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Effect of Change in the Deposit Rates of Conventional Banks on Investment Rates of Islamic Banks in Pakistan

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Abstract
The paper aims to inspect the change in deposit rates of conventional banks and its effect on investment rates of Islamic banks in Pakistan. This study would attempt to resolve the puzzle among Islamic banking is interest free or interest based by amassing data from the Islamic or non-Islamic banks in Pakistan over the period 2010 to 2014. The performance of Islamic banks is considered as a realistic evolution from the study of history. Islamic banking is actually the system of banking that is purely based on Islamic jurisprudence. They have become an undeniable reality and it is evident from the increasing number of Islamic based banks. The discriminatory feature of Islamic banking is the prohibition of Riba (interest) and profit and loss sharing according to shariah principle. From the analysis, it is found that the concept of Islamic banking is not much different from that of conventional banking. The investment rates of Islamic banks fluctuates with that of deposit rates of conventional banking but not vice versa.
Keywords: Deposit Rate, Investment Rate, Islamic Banking, Conventional Banking
Jell Classification: *G21, E22*

1. Introduction

Islamic banking is based upon the principles of sharia and practical applicable with the development of Islamic economics. Islamic banking concept goes back to 7th century but commercially it was implemented in previous century and now Islamic finance is growing in western as well as Islamic market. Islamic banking is developed under religious viewpoint and its success depends not only on achievement of financial goals but also to follow Islamic faiths (Shah, Raza & Khurshid, 2012). Islamic banking has global growth rate of 10-15 percent per anum and Islamic financial institutions are present in more than 51 countries (Sole, 2007). Moreover, Islamic banking has a positive effect on the growth of banking sector in the countries in which Islamic banks operate which in turn increase the economic growth of the country (Gheeraert, 2014). Furthermore, Islamic banks contain larger share of their assets to financing activities than conventional banks on the other hand Islamic banks are less competitive as compared to conventional banks and less profitable than conventional banks (Ariss, 2010).

1.1 Background of the study

In 1980 government of Pakistan plan to eliminate interest from its financial sector. After a great struggle there started Islamic banking practice in Pakistan in 2002 within existing conventional system in Pakistan (Khan, 2008). The growth of Islamic banks in Pakistan is on fast track because state bank of Pakistan is well committed with this sector. There are also exist conventional banking in Pakistan and it creates a competition between Islamic and conventional banks in Pakistan (Akram, Rafique & Alam, 2011). Islamic banking in Pakistan is growing at an annual rate of 76% in the previous six years (Hanif, 2011). Growth of Islamic banks is very fast in Pakistan as compared to other countries and state bank of Pakistan established a separate department for Islamic banking and in June 2010 Islamic banking has total asset worth of 411 billion (Ashraf, 2013). Islamic banking is based upon the shariah principles and prohibition of riba (interest) is its most important feature (Botis, 2013). Islamic banking model encourages labors and emphasized on risk sharing on both parties instead on one party (Fasih, 2012). As system of Islamic banking is grounded in Islamic principles and all the undertakings of the banks follow Islamic morals so it could be said that financial transactions within Islamic banking are a culturally-distinct form of ethical investing. Two basic principles behind Islamic banking are the *sharing of profit and loss* and, significantly, *the prohibition of Usury*, the collection and payment of interest, also commonly called *Riba* in Islamic discourse. Although collecting and paying interest is not permitted under Islamic law, revenue-sharing arrangements are generally permitted (Ali and Zubair, 2016).

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)****."*

But in Malaysia Islamic banking is not different from conventional banking because majority of Islamic banks financing is still based on non-PLS mode that ignores spirit of usury prohibition and Islamic deposits are also interest based (Chong & Lieu, 2009). The main cause behind the lack of PLS sharing is the imbalance in management and control (Dar & Presly, 2000). It is theoretically expected that Islamic banking should not affect by interest rates as it is an interest free banking system but deposits and loans in Islamic banks in Turkey highly depend on interest rate changes (Ergec & Arslan, 2011). Khan (2010) fond that there is just a negligible part of Islamic finance which is based on profit and loss (PLS) and that Islamic deposits are not interest free. Many Islamic banks manage their profit distribution with respect to religiosity, financial growth, asset composition, and inversely linked to familiarity of market with Islamic banks, depositor funding trust and bank age (Farook, Hassan & Clinch, 2012).Most of Islamic banks perform commercial and investment banking services but do not set a firewall to separate these services legally and managerially. Supervisory authorities in the countries have taken various steps to regulate Islamic banks. This includes introducing Islamic banking act and regulating Islamic banks by laws that govern all the banks (Ahmed & Karim, 2001). Islamic banking industry making significant improvements to become an alternative to conventional banking and it attained a significant ground in Middle East, South East and South East Asia (Khan & Bhatti, 2008).The existing system of Islamic banking in Pakistan is based on illegal subterfuges and there is only a little support to this system from Islamic law but the real shariah objectives in practicing Islamic banking is tramping (Zubair & Chaudhry, 2014). There are few problems exist in Islamic banking especially in the area of financing which can be eliminated with only minor changes and Islamic banks can offer interest-free banking. These problems can be also eliminated by using two types of financing, loans along with service charge and participatory financing in Mudarabah (Saeed, 2012). Moreover, there is exist a significant difference in the awareness of customers regarding Islamic banking in Pakistan gender wise but in conventional banking there is no difference in perception in female and male customers. And Islamic banks in Pakistan are more concerned to increase their branch network and neglecting customer orientation strategy (Khan, 2013). Both Islamic and conventional banks have different types of instruments for liquidity management and these instruments based on the basic idea of these banks, also Islamic financial system has more equity base instruments than conventional system. Islamic financial system is criticized by shariah scholars because most of Islamic financial institutions do not practicing according to shariah rules (Hassan, Rzzaque & Tahir, 2012). Islamic banks in Pakistan engaged in a hybrid representation of Islamic and traditional financing and Islamic banks in Pakistan moving slowly in adopting profit and loss sharing(PLS) contracts in Pakistan as compared to other countries(Siddique, 2008). Awan (2009) explore that there is no inter-bank money market for Islamic banks in Pakistan and also observed that conventional banks in Pakistan have so far been able to provide financial services to only 11% population of Pakistan so huge opportunity for Islamic banks are available in Pakistan. Islamic financial system gives the concept to invest money in Halal business opportunities and utilizing funds on profit and loss sharing basis (Memon, 2007). In Islamic financial system fixed return nature is the feature of interest and there is no profit and loss sharing concept in conventional system but in Islamic finance profit and loss sharing (PLS) is main feature (Kahf & Khan, 1992). And with development of Dubai Islamic bank in UAE, 1974 and Islamic development bank in Jeddah, 1975, the practice of Islamic banking was initiated (Ahmed, 1986). Islamic modes of financing classified into two types which are fixed-return (Murabahah, Ijarah, Salam, and Istisna) and variable-return which are mainly Mudarabah and Musharka (Dar and Presley, 1999). The purpose of this study to make the clear difference between Islamic and conventional banking by analyzing whether Islamic banking is actually sharing profit or loss or it's just an alternative name for interest based finance. Our study is typically paying attention to check the change in deposit rates of Islamic banks and its impact on investment rates of conventional banks.

1.2 Islamic Banking in Pakistan

The initiate to Islamic banking in Pakistan was launched back to 2001 when Pakistani Government decided to promote Islamic banking in Pakistan. In this case Meezan bank was granted license on 31st January 2002 and started their operations in March 2002 as first Islamic bank in Pakistan and from that time till now Islamic banking in Pakistan is continuously growing. Figure 1 captures the exponential growth of Islamic banking in Pakistan in terms of total assets of Islamic banks. In 2006 total assets of Islamic banks in Pakistan were119 billion 2.4% and the in 2007 total assets increased to 206 billion and become 4.2% and till 2014 Islamic banking assets are continuously increasing and become 1089 billion in 2014 and 10.4%. In 2015 it become 1610 billion which is 11.4% and in 2016 it increases up to 1853 billion which 11.7% of share of overall banking industry.

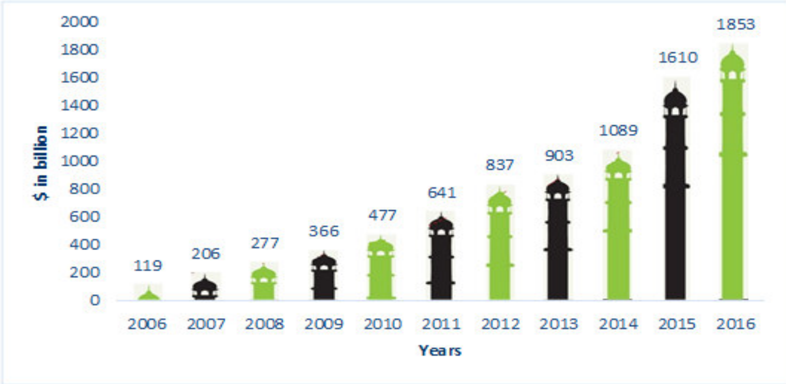

Figure 1: Total Assets growth of Islamic banks in Pakistan

Moreover, Table 1 provides information about percentage of Islamic banking assets in 2016 as compared to other financial institutions Islamic banking assets only are 7.9% as compared to other financial institutions in Pakistan and commercial banks have 46.01% and development financial institutions have only 0.06% of assets

Table-1: Percentage of Islamic banking assets in billion

	No. of Institutions	Total Assets	% of Total Assets
Islamic Banks[a]	5	1853b	7.9%
Commercial Banks[b]	34	10752b	46.01%
Domestic Banks[c]	27	10302.53b	44.08%
Foreign Banks[d]	7	279.66b	1.2%
Specialized Banks[e]	3	170.059b	0.73%
Development FI.[f]	8	13.671b	0.06%
All banks	84	23370.92b	

[a] Full fledge Islamic banks in Pakistan.
[b] Commercial banks including foreign, domestic and Islamic banks.
[c] Domestic banks including both conventional and Islamic.
[d] Foreign banks including both conventional and Islamic.
[e] Industrial development bank of Pakistan, SME bank, Zari Tarakiyati bank, Punjab provisional co-operative bank
[f] All development financial institutions in Pakistan

Modes of financing which Islamic banks use are Murabahah, Ijarah, Musharka, Mudarabah, Diminishing Musharka, Salam, Istisna, which are given in table 2.

Table-2: Financing mix of Islamic banking (Amount in billion Rupee)

Table 3: Financing Mix (% Share)			
	Dec-15	**Sep-16**	**Dec-16**
Murabaha	24.5	16.9	15.8
Ijarah	6.6	7.8	6.8
Musharaka	14.0	12.0	15.6
Diminishing Musharaka (DM)	31.7	38.5	34.7
Salam	5.3	3.3	4.4
Istisna	8.6	7.0	8.4
Others	9.3	14.5	14.3
Total	**100.0**	**100.0**	**100.0**

Source: Islamic banking bulletin Dec 2016 by SBP

2. Literature Review

2.1 Empirical Review

Dar and Presley (2000) examined the management and control imbalances in Islamic banking as in lack of profit and loss sharing. They found that the major cause of lack of Profit Loss Sharing (PLS) in the practice of Islamic finance is an imbalance between management and control rights. The agency problem gets accentuated too. However, according to them there is no theoretical reason to believe that PLS is inherently inefficient. Aioanei (2007) studied the controversies faced by Islamic Banking. It was judged that among the most crucial challenges before an Islamic bank is to create confidence in its depositors as well as all other operators in the market about the harmony of its operations with that of Sharia. Zangeneh and Salam (2009) focused on the working of Central Banking in an Interest-Free Banking System. They explored the functions and tools of central banking in an Islamic framework. It was shown that the current monetary policy tools of interest-based economies could be modified and used in an interest-free Islamic banking system. It was concluded that the existence of high speed computer technology and new accounting practices have increased the feasibility of a true interest-free Islamic banking. Beng and Minghau (2009) examined the Islamic banking as interest free or interest based financial institutions. Malaysia was taken as a basal body for data examination and findings. They concluded that there is almost no difference among Islamic and Conventional banking as Islamic deposits are not interest free but are closely similar to that of conventional deposits. Various types of contracts of Islamic banking were taken under consideration during examining the Islamic law and finance by Ismail and Tohirin (2010). They found that spirit of profit and loss sharing mechanism is found in contracts of Islamic banking. Returns on Mudarabah deposits was compared with equity in Islamic banks by Diaw and Mbow (2011).They declared results that Return on equity is two times higher than the return on Mudarabah deposits. The role of Sharia in Islamic banking was studied by Botis (2013). It was seen that Islamic banking runs its functions on the basis of Islamic jurisprudence and are according to Quran and Sunnah. Furthermore, analysis told that the distinctive characteristic of Islamic banking is prohibition of Riba (interest).The potential effect of the Islamic practices on western economic relationships was illustrated by Presley and Sessions (2014) by focusing on the prohibition of interest (Riba) in Islamic economics. They showed through their studies that the alternative method of financier remuneration (i.e. Mudarabah profit-and-loss sharing) will, under certain conditions, enhance capital investment on account of its ability to act as an efficient revelation device. Hakim and Mersin (2014) studied the use of DLLP[1] by Islamic and Conventional banks in the Middle East Region. They employed data ranging from 2000 to 2008, of 21 Islamic banks, 18 conventional banks that-facilitates Islamic modes-and 33 conventional banks from 7 Middle East countries. They found no major difference among these three groups of banks in using DLLP.

2.2 Review in Context of Pakistan

Khattak and Rehman (2010) determined the customer satisfaction with the knowledge of Islamic banking. The products offered by Islamic banking and their specifications and benefits are not familiar to most of the customers like Ijarah and Murabahah financing. The study concluded that many unaware customers believe that Islamic banking do not provide satisfactory services and products as compare to the conventional banks. Research on the performance of Islamic banking in Pakistan and the products and services it offers was conducted by Ahmed, Awan and Malik (2010). They gave results after study that there is a clear cut difference between the operations of Islamic banking and conventional banking as the former one is totally Sharia based and other is interest based. Hanif (2011) compared and contrasted the Islamic banking with Conventional banking and point-out that there is no major difference among the two of these categories as most of the operations are running in the same context. Haroon and Ahmad (2011) examined the impact of conventional banks interest rates and rate of profit on deposited funds in Islamic banks in Malaysia. Adaptive Expectation Model was utilized to examine the effect of past dividend rates on funds deposited by customers on the Islamic deposit facilities of Malaysian banks and interest rates of deposit account facilities of conventional banks. They realized that there is a strong relationship between interest rate of deposit accounts of conventional banks and rate of profit declared by Islamic banks. So the management of Islamic banks have to manage and adjust according to the market rate to satisfy its customers. The Impact of Interest Rates on Islamic and Conventional Banks was determined by Hakan and Arslan (2011) by taking the case of Turkey. It was theoretically expected that the Islamic banks, relying on interest-free banking, shall not be affected by the interest rates; however, in concurrence with the previous studies, they found that the Islamic banks in Turkey are visibly influenced by interest rates. Salman (2012) explored the operations of Islamic banking in Pakistan which interlink between different modes of financing being implemented in Islamic banks in Pakistan and KIBOR (Karachi inter-bank offering rate) and concluded the result that Islamic banks also applicable the KIBOR on its products. Anjum and Asif (2012) studied the Muslim customers' acceptance of Islamic banking. The key determinants of the Islamic banking in the banking customers living in Peshawar KPK were analyzed by them using data collected through questionnaires from the customers and multiple regression model was employed. They found through their study that the positive aspects of the Islamic banking and the flaws of the interests based has a positive relationship with the Islamic banking acceptance in Muslims across Peshawar KPK. Khairul, Shamsher and Eskandar (2013) explored that whether the Malaysian Deposit and Investment Accounts are interest free or not. The amassing data of Islamic Finance companies of Malaysia was taken from 1994 to 2012 to determine interlink between profit rates and interest rates on investments in conventional banks and Islamic banks. Sheikh and Karim (2016) explore the effect of various internal characteristics of Islamic bank such as non-interest earning, liquidity, capital ratio, size and administrative costs on the profitability and concluded that bank size and capital ratio are

[1]Discretionary loan loss provisions

positively related to return on equity and earning per shares while administrative cost are negatively related to all measures of profitability (Shahid, Hassan and Rizwan, 2015). They concluded that there is a vital link between profit rates of Islamic banks and interest rates of conventional banks. Furthermore, they found that profit rates of Islamic Finance companies are affected by the fluctuations of interest rates of conventional banks but not vice versa. So there's a gap in theory and practical implication of Islamic banking in Malaysia.

3. Data and Research Methodology

3.1 Data and Sources

In this study for practical implementation we have selected five Islamic banks (AL Baraka Islamic bank, Dubai Islamic bank, Meezan Islamic bank, Bank Islamic Pakistan, Burj Islamic bank) and five conventional banks (KASB bank, MCB bank, NBP bank, Habib metropolitan bank and summit bank). The data of monthly investment rates and deposit rates are extracted from the official website of all banks over the period of 2014-2016. The deposit rates of conventional banks are also taken in comparison to the former. The variables used in the study are the investment rates of Islamic banks and deposit rates of conventional banks. They are used in short form whose explanation is given below for better understanding:

Alwa_IB_00: Al-wadia Islamic bank saving deposit rates.
MUD_IB_01: Mudarabah deposit rates of Islamic bank-1 month term deposit.
MUD_IB_03: Mudarabah deposit rates of Islamic bank-3 month term deposit.
MUD_IB_06: Mudarabah deposit rates of Islamic bank-6 month term deposit.
MUD_IB_12: Mudarabah deposit rates of Islamic bank-12 month term deposit.
SD_CB_00: Saving deposit rates of conventional banks.
FD_CB_01: Conventional banks rates on 1-month fixed deposits.
FD_CB_03: Conventional banks rates on 3-month fixed deposits.
FD_CB_06: Conventional banks rates on 6-month fixed deposits.
FD_CB_12: Conventional banks rates on 12-month fixed deposits.

3.2 Methodology

The Granger causality test are used to determine the long-run relation and short-run dynamics among deposit rate of conventional banks and investment rate of Islamic banks. The following two null hypothesis are tested: (i) Change in Islamic investment rate do not cause conventional deposit rate to change (ii) Change in conventional deposit rate do not cause Islamic investment rate to change. Then we carried out correlation and regression tests to further ascertained the relation between the conventional deposit rate and Islamic investment rate.

4. Results and Discussion

In descriptive statistics we used two-tailed test to determine the significance of difference between investment rates of Islamic banks and deposit rates of conventional banks as shown in Table 4.

Table 4: Descriptive Statistics

Investment Rates of Islamic Banks				
Varibles[a]	**Mean**	**Std Dev**	**Minimum**	**Maximum**
Muda_IsBank_01	6.34	0.74	5.70	6.00
Muda_IsBank_03	6.59	0.60***	5.99	8.37
Muda_IsBank_06	6.98	0.62***	6.14	8.50
Muda_IsBank_12	7.97**	1.02***	5.80	8.25
Muda_IsBank_00	4.52***	0.87*	3.40	9.50
Deposit Rates of Conventional Banks				
FD_CoBank_01	6.42	1.03	5.00	8.00
FD_CoBank_03	7.08	1.40	5.03	9.00
FD_CoBank_06	7.52	1.61	5.05	10.00
FD_CoBank_012	8.34	1.90	5.12	11.50
FD_CoBank_00	5.83	0.84	5.00	8.00

Note: ***Difference between investment rates of Islamic banks and deposit rates of conventional banks is significant at 1% level.** Difference between investment rates of Islamic banks and deposit rates of conventional banks is significant at 5% level. * Difference between investment rates of Islamic banks and deposit rates of conventional banks is significant at 10% level.

[a] Each variable is denoted in xxxx-yyyyyy-zz format, wnere xxxx is the type of deposit; yyyyyy is the type of financial institution and zz is the maturity in months. For example, Muda-IsBank-01=Islamic investment rates on 1-month Mudarabah deposits; Alwa-IsBank-00= Islamic banks investment rate on al-wadiah saving deposits: FD-CoBank-01=commercial banks deposit rates on 1-month fixed deposits.

3.4 Granger Causality Test

Table 5 presents the results of pair-wise Granger causality test. Two null hypothesis are tested. The first null hypothesis is that changes in Islamic investment do not cause adjustments in conventional deposit rates. The second null hypothesis is that changes in conventional deposit cause adjustments in Islamic investment rates. In all cases first null hypothesis can be accepted and second null hypothesis can be rejected.

Table: 5 Pairwise Granger Causality Tests

Null Hypothesis:	Obs	F-Statistic	Prob.
DR_03 does not Granger Cause DR_01	10	0.08314	0.9215
DR_01 does not Granger Cause DR_03		0.09867	0.9078
DR_06 does not Granger Cause DR_01	11	0.64400	0.5580
DR_01 does not Granger Cause DR_06		0.20615	0.8192
DR_12 does not Granger Cause DR_01	9	3.80307	0.1188
DR_01 does not Granger Cause DR_12		0.08288	0.9220
DR_06 does not Granger Cause DR_03	12	0.27916	0.7645
DR_03 does not Granger Cause DR_06		0.21677	0.8103
DR_12 does not Granger Cause DR_03	10	0.13805	0.8743
DR_03 does not Granger Cause DR_12		0.10349	0.9036
DR_12 does not Granger Cause DR_06	13	1.28548	0.3280
DR_06 does not Granger Cause DR_12		0.42550	0.6674

3.5 Correlation

	DR_01	DR_03	DR_06	DR_12	SDR00
DR_01	1.000000				
DR_03	0.893039	1.000000			
DR_06	0.839027	0.979521	1.000000		
DR_12	0.702813	0.901788	0.930137	1.000000	
SDR00	0.362906	0.411563	0.415428	0.246337	1.000000

There is perfect positive correlation among all the variables and are significant at 10% level of significance. With the increase in any one variable, there is same increase in the other as the correlation is association among the variables.

3.6 Regression

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	4.226250	1.692243	2.497425	0.0231
DR_01	-0.473837	0.607403	-0.780104	0.4461
DR_03	0.464841	1.115705	0.416634	0.6822
DR_06	1.023879	0.875773	1.169114	0.2585
DR_12	-0.815660	0.390376	-2.089424	0.0520

R-squared	0.342250	Mean dependent var	5.315909
Adjusted R-squared	0.187486	S.D. dependent var	1.217471
S.E. of regression	1.097423	Akaike info criterion	3.220523
Sum squared resid	20.47373	Schwarz criterion	3.468487
Log likelihood	-30.42575	Hannan-Quinn criter.	3.278935
F-statistic	2.211425	Durbin-Watson stat	2.243040
Prob(F-statistic)	0.111070		

According to the regression model, saving deposit rates is the dependent variable and investment rates of Islamic banks, deposit rates of conventional banks are the independent variables. The variables like deposit rates of 1 month and 12 month are negatively related with the saving rates. All the variable's probability values are more than 0.05 which means that they are significant.

R-squared value tells the dependency ratio of dependent to independent variables which is 34%.

F-statistic is less than 3 somehow and Prob (F-statistic) is more than the precision level of 0.05, so there are some flaws in the applied model which could be caused for any un-identifiable reason. Durbin-Watson stat's value lies in between 1.5-2.5 which tells the model is good and there is no regression problem.

5. Conclusion

The research is based on the concept of Islamic banking in Pakistan has either it is interest free or interest based. Our results showed that any change in deposit rates of conventional banks do not causes adjustments in investment rates of Islamic banks which are consistent with previous studies of Presley and Sessions (2014), Beng and Minghau (2009), Haroon and Ahmad (2011), Khairul, Shamsher and Eskandar (2013). So we concluded that Islamic banks in Pakistan are interest free and do not follow their counterparts in conducting banking activities. According to the study, it is observed that there are no major differences among the operations of Islamic banking and conventional banking except profit and loss sharing in Islamic banks. So sharia is being followed up to certain extent but not completely. But still returns on Islamic accounts are far more attractive than on conventional accounts. Although there may be some agency problems in PLS in Islamic banking system but it is preferable too. The study has a number of limitations, most notably that only small number of firms are used as sample. In addition, the market must be efficient to observe an impact of change in the deposit rates of conventional banks on investment rates of Islamic banks in Pakistan. It can't be guaranteed however, the firm's used as sample in the study meeting the assumption or not so the results may biased. The empirical findings of this study have practical implications for customers, investors, policy makers and shareholders. After reviewing the methodology, empirically findings and conclusion of the study, future research should be directed to improve and continue the research in this field. Some important and relevant recommendations are to expand the area of research might be required large sample size to analyze the effects of change in the deposit rates of conventional banks on investment rates in order to provide more comprehensive evidence and use different models of analysis to check the significance level if any changes are observed in the study.

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