

## **Growth of Islamic Banking in Pakistan: A Comparative Study**

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### **Abstract:**

The study focused on the growth of Islamic banking in Pakistan in terms of its Deposits, Investments, Assets and Owners' Equity for the period from 2004 to 2009. The horizontal analysis technique was used to determine the growth rates of Islamic and conventional banks while t-test was used for statistical significance. The growth rate of Islamic banking was higher than its traditional counterpart in Deposits, Investments, Assets and Owners' Equity. The growth rates of deposits and Assets of Islamic bank were statistically significant, whereas growth rates in investments and Owners equity were found statistically insignificant.

**Keywords:** Islamic Banking; Growth Rates; Deposits, Investments; Assets; Owners Equity

### **1. Introduction**

Islamic banking appeared as a practical reality and started functioning in 1970s. Since then it has been growing continuously all over the world. In Pakistan, Islamic banks are growing with annual growth rate of 1% which is the highest growth rate in the world while its market share has reached to 7 % and expected to grow to 15% in the next few years. In Malaysia, where Islamic banking started its operations some 25 years back, the Islamic banking is growing at half percent. Islamic banks have also gained recognition and captured market shares around the world even in non-Muslim countries such as Western Europe, North America, and Asia (Awan, 2009).

The global conventional banks like HSBS, Standard Chartered Bank, Deutsche Bank, Citibank, etc, have also set up separate Windows/Divisions to structure Islamic financial products and are offering Islamic banking services to their Muslim clients and even to those non-Muslim clients who are interested in profit and loss sharing (PLS) financial instruments. UK, France, China, Singapore and many other countries have developed special regulatory framework to facilitate the working of Islamic banking. The speed of the growth of Islamic banking all over the world including Pakistan has been expedited since 2002.

The Islamic Banking has now expanded to more than 100 countries around the world and the size in terms of its assets has reached to about US\$ 700 billion with an annual growth rate of 15 % (Chong & Liu, 2009). In the 21st century, the establishment of full fledged Islamic banks in Pakistan created tough competition among banks to attract and retain greater number of customers by providing quality services. The Islamic banking institutions in Pakistan have shown tremendous growth in assets at around 59% per annum since 2005. The growth of Islamic banking industry in terms of assets was 34% as compared to 8.8% of overall growth of banking industry in year 2009 (SBP, 2009). The sustained growth of Islamic banking Industry was also witnessed in 2010 with annual growth of 31 % in assets, while the growth in deposits and Investments was 38.2% and 17.7% respectively in the same year. . The overall share of Islamic banking industry in the country's banking system also improved to 6.4% from 6.1% in 2010 (SBP, 2010).

The objectives of the study are i) to analyze the growth of Islamic banking in terms of Its deposits, Assets , Investments and Owners Equity and ii) to compare growth of Islamic banking with conventional banks.

### **2. Literature Review**

Islamic banking is a recent phenomenon as compared to conventional banking which operates for more than a century. Islamic banking operates on Risk sharing concept instead of interest or riba in conventional banking. Islamic banks due to its significant growth in assets all over the world have proved their existence in non Muslim countries by opening Islamic banking branches / windows to cater the growing demand for its products and services (Olson & Zoubi, 2008).

As stated by Zaher and Hassan (2001) that Islamic Financial system was predominantly practiced in the Muslim world in 80's which not only cover banking sector but also provided platform for financial markets, financial Instruments and all forms of financial intermediation. The driving force behind the dramatic growth of Islamic Finance in last few Years was the spread of Islamic religion around the globe. They mentioned that Islamic banking and Finance was grown due to introduction of structural reforms, liberalization of capital movement, globalization of financial markets and launching of new products based on Islamic principles. International banks around the world also reorganized its products structure from normal deposits to Derivatives, Hedging and Investments in order to avail profit opportunities (Siddiqui, 2008). According to Brooks (1999) Non Muslims are also interested in Islamic banking products and considered it to be commercially sound.

Iqbal (2001) compares Islamic and conventional banking in the Nineties and included 12 banks into his study sample. He studied the growth of Islamic banking industry during 1990-98 to measure annual growth rates for some key variables of Islamic banks like total equity, total deposits, total investment, total assets and total revenue. Then he used ratio analysis like capital assets ratio, liquidity ratio, deployment ratio, cost/income ratio, profitability ratio, return on asset and return on equity ratio and concluded that both return on assets (ROA) and return on equity (ROE) for the Islamic banks are substantially higher than the conventional banks. He concluded that the profit ratio of Islamic banks compare favorably with international standards, it should be noted that conventional banks depositors are guaranteed their principal amounts and hence bear less risk than Islamic banks depositors. Therefore, the depositors of Islamic banks would genuinely expect a higher rate of return to compensate for extra risk.

Awan (2009) analyzed the vertical growth of Islamic banking and compared it with its counterpart conventional banking. Six newly formed Islamic banks in Pakistan and six conventional banks of the same size were selected for the purpose of comparison. Data relating to their performance and profitability were collected from primary and secondary sources from 2006 to 2008. The ratio analysis technique was applied to measure the performance of key indicators of both Islamic and conventional banks. The results of the study showed that the performance and profitability of Islamic banks are far better than selected conventional banks. The study also found that Islamic banks are comparatively much better than conventional banks in terms of assets, deposits, financing, investments, efficiency, and quality of services and recovery of loans.

### **3. Research Methodology:**

The sample of the study includes one Islamic bank and two conventional banks operating on domestic level in Pakistan. Trend analysis technique was used to determine the growth rates of Deposits, Investments, Assets and Owners' Equity for a period from year 2004 to year 2009. Students' T-test was used to determine the statistical difference between growth rates of Islamic and conventional banking.

### **4. Results and Discussion:**

The objective of the study was to compare and evaluate the growth rates of Islamic and conventional banks in terms of its Deposits, Investments, Assets and Equity for a period from 2004 to 2009. The growth rates were determined through horizontal analysis technique. The growth rates of Deposits, Investments, assets and equity of both Islamic and conventional banking are given in Appendix-A as table 4.1, table 4.2, table 4.3, and table 4.4 respectively for the period under study and trend in the growth rates of both group of banks is shown graphically in Appendix-B as Figure 4.1, 4.2, 4.3, and 4.4 respectively.

#### *4.1 Deposits Growth Rates*

Growth rates of deposits of both Islamic conventional banking are given in table 4.1 which reveals that growth rates of deposits were higher in case of Islamic banking than conventional banks in the period under study. The Islamic bank stood at 165% in 2004-05 against growth rate of 142% of conventional banks. The growth rate of deposits decreased to 151% in 2005-06 from 165% in 2004-05 but still higher than conventional banks' growth rate of 116% in the same year. The Islamic bank gained momentum in 2006-07 by posting growth rate of 158% as against growth rate of 151% in 2005-06 while the conventional banks' growth rate was also increased to 118% in 2006-07 against growth rate of 116% in 2005-06. However the increase in growth rate of Islamic bank in year 2006-07 was more than increase in conventional banks' growth rate. Similarly in 2007-08 and 2008-09, the growth rate of Islamic bank surpassed the growth rate of conventional banks. The Islamic banking growth rates were 129% in 2007-08 and 143% in 2008-09 compared to 115% and 111% of conventional banks in 2007-08 and 2008-09 respectively. Hence the results in table 4.1 revealed that Islamic banking is growing at higher rate than conventional banking in Pakistan for period under study.

#### *4.2 Investments growth rates*

The table 4.2 displays the growth rates of Investments of Islamic and conventional banks for a study period of 2004 to 2009. It is evident from the table that Islamic banking has surpassed the conventional banks in all years except 2004-05. The growth rate of Islamic bank stood at 112% compared to 126% in 2004-05 while increase in growth rate of Islamic bank was seen in 2005-06 at 179% against 105% of conventional banks. Islamic banking in 2006-07 recorded a growth rate of 366% compared to 161% of conventional banks which is more than double of conventional banks' growth rate. Conventional banks' growth rate was declined to 94% in 2007-08 from 161% in 2006-07 whereas in case of Islamic bank, the growth rate was 138% in 2007-08 against 366% in 2006-07 but still higher than conventional growth rate in the same year. In 2007-08, Islamic banking investments' growth showed decline and stood at 138% as against 366% in 2006-07. The decline in growth rate of investments was also seen in conventional banks which decreased from 161% in 2006-07 to 94% in 2007-08. However, the growth rate of Islamic banking was still higher than conventional banks. Islamic banking and conventional banks revived from decline in 2008-09 and recorded growth rate of 160% and 138% respectively. It also indicates that Islamic bank growth rate is more than conventional banks' growth rate in the year 2008-09. On the average Islamic bank had higher growth rate in investments (191%) compared to Conventional banks (124.8%).

It is concluded from the above discussion that on average Islamic banking is growing at higher rate than conventional. The Figure 4.2 shows the trend in Islamic and conventional banks for period under study.

#### *4.3 Assets Growth Rates*

The table 4.3 shows the declining trend in growth rates of assets for both Islamic and conventional banks in the period under study except in year 2008-09. The growth rates of Islamic banking in terms of assets were 156%, 151%, 145%, 127% and 146% in years 2004-05, 2005-06, 2006-07, 2007-08 and 2008-2009 respectively. Whereas the growth rates of conventional banks were 137% in year 2004-05, 120% in 2005-06, 121% in 2006-07, 112% in 2007-08 and 113% in 2008-09.

These results indicate that Islamic bank, despite the decline in Assets growth rates, has still achieved growth rate higher than conventional banks in the period under study. The average growth rate (145%) of Islamic bank was also more than conventional banks growth rate of assets (120.6%).

#### *4.4 Equity Growth Rates*

The table 4 displays the growth rates of Owners Equity of Islamic and conventional banking which reveals that Islamic banking has grown at higher rate than conventional banks except in years 2006-07 and 2007-08. The growth rates of equity in 2004-05 was 144% for Islamic banking and 138% for conventional banking while in 2005-06 it was 157% and 138% for Islamic and conventional banking. In both these years, Islamic banking growth rate of equity not only increased but was also higher than conventional banks' growth rate (138%). The declining trend was observed in growth rates of investments of Islamic and conventional banking in years 2006-07 and 2007-08. In these years the Islamic banking growth rates (120% in 2006-07; 105% in 2007-08) were lower than conventional

banks (129% in 2006-07; 106% in 2007-08). However an increasing trend was seen in the year 2008-09 in the growth rates of both Islamic and conventional banking. The Islamic banking growth rate (154% in 2008-09) was higher than growth rate of conventional banking (128% in 2008-09). The above discussion concludes that Islamic banking have higher growth rates in 2004-05, 2005-06 and 2008-09 while lower growth rates in 2006-07 and 2007-08. However, on the average Islamic banking has grown at higher rate than conventional banking in terms of equity.

#### 4.5 An Independent Samples T-Test:

An independent samples T-Test was performed to compare growth of Islamic and conventional banks at 5% significance level. The results of T-Test are given in the table 5 (Appendix-A). The table 5 indicates that Islamic banking is growing at higher rate than conventional banking and the mean difference (28.80%) is significant at 5% level of Significance. Islamic Banking (Mean=149.20, S.D=13.936) and Conventional Banking (Mean=120.40, S.D=12.341) and conditions;  $t(8) = 3.460$ ,  $p < 0.05$ .

Similarly in respect of Assets growth rates, the Islamic Bank is growing at higher rate with Mean of 145% and S.D of 10.977 than conventional banks (Mean = 120.60, S.D = 10.015) and the mean difference of 24.40% was significant at 5% level. Conditions;  $t(8) = 3.672$ ,  $p < 0.05$ . While insignificant results were obtained in case of Investments and Equity Growth at 5%. The Islamic bank mean growth rate was 191 % and 136% in terms of Investment and Equity respectively while mean growth rates of investments and equity were 124.80% and 127.80% for conventional banks. The mean difference (66.20%) in case of investments was not significant at 5% and conditions  $t(8) = 1.418$ . similarly the mean difference (8.20%) in terms of Equity was also not significant at 5% and conditions  $t(8) = 0.702$ .

### 5. Conclusion:

The study examined the growth of Islamic and conventional banking in Pakistan for a period from 2004 to 2009. The growth was examined in terms of Total Deposits, Total investments; Total Assets and Total Equity of both Islamic and conventional banking. Horizontal analysis was used to determine the growth rates of deposits (D), investments (I), Assets (A) and Equity (E) from 2004 to 2009 using chain base method. The average growth rates of deposits, Investments, Assets and Equity were higher in case of Islamic banking than conventional banks in the study period. These results confirm the previous findings of Awan (2009), and Iqbal (2001).

In order to test statistically the growth rates of D, I, A, E for equality of means; an independent samples t-test was performed at 5% and 10% significance level. The results indicated that there was a significant difference between means of Islamic and conventional banking in terms of Deposits at 5% which led to the conclusion that Islamic bank is growing at higher rate than conventional banks in Pakistan in the study period. In terms of Investments growth no significant difference were found between two groups of banks under study. Although the investments growth rate on average was higher than conventional banks growth rate of Investments.

However in terms of assets growth, the Islamic bank had grown at higher rate in terms of Investments growth as compared to conventional banks and the difference in means was found significant at 5% level. While in case of Equity growth, there was no significant difference in Islamic and conventional banks at 5% despite the fact that Islamic bank growth rate in Equity was higher than conventional banks. These results suggest that Islamic banking has grown significantly at higher rate in case of Deposits' and Assets growth while higher growth rates in terms Investments and Equity were insignificant at 5% level. The previous findings of Awan (2009) & Iqbal (2001) confirm the above findings.

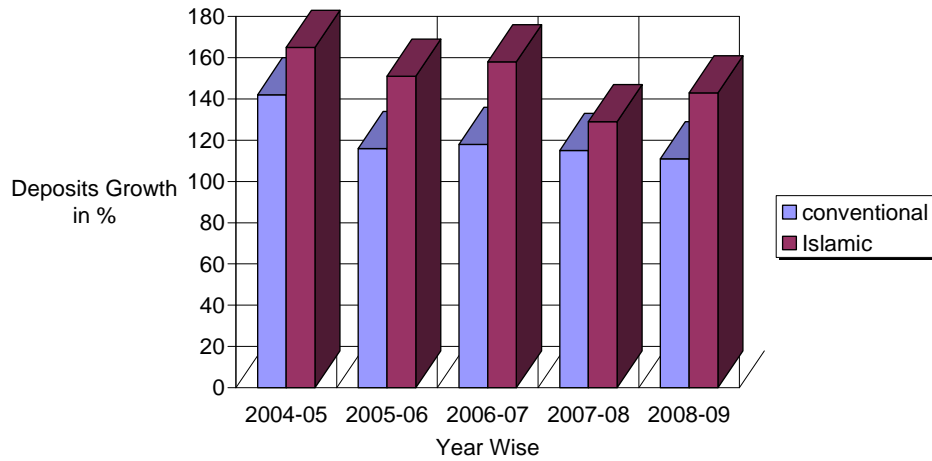
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**Appendix-A**

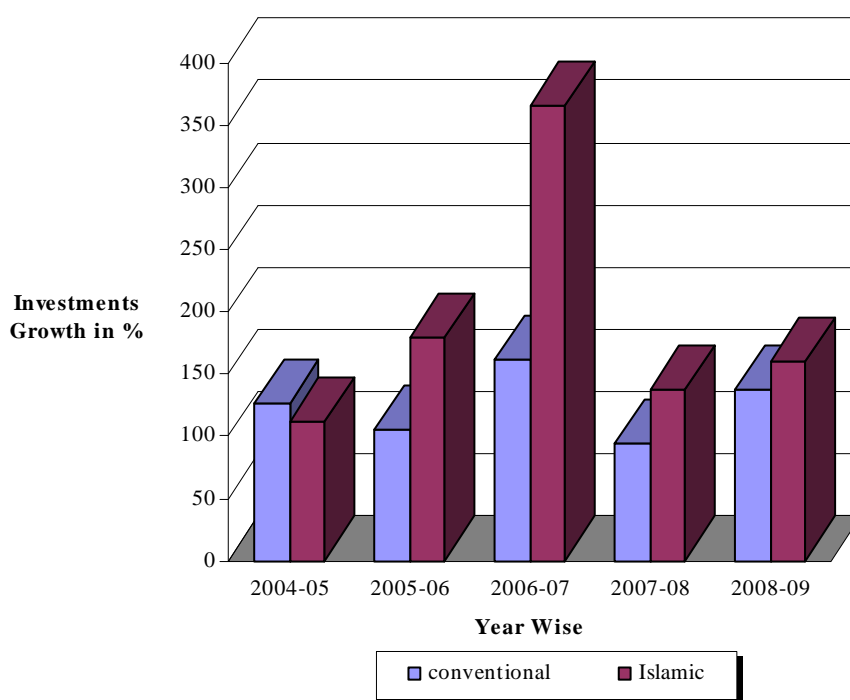
**Figure:1 Deposits Growth of Islamic and Conventional Banking**



**Table: 1 Deposits Growth Rates (%) of Islamic and Conventional Banking**

Year	Conventional banks	Islamic banking
2004-05	142 %	165 %
2005-06	116	151
2006-07	118	158
2007-08	115	129
2008-09	111	143
Average	120.4 %	149.2 %

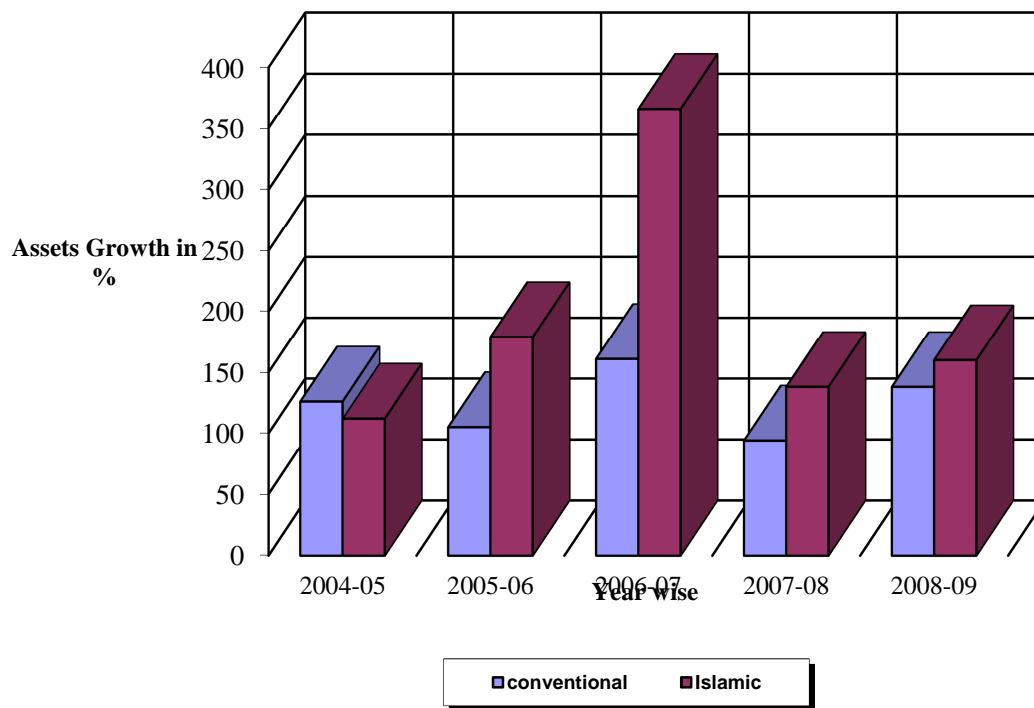
**Figure:2 Investments Growth of Islamic and Conventional Banking**



**Table: 2 Investments Growth Rates (%) of Islamic and conventional Banking.**

Year	Conventional banking	Islamic banking
2004-05	126 %	112 %
2005-06	105	179
2006-07	161	366
2007-08	94	138
2008-09	138	160
Average	124.8 %	191 %

**Figure: 3 Assets Growth Of Islamic and Conventional Banking**



**Table: 3 Assets Growth Rates (%) of Islamic and Conventional Banking**

year	conventional banks	Islamic banking
2004-05	137 %	156 %
2005-06	120	151
2006-07	121	145
2007-08	112	127
2008-09	113	146
Average	120.6 %	145 %



Figure: 4 Equity Growth of Islamic and Conventional Banking

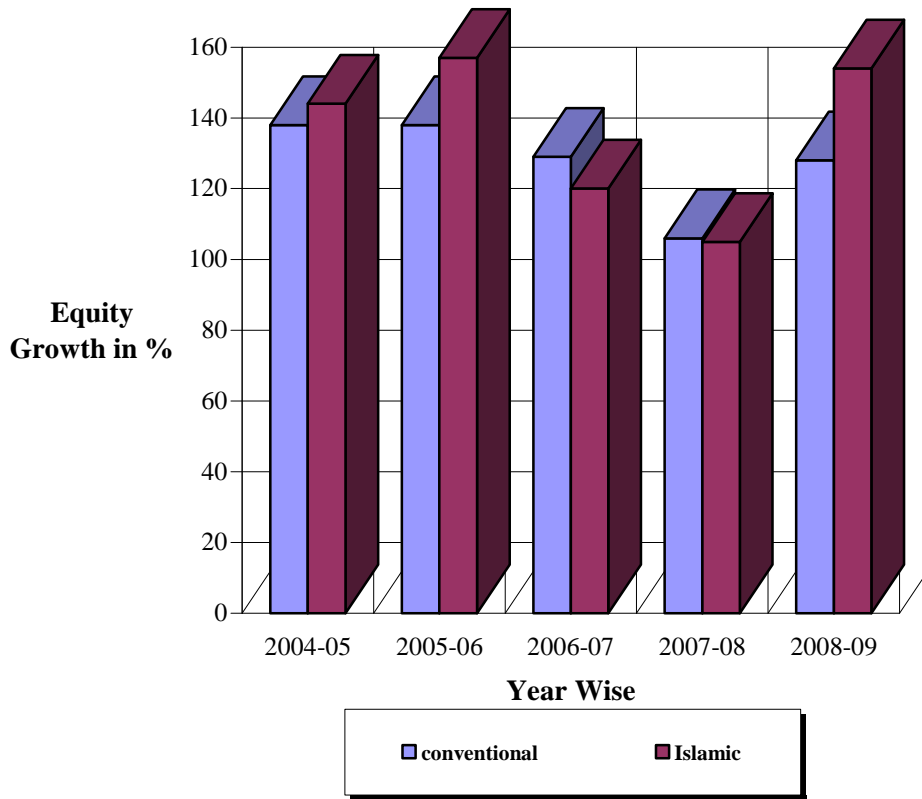


Table: 4. Equity Growth Rates (%) of Islamic and Conventional Banking.

Year	Conventional banks	Islamic banking
2004-05	138 %	144 %
2005-06	138	157
2006-07	129	120
2007-08	106	105
2008-09	128	154
<b>Average</b>	<b>128 %</b>	<b>136 %</b>

Table: 5 T-Test: Growth Rates of Islamic and Conventional Banking.

Variable	Mode of Banking	Mean	Std. Deviation	Mean Difference	T	p-value	Remarks
Deposits	Islamic Banking	149.20	13.936	28.80	3.460	.009	Accept
	Conventional Banking	120.40	12.341				
Investments	Islamic Banking	191.00	100.970	66.20	1.418	.194	Reject
	Conventional Banking	124.80	26.584				
Assets	Islamic Banking	145.00	10.977	24.40	3.672	.006	Accept
	Conventional Banking	120.60	10.015				
Equity	Islamic Banking	136.00	22.616	8.20	.702	.503	Reject
	Conventional Banking	127.80	13.084				

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