Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.8, No.19, 2017

Participation Banking Competitiveness (A Theoretical Review of Pakistan's Islamic Banking Sector)

Sadaf Mustafa
Assistant Professor, Department of Commerce, University of Karachi

Farooq Ahmed
Lecturer, Department of Commerce, Federal Urdu University of Arts, Science & Technology, Karachi

Faizan Ahmed
MPhil Scholar, Department of Commerce, University of Karachi

Faisal Arshad
MPhil Scholar, Department of Commerce, University of Karachi, Karachi

Abstract
This paper theoretically reviews the performance and growth of participation banking industry of Pakistan. Secondary data is obtained from central banks, commercial banks, DFIs and organizations involved in financial research. In addition, financial data of the four participation (Islamic) banking operating in Pakistan has been sought to determine the issues, bottlenecks and opportunities present in the participation banking sector of Pakistan. In relation to the conventional banking sector, this research finds higher proportional increase and growth for participation banking sector as depicted by their financial indicators like leverage, cost to income ratio, asset growth, financing growth, investment account growth (YoY). In contrast, conventional banks present a far better picture in their financial indicators of total banking assets, financing assets, investment accounts and they performs better with respect to return on assets, return on equity , revenue/asset ratio and non-financing income ratio. Based on the above analyses, it can be concluded that participation banking has a great potential for growth in near future and with better image-building and perceptual shift regarding Islamic modes of finance, extensive growth could be expected.
Keywords: Competitiveness, Participation Banking, Conventional Banking, Financial Indicators

Background and Introduction

The urge for an alternative to conventional banking is present as long as the inception of Pakistan. The state judges the need of this, as most of the populous did not trust the conventional banking and their practices. To endure their trust in a banking system and to utilize their idle saving, which could play an active part in the economy, there must be an interest free economy and banking system where the Muslim natives of the country can whole heartedly invest in order to earn returns with the money they have in excess.

The banking sector, although proved to be significant in growth of our economy but did not cater the potential depositors, who avoid the system because it is interest based and choose the alternatives which expose their hard-earned money on high risk with low returns. At the same time, this saving has not been utilized in the best manner in an economy. After all, a bank proved to be the most appropriate channel to utilize the funds in the most effective way possible. So, there is a gap between the conventional banks and these potential customers, whose saving could be better utilized and helps in the economy of the country. This could be the leading reason to introduce a participation banking system.

Review of Literature

When we look at the conventional banks and their performance over the years, it is evident, that they are unable to achieve economic prosperity globally (Awan, Abdul Ghafoor). Past studies have greatly blamed conventional banking for the downfall and collapse of economy and prevailing financial crises. The story of 2007 bubble burst is no newer. The excessive money supply enabled the borrowers to take the loans for the properties that they could not afford and hence resulted in emerging and magnified investments in real estate, where the borrowers were expecting a raise in the worth of their property, oppositely it resulted in the fall because of excessive supply, ultimately the borrowers were unable to repay the loan against the mortgage and went bankrupt. This was done in such a mass number and large scale that the US economy had a financial shock in 2007 that amounted to \$20Billion (Addawe, Salad).

Many studies have been conducted for the comparison of performances of Conventional and Islamic Banks worldwide, especially in Muslim countries. A study conducted in Malaysia concluded that Islamic banks were better in terms of operational efficiency, Assets quality, liquidity, capital adequacy and board independence whereas Conventional banks were better with bank size, board size and return on average asset

(ShaistaWasiuzzaman).

A recent study is conducted to find out the relationship between Participation Banking and Economic growth. The statistics shows Islamic banks performs better even during the recession. This explains that Islamic Banks controls the expansion of artificial hikes and creates real bases which ultimately contribute to macroeconomic factors. (Ahmed AL Galfy).

Even with of the above claims, there is still a room for comparing these two, specifically in case of Pakistan. Where the conventional banking dominates the arena, and at the same time the Islamic banks made their way in the industry. In 2008, with the assets worth 225 Billion, Islamic banks captured 4.5% of total industry and in terms of deposit 4.2% of market share. This accounted for total 4 fully fledged Islamic Banks and 17 conventional banks offering Participation Banking services. (SBP, 2016, p. VII)

Today Islamic Banks of Pakistan account for around 15% of market share with 12-15% growth per annum. The assets under Islamic Banks have reached above one Trillion in 2013 (Farooq Haq et al, 2014). There 27 conventional banks operating in Pakistan out of which 17 also offer Participation Banking Service and 10 are purely conventional. The total number of pure Islamic Banks is now four. (KPMG, 2016).

There has been a number of research attempts to compare the performance of Conventional and participation banking. For example, K.K. Siraj, P. P. (2016) carried a research on GCC (Gulf Council Countries) between the conventional and participation banks resulted in a mix result, where the conventional banks are better in terms of generating revenues but at a cost of heavy credit losses (Bad debts). On the other hand an Islamic bank doesn’t have these issues.

Another study carried out by Johnes, Marwan& Pappas(2012) in Lancaster University UK comprising of 210 conventional and 45 Islamic banks across 19 countries, all of whom the population comprising of more than 60% Muslims. This study concludes that prime reason behind the efficiency and performance of Islamic banks in global crises is their less exposure towards the external environment. Their investment size and linkage to the international finances are not as strong as the conventional banking system. It further concludes that Islamic banks proved to be less efficient when both are exposed into the same level environment.

History and traces of Participation Banking in Islam:

This history of Islamic mode of commerce begins with the living example of Muhammad (PBUH). He (PBUH) has been performing services for the rich Lady Khadija (R.A) who later was very impressed with the honesty and devotion in the business and hence marries Muhammad.

This sort of agreement in today’s Participation Banking is referred to as Mudarbah; where one person invests in the business, and the other performs the services. The person does that because he/she has the appropriate expertise and knowledge. For their services they charged a pre-agreed fee, which is usually in the form profit sharing ratio. The loss, if there are any, to be borne by the financier when their quantum exceeds profit.

Evolution of Participation Banking in Muslim World:

The practical establishment of Islamic Banks in Muslim world dates back to 1960s in Egypt. Where a bank named "The Nasir Social Bank" was established. This was a brain child of Ahmed Al Najjar, who in 1963 performed an experiment with Participation Banking. The same bank started in 1967 and able to declare itself as an interest free bank in 1971.

With this start, a large number of Islamic banks started to appear in the Muslim world like Dubai Islamic Bank (1975), Fasial Islamic Bank of Egypt (1977), Faisal Islamic Bank of Sudan (1977), Bahrain Islamic Bank (1979). Other than Egypt; Indonesia, Malaysia and GCC (Gulf Council Countries) are the early adopters of Participation Banking and have performed exceptionally well and contributed to the development of economies (RosylinMohd. Yosuf, 2013).

Following the high success rate of Islamic banks in the countries, who innovated and contributed into the development of Islamic Banks. As a result, it ultimately reflects into the boom of economy. Other nations who have a major muslim populas also adopted the Islamic mode of banking.

Pakistan adopted the Participation Banking in 2001 with its first Islamic Bank named Meezan Bank Limited. (SBP, Strategic Plan, Islamic Banking Industry of Pakistan, 2016).

Need of Participation Banking in Pakistan:

The demand for Islamic mode of banking has emerging primarily out of the religious reasons, but now this sector creates its economic need as well(SBP, Pakistan's Islamic Banking Sector Review, 2016).

Pakistan is a developing nation, where youth comprises in the majority of population. So, the potential to boost the economy along with innovative business ideas that effectively uses the available resources. The real problem is the shortage of finance, which can be compensated by the Islamic mode of financing.

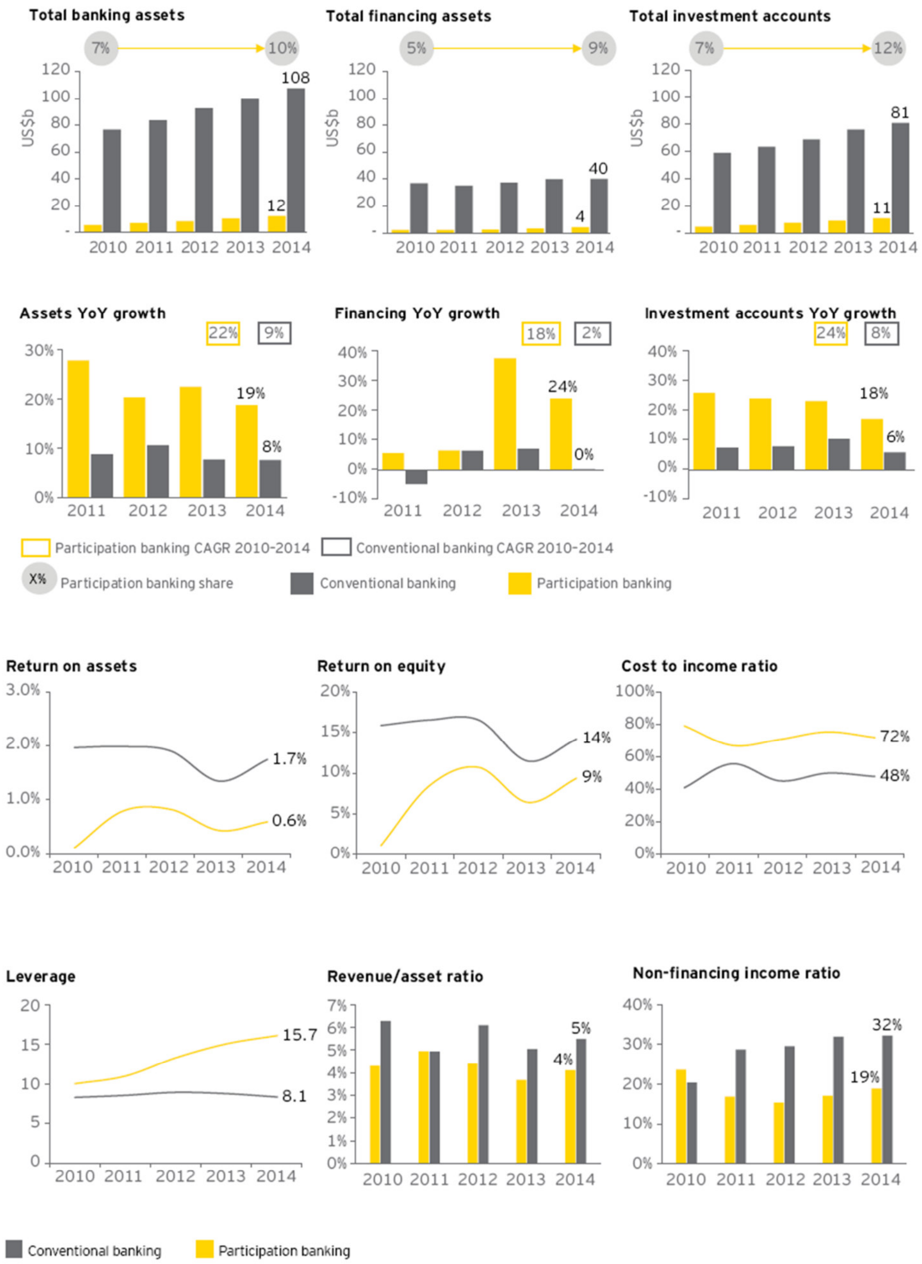
Participation banking sector proved itself appropriate to serve all of these purposes. It not only enhance the customer satisfaction by offering innovative products, but at the same time expand their reach to those customers who have not yet involved in the banking. The frame work is designed in such a way, that along with profit and loss sharing, the mechanism also works in capacity building and contributes towards a greater accessibility for those who needs financing.

Participation Banking is more of a mutual benefit nature of banking system where risk is equally shared as against of that of conventional bank where traditionally the tied interest rates are implied on the customers not only producing greater chances of bankruptcy and default but also creating a huge imbalance in distribution of wealth across the country.

Comparative Analysis

Conventional banks have an advantage of being old, well established, well-practiced system. At the same time participation banking is a new concept and going through the process of development.

In order to gauge the potential, growth and performances of two systems, a comparative analysis taking in financial performance of the two financial streams, conventional banking versus participation banking, was carried out.

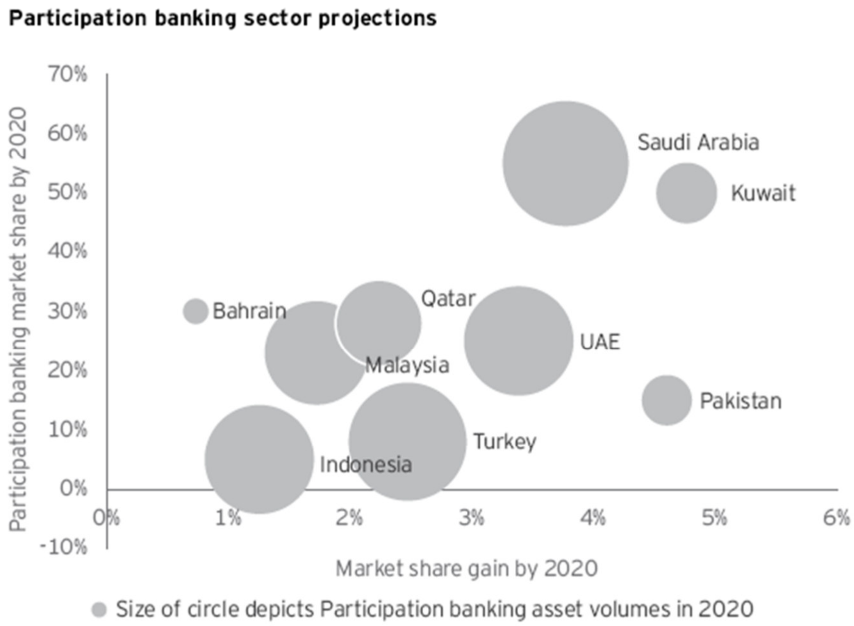


Source World Islamic Banking Competitiveness Report 2016.

In our review, we compared banking sector performance through the financial measures of Total Banking

Assets (TBA), Total Financing Assets (TFA), Total Investment Accounts (TIA), Asset Year to Year Growth (YoY), Financing Year to Year Growth, Investment accounts Year to Year Growth, Cost to Income Ratio, Return on Assets , Return on Equity, Leverage, Non Financing Income Ratio, and Revenue/Asset Ratio.

Our result also indicates an optimistic view for the future of participation banking as they are performing better in comparison to the conventional banks of their size and age.



Source World Islamic Banking Competitiveness Report 2016.

It is very important to understand the reason why we use these indicators, for the selection of the above mentioned indicators papers were studied which focuses upon the banking sector. Our comparative analysis is slightly in contrast with the framework developed by Price Water House Coopers (2011), which uses the key performance indicators (KPI) such as Customer Satisfaction, Customer Retention, and Asset Quality, Assets under Management, Capital Adequacy and Loan Losses to determine the performance of banking sector. Most of the banks, big or small in size have given their KPIs in their financial statements.

Highlights of our Comparative analysis

Based on the above carried out analysis, we present the following highlights and performance themes of the participation sector in relation to the conventional banking sector.

1. In order to replace their conventional counter parts in real sense, Participation banks needs more products which are really new into the arena. Till now, Participation banking sector in Pakistan used to tailor made the conventional products in a way that it can comply with the sharia laws. Which is again an innovation, but not up to that mark which really push a customer to prefer a Participation bank over the conventional banking system in a more rational way.
2. The Year to Year Asset Growth , Financing growth, Investment account growth of Participation banks are higher than the conventional banks. This is due to the fact that, most of the times these banks have small set ups, and a small amount of portfolio to manage having a selected cluster of customers.
3. In order to meet the Sharia Laws, the Islamic banks are more exposed to risky investment which ultimately gives them a higher return (i-e higher the risk, higher the return) so conventional banks proved to be more safe while on the other hand Participation banks giving the higher returns.
4. The Return on Assets, Return to Equity of conventional banks are greater than Islamic banks. The prime reason is quite obvious that Islamic banks have investment opportunity constraints due to their sharia laws, their investment avenues are restricted and they cannot freely invest their reserves.
5. The Islamic banks hold most of its idle money due to the lack of any new means to utilize this money,lacking a way which could be more efficient at the same time complies with the Sharia Laws.
6. The Islamic banks are in a better position in terms of their Cost to Income and Leverage Ratio rather than conventional banks. This is mostly due to a limited amount of capital these (Islamic) banks are undertaking.
7. Participation banks have always been and are still facing the investments constraints and hence need to develop and to innovate the product line as efficient as that of conventional banks.

Conclusion

In the light of this discussion we can conclude that Participation banking is not merely a new or temporary phenomenon. The Participation Banking proves its way, and there is clear indication that this sector will grow and expand. But they have to introduce something drastically unique and give room to innovative ideas, by that manner the sector might add more variety in their existing portfolio.

One of the major marketing advantage this sector possess that, at least in theory, they are more concerned about the productivity and capability of the plan rather than the size of collateral . So in that sense, these institutions can play an important role in encouraging the economic development. However, in practice the Islamic banks focuses on short-term trade finance because of their low risk nature. Maybe one of the reason is that long-term financing involves expertise, upon which most of the Islamic institutions lacked. As the banks grows older, they learn to pay attention upon equity financing.

There is a strong feeling in the Participation Banking sector that they had a captive market in the Muslim masses that prefer them on religious ground. This needs to be revised. Though this could be a differential advantage, but would not be the sole factor in the coming times. As these banks need to grow themselves on real competitive grounds rather than relying on just religious factors. The statistics shows that there is a huge populace of Muslims in Pakistan, who find themselves convenient to deal with the conventional banks, and their only preference lies on which bank offers them a better return. This might force these banks to become more competitive and innovative.

In the end, Participation Banking are still in the face of development. The inaccuracies happen in adapting the system and difference between what is in theory and what is happening in the ground, keeping it away from the competition. Though Islamic banks when compared with the conventional banks of the same size, proved to perform better but still there are areas, where these institutions need important changes and fortunately the State wants to help them, and the central bank is taking these vital measures to ensure a complete and competitive Participation Banking sector in the country.

Recommendations

Islamic banks in order to develop should win their customer's trust so much that the customers from conventional banks should start switching to Participation Banking sector. To do this the professionals related to this sector should conduct seminars and workshops to reach those who actually want to adopt finance as their field of work.

The statistics for Participation banking are already very promising. They need to work on capturing more market in order to generate more profit. More licenses should be issued to practice Participation Banking so that the network can grow.

Proper cash handling and utilization of cash is seriously required as a large gap in deposits and investments is seen for Islamic Banks. New products with intention to replace available conventional banking products is highly required to generate more profits if Islamic bank is meant to replace Conventional banks in years to come.

In order to perform better Islamic Banks also need to improve their investments in assets and wisely decide for the buying purchase decisions so that they can generate more ROA and improve one of their KPIs.

Overall Islamic banks are performing better but the point to emphasize here is that it has more ability, capacity, funds and resources to develop itself than it is doing at present. Islamic Banks and its management has all the suitable infrastructure and appetite to get control over all the financial transactions, all it needs is governmental support to meet the prominent changes, which also should not be a big issue since Participation Banking is establishing it roots over all the world including the non-Muslim countries. We can expect the international transactions, imports, exports and commodity dealings to be done by Islamic Banks in 20-25 years if Participation Banking keeps up the same pace around the world in its growth and development.

Areas for further research

As said, there is always a room for improvement; scholars worldwide are looking forward to do more research and development in this area. In order to develop this domain of the industry it is important to know the customer feedback and their level of satisfaction with the products. In the phenomenon like Participation Banking it is highly advisable to keep up with the expectations and perception of customers about the products being introduced and developed. In this context should be studied and quantified the impact of customer satisfaction on the operations. The analysis of the size of institution and operating expenses to manage explored should be the ways to optimize the costs and profits.

References

Addawe, Salad. (2012). What are the impacts of the global financial crisis on Islamic banking system and how Islamic bank spared from the crisis? MBA Thesis, Aalto University, School of Economics, Department of Accounting.

Ahmed AL Galfy, K. A. (2012, October). Islamic Banking and Economic Growth: A review. The journal of applied business research, Vol.28 No.5, 952.

Arifeen, N. U., Hussain, M., Kazmi, S., Mubin, M., Latif, S., & Qadri, W. (2014). Measuring Business Performance: Comparison of Financial, Non Financial and Qualitative Indicators. *European Journal of Business and Management*, 6(4), 38-45.

Awan, Abdul Ghafoor. (2009). Comparison of Islamic and conventional banking in Pakistan. CBRC, Lahore (p. 3). Bahawalpur: Islamia University.

Company of Chartered Accountants, Taseerhadi KPMG. (2016, May). Banking Survey 2016. Pakistan: KPMG TaseerHadi and co. of chartered Accountants. Retrieved February 04, 2017,fromwww.kpmg.com/pk: https://www.kpmg.com/PK/en/IssuesAndInsights/ArticlesPublications/Documents/BankingSurvey2013.pdf

Dr.Mian Farooq Haq, BushraShafique,Muhammad Usman Abbasi,Edbiz consulting (Pvt.Ltd). (2014). Knowledge, Activities and Practices of Islamic Banking in Pakistan. State Bank of Pakistan, Department of International Development, Islamic Banking Department. SBP.

Habib, Sitwat and Masood, Haris and Hassan, Taimoor and Mubin, Muhammad and Baig, Umair, Operational Risk Management in Corporate and Banking Sector of Pakistan (2014). *Information and Knowledge Management*, Vol.4, No.5, 2014. Available at SSRN: https://ssrn.com/abstract=2663415 or http://dx.doi.org/10.2139/ssrn.2663415

Islamic Banking Bulletin, March 2017, Retrieved on June 2017, from State Bank of Pakistan Website :http://sbp.org.pk/ibd/bulletin/Bulletin.asp

Jill Johnes, Marwan Izz el din,Vasileios Pappas. (2012). A comparison of performance of Islamic and Conventional Banks 2004-2009. Lancaster University, Department of Economics. UK: Lancaster University Management School. Retrieved March 01, 2017

K.K. Siraj, P. P. (2016). Comparative study on performnace of Islamic and conventional banks in GCC region. Journal of Applied Finance and Banking, 123-124.

Naveed, M., Hassan, S. T., Azhar, T., Latif, S., Mubin, M., & Qadri, K. (2014). The Allusions of Behavioral Finance. *Research Journal of Finance and Accounting*, 5(9), 68-75.

Price Water House Cooper. (March 2011). Guide to key performnace Indicators. Guide, PWC, UK.

Rosylin Mohd. Yusof, MejdaBahlous, (2013) "Islamic banking and economic growth in GCC & East Asia countries: A panel cointegration analysis", Journal of Islamic Accounting and Business Research, Vol. 4 Issue: 2, pp.151-172,
Website: https://doi.org/10.1108/JIABR-07-2012-0044

SBP. (2016). Pakistan's Islamic Banking Sector Review. State Bank Of Pakistan, Islamic Banking Department. Islamabad: State Bank Of Pakistan. Retrieved 2017.

ShaistaWasiuzzaman, U. N. (2013). Comparative study of the performance of Islamic and Conventional Banks- The case of Malaysia. Humanomics, Vol 29 No.1, 43.

Simpson, S. D. (n.d.). Investopedia. Retrieved February 26, 2017, from www.investopedia.com: http://www.investopedia.com/university/banking-system/banking-system9.asp

World Islamic Banking Competitiveness Report 2016, www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016.pdf