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Global Financial Crises and its Impact on Banking Sector in Pakistan

Lutuf Ali Phulpoto (Dean, Faculty of Commerce & Business Administration,Shah Abdul Latif University, Khairpur-Mirs, Pakistan)

Aisha Bashir Shah (Assistant Professor; IBA-University of Sindh-Jamshoro, Pakistan)

Faiz Muhammad Shaikh (Assistant Professor; SZABAC-Dokri, Pakistan)

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Author(s)

Lutuf Ali Phulpoto
Dean, Faculty of Commerce & Business Administration,Shah Abdul Latif University, Khairpur-Mirs, Pakistan

Aisha Bashir Shah
Assistant Professor-IBA-University of Sindh-Jamshoro, Pakistan

Faiz Muhammad Shaikh
Assistant Professor, SZABAC-Dokri, Pakistan
Email: faizanmy2000@hotmail.com

Abstract

The research investigates the performance of Islamic banking in Global economic recession period in Compare with Conventional Banking from the period of September 2008b to December 2009 in Pakistan. Data were collected from four leading Islamic banks and Four Conventional banks from the period of Sept.2008 to December 2009 operated in Pakistan. It was revealed that Islamic banking has more growth in the recession period in Pakistan. The main reason of slow growth of Islamic banking is due to unawareness among the customers and the conventional banks in Pakistan has longer history and experience in doing the banking business and holding dominant position in the financial sector in Pakistan. The financial ratios such as return on Assets (ROA), return on Equity (ROE), Loan to Deposit ratio (LDR) Loan to Asset Ratio(LAR) Debt to equity Ratio(DER), Assets Utilization(AU), and Income to Expense ratio(IER) are used to assess banking performance. T test and F-test were used in determining the significance of results. It was revealed that Islamic banking is less profitable, less risky and less efficient compare with the conventional banking in Pakistan during the study period 2007- to marchKey implication of current study to analyze the impact of Global Economic Recession wave affected the Banking sector in Pakistan in general and Islamic banking particular. This research also provides the guide line for the investors to invest in Islamic banking.This study contributes and explores the opportunities for the customers and investors to invest in the Islamic banking because that is less risky compare with the Conventional banking in Pakistan.

Keywords: Islamic banking, compare, conventional banking in Pakistan

Introduction

The main objectives of this paper are to review the growth of the Islamic banking on a global basis, assess its performance based on the latest financial data available, discuss its salient products/services, evaluate them for likely departures from traditional Islamic principles, and offer suggestions for improvement based on the experience of the authors and evidence provided by other recent studies in this area.

The study is aimed at comparative financial performance of Islamic banking with conventional banking in Pakistan. Specifically, study makes comparison of 4 Islamic banks and a group of 5 conventional banks performances each year in 2005-2009. 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. In today's competitive financial market, one can better understand the performance of a bank by an analysis of inter-bank comparison.

Research Methodology

In order to see how Islamic banks have performed in competition 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 that of Islamic banks each year. T-test and F-test are used in determining the significance of the differential performance of the two groups of banks.

Empirical Results

Profitability Ratios

Return on Assets (ROA)

The result indicates several important points of comparison of ROA between Islamic banks and conventional banks. First, ROA of conventional banks has been greater than

Islamic over time except year 2009 in which Islamic banks ROA (1.43%) slightly surpassed conventional banks ROA (1.38%). Second, ROA decreased drastically to 1.14% from 1.93% (40% decreases) and from 2.18% to 1.35% (38% decrease) during 2005-2006 for Islamic banks and conventional banks respectively. Third, after having drastic decrease in 2005-2006, conventional banks recovered their ROA in 2006-2007.

But this recovery was not only small but also temporarily. Since 2007, ROA of conventional banks is consistently on decreasing trend. Islamic banks has similar story as of conventional banks but with one difference i-e ROA of Islamic banks seem to be more fluctuating in that it increased in 2006-2007 from 1.14% to 1.37%, but again decreased to 1.30% in 2008 and ended up at 1.43% in 2009 with an increase of 0.13%. Finally, on average, ROA of conventional banks (1.59%) is higher than average ROA of Islamic banks (1.49%); however, statistically there is no difference between the two means at 5% significance level.

Financial results of 2010 of Islamic banks and conventional banks will reveal whether this declining trend of conventional banks ROA would continue and ROA of Islamic banks would increase or decrease. Nevertheless, banking sector in Pakistan is growing significantly but considering the last 4 years trend in ROA, both types of banks are experiencing difficulties in profitability.

Table 1.1: Return on Assets

	2005	2006	2007	2008	2009	Mean	S.D
Islamic banks	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

Figure 1.1

Return on Equity (ROE)

Similar to ROA, from the study of ROE of both conventional banks and Islamic banks, we emphasize some important points to consider. The result shows that conventional banks ROE is consistently higher than Islamic banks ROE during 2005-2009. In year 2005, the difference was huge which decreased considerably during 2006-2009. The difference is 17.6% in 2005, which has plummeted to 2.5% in 2009. This momentous decrease in difference of two ROEs is essentially due to overall increasing trend in ROE of Islamic banks and decreasing trend in ROE of conventional banks. This gives us an important insight. ROE of Islamic banks followed conventional banks ROE in terms of increase and decrease during 2005-2009, however, in the years when ROE of the two banks increased, increase in ROE of Islamic banks has been more than increase in ROE of conventional banks (30% increase for Islamic banks as compared to 12% increase for conventional banks in 2005-2007), and decrease in ROE of Islamic banks has been less than decrease in ROE conventional banks (8.5% decrease for Islamic banks as compared to 15% decrease for conventional banks in 2007-2008). ROE of Islamic banks increased from 12.23% in 2005 to 16.88% in 2009, whereas, ROE of conventional banks decreased from 29.83% to 19.3 8% in 2009. Analysis of the last five years financial statements further hi^{g}hli^{g}hted that overall profits base has increased more than equity base in Islamic banks resulted into an increase in ROE over time. On the contrary, for some of the conventional in a group of 5 conventional banks, equity base increased and profits base decreased which stood the main cause of overall reduction in ROE during 2005-2009. Nevertheless, ROE of Islamic banks has improved; ROE of Islamic banks is lagging behind the conventional banks as yet. An average ROE of the Islamic banks is 13.27%, whereas the average ROE of conventional banks for the same periods is 22.76%. The difference of the two means is strongly significant (see Table-1.2.

Table1.2: Return on Equity (ROE)

	2005	2006	2007	2008	2009	Mean	S.D
Islamic banks	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

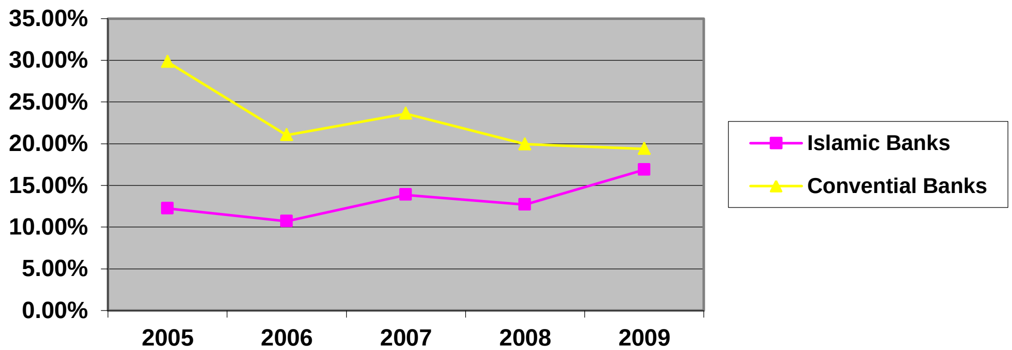


Figure 1.2

Profit Expense Ratio (PER)

Another measure of profitability, PER, is supporting the conventional banks to be more profitable in terms of expenses as compared to the Islamic banks over the time period of 2005-2009. The analysis of PER of Islamic banks and conventional banks indicates that conventional banks have generated consistently higher profits for every one rupee of expense spent during 2005-2009 but with decreasing trend as compared to Islamic banks during the same time period. After the decrease in 2005-2006, PER of conventional increased in 2007, but again it decreased afterwards with no sign to rise again. PER of conventional banks was 1.91 in 2005 which decreased by 57% from 1.91 in 2005 to 0.82 in 2009. This decrease in PER of conventional banks is far greater than decrease in PER of Islamic banks during the same time period. PER of Islamic banks decreased to 0.72 in 2009 from 0.94 in 2005 accounting for only 23% decrease. Further analysis of financial statements of the 5 conventional banks included in the study revealed the fact that expenses of these conventional banks have increased during 2007-2009, however, for some banks profits did not increase much and for others even decreased during the same time period, which resulted into decrease in PER of the group of conventional banks. Mean PER of the Islamic banks is 0.77 which is less than conventional banks mean PER of 1.34. This difference in the two means is statically different at 5% significance level (see Table-1.3).

Table1.3: Profit to Expenses Ratio (PER)

	2005	2006	2007	2008	2009	Mean	S.D
Islamic banks	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

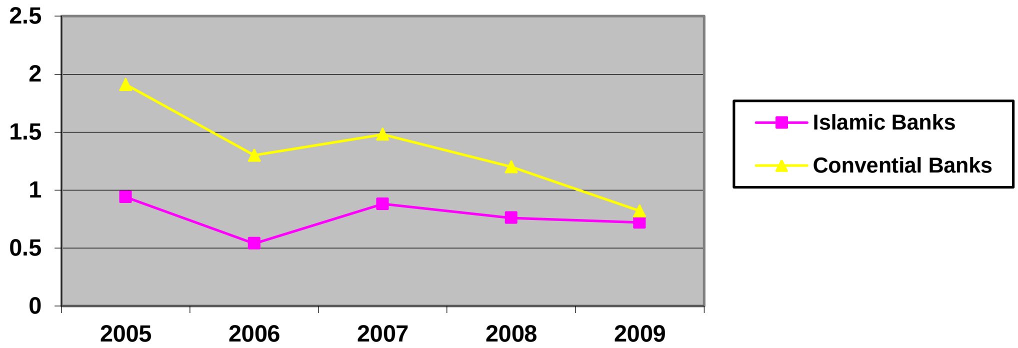


Figure 1.3

Nonetheless, overall all results of profitability measures go in favor of conventional banks. The results indicate that conventional banks are *more profitable* compared with Islamic banks, however, Islamic banks are consistently improving and performing better in making good returns on investment (assets), satisfying their shareholders in offering competitive or even better returns, and also managing their operating expenses.

Profitability Ratios

Loan to deposit Ratio (LDR)

High loan to deposit ratio for Islamic banks compared with conventional banks during 2005-2008 indicates that Islamic banks has been comparatively less liquid. However, in 2009, Islamic banks LDR (63.3 5%) decreased below conventional banks (70. 89%) turning Islamic banks into comparatively better liquidity position. LDR of Islamic banks decreased from 95.36% in 2005 to 63.35% in 2009. This overall declining trend in LDR of Islamic banks indicate the tendency of comparatively more increase in deposits than loans (financings) and further emphasizes improved liquidity position of Islamic banks. Compared with Islamic banks, LDR of conventional banks has been reasonably lower and floating between approximately 70% and 77%. Conventional bank LDR was 73.85% in 2005 which decreased to 70. 89% in 2009. Although Mean LDR of Islamic banks 82.70% is higher than Mean LDR of conventional banks 73.55% but statistically there is no difference between the two means a t 5% level of significance (see Table-1.4).

Table1.4: Loan to Deposit Ratio (LDR)

	2005	2006	2007	2008	2009	Mean	S.D
Islamic banks	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

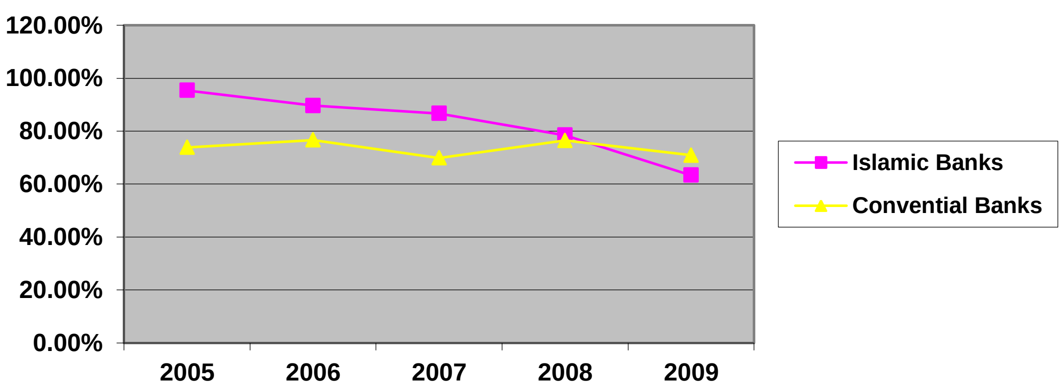


Figure 1.4

Cash & Portfolio Investments to Deposits & Borrowings Ratio (CPIDBR)

After decrease in ratio of cash & portfolio investment to deposits & borrowings of both Islamic banks and conventional bank during 2005 and 2007 from 25.77% to 21.60% and 39.88% to 29.12% respectively, CPIDBR increased to 28.39% for Islamic banks and 36.90% for conventional banks in 2009. However, decrease in CPIDBR was more than increase for both sets of banks. Since 2007, an increasing trend in CPIDBR indicates that liquidity position of both Islamic banks and conventional banks is improving over time. Higher CPIDBR of conventional banks supports that conventional banks are more liquid as compared to Islamic banks. Table-1.5 shows that mean CPIDBR of Islamic banks (24. 56%) is lesser and statistically different from mean CPIDBR of conventional banks (34.11%) a t 5% significance level (see Table-1.5)

Table 1.5: Cash & Portfolio Investment to Deposit Ratio (CPIDR)

	2005	2006	2007	2008	2009	Mean	S.D
Islamic banks	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

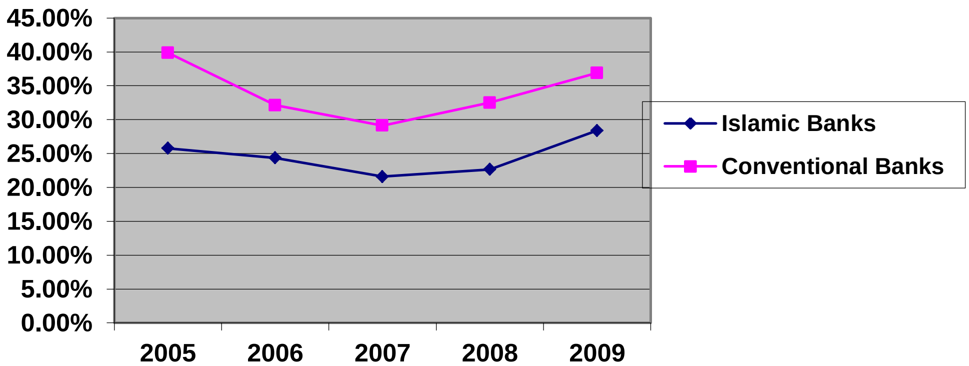


Figure 1.5

Loan to Asset Ratio (LAR)

Whereas loan to deposit ratio shows that liquidity position of Islamic banks is getting better, loan to asset ratio shows somewhat different results. Figure 1.6 shows that LAR of Islamic banks is on increasing trend whereas LAR of conventional banks is swinging between 59% and 64%. This increasing trend of Islamic banks LAR is palpable evidence of more financial stress which Islamic banks is taking by making excessive loans and holding less liquid assets. However, this is an indication of potential betterment in profitability and also conforms to our results drawn from profitability ratios of Islamic banks. LAR of Islamic banks increased to 66.63% in 2009 from 51.47% in 2005 while LAR of conventional banks increased from 59.57 % in 2005 to 59.78 % in 2009. Further analysis of LAR indicated that Murabaha has been the most famous and mostly used mode of financing followed by Ijara, export refinance under Islamic scheme, and Musharaka are standing second, third, and fourth respectively in a row.

Overall result indicates that Islamic banks are as liquid as the conventional banks are. Table-1.6 shows that the average LAR of conventional banks is slightly higher than that of Islamic banks; however, the difference is not statistically significant a t 5% significance level (see Table-1.6)

Table 1.6: Loan to Asset Ratio (LAR)

	2005	2006	2007	2008	2009	Mean	S.D
Islamic banks	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

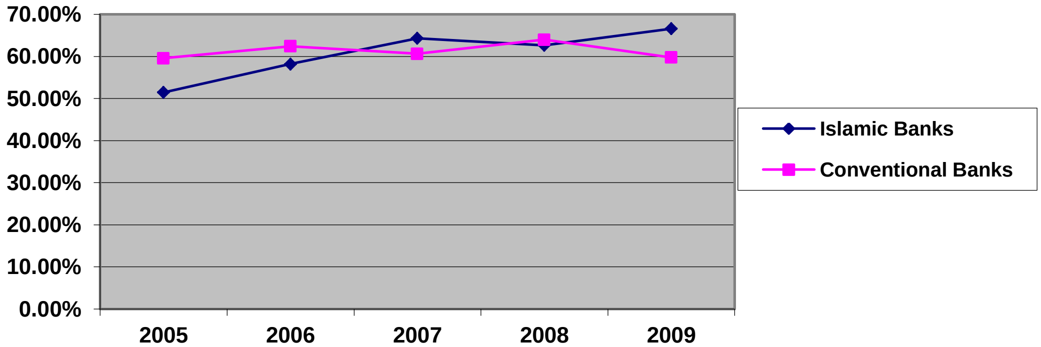
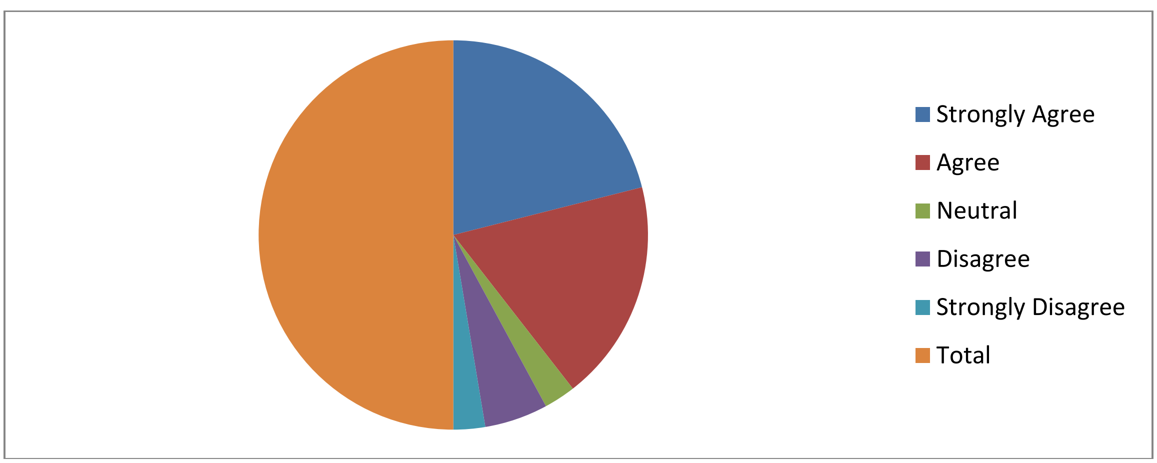


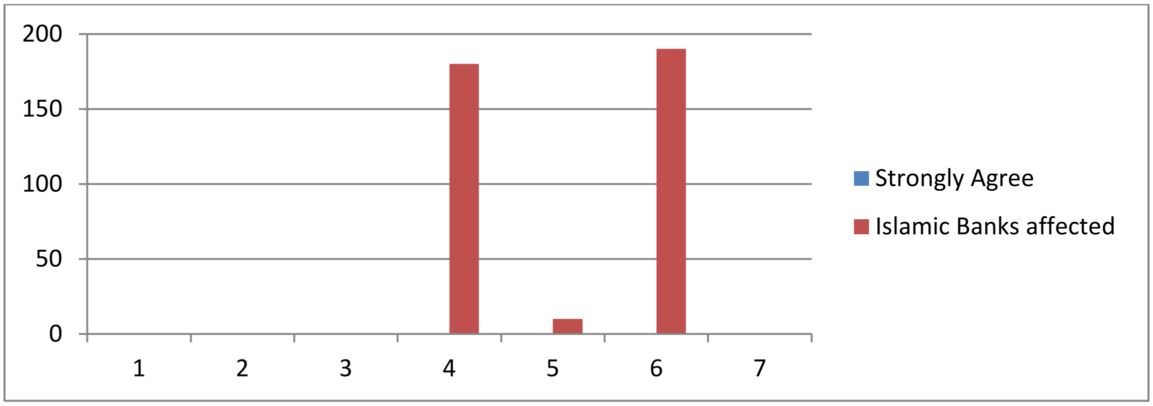
Figure 1.6: Loan to Asset Ratio (LAR)

1. Global Financial Crisis has affected Banking System in Pakistan, According to the response analysis, 80 respondent were in the favour of Strongly agreed, seventy agree, ten Neutral, Twenty disagree and ten strong disagree.

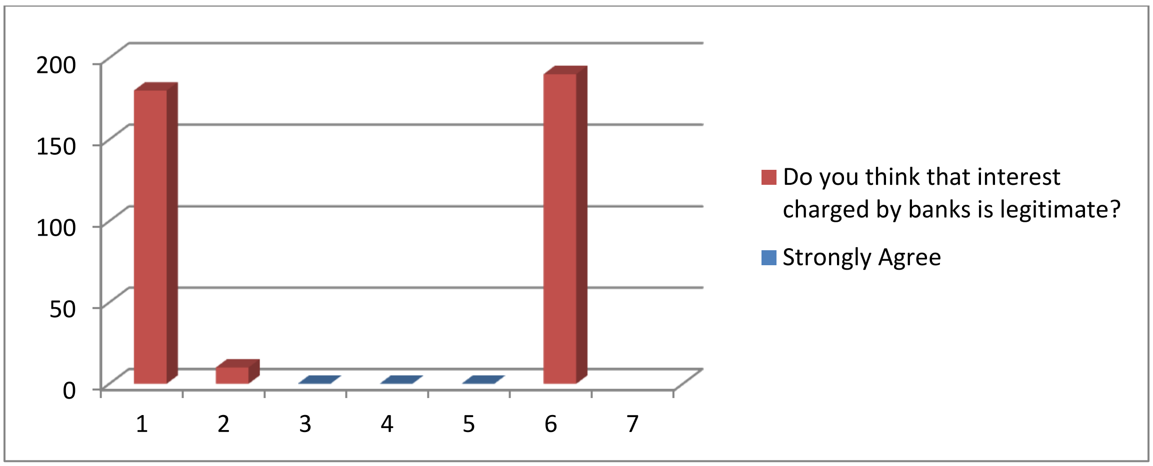


2. Conventional Banks affected, according to this question, One hundred Eighty responded in the favour of Strongly agree and ten responded Agree. Hence it is proved that conventional banks are more affected compare with the Islamic banking.

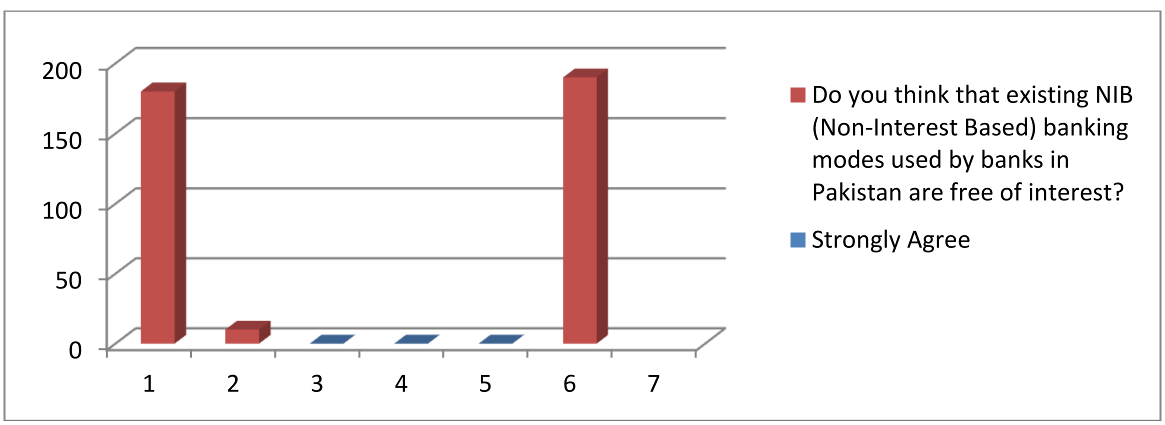
3. Islamic Banks affected, according to this question, One hundred Eighty responded in the favour of Strongly disagree agree and ten responded Dis Agree. Hence it is proved that Islamic banking is less affected compare with conventional banks.



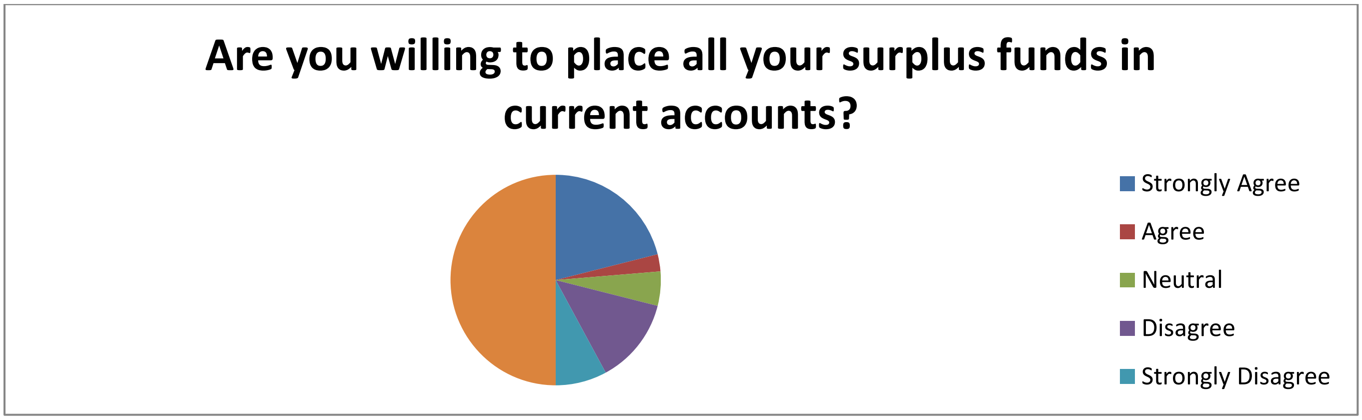
4. Do you think that interest charged by banks is legitimate? according to response analysis, , One hundred Eighty responded in the favour of Strongly disagree agree and ten responded Dis Agree and total One hundred and Ninty respondent have respondent this question.



5. Do you think that existing NIB (Non-Interest Based) banking modes used by banks in Pakistan are free of interest? According to response analysis, One hundred Eighty responded in the favour of Strongly disagree agree and ten responded Dis Agree and total One hundred and Ninty respondent have respondent this question.

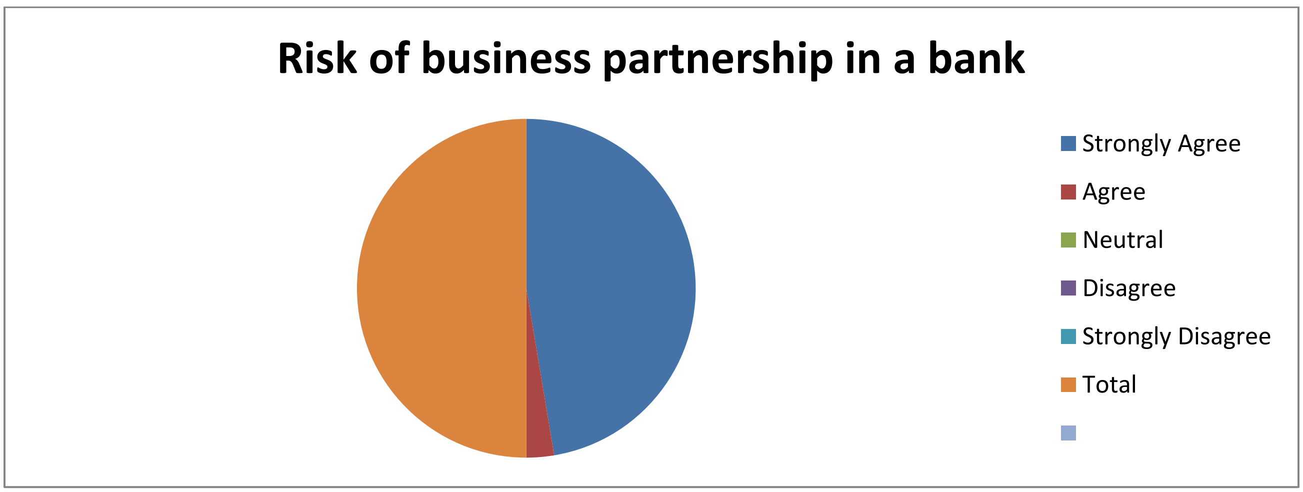


6. Are you willing to place all your surplus funds in current accounts? According to the analysis eight respondents favors Strongly disagree, Ten agree, Twenty Neutral, Fifty Strongly Disagree, and Thirty Disagree.

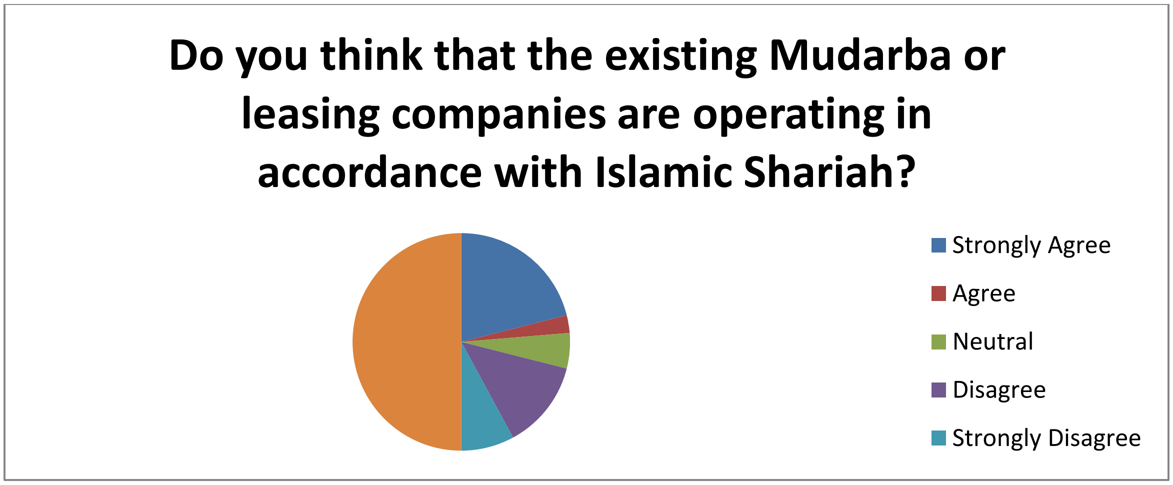


7. Risk of business partnership in a bank,

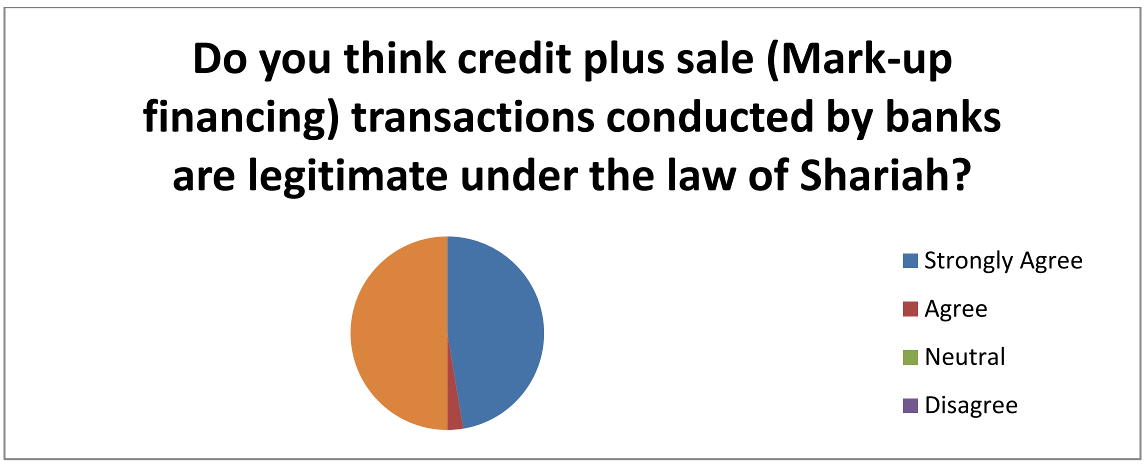
a) Mushraka
b) Mudaraba
c) Leasing, ?, according to response analysis, , One hundred Eighty responded in the favour of Strongly disagree agree and ten responded Dis Agree and total One hundred and Ninty respondent have respondent this question.



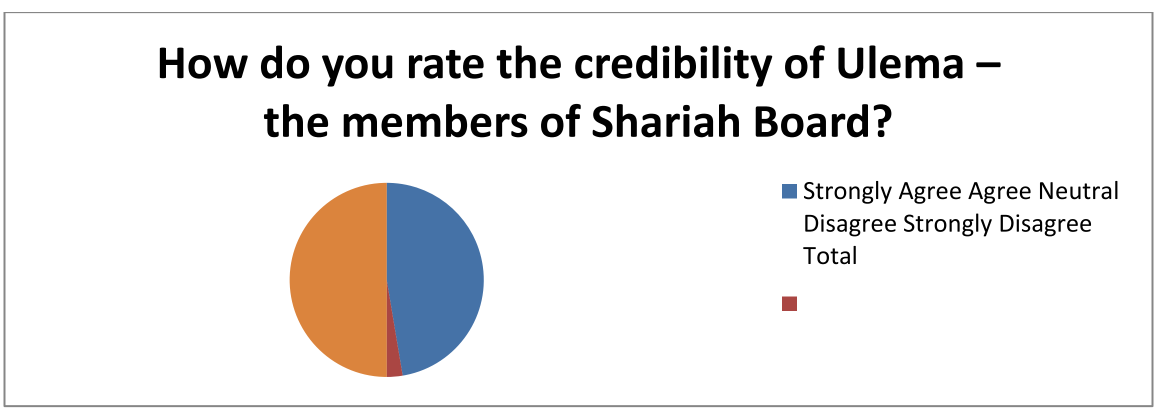
8. Do you think that the existing Mudarba or leasing companies are operating in accordance with Islamic Shariah? According to the analysis eight respondents favors Strongly disagree, Ten agree, Twenty Neutral, Fifty Strongly Disagree, and Thirty Disagree.



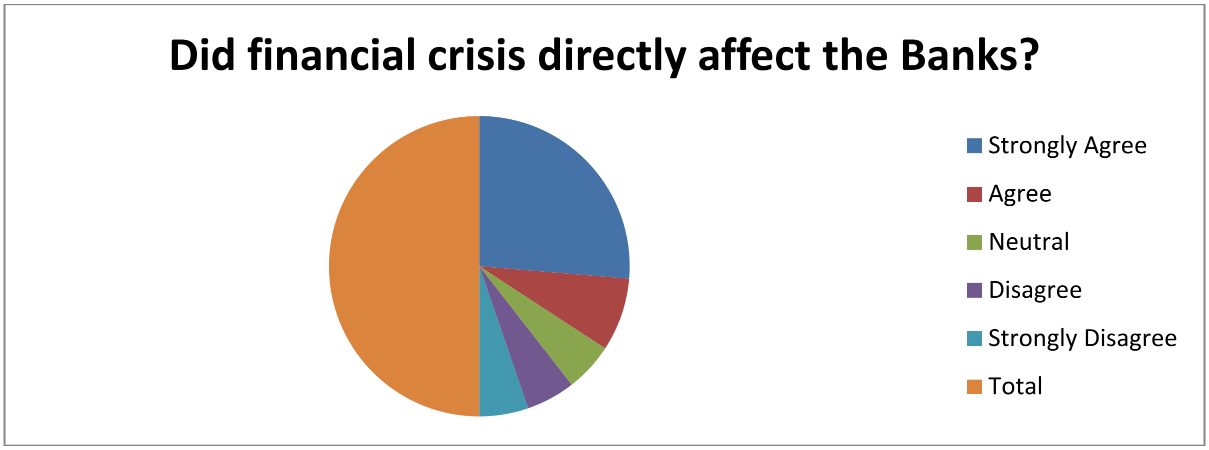
9. Do you think credit plus sale (Mark-up financing) transactions conducted by banks are legitimate under the law of Shariah? According to response analysis, One hundred Eighty responded in the favour of Strongly disagree agree and ten responded Dis-Agree and total One hundred and Ninty respondent have respondent this question.



10. How do you rate the credibility of Ulema – the members of Shariah Board according to response analysis, One hundred Eighty responded in the favour of Strongly disagree agree and ten responded Dis Agree and total One hundred and Ninty respondent have respondent this question.



11. Did financial crisis directly affect the Banks? According to response analysis, Hundred respondent favors to strongly agreed, Thirty to Agree, Twenty Neutral, Twenty for Strongly disagree, and twenty for disagree.



Non Performing Loans / Default rate increased followed by economic crunch.According to response analysis, One hundred Eighty responded in the favour of Strongly agree and ten responded Agree and total One hundred and Ninty respondent have respondent this question.

Conclusion

The current research highlighted the Global financial crisis its impact on the banking industry in Pakistan as a general and particular in Islamic banking in Pakistan. Islamic banks have been less affected than many conventional banks in the current global recession as they are prohibited from activities that have contributed to the credit crunch such as investment in toxic assets, Prohibition of Riba, element of Un-certainty and Gambling in their dealings and contracts. Due to sound footing of Islamic Banks dealing in only participative mode of finance based on Islamic Shariah they remained highly resilient during Financial Crisis.

Islamic Banks were not affected by Liquidity problem as faced by conventional banks due to rumors people at large with drawn heavy deposits from conventional banks either maintained in Pak Rupees or Foreign Currencies and tried to move these funds abroad in shape of US dollars due to un certainty prevailing in the market followed by Financial Crisis and stock exchange Crash.

Central Bank timely intervened to lubricate the financial markets and it released Rs 250 billion in the first round between October11 to October 20 and additionally released Rs 30 billion on November 01,2008

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