operation of usury were commenced. Most of these emigrants were Jews.

3.1 LEGALIZATION OF INTEREST

In 1545 the British King Henry III through his order allowed the Jews to charge maximum 43 percent interest on loans per annum. The fixation of interest rate ceiling was aimed at cooling down the sentiment of the public, on one hand, and permitting the Jews to charge 43 percent interest rates on loans, on the other hand. The enactment of this law, in fact, was an attempt to legalize the charging of interest, which was prohibited by the Church since long. The law was passed under the influence of the Jews who were the major beneficiary because 43 percent interest rate was too much. To get approved this law the Jews bribed the English parliamentarians because it paved the way for institutionalization of interest and was a first step towards formal introduction of interest-based banking system.

The formal permission interest charging created favorable environment and prompted other communities to rush into this money-making field. The English jewelers took advantages of new business opportunity and started money lending on interest. They offered low rate of interest as compared to Jews and Lombardians. After legalization of interest, the Jews founded commercial banks on the pattern of joint stock companies and hid themselves behind the veil of banks by institutionalizing interest that saved them from the wrath of people who always revolted against them for charging high rate of interest in about all European countries.

4. RESEARCH METHODOLOGY

OBJECTIVES OF THE STUDY

The objective of this research study is to compare the performance of newly constituted six Islamic Commercial Banks with the performance of the similar size of the selected Conventional Commercial

Banks in order to draw the conclusion whether these new Islamic Commercial banks can operate in a competitive environment and meet the expectations of their depositors, besides sustaining their growth.

RESEARCH QUESTION

The main theme of this study is to investigate the phenomenon of Islamic banking and compare it with the conventional banking in the perspective of overall operational framework of banking sector in Pakistan.

RESEARCH DESIGN

This research study has been designed in such a way that it helps compare the performance and profitability of Islamic banks with the conventional banks. The area of the study is the whole Pakistan where Islamic and selected Conventional banks are operating under the same legal, political, social and economic framework.

SAMPLE OF RESEARCH

At present six full-fledged Islamic Commercial Banks and 23 Conventional Commercial Banks are operating in Pakistan. Total 12 Commercial banks, six Islamic Commercial Banks and six Conventional Banks have been included into the sample of this research study. Six Islamic Banks that included into this study are:

1. Al-Baraka Islamic Bank.
2. Bankislami Pakistan Limited
3. Dawood Islamic Bank Limited
4. Dubai Islamic Bank Pakistan Limited
5. Emirates Global Islamic Bank Pakistan Limited
6. Meezan Bank Limited

Six Conventional Commercial Banks that have been included into the sample are:

1. Askari Comercial Bank Limited
2. Atlas Bank Limited
3. Bank of Khyber Limited
4. KASB Bank Limited
5. SAMBA Bank Limited.
6. Saudi Pak Commercial Bank Ltd.

SELECTION CRITERIA

In KPMG Banking Survey, 2007, Pakistani banking sector has been bifurcated into three segments: large size banks, medium size banks and small size banks on the basis of their size, assets, deposits, loans, and financing of banks. Islamic banks have been included into small size banks, because they are new and take time to become big banks. The Criteria of KPMG, which is an audited and accounting firm and is affiliated with KPMG international, is realistic and logical. We have also used the same criterion as a yardstick for selection of banks out of third segment of banking sector for our study.

SOURCE OF DATA

1. PRIMARY DATA

In order to make this research study more comprehensive the author used both primary and secondary sources for collection of relevant data and required information. The author used “interview Method” to collect primary data from respective professional bankers.

2. SECONDARY DATA

The author also collected data from secondary source because the primary data was not sufficient to meet the requirement of this study. This data was collected from the following sources:

1. Annual and quarterly financial statements of six Islamic Commercial Banks and selected Conventional Commercial Banks
2. Database of the State Bank of Pakistan.
3. Quarterly Brochures of the State Bank of Pakistan on Islamic Banking.
4. Annual Report of Modaraba Association of Pakistan, 2007.
5. Mutual Funds Association of Pakistan
6. Database of Karachi Stock Exchange.
7. Database of IMF, World Bank, IFC and Asian Development Bank
7. Database of Islamic Development Bank, Jeddah, Saudi Arabia.
9. Leading Pakistani English Newspapers.
10. Different Research Journals
11. Books on Islamic Banking and Finance.

PERIOD OF THE STUDY

The period of study is spread over two years starting from September 30, 2006 to September 30, 2008. The data of six Islamic banks and six selected conventional banks relating to this period have been included into this study. The specific reason for selecting this period is that out of six, five Islamic banks have started operation in Pakistan in 2006 and their published annual and quarterly accounts mostly cover this period. Only one Islamic Bank, Meezan Bank, has completed five years period by 2008 while the rest of Islamic banks have only less than three years life.

RESEARCH TECHNIQUES

The author used the following research techniques in this study.

1. Direct interview method was used to record the views of Islamic and conventional bankers.
2. Comparative analysis technique was applied to compare the operational framework of Islamic and conventional banks.
3. Ratio analysis technique was used to measure the asset quality, profitability and earning potential of Islamic and conventional banks.

FINANCIAL INDICATORS

The author has selected following four financial indicators, which are commonly known as “Financial Soundness indicators” and have been identified by IMF in its “Compilation Guide on Financial Soundness Indicators, 2004” and the State Bank of Pakistan in its “Financial Stability Review, 2007-2008 as main indicators of his research study to draw some concrete conclusions. These indicators are the followings:-

1. Capital Adequacy

2. Asset Quality
3. Earnings
4. Liquidity

5. LITERATURE REVIEW

The volume of literature on Islamic banking profitability is rapidly expanding and a handsome research work has been done by Muslim researchers during last two decades. As Islamic banking is a new industry and as such sometimes researchers face problem of the scarcity of relevant data. In this section, we have intended to review some of the leading research studies on Islamic and conventional banking. Let us see what previous studies say about the profitability of Islamic banking.

4.1 REVIEW OF STUDIES ON ISLAMIC BANKING PROFITABILITY

Sudin Haron (1996), while discussing external determinants of the profitability of Islamic Banks, argued that conventional banking theory postulates that the bigger the market, the more profit the banks earn, this theory is not necessarily true for Islamic banks. Islamic banks perform well due to efficient use of capital in short-term financing. Similarly, Islamic banks in a competitive market are better managed than those in the monopolistic markets. This finding is also in line with general assumption. Those businesses which operate in a competitive environment must be alert to the changes and produce innovative strategies and policies, if they wish to remain in the market. In contrast, conventional banks perform better in monopolistic environment as competitive environment involve them in moral hazard and adverse selection, causing high rate of default and less profitability.

Bashir (2000) assessed the performance of Islamic banks in eight Middle Eastern countries. He analyzed important bank characteristics that affect the performance of Islamic banks by controlling economic and financial structure measures. The paper studied fourteen Islamic banks from Bahrain, Egypt, Jordan, Kuwait, Qatar, Sudan, Turkey, and United Arab Emirates between 1993 and 1998. To examining profitability, the paper used Non Interest Margin (NIM), Profit before tax (PBT), Return on Assets (ROA), and Return on Equity (ROE) as performance indicators. There were also internal and external variables: internal variables included in the regression were bank size, leverage, loans, short term funding, overhead, and ownership; while external variables included macroeconomic environment, regulations, and financial market. In general, results from the study confirm previous findings and show that Islamic banks profitability is positively related to equity and loans. Consequently, if loans and equity are high, Islamic banks should be more profitable. If leverage is high and loan to assets is also large, Islamic banks will be more profitable. The results also indicate that favorable macro-economic conditions help profitability of Islamic banks.

Bashir and Hassan (2004) research study is a comprehensive piece of literature covering every aspect of examining profitability of Islamic banks. Similar to Bashir (2000), Bashir and Hassan (2004) studied the determinants of Islamic banking profitability between 1994 and 2001 for 21 countries. Their findings show that Islamic banks have a better capital asset ratio as compared to commercial banks which means that Islamic banks are well capitalized. Also, their paper used internal and external banks characteristics to determine profitability as well as economic measures, financial structure variables, and country variables. They used, Net-non Interest Margin (NIM), which is non interest income to the bank such as, bank fees, service charges and foreign exchange to identify profitability. Other profitability indicators adopted were Before Tax Profit divided by total assets (BTP/TA), Return on Assets (ROA), and Return on Equity (ROE). They studied 43 Islamic banks. Results obtained by Bashir and Hassan (2004), were similar to the Bashir (2000) results, which found a positive relationship between capital and profitability but a negative relationship between loans and profitability. Bashir and Hassan also found total assets to have a negative relationship with profitability which amazingly means that smaller banks are more profitable. In addition, during an economic boom, banks profitability seems to improve because there are fewer non-performing loans. Inflation, on the other hand, does not have any effect on Islamic bank profitability. The results also

indicate that overhead expenses for Islamic banks have a positive relation with profitability which means if expenses increase; profitability also increases.

Munawar Iqbal (2001 and 2004) compares Islamic and conventional banking in the Nineties and included 12 banks into his study sample. He studied the growth of Islamic banking industry during 1990-98 to measure annual growth rates for some key variables of Islamic banks like total equity, total deposits, total investment, total assets and total revenue. Then he used ratio analysis like capital assets ratio, liquidity ratio, deployment ratio, cost/income ratio, profitability ratio, return on asset and return on equity ratio and concluded that both return on assets (ROA) and return on equity (ROE) for the Islamic banks are substantially higher than the conventional banks and the two ratios are respectively 2.3 and 22.6 percent for the Islamic banks as against 1.35 and 15 percent for conventional banks. He concluded that the profit ratio of Islamic banks compare favorably with international standards, it should be noted that conventional banks' depositors are guaranteed their principal amounts and hence bear less risk than Islamic banks' depositors. Therefore, the depositors of Islamic banks would genuinely expect a higher rate of return to compensate for extra risk.

Alkassim (2005) in his study of GCC countries banking find that higher capital ratios support Islamic banks profitability. Total Loans for both types of banking have a positive relationship with profitability indicating that lending improves profitability. Deposits have a positive relation with profitability for Conventional and a negative relation for Islamic banking. This indicates that deposits impact Islamic banks profitability negatively whereas it contributes to Conventional banks profitability.

Cihak and Hesse (2008) in their cross-country empirical study on "Islamic banks and financial stability" analyzed 20 banking systems operating in Bahrain, Bangladesh, Brunei, Egypt, Gambia, Indonesia, Iran, Jordan, Kuwait, Lebanon, Malaysia, Mauritania, Pakistan, Qatar, Saudi Arabia, Sudan, Tunisia, United Arab Emirates, West Bank and Gaza, and Yemen and covers 520 observations for 77 Islamic banks (and 3,248 observations for 397 conventional commercial banks) over the period 1993 to 2004. They measure the impact of Islamic banks on financial stability and also compare the performance of Islamic banks with the conventional banks. Using z-scores as a measure of stability, they found that (i) small Islamic banks tend to be financially stronger than small commercial banks; (ii) large commercial banks tend to be financially stronger than large Islamic banks; and (iii) small Islamic banks tend to be financially stronger than large Islamic banks.

The contrast between the high stability in small Islamic banks and the relatively low stability in large Islamic banks is particularly interesting. It suggests that Islamic banks while relatively more stable when operating on a small scale, are less stable when operating on a large scale. A plausible explanation for the above findings is that it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger. Another possibility is that small banks concentrate on low-risk investments and fee income, while large banks do more profit-and-loss (PLS) business.

The above studies prove that Islamic banking is a reality and a strong alternate financial system having solution to the existing financial problems of the world. The empirical studies of 1997-1999 periods have mixed results because during that period Islamic banking was at evolving stage while the empirical studies carried out during 2000-2008 have consistent results in favor of Islamic banking because Islamic banks and financial institutions have taken strong roots in different parts of the world.

4.2 REVIEW OF STUDIES ON CONVENTIONAL BANKING PROFITABILITY

Short (1979) studied the relationship between commercial bank profit rates and banking concentration in Canada, Western Europe and Japan. In his paper he examined the relationship between profitability and concentration for sixty banks in twelve countries during the 1970's. Short (1979) included independent variables that were unique to each country and to each bank. Some of the independent variables included are government ownership and concentration by using an H index to quantify concentration. Results show that the government ownership impact on profitability varied throughout the countries studied but expressed an overall negative relationship. He also found evidence that indicated higher concentration rates lead to higher profit rates (Short, 1979).

Bourke (1989) also compared concentration to bank profitability but included other determinants. Bourke (1989) covered ninety banks in Australia, Europe, and North America: a total of twelve territories between 1972 and 1981. The paper split the determinants of bank profitability in terms of internal and external factors: internal factors such as staff expenses, capital ratio, liquidity ratio, and loans to deposit ratio; external factors such as regulation, size of economies of scale, competition, concentration, and growth in market, interest rate, government ownership, and market power. Bourke also discusses regulation and show how it can be identified in different countries by constructing a matrix and by stating the differences in entry barriers, interest rate restrictions, and credit ceilings. He also discusses industry structure, risk avoidance; value added measures, and economies of scale. His results show that increase in government ownership leads to lower profitability in banking, which corresponds to Short's (1979) findings. In addition, results also reveal that concentration, interest rates, and money supply are positively related to profitability. The results show that capital and reserves of total assets as well as cash and bank deposits of total assets are both positively related to profitability. Bourke adds that well capitalized banks enjoy cheaper access to sources of funds as they are less risky than less capitalized banks (Bourke, 1989).

Molyneux and Thornton (1992) studied the determinants of European banks profitability. The paper examined eighteen countries in Europe between 1986 and 1989. The studied sample included 671 banks in 1986, 1,063 in 1987, 1,371 in 1988, and 1,108 in 1989. This paper replicated Bourke's (1989) work by using internal and external determinants of bank profitability. However, Molyneux and Thornton (1992) results contradict Bourke's findings showing that government ownership expresses a positive coefficient with return on capital (profitability). The other results were similar to Bourke's, showing that concentration, interest rate, and money supply were positively related to bank profitability (Molyneux and Thornton, 1992).

Spathis, Kosmidou, and Doumpos (2002) research work on the profitability factors in the Greek banking system is an interesting study which measures the effectiveness of small and large banks in Greece with the use of ROA, ROE, and Net Interest Margin (MARG) ratios as profitability measures. There were a total of 23 banks - seven large and sixteen small - between 1990 and 1999 using panel data. The results indicate that large Greek banks have a higher ROA and have more access to resources than small banks. Surprisingly, small banks had large ROE and MARG as well as high financial leverage and high capital adequacy (Spathis, Kosmidou, and Doumpos, 2002).

Goddard, Molyneux, and Wilson (2004) confirm the findings of Molyneux and Thornton (1992). Their study investigates the determinants of profitability in six European countries like Denmark, France, Germany, Italy, Spain, and United Kingdom and the study covered 665 banks between 1992 and 1998. The study used cross-sectional and dynamic panel data. The variables used in the regression analysis were ROE, the logarithmic of total assets, Off Balance Sheet (OBS) dividends, Capital to Asset Ratio (CAR). The results from both models were similar: evidence reveals that there is a positive relationship between size (total assets) and profitability. (Goddard, Molyneux and Wilson, 2004).

6. THEORETICAL AND PRACTICAL DIFFERENCES BETWEEN ISLAMIC AND CONVENTIONAL BANKING

Islamic and conventional banking has some basic difference in theory and practice which draws a line of demarcation between the two entities. Although the basic function of the two institutions is to collect savings and transform them into junk amount and then lend to business firms, government, public sector organizations and individuals, yet the mode of the collection of surplus funds from the savers and lending it to the borrowers is different.

In the same way, the two institutions used to lend money to the borrowers but the objective of lending money is also different. For instance, the objective of the conventional bank is to maximize the wealth of the shareholders and in this way accumulate wealth through the institution of interest while the objective of Islamic bank is to stimulate business activities through profit-and-loss sharing and in this way it accelerates circulation of wealth and facilitate distribution of income. The mood and target of credit allocation is different The conventional bank helps concentration and accumulation of wealth in the sense that the net

profit is distributed among shareholders which are few in number and in this way the wealth of shareholders rises exponentially year after year while the profit of Islamic bank is distributed among the depositors which are thousands in number and in this way Islamic bank helps widen distribution of wealth in the society. In other words, Conventional bank accumulates wealth by charging interest from its borrowers who are thousands in number but distributes it among few shareholders. Warde (2006:136) argues that “Conventional banking favors the rich, and those who are already in business, and is only marginally concerned with the success of ventures it finances. In contrast, under profit-and-loss sharing (PLS) system Islamic institutions as well as their depositors link their own fate to the success of the projects they finance. The system allows a capital-poor, but promising, entrepreneur to obtain financing.” These differences make the two institutions totally different from each other. The two institutions operate in the same environment but with different modes of operation and opposite objectives Let us see how Islamic and conventional banks are different in their objectives and operations.

6.1 DIFFERENT MODE OF BORROWING

Conventional banks offer different deposit schemes and borrow funds from the depositors. The rates of interest on these schemes are fixed and the banks are liable to pay these fixed rates of interest to depositors at the completion of term whether they earn profit or suffer loss. The depositors have nothing to do with the loss of bank. However, conventional banks used to pay low return to their depositors and charge high interest from their borrowers in order to maximize their profit, which can be judged from the study of conventional banks in Pakistan. According to the State Bank’s report, 2008, the average weighted deposits rate between 2006 and 2007 in Pakistan was between 2.09 percent to 2.30 percent per annum on interest-bearing deposits while average lending rate was between 11.2% and 11.56% in the same period. The difference between weighted lending rates and deposits rate is 7.82 percent which is highest as compared to 3 percent of international standard. It indicates how much high rates of interest is being charged by conventional banks from the borrowers and are paying very low profit to the depositors. In contrast, Islamic banks paid high return to their depositors and weighted average profit rate on PLS deposits were between 3.56 percent and 3.79 percent. Profit and Loss sharing deposits earns more than one percent high return than interest-bearing deposits.

6.2 DIFFERENT MODE OF FINANCING

Conventional banks provide loans to government, business firms, public sector organizations and individuals. These loans are provided for project-financing, consumer financing and working capital on fixed interest basis. The conventional banks charge high rates of interest on all these types of loans. High rate of interest results in failure of businesses and default of loans. Non-performing loans are the main problem of conventional banking sector in Pakistan and also in advanced economies. According to the State Bank of Pakistan’s State of Pakistan’s Economy-second Quarterly Report,2008-2009,the non-performing loans of conventional banks in Pakistan has increased by Rs.100 billion in just one year,2008 and they have aggregated to Rs.312 billions.Islamic bank also provides funds for project financing, consumer financing and for working capital. But its practice of financing is different from conventional bank. It provides loans on profit-and-loss (PLS) basis. Moreover, Islamic banks provide loans only for productive purpose and can be used for specific objective. The funds provided by Islamic banks cannot be used for gambling, speculation, pornography, alcohol, prostitutions and other such immoral purpose because Islam has prohibited such activities. Molyneux and Iqbal (2005) states that *“Islamic banks cannot finance any project which conflicts with the moral value system of Islam. For example, Islamic banks will not finance a wine factory, a casino, a night club or any other activity which prohibited by Islam or is known to be harmful for the society. In this respect Islamic banks are somewhat similar to “Ethical Funds” now becoming popular in the Western world.”*

6.3 DIFFERENT MODES OF INVESTMENT

Conventional banks make more than 50 percent investment in government Treasury bills, bonds and term finance certificates for security and smooth return. They also earn huge profit from stock market in case of bull-run and suffer badly in case of its crash. In 2008 the investment to deposit ratio of conventional banks in Pakistan were 23.85% as compared to 15.39% of Islamic Banks.

Islamic banks also make investment out of their deposits in different sectors. But this investment is different from conventional banking in a sense that Islamic banks cannot invest in government treasury bills, bonds and Term Finance Certificates which carries fixed rate of interest. Because under Islamic laws Islamic banks can only invest in non-interest bearing financial instruments like equity market and they are prohibited to invest in government bonds and treasury bills. On account of this, Islamic bank has to face twin problems of excess liquidity and market risk. These two factors in past were responsible for low profitability of Islamic bank.

But now the situation has been changed and Islamic bank faces no more such problem due to existence of well-established Islamic money market, Islamic Sukuk and Islamic mutual funds in almost all Muslim countries. Since 2000 about all central banks of Muslim countries have started issuing Islamic Sukuks (bonds) and it has provided an opportunity to Islamic banks to invest their surplus funds in these Sukuks. During 1999 and 2006 four Muslim countries, Pakistan, Malaysia, Bahrain and Qatar issued US\$6.036 billion of sovereign Sukuks (See Table 1).

Issuer	Issue Date	Maturity	Issue Size Millions USD	Coupon	S&P Rating	Percent of Trade Days
Malaysia						
Malaysia Global Sukuk	25-Jun-02	5	600	6m Libor+0.95	A-	23%
Malaysia 2001 (Bond 1)	30-Jun-01	10	1750	7.5 Fixed	A-	90%
Malaysia 1999 (Bond 2)	28-May-99	10	1500	8.75 Fixed	A-	97%
Pakistan						
Pakistan International Sukuk	18-Jan-05	5	600	6m Libor+2.20	B+	45%
Pakistan 2004 (Bond 1)	12-Feb-04	5	500	6.75 Fixed	B+	54%
Pakistan 2006 (Bond 2)	23-Mar-06	10	500	7.125 Fixed	B+	58%
Pakistan 2006 (Bond 3)	23-Mar-06	30	300	7.875 Fixed	B+	56%
Qatar						
Qatar Global Sukuk	30-Sep-03	7	700	6m Libor+0.40	AA-	12%
Qatar 1999 (Bond 1)	13-May-99	10	1000	9.50 Fixed	AA-	85%
Qatar 2001 (Bond 2)	23-Jun-00	30	1400	9.75 Fixed	AA-	95%
Bahrain						
BMA International Sukuk	23-Jun-04	5	250	6m Libor+ 0.60	A	90%
Bahrain 2003 (Bond 1)	21-Jan-03	5	500	4 Fixed	A	98%

Source: *Selim Cakir and Faezeh Raei*, “Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk? IMF working paper No. WP/07/237, Middle East and Central Asia Department, Washington D.C., October 2007.

6.4 DIFFERENT CONCEPT OF MONEY

Conventional bank and Islamic bank uses the money in different way and they have different approaches about the use of money. The conventional bank uses the money as a commodity which is bought and sold and on such two-way transactions they charge interest on it and make huge profit. Margrit Kennedy and Declan Kennedy (1995:17) maintains that

“Every day almost everyone on this planet uses money. Yet few people understand how money works and affects their lives directly and indirectly. Money is one of the most ingenious inventions of humankind as it helps the exchange of goods and services and overcomes the limits of barter, that is, the direct exchange of goods and services. This is good news. But bad news is that money does not only help the exchange of goods and services but can also hinder the exchange of goods and services by being kept in the hands of

those who have more than they need. Thus it creates a private toll gate where those who have less than they need pay a fee to those who have more money than they need. The growth of cancer disease and interest bearing money has similarly in a sense cancer follows exponential growth pattern. It grows slowly first, although always accelerating, and often by the time it has been discovered it has entered a growth phase where it cannot be stopped. Exponential growth in the physical realm usually ends with the death of the host and the organism on which it depends. Based on interest and compound interest, our money doubles at regular intervals, i.e., it follows an exponential growth pattern. This explains why we are in trouble with our monetary system today. Interest, in fact, acts like cancer in our social structure.”

This is a good example how conventional banking system works and uses interest to make money out of money. People who borrow money on interest sometimes commit suicide when they have lost all their assets and have nothing to pay off their loans. In other words, interest is just like cancer and it cripples the human being in the same way as cancer disease.

In contrast, Islamic bank use money as a medium of exchange to facilitate trade transactions. Islamic bank supplies money to traders to purchase real assets and to industrialists to purchase plants or raw material to augment production process and produce value-added products. If the finance-takers generates profit from their business activity they will share it with Islamic bank according to proportion of bank’s financing. If he suffers losses the bank will share the loss. Thus, Islamic bank does not use money to multiply its wealth and it has opposite concept of money.

6.5 DIFFERENT CONCEPT OF RISK-SHARING

Islamic banking is perfectly a risk-sharing (PLS) system because both investor (lender) and entrepreneur (borrower) equally share risk. There is no mismatch between the asset and liabilities of Islamic bank or business firm because their depositors or investors are ready to share loss in case of economic shock. Thus, there is very minimal chance of bankruptcy of Islamic bank or business firm because they have inherent strength to cope with the onslaught of financial turmoil or market disturbance. Whereas the conventional banking is non-risk-sharing system as the investors or lenders have nothing to do with the loss of borrower. They receive fixed rate of interest on their investment and they are not bother where the borrowed money is being spent. In conventional banking, the borrowers are fully responsible to take every kind of risk and bear loss. In case of business failure, he has to loose collateral. Opposite to this practice, Islamic bank or investor is vigilant about the proper use of loan and watch the activities of the borrower because his risk is involved and he can lose total investment in case of business failure or misuse of loan.

6.6 DIFFERENT APPROACHES OF INCOME DISTRIBUTION

The interest-based financial system is a pro-rich and anti-poor because it facilitates accumulation of wealth and resources. The study of advanced capitalist economies has proved that the rich are becoming richer while poor have been kept at subsistence level. During 1960 and 1998 the income of poorest 20 percent of the world population was reduced from 2.3 percent to only 1.2 percent more than 100 percent fall in their income. Whereas the income of the top 20 percent of the world’s population jumped to 89 percent, an increase of about 26 percent. Similarly, the income of super rich in UK was increased by 30 percent, 15 times as fast as inflation in 2003. This top class is just 0.002 percent of UK population. In some countries the concentration of wealth and power has become so enormous that the World Bank has warned of the “inefficiency of such wealth concentration”. Gregory and Stuart (1992:87) in their book “Comparative Economic System” quoted the philosopher, John Rawls, who argues that “an unequal distribution of income persists because those who benefit from income inequality are unwilling to accept changes that favor the poor. People are unwilling to agree to redistribution because those who will be rich know fairly early in life their chances of being rich. For this reason, a social consensus can never be formed whereby the rich agree to redistribute income to the poor”.

Contrary to conventional financial system, Islamic financial system has a clear vision about equitable distribution of resources and amelioration of human being particularly poor class. Zakat, a compulsory tax on the wealth of rich, plays a vital role in eradication of poverty and uplift of the living standard of the poor. The underlying objective of Zakat is to collect money from the rich and distribute it among the poor. The Second Caliph, Hazrat Umar, who first introduced “social security system” in the world, fixed cash allowance and a quantity of essential food items for each citizen including women, children, infants and minorities and distribute extra revenue among them. It made the whole society prosperous and happy. The 2.5 percent Zakat on the wealth of the rich is aimed at discouraging hoarding and concentration of wealth.

6.7 HAVING DIFFERENT OBJECTIVES AND GOALS

The goals of Islamic banking are quite different from the goals of Conventional banking. The core difference between the goals of these two financial systems is that the former works for the benefit of overall society and for equitable allocation of resources through credit distribution while the latter works for the financial uplift of the rich and their owners. Islamic bank works for every one, needing money to start or expand his business or produce value-addition whereas Conventional bank works for a specific class that is rich. The underlying objective of Islamic bank is to earn profit through horizontal distribution of financial resources while the objective of Conventional banks is to maximize its profit by concentrating the resources and charging high rates of interest.

Margrit Kennedy (1995) in his book “Interest & Inflation Free Money” highlights of the goals of Conventional banking by arguing that “Most often bankers impress people with the idea that money should ‘work’ for them. However, nobody has ever seen money working. Work has always been done by people with or without machines. They conceal the fact that dollar which goes to the investor of money is the accomplishment of another person from whom this amount is being taken away, no matter in which way that might happen. In other words, people who work for their money are getting poorer at the same rate at which the investment of those who own money doubles. That is the whole mystery of how money ‘works’ which banks do not like to have uncovered.”

She means that the banks make fortune from the money of the poor people who generate it through their physical work but could not prosper due to the manipulation of bankers. Thus, in conventional banking the flow of resources is towards rich class and ultimate objective of conventional financial system is to concentrate wealth and financial resources into few hands, keeping the majority of the people at subsistence level.

7. PRACTICAL FRAMEWORK OF ISLAMIC BANKING MODEL

7.1 DEFINITION OF ISLAMIC BANKING

Iqbal and Jarhi (2001) define Islamic Bank in the following words:

“An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes funds on the basis of a *mudarābah* or *wakālah* (agent) contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank. On the assets side, it advances funds on a profit-and-loss sharing or a debt-creating basis, in accordance with the principles of the *Sharīfah*. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and date-to-maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank.”

7.2 FUNCTIONS OF ISLAMIC BANKING

1. To collect deposits from the people on profit-and-loss sharing basis.
2. To provide all necessary banking services to its customers.
3. To finance those projects which generates employment?
4. To allocate financial resources (financing) in a way that it ensures equitable distribution of income.
5. To act as a development institution.
6. To promote entrepreneurship by providing finance on profit and loss basis.
7. To transform saving into investment in such a way that it benefits to the majority.
8. To provide expertise and technical advice to the finance-taker in order to improve the process of production and profitability.
9. To disperse financing and discourage its concentration.

7.3 PRODUCTS OF ISLAMIC BANKS

The industry over the years has managed to offer a wide array of products encompassing almost the entire range of Islamic modes of financing that are able to cater to the needs of majority of the sectors of the economy.

7.3.1 SPECIFIC PRODUCTS

ASSETS SIDE PRODUCTS

The segments covered by the industry through various Shariah compliant modes such as

1. Murabaha,
 2. Mudaraba,
 3. Musharaka,
 4. Ijarah,
 5. Diminishing Musharaka,
 6. Salam,
 7. Istisna,
 8. Wakala .
 9. Islamic Export Refinance etc.
- (Please See Table. 10.13) include
- Corporate / Commercial,
 - Agriculture,
 - Consumer,
 - Commodity Financing,
 - SME sector,
 - Treasury & Financial Institutions

Also with the increased issuance of Sukuk by corporate investments of IBIs in these Shariah compliant instruments is on the rise.

LIABILITY SIDE PRODUCTS

On the Liability side, Islamic Banking Industry offers various Shariah compliant deposit schemes that are available for customers to invest their funds. These include

- Current Accounts,
- Basic Banking Account,

- Savings Accounts,
- Term Deposits of various maturities, and
- Certificates of Investment etc.

Current Account is mostly being offered on Qard basis whereas Mudaraba is the preferred mode used by Islamic banks for offering savings accounts, term deposits & certificates of investment.

7.3.2 GENERAL PRODUCTS

Some full fledged banks are also offering investment banking products and services including Sukuk Arrangement, Financial Advisory, Private Placement, Syndication, Trusteeship, Underwriting, Structured Finance, Listing on Capital Markets, Project Financing, Mergers & Acquisitions etc. Further, a variety of other ancillary services are also being offered in a Shariah compliant manner such as

- Bonds & Guarantees,
- Letters of Credit
- Remittances (local & International),
- Online banking,
- ATM/debit card (including Visa),
- Safe deposit lockers and
- Utility bill payments etc.
- Collection of export bills, assignment of export / local bills
- Inter-Bank funds transfer facility through ATM,
- E-Statement facility,
- Lockers,
- Phone Banking and 24 /7 Call Centre service.
- Deposit accepting ATMs

8. DEVELOPMENT OF ISLAMIC BANKING IN PAKISTAN

Pakistan was created in the name of Islam in 1947. All Constitutions of Pakistan have incorporated, within the principles of policy, the elimination of Riba(interest) as an important objective of the State policy. Article 38(f) of the Constitution of the Islamic Republic of Pakistan provides: “The State shall Eliminate Riba as early as possible.” The Objectives Resolution, now a part of the Constitution, as well as principles of policy enunciated in the Constitution also require to establish an order in Pakistan “[w]herein the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and tenets of Islam as set out in the Holy Quran and Sunnah”. In Pakistan Islamic banking emerged as a response to both religious and economic needs. The earliest efforts for finding an alternative to the interest-based system could be found in a number of reports submitted by the Council of Islamic Ideology (CII).

The process of Islamisation of the economy was started in 1980s and mark-up was introduced in place of interest and separate windows were established in all commercial banks to carry out banking practice under profit-and-loss system (PLS). Modarba Companies (Floatation and Control) ordinance, 1980 was enforced and more than 30 Modarba Companies were launched and enlisted at Karachi Stock Exchange. These companies are still operating and paying handsome dividend every year to their shareholders. The successful experience of Modarba Companies and people’s enthusiastic participation in their equity paved the way for initiation of Islamic banking in Pakistan.

8. I BEGINNING OF ISLAMIC BANKING

In 2001 an Islamic Banking Division and Banking Policy Department was established at the State Bank of Pakistan and different practical regulatory and policy measures were taken to promote Islamic banking keeping in view the experience of Islamic banking models working in Saudi Arabia, Malaysia and Bahrain. A formal license in the name of Meezan Bank Limited was issued to operate as a full-fledged Islamic bank

in January, 2002. Later on, a separate department to look after the regulation and promotion of the Islamic banking sector, the Islamic Banking Department (IBD) was established in the State Bank in September, 2003. Under policy guideline 2003 of SBP, five more Islamic Banks named, Bankislami Pakistan Ltd, Dawood Islamic Bank Ltd, Dubai Islami Bank Ltd, Emirates Global Islamic Bank Ltd, were granted permission to start Islamic banking business. Albaraka Islamic Bank was already functioning in Pakistan as a subsidiary of a foreign bank. Thus, total six full-fledged Islamic banks were working in Pakistan by December 2008. Similarly, The State Bank of Pakistan was also allowed existing conventional banks to open separate Islamic banking branches in the country to provide Islamic banking services to their clients. At the moment total 12 conventional banks have also opened their separate Islamic banking branches. The combined branches of Islamic banking of both conventional and Islamic banks have reached 514 by December 30, 2008, which is a tremendous achievement.

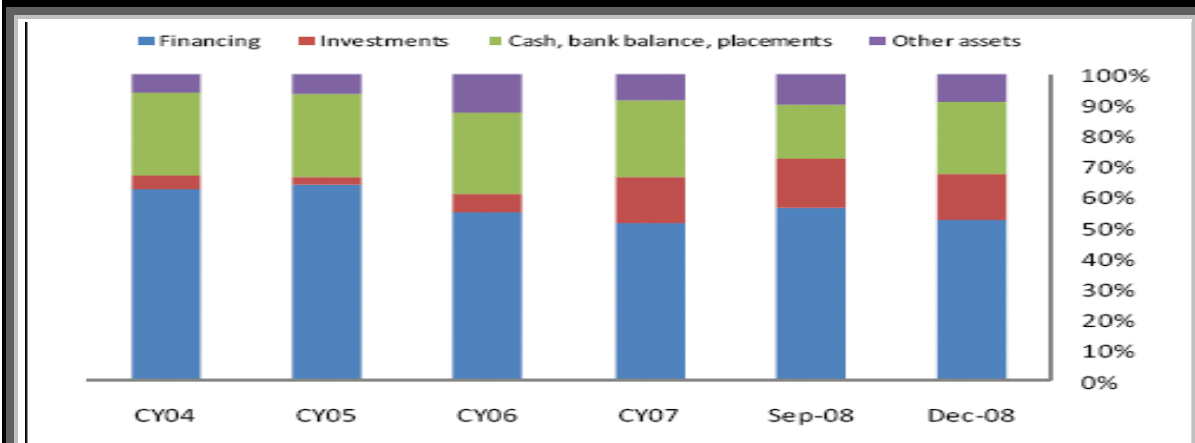
8.2 A GLANCE AT THE BALANCE SHEETS OF ISLAMIC BANKS

Balance sheet is a financial statement that contains all vital information regarding the business operation of any company. It is a vital document to analyze the performance of any company. It is more important for a banking company because it highlights the assets and liabilities of a bank. By analyzing the balance sheet of bank we can measure its strength and weakness

Misbkin (1997:226) argues that “To understand how a bank operates, first we need to examine its balance sheet, a list of the bank’s assets and liabilities. As the name implies, this list has following characteristics: Total Assets+ total liabilities = Capital.

Furthermore, a bank’s balance sheet lists sources of bank funds (liabilities) and uses to which they are put (assets). Banks obtain funds by borrowing and by issuing other liabilities such as deposits. They then use these funds to acquire assets such as securities and loans. Conventional banks earn income through interest while Islamic banks earn profit through equity-based financing and investment. Let us look at the assets of Islamic banks working in Pakistan. The composition of Islamic Banks’ different assets from 2003 to September 2008 is given in the Figure 2

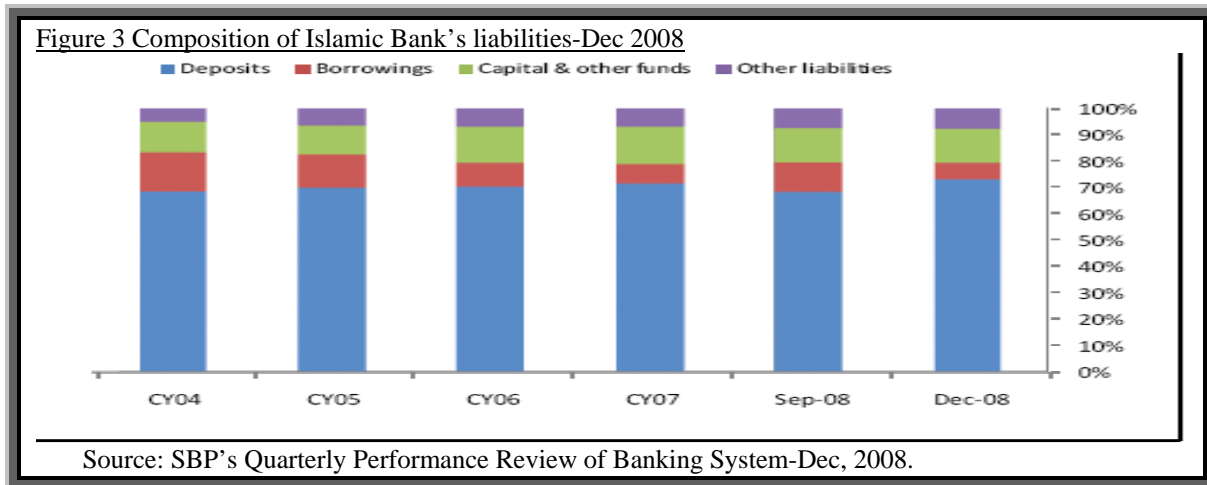
Figure: 2 **Composition of Islamic Banks’ Assets- during 2003- 2008**



Source: SBP Quarterly Performance Review Dec 2008.

The figure shows that the share of financing is 56.6 percent, the share of investment is 16 percent and the share of Cash, Bank Balance and Placement is 17.5 percent in September 2008. This also shows that financing was around 70 percent during 2003-2005 and its share gradually declined to about 58 percent in 2007-2008. The share of investment which was very low during 2004-2006 was jumped to 16 percent in 2008. Similarly cash, bank balance and placements, which was more than 25 percent during 2004-2006 was reduced to around 17 percent in 2008 due to launching of Islamic Sukuks by State Bank of Pakistan and

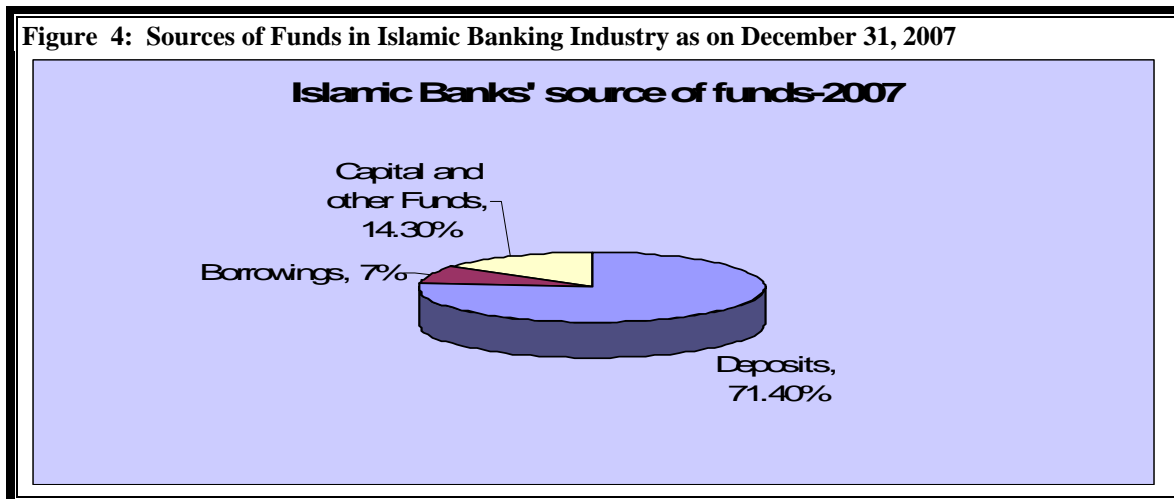
Private Companies. The composition of Islamic Banks' liabilities can be seen in the Figure 3 that shows around 68 percent deposits, 17 percent capital and other funds and 10 percent borrowings



It is pertinent to note that deposits remained around 70 percent of total liabilities of Islamic Bank throughout period from 2003 to September 2008 with slight difference. The major fluctuations were occurred in the share of borrowings and capital during the aforesaid period.

8.3 SOURCES AND USES OF FUNDS

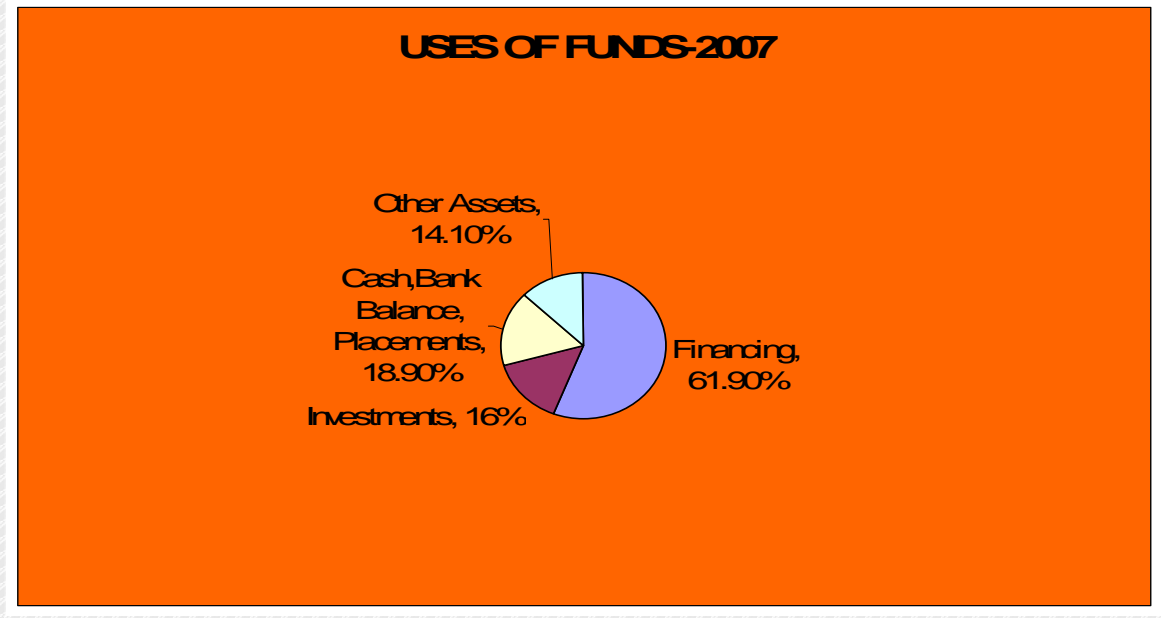
The sources of funds of Islamic banks and bifurcation of their uses are consolidated and presented in the Figure 4 for general analysis.



The Figure 4 shows that Islamic banks generated more than 71 percent of resources through deposits while about 14 percent through capital. While borrowing from other banks and financial institutions was negligible, just 0.7 percent. The low borrowing means that Islamic banks are managing their resources efficiently and are not lending or investing excessively. Similarly, the percentage of financing and investment (lending) is 51.88 and 15 percent respectively. Another worthwhile point is that Islamic Banks are mostly using their capital to meet the cost of the expansion of their branch network and training of human capital. As the start-up cost of every institution is high and there is likely to incur losses. The cash with the Islamic banks is 18.99 percent, which shows strong liquidity position of Islamic banks. However, it indicates that Islamic banks are retaining a large amount of cash idle, which is not good from profitability

point of view. Lack of investment opportunities and risk aversion may be the reason for high percentage of cash retention. How Islamic banks are using their funds can be seen in the Figure 5.

Figure 5: Uses of Funds in Islamic Banking Industry as on December 31, 2007



Note: The Figure 5 was sketched by author on the basis of data collected from SBP Statistics.

A glance at the sources and uses of funds (for end of December, 2007) shows that the deposits and financing continue to dominate the balance sheet of the Islamic Banking Institutions in Pakistan. The Figure shows that Islamic banks have not used all deposits funds in financing but maintained balanced between them. They have used 61.9 percent resources for financing and 16.0 percent for investment while maintaining cash assets of 18.0 percent. However, financing has constituted the major share of the asset portfolio, though the share has decreased over the years from 67% as at end December 2003 to 61.9 % as at end December 2007. While this decline can partly be attributed to monetary tightening, the share of investments in total assets has increased from 9% as at end December 2003 to 15% as at end December 2007. The share of financing has decreased further in 2008 while share of investment has increased.

10. PERFORMANCE OF ISLAMIC BANKS

Islamic banks have recorded consistent growth during our study period-2006-2008. The assets of Islamic banks were increased around 278 percent, nearly 139 percent per year. Advances and investments of Islamic banks recorded growth of 253 percent, about 127 percent per year during the same period. The branch network of Islamic Banks has recorded 333 percent growth during 2006-2008 and total numbers of Islamic banking branches have jumped to 514 by the end of December 2008, which is not less than a miracle in the financial history of Pakistan. Market share of Islamic Banks were increased from 2.5 percent in 2006 to 5 percent of total banking industry in 2008. The 100 percent increase in the market share is itself a solid proof that Islamic banking is gaining momentum and has emerged as a strong alternate financial system to meet the financial requirements of customers and business community under the norms of Shariah Compliance.

It is generally believes that collective figures are misleading and they do not highlight individual performance of any institution or company. In order to mitigate this assumption, we have also examined the individual performance of six Islamic banks by analyzing their key financial indicators. This analysis is tabulated in the Table 2. By glancing at the Table 2 we can easily see how an individual Islamic bank is performing.

Table: 2 Key Financial indicators of Islamic Banks during 2006-2008

ALBARAKA ISLAMIC BANK

	2006	2007	2008
Total assets	18,868	22,077	21,725
Total deposits	13,821	16,964	16,967
Total financing	9,693	12,585	14,266
Total investment	1,166	1,153	1,172
Share capital	1,036	2,046	2,046
Reserves			
Retained earning		400	120
Share holder equity	2191	2444	2141
Net spread(return)	286	385	333
Other income		92	92
Operating Expenses	170	314	338
Profit before tax	170	314	94
Profit after tax	143	245	67
EPS			
No of branches	11	16	22
NPLS	246	226	338
Provisions to NPLS	2.05	182	272
Operating fixed assets	71	102	128

DAWOOD ISLAMIC BANK

	2006	2007	2008
Total assets	2,695	4,433	10,217
Total deposits		1,071	4,947
Total financing	10	1,462	5,750
Total investment		609	2,083
Share capital		3,601	4,001
Reserves		10	17
Retained earning		40	68
Share holder equity	2,686	3,037	4,115
Net spread(return)	121	63	327
Other income	19	9	11
Operating Expenses	97	52	308
Profit before tax	25	12	55
Profit after tax	18	9	35
EPS	0.03	0.06	0.08
No of branches	5	6	17
NPLS	Nil	Nil	1.0
Provisions to NPLS	Nil	Nil	1.0
Operating fixed assets		299	418

EMIRATES GLOBAL ISLAMIC BANK

	2006	2007	2008
Total assets	2,448	7,485	15,370
Total deposits	0	4,271	8,740

BANKISLAMI PAKISTAN

	2006	2007	2008
Total assets	4,025	14,447	17,230
Total deposits	1,778	9,934	11,241
Total financing	959	3,962	6,827
Total investment		3,864	5,018
Share capital	2,000	3,200	4,279
Reserves	0	0	0
Retained earning	8.3	-45	-40
Share holder equity	2003	4248	3844
Net spread(return)	81	185	516
Other income	40.38	68.82	167
Operating Expenses	159	510	680
Profit before tax	-34	-100	38
Profit after tax	-8.3	-37	6.2
EPS	-0.04	0.13	0.13
No of branches	16	40	102
NPLS		78	29.
Provisions to NPLS		20	13
Operating fixed assets	441	1,093	1,536

DUBAI ISLAMIC BANK PAKISTAN

	2006	2007	2008
Total assets	8,434	17,068	28,209
Total deposits	43,22	12,421	22,952
Total financing	3,279	7,029	17,566
Total investment	0.832	2,090	3,021
Share capital	3,917	4,672	5,126
Reserves	0	0	0
Retained earning	411	780	981
Share holder equity	3,530	3,930	4,144
Net spread(return)	66	336	953
Other income	19	173	123
Operating Expenses	323	515	1318
Profit before tax	323	515	301
Profit after tax	211	340	201
EPS	1.27	0.86	0.39
No of branches	10	16	22
NPLS		10.09	159.643
Provisions to NPLS		75	176
Operating fixed assets	661529	1244	1547249

MEEZAN BANK

	2006	2007	2008
Total assets	46439	67,179	76,421
total deposits	34449	54,582	61,391

Total financing	656	920	8,820	Total financing	27031	34,576	40,006
Total investment	0	2091	2,758	Total investment		10,535	13,646
Share capital	250	3,000	4,500	Share capital	3780	3,780	4,535
Reserves	0	0	0	Reserves		720	826
Retained earning	-130	-168	-297	Retained earning		1,219	884
Share holder equity	2,359	2,831	4,202	Share holder equity	4,763	5,720	6,246
Net spread(Return)	8.6	177	386	Net spread(return)	1,240	2,122	2,439
Other income	0	26	83	Other income	418	714	337
Operating Expenses	88	243	612	Operating Expenses	1,028	1,765	1,825
Profit before tax	80	40	152	Profit before tax	780	1,269	750
Profit after tax	49	37	109	Profit after tax	604	963	526
EPS	-3.2	-0.16	-0.25	EPS	1.88	2.55	1.26
No of branches		9	27	No of branches	62	100	160
NPLS	0	0.7		NPLS	408	553	1,755
Provisions to NPLS	0	4	9.3	Provisions to NPLS		219	254
Operating fixed assets	656	920	1,515	Operating fixed assets		1,032	1,457

Note: The author collected this data from the annual and quarterly Reports of Islamic Banks for the period 2003 to 2008 and consolidated it into the present form.

10. PERFORMANCE OF SELECTED CONVENTIONAL BANKS

In this section, We will examine the combined performance of six selected Conventional Banks(SCBs), namely, Askari Commercial Bank, Atlas Commercial Bank, Bank of Khyber, KASB Bank, Samba Bank and Saudi Pak Commercial Bank for the period starting from September 30,2006 to September 30,2008. The underlying objective of the analysis of the performance of selected conventional banks (SCBs) is to examine how these banks are performing vis-à-vis six newly formed Islamic Banks. This analysis will help us compare the performance of SCBs with Islamic Banks and draw some conclusion which segment of banking sector is doing well and what the key financial indicators predict about their future prospect. When we look at different components of combined balance sheet of SCBs we find that total combined share capital of six selected conventional banks were Rs.16.03 billion in September 2006, which were increased to Rs.26.717 billion in September 2008 to meet Capital Adequacy Requirement (CAR) set by the Central Bank.

The number of branches of SCBs was 275 in 2006 and they were increased to 359 by September 30, 2008, an increase of about 30 percent. Total 84 branches were added by Selected Conventional Banks during 2006 and 2008. The combined assets of SCBs were increased from Rs.308 billion in 2006 to Rs.396.35 billion in 2008, an increase of about 12.85 percent. The deposits of SCBs were increased from Rs.235.62 billion in 2006 to Rs.307.65 billion in 2008, an increase of about 30 percent. The advances/loans of SCBs were increased from Rs.162.15 billion to Rs.228.43 billion in 2008, an increased of about 41 percent. The net interest income of SCBs was Rs.4.16 billion in September 2006, which was decreased to Rs.3.61 billion in 2008, a decrease of 15.19 percent. The decline in net interest income means the decline of core banking business of conventional banks because interest income is the main source of revenue of conventional banks. Total combined expenditures of SCBs were more than doubled during 2006 and 2008 and jumped from Rs.4.73billion in 2006 to Rs.9.24 billion in 2008, an increase of 96 percent. The profitability situation of selected conventional banks in 2008 was very bleak because the combined net profit of SCBs was fallen from Rs.1.84 billion in September 2006 to loss of Rs.Rs.1.99 billion in September 2008. The Earning per Share (EPS) which was positive in 2006, i.e.,Rs.1.22 was turned into negative Rs.2.05.in 2008. The profitability indicators of SCBs are explained in the Table 3 that highlights the bleak picture of the individual profitability of SCBs.

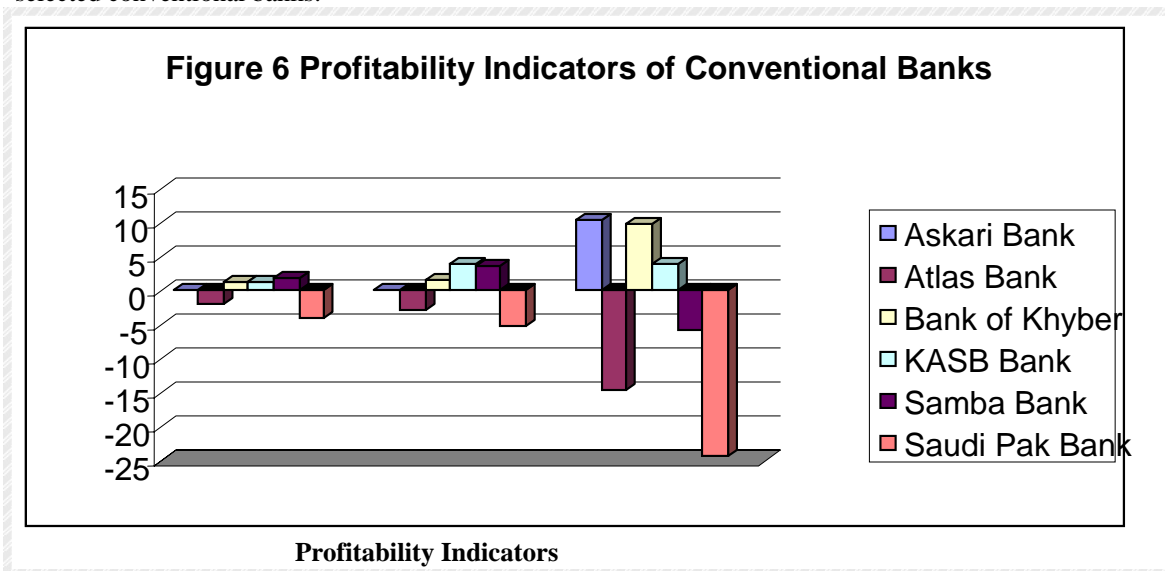
Table: 3 **PROFITABILITY INDICATORS OF SELECTED CONVENTIONAL BANKS**
EARNING RATIOS

Name of Banks	ROA	ROD	ROE	EPS
1. Askari Bank Ltd	0.21	0.26	9.53	0.95

2. Atlas Bank Ltd	-1.88	-2.74	-14.41	-0.66
3. Bank of Khyber	1.17	1.67	9.89	0.27
4. KASB Bank	1.29	-2.07	-23.25	-2.43
5. Samba Bank	-1.84	-3.58	-5.68	-0.38
6. Saudi Pak Com. Bank	-4.10	-5.06	-24.10	-2.83
Average	-5.11	-5.63	-8.00	-3.93

Note: These ratios are calculated by the author from third quarterly and annual Reports of selected conventional banks for the year 2008.

Table 3 shows poor profitability of conventional banks although they are standing in the market for a long time vis-à-vis newly formed Islamic Banks. Even Askari Commercial bank, which is regarded as one of strong banks, has shown poor performance in 2008 and generated just 0.95 earning per share while Saudi Pak Commercial Bank has generated negative 2.05 earning per share. We have pictured the profitability indicators of conventional banks in the Figure to highlight the performance of individual performance of selected conventional banks.



The situation of non-performing loans (NPLs) of SCBs is very disappointing because they were increased to around 220 percent from Rs.11.82 billion to Rs.26.02 billion during two years period of 2006-2008. The total amount of NPLs is nearly equal to total capital of SCBs. It means that NPLs have swallowed total capital of selected conventional banks and the shareholders of the most of SCBs do not expect dividend in near future. This factor may become a cause of insolvency or lead to merger with other banks in future. The bifurcation of NPLs of SCBs is stated in Table 4.

TABLE 4 NON-PERFORMING LOANS OF SELECTED CONVENTIONAL BANKS AS ON SEPTEMBER 30,2008

<u>Name of Bank</u>	<u>Amount in Rs.000</u>
Askari Bank Ltd	Rs.10,961,631
Atlas Bank Ltd	Rs. 495,370
Bank of Khyber Ltd	Rs. 2,033,061
KASB Bank Ltd	Rs. 1,472,072
SAMBA Bank Ltd	Rs. 2,412,450
Saudi Pak Commercial Bank Ltd	Rs. 8,853,615
Total =	Rs.26,228,203

The above table shows that the performance of Askari Bank and Saudi Pak bank was worse because their share in total NPLs of selected conventional banks is 76 percent, which is too much. The other key performance indicators of selected conventional banks are tabulated in the Table 5 for comparison purpose.

Table 5 Comparison of the Financial Ratios of Islamic and Conventional Banks

<u>Indicators</u>	<u>Islamic Banks</u>	<u>Conventional Banks</u>
<u>EARNING RATIOS</u>		
Returns on assets	0.47	-0.75
Return on deposits	0.42	-0.75
Return on equity	7.78	-2.27
Earning per share	0.94	-0.34
<u>ASSET QUALITY RATIOS</u>		
Non-performing loans (NPLs)	Rs.790,654 million	Rs.26.228 Billion
NPL to advances	1.06	5.88
Provisions to NPLs	47.09	40.89
<u>DEBT MANAGEMENT RATIOS</u>		
Debt to Equity	2.3	8
Deposit time capital	3.57	5.71
Debt to Assets	0.78	0.85
<u>LIQUIDITY RATIOS</u>		
Earning assets to total assets	0.95	0.93
Advances to deposits	0.83	0.70
yield on earning assets	1.81	-0.27
<u>SOLVENCY RATIOS</u>		
Equity to total assets	21.78	14.59
Equity to deposits	36.2	20.09
Earning assets to deposits	143.79	115.98

Note: The author calculated these ratios from the data taken from third quarterly Reports of Islamic and Conventional Banks for the period September 30, 2008.

11. COMPARISON OF FIANCIAL RATIOS OF ISLAMIC AND CONVENTIONAL BANKS

Kenneth and Gustafson (1992) argue that “An analysis of the firm’s financial ratios is generally the key step in a financial analysis. The ratios are designed to show relationships among various indicators. Different analysts use these ratios widely in their empirical studies to measure the performance and

profitability of banks but they have given them different names. For example, Sudantaron (1996) named these ratios as “determinants of profitability of Islamic banks” while Hamid (1999) build his comparative studies on the basis of “financial accountancy ratios”. Bashir and Hassan (2004) named them as determinants of Islamic banking profitability and used financial ratios like RAD, ROD and ROF as profitability indicators of Islamic banks. Iqbal (2001 and 2004) used ratios analysis like capital assets ratio, liquidity ratios, deployment t ratio, cost finance ratio, and profitability ratio like ROA and ROE to measure and compare the performance and profitability of Islamic and conventional banks in Gulf countries. We have also used these financial ratios in our study to compare the performance and profitability of Islamic and selected conventional banks. Let us start the comparison of these ratios.

1. COMPARISON OF EARNING RATIOS

The Earning ratios indicate the condition of the profitability of banking institutions. Mostly four financial ratios like Return on Assets (ROA), Return on Deposits (ROD), Return on Equity (ROE) and Earning per share (EPS) .The first two ratios indicate what rate of profit the bank is earning on its assets and deposits. These two ratios indicate how much the banks are generating profit through efficient employment of its resources. It the rate of return on assets and advances is handsome it means that the assets and deposits are being used properly and bank’s business is growing. The rest of two ratios ROE and EPS are also very important. But these are weighted by owners and shareholders of the banks because high ROE and EPS mean high dividends and pay-outs now and in future. These two ratios are calculated on the basis of net profit of the bank. The investors also give much importance to these two ratios when they decide to buy the shares of any company listed on Stock Exchange.

The profitability indicators of Islamic banks depicts healthy picture. For example, the ROA and ROD of Islamic banks are 0.47 and 0.42 percent respectively while the return on equity (ROE) and Earning per Share (EPS) are more promising, predicting handsome dividend for the shareholders of Islamic banks in near future. The ROE is 7.78 percent while EPS of Islamic Banks is around 0.94 percent and yield on earning assets is 1.81 percent as is shown in Table 6.

**Table: 6 - PROFITABILITY INDICATORS OF ISLAMIC BANKS
EARNING RATIOS**

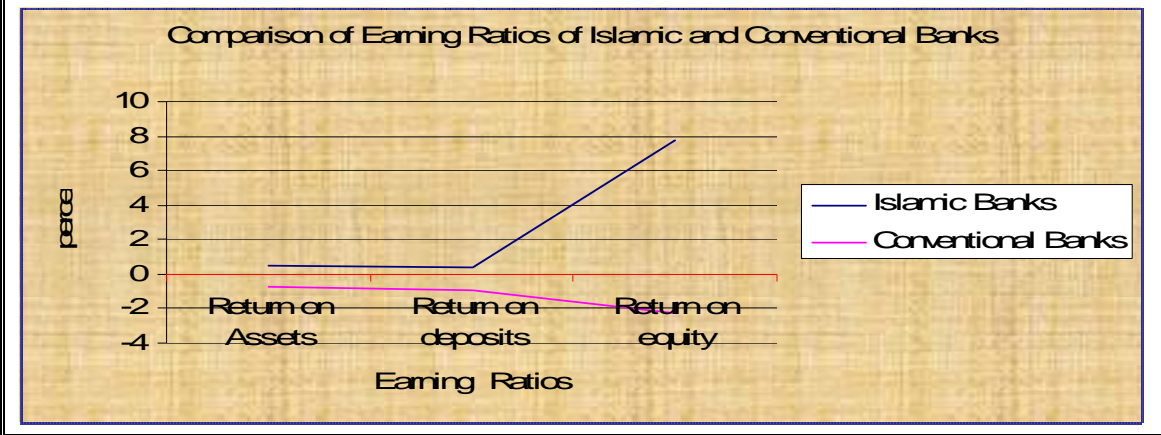
	ROA	ROD	ROE	EPS	-----	-
ALBARAKA ISLAMIC BANK	0.84	0.94	3.27	0.33		
BANKISLAMI PAKISTAN	0.03	0.05	0.14	0.01		
DAWOOD ISLAMIC BANK	0.34	0.76	0.87	0.08		
DUBAI ISLAMIC BANK	-0.71	-0.87	- 3.92	-0.39		
EMIRATES GLOBAL	-0.71	1.25	-4.17	.025		
MEEZAN BANK	0.68	0.85	11.59	1.26-		
AVERAGE	0.079	0.07	1.297	0.38		

Note: These calculations were made by the author from the data extracted from the un-audited quarterly accounts for the period ended September 30, 2008 of six Islamic banks.-----

When we look at the earning ratios of selected conventional banks we find that all these ratios are negative. For example, Return on Assets (ROA) of six conventional banks is minus 0.75 percent while Return on Deposits (ROD) is also minus 0.93 percent. Similarly, the Return on Equity (ROE) of conventional banks is minus 2.27 percent while the Earning per Share (EPS) is minus 0.34 percent. The amazing point is that the yield on earning assets of Conventional banks is negative and is around minus 0.27 percent. The negative yield is meant that the assets of Conventional banks are not earning desired rate of profit and their advances are suffering losses due to high rate of defaults.

The comparison of the profitability indicators of Islamic and selected conventional banks has been given in the Figure 7

Figure:7



The negative earning ratios is meant that the conventional banks are suffering losses due to rising NPLs, imprudent lending practice and negligence in recovery of advances. Thus the profitability indicators of Conventional Banks depict a dismal picture.

2. COMPARISON OF ASSET QUALITY RATIOS

Assets quality ratios reflect the qualities of assets of the bank and productive and efficient utilization of available resources. Generally four ratios are used to measure the quality of assets. These ratios are the amount of total non-performing loans (NPLs), ratio of NPL to advances/ financing, ratio of provisions to NPLs and ratio of NPLs to deposits.

When we look at total amount of selected Conventional Banks we find a very dismal picture because their NPLs amount on Sept. 30, 2008 was Rs.26.22 billion, which is huge alarming. It shows that Conventional banks are not prudent in their lending and inefficient in recovery of their defaulted loans. In contrast, total amount of non-performing loans (NPLs) of six Islamic Banks are Rs.790 million, which is 0.03 percent of the NPLs of conventional Banks. It means that the default rate of Islamic Banks loans is very low and their lending and recovery policy is strict and efficient.

Similarly, there is big difference in other three ratios. For instance NPLs to advances of Conventional Banks is 5.88 percent against just 1.06 percent of Islamic Banks. Provisions to NPLs by Islamic Banks are 47.09 percent as compared to 40.89 percent of Conventional. High provisioning policy of Islamic Banks makes their balance sheets healthier, transparent and reflects true picture of their assets.

Table 7 shows the comparison of the NPLs of Conventional and Islamic Banks.

TABLE 7 COMPARISON OF NPLS OF CONVENTIONAL AND ISLAMIC BANKS

**NON-PERFORMING LOANS OF SELECTED CONVENTIONAL
BANKS AS ON SEPTEMBER 30, 2008**

<u>Name of Bank</u>	<u>Amount in Rs.000</u>
Askari Bank Ltd	Rs.10,961,631
Atlas Bank Ltd	Rs. 495,370
Bank of Khyber Ltd	Rs. 2,033,061
KASB Bank Ltd	Rs. 1,472,072
SAMBA Bank Ltd	Rs. 2,412,450
Saudi Pak Commercial Bank Ltd	<u>Rs. 8,853,615</u>
Total =	<u>Rs.26,228,203</u>

NON-PERFORMING LOANS OF ISLAMIC BANKS

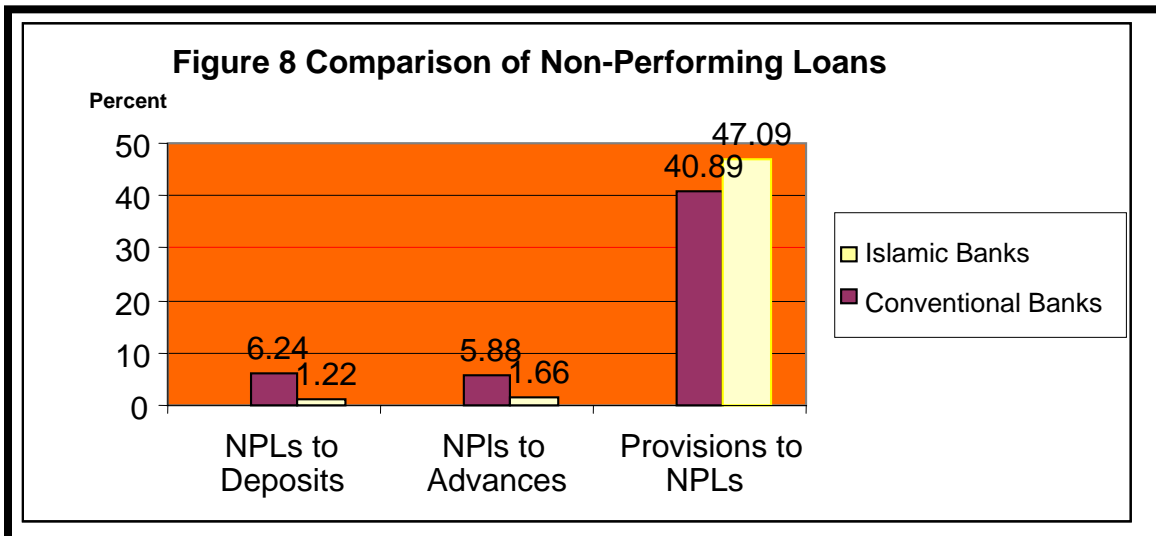
AS ON SEPTEMBER 30,2008

<u>Name of Bank</u>	<u>Amount in Rs.,000</u>
ALBARAKA ISLAMIC BANK	Rs. 356,614
Bankislami Pakistan	Rs. 120,658
Dawood Islamic Bank	Rs. 1,000
Dubai Islamic Bank	Rs. 277,662
Emirates Global Islamic Bank	Rs. 9,200
Meezan Bank	<u>Rs. 254,000</u>
Total =	<u>Rs. 790,654</u>

Source: Annual Reports of Selected Conventional and Islamic Banks, 2008

The comparative data of NPLs of Islamic and conventional banks is plotted in the following Figure 8 for visualization of readers.

Comparative data of NPLs of Islamic and conventional banks has been plotted in Figure 8 for further illustration.

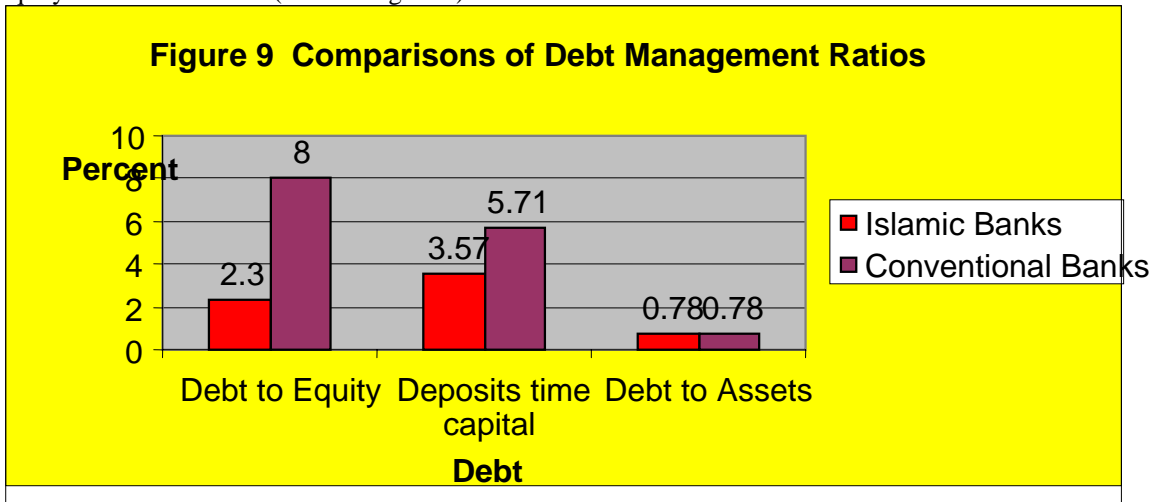


Moreover, NPLs to deposits ratio of Conventional Banks is 6.24 percent as compared to 1.22 percent of Islamic Banks. It reflects the reckless lending practice of Conventional banks and this is one of the main causes of their existing liquidity problem.

2. COMPARISON OF DEBT MANAGEMENT RATIOS

The indicators of debt management ratios show total amount of debt of the bank that is consisted on deposits and borrowing from other financial institutions or money market, bills payables and subordinated loans. The debt to equity ratio is very important because it indicates the capacity of bank to meet its obligations in case of bank run or default of b by big borrowers. If we compare the above ratios of Islamic and Conventional banks we find that the amount of debt of Islamic banks is less than those of Conventional Banks. Islamic Banks' debt to equity ratio is 2.3 percent as compared to 8 percent of Conventional Banks. Deposit time capital of Islamic and Conventional banks is 3.67 and 5.71 percent respectively while debt to assets ratio of Islamic banks is 0.78 percent as against 0.85 percent of Conventional banks. All three ratios of Islamic banks are healthy and the amount of their debt vis-à-vis their assets are not very high. For example, the equity and debt of Islamic Banks are 31.29 and 68.70 percent respectively against 17.16 percent equity and 82.83 percent debt of Conventional banks. The combined deposits of six Islamic Banks on September 30, 2008 were Rs.126.24 billion against Rs.307.658 billion of Conventional Banks. Though

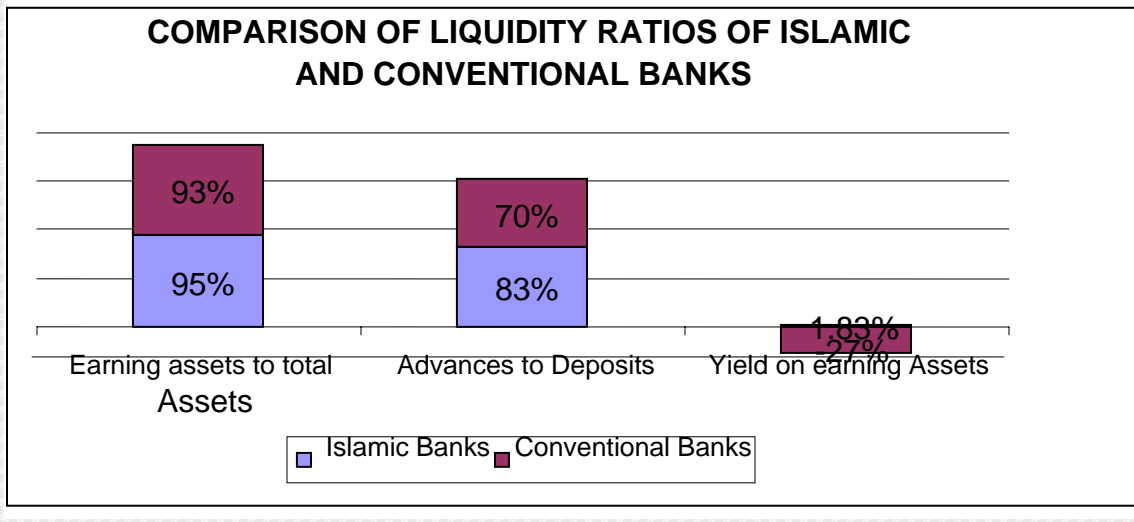
Islamic banks are far behind from Conventional Banks in deposit mobilization due to their recent start-up, yet they are nearly at par with Conventional Banks in Capital and Equity. The combined equity of six selected Conventional Banks on September 30, 2008 was Rs26, 747 billion as compared to Rs.25.13 billion equity of Islamic Banks. (See the Figure 9)



4. COMPARISON OF LIQUIDITY RATIOS

The comparison of the liquidity ratios of Islamic and Conventional banks reveal high ratio of earning of Islamic Banks vis-à-vis Conventional Banks. The Earning assets of Islamic Banks are 95 percent as compared to 93 percent earning assets of Conventional Banks. The ratio of advances to deposits for Islamic and Conventional Banks is 0.83 and 0.70 percent respectively. The point to be noted is that Islamic banks' financing is 83 percent of their assets as compared to 70 percent of Conventional banks.. Figure 10 highlights this fact.

Figure 10



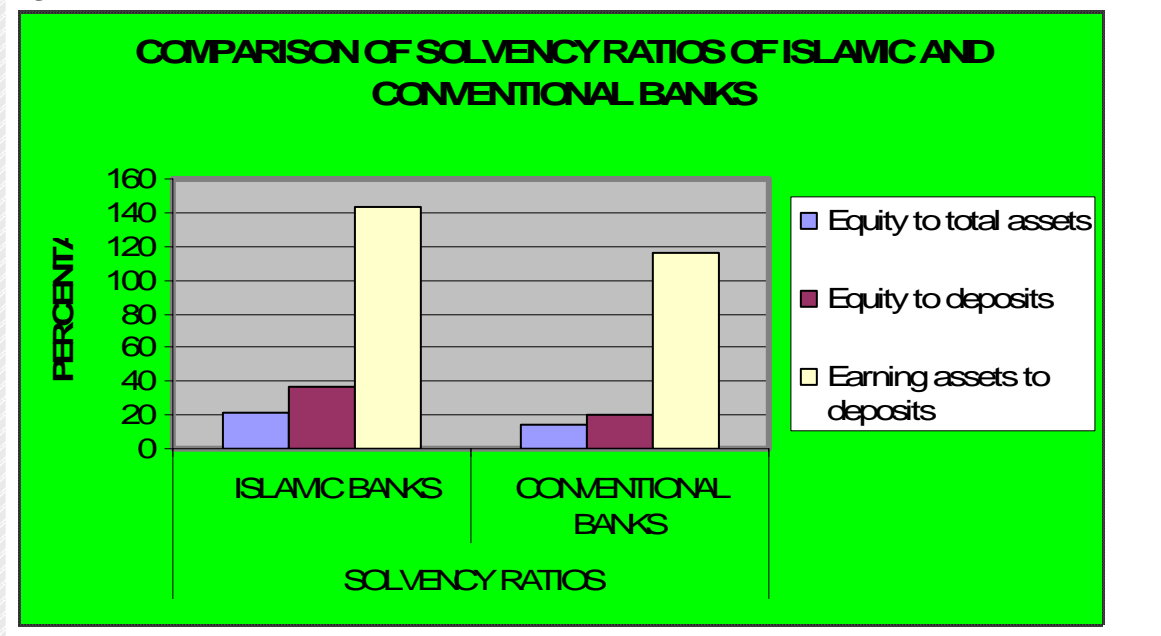
Inspite of high percentage of financing, the default rate of Islamic banks' financing is very low. Whereas the conventional banks are facing problem of high rate of default inspite of low percentage of their lending.

5. COMPARISON OF SOLVENCY RATIOS

Simons (1985:149) states that “A Company is solvent if the break-up value its total assets exceeds its total liabilities. In such a case, all the creditors of the company would be capable of being paid in full. The degree of solvency of a company is qualified by its “Solvency Ratio”, which is the percentage of the total assets, represented by share capital. The optimum solvency ratio is that on which earning on share capital could be maximized.”

The solvency ratio of Islamic banks is far better than selected conventional banks. For example, equity to total assets of the ratios of Islamic banks is 21.78 percent while the same is 14.59 percent for Conventional banks. The equity to deposits ratio of Islamic and Conventional banks is 36.2 and 20.09 percent respectively. Similarly, the earning assets to deposits ratio of Islamic banks are 143.79 percent as compared to 115.98 percent of Conventional Banks. The Figure 11 depicts the comparative solvency ratios of Islamic and Conventional Banks.

Figure 11



The high ratio of equity to total assets and deposits reflects strong solvency condition of Islamic Banks. Moreover, the 144 percent earning assets to deposits also proves the fact that Islamic banks are working on strong footing and they have built-in capacity to cope with any challenge or sudden credit or market shocks. The capital adequacy ratio (CAR) of the Islamic banks is 21.78 percent, which is far above from the regulatory benchmark of 9 percent set by the State Bank of Pakistan for all banks with effect from December 30, 2008. The substantially higher ratio for some banks indicates their reliance on capital for expanding their business. All Islamic Banks also meet the existing minimum capital requirement (MCR), which is Rs.5.0 billion, except Albaraka Islamic Bank, which is allowed to operate with a paid-up capital of Rs.2.0 billion in its capacity as a branch of a foreign bank. Thus, the capital base ensures that these banks are well-equipped to meet different kinds of shocks.

6. COMPARISON OF CASH TO DEPOSIT RATIO

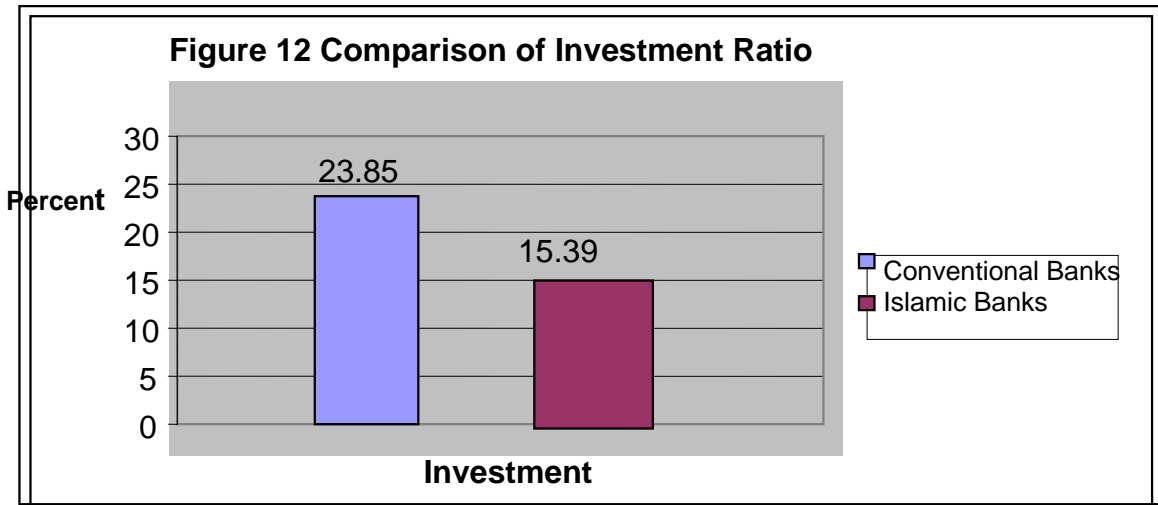
It is generally believed that Islamic banks have excess liquidity due to lack of investment opportunities and this is one of the causes of the low profitability of Islamic Banks. But our study found slight difference between the cash assets of Islamic and Conventional Banks. For example, at the end of September 30, 2008, the combined cash and balance with Treasury of conventional banks was 11.55 percent as compared to 12.55 percent of total assets of Islamic banks which is minor difference of just one percent. Thus, our empirical study shows that there is no truth in general impression that Islamic banks have excess liquidity and face the problem of lack of investment opportunities. The comparison of Cash and Bank balance of Islamic and Conventional banks are given in the Table 8.

ISLAMIC BANKS	CASH & BANK BALANCE	CONVENTIONAL BANKS	CASH & BANK
1. Albaraka Islamic Bank	Rs.3, 276,754	Askari Bank Ltd	Rs.21, 311,410
2. Bankislami Pakistan	Rs.1, 389,615	Atlas Bank Ltd	Rs. 2,858,129
3. Dawood Islamic Bank	Rs. 605,504	Bank of Khyber	Rs. 2,053,859
4. Dubai Islamic Bank	Rs.2, 567, 980	KASB Bank	Rs. 4,400,711
5. Emirates Global Bank	Rs.1,238,217	Samba Bank	Rs. 928,962
6. Meezan Bank Ltd	Rs.6,706,241	Saudi Pak Bank	Rs. 4,010,450
Total =	Rs.15.78 Billion		Rs.35. 55 billion
Total Deposits as on Sept 30, 2008	Rs.126.24 billion		Rs.307.55 billion
Cash to deposit Ratio	11.55 percent		12.5 percent

Note: These calculations were made by author on the basis of data given in third quarterly and Annual Reports, 2008.

8. COMPARISON OF INVESTMENT TO DEPOSIT RATIO

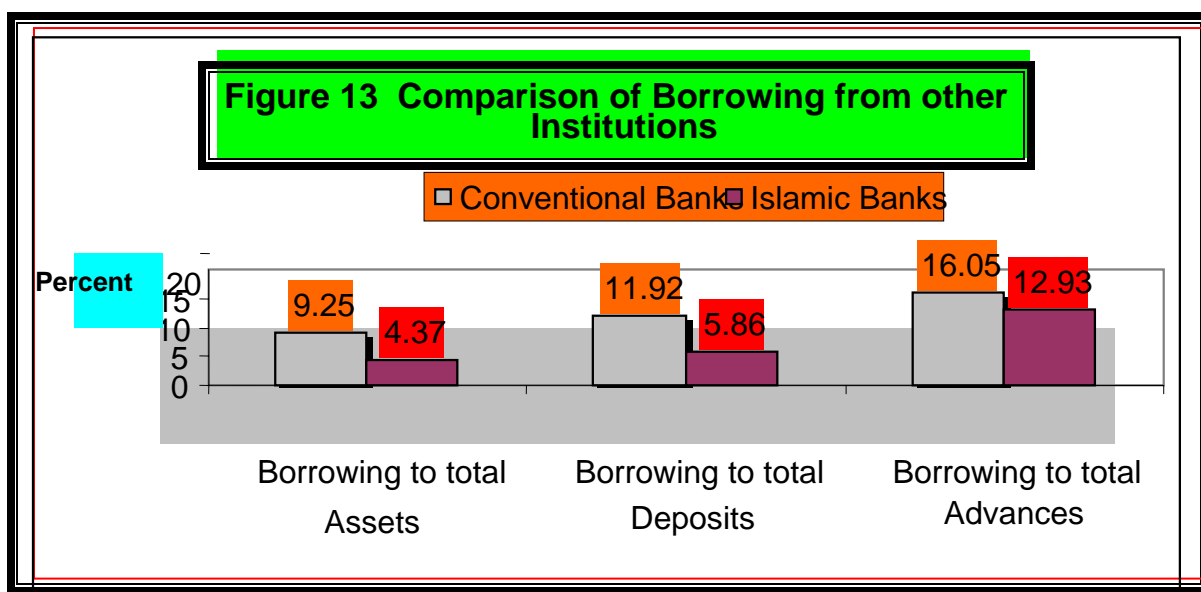
The investment to deposit ratio means is the percentage of the amount of deposits to be invested in different financial instruments. The conventional banks mostly invest in the Government fixed-income securities, private Term Finance Certificates and in equity markets while Islamic banks mostly invest in sovereign and private Islamic Sukuks (bonds), equity market and other Islamic instruments. When we look at the investment portfolio of conventional banks we find that conventional banks have invested 23.85 percent of their deposits and 9.25 percent of their total assets in fixed income and other securities. While Islamic Banks have invested 15.39 percent of their deposits and 4.37 percent of their total assets in Islamic Sukuks,etc. This comparison clearly shows the lack of investment opportunities for Islamic banks the ratio of their investment is far less than the investment portfolio of conventional Banks. However, high percentage of financing by Islamic banks compensates them otherwise they are not able to earn profit on their idle cash assets. Comparison of the percentage of investment to total deposits of Conventional and Islamic Banks has been sketched in the Figure 12



9. COMPARISON OF BORROWINGS RATIO

The banks do not only collect deposits from the people but they also borrow funds from other institutions through money market to meet their urgent needs. The banks having excess liquidity lend money to other banks facing liquidity shortage. Mostly banks borrow funds from money market when inter-bank interest rate is low. But when the interest rate is high and liquidity is scarce the banks will have to offer high rates to collect deposits from general public. When any bank is borrowing more from money market it means that it is facing liquidity crunch. Now we compare the borrowing of both Islamic and conventional banks.

The borrowing to total assets of Conventional Banks is 9.25 percent as compared to 4.37 percent of Islamic Banks. The borrowing to total deposits of Conventional Banks is 11.92 percent as compared to 5.86 percent borrowings of Islamic Banks. The borrowing to total advances of Conventional banks is 16.05 percent against 12.93 percent borrowings of Islamic Banks. Thus, there is a wide gap between the percentage of borrowing of conventional banks and Islamic Banks. It means that Islamic banks is relying more on their own resources and having sufficient funds to discharge their obligations as compared to conventional banks which are borrowing heavily. It also shows that conventional banks are facing liquidity crunch. This fact has been pictured in the Figure 13.



11. FINDINGS AND RESULTS

In previous section we have compared the performance of Islamic and conventional banks in the light of key financial ratios. . In this section we will describe findings and results of our study by comparing the financial indicators of Islamic and conventional banks. The numerical ratios of these indicators have been calculated on the basis of data collected from third quarterly financial statements of Islamic and selected conventional banks (SCBs) for the period ended September 30 2008 and consolidated it into the table 5 . In this section we will discuss finding and results in the light of five main ratios, namely, earning ratios, assets quality ratios, debt management ratios, liquidity ratios and solvency ratios.

We start from Earning Ratios that consisted of four ratios like ROA, ROD, ROE and EPS. The return on assets (ROA) of Islamic banks is 0.47 as compare to negative -0.75 of conventional banks. The return on deposits (ROD) of Islamic banks is 0.42% as compare to minus -ROD of 0.93% for conventional banks. The return on equity (ROE), which is a core indicator of profitability from dividend point of view, is 7.78% for Islamic banks against minus -2.27% for conventional banks. The earning per share of Islamic bank is 0.94% as compare to negative EPS of -0.34%. The yield on earning assets of Islamic banks is 1.81 percent as compared to minus 0.27 percent of Conventional banks. Thus all profitability indicators of Islamic banks are positive while the same indicators of conventional banks are negatively. The positive profitability indicators of Islamic banks indicate the future potential and high profitability as well as handsome dividends for sponsors and shareholders. These results are in consistent with the finding of Sudin Haron (1996)who argued that “ conventional banking theory postulates that the bigger the market, the more profit the banks earn, this theory is not necessarily true for Islamic banks which performs well due to efficient use of capital in short-term financing. Similarly, Islamic banks in a competitive market are better managed than those in the monopolistic markets.” Our results are also confirmed his contention that “Islamic banks in a competitive market are better managed and performed well than conventional banks”.

Next, we examine the assets quality of Islamic and conventional banks. We find that conventional banks are not employing their assets efficiently because aggregate amount of their non-performing loans (NPLs) stands at Rs26.22 billion. This high amount of NPLs indicates imprudent lending behavior and inefficient recovery of loans by conventional banks. It also indicates that assets allocation is not diversified and growing NPLS is major cause of their losses. In contrast, total NPLS of Islamic banks on September 30, 2008 were only Rs.790 million which is only 0.3% of SCBs’ NPLS. It confirms that Islamic banks’ loan portfolios and allocation of credit is diversified and recovery of loans is prompt. Similarly NPLS to financing/advances ratio of Islamic banks is 1.06 percent as compared to 5.88 percent of SCBs. This ratio of SCBS is 4.28% more than Islamic banks. Provision to NPLS of Islamic banks is 47.0p percent as against 40.89 percent of conventional banks. This shows that assets quality of Islamic banks is better and the balance sheets of Islamic banks are more transparent.

As regarded to debt management ratios; we find debt to equity ratios of Islamic banks around 2.3 percent against 8 percent of conventional banks. Deposits time capital for Islamic banks is 3.57 percent as compared to 5.71 percent of conventional banks... Similarly, debt to assets for Islamic banks is 0.78% as compared to 0.85% of conventional banks. All three ratios at the moment are favorable for Islamic banks because their debt is low and capital is high as compared to conventional banks. This factor makes the position of Islamic banks strong and strengthens their capability to absorb sudden shocks.

The liquidity ratios of Islamic bank are also better and demonstrates healthy state of affairs. For example earning assets to total assets of Islamic banks are 96 percent as compared to 93 percent of conventional banks. Likewise, Advances to deposits ratio of Islamic banks is 83 percent as compared to 71 percent of conventional banks. It indicates that Islamic banks use 83 percent of their deposits which is 13% more than the lending of conventional banks. The Yield on earning assets of Islamic Banks is 1.81% as compared to minus yield of -0.27% of conventional banks. The negative yield of SCBs is the result of high non performing loans. This predicts further deterioration of conventional banks’ profitability in near future.

Another important financial indicator is solvency ratio. Solvency ratio is the percentage of total assets as it indicates the performance of banks and its future earning potential. It also indicates how much share capital is being used efficiently to maximized profit. Under solvency ratios head we will discuss three ratios:

Equity to total assets, Equity to deposits and Earning assets to deposits. The equity to total assets of Islamic Bank is 21.78 percent as compared to 14.59 percent of conventional banks. Equity to Deposits ratio of Islamic banks is 36.20 percent against 20.09% of conventional banks. The earning assets to deposits ratio of Islamic Banks is 143.79% as compared to 115.9 percent of conventional banks.

Thus, Equity to total assets, Equity to total deposits and Earning assets to deposits of Islamic banks are 7.19, 16.12 and 27.81% are high than conventional banks, respectively. It shows strong solvency position of Islamic banks vis-à-vis conventional banks.

In short, the comparisons of all of financial ratios of Islamic banks are healthy and relatively operating well. On the basis above empirical analysis we can fairly assume that future prospective of Islamic banks in Pakistan is bright

13. CONCLUSIONS AND POLICY RECOMMENDATIONS

- ❖ The comparison of the growth of Islamic banks with the selected conventional banks during 2006-2008 shows that Islamic banks have recorded consistent growth right from the beginning. The assets of Islamic banks were increased around 278 percent, nearly 139 percent per year, as compared to only 13 percent increase in the assets of conventional banks during 2006-2008. Advances and investments of Islamic banks recorded growth of 253 percent, about 127 percent per year, against 57 percent of conventional banks during the same period. The branch network of Islamic Banks has recorded 333 percent growth during 2006-2008 and total numbers of Islamic banking branches have jumped to 514 by the end of December 2008, which is not less than a miracle in the financial history of Pakistan. Market share of Islamic Banks were increased from 2.5 percent in 2006 to 5 percent of total banking industry in 2008. The 100 percent increase in the market share is itself a solid proof that Islamic banking is gaining momentum and has emerged as a strong alternate financial system to meet the financial requirements of customers and business community under the norms of Shariah Compliance.
- ❖ Islamic banks are far ahead from the selected conventional banks in quality of the assets because total amount of non-performing loans NPLs of Islamic banks on September 30, 2008 was only Rs.790 million out of total advances and investment of Rs.107 billion of six Islamic banks as compared to Rs.26 billion of selected conventional banks. The rate of NPLs to total financing of Islamic banks is just 1.06 percent as compared to 5.88 percent of SCBs. Provisions of NPLs of Islamic Banks was 47 percent against 41 percent of conventional banks. This indicates that the assets of Islamic banks are more efficient, the balance sheet of Islamic banks is more transparent and earning of Islamic banks is healthier.
- ❖ All earning indicators of Islamic banks are positive and prove the fact that equity-based Islamic Banking is profitable institutions. Placing deposits with Islamic banks without pre-determining rate of profit do not mean that the depositors will not be paid any profit and the bank is free to use this money. Our study noted that Islamic banks collect deposits on Modarba basis and profit earned on it is distributed 50:50 percent among the depositors and the shareholders. This is a healthy practice. According to the State Bank of Pakistan, Islamic banks are paying high return to their depositors and their cost of deposit is 6.5 percent as compared to 4.5 percent of Conventional banking industry. It means that the depositors of Islamic banks are better off and, getting 2 percent more return than market rate. It also proves that Islamic bank is really contributing in equitable distribution of income and reducing income inequality.
- ❖ The profitability of Islamic banks operating in Pakistan is less volatile as compared to the profitability of conventional banking industry in Pakistan, which is highly volatile and abnormal. For example, the profit of Askari Bank Ltd in 2007 was Rs.2.681 billion which was steeply fallen to only Rs.0.386 billion in 2008, a fall of about 694 percent. Similarly, the loss of Atlas Bank Ltd in 2007 was Rs.309 million which was jumped to Rs.1,071 billion in 2008, an increase of 347 percent. The profit of Bank Al-Falah was Rs.3.130 billion in 2007, which was massively declined to Rs.1.301 billion in 2008, a fall of 240.54 percent. In contrast, the profit of Meezan Islamic Bank Ltd in 2007 was Rs.963 million, which was decreased to Rs.621 million in 2008, a fall of about 35 percent. Similarly, the loss of Bankislami Pakistan was Rs.37 million in 2007 which was increased to Rs.52 million in 2008, an increase of 43 percent. Thus the volatility in the profitability or loss of conventional banks is between more than 300 to 700 percent while the change in the profitability and loss of Islamic banks is between

35 to 43 percent, a normal up-and down in accordance with the change in macroeconomic indicators and overall economic environment.

- ❖ The performance of Islamic banks are encouraging if we analyze them in the perspective of recent global financial meltdown that has caused the collapse of many strong and established banks like Northern Rock, Royal Bank of Scotland of the United Kingdom and Lehman Brothers, Goldman Sacs, Merrill Lynch and Washington Mutual of the United States. But, surprisingly, Islamic banks have proved their inherent strength to grow in adverse macroeconomic condition. It indicates that Islamic banks have capability to cope with sudden economic and market shocks due to their real business activity and refrain from speculative business activities.
- ❖ Islamic banks in Pakistan are facing twin types of competition, i.e., competition among themselves and competition with conventional banks. The dual policy of the State Banks of Pakistan to promote Islamic banking side-by-side conventional banking appears not to be appropriate and may damage Islamic banking industry in future. SBP has allowed all conventional banks to open their separate Islamic banking branches and these branches are also using the logo of Islamic banking. This has created a confusing situation particularly for the common man and less educated persons to differentiate which bank is Islamic and which is conventional. This is the reason that newly formed Islamic banks are facing problem of outreach and recognition.
- ❖ Human resources development is the main challenge being faced by the Islamic banking industry. As the industry is expanding all over the Muslim world including Pakistan it needs Islamic scholars having vast knowledge of Islamic finance to help the bank in development of new financial products and ensure the operation of the bank in accordance with the Shariah compliance. It also needs trained staff having experience and knowledge of Islamic banking for introducing Islamic financial products. Presently, this shortage of skilled Islamic bankers is being met through short courses and training of new staff or hiring staff from conventional banks at higher financial package. This is not a permanent solution. The Islamic banks must chalk out a long-term human resource development strategy to meet the future demand of skilled human capital.
- ❖ Since Islamic banks mostly engage in trade financing, leasing, sale and purchase of real goods they have to face double taxation on their business transactions. Islamic bank's buying and selling transactions are counted twice and as such are taxed twice. This tax anomaly creates policy implication, which cannot only affect the growth of Islamic banking industry but also affect its profitability badly in future when the size of the industry will be increased. Thus, the Government should take proper steps to remove this anomaly as early as possible to ensure smooth growth of Islamic banking.
- ❖ The absence of inter-bank money market for Islamic banks is another serious problem. The Islamic banks cannot use interest-based money markets and its instruments to manage their liquidity and hence the development of a separate market mechanism for Islamic banks is necessary so that they may be able to use their excessive funds. This mechanism can be developed in the light of the experience of Malaysia and Bahrain. Malaysian inter-bank money market has been functioning since 1994 with several Islamic instruments. Similarly, Bahrain Monetary Authority has established the "Liquidity Management Centre (LMC) in 2002 with the objective of facilitating Islamic banks to manage their liquidity. The Governments of Muslim countries should issue Islamic Sukuks and sovereign securities on large scale to enable Islamic Banks to invest their funds in these secure instruments. In this respect, Sudan's experience can be materialized.
- ❖ It is a fact that conventional banks have so far been able to provide financial services only to 11 percent population of Pakistan and the rest of 89 percent is yet to be approached, indicating the existence of vast market for Islamic banking services. Now it depends upon the Islamic banks how to tap this vast market potential. It is suggested that Islamic banks must enhance their outreach and launch awareness campaign through media to inform the people of their products and financial benefits. They must establish their branches in small towns and big villages where the people have strong commitment with interest-free financial products and competition is less as compared to urban areas.

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