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Should a Conventional Bank Open an Islamic Branch? The Financial Efficiency Analysis

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ABSTRACT

In recent years, a notable trend of conventional banks establishing Islamic branches has been observed. The primary driver behind this rise in Islamic branch openings appears to be the public's growing interest in halal business practices and transactions. Additionally, the State Bank's shift towards promoting Islamic finance has further incentivized conventional banks to expand their Islamic banking offerings. However, the senior management of these dual banking institutions is primarily concerned with maximizing their financial benefits and profits. As such, they are focused on determining which type of branch, Islamic or conventional, is more conducive to the profitability and efficiency of their organization. The present study aims to investigate the factors that make Islamic branches more beneficial compared to their conventional counterparts. To this end, the researchers will analyze secondary data from both banking sectors and apply regression analysis to examine the differences in the drivers of profitability and efficiency between Islamic and conventional branches.

Keywords: ROE, ROA, Car, financial benefits, Islamic branches

1. INTRODUCTION

1.1. Background

Islamic banking is highly popular in Pakistan. The development of Islamic banking in a country with a predominantly conventional economic structure like Pakistan is truly remarkable. This rapid growth can be attributed to several factors, including the availability of interest-free halal products, high customer satisfaction, and the State Bank's 2027 objective of fully Islamizing the banking sector. The Federal Shariat Court's 2022 decision to convert the entire economy into an interest-free and Shariah-compliant system has also been a leading factor in the proliferation of Islamic windows and branches. By the end of December 2022, the Islamic banking market share was recorded at 26.5%. Given that the conversion of approximately 73% of interest-based banking into Shariah-compliant banking in just five years is a daunting task, there is a clear need to open new Islamic branches.

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Islamic banking and conventional banking differ primarily in their foundational principles and operational frameworks. Islamic banking operates under Shariah law, which prohibits interest and emphasizes profit-sharing arrangements based on risk-sharing and asset-backed transactions. This approach aims to promote fairness, ethical conduct, and socioeconomic justice by aligning banking activities with Islamic principles. In contrast, conventional banking operates within secular financial systems that permit interest-based transactions, focusing on maximizing shareholder returns through lending and investment practices. While both systems aim to facilitate financial activities and economic growth, Islamic banking places a stronger emphasis on ethical finance, risk-sharing, and community welfare, whereas conventional banking prioritizes profitability and regulatory compliance within the broader global financial landscape.

Previous studies have provided a detailed picture of the operational differences between Islamic and conventional banks. Numerous researchers have examined the products introduced and used by Islamic banks, their benefits, uniqueness, and profitability.

In the current scenario in Pakistan, the higher management of banks is keen to determine whether to open an Islamic branch, convert an existing conventional branch, or establish a new Islamic branch. The higher management in the dual banking system is always concerned with analyzing which type of bank branch is more helpful for the profitability and efficiency of the relevant organization. Banks are primarily focused on profitability, so the financial benefits of opening an Islamic branch must outweigh the religious obligation. To the best of the researchers' knowledge, an empirical study on this issue is still lacking.

1.2. Significance of study

This study aims to determine which branch type - conventional or Islamic - can better contribute to the profitability and sustainability of conventional banks. For this purpose, the study will compare the performance of conventional and Islamic branches across key financial metrics, including return on assets, return on equity, cost-to-income ratio, and capital adequacy ratio. Data for the Islamic branches will be sourced from the Islamic Financial Services Board, while data for the conventional branches will be obtained from the State Bank of Pakistan.

1.3. Problem Statement

The debate in Pakistan revolves around the growth of Islamic branches. Some argue that Islamic branches are performing better, leading to their expansion, while others believe it is the State Bank's enforcement that has driven the opening of Islamic branches, with conventional branches actually performing better. The outcome of this debate remains unclear and requires further investigation.

2. LITERATURE REVIEW

Recent studies have delved into exploring the differences in performance between Islamic and conventional banking across various regions worldwide. These studies provide updated insights into various aspects of Islamic banking performance, including comparative analyses, efficiency evaluations, risk management practices, economic impacts, sustainability efforts, and the influence of digital transformation. They contribute to understanding how Islamic financial institutions navigate contemporary challenges and opportunities in the global financial landscape.

A study conducted by Awan in 2009 used ratio analysis to compare the performance of Islamic and conventional banking sectors in Pakistan. The research focused on twelve banks, six Islamic and six conventional, of equal size operating between 2006 and 2008. Awan analyzed various financial metrics such as ROA, ROE, EPS, as well as ratios like Equity to Total Assets, Debt to Asset, and Cash to Deposit ratios. The findings revealed that during the study period, most profitability ratios for conventional banks were negative, indicating poor performance. In contrast, Islamic banks showed significantly positive results across these metrics, suggesting higher returns for both the banks and their shareholders. Notably, Islamic banks experienced a substantial asset growth of around 78%, compared to only 57% in conventional banks from 2006 to 2008. The market share of Islamic banks also increased from 2.5% to 5% during this period.

Moreover, Islamic banks had a lower ratio of non-performing loans compared to conventional banks, and they maintained higher provisions for bad debts. The study concluded that Islamic banks generally outperformed their conventional counterparts. The success of Islamic banks was attributed to providing investors with superior returns without exploiting shareholders or depositors. Islamic banks charged an average interest rate of 6.5% for financing, whereas conventional banks charged 4.5%, while sharing profits with depositors under a Modarabah arrangement. Additionally, Islamic banks in Pakistan exhibited less profitability volatility compared to conventional banks (Awan 2009). Overall, the comprehensive analysis by Awan suggested that Islamic banking could offer a viable solution to financial crises, particularly evident during the 2007 crisis.

A comparative analysis of the financial performance of the top ten Islamic banks (IBs) and conventional banks (CBs) offering Islamic windows in Pakistan was conducted in 2021 (Ika and Abdullah 2021). To ensure an accurate comparison, cross-sectional data from the annual reports of these banks spanning 2008 to 2019 were gathered from each bank's official website. The results show that during this period, the examined Islamic banks in Pakistan demonstrated superior liquidity, stronger capitalization, and lower risk compared to the sampled conventional banks. The heightened liquidity can be attributed to stringent financial policies, although the shortage of Islamic financial instruments posed a challenge for these banks in effectively deploying their excess liquid funds in the market. The improved capitalization was a result of effective risk management practices, with Islamic banks relying less on loans for asset acquisition and avoiding debt financing for growth purposes.

A comparative analysis of efficiency ratios between Islamic and conventional banks in Pakistan revealed that Islamic banking demonstrated higher efficiency. The study highlighted that Islamic banks could enhance their performance by developing new products and leveraging technological innovations to better meet customer needs and ensure proactive service delivery. The findings concluded that Islamic banks possess a more robust structural framework compared to commercial banks, offering lower risk profiles while maintaining comparable levels of profitability (Ali and Naeem 2019).

3. HYPOTHESES

H1: Customers' trust is influenced by factors related to both types of branches, i.e., Islamic and conventional.

H2: Customers' trust is not influenced by factors related to both types of branches, i.e., Islamic and conventional.

4. METHODOLOGY

To analyze the profitability of the branches, secondary data was collected from IFSB (for Islamic branches) and from the State Bank of Pakistan (for conventional branches).

4.1. Financial Ratios

Profitability, efficiency, and liquidity ratios for the two types of branches were calculated and compared. The following ratios were analyzed:

4.2. Return on assets (ROA)

This ratio evaluates an organization's efficiency in generating profit from its available assets. It represents the percentage measure of a company's average earnings through its business operations and investments over the given years. ROA provides insights into the company's previously acquired resources and the efficiency of the firm in managing its assets to generate profit.

4.3. Return on Equity (ROE)

This metric measures the financial performance of the company by dividing its net income by shareholder equity. As shareholder equity is equal to a business's assets minus its debts, ROE can also be considered a measure of the return on net assets. Due to this reason, it is also, sometimes, used to measure how efficiently a firm's management is generating profit with the available assets.

4.4. Cost to income (CTI)

The cost-to-income ratio, also referred to as the cost-income ratio, represents the relationship between a bank's income and the cost incurred to generate that income. This ratio is crucial in evaluating a bank's performance, as a lower cost-to-income ratio is generally considered an indicator of higher efficiency.

4.5. Asset Adequacy ratio (CAR)

The Capital Adequacy Ratio measures a bank's financial strength by using its capital and assets. This ratio is widely used globally to protect depositors and improve the stability and efficiency of financial systems.

4.6. Population and sample

The population comprises all Islamic and conventional branches in Islamic countries, and the sample consists of Islamic and conventional branches in Pakistan.

Ratio Analysis: Microsoft Excel was used for calculating the ratios and drawing graphs.

5. DATA ANALYSIS AND RESULTS

The performance of Islamic and conventional branches was compared through graphical analysis. The results are as follows:

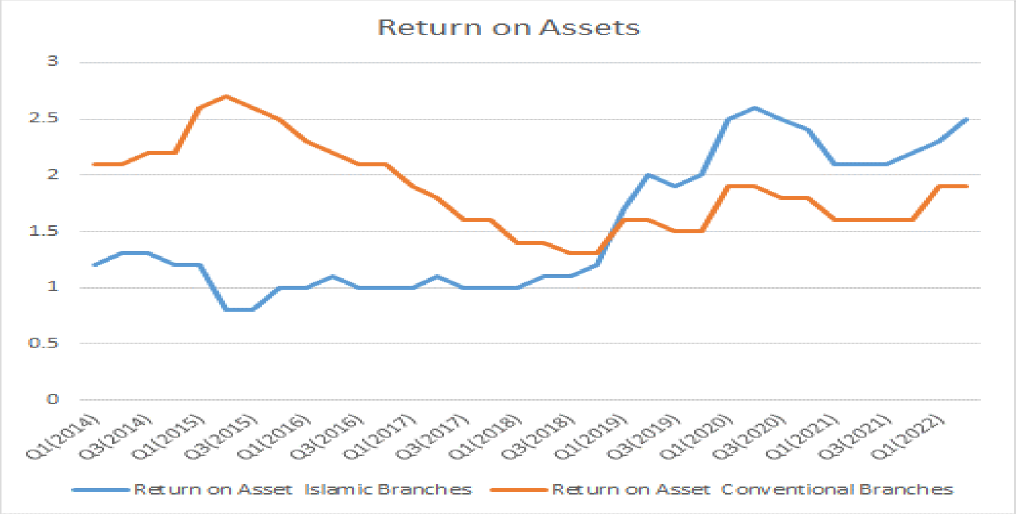

Figure 1: *Return on Assets*

The return on assets of Islamic branches has shown a remarkable increase from 2019 to 2022, indicating growing customer interest and the expanding success of Islamic branches compared to conventional branches.

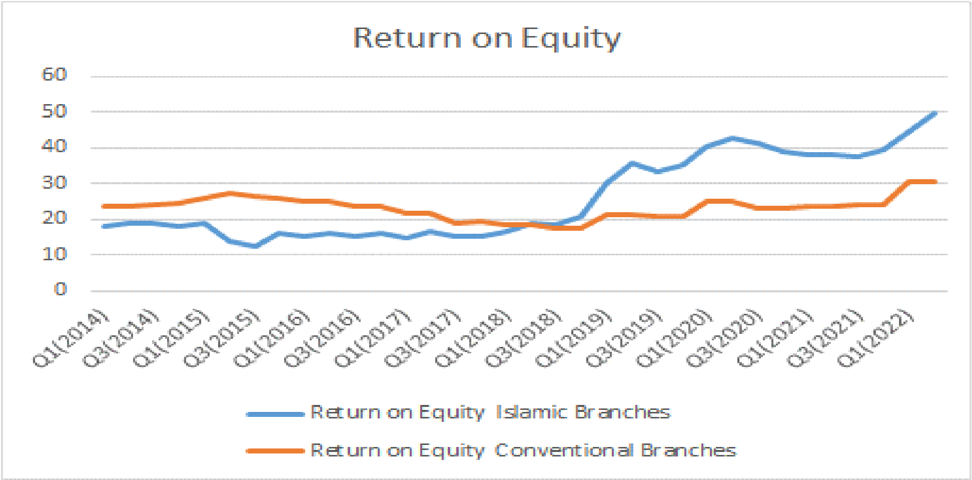

Figure 2: *Return on Equity*

Islamic branches have experienced a rising trend in return on equity from the third quarter of 2018, which has continued upward through 2022. The trend line suggests the continuation of this upward performance in the coming years.

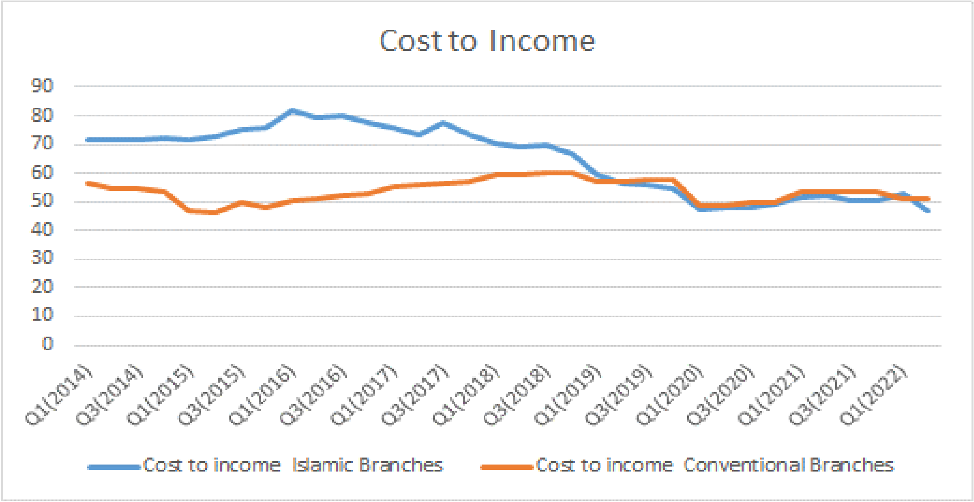

Figure: 3: *Cost-to-Income Ratio*

A declining trend in the cost-to-income ratio has been observed from the third quarter of 2019 to 2022, with the performance of Islamic and conventional branches overlapping during this period. This decline indicates a better performance of Islamic branches.

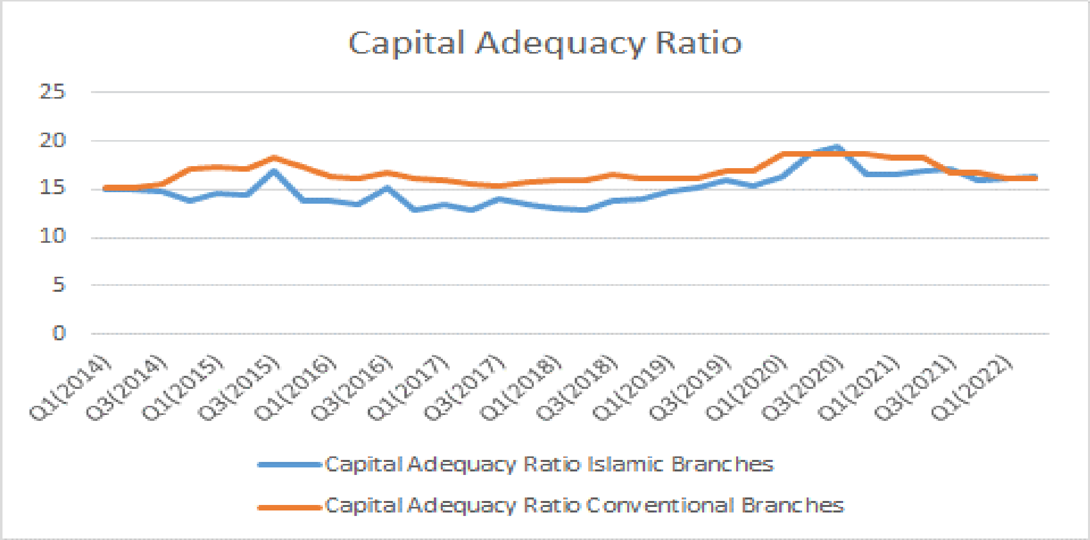

Figure 4: *Asset Adequacy Ratio*

The Capital Adequacy Ratio increased in 2022 but fell in 2021. However, it has been trending upwards in the first quarter of 2022, suggesting better performance in the coming years.

6. CONCLUSION

These results indicate that Islamic branches are performing quite well, satisfying their customers not only spiritually but economically as well. As a result, customer trust in Islamic banking is increasing, prompting conventional banks to consider opening Islamic branches. These findings suggest that Islamic banking can be a viable solution for economic problems worldwide. The robust financial performance and growing customer trust of Islamic branches have captured the attention of conventional banks. Recognizing the rising demand for Islamic financial products and services, many conventional banks are actively considering or have already established Islamic banking subsidiaries or branches. This strategic move allows conventional banks to diversify their service offerings, tap into new market segments, and cater to the needs of a diverse customer base. By integrating Islamic banking within their operations, conventional banks can not only expand their market reach but also enhance their competitiveness in the global financial landscape.

6.1. Limitations

The present research is based on short-term performance ratios. To gain a clearer understanding of the financial performance of Islamic branches, long-term ratios could be utilized. While short-term ratios are valuable for assessing immediate financial health, long-term ratios are essential for understanding the sustained financial performance, stability, strategic opportunities, and regulatory compliance of Islamic branches. These long-term metrics provide a more holistic picture that can help stakeholders make informed decisions about investments, operations, and regulatory oversight.

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