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# Performance comparison of Islamic and Conventional banks in Pakistan

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**Classification:** GJMBR-B: JEL Classification L15, E58, G21



*Strictly as per the compliance and regulations of:*



# Performance comparison of Islamic and Conventional banks in Pakistan

Muhammad Jaffar<sup>1</sup>, Irfan Manarvi<sup>2</sup>

**Abstract**—The study examined and compared the performance of Islamic and conventional banks operating inside Pakistan during 2005 to 2009 by analyzing CAMEL test standard factors such as capital adequacy, asset quality, management quality, earning ability and liquidity position. The financial data for the study was mined from the banks' financial statements existing on state bank of Pakistan website. A sample of 5 Islamic banks and 5 Conventional banks were selected to measure and compare their performance. Each year the average ratios were considered, because some of the young Islamic banks in the sample do not have 5 years of financial data. CAMEL test which is a standard test to check the health of financial institutions was used to determine the performance of Islamic and conventional banks. The study found that Islamic banks performed better in possessing adequate capital and better liquidity position while conventional banks pioneered in management quality and earning ability. Asset quality for both modes of banking was almost the same; conventional banks recorded slightly smaller loan loss ratio showing improved loan recovery policy whereas, UNCOL ratio analysis showed a nominal better performance for Islamic banks.

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## I. INTRODUCTION

Islam is the complete code of conduct for the Muslims. Islamic finance has been in practice throughout the world and a few concept, instruments, and techniques of Islamic finance were adopted by the European Financiers and businessmen. A few visionary individuals, scholars, bankers, Islamic economists and Shari'ah scholars started Islamic banking system as a universal banking in 1970. Although Riba-free business transactions were in practice before this, a well defined working model for Islamic banking did not exist [1][2].

An Islamic bank carries out all known banking activities; it operates on the basis of profit and loss sharing. Islamic banks were established against "Riba" which is forbidden in all forms and conditions. "Muslim Umah want to eliminate "Riba" from their financial system but consensus on what includes in "Riba" could not be attained. This has reduced the progress of implementation of the Riba free financial system [3].

Like other Muslim countries scholars who implied the concept of Shari'ah compliant financial system which became the base of Modern Islamic financial and banking system, Pakistan also started interest free financial system from 1970 with very limited interest free products. The actual work started during the era of Zia-ul Haq government in 1980s when Islamization of financial system and economy gradually started under government policy [4][5]. The period of 1990 to 2001 has seen the legal debates and cases in FSC and SCP on the issue of 'Riba'. The court decision against Riba forced the government to convert the interest based financial system to interest free based financial system. The government and many influential interest based financial institution were not interested for the abrupt change [6].

From 2001 onward government and SBP fully supported Islamic Banking. Policies, framework, structural support and rules of business for Islamic banks were established and Islamic Banking started in the shape of full-fledged banks and Islamic Subsidiaries by commercial banks [7].

Like Conventional bank, Islamic bank is an intermediary and trustee of money of people. On contrary, it shares profit and loss with its depositors and introduces the element of mutuality in Islamic banking [8]. Conventional banking follows Conventional interest-based principle, whereas, Islamic banking is based on interest free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries [9].

Islamic banks in Pakistan have showed good performance. Many writers in the world have compared Islamic banking performance with Conventional banking. The results showed that Islamic banks were better in maintaining Capital Adequacy and Asset quality than the Conventional banks [10][11].

Islamic banks are less profitable, more solvent and less efficient comparing to Conventional banks. In terms of liquidity, no major difference is seen between the two sets of banks [12]. Islamic banks profitability is positively related to equity and loans [13].

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## II. METHODOLOGY

This study is basically based on the historical data. The population for this study are the all Islamic and Conventional banks that operate inside Pakistan. The sample size is comprised of 5 full-fledged Islamic and 5 Conventional banks. The Islamic banks selected are Meezan Bank, Albaraka Islamic Bank, Dubai Islamic Bank, Bank Islami Pakistan and Dawood Islamic Bank. The Conventional banks are ACBL, MCB, SCB, HBL and AL-Fallah bank. To measure and compare the performance of Islamic and Conventional banks, CAMEL analysis is used, which is a standard test for performance analysis of financial institutions and the latest technique nowadays used. CAMEL test consists of Capital Adequacy, Asset quality, Management Quality, earning ability and Liquidity. The financial data of all Islamic and Conventional banks were extracted from the SBP website for the period 2005-2009. For better comparison, each year the average ratios for Islamic and Conventional banks were considered and then the mean of each ratio for each modes of banking was calculated.

## III. CAPITAL ADEQUACY

This study analyses capital adequacy by using the standard ratios of debt to equity and capital to risk assets. The average and mean ratios for both Islamic and Conventional banks are displayed in the figures 4.1 and 4.2.

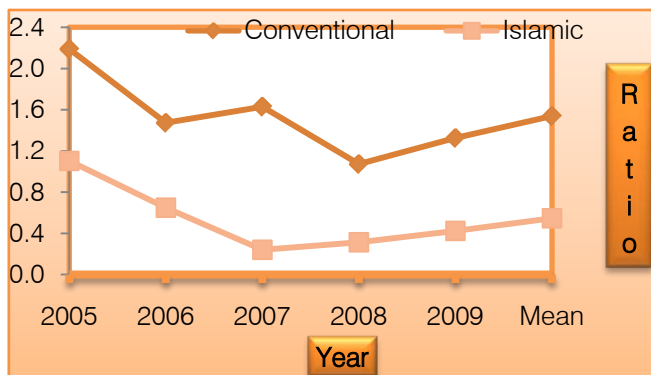


Figure 4.1 Debt to Equity ratio

The figure 4.1 shows that in 2005 the Islamic banks' D/E ratio was 1.1033 which is greater than 1.0. This fact indicates that Islamic banks have financed their operations primarily through debt. In 2006 this ratio has considerably decreased to 0.6487 and further decreased to 0.2403 in 2007. This is because the Islamic banks have taken safer position and decreased the risk by financing their assets and operations through more of equity rather than debt. These banks gradually increased their dependence on the debt financing in the years 2008 and 2009 but their D/E ratio still remained below 1.0 (0.4236 in 2009) which signifies that they have

financed their operations, assets and growth through more of equity and less of debt. This fact guaranteed less risk and save returns for the shareholders of Islamic banks.

On the other hand, Conventional banks D/E ratio has been greater than 1.0 in the period of 2005-2009. This is because the Conventional banks have aggressively depended on debt financing. As the ratio goes bigger than 1.0 the volatility and risk of returns increase. The D/E ratios have increased and decreased in the alternate years of the study period with the greatest ratio of 2.1889 indicating the riskiest position in 2005 and smallest ratio of 1.0724 showing the safest position in 2008 for conventional banks.

The mean D/E ratio for the period 2005-2009 recorded 1.5377 for Conventional banks and 0.5459 for Islamic banks. Comparatively, the Islamic banks had 2.82 times smaller ratio than the Conventional banks showing safer liquidity position for Islamic banks. On contrary, 1.5377 D/E ratio of Conventional banks means that they have followed the policy of higher risk leading to higher return. This position is promising in the times when interest rates are low and may lead to bankruptcy and DOG position in the times when interest-rates are on rise.

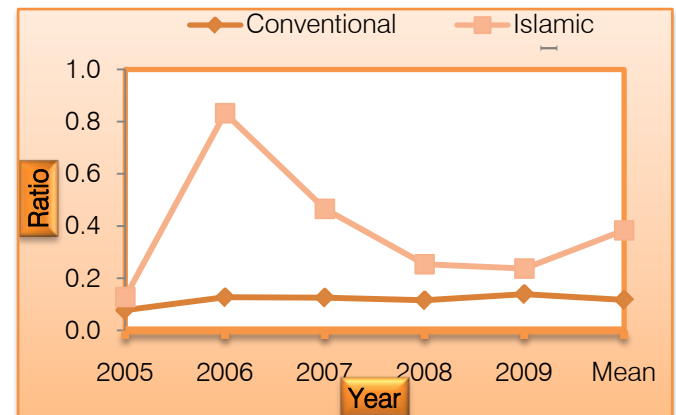


Figure no. 4.2 Capital to Risk Assets Ratio

The figure 4.2 analyses the capital to risk asset ratio of both Islamic and Conventional banks for the period of 2005-2009. CRAR is also called capital adequacy ratio (CAR). According to State Bank of Pakistan the minimum paid up capital for the banks is 5.0 billion rupees and minimum CAR for the banks is 10%.

During the period of 2005-2009 the Islamic banks maintained a very high CRAR which means that they had abundant capital to manage any shock to the balance sheet. Their high CRAR denotes their ability to maintain confidence in the Islamic banking system and protect their depositors and lenders. In 2005 Islamic banks had minimum CRAR of 12.84% which extraordinarily rose to 83.26% in the year 2006. From 2006 the CRAR constantly fell down each year and

recorded 23.73% in the year 2009. The high CRAR of Islamic banks shows their financial soundness.

The CRAR of Conventional banks proved to be above the minimum requirement except in the year 2005. The Conventional banks were strong enough to respond to the balance sheet shocks such as liabilities payment, operational and credit risks or any other loss. The best CRAR for the Conventional banks was 13.93% in 2009.

The mean of Islamic and Conventional banks shows that both banks have been strong to cushion any loss and protect their lenders and depositors. The mean for Islamic banks was 38.37% which is approximately 4 times of minimum requirement and at least 3 times of the Conventional banks CRAR mean. This comparison proves that Islamic banks have been many steps ahead of Conventional banks and had more capital than them.

#### IV. ASSET QUALITY

The study evaluates asset quality by the UNCOL and loan loss reserve ratios. The figures 4.3 and 4.4 show these ratios for years 2005- 2009. UNCOL ratio, whether high or low, shows the risk of loans becoming non-performing. The lower UNCOL ratio the more efficient assets and loans are. According to the figure 4.3, in 2005 the Conventional banks' asset quality was slightly better than Islamic banks' asset Quality backed by 0.04 UNCOL ratio for Conventional banks and 0.472 for Islamic banks. This superiority didn't

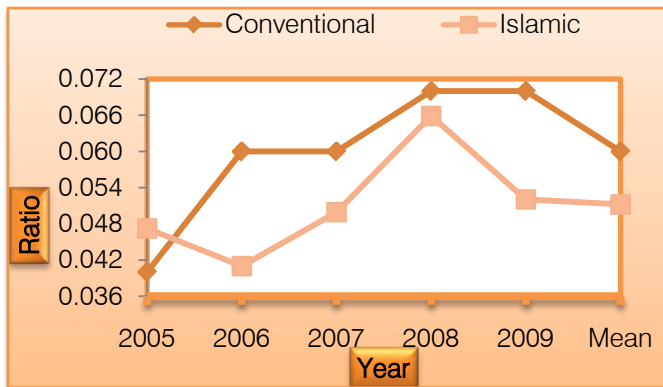


Figure no.4.3 UNCOL ratio

remain longer as the ratio rose to 0.06 in 2005, 2006 and further increased to 0.07 in both 2008 and 2009 years. The increasing UNCOL highlights the decrease in asset quality and weakness of management. As asset quality and loan quality has same basic meaning, the graph movement for Conventional banks explains that their loan quality has become lower after each two years and the amount of uncollected returns on loan has increased. This fact supports the statement that more money is blocked and remained unproductive which is a negative sign for asset and loan quality.

Since Islamic banks were weaker to produce asset quality in 2005, they managed to improve the

asset quality in 2006 when the assets were most efficient to produce quality performance. The year 2008 marked the weakest asset quality for Islamic banks during the years 2005-09. Comparing to Conventional banks, the Islamic banks asset quality was better in the whole period except the 2005 year. This denotes that Islamic banks had lesser uncollected income earned on their loans and lesser money was blocked.

The mean ratio for both banks shows a slight difference between their asset qualities. Lower ratio is favorable as the risks of loans to become uncollectable decreases and asset quality improves. The average UNCOL ratio for Islamic banks is lesser showing better management of assets.

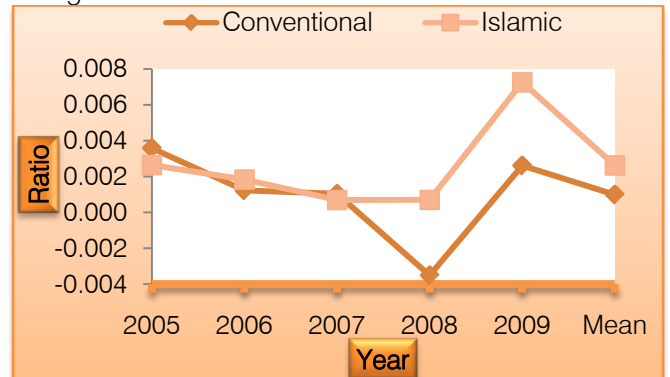


Figure no.4.4 Loan loss average ratio

Loan loss ratio shows the ratio of loan loss provision to total loans. Loan loss provision is the amount of money set aside to meet the losses when people and entities default to pay the loans they have borrowed from banks.

Islamic banks' loan loss ratio in 2005 was 0.26% which decreased to 0.18% and 0.07% in 2006 and 2007 respectively. This gradual fall was backed by the decrease in loan provision denoting less loan risks and improved loan recovery policy. The ratio drastically climbed to 0.73% indicating higher risk of bad loans and inclusion of more capital to survive defaulted loans.

Conventional banks' loan loss ratio in 2005 was recorded 36% which fell to 0.1% in 2007, climbed back to 0.35% in 2008 and again fell to 0.26% in 2009. The fluctuating ratio infers various levels of bad loans and risk for Conventional banks.

0.26% was average loan loss ratio for Islamic banks meaning that they had to maintain a provision of 0.26 PKR for each 100 PKR loan. This ratio has been smaller for Conventional banks and was only 0.24 %. The difference shows better asset/loan quality performance for Conventional banks.

#### V. MANAGEMENT QUALITY

Management quality of Islamic and Conventional banks is measured by operating expense and cost per money lent ratios. These ratios are

displayed in the figures 4.5 and 4.6 for the period of 2005-2009.

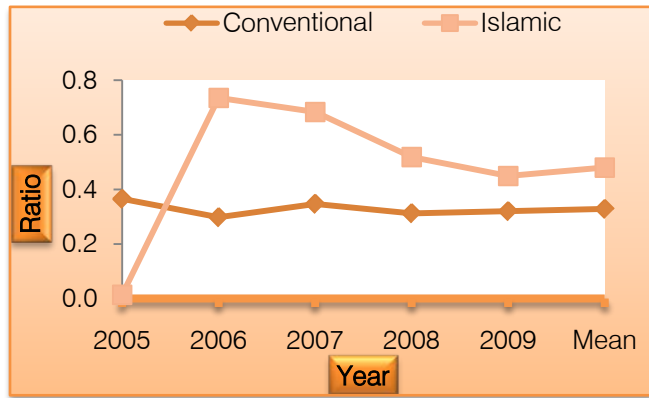


Figure no. 4.5 operating expense ratio

The management quality of Islamic banks has been quite different from Conventional banks during the study period of 2005-2009. The operational ratio of Islamic banks in 2005 was 1.37% which verifies a very good management. Unfortunately, this ratio rose to 73.52% in 2006 marking a disastrous management quality by spending approximately three quarters of income on operational expenses. Gradual improvement is seen from 2007 to 2009 as the ratio has decreased each year and management efficiency has got better followed by greater profit for the investors/depositors in the last 3 years of the study.

Conventional banks' time series represents a rise and fall in their management quality during the period 2005-2009; showing a weak management in 2005 as bigger percentage of return is used to pay operational expenses. The best year of management for Conventional banks was in 2006 when operational ratio was the lowest.

A comparison of management quality is important to show the efficiency of one over the other mode of banking. The mean operational ratio for Conventional banks indicates that almost 33% of revenues were spent to cover the operational expenses, whereas, Islamic banks spent about 48% of their returns on operational expenses. This difference clearly denotes a better management quality of Conventional banks. This may be because Islamic banking is very young industry and doesn't have as much experience in management as Conventional banks. Islamic banks management has not been able to capitalize on their new income properties, which requires lesser maintenance expense.

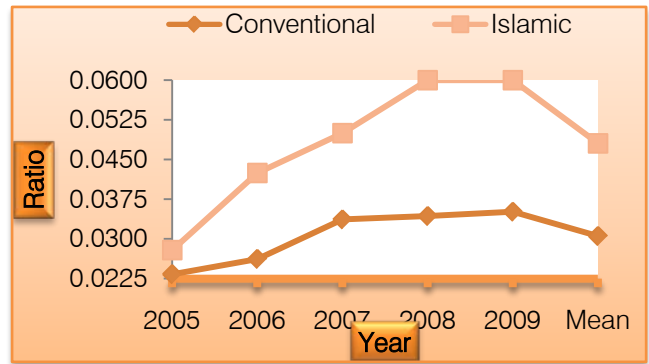


Figure no.4.6 Cost per money lent ratio

The cost per money lent ratio highlights the operating cost incurred to lend one unit of money. According to figure 4.6, for Islamic banks the cost of lending one unit of money increased from 2005 to 2008 making the loan disbursement process less efficient. This ratio remained unchanged in 2009, which may be due to no variance in the operational cost and amount of total loan disbursed as compared to 2008.

Conventional banks too didn't experience an efficient loan disbursement process and the ratio gradually increased from 2005 to 2009. The ratio recorded 2.33% in 2005 and consequently rose to 3.51% in 2009. During 2005 to 2009 the loan disbursement expense increased approximately 51% which is a negative sign for Conventional banks performance.

The mean cost per money lent ratio was 4.81% for Islamic banks while 3.05% for Conventional banks. This evidently supports a well-organized loan disbursement process for Conventional banks.

## VI. EARNING ABILITY

Earning ability according to camel test is calculated by ROA and ROE. As the Islamic banks are interest free banking, only ROA is used to measure the earning ability of Islamic and Conventional banks. Figure 4.7 examines the ROA ratio for the period of 2005-2009.

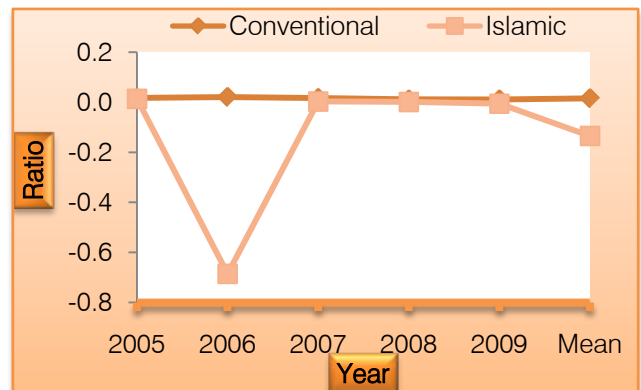


Figure no. 4.7 Return on asset ratio

Exhibited in figure 4.7, Islamic banks return on asset ratio was poor enough with the highest 1.37% in 2005 and the lowest -68.55% in 2006. In 2005 Islamic

banks have earned only 1.37 rupees of each 100 rupees invested on assets. This value drastically fell to -68.55% recording the worst earning ability during 2005 to 2009. Lack of management is the main reason for this poor performance. Furthermore, Islamic banks are focused on growth and expansion strategies which deviates them from profit-oriented strategies.

The Conventional banks return on invested asset could not surpass 2.03% during the period 2005 to 2009. This result for Conventional banks is comparatively better. Conventional banks lead the way in earning on their invested assets. This determines better investment decision, more profit for banks and shareholders.

### VII. LIQUIDITY

In this study the CAMEL's two ratios of Loan to Asset ratio and deposit to asset ratio are examined to find out the liquidity position of the Islamic and Conventional banks. These ratios are shown in the figures 4.8 and 4.9 for the period 2005 to 2009.

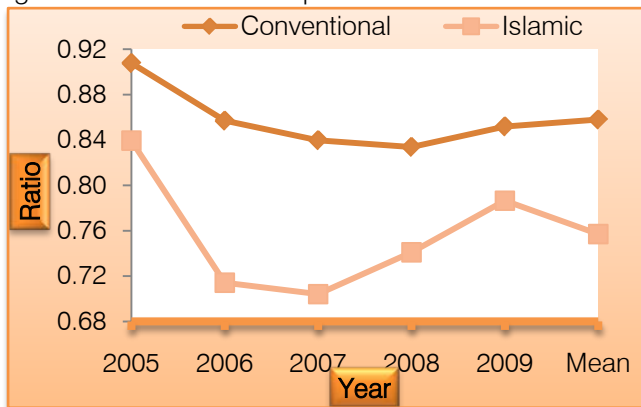


Figure no. 4.8 Loan to asset ratio

Islamic banks' loan to asset ratio decreased in 2006 and 2007. Reduction in loan to asset ratio coins comparatively better position and lower risk. On contrary, this ratio constantly increased in 2008 and 2009 indicating that Islamic banks were loaned up more as compared to the past two years. In the whole period of 2005 to 2009 Islamic banks had high loan to asset ratio which brings on a high risk if the creditors demand repayment of debt. The highest ratio for the Islamic banks was 83.94% in 2005 indicating that almost 84% of the assets were financed through debts.

Similarly, in the year 2005, Conventional banks recorded 90.78% loan to asset ratio inferring that nearly 91% of their assets were financed through debt. This soaring ratio gradually decreased and finally in 2008 marked 83.38% which is still a high risk ratio and is associated with great risk in the Conventional banks operation. High ratios not only add to risk of defaulting but also reduce the borrowing capacity which in turn lowers the Conventional banks financial flexibility.

Both Islamic and Conventional banks exhibited high loan to asset ratio coupled with higher debt and risk of default. On average Islamic banks got a ratio of 75.71% which is lower than the average ratio of 85.80% for Conventional banks. Lower loan to asset ratio means that Islamic banks should pay lesser for loan settlement. This fact reflects better liquidity position for Islamic banks.

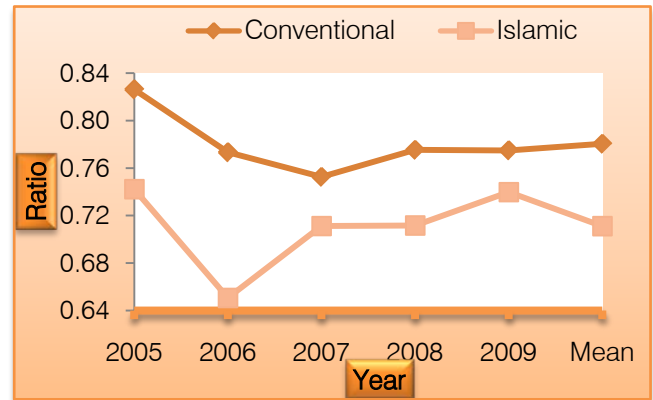


Figure no.4.9 Deposit to asset ratio

According to figure 4.9 Islamic banks had intermittent deposit to asset ratios showing varying amount of customers' deposits to banks' assets in the study period. The biggest amount of deposits customers left with the Islamic banks was in 2005 making 74.23% of total assets of these banks. This ratio means that Islamic banks had to dedicate comparatively a bigger proportion of asset to the customers who withdrew their deposits in 2005. Followed by the year 2006 when the amount of deposits to assets was the lowest for the Islamic banks.

Similar to Islamic banks, the Conventional banks too noted the highest deposit to asset ratio in the year 2005 and the lowest in 2007. During the whole study period the deposit to asset ratio of Conventional banks didn't fell below 75% indicating that much of asset was spent for the payment of customers' deposits. This ratio may create liquidity problem for the banks if the customers rush to withdraw their money in bad economic situations such as the 2009 economic crisis.

The mean deposit to asset ratio for the Islamic banks was 71.11% which is lower than 78.05% ratio of Conventional banks. This supports the better liquidity performance for the Islamic banks.

### VIII. FINDINGS

The Islamic and Conventional banks' performance was compared by evaluating CAMEL test variables such as capital adequacy, asset quality, management, earning ability and liquidity position for a period of 2005-2009. Each CAMEL variable was measured by relevant ratios and the following results were found:

- Islamic banks D/E ratio specified a safer position by financing their assets more through equity than debt comparing to Conventional banks who followed the policy of higher risk leading to higher return. The CRARs of both modes of banking proved to be higher than minimum requirement. Islamic banks' CRAR was at least 3 times of Conventional banks' CRAR marking a larger possession of capital for them. Thus, the Islamic banks pioneered in capital adequacy.
- Both modes of banking varied slightly in UNCOL ratio and recorded lower ratio for Islamic banks representing more efficient assets and loans. On contrary, Conventional banks proved to have better loan loss ratio, which means less loan risks and improved loan recovery policy. Both modes of banking showed superiority in different perspectives of asset quality; the Conventional banks held a competitive advantage by having a mean loan loss ratio of 0.24% as compared to 0.26% of Islamic banks, whereas, Islamic banks led the way having a slightly lower mean UNCOL ratio of 5.12% as compared to 6% of Conventional banks. Hence, both modes of banking showed almost same performance in their asset quality management.
- Operating expense ratio for Islamic banks recorded different values from 1.37% in 2005 to 73.52% in 2006 and an overall ratio of 48% which was higher than 33% of Conventional banks who spent 33% of their revenues to cover the operational expenses. Both Islamic and Conventional banks didn't experience an efficient loan disbursement process supported by the weak cost per money lent ratios in various years. The mean ratio was 3.05% for Conventional and 4.81% for Islamic banks indicating a well-organized loan disbursement process and consequently, better management performance for Conventional banks.
- The study concludes that Islamic banks performed poorly in earning on their assets with records of 1.37% in 2005 and -68.55% in 2006 and overall return on asset ratio of -13.47% during the period 2005 to 2009. Conventional banks had a mean ratio of 1.53% marking better investment decision and more profit for the banks and shareholders.
- Both Islamic and Conventional banks exhibited high loan to asset ratio resulting higher debt and risk of default. On average Islamic banks exhibited lower loan to asset ratio than Conventional banks meaning that Islamic banks should pay lesser for loan settlement which in

turn reflects higher liquidity for Islamic banks. Furthermore, the mean deposit to asset ratio for the Islamic banks was 71.11% which is lower than 78.05% ratio of Conventional banks supporting a better liquidity performance for the Islamic banks.

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