Determining the Factors of Profitability in Islamic and Conventional Banks of Pakistan; a Management Perspective

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Abstract

Banks plays vital role in capitalist economy. During the period of financial turmoil, it has been viewed that banks lost a huge capital due to non-recovery of loans from customers. Since there are two type of banks working in Pakistan therefore this thesis analyze which banks performance was better during the financial crunch between 2008 and 2012. The objective of this thesis is to determine the factor affecting the profitability of Islamic and Conventional banks in Pakistan during the period 2008 – 2012.

Data was collected through financial books of seventeen conventional and five Islamic banks. Two dependent variables i.e. Return on Asset and Return on Equity were used to determine the profitability of Islamic and conventional banks in Pakistan. Whereas Liquidity, Credit Risk, Capitalization, Efficiency, Bank Size, Economic Performance, Inflation and a dummy variable were used as Independent variables. Panel Data analysis is used to find out the result of secondary data. Initially the analysis was conducted on whole industry, which then applied on Islamic and Conventional banks separately.

Keywords

Islamic Banking, Conventional Banking, Profitability factors

Introduction

Bank is a financial institute who lends money in form of advances and adds cash in form of deposits. Bank generates profit in form of interest while giving loan to others, financial service charges. The profitability of the banks indicates the success of the banks management (Yilmaz, 2013) Government of Pakistan through an ordinance in 1974 nationalized major banks (SBP, 1974). After the nationalization of banks, privatization of government owned banks and other measures were taken to liberalize the financial sectors in Pakistan. (Khalid, 2006). Major public sector banks were privatized and license was issued to open new private banks/ institutions. A number of mergers and acquisitions were took place that brought viable changes in the banking sector, in term of structure,

corporate governance and innovation. As a part of it, today 56 banks and DFI's are operative in Pakistan (SBP, 2013).

There is a viable difference between Islamic and conventional banking. According to SBP, conventional banks use money as a commodity. Money has a value, which could be sale higher than its face value due to time value of money. The basis of conventional banks is interest so banks do not share loss with customer if they suffer any loss. On the other hand Islamic banks do not consider money as a commodity but it is a medium of exchange and could not be sale greater or lower than its face value. Islamic banks operate on profit and loss sharing basis therefore the impact of profit and loss is transferred to customer. There are many other factors that differentiate between Islamic and conventional banking, but they are not discussed here as they are not my scope of study.

In Pakistan the process of Islamization in financial sector was initiated in 1977. The objective of this step was to introduce an interest free financial system. Today Pakistan has five Islamic banks, whereas twelve conventional banks are also having a few Islamic windows in their branches. Islamic banks in Pakistan see an extensive growth in last few years. The total asset of Islamic banks in year 2005 were 71.5 billion which gradually increase year by year and today they have total assets of more than 800 billion (Gul, 2013).

Banks contribute to the growth of the capitalist economy and a weak banking system could lead to major disaster for capitalist financial system, which the world recently seen in 2008 global financial crisis. It is supported by Gul (2008) who stated that global economy faced a major financial meltdown since August 2008, which was emerged due to mortgage loan portfolio, and severely trembled the confidence in financial markets around the world. Due to internal macroeconomic situation the magnitude of this crisis varied across regions. Developed countries faced severe liquidity crisis while some Asian countries recovered due to resilient reserve positions (Gul, 2008).

During the period 2008 -2012, world faced financial turmoil but Pakistani banking industry proved to be resilient during this period, (Gul, 2013). She further stated that now a day's economic meltdown is due to security situation, power crisis and massive floods. Accordingly as there are no foreign investments and debt burden is increasing therefore there is a huge gap between cash inflow and outflow. Despite that financial sector is growing.

According to statistical reports of State Bank during the period 20008 − 2012, despite the financial turmoil the private banks show an increasing trend in deposit, advances and investments. In 2008 the total deposit of private banks were 2986.7 billion rupees which is now 5317 billion rupees showing an increase of 78%. The advances were 2292.3 billion rupees in 2008 which are now 2645.7 billion rupees, showing an increase of 15%. Investment was also increased from 796.6 billion rupees to 3283.8 billion rupees, showing an increase of 312% (Gul, 2013).

While analyzing the conventional and Islamic banks financial reports it has been found that total assets of conventional banks were 3882 billion rupees in 2008 which grew by 78.6% and now they are having total assets of 6932 billion rupees. On the other hand Islamic banks' total assets were 163 billion rupees in 2008 also grew by 228% and are now 533 billion rupees. Total advances of conventional banks were 2317 billion rupees which grew by 23.8% and are now 2870 billion rupees. While Islamic banks' advances/ finances were 81 billion rupees in 2008 which grew by 152%, and are now 204 billion

rupees. Total deposits of conventional banks were 2986 billion rupees in 2008, and are now 5255 billion rupees showing a growth of 76%. Whereas Islamic banks shows the growth of 282% in its deposit account, where total deposit in 2008 were 116 billion rupees which are now 446 billion rupees. Gross income also shows an increasing trend for both types of banks. Total gross income of conventional banks was 238 billion rupees in 2008 which was increased by 53.9% and reached to 367 billion rupees in 2012. On the other hand Islamic banks gross income was only 8 billion rupees in 2008 which grew by 182% and reached to 23 billion rupees in 2012.

These results are showing an overall growth trend in private banks. Percentage depicts more progress of Islamic as compared to conventional banking. Therefore this study aims to find out the answer of following question; With respect to comparison of Islamic versus conventional banking in Pakistan which factors emphasize more on the profitability during the period of financial crunch?

Literature Review

Islamic and conventional banks performance in a financial point of view was discussed by Moin (2013) in his research article. In this article the writer wanted to evaluate the performance of Islamic and conventional banks in Pakistan. The writer gave a brief history of both banks that from where the Islamic& conventional bank started their business. The author tried to find that whether Islamic banks have better financing policies or conventional banks. He compared the Meezan bank with five other conventional banks. Meezan bank is an Islamic bank. He collected the financial statements to analyze his findings. The author used deductive approach and simple random sampling for research purpose. The researcher used mono method in his research. After collection of data the writer applied different ratios on the data for example ROA, ROE and then the writer compared these ratios with each other and found that the conventional banks have better policies to perform the financial activities. The writer found that all ratios are in the favor of conventional banks. The author used time series data of five years and found that all ratios are good and in the favor of conventional banks. The writer stated that in the last five years the conventional banks earned the high return on assets.

Micro economic factors have certain impact on the profit of the banks which were analyzed by Riaz et al (2013). In Pakistan banking industry include Islamic and conventional banks Successful banking sector plays important role in economic growth of the country for the well-functioning banking area. In this way there are minor losses in banking operations. There are several questions which were initiated in this paper like in which mode internal determinants force, to what extent do external variables shock financial performance of the lender. Another search of this inquiry is to find out how the impact of financer specifies the micro economic indicator of prosperity of business institutes and object of this research is measuring the profitability on interest rate. The dependent variables are return on asset & return on equity and the independent variables are logarithm of total assets, credit risk, Operating efficiency, total assets, total loan, gross domestic production, consumer price inflation rate or Interest rate. Author follows the deductive approach in this article and the design of the research is based on 141 observation and survey of 32 commercial banks in Pakistan. Authors followed the

multiple regression analysis technique to test the assumption and analyzed the data through ANOVA, regression and coefficient return on assets. They explored that liquidity had the positive influence on capitalization and credit risk on the revenue of banks.

Comparison of Conventional banking and Islamic banking on the basis of financial performance was investigated by Sehrish et al. (2012). Banks based on Islamic values expand surroundings of interest free finance. Authors contrasted the financial performance of banks of Islamic rules with the conservative banks for the time era of 2007-2011. The main idea of this article was to assess the presentation in terms of productivity, resources and solvency of both banking types. In this article there were basically five variables in which act evaluation is the criterion variable and productivity, solvency, risk and competence are the independent variables on the basis of productivity discuss the ratio of return on assets and return on deposits. Similarly on the basis of efficiency discuss the ratio about assets utilization and operation efficiency. The authors used the deductive approach and time series analysis for five years. Multi methods were used and can be checked through t tests and random sampling techniques. The study found that banks of Islamic principles were remain profitable as compare to conventional banks in year 2007, 2008 and 2009, but the success started declining. In year 2009, as a consequence of financial disaster, the profit ratio of both the banking sectors have been decreased, but banks based on Islamic principles have manage to compensate this issue by leveraging their lending finances. On the other side, traditional banks have shown a marvelous development in productivity in year 2010 and 2011. In year 2011, the height of productivity being achieved by traditional banks is the uppermost in all five years. Author stated that when banks of Islamic rules were at its early stage in Pakistan, it was very hard to compete the productivity height of obtainable well recognized traditional banks. One of the reasons of this difficulty was that banks based on Islamic principles were recently recognized banks having less skilled people who were not fully aware of the interest free banking system. The problem lies with the operating fixed cost of Islamic banks because asset use of Islamic banks have better in year 2008 which means they have better their income by utilize their possessions professionally. But during the same era in service competence of banks on Islamic principles has also been greater than before which means the banks face higher costs as compare to their in service income. Authors stated that banks on Islamic principles have augmented their incomes in last few years but the fixed cost to produce these incomes are much better which has put a fence to banks on Islamic principles competence.

Model specification

Profitability can be measured by Return on Asset (ROA), Return on Equity (ROE), Net Interest Margin (NIM) and Return on Capital Employed (ROCE) variables, but for my research Return on Assets (ROA) and Return on Equity (ROE) was focused. There are eight independent variables Liquidity (L), Credit Risk (CR), Capitalization (CAP), Efficiency (EFF), Bank Size (BS), Economic Performance (GDP), Inflation (INF) and Dummy Variable (DT).

The following model is constructed for the complete sample and for one industry.

$$Y_{it} = \beta_0 + \beta_1 L + \beta_2 CR + \beta_3 CAP + \beta_4 EFF + \beta_5 BS + \beta_6 GDP + \beta_7 INF + \beta_8 DT + \mu$$

Here subscripts "i" and "t" denotes the banks and time in year. Y represents the dependent variable, which are ROA and ROE.

This data was collected from the annual financial books of seventeen conventional and five Islamic banks. All the data was available on the websites of these banks. Cross sectional data is for the period from 2008 to 2012. There are some conventional banks which are also operating into Islamic windows, to avoid profitability of those Islamic windows on conventional banks; the data of conventional banks retrieved from unconsolidated annual books. Therefore, a pure profitability comparison between Islamic and conventional banks based on their products can be analyzed. This study is interested in determining the profitability of Islamic and Conventional banks using ROA and ROE as dependent variables. There are 22 cross – sectional units and 5 time periods. Data was balanced consisting of 110 observations. By pooling all the 110 observations, this study can write the equation as;

$$Y_{it} = \beta_0 + \beta_1 L_{it} + \beta_2 CR_{it} + \beta_3 CAP_{it} + \beta_4 EFF_{it} + \beta_5 BS_{it} + \beta_6 GDP_{it} + \beta_7 INF_{it} + \beta_8 DT_{it} + \mu_{it}$$

Where $i = 1, 2, 3 \ldots 22$ and $t = 1, 2, 3, 4, 5$

In our equation, cross-sectional dimension is shown by "I" hence having 22 cross-sections. Whereas time series dimension is shown by "t" hence having 5 time series.

Methodology

Antweiler (2001) explained that Panel Data actually refers to the data containing the time series observations. In general panel data involves two dimension the cross-section and time series dimensions. It is also mentioned by Brooks (2008) that a panel data retains the similar objects and measures some of them over time. Verbeek (2012) explained that panel data has some leads when they associate it for using it with time series data or cross sectional data. The most significant lead is when they use panel data analysis, a wider variety of matters can be solved either they are complex or not. A model can be fixed into time series or cross sectional aspect. When it is fixed into time series aspect it is possible to examine the influence of object specific and time invariant features of the model. When the model is fixed into cross sectional aspect it is possible to examine how correlation among variables changes over time. The easiest or simplest technique to estimate a panel data regression is by using pooled regression method, which involves estimating a single equation on all data jointly (Brooks, 2008). Usually pooled regression is applied on time series cross section data. Pooled regression is the chunk of panel data of regression model. It is also known as pooled OLS method. This method can be applied when the data to be pooled or regressed are quite alike or identical. The assumption of this model is that if it yields large standard error, it indicates that data is not homogeneous. It is supported by Brooks (2008) that though the pooled regression is the simplest technique but it has some limitations. One of which is that, when pool the data, it assumes that average values of the variables, as well as the relationship between them, are constant over time and across all the cross sectional objects. It means that data is not heterogeneous. It then means that more approaches like fixed effect model or random effect model may be used.

Fixed effect model measures variances in intercepts for each clusters, this approach is known as LSDV or least square dummy variable method because the data is calculated using a discrete dummy variable for each group. On the other hand random effect model influences the differences in the variance of the error term to prototypical groups together, supposing constant intercept and slope.

Fixed effect model molds the error term in any cross sectional effect and a rest error which varies over time and cross sections. Brooks (2008) further stated that it is also possible to use a time series model, rather than a cross sectional model. In this case the error term is molds into a time series model. Moreover both time series and cross sectional can be used within the model. Here the error term is molds into time series and cross sectional effect, and a remainder error. F – Test is used to test the FEM. It is used when Least Square Dummy Variable (LSDV) model is unrestricted and pooled model is used as restricted (Chapra and Khan, 2000). If the null hypothesis is accepted it means that pooled regression will be used.

Unlike fixed effect model, the random effect model uses a different approach. It suggests dissimilar intercepts for each time and cross section model. It helps to purge the data from the correlations between error terms. By and large, the REM is more efficient than the FEM, since fewer limitations have to be assessed. REM can be tested by using Hausman test. If the NULL hypothesis (cross sectional variance components are zero) is rejected, then FEM should be used.

Before going to modeling, it is necessary to check first whether the data is stationary or non-stationary. To analyze the efficiency of the variables in model, unit root test should be applied. If data is non-stationary at level then it is need to check at first difference or second difference because non stationary of data can produce spurious results that cause the insignificants of model. The Augmented Dickey Fuller test has been run without constant regression form;

$$\Delta Yt = \delta Yt\text{-}1 + \mu t$$

Hypothesis

H0: $\delta = 0$ (unit root)
H1: $\delta \neq 0$ (series is stationary)

Table 1- Unit Root Results

H0: Series contain a Unit Root			
H1: Series is stationery			
Series	ADF	p - value	Decision
Bank Size	67.9555	0.0117	Stationery at Level
Liquidity	86.1324	0.0002	Stationery at Level
Credit Risk	70.3482	0.007	Stationery at Level
Capitalization	82.9499	0.0003	Stationery at Level
Efficiency	71.7418	0.0052	Stationery at Level

Inflation	70.7324	0.0065	Stationery at Level
Economic Performance	102.284	0.0001	Stationery at Level

Model Selection

Random Effect model is used when the sample has different characteristics. Because companies are not same in characteristics such as Return on Assets, firm size, firm growth, number of shareholders and business in nature etc. Fixed Effects model is applied for firms to control all characteristics that are stable considered for research for time of fixed period. This model delivers results that statistically more better by eliminating biasness from data and describes within sample differences only (Gujarati, 1988). That's why random effect model is more appropriate to describe deviations between determinants of profitability.

First, when number of cross section N is greater than number of period T than random effect model is more appropriate. N > T (REM) (Gujarati, 1988). When number of cross section N is less than number of period T than fixed effect model is more appropriate. N < T (FEM) (Gujarati, 1988). The other way to check which model is more appropriate through Hausman test.

Hausman Test

Panel data is used in this study, so the data is analyzed whether through random effect or fixed effect. In this purpose, Hausman test criteria used to check which model is more appropriate in this study.

H0: Random Effect model appropriate

H1: Fixed Effect model appropriate

Table 2- Hausman Test Results

Bank	Pool	Correlated Random Effects - Hausman Test			
		Test cross-section random effects			
		Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Islamic Banks	ROE	Cross-section random	12.6755	7	0.0254
	ROA	Cross-section random	13.5485	7	0.0428
Conventional Banks	ROE	Cross-section random	10.3548	7	0.0205
	ROA	Cross-section random	8.65254	7	0.0254

For both Islamic and Conventional Banks when ROE and ROA were tested Alternate Hypothesis was accepted, because p value is significant. According to Hausman test Fixed Effect model is appropriate in this study.

Panel Data Analysis (Islamic Banks)

$$Y_{it} = \beta_0 + \beta_1 L_{it} + \beta_2 CR_{it} + \beta_3 CAP_{it} + \beta_4 EFF_{it} + \beta_5 BS_{it} + \beta_6 GDP_{it} + \beta_7 INF_{it} + \mu_{it}$$

Table 3 (a) and Table 4 (b) shows the results of fixed effect model for Islamic Banks. Liquidity is negatively correlated with ROE but insignificant. On other hand it is positively correlated with ROA but insignificant as well. This result is supported by Barros, C. P et al. (2007). The credit risk is negatively correlated with ROE but significant at 10% whereas the same result was found with ROA where it is significant at 5%. It indicates that when non-performing loans of Islamic banks will be less the profitability will be on higher side. This result is supported by Bilal et al. (2013), and Chua, Z. (2013). Capitalization is also significant at 10% and positively correlated with ROE. It indicates that when banks will use more equity than its assets there will be positive impact of capitalization on returns on equity. This result is supported by Chua, Z. (2013), Faizulayev, A. (2011) and Khalid, U. (2006). But Capitalization is insignificant with ROA. This result is contradictory to the results of Chua, Z. (2013), Faizulayev, A. (2011) and Khalid, U. (2006) in terms of its significance. Efficiency is significant at 5% and positively correlated with ROE and same result was found with ROA where it is significant at 1%. It indicates that when operational expenses will be less than operational income the efficiency will be high, and when efficiency will be high bank will have more returns on equity and asset. This result is supported by Yilmaz, A. (2013), Zeitun, R. (2012), and Rivard, R. J., et al (1997).

Table 3- (a) Fixed Effect Model (Islamic Banks) (ROE)

Variable	Coefficient	t-Statistic	Prob.
C	-115	-1.6394	0.1251
Liquidity	-0.0708	-0.4391	0.6678
Credit Risk	-0.5781	-1.7957	0.0958***
Capitalization	0.59275	1.98533	0.0686***
Efficiency	14.7479	2.41599	0.0311**
Bank Size	11.4468	2.10689	0.0551***
CPI	-0.7025	-0.6506	0.5267
GDP	-4.0294	-1.4437	0.1725
R-squared	0.9429	F-statistic	19.514
Adjusted R-squared	0.89458	Prob(F-statistic)	0.000003*
Durbin-Watson stat	1.92188		

* Significant at 1% Level** Significant at 5% Level***Significant at 10% Level

Table 4- (b) Fixed Effect Model (Islamic Banks) (ROA)

Variable	Coefficient	t-Statistic	Prob.
C	-26.279	-4.5081	0.0006
Liquidity	0.00368	0.27497	0.7877
Credit Risk	-0.0703	-2.6272	0.0209**
Capitalization	0.01126	0.45364	0.6576
Efficiency	3.48408	6.86829	0.0001*
Bank Size	1.87705	4.15745	0.0011*
CPI	0.17143	1.91032	0.0784***
GDP	-0.0322	-0.1386	0.8919
R-squared	0.97676	F-statistic	49.6734
Adjusted R-squared	0.9571	Prob(F-statistic)	0.0001*
Durbin-Watson stat	1.75858		

* Significant at 1% Level ** Significant at 5% Level ***Significant at 10% Level

Bank size is also showing the similar results. It is positively correlated and significant with ROE and ROA. It indicates that when banks size will be large enough banks will earn more through their equity and asset as well. This result is supported by Faizulayev, A. (2011) and Khalid, U. (2006). Economic Growth shows insignificant results but negatively correlated with ROA and ROE. Whereas Inflation in positively correlated with ROA and significant at 10%. This result is contradictory to García-Herrero et al. (2009)

The adjusted R2 for ROE shows the goodness of fit of model. Adjusted R2 is .8945 which means that there is 89.45% variation in dependent variable with due to predictors (independent variables). The value of Durbin Watson is 1.92 which means there is no auto correlation in sample.

The adjusted R2 for ROA shows the goodness of fit of model. Adjusted R2 is .9570 which means that there is 95.70% variation in dependent variable with due to predictors (independent variables). The value of Durbin Watson is 1.75 which means there is no auto correlation in sample.

Panel Data Analysis (Conventional Banks)

$$Y_{it} = \beta_0 + \beta_1 L_{it} + \beta_2 CR_{it} + \beta_3 CAP_{it} + \beta_4 EFF_{it} + \beta_5 BS_{it} + \beta_6 GDP_{it} + \beta_7 INF_{it} + \mu_{it}$$

Table 5 (a) and Table 6 (b) shows the results of fixed effect model for Islamic Banks. Liquidity is positively correlated with ROE and ROA but insignificant. This result is supported by Goddard, J., et al. (2007). The credit risk is negatively correlated with ROE and ROA and significant at 1%. It indicates that when non-performing loans of Islamic banks will be less the profitability will be on higher side. This result is supported by Bilal et al. (2013), and Chua, Z. (2013). Capitalization is significant at 1% and positively correlated with ROE. It indicates that when banks will use more equity than its assets there will be positive impact of capitalization on returns on equity. This result is

supported by Chua, Z. (2013), Faizulayev, A. (2011) and Khalid, U. (2006). But Capitalization is negatively correlated and significant at 1% with ROA. This result is supported by Iannotta, G., et al. (2007) and Kumbirai, M., et al. (2013). Efficiency is significant at 1% and positively correlated with ROA. It indicates that when operational expenses will be less than operational income the efficiency will be high, and when efficiency will be high bank will have more returns on equity and asset. This result is supported by Yilmaz, A. (2013), Zeitun, R. (2012), and Rivard, R. J., et al (1997). Whereas it is insignificant with ROE. Bank size is positively correlated and significant at 5% with ROE and ROA. It indicates that when banks size will be large enough banks will earn more through their equity and asset as well. This result is supported by Faizulayev, A. (2011) and Khalid, U. (2006). Inflation and Economic Growth shows significant results but both are negatively correlated with ROA and ROE. When both will be low return on equity and asset will be on higher side. These results are contradictory to Athanasoglou, P (2004).

Table 5- (a) Fixed Effect Model (Conventional Banks) (ROE)

Variable	Coefficient	t-Statistic	Prob.
C	48.1367	0.85078	0.3975
Liquidity	0.27376	1.49257	0.1396
Credit Risk	-2.0627	-5.9437	0.0001*
Capitalization	0.6554	3.51123	0.0007*
Efficiency	6.14709	1.64888	0.1032
Bank Size	6.3908	1.90442	0.0606**
GDP	-16.754	-3.2044	0.00201*
CPI	-5.5616	-3.8062	0.0003*
R-squared	0.56848	F-statistic	14.4913
Adjusted R-squared	0.52925	Prob(F-statistic)	0.0001*
Durbin-Watson stat	1.89662		

* Significant at 1% Level ** Significant at 10% Level

The adjusted R2 for ROE shows the goodness of fit of model. Adjusted R2 is .5684 which means that there is 56.84% variation in dependent variable with due to predictors (independent variables). So, this model is little bit weak but in panel data adjusted R2 is mostly low as compared to series and cross-sectional data (Victoria, 2013). The value of Durbin Watson is 1.89 which means there is no auto correlation in sample.

The adjusted R2 for ROA shows the goodness of fit of model. Adjusted R2 is .5851 which means that there is 58.51% variation in dependent variable with due to predictors (independent variables).

So, this model is little bit weak but in panel data adjusted R2 is mostly low as compared to series and cross-sectional data (Victoria, 2013). The value of Durbin Watson is 1.87 which means there is no auto correlation in sample.

Table 6- (b) Fixed Effect Model (Conventional Banks) (ROA)

Variable	Coefficient	t-Statistic	Prob.
C	2.64763	0.69434	0.4896
Liquidity	0.02032	1.65751	0.1015
Credit Risk	-0.1055	-4.5547	0.0001*
Capitalization	-0.0261	-2.1226	0.0370**
Efficiency	0.65479	2.56795	0.0122**
Bank Size	0.4791	2.06962	0.0418**
GDP	-1.2128	-3.6233	0.0005*
CPI	-0.369	-3.9216	0.0002*
R-squared	0.58517	F-statistic	15.5168
Adjusted R-squared	0.54746	Prob.(F-statistic)	0.0001*
Durbin-Watson stat	1.87038		

* Significant at 1% Level ** Significant at 5% Level ***Significant at 10% Level

Conclusion and Discussion

This study investigated the profitability of Islamic and Conventional banks in Pakistan for the period 2008 – 2012, using a cross-sectional time-series (panel data). Bank-specific factors (internal variables), and macroeconomic factors (external variables), have been used in this study. Increasing Profitability of Islamic Banking sector provides motivation for the study. The sample contains 17 conventional and 5 Islamic banks. The study results on the basis of banks financial books shows that both banks are of same kind in respect of business. The Liquidity does not play a significant role to account profitability for both types of banks. The results were insignificant for all the variables and for all the type of banks. Credit Risk is more significant for Conventional banks than Islamic Banks. One reason of this is, the share of conventional banks in market is higher than Islamic banks, and therefore non-performing loans will definitely impact the profitability of conventional banks in inverse way, higher than Islamic banks.

The impact of capitalization i.e. more business through equity on profitability is also more significant for conventional banks than Islamic banks. Conventional banks are earning more than Islamic banks through equity mode of financing. The efficiency of Islamic banks is better than conventional banks. It is due to the reason that conventional banks are higher in number and having more operating expenses than Islamic Banks, but on the other hand Islamic banks are utilizing there resources efficiently and earning far better than conventional banks by reducing their expenses. The results of Bank size were also supportive for Islamic Banks. Though the results were quite eccentric, because conventional banks assets are number of times larger than Islamic banks, but despite their low assets, Islamic banks utilizes their assets quite efficiently and remain more profitable than Conventional banks during this period.

Inflation is negatively correlated for all type of banks but more significant for conventional banks. It shows that due to higher inflation the profitability of conventional banks will be lower. The results of GDP are also similar for conventional banks. It shows that Higher GDP turns profitability into inverse path.

Recommendations

On the basis of above discussion this study is provide the following recommendation to banking sector of Pakistan.

a) Banks needs to focus equally on advances and deposits sector. Advances helps to increase income of banks whereas deposit helps banks to invest in money market as well as mudharabh projects to earn more.

b) Banks also needs to focus on decreasing the ratio of non – performing loans. These NPL's have impact on bank balance sheets as well as income statement. NPL's can be reduced through strong colletral or hypothecation.

c) Banks should reduce their operating expense in order to increase their profitability. Operating expenses can be redcued by controlling over head expenses. Bank may also increase their operating income by introducing new products.

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