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STUDY OF PERFORMANCE COMPARISON BETWEEN ISLAMIC AND CONVENTIONAL BANKING IN PAKISTAN

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ABSTRACT: *In Pakistan initial attempts were made in 1980s to Islamize the banking sector resulted into lot of changes in banking companies' ordinance 1962. Since then, changes in financial system for allowing the issuance of interest free instruments, permission of Modaraba companies and Modaraba certificates' floatation, establishment of commission for Transformation of Financial system (CTFS) and setting up of Islamic Banking Department by State Bank of Pakistan are major steps taken by government. The purpose of this study is to comprehend the nature of Islamic banks, measure and compare the performance of five Islamic banks with five conventional banks working in Pakistan over a period of five years from 2006-10. Performance comparison was conducted by trend analysis and using twelve financial ratios under category of profitability, risk, liquidity and efficiency. The study concluded that Islamic banks are less risky, more solvent and efficient than conventional banks but there is not much difference seen in terms of profitability. In respect of trend analysis balance sheet & income statement of Islamic banks revealed good positive trends as compared to conventional banks. The results of the study would be beneficial to current management of Islamic banks to improve their performance as well as potential stakeholders.*

KEYWORDS: Performance, Ratios, Trend Analysis, Conventional Banks, Islamic Banks

INTRODUCTION

Banking sector is performing extremely important role in economic progress. Banking activities are decisive for healthy economies which ultimately become the reason to be included in the list of develop nations. Trade and business activities enlarged in 18th century during industrial revolution by the commencement of large scale production. To boost business operations banking obtained importance and became fundamental facility. In today's borderless and global market, customer satisfaction and product/service quality may enhance the performance of banks for the prosperous remnant.(A. Ahmad, 2010)

In Babylonia in the 2nd millennium B.C. banking activities were regarded extremely important. In 1397 Medici bank was established by bankers from North Italy jointly known as Lombards and also introduced double entry system. Banking in India started in 18th century by the commencement of The General Bank of India in 1786. Banking activities in Pakistan started after its independence on 14th august 1947. (A. Ahmad, 2010)

Pakistan banking sector experienced a significance shift resulting from main function of private segment having 80% banking assets.(Husain, 2005)

Banks perform an essential part in mobilizing money and encourage investment for fruitful ventures. They receive deposits from customers and forward loans to businessmen to increase investment opportunities that are necessary for sound economy.

Globalization, deregulations, consolidation among banks; rising and stiff competition, liberalization & continual innovation to furnished financial services that are acceptable under Islamic rules and teachings have given rise to the interest of all the parties that have any concern or stake to have detailed critical evaluation of Islamic banks.(Moin, 2008)

Investors, customers, managers, regulators one thing is important for all parties and that is performance evaluation of banks. Invest/withdraw money from banks in highly competitive market the most important is bank performance as it provides a signal to investors and depositors. In order to improve the deposit/debt service managers are very much keen to know and evaluate the consequences of former management decisions. Regulators being responsible for the soundness and safety of banking scheme and building public trust monitor and evaluate bank performance to locate those banks that are facing problems. It is important that performance is persistentently monitored because sometime the current problems stay unnoticed and otherwise can lead to bankruptcy in future. (Hassan & Bashir, 2003; Samad & Hassan, 2000)

Islamic banking in Pakistan started with an initiative to make commercial banks free from interest and specialized institutions around three decades ago in 1977 to 1978. But earnest pains have taken only recent decade when State Bank of Pakistan (SBP) introduced shariah compliant modes of financing constituted a (CTFS) commission for transformation of financial system and in September 15, 2003 (SBP) set up Islamic Banking Department. Because of steady efforts, Islamic banking in accordance with the principles of Islamic shariah is playing significant part in contributing & financing to different social & economic sectors of the country under Islamic banking practices.

Meezan bank was first bank that granted Islamic banking license by State bank of Pakistan in 2002 to operate as full fledge Islamic bank in order to give real boost to Islamic banking operations in the country.

The primary difference amid Islamic and capitalist system is that private ownership is allowed unrestricted authority to take economic decisions. So wealth belongs to few hands in capitalist system of economy. Due to their limitation to work only in situation of free competition the capitalist system disturbs the natural process of demand and supply. The capitalist method generate aperture between real assets and in money supply. On other side the Islamic economy base on asset backed phenomena and deals accordingly.(Usmani & Zubairi, 2010)

In addition Islamic financial institution generate credit which boost the commerce and industry activities, provides services to the public. Strive to evolve the practice to economize excess money by making secure savings and creating chances for the investment and do not allow the activities of unproductive health to appreciate. (A. U. F. Ahmad & Hassan, 2007)

(Akhtar, 2007) investigated that public is now accepting the significance and magnitude of Islamic finance industry but in Pakistan Muhammad Ali Jinnah in 1948 while addressing the inauguration of the SBP emphasized on significance of Islamic principles of finance, Said:

> “I shall watch with enthusiasm the work of your organization in developing banking practices consistent with Islamic concepts of economic and social life. We must work

> our fate in our own way and show to the world an economic system based on true Islamic concept of social justice and equality of manhood"

In Pakistan only five full fledge Islamic banks are working now and most banks commenced operations in recent years the oldest of these is Meezan bank started operations more than ten years. On the other hand conventional banks are larger in numbers, size and age.

Purpose of the Study

The aim of this study is to investigate comparative performance evolution of Conventional and Islamic banking systems in Pakistan so that the performance of each sector can be documented for the epoch under study. This research will assist in allocating resources in hereafter like investments, finance, deposits & different banking related services. In short the research question;

To determine whether Islamic banks are performing superior compare to Conventional banks in Pakistan?

In order to answer the above question we have included five full fledge Islamic banks operating in Pakistan and five conventional banks. The study period is five years 2006 to 2010. In private sector banks the Government owned banks has not been included because they are quite large in size and pretty old as well. The private banks selected are of similar age because most Islamic banks in Pakistan started their operations after 2003. The conventional banks selected are not old and large in size like Islamic bank. For performance comparison among Islamic & conventional banks we have used in study the financial ratios analysis technique to determine the liquidity, profitability, risk & solvency and efficiency of these banks. Overall pattern contains financial ratios as independent variable & financial performance as dependent variable.

Overview of Banking Sector in Pakistan

Economic Development and Financial Sector Development are interrelated. Efficient and well-functioning financial segment acts central part in development of economy and also in raising living norm of its people. Pakistan financial sector constitute 95 percent by banks, so therefore soundness of the banks & development and economic growth directly connected.(Husain, 2005)

Pakistan banking sector has seen radical changes since its independence in 1947. Initially it experienced deficiency of means and insecurity because of prevailing socioeconomic and political conditions. Shortage of professionals and trained peoples resulted into poor standards of yield & services. To control the financial sector SBP established in 1948. In 1956 through SBP act 1956 amendments were done to extend the functions and control of SBP. SBP promote the private sector to set up banks and financial institutions. But during the decades of 1950s and 1960s it resulted into illegal practices and unhealthy competition due to corruption and bribe.(Switzerland, 2011)

Governments took all banks into ownership in 1974. Performance deteriorated of banks because of government security to employees, consequently supply of poor services and low quality products. It also discouraged the foreign financial institutions and local private investors. In early 1990s the privatization/reforms of banking sector initiated due to poor performance of nationalized banks.(Switzerland, 2011)

Today Pakistan banking sector playing cardinal role in the development of country's economy. Pakistan banking system is encompassing of 52 banks as on 12 September 2012. There are 34 Commercials Banks, 2 Specialized Banks, 8 Development Financial institutions and 8 Micro Finance Banks. Commercial Banks includes 5 public sector banks, 17 local private banks, 7 foreign banks and 5 Islamic banks. Financial view of nation changed significantly 1970s has been changed into a sound, efficient and strong banking system through sector reforms started in early 1990s. Outcome of these reforms have resulted into competitive and efficient financial system.(SBP, 2012b)

Today private sector almost holds 95% percent of the banking assets. Total asset of all banks stands at 8386bn and deposit 6315bn on March 12. The top five banks hold 51% of the banking assets. State bank of Pakistan and foreign banks enjoy 1.8 and 3.1 percent share respectively. There has been seen a great culture of professionalism and service orientation in place of apathy and bureaucracy since the privatization of nationalized commercial banks. Few years ago banking technology was nearly non-existence in Pakistan but now it has changed services & access internet, mobile & branchless banking, ATMs and different methods of delivery make feasible to reduce the transaction cost of the bank while providing convenience to the customer. The debit card, credit card, smart card business has also outspread.(SBP, 2012a)

Current Trends in Pakistan's Banking Sector

Since 2007 Pakistan confront tough macroeconomic situation not because 0f global slump but conflux of factors especially gradually increasing imbalance which force the country in November 2008 to embark on a Macroeconomic stabilization program with assistance of (IMF) SBA Stand By Arrangement. Main challenges confronting the home economy partially impute to GFC. Fall in exports to main trading Partners of Pakistan due to recession in economies.(Switzerland, 2011)

However, factors such as power shortage crisis lead us to rise in the cost of production and low utilization of industrial capacity, high inflation, and significant fall in foreign direct investment due to feeble economic fundamentals, the prolonged issue of inter corporate circular debt, security issues and above all the rising fiscal deficit breaking country's all records of economic history had all play their part in maintaining weak economic recovery of Pakistan. (Switzerland, 2011)

The enhanced credit danger is reflected in persistent and noticeable rise in NPLs by doubling itself at the end of 2009. Though it has examined the resilience of banking system therein banks have compelled to raise accidental reserves and supply unhealthy assets. These kinds of requirements influencing dividend and hence placing pressure on share prices.

In first half of the financial year 2012 the public sector banks showed stagnant profitability. Profit after tax which Rs9.3bn recorded last year during same period was now stood as Rs.9.5bn. local private banks profit increased during first half by 38% from RS34bn to Rs47bn. While foreign banks total seven showed profit decline from Rs3.3bn in first half of 2012 as compared to Rs3.6bn in first half of 2011. Lastly all commercial banks profitability if combined showed growth of 27% or Rs13bn in first quarter of 2012 as compared to Rs 47bn in same period of 2011.(Sabir, 2012)

Islamic Banking Sector

In Pakistan Islamic banking appeared as a reaction to both economic and religious needs as Islamic banks are basically pertain to remove Riba (interest) from economy.

Islamic banking practices were started during the decade of 1990s throughout the world particularly in Muslim dominated areas of the globe. In order to set up fully fledged Islamic banks in private segment SBP published detail criteria in December 2001. In January 2002 Al Meezan Investment Bank got the License from SBP and from March 20, 2002 started its operations as first Islamic bank. In Pakistan since its start up number of new Islamic banks are coming into existence and increasing the share of Islamic banking in the market.(Bashir, 2001)

By the end of first half of financial year 2012 in Pakistan there were five full fledged Islamic banks operating. Islamic banking in first quarter of 2012 had asset base of Rs.644bn comprising of 7.7 % of total banking industry. Islamic banking remained at same level in terms of deposit share at Rs530bn while showed decline of 0.1% in market share of assets which were recorded 7.8% in last quarter. Islamic Banking started their first quarter of 2012 with addition of 19 new branches making up the total of 905 branches in 76 cities. There are also 296 Islamic branches/windows of conventional banks in the country. The full fledge Islamic banks includes Burj Bank Limited, Meezan Bank limited, Bank Islami Pakistan Limited, AlBaraka Bank (Pakistan) Limited, Dubai Islamic Bank Pakistan Limited.

Islamic Modes of Finance

In participatory mode of finance includes Mudarabah and Musharka. Mudarabah is kind of Partnership where investment comes from one partner also called Rab-ul-Mall while the other partner rendered its services called Mudarib and the profit are distributed according to predetermine ratio. The Musharakah is derived from the Arabic word Shirak meaning “partner”. In Islamic law the Musharakah taken as collective venture formed to carry out business & all the participants share loss according to their contribution while profit is divided accordance to specific ratio. It gives us a perfect alternative to avoid interest based financing.(Usmani & Zubairi, 2010)

Non participatory mode of finance includes Murabaha, Musawamah, Salam, Istisna and Ijarah. Murabaha is special kind of sale in which the seller is bound to tell the cost he has incurred on the selling commodity and by adding some profit sells it to another person. Musawamah is kind of sale in which cost price is not known. In Salam, the seller commits to provide particular merchandise to buyer in forthcoming term in swap of fully paid price in advance at spot. The supply of purchased goods is deferred but price in cash. Istisna defined as sale deal where product is transacted ahead of its existence. In other words it is command to a manufacturer to produce particular goods for purchaser. The producer utilizes his own substance to produce required goods. Lastly in Ijarah (leasing) a proprietor transmit its usufruct to other person at an agreed consideration for an agreed period. The subject of lease should be identified, quantified and valuable.(Usmani & Zubairi, 2010)

Islamic co-operative Insurance (Takaful) is based on Arabic word “Kafala” which means “to guarantee”. This is Islamic Insurance based on the Principles of ‘Tabarru’ (donation, gift) and ‘Ta’awun’ (mutual assistance) voluntarily risk share jointly by group. It’s a pact between members of the group or participants who willing to collectively guarantee between themselves versus damage/loss suffer by anyone specify in agreement.(Bank, 2011)

The difference between Takaful and Insurance is that Insurance is business institution operated venture based on the principles of "Contract" while Takaful is a co-operative Institution based on the principles of 'Ta'awun' (mutual co-operation). Another major difference is Risk transfer mechanism in Insurance where the insured substitutes certainty for uncertainty but in Takaful as such no transfer of risk is involved. Currently there are three kinds of Takaful model being operated worldwide.(Bank, 2011)

a. Pure Mudarabah Model
b. Wakalah Model (mix of Mudarabah & Wakalah)
c. Wakalah base on Waqf Model.

LITERATURE REVIEW

Although therein ample literature inspecting efficiency characteristics of European and the United States markets across lately, job over Islamic banking sector is yet in nonage. Typically, theoretical issues were concentrated in studies of Islamic banks' efficiency and experimental work especially depend on test of descriptive statistics instead of rigid statistical valuation (El-Gamal & Inanoglu, 2003)

The foundation of a sound financial system is always built on an underlying theoretical framework. Both Islamic and conventional banks have their distinct. The conventional banks are based on the principles of positive theory of economics while Islamic banks are based on the principles of the normative scientific theory of economics.(Ali, 2009)

Metwally (1997) examined the basic disparity between financial disposition of Conventional and Islamic banks with respect to credit risk, profitability, leverage and efficiency, applying statistical techniques on 30 banks covering the period of 1992-94. He concluded that there is no much difference among efficiency and profitability between the banks.

Iqbal (2001) compared the performance of Islamic and conventional banks. Many hypothesis and common understanding about the practice of Islamic banking for the period 1990-98 have been examined. Trend and ratio assay method was used to evaluate the accomplishment of Islamic banks. Performance of Islamic banks compared with a control group of conventional banks. The study concluded that Islamic banks are well profitable, stable and capitalized however they are not cost effective in their operations.

Samad (2004) in his research paper studied the performance comparison between conventional banks and Islamic banks of Bahrain over period of 1991 to 2001. The study employed 9 monetary ratios to measure the performance with regards to liquidity risk, profitability, credit risk. Paper illustrated as there is notable difference among two types of banks in compare to credit performance. But study finds no big variance with regards to liquidity and profitability performances between conventional banks and Islamic banks.

Rosly and Bakar (2003) analyzed performance of main stream conventional banks to main stream banks providing Islamic services in Malaysia during 1996-99. The paper concluded that Islamic banking main stream registered higher (ROA) since they are competent to employ present overhead suffered by main stream conventional banks. It is also recognized that superior (ROA) for Islamic banks doesn't suggest efficacy. It is incompatible with their comparatively low investment margin ratio and low asset utilization ratios.

Samad and Hassan (2000) studied interbank and intertemporal execution of Bank Islamic Malaysia Berhad (BIMB) with regard to liquidity, risk, profitability and solvency, and community involvement during 1984 to 1997 over 14 years period. The study is said to be intertemporal in the sense that it was conducted in two stage period between 1984 to 1989 & 1990-97 of BIMB. The study compared the (BIMB) with 8 conventional banks. The outcome indicated as BIMB shows statistically important betterment with regards to profitability by 1984-97 by using financial ratios to measure the performance. This result shows consistency with Hassan (1999) and Samad (1999). The study concluded that BIMB was more solvent & lesser risky in compare to with set of eight conventional banks.

Islamic banks can still survive even in the context of traditional model of banking where (PLS) sharing form of financing are still less predominate to gauge the effectiveness of Islamic banks in Bangladesh by applying Banking efficiency Model. There should be different prudential regulations apply on Islamic financial products because they have different risk characteristics further claims by (Sarker, 1999)

Moin (2008) argued about the history of Islamic banks and also compared the performance of (Meezan), first shariah compliant bank with set of 5 conventional banks. The study was conducted to determine the performance in terms of profitability, risk, efficiency & liquidity and during period from 2003-07.He efficient, profitable but more solvent as compared to conventional bank.

Jaffar and Manarvi (2011) collate and examined performance on conventional and Islamic banks functioning in Pakistan by using CAMEL test during 2005-09. Five banks from each sector were chosen to compare and measure their performance. Various ratios were employed to estimate every factor of CAMEL. Study concluded as Islamic banks acted better in holding appropriate capital and superior liquidity whereas conventional banks pioneered in earning ability and management quality. Asset attribute towards both types of banking was nearly the same while conventional banks registered slightly small debt loss ratio due to enhanced debt recovery policy.

Safiullah (2010) carried out comparative research on performance of interest free and interest based banking in Bangladesh. He selected 4 Islamic and 4 conventional banks for time period from 2004-08. Ratio analysis was carried out to evaluate profitability, solvency, business development, liquidity, commitment to community and economy, Productivity and efficiency of both types of banking sector. Results concluded that conventional banks were doing better in commitment to economy & community, efficiency and productivity.

Ali (2009) in his dissertation analyzed the performance of conventional and Islamic banks functioning in Pakistan across period of 2004-08. The study investigated whether Islamic banks doing better as compared to conventional banks in Pakistan. Ratio analysis was used to determine the liquidity, profitability, risk, solvency & efficiency of both streams of banks. Study concluded that Islamic banking is more liquid, profitable and better asset quality compared to conventional banks.

Akhter, Raza, and Akram (2011) construed the performance & efficiency of Islamic banking with private & public banks in Pakistan. They used nine financial ratios under liquidity risk, profitability and credit risk while 2006-10 financial year statements were taken from banks. To check the trends of income statements & balance sheets used Trend analysis tool in their study. The paper concluded there is not much difference seen amid Islamic & conventional banking in respect of profitability. The balance sheet trend analysis of Islamic bank showed good trend and there is no difference in trend analysis of income statement.

Zia-ur-Rehman (2011)analyzed and compared the performance of conventional and Islamic banking by using financial tools. They selected two banks each from Islamic and conventional sector and used bank level data from 2007-10. They have used ratios of liquidity, profitability, credit risk, earnings and assets activity to compare the performance of two types of banks. The study concluded that performances of Islamic banks are less effective due to inefficiency of management and enhanced operating cost.

Hanif et al. (2012) also compared and analyzed the performance of conventional and Islamic banking in Pakistan to determine which banking sector is doing superior than other. For research 5 Islamic and 22 conventional banks were tried and major performance indicators separated into inner & outer bank factors. Outer factors comprised customer conduct and understanding about both conventional & Islamic. Inner factors for the study comprised of four ratios include liquidity, profitability, credit risk and solvency. Results indicated that in liquidity and profitability conventional banking leading while in solvency maintenance and credit risk management Islamic banks dominate.

Bank grade datum used to appraise performance of Islamic banks of UAE. Income statements and balance sheet of 5 conventional banks & 3 Islamic banks were used to collect the data for study in the time period 2004-06. To examine the performance of the Islamic banks financial ratios are used to evaluate the performance in solvency, risk, profitability and liquidity. The study concluded that UAE Islamic banks in comparison with conventional banks comparatively greater efficient, profitable but lessen liquid & risky.(Kader, Asaporta, & Al-Maghaireh, 2007)

Saleh and Zeitun (2006) examined and analyzed the experience with two Islamic banks the first was (JIBFI) Jordan Islamic Bank for Finance & Investment and second with (IIAB) Islamic International Arab Bank in Jordan to evaluate the Performance of Islamic Banks in Jordan. Study not only highlighted the domestic challenges but also global challenges being faced by this sector. The paper exhibited several interesting results by conducting capital structure, profit maximization and liquidity tests as performance evaluation methodology. Firstly the result indicated that both bank’s efficiency and ability have been enhanced & widen their activities and investment. Second most important development was that both banks contributed huge investment to projects in Jordan. Third banks main focus was low period investment. Fourth the highly profitable bank was found to be (JIBFI). Finally the Islamic banks had rising growth in profitability and credit facilities.

DATA AND METHODOLOGY

The aim of the study is the financial performance comparison between Islamic and conventional banking in Pakistan. The study includes performance comparison of five Islamic and five conventional banks every year in 2006-2010.

Sr.no	Islamic Banks	Conventional Banks
1	Meezan Bank	JS BANK
2	Burj Bank Limited	NIB Bank
3	Dubai Islamic Bank Pakistan	KASB Bank
4	Bank Islami Pakistan Limited	SAMBA Bank
5	Al Baraka (Pakistan) Limited	Summit Bank

Data collected from statements of banks under study. Sabi (1966) stated that this type of performance comparison between banks is very common. By this type of inter banks comparison the performance of a bank can be best judge.

Many indexes provided to measure the bank's performance by financial management theories. To use the ratios is one of them. In literature the use of financial ratios is quite common and extensive. Samad and Hassan (2000) also stated that bank regulators also used financial ratios to evaluate bank's performance. There are many evidences found that favors the use of financial ratios like Elyasiani, Mehdian, and Rezvanian (1994),(Sabi 1996), (Samad, 2009) and(Saleh & Zeitun, 2006) for appraising bank's performance.

To view the performance comparison between Islamic and conventional banks over the five years period, the study includes twelve financial ratios to ascertain bank's performance. Ratios are mainly divided into four main categorize include: Profitability ratio, Liquidity ratio, Risk & solvency ratio and Efficiency ratio. Average ratio of each year taken from Islamic banks & Conventional banks and then compare these ratios between these two categories' of banks.

Profitability Ratios

In order to know how the bank is performing relevant to profitability, below stated ratios are regarded as primary bank ratio.

Return on Assets (ROA)

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

It ascertains that as much is firm's earning after tax for each dollar it invest in assets of firm/bank. Thus it is the given assets per unit net earnings. If a firm has higher (ROA) ratio then it indicates efficient utilization of assets and better managerial performance.

Return on Equity (ROE)

$$= \frac{\text{Net profit after tax}}{\text{Total Equity}}$$

Return on Equity (ROE) is the indication of the profitability belong to shareholders of firm after taking into account all expenses & taxes (Van Horne & Wachowicz, 2008). If a firm has higher (ROE) then it consider being preferable managerial accomplishment.

Profit Expense Ratio (PER)

$$= \frac{\text{Profit before Tax}}{\text{Operating Expenses}}$$

It is evident from the formula that it is the indication of the operating profitability of firm as compares to total operating expenses. Samad and Hassan (2000) asserted that higher (PER) for a bank indicates that bank is efficient with regard to its cost while making higher profits.

Liquidity Ratios

Liquidity ratios shows firm's capacity to meet its periodical financial obligations. If a firm has higher liquidity ratio it means that it has greater cushion of safety margin to cover its short term obligations. Liquidity ratios can be measured by the following ways

Loan to Deposit Ratio (LDR)

$$= \frac{\text{Loan}}{\text{Deposit}}$$

Here in this study a loan is taken as advances in case of conventional banks and financing in case of Islamic banks. Because Islamic banks can't extend loans and earn (interest) Riba. Islamic banks are while conducting their banking operations also bound to follow shariah's principles. Thus Islamic banks can invest their deposit pool in only one way by offering different Islamic products. Banks considered being less risk, low profits and excessive liquidity with lower (LDR) as compared to bank with high (LDR). If a bank has high (LDR) then it is an indication that bank is taking financial stress due to its excessive loans and in future may have to sell loans at loss to meet depositor's claims.

Loan To Asset Ratio (LAR)

$$= \frac{\text{Loan}}{\text{Total Asset}}$$

In this ratio the liquidity condition of the bank is taken into account in terms of total assets. So it estimates the investment in loans (financing) with regards to percentage of total asset of the bank. The liquidity of the bank will be low if the liquidity ratio is higher. So the bank is deemed to highly liquid with low (LAR) collate to bank of higher (LAR). It means that there will be indication of high profitability with higher (LAR) and more risky.

Cash and portfolio investment to deposit ratio (CPID)

$$= \frac{\text{Cash and Portfolio Investment}}{\text{Deposit}}$$

Cash & Portfolio Investment to Deposit (CPID) is another ratio to measure liquidity of the bank. The customers (depositors) show more confidence and trust if a bank have higher ratio because it indicate better liquidity condition of bank as contrast to bank of lower (CPIDR).

Risk and Solvency Ratios

As it is clear from the name these ratios belong to risk and solvency measure of the firm. Financial leverage or debts, gearing ratios are other names of risk and solvency ratios. To measure risk & solvency ratios of bank following usually are used.

Debt To Equity Ratio (DER)

$$= \frac{\text{Total debt}}{\text{Shareholder Equity}}$$

As it is clear from the above formula which is used by the financial institutions and it measure the extent of the debt use by the firm. It is also use to check the ability of the capital of a bank to show the capability to absorb financial shocks. In situation where the asset value decrease or might creditors default then comes the bank capital which provide the shield against any loan losses.

Debt to Total Asset Ratio (DTAR)

$$= \frac{\text{Total Debt}}{\text{Total Asset}}$$

The above formula shows that it measures the total asset finance by the firm by using the amount of total debts. If a firm has higher (DTAR) means that bank as compared to equity financing has financed its most assets through debt and higher (DTAR) ratio is also an indication that bank has involved in more risky business.

Equity Multiplier (EM)

$$= \frac{\text{Total Asset}}{\text{Total Shareholder Equity}}$$

The above formula shows that equity multiplier measure that as much time total asset are of shareholder equity. Generally it is considered that if value of the (EM) is big than it is greater risk for a bank.

Efficiency Ratios

This ratio gives us an idea that how efficiently and effectively a firm controlling and managing assets. If these ratios have higher values then it is taken as good indication in other words the firm is managing well. Following ratios are used for measuring the efficiency of banks.

Asset Utilization (AU)

$$= \frac{\text{Total Revenue}}{\text{Total Asset}}$$

The ratios indicate clearly from the above formula that how the firm is utilizing its all assets. If (AU) is ratio is high then bank is said to generate total revenues by effectively using its assets.Ross et al. (2005)concluded that the bank is said to be not using effectively it’s to their full capacity if the (AU) indicate lower value.

Income to Expense Ratio (IER)

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

Ratio indicates that amount of income a firm earned per dollar of operating expenses. If a firm has higher (IER) ratio then it denotes the efficiency and ability of firm in creating more income when compared to its operating expenses.

Operating Efficiency

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

The above ratio indicates amount of operating expense per dollar of operating revenue. In other way it tells how bank is efficient in its operations. If a firm has lower (OE) then it is preferred over the high because it denotes that operating expenses is less than operating revenues.

Empirical Results

There is lot of ratios used to measure the financial position of Islamic and conventional banks.

In terms of profitability which includes (ROA, ROE, PER) ratios there is not much difference between the two types of banks as shown in table 1. The ROA for Islamic and conventional banks are (.74%) and (1.99%) respectively. The ROE is (5.04%) and (21%) respectively for Islamic and conventional banks. The PER is (.43) is for Islamic banks and (.48) for conventional banks.

In terms of liquidity which includes (LDR, LAR, CPIDBR) ratios Islamic banks are performing better in two ratios while conventional banks performing better in one ratio. In (LDR) Islamic banks are better with LDR of 60.65% as compared to conventional banks with LDR of 76.86% as shown in table 1. In LAR Islamic banks once again at better position with 40.09% LAR ratio as compare to conventional banks with 43.73%. But in CPIDBR conventional banks are performing better as compare to Islamic banks. The CPIDBR for Islamic and conventional banks are 36.23% and 42.87% respectively.

Our analysis for risk and solvency reveals that Islamic banks are more solvent and less risky as compare to conventional banks as shown in table 1. The (DER) for Islamic banks is 5.05t as compare to 7.30t of conventional banks. In (DTAR) Islamic banks are better with 72.13% as compare to 79.87% of conventional banks. In (EM) Islamic banks once again showing better performance with 6.64t as compare to conventional banks with 9.84t.

Lastly in efficiency ratios Islamic banks are better like in Risk and Solvency ratio. In efficiency ratio which includes (AU, IER, OE) ratios Islamic banks shown superior performance. In (AU) Islamic banks stand at 4.04% as compare to 2.96%. Similarly in (IER) conventional banks show poor performance with 0.90t as compare to 1.40t. Lastly in (OE) Islamic banks show 159.07% as compare to 160.74% of conventional banks.

Trend Analysis

The trend analysis of Islamic banks is on positive side as it shows gradually increasing trend from 2006 to 2010 period with regard to share capital, liabilities, Assets and Reserves. These results indicate that Islamic Banking is developing and increasing its share in market every year. While the Trend examination of Income Statements of Islamic banks shows the zig zag trend.

Trend analysis of conventional banks shows mix kind of trend as there is increasing trend in all balance sheet items after that there is a consistency period up to 2009. After that there is decreasing trend in some items. So there is not much growth in conventional banks as we have witness in Islamic banks. While the trend analysis of the income statements of the conventional banks shows negative trend and requires serious attention from the management. (See Figures in Appendix)

CONCLUSION

Profitability of both types of banks shows negative results but Islamic banks are slightly better in terms of loss as compared to conventional banks. Basic reason is that both types of banks selected are new entrants to the market. So they are unable to control their operating expenses. In terms of return on assets the Islamic banks are continuously doing better than conventional banks from 2007 to onwards. Conventional banks in terms of return on equity are showing negative trend from 2008 in contrast to Islamic banks who are nearly maintaining their growth. Profit to expense ratio shows up and down trend for both types of banks on average Islamic banks are showing better results but conventional banks also showing improvement since 2009. Analysis of profitability ratios shows that although both types of banks are exhibiting overall in loss but encouraging thing is that both banks showing sign of improvement especially Islamic banks and will overcome their loss in near future.

In terms of liquidity mix findings reveals by empirical analysis. Islamic banks are showing better results in loan to deposit ratio and loan to asset ratio while conventional banks are exhibiting slightly good result in terms of cash & portfolio to deposit & borrowing. Findings also indicate that loan to deposit ratio of conventional banks is somewhat steady and decreasing across particular range. Loan to deposit ratio of Islamic banks is falling overtime. This declining trend is due to rise in deposit base of Islamic banks which is good and positive sign. In addition this exhibits the level of reliance and belief of the public strengthen on Islamic banks with elapsing of epoch and also display of absolute stance of peoples for reckoning Islamic pecuniary products as viable and alternate options. Examination of loan to asset ratio showed that Murabaha has been highly famous other famous modes of finance includes diminishing Musharakah, Ijarah and export refinance under Islamic scheme.

Our results of risk & solvency permit us to infer that interest based banks are less solvent and more risky in comparison to Islamic banks. Examination of findings of entire solvency & risk measures, debt to total asset, debt to Equity and Equity Multiplier suggests that conventional banks are less solvent and more risky as compared to Islamic banks.

Like in risk & solvency Islamic banks show efficiency in usage of assets in producing their revenue and controlling outlay in contrast to conventional banks.

Finally for future studies when longer time period and more Islamic banks to investigate alike research would produce improve understanding on the question of performance comparison.

Table.1 Performance comparison between Islamic and Conventional Banks

Performance Measure	Islamic Banks		Conventional Banks	
	Mean	S.D	Mean	S.D
Profitability				
ROA	(.74)%	0.006	(1.99)%	0.010
ROE	(5.04)%	0.073	(21)%	0.261
PER	(.43)	0.513	(.48)	0.425
Liquidity				
LDR	60.65%	0.131	76.86%	0.089
LAR	40.09%	0.091	43.73%	0.046
CPIDBR	36.23%	0.103	42.87%	0.507
Risk and Solvency				
DER	5.05	1.999	7.30	3.843
DTAR	72.13%	0.191	79.87%	0.053
EM	6.64	1.033	9.84	6.849
Efficiency				
AU	4.04%	0.014	2.96%	0.007
IER	1.40	0.898	0.90	0.163
OE	159.07%	0.968	160.74%	0.808

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APPENDIX

Figure.1

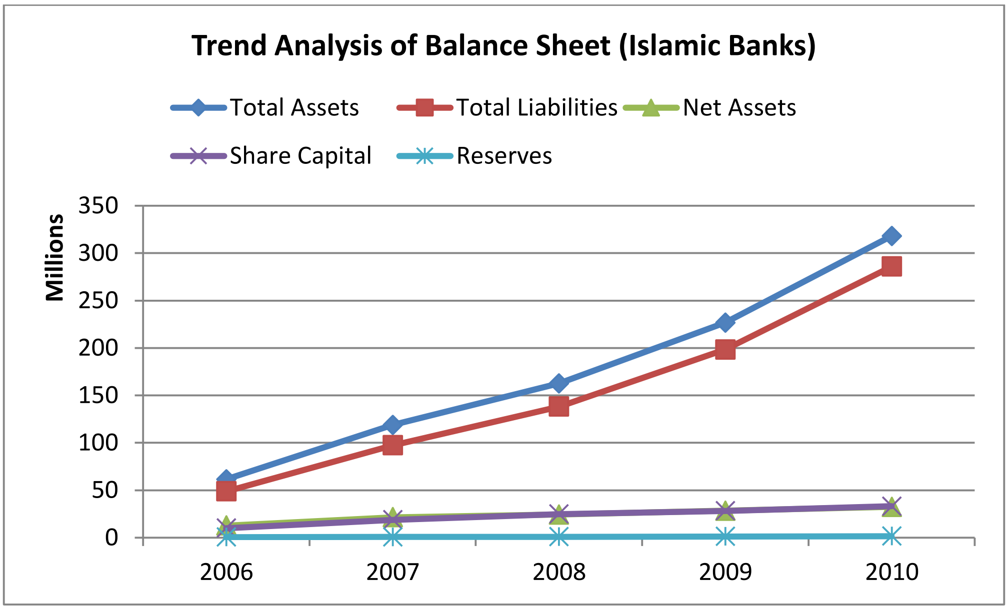


Figure.2

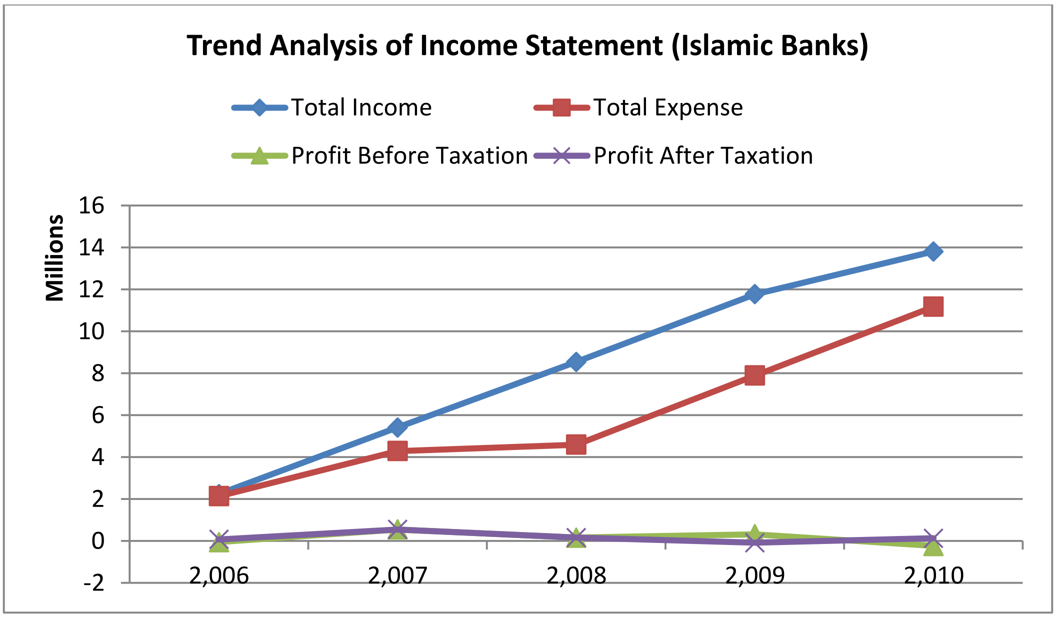
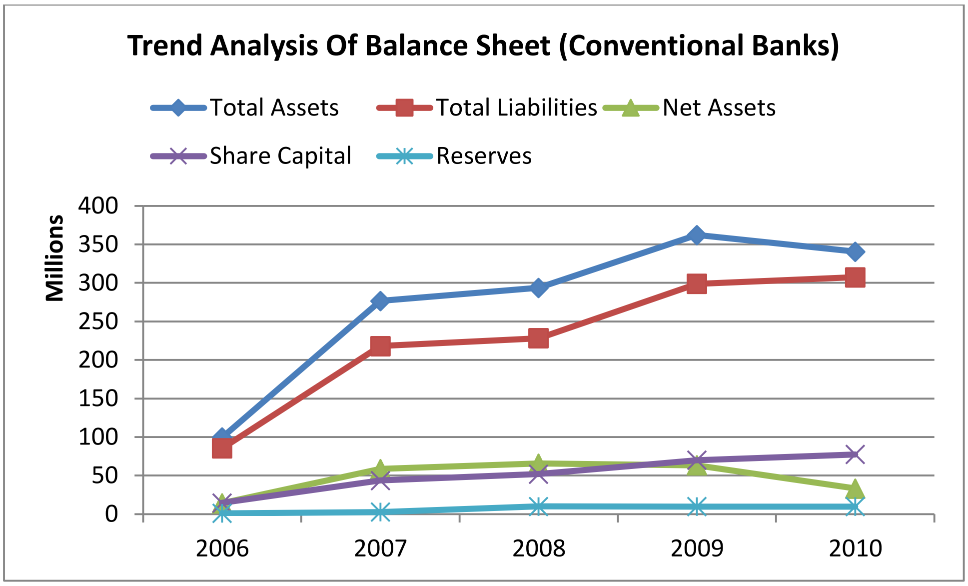


Figure.3



Figur.4