



Financial Performance of Islamic Banking and Conventional Banking in Pakistan: A Comparative Study

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Abstract

The aim of this study is to examine and evaluate the performance of the first Islamic bank in Pakistan, i.e. Meezan Bank Limited (MBL) in comparison with a group of 5 Pakistani conventional banks. The study evaluates performance of the Islamic bank (MBL) in profitability, liquidity, risk and solvency, and efficiency for the period 2003-2007. Financial ratios (12 in total) such as Return on Asset (ROA), Return on Equity (ROE), Loan to Deposit ratio (LDR), Loan to Assets ratio (LAR), Debt to Equity ratio (DER), Asset Utilization (AU), and Income to Expense ratio (IER) are used to assess banking performances. T-test and F-test are used in determining the significance of the differential performance of the two groups of banks. The study found that MBL is less profitable, more solvent (less risky), and also less efficient comparing to the average of the 5 conventional banks. However, there was no significant difference in liquidity between the two sets of banks. The reasons are due to the facts that conventional banks in Pakistan have longer history and experience in doing banking business and hold dominating position in the financial sector with its large share in the overall financial assets of Pakistan, as compared to Islamic banks, which in true sense, started only a few years back with all letter and spirit. Albeit, the study found that MBL is less profitable, more solvent (less risky), and less efficient during 2003-2007, however, it is improving considerably over time indicating convergence with the performance of the conventional banks.

Key Words: Financial performance; Banks; Comparison; Pakistan

Introduction

Rising and stiff competition, consolidation among banks, globalization, deregulation, liberalization, and continuous innovation to provide islamically acceptable financial services have given rise to the interest of all the concerned and interested parties in detailed critical evaluation of Islamic banks.

Whether these are depositors, investors, bank managers, or regulators, performance evaluation of banks is important for all parties. In a highly competitive financial market, bank performance provides signal to depositor-investors whether to invest or withdraw funds from the bank. Depositors may also be interested in evaluating the performance of the bank as they are not entitled to fixed returns and the nominal values of their deposits are not guaranteed. Managers

are keen to know the outcomes of previous management decisions as well as to evaluate whether to improve loan service or deposit service or both to improve its finance. Being responsible for safety and the soundness of the banking system and preserving public confidence, bank regulators monitor banks' performance to identify banks that are experiencing severe problems. Persistent monitoring of performance is important as existing problems may remain unnoticed and can lead to financial failure in the future otherwise [Samad & Hassan (2000), and Hassan & Bashir (2003)].

Existing literature on Islamic banking unleashes various studies made on performance measurement of Islamic banks [for example see, Bashir (2000), Hassan & Bashir (2003), Samad & Hassan (2000), Rosly & Abu-Bakar (2003), Samad (1999), Samad (2004), Sufian (2007), Saleh & Rami (2006)]. Although, studies on assessing financial performance of Islamic bank(s) and conventional bank(s) in different countries have been captured by the existing literature on Islamic Banking and Finance, however, we could not detect any studies published on comparative analysis of financial performance of Islamic bank(s) and conventional bank(s) of Pakistan.

The paper is aimed at to examine and analyze the experience with Islamic banking of the first Islamic bank, Meezan Bank Limited (MBL), in order to evaluate the Islamic bank's performance in comparison with the group of 5 conventional banks in Pakistan. Since MBL is the only old, somewhat large, and experienced domestic private Islamic bank in Pakistan, the study is expected to give us some room to generalize our results with regards to performance evaluation of Islamic banks in Pakistan on standalone basis as well as on comparative basis.

Although, Islamic banking in Pakistan started around three decades ago with an initiative of elimination of interest from the operations of specialized institution and commercial banks in 1977-78, but the serious efforts have been the part of recent past only when in January 2000, State Bank of Pakistan (SBP) constituted a Commission for Transformation of Financial System (CTFS) to introduce Shari'ah compliant modes of financing, and, on 15 September 2003, when the State Bank of Pakistan (SBP) established the Islamic Banking Department. As a result of these staid efforts, Islamic banking is now playing an important role in financing and contributing to different economic and social sectors in the country in compliance with the principles of Islamic Shari'ah in Islamic banking practices.

To give a real boost to Islamic banking operations in Pakistan, in an historic initiative, in January 2002, Meezan Bank Limited was granted first *Islamic Banking License* by the State Bank of Pakistan to operate as first full-fledged Islamic bank in Pakistan.

Including six full-fledged Islamic banks, there are thirty-five banks in total operating as commercial banks in Pakistan. Out of these six Islamic banks, five are private banks and one is a foreign bank. Among all Islamic banks, Meezan Bank Limited (MBL) is the only old, somewhat big, and experienced private Islamic bank of Pakistan operating last for more than six years. Almost all rest of the Islamic banks in the country started their operations only recently except Albaraka Islamic Bank (AIB), which is a foreign bank operating in the country as branches of AlBaraka Islamic Bank Bahrain since 1991 (Source: AIB). Being foreign bank, we did not select AIB as Islamic bank for our study because the study is aimed at comparing performance of *domestic* Islamic and conventional banks in Pakistan. Another reason for *not* selecting AIB is its very small size (measured both in terms of value of total assets and the number of branches operating in Pakistan).

Another prime reason for selecting MBL as Islamic bank is the availability of this bank's latest 5years' data. Also this was the reason for selecting latest five years (2003 to 2007) to

perform our analysis. Since MBL is the private bank, all 5 conventional banks selected for the study are also private banks. Moreover, these 5 conventional have been selected keeping in mind that these banks, at large, should duly represent private banking sector of Pakistan. Any of Government owned banks and privatized banks hasn't been made part of this group because almost all of these banks are pretty old and quite large in size as compared to the private sector banks of Pakistan. Reason for not selecting foreign bank, whether Islamic or conventional, is to focus on financial performance of *domestic banks* only. Time, data availability, and some other limitations also restricted the scope of the study.

Among different tools and techniques different authors used as performance measure, financial ratios found to be quite commonly used in the literature. For the study, we used financial ratios to measure and compare Islamic bank and conventional banks performances in the profitability, liquidity, risk & solvency, and efficiency. T-test and F-test are used to determine the significance of the results.

The paper is organized in 5 sections: Section 1 introduced Introduction to the study, which is continued in Section 2 with "Introduction to Islamic Banking" followed by "Data and Methodology" in Section 3. Section 4 and 5 constitute "Empirical Results" and "Conclusion" of the study respectively. Paper ends up with Appendix, which introduces "Banking sector of Pakistan" and "Islamic Banking Sector" of Pakistan.

Introduction to Islamic Banking

After its first introduction on experimental basis in a small town of Egypt in 1963, many Islamic Banks, both with letter and spirit, were established in the Middle Eastern and Asian regions. The growth of Islamic banking has been increasing ever since, not only in terms of number of countries it is operating in but also in term of areas of finance it has ventured in (El Gamal, 2006). In three decades, Islamic banks have grown in number as well as in size world wide and are being practiced on even more intensive scale. Some countries like Sudan and Iran, have converted their entire banking system to Islamic banking. In other countries where conventional banking is still dominating the Islamic Banking is operating alongside. Today, Islamic banks are operating in more than sixty countries (Aggarwal and Yousaf 2000). Islamic Banking and Finance is growing at between 10%-15% per annum and is boasting global assets in excess of \$1Trillion. A recent survey indicated that there are more than 160 Islamic financial institutions existing world wide (Dar 2003).

Gradual and steady spread of the Islamic banks over time over the world is a lucid manifestation of success and the symbolic growth rate is the hallmark of this emerging market. Being fastest growing segment of the credit market in Muslim countries, market share of Islamic banks in Muslim countries has risen from 2% in the late 1970s to about 15 percent today (Aggarwal and Yousaf 2000). Islamic banking is getting popularity, warm welcome, and appreciation also by non-Muslims in Muslim and non-Muslim countries. According to Yudistira (2003), although, most of the Islamic banks are within Middle Eastern and/or Emerging countries, many universal banks in developed countries have started to spigot huge demand of Islamic financial products. This also confirms that Islamic banking is as viable and efficient as the conventional banking is.

Where the financial liberalization and deregulation have created new challenges and new realities for Islamic banks, the globalization effect has also put these institutions in cutthroat competition with traditional financial institutions in well developed financial markets. It has become indispensable for Islamic banks to be innovative in designing Islamically acceptable

instruments to grapple with the unremitting innovations in financial markets and to compete in local and global deposit markets. Moreover, for fund mobilization and utilization, Islamic banks must seek investment opportunities and avenues that offer competitive rates of return at acceptable degrees of risk. In order to maximize the value of the bank, management of the bank should carefully consider interactions between different performance measures.

Islamic finance refers to the means by which corporations in the Muslim world, including banks and other lending institutions, raise capital in accordance with Shari'ah, or Islamic law. It is also referred to the types of investments that are permissible under this form of law. A unique form of socially responsible investment, Islam makes no division between the spiritual and the secular, hence its reach into the domain of financial matters (Ross 2007).

Islamic Banking and Finance Defined

Islamic banking is the system of banking consistent with principles of Islamic law (Shari'ah) and guided by Islamic economics. Islamic economics is referred to that body of knowledge which helps realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances (Chapra 1996). A key element of Islamic economics is distribution of equitable rewards to the different factors of production. Islamic economic system seeks system of Redistributive justice where concentration of wealth in a few hands is countered and flow of money into the economy is fluent. Islamic banking is, therefore, seen as a lynchpin to achieving the economic and social goals of the Islamic economic system.

(Source: Bank Alfalah).

The thrust of Islamic banking is founded on the desire to submit to the Divine Instructions on all transactions, particularly those involving exchange of money for money. However, it would be quite unfair to limit Islamic banking to elimination of *Riba* only. *Riba* is but one of the major undesirable elements of an economic transaction, the others being *Gharar* (risk or uncertainty) and *Qimar* (speculation). While elimination of these objectionable aspects in a transaction is indeed a critical aim of Islamic banking, it is by no means its ultimate objective. According to some, usury or excessive and exploitative charging of interest; while according to others, interest per se – is forbidden by the Qur'an. For example:

“And that which you give in gift (loan) (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allâh; but that which you give in Zakât (sadaqa - charity etc.) seeking Allâh's Countenance, then those, they shall have manifold increase. Sura Ar-Rum (30:39).”

“That they took riba (usury), though they were forbidden and that they devoured men's substance wrongfully – We have prepared for those among men who reject faith a grievous punishment. Sura An-Nisa (4:161).”

It has been argued in vain for long in some circles that the prohibition in Islam is that of excessive interest only or that it is the interest on consumptive loans that has been forbidden and as such loans extended for commercial purposes are entitled to an excess over the principle amount lent. Such tendentious arguing fails to give due understanding to versus 278 & 279 of *Surah Albaqra* (quoted below);

“O ye who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury) (from now onwards) if you are (really) believers. (2:278).”

“And if you do not do it, take notice of war from Allah and His messenger! But if you repent, you shall have your capital sums. (2:279).”

However, this does not mean that Islam prohibits any gain on principle sums. In Islam, profit is the recognized reward for capital. When capital employed in permissible business yields profit that profit (excess over capital) becomes the rightful and just claim of the owner of the capital. As a corollary, the risk of loss also rests exclusively with the capital and no other factor of production is expected to incur it. Another important element of Islamic finance is that profit or reward can only be claimed in the instance where either risk of loss has been assumed or effort has been expended. Profit is therefore received by the provider of capital and wages/remuneration by labor/manager.

Historical Perspective of Islamic Banking: A Glance

As with all things Islamic, the origination of Islamic finance goes back to the time of Prophet Muhammad (*Peace be upon Him*). The Prophetic example was the very epitome of fair-trade. Refraining from usury, ensuring transparency in transactions, and total honesty entitled him Al-Amin (The trustworthy) in pre-Islamic Arabia (Sufyan).

In Muslim communities, limited banking activity, such as acceptance of deposits, goes back to the time of the Prophet Muhammad (*Peace be upon Him*). At that time people deposited money with the Prophet Muhammad (*Peace be upon Him*) or with Abu Bakr Sedique (*May Allah be pleased with Him*), the first Khalif of Islam.

Ahmad El Najjar made pioneering effort and established a Savings Bank based on *profit-sharing* in Egyptian town of Mit Ghamr in 1963. There were nine such banks in the country by 1967. These banks, which neither received nor paid any interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi 1988). These banks were functioning essentially as saving-investment institutions rather than as commercial banks. Although its charter made no reference to Islam or Shari'ah (Islamic law), Nasir Social Bank, established in Egypt in 1971, was declared an interest-free commercial bank (Arif 1988).

In the seventies, with letter and spirit, a number of Islamic banks were established in the Middle East, e.g., the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Egypt (1977), the Faisal Islamic Bank of Sudan (1977), and the Bahrain Islamic Bank (1979), to mention a few. A number of banks were also established in the Asia-Pacific region in response to these winds of change, e.g., The Philippine Amanah Bank (PAB) was established in 1973 as a specialized banking institution by Presidential Decree without reference to its Islamic character in the bank's charter. The PAB is not strictly an Islamic bank; nevertheless, efforts are underway to convert the PAB into a full-fledged Islamic bank (Mastura 1988). Islamic banking was introduced in Malaysia in 1983. The success of the Tabung Haji also provided the main thrust for establishing Bank Islam Malaysia Berhad (BIMB), which represents a full-fledged Islamic (commercial) bank in Malaysia. The Organization of Islamic Countries (OIC), established Islamic Development Bank (IDB) in December 1973. The IDB not only provides fee-based financial services but also provides financial assistance on profit-sharing bases to its member countries (Source: IDB).

Reference should also be made to some Islamic financial institutions established in countries where Muslims are a minority. There was a proliferation of interest-free savings and loan societies in India during the seventies (Siddiqi 1988). The Islamic Banking System (now called Islamic Finance House), established in Luxembourg in 1978, represents the first attempt at

Islamic banking in the Western world. There is also an Islamic Bank International of Denmark, in Copenhagen, and the Islamic Investment Company has been set up in Melbourne, Australia (Arif 1988). In the late 20th century, a number of Islamic banks were created, to cater to this particular banking market.

Difference between Islamic Banking and Conventional Banking: An Overview

Like conventional bank, Islamic bank is an intermediary and trustee of money of other people but the difference is that it shares profit and loss with its depositors. This difference that introduces the element of mutuality in Islamic banking makes its depositors as customers with some ownership of right in it (Dar and Presley 2000).

Islamic banks are similar to those of non-Islamic banks in that both offer similar (financial) services and play a pivotal role in the economic development of their societies. But they are different in that Islamic banks, unlike non-Islamic banks, are bound to follow Islamic Shari'ah in their operations. For instance, according to Islamic Shari'ah exploitative contracts based on Riba (usury or interest) or unfair contracts that involve risk or speculation are unforeseeable.

Islamic banking and conventional banking differs in that while the conventional banking follows conventional interest-based principle, the Islamic banking is based on interest-free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries (Arif 1988). Rationale behind prohibition of interest and the importance of PLS in Islamic banking has been discussed in many Islamic economics studies. Moreover, Islamic PLS principle creates the relationship of financial trust and partnership between borrower, lender, and intermediary (Yudistira 2003).

Islamic finance is a financial system with the aim to fulfill the teaching of Holy Qur'an as opposed to reaping maximum return on financial assets. Conformity to norms of Islamic ethics is the main concern of Islamic financial system. These norms of Islamic ethics as enunciated by the Shari'ah govern all transactions in an Islamic financial system. At a fundamental level, an Islamic financial system can be described as a "Fair" and a "Free" system where "Fairness" is the primary objective; however, it also circumscribes the "freedom" of the participants in the system. Though, in Islam participants are free to enter into transactions but this basic norm of freedom does not imply rampant freedom to contract and is constrained by other norms, such as, the prohibition of *Riba and Gharar*.

Data and Methodology

The study is aimed at comparative financial performance of Islamic banking vis-à-vis conventional banking in Pakistan. Specifically, study makes comparison of Meezan Bank Limited (Islamic bank) and a group of 5 conventional banks performances each year in 2003-2007. Data for each year have been compiled from the income statements and balance sheets of these two sets of banks. In the bank performance study, this type of inter-bank analysis is pretty common (Sabi 1966). In today's competitive financial market, one can better understand the performance of a bank by an analysis of inter-bank comparison.

Various indexes have been provided by financial management theories for measuring bank's performance. Using accounting ratios is one of them. To measure performance, financial ratios have been used quite commonly and extensively in the literature. For example, bank regulators use financial ratios to evaluate bank's performance (Samad & Hassan 2000), Patnam

(1983), Meister and Elyasiani (1988), Spindler (1991), Akkas (1994), Sabi (1996), and Samad (1999), Ali & Rami (2006) gave employed ratios for evaluating a bank's performance.

In order to see how Islamic bank has performed in comparison with the conventional banks over 5 years, the study uses 12 financial ratios for the bank's performance. These ratios are broadly categorized into four groups: (a) profitability ratios; (b) liquidity ratios; (c) risk and solvency ratios; and (d) efficiency ratios. Since there are five conventional banks in a group to compare with one conventional bank, so we first calculated ratio of each bank in that group and then calculated average of those five ratios to compare that average ratio with one ratio of Islamic bank in each year.

Profitability Ratios

Profitability ratios are generally considered to be the basic bank financial ratios in order to evaluate how well bank is performing in terms of profit. There are various ratios to measure profitability performance of the banks, however, this study applies these ratios: *Return on assets (ROA)*, *Return on Equity (ROE)*, and *Profit Expense Ratio (PER)*.

i. Return on Assets (ROA) = *Net profit after tax / Total assets*. It measures how much the firm is earning after tax for each dollar invested in the assets of the firm. Generally, a higher ratio means better managerial performance and efficient utilization of the assets of the firm and lower ratio is the indicator of inefficient use of assets.

ii. Return on Equity (ROE) = *Net profit after tax / Shareholders' Equity*. ROE measures how much the shareholders are earning after tax for each dollar invested in the firm. It's also a measure of managerial efficiency; higher ROE means better managerial performance.

iii. Profit to Expenses Ratio (PER) = *Profit after tax / Operating Expenses*. The ratio measures the amount of operating profit earned for each dollar of operating expense. The ratio indicates to what extent bank is efficient in controlling its operating expenses. A higher PER means bank is cost efficient and is making higher profits.

Liquidity Ratios

These ratios measure ability of the firm to meet its short term obligations, maintain cash position, and collect receivables. In general sense, the higher liquidity ratios mean bank has larger margin of safety and ability to cover its short term obligations. Because saving accounts and transaction deposits can be withdrawn at any time, there is high liquidity risk for both the banks and other depository institutions. Measures of liquidity are: *Loan to Deposit Ratio (LDR)*, *Cash & Portfolio Investment to Deposit Ratio (CPIDR)*, and *Loan to Asset Ratio (LAR)*.

i. Loan to Deposit Ratio (LDR) = *Loan / Deposits*. Bank with low LDR is considered to have excessive liquidity, potentially lower profits, and hence less risk as compared to the bank with high LDR. However, high LDR indicates that a bank has taken more financial stress by making excessive loans and also shows risk that to meet depositors' claims bank may have to sell some loans at loss.

ii. Cash & Portfolio Investment to Deposit Ratio (CPIDR) = *Cash & Portfolio Investments / Deposits*. The higher the CPIDR ratio the better is the liquidity position of the bank, therefore, the more is the confidence and trust of the depositors in the bank as compared to the bank with lower CPIDR.

iii. Loan to Asset Ratio (LAR) = *Loan / Assets*. This ratio gauges the percentage of total assets the bank has locked-up in loans (or financings). The higher is the ratio the less the liquidity is of the bank. Similar to LDR, the bank with low LAR is also considered to be more liquid as

compared to the bank with higher LAR. However, high LAR is an indication of potentially higher profitability and hence more risk.

Risk and Solvency Ratios

The more the debt a firm has, the higher is the chance that firm would become unable to fulfill its contractual obligations and this what this set of ratios measure. If the amount of assets is greater than amount of liabilities, the bank is considered to be solvent. To gauge risk and solvency of the banks this study uses: *Debt-Equity Ratio (DER)*, *Debt to Total Assets Ratio (DTAR)*, and *Equity Multiplier (EM)*.

i. Debt-Equity Ratio (DER) = *Debt / Shareholders' Equity*. It measures ability of the bank capital to absorb financial shocks. In case, creditors default in paying back their loans or the asset values decrease bank capital provides shield against those loan losses. A bank with lower DER is considered better as compared to the bank with higher DER.

ii. Debt to Total Assets Ratio (DTAR) = *Debt / Total Assets*. It provides information about the solvency and the ability of the bank to obtain additional financing for potentially attractive investment opportunities. Higher DTAR means bank has financed most of its assets through debt as compared to the equity financing and that bank is involved in more risky business.

iii. Equity Multiplier (EM) = *Total Assets / Shareholders' Equity*. The ratio indicates the amount of assets per dollar of shareholders' equity. Higher value of EM means that bank has used more debt to convert into assets with share capital. Generally, the higher is the EM the greater is the risk for a bank.

Efficiency Ratios

These ratios measure how effective and efficient the firm is in managing and controlling its assets, generating sales, controlling its expenses, and etc., etc. Higher value of these ratios is an indicator of good performance of the bank. Ratios used to measure efficiency of the bank are: *Asset Utilization (AU)*, *Income to Operating Expenses Ratio (IER)*, and *Operating efficiency (OE)*.

i. Asset Utilization (AU) = *Total Revenue / Total Assets*. How effectively the bank is utilizing all of its assets is measured by assets utilization ratio. The bank is presumably said to using its assets effectively in generating total revenues if the AU ratio is high. If the ratio of AU is low, the bank is not using its assets to their capacity.

ii. Income to Operating Expense Ratio (IOER) = *Total Income / Total Operating Expense*. This is the most commonly and widely used ratio in the banking sector to assess the managerial efficiency in generating total income vis-à-vis controlling its operating expenses. High IER is preferred over lower one as this indicates the ability and efficiency of the bank in generating more total income in comparison to its total operating expenses.

iii. Operating Efficiency (OE) = *Total Operating Expenses / Total Operating Revenue*. It measures managerial efficiency in generating operating revenues and controlling its operating expenses. That is, how efficient is the bank in its operations. Lower OE is preferred over higher OE as lower OE indicates that operating expenses are lower than operating revenues.

Empirical Results

Profitability Ratios

i) Return on Assets (ROA). ROA of both sets of bank show somewhat similar results; however, ROA of conventional bank is constantly higher than Islamic bank's ROA during time horizon of the study except year 2007, wherein ROA of Islamic bank is slightly higher than that of conventional banks. Moreover, having decreased by 40% in 2004 and increased by 20% in 2005, ROA of conventional banks is delineating continual decreasing trend thereafter. The study of ROA of Islamic bank shows somewhat alike results during 2003-2005 but ROA of Islamic bank is exhibiting, though overall increasing but, fluctuating trend since 2005. Finally, the results show an average of conventional banks' ROA higher than ROA of Islamic bank. Moreover, statistically there is no difference between the two means at 5% level of significance (*see TABLE 13*).

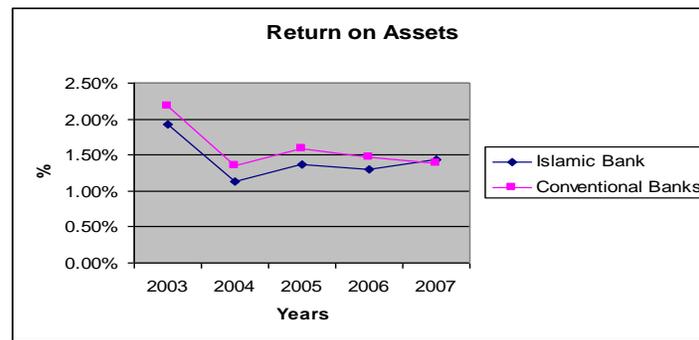


Figure 1.

Table 1.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|-------|-------|-------|-------|-------|-------|---------|
| Islamic Bank | 1.93% | 1.14% | 1.37% | 1.30% | 1.43% | 1.49% | 0.00296 |
| Conventional Banks | 2.18% | 1.35% | 1.59% | 1.47% | 1.38% | 1.59% | 0.0034 |

ii. Return on Equity (ROE). The result of ROE indicates several important points. First, it shows that ROE of conventional banks is consistently higher than that of ROE of Islamic bank during 2003-2007. Second, the monumental difference of 17.6% in 2003 plummeted to minuscule difference of only 2.5% in 2007. And this noteworthy decrease in difference of performance is essentially due to overall increasing trend in ROE of Islamic bank and decreasing trend in ROE of conventional banks. Further study of the last five years' financial statements of both sets of banks reveal that increasing trend of Islamic Bank's ROE during 2003-2007 is due to *increase in profits base more than equity base*, and decreasing trend of ROE of conventional banks is due to the fact that for most of the banks in a group of 5, *equity base increased more than profits base*. The difference of the two means is strongly significant at 5% level of significance (*see TABLE 13*).

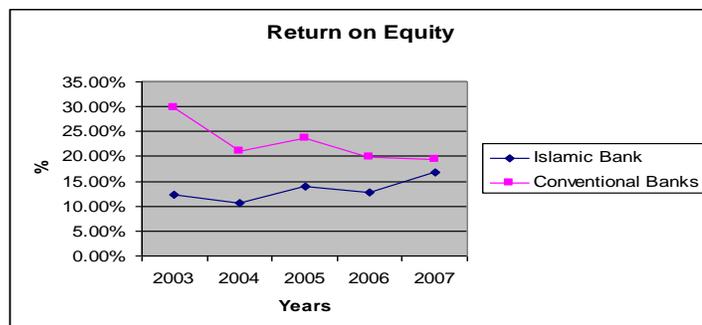


Figure 2.

Table 2.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|--------|--------|--------|--------|--------|--------|---------|
| Islamic Bank | 12.23% | 10.69% | 13.87% | 12.69% | 16.88% | 13.27% | 0.02317 |
| Conventional Banks | 29.83% | 21.04% | 23.60% | 19.95% | 19.38% | 22.76% | 0.04271 |

iii. Profit Expense Ratio (PER). Similar to ROE, PER of conventional banks is consistently higher than PER of Islamic bank and exhibiting declining trend during 2003-2007. Whereas, unlike ROE, PER of Islamic bank is fluctuating between 0.94 and 0.72 during the same time period. Conventional banks' PE ratio decreased by 57% while PE ratio of Islamic bank accounted for only 23% decrease during 2003-2007. Further study of conventional banks' financial statements revealed that declining trend of PER is not only due to increase in expenses but also decrease in profits for some of the banks in the group. The results indicate that difference between the two means is statistically different at 5% significance level (*see TABLE 13*).

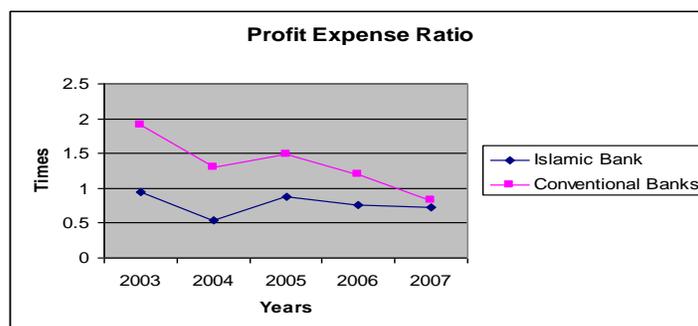


Figure 3.

Table 3.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|------|------|------|------|------|------|----------|
| Islamic Bank | 0.94 | 0.54 | 0.88 | 0.76 | 0.72 | 0.77 | 0.155306 |
| Conventional Banks | 1.91 | 1.3 | 1.48 | 1.2 | 0.82 | 1.34 | 0.398773 |

Liquidity Ratios

i. Loan to Deposit Ratio (LDR). High LDR of Islamic bank compared with conventional banks during 2003-2006 indicates less liquid condition of Islamic bank; however, in 2007, LDR of Islamic bank (63.35%) fell below conventional banks (70.89%) indicating improvement in its liquidity position. LDR of Islamic bank is delineating declining trend essentially due to more increase in deposits than loans (financings). Compared with Islamic bank, LDR of conventional banks has been reasonably lower and hovering between 69% and 77%. Results also indicate that average of Islamic bank LDR is higher than average of conventional banks' LDR, however, statistically there is no difference between the two means at 5% level of significance (see TABLE 13).

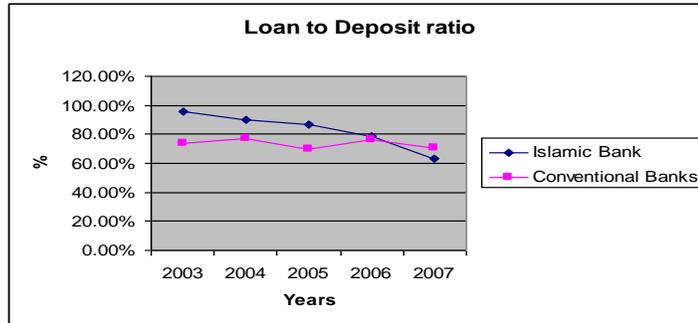


Figure 4.

Table 4.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|--------|--------|--------|--------|--------|--------|---------|
| Islamic Bank | 95.36% | 89.61% | 86.70% | 78.47% | 63.35% | 82.70% | 0.12413 |
| Conventional Banks | 73.85% | 76.66% | 69.90% | 76.44% | 70.89% | 73.55% | 0.03103 |

ii. Cash & Portfolio Investments to Deposits & Borrowings Ratio (CPIDBR). CPIDB ratio of both sets of banks depicts first decreasing and then increasing trend. An increasing trend of CPIDB ratio in second half of the study period indicates that liquidity position of both Islamic and conventional banks is getting improved. The results also indicate that CPIDB ratio of conventional banks is higher than that of Islamic bank, which means that conventional banks are more liquid than Islamic bank. Moreover, Mean CPIDBR of Islamic bank is statistically different from Mean CPIDBR of conventional banks at 5% significance level (also see TABLE 13).

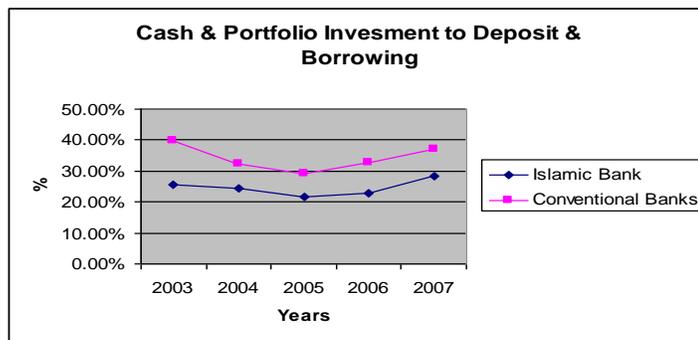


Figure 5.

Table 5.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|--------|--------|--------|--------|--------|--------|---------|
| Islamic Bank | 25.77% | 24.37% | 21.60% | 22.65% | 28.39% | 24.56% | 0.02673 |
| Conventional Banks | 39.88% | 32.12% | 29.12% | 32.52% | 36.90% | 34.11% | 0.04256 |

iii. Loan to Asset Ratio (LAR). We can see from FIGURE 6 that LAR of Islamic bank is on increasing trend whereas LAR of conventional banks is oscillating between 59% and 64%. We find from your analysis that this increasing trend of Islamic bank’s LA ratio is due to excessive loans (financings) made by Islamic bank during 2003-2007. Further analysis reveals that Murabaha has been most famous and widely used mode of financing followed by Ijara, export refinance under Islamic scheme, and Diminishing Musharaka. The results indicate that average LAR of conventional banks is slightly higher than Islamic bank; however, statistically there is difference in two means at 5% level of significance (see TABLE 13).

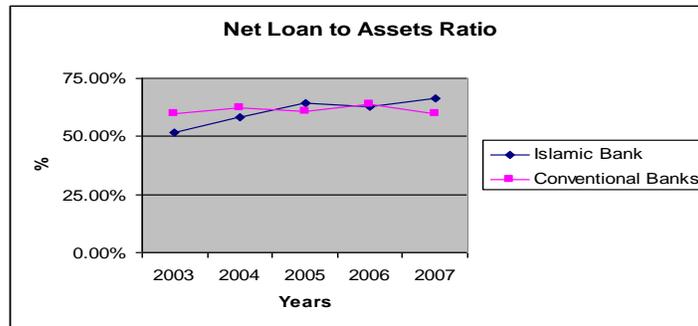


Figure 6.

Table 6.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|--------|--------|--------|--------|--------|--------|---------|
| Islamic Bank | 51.47% | 58.21% | 64.35% | 62.65% | 66.63% | 60.66% | 0.05993 |
| Conventional Banks | 59.57% | 62.44% | 60.63% | 63.99% | 59.78% | 61.28% | 0.01890 |

Risk and Solvency Ratios

i) Debt to Equity Ratio (DER). We can see from the FIGURE 7, there is momentous difference of approximately 10times in 2003, which plunged to 2.72times in 2007. This difference shrunk essentially due to increasing trend of DER, which is due to more increase in deposits base than in equity base of Islamic bank. Compared with Islamic bank, conventional banks’ DER delineates decreasing trend partly due to more reliance on equity financing than debt financing and also due to less deposits base. The difference in two means is statistically different at 5% level of significance (see TABLE 13).

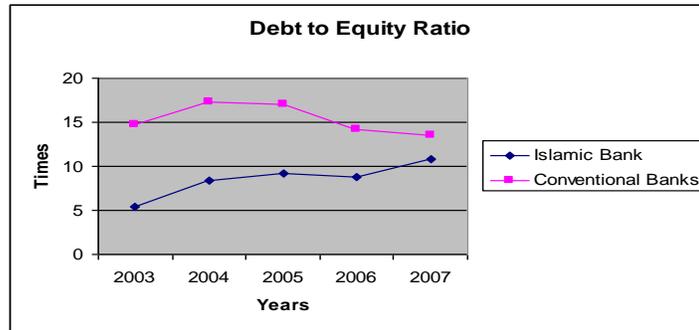


Figure 7.

Table 7.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|-------|-------|-------|-------|-------|-------|---------|
| Islamic Bank | 5.35 | 8.39 | 9.14 | 8.75 | 10.77 | 8.48 | 1.97216 |
| Conventional Banks | 14.76 | 17.29 | 17.06 | 14.23 | 13.49 | 15.37 | 1.71381 |

ii. Debt to Total Assets Ratio (DTAR). The analysis of DTAR indicates that conventional banks' DTAR is higher than that of Islamic bank and quite stable between 92% and 94%. Similar to DER, the results of DTAR signify that conventional banks are comparatively more *risky* (and less solvent) than Islamic bank. Albeit, DTAR of Islamic bank is less but it is also on notable increasing trend and converging with conventional banks. The performance in terms of average DTAR of two sets of banks is statistically different at 2.5% level of significance (see TABLE 13).

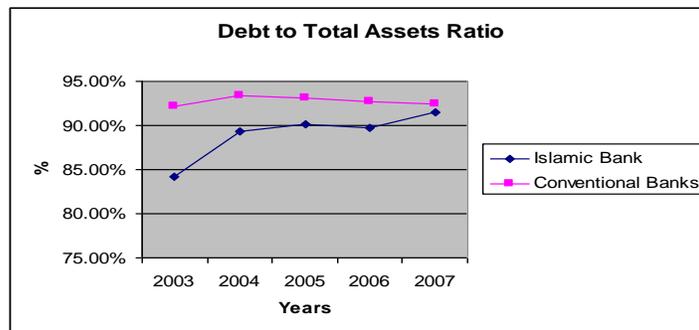


Figure 8.

Table 8.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|--------|--------|--------|--------|--------|--------|---------|
| Islamic Bank | 84.25% | 89.35% | 90.14% | 89.74% | 91.51% | 89.00% | 0.02776 |
| Conventional Banks | 92.22% | 93.39% | 93.12% | 92.67% | 92.48% | 92.78% | 0.00475 |

iii. Equity Multiplier (EM). The analysis of another measure of risk, EM, further corroborates conventional banks to be more *risky* (and less solvent) than that of Islamic bank. The results are consistent with the results found in DER and DTAR for both sorts of banks. EM of Islamic bank increased to 11.77times in 2007 from 6.35times in 2003. Not surprisingly, conventional banks' EM exhibits trend similar to that of DER, which also further verifies that relative to debt, equity

base is increasing more in conventional banks. TABLE 9 shows mean values for two sets of banks. Two means are statistically different at 5% significance level (see TABLE 13).

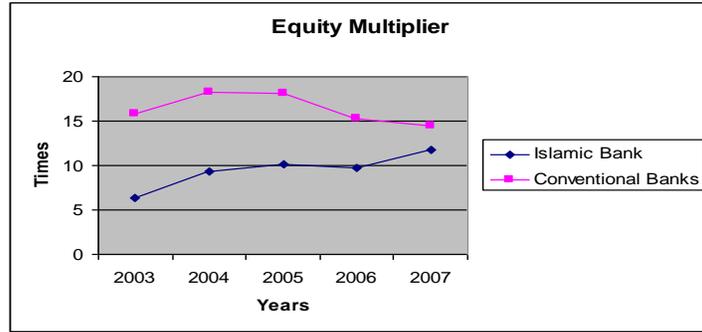


Figure 9.

Table 9.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|-------|-------|-------|-------|-------|-------|---------|
| Islamic Bank | 6.35 | 9.39 | 10.14 | 9.75 | 11.77 | 9.48 | 1.97216 |
| Conventional Banks | 15.79 | 18.29 | 18.07 | 15.23 | 14.49 | 16.37 | 1.71367 |

Efficiency Ratios

i. Asset Utilization (AU). The AU ratio for Conventional Banks is high comparing to Islamic bank in all 5 years. Having decreased drastically in 2003, AU of conventional banks recovered during 2004-2007. AU ratio of Islamic bank also mapped the trend in the same direction and increased from 2.5% in 2004 to 4.22% in 2007. Average AU ratio of conventional banks (4.46%) is higher and, at 5% significance level, statistically different from average AU ratio of Islamic bank (3.38%). We conclude that conventional banks are comparatively more efficient in utilization of the assets and generating total income (revenue).

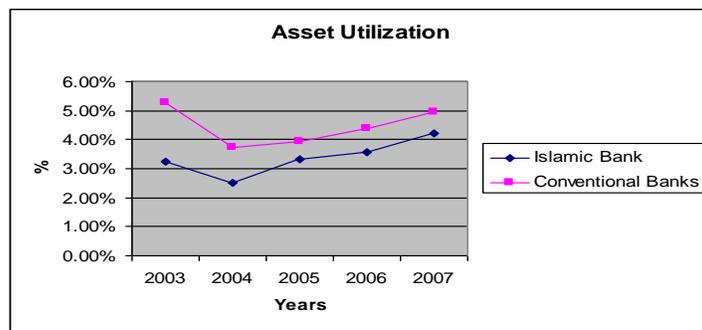


Figure 10.

Table 10.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|-------|-------|-------|-------|-------|-------|---------|
| Islamic Bank | 3.26% | 2.50% | 3.33% | 3.57% | 4.22% | 3.38% | 0.00619 |
| Conventional Banks | 5.29% | 3.73% | 3.95% | 4.37% | 4.94% | 4.46% | 0.00656 |

ii.

Income to expense Ratio (IER). Results drawn from study indicate that IER of conventional banks is consistently higher than that of Islamic bank in all 5 years; however, it is decreasing for conventional banks while increasing for Islamic bank since 2005. Our further study of financial statements of both sets of banks reveals us that decreasing trend of IE ratio for conventional banks is due to increase in expenses and decrease in income whereas increasing trend for Islamic bank's IE ratio is due to increase in income more than increase in expenses. We also find that Mean IER of Islamic bank (1.45times) is less and statistically different from Mean IER of conventional banks (2.26times) at 1% level of significance (see TABLE 13).

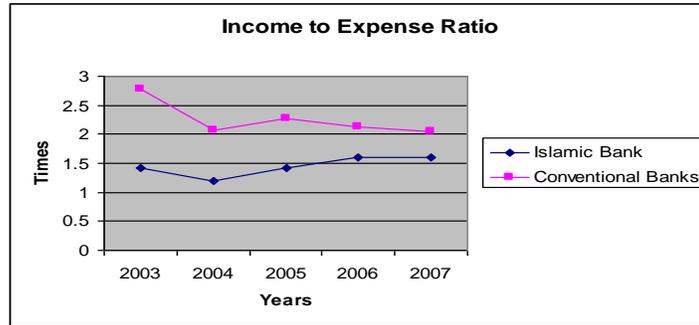


Figure 11.

Table 11.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|------|------|------|------|------|------|---------|
| Islamic Bank | 1.42 | 1.2 | 1.42 | 1.61 | 1.61 | 1.45 | 0.16991 |
| Conventional Banks | 2.78 | 2.07 | 2.27 | 2.12 | 2.04 | 2.26 | 0.30599 |

iii. Operating Efficiency (OE). Another measure of efficiency, OE ratio, indicates that conventional banks are more efficient than Islamic bank in managing their operating expenses and generating more operating revenues. FIGURE 12 shows that OE ratios for both Islamic and conventional banks are converging with each other in 2007. We can also see that in 2003, Islamic bank OE ratio is far higher than those of conventional banks and the difference is titanic, which not only reduced drastically during 2003-2007, but also resulted into convergence of OER of both types of banks in 2007. The results indicate that over time Islamic bank is becoming more efficient in its operation in comparison with its counterparts. However, mean results in TABLE 12 indicate that Islamic bank is less efficient than conventional banks and difference in performance of the two sets of banks is statistically different at 5% significance level (see TABLE 13).

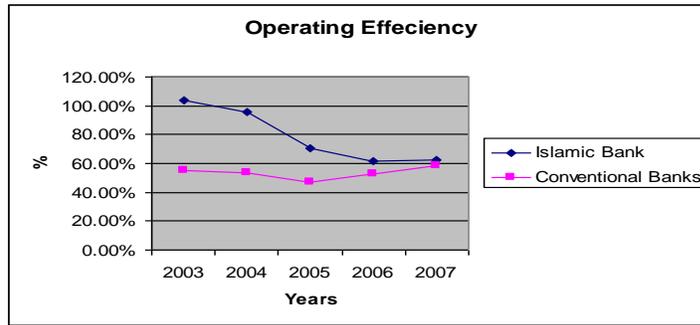


Figure 12.

Table 12.

| | 2003 | 2004 | 2005 | 2006 | 2007 | Mean | S.D |
|---------------------------|---------|--------|--------|--------|--------|--------|---------|
| Islamic Bank | 103.39% | 95.94% | 70.37% | 61.99% | 62.23% | 78.78% | 0.19536 |
| Conventional Banks | 54.95% | 53.51% | 47.43% | 52.95% | 58.72% | 53.51% | 0.04076 |

Conclusion

Examination of the empirical analysis makes it possible for us to shed some light on our findings and draw some conclusions. First, our analysis of profitability measures indicates that conventional banks are more profitable and are significantly different from Islamic bank in Return on Equity (ROE) and Profit Expense Ratio (PER). However, conventional banks are not significantly different from their counterpart in terms of Return on Asset (ROA). Further analysis of ROE and PER reveals that Islamic bank is getting closer to conventional banks in an upward trend; it is not inconceivable that in the near future Islamic banks might outperform the conventional banks of Pakistan.

Examination of the liquidity measures, LDR and LAR, of the two sets of banks shows that Islamic bank liquidity is not statistically different from that of the conventional banks. However, conventional banks are found to be more liquid than Islamic bank in CPIDB Ratio. Findings also show that while LDR of the conventional banks is stable and falling within particular range, LDR of Islamic bank is decreasing over time. This decreasing trend is due to increase in its deposits base which can be considered a positive and a good sign for the Islamic bank in that Islamic banking is making inroads into the society. Moreover, this shows that level of trust and confidence of the people is increasing in Islamic banks with the passage of time and also a manifestation of a positive attitude of the people for considering Islamic financial products as alternate and viable financing options.

Our findings of profitability and risk & solvency perfectly fit in this risk-return profile and allow us to conclude that conventional banks are more profitable and hence more risky and less solvent than Islamic bank. Analysis of the results of all the risk and solvency measures, Debt Equity Ratio (DER), Debt to Total Assets ratio (DTAR), and Equity Multiplier (EM), indicates conventional banks to be more risky and less solvent than Islamic bank. The difference in these performance measures is statistically significant, which suggests that these two sets of banks do not fall in the same risk class. This confirms that product of Islamic banking is a viable investment class providing unique risk structure for interested investors.

Like in profitability, and risk & solvency measures, conventional banks are also found to be statistically different and more efficient in terms of utilization of their assets, in generating income, and managing their expenses as compared to Islamic bank. Although, all efficiency

measures, Asset Utility (AU), Income Expense Ratio (IER), and Operating Efficiency (OE) suggest that Islamic bank are significantly less efficient but increasingly converging towards that of conventional banks, during 2003-2007. This gives us some insight regarding Islamic bank's improvement in generating income, utilization of assets, and effective management in controlling expenses.

Our findings on the performance measurements of Islamic banking in Pakistan are different and at times mixed in comparison to the results drawn from the similar studies done in different parts of the world. For example, Kader and Asarpota (2007) found in their study that UAE Islamic banks are relatively more profitable, less liquid, less risky, and more efficient as compared to the UAE conventional banks. Samad & Hassan (2000) revealed in their study that BIMB (Bank Islam Malaysia Berhad) is less profitable, relatively less risky and more solvent as compared to conventional banks of Malaysia. Abdus Samad (2004) in his paper examined the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks and concluded that there exists a significant difference in credit risk performance between the two sets of banks. However, he did not find any major difference in profitability and liquidity performances between Islamic banks and conventional banks.

The difference in results is largely due to the fact that Islamic banking has longer history in these countries as compared to Pakistan where full-fledged Islamic banking started merely few years back. Moreover, conventional banking has a longer history, deeper roots, vast experience of learning from the financial markets mechanisms, and larger share in the Pakistan financial sector. Finally, for future studies, as the time passes, when there will be more Islamic banks to study and longer time period, a similar study would generate better insight on the issue of performance comparison and provide solid evidence one way or another. By then, we would gladly join the discussion again.

Table 13. Comparison of Mezaan Bank Ltd. (Islamic Bank) with 5 Conventional Banks' Financial Ratios

| Performance Measure | Islamic Bank | | Conventional Banks | | T-test | F-test |
|---------------------------------|--------------|----------|--------------------|----------|--------------------|--------------------|
| | Mean | S.D | Mean | S.D | | |
| <u>Profitability</u> | | | | | | |
| ROA | 1.43% | 0.00296 | 1.49% | 0.0034 | 0.45192 | 0.79644 |
| ROE | 13.27% | 0.02317 | 22.76% | 0.04271 | 0.0024**** | 0.263059 |
| PER | 0.77 | 0.155306 | 1.34 | 0.398773 | 0.017198*** | 0.098444* |
| <u>Liquidity</u> | | | | | | |
| LDR | 82.70% | 0.12413 | 73.55% | 0.03103 | 0.14852 | 0.01986**** |
| CPIDBR | 24.56% | 0.2673 | 34.11% | 0.4256 | 0.0028**** | 0.38803 |
| LAR | 60.66% | 0.05993 | 61.28% | 0.0189 | 0.83068 | 0.04605** |
| <u>Risk and Solvency</u> | | | | | | |
| DER | 8.48 | 1.97216 | 15.37 | 1.71381 | 0.00036**** | 0.79022 |
| DTAR | 89.00% | 0.02776 | 92.78% | 0.00475 | 0.01705*** | 0.00474**** |
| EM | 9.48% | 1.97216 | 16.37% | 1.71367 | 0.00036**** | 0.78926 |
| <u>Efficiency</u> | | | | | | |
| AU | 3.38% | 0.00619 | 4.46% | 0.00656 | 0.02782** | 0.90979 |
| IER | 1.45 | 0.016991 | 2.26 | 0.30599 | 0.00084**** | 0.27904 |
| OE | 78.78% | 0.19536 | 53.51% | 0.04076 | 0.0221*** | 0.01015**** |

**** Difference in means: Significant at 1%

*** Difference in means: Significant at 2.5%

** Difference in means: Significant at 5%

*Difference in means: Significant at 10%

End Notes

¹ An investment that is considered socially responsible because of the nature of the business the company conducts. Common themes for socially responsible investments include avoiding investment in companies that produce or sell addictive substances (like alcohol, gambling and tobacco) and seeking out companies engaged in environmental sustainability and alternative energy/clean technology efforts. Socially responsible investments can be made in individual companies or through a socially conscious mutual fund or exchange-traded fund (ETF).

² We calculated Average ROA of 5 conventional banks by calculating ROA for each conventional bank in the group in each year and then calculated an average ROA ratio by adding up those 5 ROA ratios and dividing by 5 to compare this average ROA ratio with ROA of Islamic bank of that year. We calculated each ratio for group of 5 conventional banks in each year in similar manner.

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Appendix – 1

Banking Sector of Pakistan

Financial Sector Development and Economic Development are inter-related. Well functioning and efficient financial sector plays pivotal role in the growth of the economy as well as in improving the living standards of its population. Banks in Pakistan share 95 percent of the financial sector, therefore good health of banks and economic growth and development of Pakistan are directly related to each other (Ishrat Hussin 2005).

Pakistani banking system is comprised of 53 banks. *Thirty* commercial banks, *four* specialized banks, *six* Islamic banks, *seven* development financial institutions and *six* micro-finance banks make up this total. The banking sector of Pakistan is composed of government owned banks (9), private banks (22), privatized banks (4), foreign banks (5), development institutions (7), non-member banks (4), and small and medium enterprises (2). Of the total system assets, four largest commercial banks make up 44.2 percent, while eight second-tier banks account for a further 35 percent indicating moderate concentration (Source: Daillytimes).

Islamic Banking Sector

Let us begin with the view of Quaid-e-Azam Muhammad Ali Jinnah (the founder of Pakistan) on Islamic Banking he expressed on the occasion of the Opening Ceremony of The State Bank of Pakistan on July 1, 1948”

“We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice. We will thereby be fulfilling our mission as Muslims and giving to humanity the message of peace which alone can save it and secure the welfare, happiness and prosperity of mankind”

Islamic banking in Pakistan started in 1977-78, which included the elimination of interest from the operation of specialized institution and commercial banks. On June 26, 1980, amendments were made in the corporate and financial system to allow the issuance of new interest-free instrument of corporate financing named, Participation Term Certificate (PTC). In the same time, with the aim of rising risk based capital, Ordinance was introduced to permit the

establishment of Mudaraba companies and floatation of Mudaraba Certificates. July 1, 1985, all commercial banks in Pak Rupee were made interest free which was mark-up technique with or without buy-back agreement. However, in November 1991, Federal Shariat Court (FSC) declared it un-Islamic (Source: IIFM).

In January 2000, in the State Bank of Pakistan, a Commission for Transformation of Financial System (CTFS) was constituted to introduce Shari'ah compliant modes of financing. CTFS was held responsible primarily for creating legal infrastructure conducive for working of Islamic financial system, launching a massive education and training programs for bankers and their clients, to create awareness for the general public about the Islamic financial system and also to deal with major products of banks and financial institutions, both for assets and liabilities side (Source: IIFM).

In September 2001, Government of Pakistan decided to make shift to interest free economy in a gradual and phased manner without causing any disruptions. It was also agreed that State Bank Pakistan would consider for establishing subsidiaries by the commercial banks for the purpose of carrying out Shari'ah compliant transactions, specifying branches by the commercial banks exclusively dealing in Islamic products and, creating new full-fledged commercial banks to carry out utterly banking business based on proposed Islamic financial products (Source: IIFM).

In January 2002, Meezan Bank Limited was granted first *Islamic Banking License* by State Bank of Pakistan.

On 15 September 2003, The State Bank of Pakistan (SBP) established the Islamic Banking Department with the mission to promote and regulate Islamic Banking Industry in line with best international practices ensuring Shari'ah Compliance and transparency and the with the vision of making Islamic banking the banking of first choice for the providers and users of financial Services. The foremost task of the department is to promote and develop the Shari'ah Compliant Islamic Banking as a parallel and compatible banking system in the country. Department is comprised of three divisions: Policy Division, Shari'ah Compliance Division, and Business Support Division. A Shari'ah Board comprised of experts to guide the Islamic banking industry is also in place at SBP. Risk Management, Corporate Governance, Prudential Regulations, and Accounting & Shari'ah Standards etc., are the key areas SBP is working on to regulate and supervise the Islamic Banking Sector. Currently, Islamic Banking Sector is operating under the existing laws & regulations for conventional banks (Source: SBP).

Presently, there are six full-fledged Islamic banks operating in Pakistan. These banks with their year of incorporation are: AlBaraka Islamic Bank Pakistan (1991), Meezan Bank Limited (2002 – restructured as Islamic bank), BankIslami Pakistan Limited (2003), Dubai Islamic Bank Pakistan Limited (2005), Emirates Global Islamic Bank Limited (2007), Dawood Islamic Bank Limited (2007).

The market share of Islamic banking assets in the overall banking system rose to 4.3% as of December 31, 2007 compared with 3.0% in preceding year. Islamic banking deposits, financing and investment stood at 4.1%, 4.3% and 2.6% respectively as compared to 2.79%, 2.88% & 0.94% a year earlier. Year on Year (YoY) growth for total assets, deposits and financing & investment was 75%, 78%, 91% respectively. Branch network during the same period reached 289 from 150 branches, showing 93% increase in year 2007. It is hoped that by the end of this financial year the share of assets of Islamic banking to overall industry will cross 5.0%. We may safely say that Islamic banking industry is growing with healthy signs of financial

inclusion. Meezan Bank is leading Islamic bank while the Bank Alfalah is on the top among IBDs of conventional banks (Source: SBP).

There is massive demand for Islamic financial services and the growth of Islamic Banking in Pakistan has been commendable during the last two years. However, the lack of infrastructure support & lack of professional Islamic Bankers has constrained the growth.