

## Comparison of Islamic and Conventional Banking on the Basis of Riba and Services A case study of Peshawar Region

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### *Abstract*

*Islamic banking was introduced in Pakistan in 1970 to meet the religious and economic needs of the people of Pakistan, wider steps have been taken in 1980 by the Banking Companies Ordinance (BCO 1962), which was modified to accommodate transactions are not interest-based banking system in Pakistan. What needs to be evaluated is the knowledge of Islamic banking products among customers of Peshawar. The reasons for changing the conventional banking to Islamic banking has been analyzed. This study will present the results of research carried out mainly with people who currently use conventional and Islamic banking and Islamic banking knowledge. In this research, we have tried to highlight some of the problems that are causing problems for the growth of Islamic banking. The dependent variables in this research are changing in other Islamic banks, customer satisfaction. We selected a sample size of 150 banking client (male and female) and used descriptive and correlation analysis to analyze the relationship between customer satisfaction and Islamic Banking Services in Peshawar.*

**Key Words:** *Islamic Banking, Conventional Banking, Islamic Finance.*

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### **Introduction**

The purpose of this research is to examine as to why the people of Peshawar are not choosing Islamic banking as compared to conventional banking because the customers of conventional banking are more satisfied as compared to Islamic banking. Because the type of facilities offered by conventional banking are not offered by Islamic banking. As we are living in Islamic country that's why the people of this country are trying to follow the Islamic laws almost in every field of life.

Islamic banking emerged in 1970 in Pakistan and after its establishment it is spreading in a very rapid way but its speed is not as fast as conventional banking.

Since long time, muslims are trying to introduce the financial system without interest for the productive use of finance and satisfy consumer needs. The system worked quite effectively during the heyday of Islamic civilization and for centuries thereafter (Burhonov, 2006).

Presently, Islamic banking industry has reached US\$1.0 trillion US dollars by the end of 2008. According to the figures of Standard and Poor estimates about US \$4 trillion of Islamic Financial Industry grow. It is interesting to note that world renewed interest based banks like HSBC, Standard Chartered, Citibank etc have also introduced a window for Islamic Banking to utilize Islamic financial products and give services to their muslim clients and to non muslim also who are interested in Islamic banking. (Awan, 2009).

In this research we will explore the performance of Islamic banking and conventional banking on the basis of facilities, provided to their clients and customers. Besides we will try to find the factors which will attract clients to Islamic banking and conventional banking in Peshawar. This research work will be helpful in the growth of Islamic Banking as the Islamic Banking is going in terms of size and structure up to 114 % annually (SBP 2006).

In Pakistan, Islamic banks and conventional banks are in strong competition with each other. Different types of products offered from both sides for the satisfaction of their customers. After the entrance of Meezan Bank in 2002 the people who want to ignore interest in their financial and daily transactions and savings shifted to Meezan Bank. As 96% population of Pakistan is muslims, keeping in focus this ratio the Islamic Banks is providing multi opportunities to get the satisfaction of their customer in the society.

### Concept of Islamic and Conventional Banking

Like interest based commercial banks, Islamic banks are also the guardian of people's money but with a disparity, that Islamic bank is sharing profit and loss with customer while conventional banks not. This superiority makes Islamic banking unique from conventional banking and give some ownership rights to customers. Islamic banking and conventional banking are very much dissimilar from each other, as conventional banking have interest based ideology. While Islamic banking has interest free system and principles and distribution their profit and loss with customer and some times share their services with business intermediaries (Arif, 1988).

The logic behind the ban of interest and significance of Islamic financial system has been discussed in many Islamic economic system. The principles of Islamic financial system is creating financial atmosphere between partners, intermediaries, lenders and borrowers (Yudistira, 2003).

Islamic system of finance is a system with the aim to accomplish the education of Holy Qur'an as contrasting to gathering utmost income on financial assets. Islamic financial system has certain Islamic principles, and these ethics are the major concerns of Islamic system of finance. Standards of Islamic Law are created by Shariah & all dealings of Islamic system of finance governed by Shariah and Fiqah.

At a fundamental stage, an Islamic financial system can be illustrate as a "Fair" & a "complimentary" arrangement where "Fairness" is the major purpose; nevertheless it also restrict the "freedom" of the Islamic financial system contributors are free to enter in any type of business but this freedom of entering in contract doesn't mean to enter in such transactions which involves Riba and Gharar.

Islamic Banks have a strong association with depositor and in the same time it have affiliation with businessmen. The funds of depositors are concerned in productive Islamic financing while conventional banking is a simple example of lending and borrowing of funds.

These two banking systems have huge difference in authority configuration also. Islamic banks have to pursue a diverse set of regulations – those stated by the Holy Qur'an, & meet up the viewpoint of Muslim culture by given that Islamically-adequate financing modes (Suleiman, 2001). Islamic banks are similar to those of non-Islamic banks in that equally propose alike (financial) services to their customers & play a essential responsibility in the economic expansion of their civilizations. Some interest based banks are analogous as Islamic banks as they deal in same financial services, but in this case the conventional banking has to go after the rules of Islamic Shariah for their financial services so that all the products contribution to the customer must be according to Islamic Law.

For instance, according to Islamic Shari'ah exploitative contracts based on Riba (usury or interest) or unjust contracts that involve risk or conjecture are unforeseeable.

Islamic banks compared with non-Islamic banks seek a "just" and "equitable distribution of resources". Islamic Fiqah governs Islamic banking and it ensures that all operations of Islamic Banking are in the circle of Islamic Law and Shariah. (Siddique, 1985).

There are four rules that govern investment behavior

- a. In Islamic banking there will be no riba transactions
- b. To avoid those type of transactions which involve speculative transactions (Gharar)
- c. To support Islamic tax system (Zakat)
- d. To discourage the production of those products and services which are prohibited (Haram) by Islamic Law (Suleiman, 2001).

## Literature Review

In all over the world, Islamic Banking is growing very fast and particularly in Pakistan while on other hand conventional banking is declining in even those economies who were considering the base of capitalism and roots of interest based banking. Due to the economic crises these financial organizations are trying to lower their interest rates to get customers from market but they are not succeeded in getting desired the results. Dozens of strong financial institutions are trapped in savior condition. (Ahmed, 2007).

In this depressed world financial scenario, Islamic banking has emerged as a strong alternate financial system. According to the statistics of (SBP. 2008). Islamic Financial capital reached to \$1 trillion and by 20% annually growing. This growth of Islamic Financial system is only the contribution of muslim societies but a reasonable portion of this capital assembled from the contribution of non muslim countries also. Giants of interest based banking have now open separate window of Islamic banking for their muslim customers. World financial leaders like IMF, World Bank, etc have established a separate cell to research Islamic Financial System . (Ahmad, 1995).

In this paper, the author has probed how an idea floated by some muslim economists a few years back has now become a potent reality. Keeping this point as a center the specialist in Islamic banking is comparing the performance of Islamic banking to conventional banking. Six new established Islamic banks and six conventional banks have been chosen for acquiring the data and compare their performance. Data regarding their revenues and performances are gathered from both 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 outcomes from the data is very satisfactory, the performances of Islamic Banking is very much better than conventional banking. Islamic banks outperform conventional banks in assets, deposits, financing, investments, efficiency, and quality of services and recovery of loans. It predicts the bright future of Islamic banking in Pakistan (Ghafoor, 2005).

This research investigate the acceptable level of the customers of Islamic banks & non Islamic banks in Pakistan means which bank's clients are extra fulfilled by the amenities offered by Islamic & Conventional Banks. In this study, it is examined that financial remuneration, financial position of banks, most recent services, and interest on funds, strong universal representation and status are the factors that are magnetizing customers to interest based banking system. Interest free loans, Islamic banks financial status, Islamic Laws and Shariah, understanding of Islam and religious atmosphere are the factors that are inspiring customers towards Islamic Banks.

Results reflects that the customers of both Islamic banking and conventional banks are satisfied with the facilities that are provided by both the banks but customers of conventional banks are more satisfied than the customers of Islamic banks (Shaikh and Naeem, 2005). Islamic Banking in Pakistan has been growing steadily for the past ten years. Its market share in the overall banking industry has increased from 1 percent in the year 2001 to more than 7 percent by January 2011 (Samad, 2004).

## Objectives of the study

The objectives of this research study are:

1. To investigate the quality of services of Islamic Banking as compared to conventional banking.
2. To know the reasons why the people switching to Islamic Banking from conventional Banking.

### Research Methodology:

The Research is conducted to find out the problems of Islamic Banking system that blocked the growth of Islamic Banks as compared to conventional Banking System.

The study is based on both secondary and primary data, 150 account holders of Islamic banking were selected who were the customers of conventional banking at the same time as well the data is secured through questionnaires, informal interviews. Out of this 150 respondents, 70 were selected for the data compilation. It consisting of both sources of data that is, secondary as well as primary.

- Primary data includes the results of the questionnaires, observations at the bank, informal discussion with customers.
- Secondary sources of the data include; Reports of Meezan Bank, Al Barka Bank, Habib Bank Ltd, Bank Al-Falah Ltd, United Bank Ltd, Allied Bank Ltd, Articles on Islamic Banking in Newspaper, books, journals, periodicals, and other publications, Internet web sites, SBP Reports.

### Hypotheses

- H<sub>0</sub>: Service of Islamic banks is not better than conventional banks.
- H<sub>1</sub>: Service of Islamic banks is better than conventional banks.
- H<sub>0</sub>: Interest factor (Riba) is not the reason to switch to Islamic banking.
- H<sub>2</sub>: Interest factor (Riba) is the reason to switch to Islamic banking.

### Variables

In this research study the first statement to testify is switching from conventional to Islamic banking, in this statement switching from conventional to Islamic banking is a dependent variable and riba or interest is independent variable.

Another statement for research is that the customer of non Islamic banks are extra pleased than Islamic banks clients on the basis of service quality. Satisfaction of customers are dependent variable and quality of service is independent variable.

### Hypothesis Testing

- H<sub>0</sub>: Service of Islamic Banks is not better than conventional banks.
- H<sub>1</sub>: Service of Islamic Banks is better than conventional banks.

Table 1: Quality of Service (Islamic Vs Conventional banking)

| Significance: 95% Confidence Interval |              |                  |            |
|---------------------------------------|--------------|------------------|------------|
| Better                                | Same Quality | Lower in Quality | Don't Know |
| 25                                    | 19           | 24               | 2          |

Source: Own data 2012.

- Null hypothesis = 35%
- Alternate Hypothesis = 67%
- N = 70
- Level of Significance = 0.05
- Tail = 2
- Test Statistics = Z=

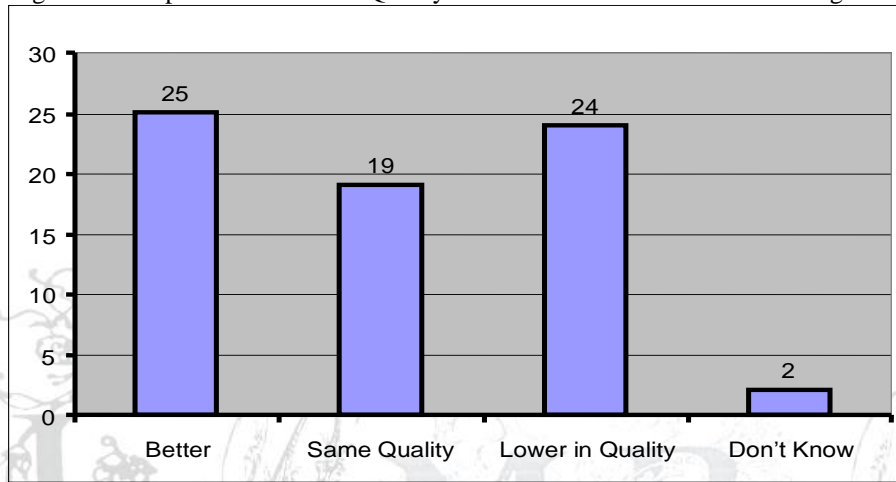
Calculated Value = -5.69383

$$Z = \frac{\hat{P} - P_0}{\sqrt{\frac{P_0(1-P_0)}{n}}}$$

Tabulated Value = -1.96  
Decision = Reject

For the calculation we have unspecified that 2/3<sup>rd</sup> of our replica (25 persons) substantiate that the services of Islamic Banking is a great deal better than the services of the Conventional Banking, Or else it would be tacit by 19 persons of questioners that the excellence of Services of Conventional Banking is similar. 24 people concur that services of Islamic Banking is not as much quality as conventional banking.

Figure 1: Comparison of Service Quality of Islamic Vs Conventional Banking



Source: Own data 2012.

As the calculated Value comes in the refusal area, so we can utter that the test consequences are statistically momentous at the 5% level; i.e. at the 5% significance level we have sufficient data to suppose that, the services of Islamic Banking are not improved as contrast to the Services of the Conventional Banking; therefore we will reject the hypothesis.

From the refusal it is talented that Islamic Banks require to sternly refurbishing their service excellence level to meet up the least amount criteria of customer fulfillment.

H<sub>0</sub>: Interest factor (Riba) is not the reason to switch to Islamic Banking.

H<sub>2</sub>: Interest factor (Riba) is the reason to switch to Islamic Banking.

Table 2: Reason to Switch from Conventional to Islamic banking.

| Significance: 95% Confidence Interval |          |                |        |
|---------------------------------------|----------|----------------|--------|
| Riba                                  | Services | Branch Network | Others |
| 42                                    | 5        | 11             | 4      |

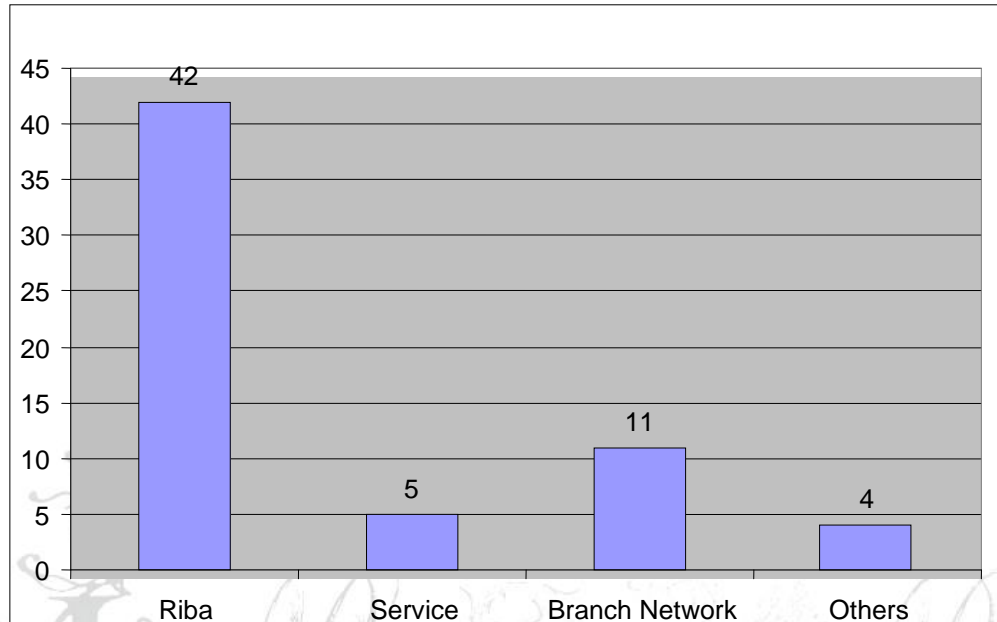
Source: Own data 2012.

Null hypothesis = 65%  
Alternate Hypothesis = 67%  
N = 62  
Level of Significance = 0.05  
Tail = 2  
Test Statistics =  
Calculated Value = -0.33491

$$Z = \frac{\hat{P} - P_0}{\sqrt{\frac{P_0(1-P_0)}{n}}}$$

Tabulated Value = -1.96  
Decision = Accept

Figure 2: Reason to Switch from Conventional to Islamic banking



Source: Own data 2012.

For our study we have unspecified that 2/3<sup>rd</sup> of our model data be supposed to believe that they have switched from conventional Banking to Islamic Banking due to Interest (Riba) factor, or else it would be measured that the Riba is not the major intention for a person to switch from conventional Banking to Islamic Banking. Since the calculated figure come in the acceptance region, consequently at the 5% significance level we don't have sufficient data to wind up that Interest is the important reason for a person to switch to an Islamic Bank. Therefore we will accept the Hypothesis.

From the over chart appearance it can be completed that greater part of the sample size have switched from conventional banking to Islamic banking due to the Riba/ Interest factor.

Table 3: Product differentiation (Islamic Vs conventional banking).

| Similar to Conventional | Different from Conventional | Don't Know |
|-------------------------|-----------------------------|------------|
| 21                      | 45                          | 4          |

Source: Own data 2012.

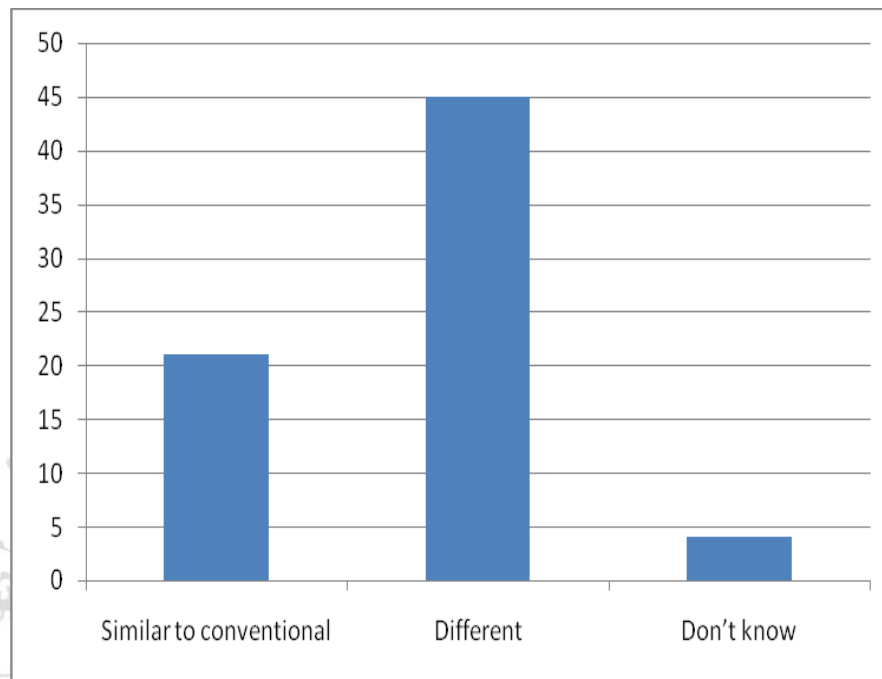
Product severance is not a important issue when we are studying product in a Banking Industry. But when we are contrasting Islamic Banking Products with the Conventional Banking Products, the consumer's examination alter totally. The customer forever believes that there have to be product separations when we are contrast Islamic Banking products with the Conventional Banking Products. But in practicality the only things that distinguish Islamic Banking from the Conventional Banking is 'RIBA' whereas all the necessary products of Islamic and Conventional Banking are alike to each other.

If we look at from our research we can see that it is moderately understandable that a major group of people distinguish that the products easy to get to by the Islamic Banks are unrelated from the Conventional Banking, while only a little number of public have the same view that the products of both are similar to each other.



One of the motives why the expansion of the Islamic Banking has turn out to be lethargic is because they have ineffective to appreciate the general community that the products contribution by Islamic Banking cannot be varied from Conventional Banking in practical, the only, trait that distinguish them is the Riba factor. Once the ordinary customers have learnt this thing they can have extra hope and self-assurance in the Islamic Banking systems and practices.

Figure 3: Product differentiation (Islamic Vs conventional banking)



Source: Own data 2012.

Table 4: How do you know about Islamic banking

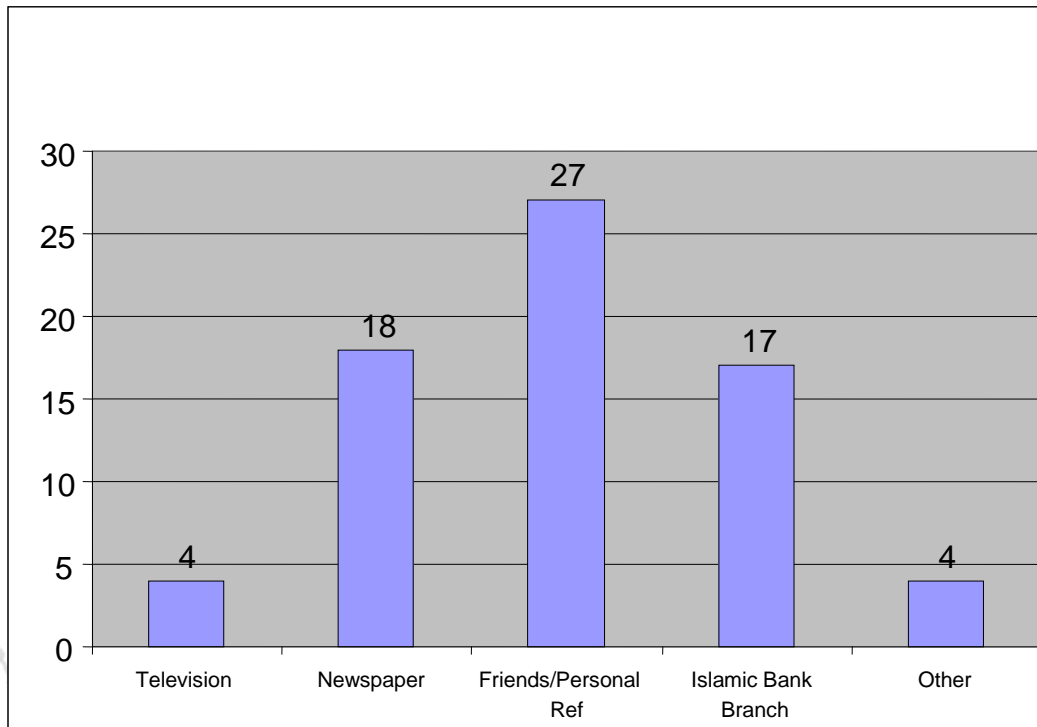
| How do you come to know about the Islamic Banking? |           |                             |                     |        |
|--|-----------|-----------------------------|---------------------|--------|
| Television   | Newspaper | Friend / Personal Reference | Islamic Bank Branch | Others |
| 4  | 18        | 27                          | 17                  | 4      |

Source: Own data 2012.

In a service Industry individual orientation deliberates to be a important development factor. Even in a Banking Industry, Personal mention and Branch system is a very important factor for the expansion and faithfulness of that bank, that's why branch convenience is measured to be one of the majority significant factors in banking industry.

If we look at the outcomes of our study, it is quite clear that the bulk of the people got to recognize about the Islamic Banking throughout their Friends / Personal Reference or through the bank branch. From the response of about 27 peoples review came to know about Islamic Banking through their friend or Personal Reference, while 17 people from the sample got to know about Islamic Banking through the Branch network.

Figure 4: Know about Islamic banking



## Conclusion

The achievement and expansion of Islamic Banking after present re-launch by State Bank of Pakistan is the evidence of strategic planning and tough work. That's why Islamic Banking in Pakistan has engaged about 4.5 % in the market in 5 years. This enlargement is very much speedy as evaluate to other countries which has a very strong Islamic Banking network.

But this growth is not receiving the self-confidence of the customers of Islamic Banking as conventional banking. Some reasons are:-

Lack of proficiency in Islamic Banking system. They are not having a lofty level of specialist team, who can encourage customers to make Islamic Banking as their first and last option.

Therefore It is, very critical to have the teams of specialist people in Islamic Finance and having abilities and promise to run Islamic financial institutions. Taking a solemn view of this trouble, SBP should get some decisions of receiving expert people and systematize seminars, workshops and education programs for the teams in side the country and outside the country as well. SBP itself should generate certain the know-how of the team before awarding the license to the Islamic Bank.

Another difficulty in this observes is shortage of consciousness among the people concerning the Islamic Banking. Whenever a new product is bring in to the market it must be dispersed and go through normal active and the people of the society must be given easy excess to Islamic Financial Products and full information concerning participation in these tool, they must be guided. This will make, Islamic Banking as the best option of investment for the people.

These are the two factors which is affecting the growth of Islamic banking. Some other factors like Slow account opening procedures, Not efficient counter services, Branches locations, Awareness regarding business plans, etc. All these factors irrespective of their size and intensity of damaging the growth, must be eliminated as soon as possible. Other wise people will loose their confidence in Islamic Banking System.



## Recommendations

The scheme can be easily completed that Islamic Banking System is scattering in a very elevated speed as contrast to conventional Banking in Pakistan, and according to the declarations of different researches, Banking Survey and State Bank of Pakistan, Islamic system of Banking will grow more in future.

The strategy maker should provide more significance to the Awareness, since the people in Pakistan and still in different Islamic countries around the world believe Islamic Banking as the same to Conventional, the dissimilarity is of name only and nothing else. They think that Conventional Bank is contribution Interest and Islamic Bank sharing profit and loss among its customers. The focal point should be on this subject that makes consciousness all of them that there is enormous disparity between Conventional and Islamic Banking. A general awareness is essential to make clear the difference between Islamic and Conventional Banking.

Special importance should be known to make sure that good training programs are working by the Islamic Banking Institutions. Islamic Banks should be asked to give proper training seminars to the team members so that they may work in a better way.

The Banking network of Islamic Banks is to the rear and poor as contrast to Conventional Banks network, main grounds is that Conventional Banks have been former introduced than the Islamic Banks in Pakistan. Though Islamic Banks have good growing rate in Branches network but they require more and more investment to fulfill the need of the market. Islamic Banks should Introduce new Islamic financial products that can be easily compared and competed with the products of conventional banking so that they may attract the new clients.

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