

## How Efficient is the Islamic Banking Model in Pakistan?

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### Abstract

*The purpose of this study is to analyze the conventional and Islamic banking in Pakistan. For this study, a sample of 19 conventional banks and five Islamic banks was selected. The CAMEL approach is used to evaluate the performance of both conventional and Islamic banks. Ten ratios were used to measure profitability, liquidity and credit risk. Our findings suggest that Islamic banks are less efficient than conventional banks in asset management, management capability and liquidity. Conventional banks have better earning capability in terms of return on assets and overhead ratios. The analysis also shows that Islamic banks have better capital adequacy than conventional banks.*

**Keywords:** Islamic banking, efficiency, CAMEL, capital adequacy.

**JEL classification:** G21, N20, Z12.

### 1. Introduction

Islamic banking is now considered one of the most popular banking systems in the Islamic world. Its assets have outgrown the assets of the conventional banking industry and the global worth of Islamic banks is now US\$1 trillion in terms of assets. The sector has experienced an annual continuous growth rate of 16 percent, assisted by the Gulf Cooperation Council through its contribution of an additional US\$91 billion to the Islamic banking system. While the foundations of Islamic banking can be traced to the Quran, its real contribution to the global banking system was observed in the 20th century (Khan, 2013) when proponents of Islamic principles began to express the need for an alternative banking system that did not contravene core Islamic principles.

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There are two fundamental differences between Islamic banking and conventional banking. The first is the model of profit-and-loss sharing in Islamic banks, whereby there is a system for sharing not only profits, but also losses between the lender and borrower. The second is that of interest payment collection: Islamic banks maintain strict regulations to avoid receiving, giving or otherwise partaking in any form of interest. Other differences include additional regulations faced by Islamic banks, which are to practice in accordance with Sharia law as well as local and international banking laws. Islamic banks are also limited in their investment opportunities, as they cannot be involved in any anti-Islamic projects such as those involving alcoholic drinks or gambling.

In Pakistan, Islamic banking is very recent. Despite this, it is considered one of the most effective forms of banking and has shown a significant increase in activity since its inception. As of 2016, a total of five Islamic banks were operational in Pakistan, while 17 conventional banks have incorporated aspects of Islamic banking in their operations. Considering the success of Islamic banks, existing conventional banks have undertaken to introduce their own Islamic banking windows alongside maintaining conventional operations. Deposits have seen an exponential increase of more than 200 percent compared to the figures for 2008. This is noteworthy considering that, prior to 2008, Pakistan had a smaller banking and financial sector with limited growth. Banking has become one of the most profitable businesses in Pakistan since picking up pace in 2008. Due to the exponential growth of this sector as well as its expected future expansion, it is an area that requires further analysis.

This paper attempts to assess the fundamental differences in the performance of both types of banks. Previous studies have reached varying conclusions: while studies such as Usman and Khan (2011) find Islamic banking to be superior in terms of growth and profitability, others – such as Rosly and Abu Bakar (2003) – conclude that Islamic banking is less likely to outshine conventional banking systems. Some findings show that both kinds of banks are similar in performance, such as Samad (2004), who concludes that both show similar results in terms of liquidity and profitability.

Other studies highlight various specifics of the comparison. Jaffar and Manarvi (2011), for example, find that Islamic banks lack recovery of loans, which makes their provisions very high, leaving them with what may be considered an inadequate safety net in times of trouble. Similarly, in comparing the cost efficiency of the two types of banks on a global scale, Beck et al. (2013) find that Islamic banks tend to lean toward higher

cost effectiveness, but lack stability due to their small scale of operations. Akhtar et al. (2011) analyze the liquidity risk management of Islamic banks compared to conventional banks, finding a positive but insignificant relationship for bank size and net working capital to net assets, with liquidity risk in both models. The capital adequacy ratio in conventional banks and return on assets in Islamic banks was found to be positive and significant.

Only a few comparative studies exist on Islamic banking and conventional banking on the basis of the CAMEL approach, despite its advantages in facilitating evaluations of the different aspects of the banking system, ranging from capital to risk sensitivity. Furthermore, there is limited research on this topic for the period 2008–13. In this context, the current study contributes to the literature.

Jaffar and Manarvi (2011) utilize the CAMEL approach to evaluate the performance of Islamic and conventional banking systems. However, their research is limited to five Islamic and five conventional banks. Kouser and Saba (2012) use the model for the Pakistani banking industry in their comparison of three types of banks – Islamic, mixed and conventional – and find that Islamic banks have the best capital adequacy, asset quality, earnings and management competency. Their research is limited to four Islamic banks, five Islamic branches of conventional banks and four conventional banks. Our study utilizes the CAMEL approach to evaluate 19 conventional banks and five Islamic banks. Its significance lies in its larger sample. Moreover, we evaluate each aspect of both banking systems using the CAMEL approach and provide an in-depth analysis of their performance.

The paper is organized as follow. Section 2 provides a review of the literature comparing conventional and Islamic banks. Section 3 describes the data and methodology. Section 4 presents an analysis of the results, followed by Section 5, which concludes the study.

## **2. Literature Review**

Islamic banking has grown rapidly in the last ten years, warranting a comparison with competitive banking systems. The following studies focus on different perspectives of Islamic and conventional banks: some relate to financial aspects, using ratios and other financial measures. Others look at banks' efficiency, categorizing Islamic and conventional banks by size and age.

Kouser and Saba (2012) compare the performance of three categories of banks – Islamic, mixed (which contain elements of Islamic and conventional banking in different branches) and conventional – using the CAMEL model. Islamic banks are found to have the best capital adequacy and asset quality compared to mixed and conventional banks. Furthermore, earnings and management competency are higher in Islamic banking than in conventional or mixed banking. They conclude that the operations of Islamic banks are developmental.

Bader et al. (2008) compare the cost, revenue and profit efficiency of 43 banks – Islamic and conventional – over 1990–2005. They find that cost and revenue structure is the major dividing line between the two, with no major differences in efficiency. Similarly, Hasan and Dridi (2010) compare Islamic and conventional banks on a financial basis to measure credit, asset growth and profitability over the recent global crisis period for a sample of 120 Middle Eastern banks, one fourth of which are Islamic banks. Overall, they find an adverse effect on the profitability of Islamic banks, although these banks perform better in credit and asset growth compared to conventional banks, thus adding to stability in a global crisis.

Rima (2010) analyzes the competitive and financial aspects of Islamic as well as conventional banks, using a sample of 13 banks for 2000–06, using multivariate techniques. The results signal better capitalization in Islamic banking, along with which Islamic banks allocate their assets better among financing activities. The second-stage analysis shows a significant increase in profitability, thus not guaranteeing higher profits for Islamic banks in the market. Samad's (2004) comparative analysis measures the profitability, liquidity and credit risk of interest-free banks (Islamic banks) and interest-based banks (conventional banks). The sample covers 11 years from 1991 to 2000 for banks in Bahrain. Nine financial ratios are used to measure these factors. While profitability and liquidity are shown to be similar, Islamic banks are ahead in credit risk.

Akhtar et al. (2011) use financial ratios to observe the solvency and liquidity risk difference between conventional and Islamic banks, using a sample of 12 banks for the period 2006–09. Net working capital and net assets have an insignificant relationship with liquidity risk management. However, the capital adequacy ratio in conventional banks and return on assets in Islamic banks have a significant, positive relationship. A negative relationship is found between the capital adequacy ratio and return on assets in Islamic banks. Khaled (n.d.) focuses on the financial aspects of Islamic and conventional banks in Sudan by measuring operational

efficiency. A stochastic cost frontier approach is applied to 17 banks over the period 1990–2000. Sudanese banks are found to be more stable than those owned by the state. Foreign investment in Sudan appears to increase the cost efficiency of banks, but with room for improvement in the paid-up capital ratio.

Jaffar and Manarvi (2011) look at the liquidity position of Islamic and conventional banks in Pakistan. The variables analyzed are capital adequacy, asset quality, management quality and earning ability, applying the CAMEL test standards to five conventional and five Islamic banks over 2005–2009. Islamic banks perform better in terms of adequate capital and liquidity. Conventional banks fare better in management quality and earning ability. However, asset quality for both modes of banking is almost the same.

Cihak and Hesse (2008) look at data for 18 banks over 1993–2004, comparing small Islamic banks, large Islamic banks and conventional banks. Their regression results show that small Islamic banks tend to be financially stronger than small commercial banks, whereas large commercial banks are financially stronger than large Islamic banks. Small Islamic banks tend to be financially stronger than large Islamic banks. Beck et al. (2013) focus on the efficiency of Islamic as well as conventional banks and highlight the different products and services offered by both types of banking systems. Their sample of 510 banks across 22 countries over the period 1995–2009 shows that Islamic banks are more profitable and better capitalized, and exhibit better asset quality than conventional banks.

Abdul (2009) measures the efficiency of Islamic and conventional banks in terms of quality of services, recovery of loans, financing and investments. Based on data from primary and secondary sources for 2006–08, Islamic banks appear to outperform conventional banks in terms of asset quality, liquidity, shock absorption and solvency. Shahid et al. (2010) test technical, cost and allocative efficiencies across a sample of five Islamic banks and five conventional banks over 2004–08. Applying the DEA model to evaluate the performance of both banking systems under the CRS and VRS approach, they find conventional banks to have better technical efficiency than Islamic banks, whereas both banking systems show similar results for cost and allocative efficiencies.

Other comparisons can be based on profitability determinants such as growth, inflation, GDP and real interest. A study by Hassan and Bashir (n.d.) encompasses all these variables. High capital and loan-to-asset ratios

are shown to lead to higher profitability, unlike the adverse effects of implicit and explicit taxes, while favorable macroeconomic conditions have a positive impact on performance measures. Surprisingly, the results indicate a strong, positive correlation between profitability and overheads.

Kaleem (n.d.) finds that monetary policy is a very important factor in economies where Islamic and conventional banks coexist. He explains the significance of monetary policy by referring to real economic growth, reduced inflation and lower unemployment as among the few benefits of a good monetary policy. However, his results reject the notion of one framework for both banking systems. Iqbal and Molyneux (2006) discuss the history of Islamic banks. Conducted in Saudi Arabia, which is where Islamic banking was initiated in the 1970s, the authors refer to Islamic banking as a viable alternative to conventional banking based on factors such as profitability and reliability. They argue that Islamic banking has shown far better results than conventional banking.

The studies discussed above yield mixed results. Some argue in favor of Islamic banks as an alternative banking system based on their better performance. Others refer to Islamic banking as a growing phenomenon with immense potential, but also room for improvement in defining their instruments. Some studies argue that Islamic and conventional banks have no significant differences in financial or efficiency terms. Others are of the view that Islamic banking products are no more or less attractive than those offered by conventional banks.

### **3. Data and Methodology**

This study focuses on a comparison of Islamic and conventional banks. The research is quantitative as the analysis uses financial ratios. In a similar study, Samad (2004) uses nine ratios and concludes that credit activities in Islamic banks are superior. Our sampling frame includes 24 banks in Pakistan. Of these, 19 are conventional and five are Islamic banks. These five Islamic banks were the only Islamic banks in Pakistan in 2015. The 19 conventional banks consist of both big and small banks. The research is based on secondary data for 2008–13, including financial reports for all the banks in the sample. Three banks were excluded as they did not have data for the given years. The components of their financial statements are used to calculate certain financial ratios. These ratios represent the CAMEL approach. Its most commonly used bank-specific indicators are: capital adequacy, asset quality, management quality, earnings and liquidity (Bongini et al., 2002).

- Capital adequacy measures a bank's capital as a percentage of its risk-weighted credit exposure. Reddy and Prasad (2011) explain that capital adequacy takes into account the capital adequacy ratio. Another measure is the debt-to-equity ratio, which is defined by Reddy and Prasad as total outside liability to net worth. Advances/deposits is another measure, along with government securities/total investments.
- Asset quality is a measure of loan marketability as well as the likelihood of default. This is determined using three equations specified by Reddy and Prasad (2011): net nonperforming assets/total assets, net nonperforming assets/net advances, and total investments/total assets.
- Management efficiency involves the ability of the management to use the lowest possible inputs to generate the highest possible outputs without compromising on quality. This generally incorporates total advances/total deposits, business per employee and profit per employee.
- Earning quality can be expressed as the ability of current earnings to be used as a measure of future earnings. It is subdivided into operating profit/average working funds, spread (interest earned less interest expended)/total assets, net profits/assets, interest income/total income, and noninterest income/total income.
- The final component is liquidity, which measures a firm's ability to meet short-term obligations using cash or cash-like resources with easy convertibility. This incorporates equations such as liquid assets to total assets, government securities/total assets, liquid assets/demand deposits and liquid assets/total deposits.

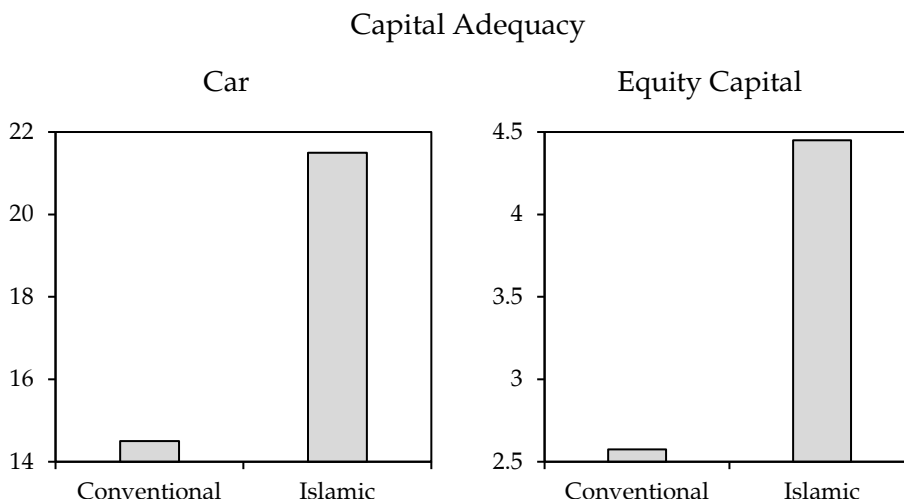
Each component of the CAMEL approach uses a financial ratio to compare the two types of banking systems in Pakistan. A dummy variable is used to assess the performance of all banks with respect to Islamic and conventional banks. A total of nine ratios is used.

#### **4. Analysis and Results**

The CAR of Islamic banks is significantly higher than that of conventional banks (Figure 1). However, there is a lot of instability in the results for both types of banks. Equity capital is a measure of capital strength (how much capital is dependent on the assets of the bank): the lower its equity capital, the more leverage it has. Conventional banks have

lower equity capital, so they are less dependent on their assets, while Islamic banks are more dependent on their assets. These findings are in line with Jaffar and Manarvi (2011), who use the CAMEL approach to show that Islamic banks experience a higher CAR than conventional banks. In another study by Akhtar et al. (2011), the analysis reveals an insignificant but positive CAR for Islamic banks.

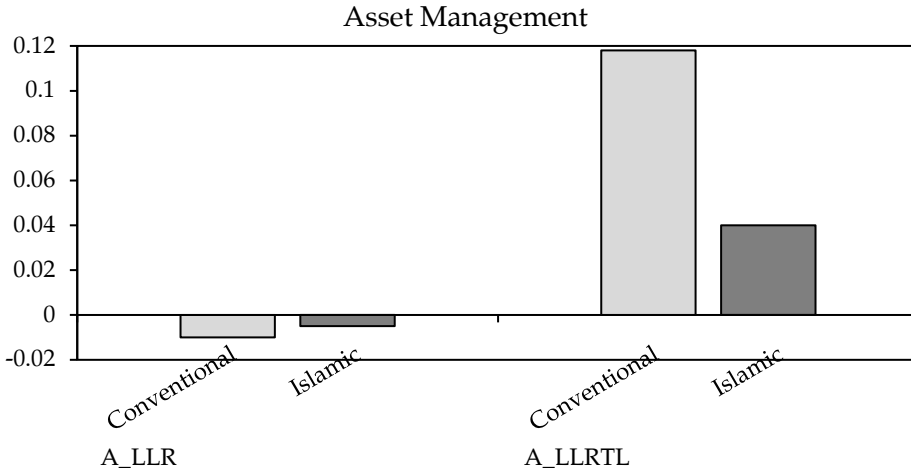
**Figure 1: Capital adequacy**



Asset management is tested using two ratios. The first is the loan loss reserve (LLR), whereby a higher LLR means that the bank is less efficient in the recovery of loans. Our results indicate that Islamic banks have a higher LLR than conventional banks. The second ratio, loan loss reserve/total loans (LLR/TL) represents loan reserves as a percentage of total loans. The analysis reveals that this ratio is higher for conventional banks than Islamic banks (Figure 2). Thus, conventional banks have a higher ability to absorb loss than Islamic banks. Jaffar and Manarvi (2011) also find that conventional banks have a slightly smaller LLR than Islamic banks, although their asset quality is almost the same.

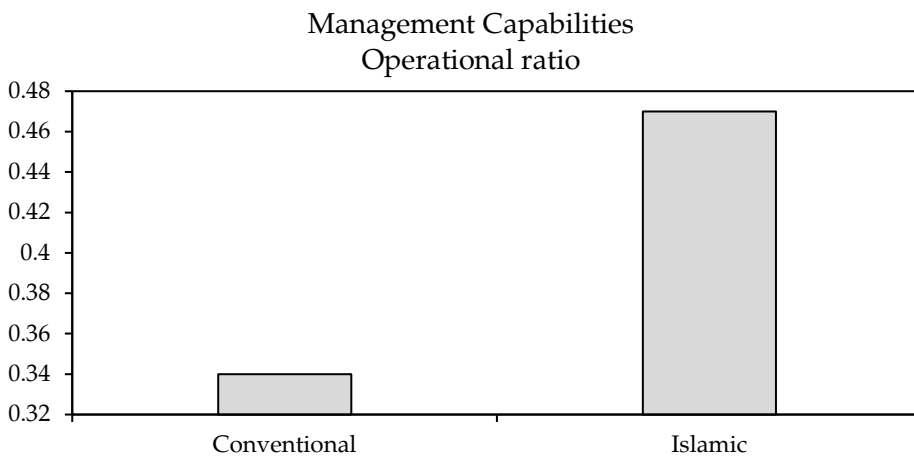


**Figure 2: Asset management**



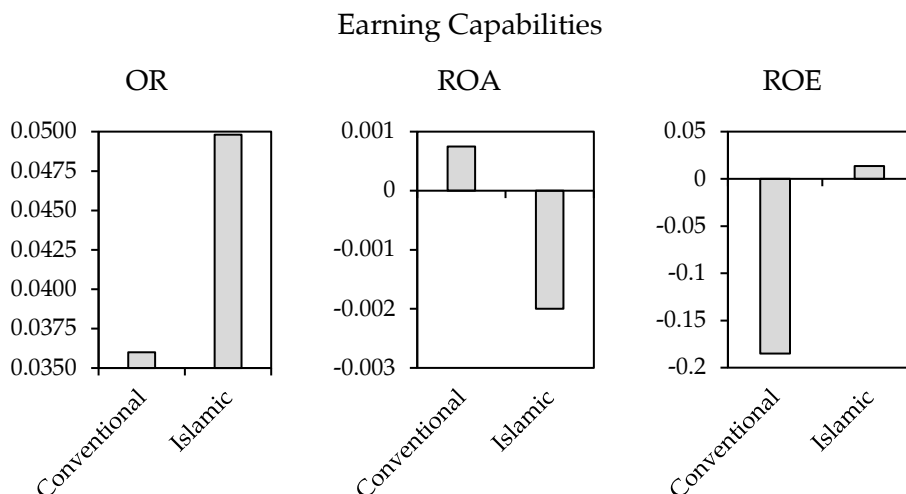
However, in terms of operational ratios, Islamic banks are less efficient because they have lower economies of scale and are new market entrants. Figure 3 shows that the operational ratio of conventional banks is significantly lower than that of Islamic banks, which makes conventional banks far more efficient than Islamic banks. Bader et al. (2008) find that overall efficiency is similar for both types of banking models, while Jaffar and Manarvi (2011) find that conventional banks perform better in terms of management quality – similar to our results.

**Figure 3: Management capabilities**



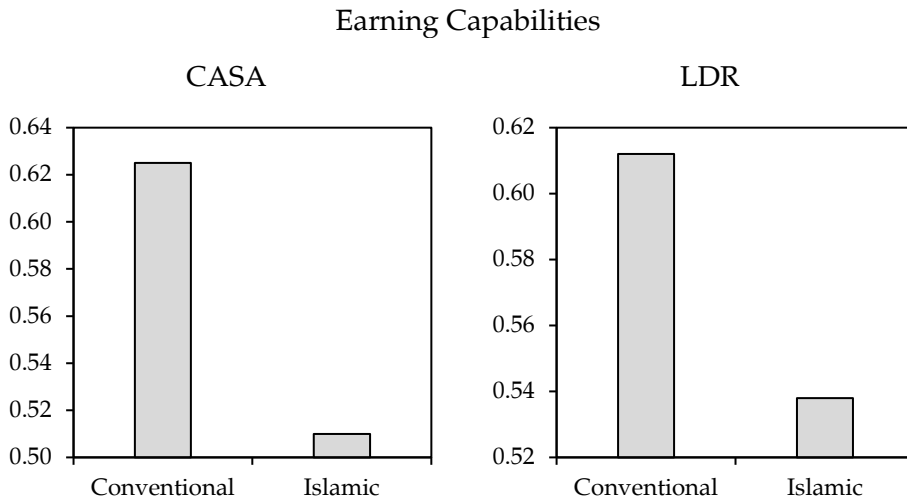
Earning capability is evaluated using three ratios: the overheads ratio, ROA and ROE. The overheads ratio depicts how efficient a bank is in terms of overheads. Our analysis suggests that conventional banks are highly efficient in comparison to Islamic banks (Figure 4) and this can be attributed to the lack of economies of scale for Islamic banks.

**Figure 4: Earning capabilities: OR, ROA, ROE**



The ROA is positive and significantly better in the case of conventional banks, while that of Islamic banks is negative, which implies that their earning capability is worse than that of conventional banks. Akhtar et al. (2011) also show that conventional banks are better in terms of asset returns and profitability than Islamic banks. The ROE of Islamic banks is higher and positive compared to conventional banks, for which the ROE is significantly low and negative. This may be due to the higher leverage of Islamic banks. The data for conventional banks is also highly unstable. Samad (2004) finds that there is no significant difference in the profitability of the two types of banks.

The current account and savings account (CASA) ratio explains the level of current and savings deposits. Islamic banks have a considerably lower CASA – implying more long-term deposits – compared to conventional banks (Figure 5). This also implies that Islamic banks obtain money at a higher cost than conventional banks. The loan deposit ratio (LDR) indicates the percentage of a bank’s loans funded by deposits. This is significantly lower for Islamic banks, while conventional banks have a more stable ratio.

**Figure 5: Earning capability: CASA and LDR**

## 5. Conclusion

Islamic banking is considered one of the most popular banking systems in the Islamic world. The fundamental difference between Islamic and conventional banks is that Islamic banking prohibits interest and un-Islamic practices. Thus, it operates under a model of profit-and-loss sharing, with no interest-related practices. Research shows that these banks have been enough of a success that almost every conventional bank has introduced Islamic windows alongside conventional operations.

While the literature shows that Islamic banking outperforms conventional banking in various respects, our findings for the Pakistani banking sector do not support these results. Islamic banks outperform conventional banks in terms of capital adequacy, but are at a disadvantage in terms of asset management, management capability, liquidity and earning capability (see Appendix). The results further show that Islamic banks are more vulnerable in terms of shock and loss absorption due to their lack of asset management. In terms of operations, Islamic banks are less efficient due to low economies of scale and frequent entrants in the market. Moreover, since they are more dependent on long-term deposits, their sources of funds lack diversity and expose them to additional risk.

Despite this performance differential between Islamic and conventional funds, Pakistan could still benefit from an alternative banking system such as Islamic banking. International trends point to the

success of this model and the benefits it offers proponents of Islamic schools of thought. However, the government and regulatory bodies such as the State Bank of Pakistan and Securities Exchange Commission of Pakistan need to develop policies that create a more conducive environment for Islamic banks to flourish. Conventional banks have the advantage of favorable regulations that have developed over centuries as well as international support, whereas Islamic banking is nascent. Furthermore, schemes that encourage participation in the development and use of Islamic banking would provide a better environment for Islamic banks to fulfil their potential.

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## Appendix

Table A1

Ratio	Mean (percentage)		Standard deviation (percentage)	
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
C-car	21.55	14.56	10.95	9.94
C-ec	4.45	2.56	4.18	1.71
C-llr	-0.66	-1.14	6.70	1.44
A_llrtl	4.23	11.18	3.10	8.03
M_om	46.92	33.93	16.83	14.69
E_or	4.97	3.58	2.57	1.64
E_roa	-0.21	0.07	1.28	2.18
E_roe	1.31	-18.87	11.39	144.37
L_ltr	53.14	61.31	17.19	13.53
L_casa	51.12	62.34	15.08	13.77

Table A2

Banks	Capital adequacy		ASSET QUALITY			ment Cap	EARNING		LIQUIDITY	
	Capital adequacy ratio	Equity Capital	Loan Loss Rate	Loan Loss Reserve/ total loans	Operational ratio	ROE	ROA	Overhead Ratio	Loan to deposit ratio	CASA
	ratio	ratio	> Loan loss	Ratio	ratio	Ratio	Ratio ROA	Ratio	loan to de	Ratio
Allied Bank Limited 2013	17.85	1.97	-0.01	6.83%	27.83%	27.27%	1.99%	4.77%	43.88%	67.66%
Allied Bank Limited 2012	16.17	1.87	-0.31%	6.55%	36.38%	27.20%	1.85%	5.43%	52.67%	68.31%
Askari Bank Limited 2013	10.39	1.11	-0.51%	17.29%	32.73%	-32.95%	-1.39%	2.55%	48.79%	75.27%
Askari Bank Limited 2012	11.81	1.27	-0.75%	13.08%	27.17%	7.10%	0.36%	2.62%	46.83%	78.40%
Habib Bank Limited 2013	15.39	2.02	0.68%	0.95%	28.64%	17.63%	1.34%	2.28%	37.39%	72.44%
Habib Bank Limited 2012	15.81	2.14	0.42%	8.61%	25.41%	19.50%	1.42%	2.43%	40.32%	70.38%
MCB Bank Limited 2013	22.25	3.08	-1.75%	7.84%	26.90%	22.10%	2.64%	2.48%	39.26%	89.81%
MCB Bank Limited 2012	22.13	3.11	-1.85%	9.34%	23.78%	23.75%	2.73%	2.55%	43.96%	84.56%
National Bank of Pakistan 2013	15.24	1.89	-0.70%	16.63%	33.63%	5.45%	0.40%	2.78%	55.89%	47.56%
National Bank of Pakistan 2012	15.50	2.36	-0.63%	10.56%	32.73%	13.93%	1.23%	2.88%	63.34%	61.43%

Table A3

Banks	Capital adequacy		ASSET QUALITY			ment Cap	EARNING		LIQUIDITY	
	Capital adequacy ratio	Equity Capital	Loan Loss Rate	Loan Loss Reserve/ total loans	Operational ratio	ROE	ROA	Overhead Ratio	Loan to deposit ratio	CASA
	ratio	ratio	> Loan loss	Ratio	ratio	Ratio	Ratio ROA	Ratio	loan to de	Ratio
Burj Bank Limited 2013	20.76	2.63	-0.14%	5.10%	63.37%	-21.38%	-2.12%	4.94%	67.81%	43.09%
Burj Bank Limited 2012	22.55	3.92	-1.97%	2.90%	43.56%	1.43%	0.18%	4.29%	65.06%	43.66%
Dubai Islamic Bank Pakistan Ltd 2013	14.59	2.41	-0.39%	4.65%	49.97%	1.98%	0.17%	4.44%	37.03%	64.07%
Dubai Islamic Bank Pakistan Ltd 2012	18	3.04	-0.86%	2.69%	38.34%	5.10%	0.54%	5.15%	49.55%	58.70%
Meezan Bank Limited 2013	12.48	1.48	-0.33%	3.61%	34.41%	22.09%	1.20%	2.78%	44.04%	65.81%
Meezan Bank Limited 2012	14.08	1.63	-0.61%	5.08%	31.44%	22.66%	1.28%	3.02%	38.48%	65.53%
AlBaraka Bank (Pakistan) Ltd 2013	11.97	1.80	-2.35%	12.54%	35.05%	-0.58%	-0.04%	2.78%	29.30%	49.35%
AlBaraka Bank (Pakistan) Ltd 2012	11.18	2.01	-1.07%	9.43%	14.63%	-10.93%	-0.87%	2.88%	45.48%	47.74%
Bank Islami Pakistan Limited 2013	15.37	1.71	-0.05%	1.82%	38.32%	3.36%	0.21%	3.13%	42.02%	52.54%





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