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OBJECTIVE PERFORMANCE EVALUATION OF THE ISLAMIC BANKING SERVICES INDUSTRY: EVIDENCE FROM PAKISTAN

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ABSTRACT

Purpose — The study documents the performance of the Islamic banking services industry (IBSI) in light of the Islamic finance objectives, notably financial stability, equitable distribution of wealth, and social responsibility.

Design/Methodology/Approach — After drawing the performance evaluation framework based on the objectives, the research conducts a balance sheet analysis of the IBSI in Pakistan for 32 quarters (2013Q4–2021Q3). The analysis examines sources and uses of funds by looking at the application of financial contracts and sectoral distribution of financing. Objectively classified data trends are reported through graphs.

Findings — Findings suggest that the domestic IBSI has shown progress in achieving primary and intermediate objectives, including commercial performance, contribution to equitable wealth distribution, and financial stability. However, the industry's in-practice business models lack any significant contribution to the social sector, which represents a more advanced objective.

Originality/Value — The contributions to the literature include development of a performance evaluation framework based on Islamic finance objectives, and documentation of findings on the IBSI's achievements in Pakistan.

Research Implications — The study recommends that regulators develop a legal framework for business models of the IBSI. It also recommends that managers of domestic Islamic banks include the social sector as well as agricultural and rural areas in financing and investment portfolios.

Keywords — Financial institutions, Financial services, Islamic banking, Performance evaluation

Article Classification — Research paper



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INTRODUCTION

The Islamic financial services industry (IFSI) is a recent development in the financial sector that is primarily aimed at Muslim consumers who would otherwise be reluctant to participate in the financial system for religious reasons. The IFSI started operations in the last few decades of the 20th century and has shown some significant results in the areas of resilience and expansion. During the global financial crisis (GFC) 2008, the IFSI turned to be more resilient than its conventional counterpart (Smolo & Mirakhor, 2010; Hanif & Zafar, 2020). According to IFSB (2021), the global volume of assets under management of the IFSI had reached a healthy amount of USD2.7 trillion by 2020.

Performance evaluation of an activity is essential to know the achievements and identify weaker performance areas. However, the development of the performance evaluation mechanism itself requires clarity of objectives to be measured through the process. Additionally, pre-set standards are needed for the comparison of achievements. In the case of the conventional banking sector, there are established performance evaluation mechanisms. The most widely used is the CAMELS rating system, which covers capital adequacy, asset quality, management capabilities, earnings, liquidity and sensitivity. Likewise, there are global rating agencies (e.g., Moody's, Fitch) which are engaged in assessing an institution's financial soundness. However, the mandate of these rating systems is to assess commercial performance and financial stability.

The Islamic banking services industry (IBSI) has been established with a difference in objectives from conventional banking (Chapra, 1985). Hence, performance evaluation of the IBSI on the established criteria of conventional banking is not sufficient and needs to include some other specific objectives. The objectives of the IBSI are not limited to financial soundness and profit maximisation. Its other objectives include Sharī'ah compliance in operations, economic stability in the economy, equitable wealth distribution in the society, and contributions to the socio-economic uplift of the less fortunate segments of the community. Any design of performance evaluation mechanism for the IBSI needs to incorporate these aspects.

While there are limitations in existing financial sector performance evaluation systems as far as the IBSI is concerned, the literature depicts many expectations from the industry (Lone & Ahmad, 2017). At times those mounting expectations are beyond the capacity and mandate of the IBSI. After all, the IBSI is a private sector commercial enterprise like any other halal business with its limitations. The IBSI is not a religious entity (e.g., waqf) established for the welfare of the masses. Expecting saintly behaviour from the IBSI is too much to ask. However, the IBSI cannot reduce itself to conventional banking with a few cosmetic changes to make the financial contracts Sharī'ah compliant. The IBSI needs to position itself within the parameters of rational expectations somewhere between commercialism and altruism.

The literature contains multiple types of studies on performance evaluation of the IBSI. The studies may be classified into three groups. A stream of literature exists on financial performance evaluation of the IBSI, using conventional models (e.g., Hanif *et al.*, 2012; Siraj & Pillai, 2012; Islam & Zaman, 2015; Hazman *et al.*, 2018). Another stream addresses the development of a performance evaluation mechanism for the IBSI based on specific objectives of the Islamic financial system (Mohammed *et al.*, 2008; Mohammed *et al.*, 2015; Mergaliyev *et al.*, 2021; Tarique *et al.*, 2021; Hanif & Ayub, 2022). Yet a third stream of literature exists under

the title of Shari‘ah-compliance ratings of the IBSI—with a focus on IFSI objectives (Ashraf & Lahsasna, 2017; Hanif, 2018). In the specific context of Pakistan, a review of studies on performance evaluation of the IBSI depicts mixed findings (Ansari & Rehman, 2011; Hanif *et al.*, 2012; Latif *et al.*, 2016; Qureshi & Abbas, 2019).

The studies conducted, including those in Pakistan, have generally focused on the financial performance of the IBSI. There is a lack of evidence on the achievements of the IBSI in the area of broader Islamic finance objectives based on actual financial data from multiple Islamic finance markets. This study is expected to fill this void in the literature by developing a performance evaluation framework for the IBSI and evaluating the performance of the domestic IBSI considering Islamic finance objectives based on published financial data. Hanif and Ayub (2022) developed a performance evaluation framework for the IBSI by suggesting three broad areas (legal compliance, economic objectives, and social justice) and testing them on global IBSI data; however, the study lacks detailed accounting data analysis of any specific market. This research is the need of the time due to the ever arising question as to whether the modern IFSI is successfully achieving its aspirational objectives. There is a standing call for objective performance evaluation of the Islamic financial system (Hanif & Zafar, 2020), and country-wise study of accounting data to document the progress on the achievement of Islamic finance objectives (Hanif & Ayub, 2022). Specific contributions of this study include the following:

1. Identification of Islamic finance objectives (measurable through published annual reports/accounting data).
2. Assignment of contextual ranking in the achievements of Islamic finance objectives, ranked as basic, intermediate and advanced.
3. Development of a performance evaluation mechanism for Islamic banks (based on published accounting data).
4. Testing the proposed model in one of the global Islamic finance markets to document the achievements.

The objectives of the IFSI are grouped under four areas: Shari‘ah compliance, commercial performance, broader economic goals and social responsibility. The findings of this study are based on an objective examination/classification of financial data for the latest 32 quarters (from 2013Q4 to 2021Q3) in the Pakistani market. To the best of the authors’ knowledge, no study exists on performance evaluation in the domestic market, taking into consideration the broader Islamic finance objectives.

The next section presents a summary review of performance evaluation studies in traditional Islamic finance markets, including Southeast Asia, South Asia, and the Middle East & North Africa (MENA), which is followed by the development of an analytical framework and methodology for objective analysis. Findings are reported in the following section, while the last section concludes the study.

LITERATURE REVIEW

Islamic Banking Performance Evaluation

Studies on performance evaluation of the IBSI are classified into three streams for review, namely, methodology developments for performance evaluation, ratings development for the IBSI, and empirical testing of available performance evaluation models.

Methodological developments for performance evaluation of the IBSI represent an important research area aimed at developing objective-based evaluation models. Few studies have focused on the development of a performance evaluation mechanism for the IBSI. Mohammed *et al.* (2015) developed a *maqāṣid*-based performance evaluation model (MPEM) for Islamic banks considering the five dimensions of Imam al-Ghazālī's *maqāṣid al-Sharī'ah* theory: protection of faith, life, lineage, property, and intellect. Accordingly, Islamic banks are encouraged to invest more in the real sector, agriculture, small and medium enterprises (SMEs), technology, research and training, and corporate social responsibility (CSR). Moreover, they are encouraged to apply risk-reward sharing financial contracts, pay zakat, reduce/eliminate employee turnover, generate profit and reduce/eliminate haram (impermissible) income. Mergaliyev *et al.* (2021) construct a performance evaluation model for Islamic banks based on Najjar's extended *maqāṣid* framework with four primary objectives and eight corollaries. Operationalisation includes engagement in risk-reward sharing, halal earnings, fair employment policies, corporate governance practices (fairness and transparency), investment in the real sector, microfinancing, grants for education and research, returns to depositors and shareholders, social goals (including waqf, zakat, charity, benevolent loans), employment creation, fair returns (earnings), and environmental protection. Tarique *et al.* (2021) develop a *maqāṣid al-Sharī'ah*-based performance measurement model by combining theories of al-Ghazālī and Abū Zahrah. The framework includes three concepts with 26 dimensions measurable through financial ratios based on annual accounting reports. In a recent study, Hanif and Ayub (2022) develop a performance evaluation framework for the IBSI by including three broader areas (legal compliance, economic objectives, and social justice).

Another stream of literature has addressed performance evaluation indirectly under the title of Sharī'ah-compliance ratings of the IBSI. Ashraf and Lahsasna (2017) identify 14 factors for scoring in ratings of the IBSI. The factors include capital adequacy, Sharī'ah supervision, equity-based financing, and regulatory framework, among others. Likewise, Hanif (2018) develops a Sharī'ah compliance rating mechanism for the IBSI. The selected 13 factors are grouped under four dimensions, including portfolio make-up, access to finance, reputation and Sharī'ah governance.

A significant number of studies have documented the empirical financial performance of the global IBSI using existing methods. Evidence is documented from Southeast Asia, South Asia, and MENA. Starting from the Southeast Asian IBSI, Rosly and Bakar (2003) compare the performance of Islamic and conventional banks in Malaysia for the period 1996–99 using financial ratio analysis. Results suggest better performance in profitability, but are not supported by asset utilisation and investment margin. Kamaruddina *et al.* (2008) study the performance of full-fledged Islamic banks and Islamic windows in Malaysia for the period 1998–2004 through the application of Data Envelopment Analysis (DEA). Findings suggest relatively better cost efficiency than profit generation. CAMELS ratings-based comparative results for conventional

and Islamic banking in Malaysia are documented by Rozzani and Abdulrahman (2013) for the period 2008–11. The sample includes 19 conventional and 16 Islamic banks. Overall results are similar with no significant difference (with an average score of 2.78 and 2.86 for conventional and Islamic, respectively). Recent evidence on the comparative performance of conventional and Islamic banking is documented by Hazman *et al.* (2018) in the Malaysian economy. The sample includes ten banks (five from each stream) for the period 2004–16. Performance is documented through the application of Dynamic Ordinary Least Square (DOLS) and Fully Modified Ordinary Least Square (FMOLS), based on the CAMEL model. The findings indicate better performance of conventional banking as compared to Islamic banks. Finally, a study from the Indonesian market by Wahyudi *et al.* (2021) documents poor performance in the achievement of Shari‘ah objectives based on two years (2019–2020) quarterly data with a sample of four Islamic banks. These results from the Southeast Asian IBSI have yielded inconclusive results on the comparative performance of the two banking streams.

The MENA region is at the centre stage of the IFSI landscape. The share of MENA in assets under management of the global IFSI is above 50 per cent of the industry size (IFSB, 2021). A selected review of studies on performance evaluation of the IBSI in the MENA region follows. Samad (2004) uses financial ratios to compare the performance of the IBSI with conventional banking (in Bahrain) in the areas of profitability, liquidity and credit risk for 1991–2001. The sample includes six Islamic and 15 conventional banks. Student t-test (equality of means) shows similarity in performance in the areas of liquidity and profitability. However, the IBSI displays superior performance in the area of credit risk management. Saleh and Zeitun (2007) study the performance of the IBSI in Jordan over the period 2000–03 through financial ratios, using a sample of two Islamic banks. Findings suggest that the IBSI in Jordan has shown an increase in profitability, efficiency and credit expansion. Fayed (2013), using financial ratios, compares the performance of conventional and Islamic banks in Egypt in terms of profitability, liquidity, credit risk, and solvency. The sample includes three Islamic and six conventional banks for the period 2008–10. Findings suggest superiority in performance in all areas by conventional banks over the IBSI. The Gulf Cooperation Council (GCC) region is an early adopter and leader in the provision of Islamic financial services with a close to 49 per cent share in global assets of the IFSI (IFSB, 2021). The IBSI outperformed conventional banking in performance in the GCC region during 2005–10, as documented by Siraj and Pillai (2012). The sample size consisted of 12 banks (six from each stream of banking) with the results documented through financial ratios. The authors further conclude that the IBSI was more resilient to the GFC than conventional banking. The results of these studies in MENA lead to either better performance or equality with the conventional industry, except for the Egyptian market.

Finally, the study presents a brief review of studies in South Asian IBSI. Mahmud and Islam (n.d.) study the performance of the banking sector in Bangladesh for the period 2000–05 by focusing on four performance areas, including business generation, profitability, management soundness and social profitability. Social profitability is measured through branch expansion, employment generation and rural banking. Findings suggest better performance by Islamic banks as compared to conventional banks with a few exceptions. Islamic banking leads in liquidity and capital adequacy and shows equality in asset quality while lagging in operating performance compared to commercial banks in Bangladesh during 1994–2001 (Ahmad & Hassan, 2007).

Islam and Zaman (2015) compare the financial performance of the conventional and Islamic banking industry in Bangladesh for the period 2009–13 through the application of CAMEL testing. The sample includes five banks from each stream of banking. The t-test (independent sample) shows similarity for both streams in three areas: capital adequacy, management and earnings. However, results are different for asset quality. Overall findings for Bangladesh IBSI lead to either better or equal performance compared to conventional banking.

The following studies have been conducted in the area of performance measurement of Islamic banking in Pakistan:

- Moin (2008) studies the financial performance of conventional and Islamic banking comparatively over the period 2003–07. The sample includes five conventional banks and one Islamic bank. The analysis was done through financial ratios by focusing on four significant areas including liquidity, profitability, solvency and efficiency. According to the findings, Islamic banking leads in efficiency and solvency, while it lags in profitability. No significant difference emerged in liquidity management between conventional and Islamic banking.
- Ansari and Rehman (2011) study the performance of conventional and Islamic banking in Pakistan over the period 2006–09 by calculating financial ratios. The sample includes three banks from each stream of banking. Findings lead to better comparative performance of Islamic banking in three areas, including risk, liquidity and cost-effectiveness.
- Hanif *et al.* (2012) study the comparative performance of conventional and Islamic banking during 2005–09 in Pakistan by focusing on profitability, liquidity, credit risk and solvency. The sample includes five Islamic and 22 conventional banks. Standard financial ratios were used to document findings. The results show that Islamic banking depicts better credit risk management and solvency, while it lags in profitability and liquidity, comparatively.
- In another study, Usman and Khan (2012) document the superiority of Islamic banking over conventional banking in both aspects under examination, including profitability and liquidity for the period 2007–09. The sample includes three banks from each stream of banking.
- Latif *et al.* (2016) document comparative performance results by using a sample of five banks each from conventional and Islamic streams over the period 2006–10. The analysis is done by using financial ratios with a focus on profitability, risk, liquidity and efficiency. Findings reveal Islamic banking's better performance than conventional banking in three areas, notably risk, solvency, and efficiency. However, the study shows equal performance with conventional banks in profitability.
- Qureshi and Abbas (2019) document the superior performance of Islamic banking for the period 2010–17 in two areas, including operating performance and liquidity, based on relevant ratio averages. The sample includes two Islamic and 15 conventional banks.
- Abideen (2019) compares the profitability of conventional and Islamic banking from 2015 to 2017. The sample includes one bank from each stream. Findings reveal equal performance in profitability by both banks.

- No significant difference in performance of Islamic banks was found in Pakistan except return on equity (ROE), as documented by Sohail *et al.* (2022), based on a sample of three banks for the period 2015–19.

Although findings are mixed, the evidence favours superior management by Islamic banks in the areas of solvency and risk. In the Pakistani market, earlier studies indicate lagging of Islamic banks in profitability; however, the latest evidence shows improvement in this area.

Apart from methodological issues (sample, duration, methodology), these studies have focused on financial performance. To the best of the authors' knowledge, none of the studies have evaluated the domestic IBSI by considering specific objectives of the Islamic financial system (including equitable wealth distribution and social uplift). Hanif and Ayub (2022) tried to document achievements of the global IBSI in light of Islamic finance objectives; however, the study lacks detailed accounting data analysis of any specific market due to the large volume of data. This study is intended to fill this void in the literature by evaluating the IBSI in the context of Pakistan based on aspirational objectives including Shari'ah compliance, commercial performance, economic objectives, and social responsibility.

Islamic Finance Objectives

Islamic finance was envisioned as an alternative financial system, distinct from the existing economic system, based on the religious teachings of Islam. Islamic finance aspires to incorporate Abrahamic (Judeo-Christian-Islamic) religious values in the financial system (Abdulrahman, 2010). Over the years, scholars have identified specific objectives for the Islamic financial system, including socio-economic justice (Maudoodi, 1941; Abdulrehman, 2000). Chapra (2008) postulates that a just economic system is expected to ensure financial stability and equitable distribution of wealth. Economic stability is achieved through the linkage of real and financial sectors, while equitability in wealth distribution is expected from the application of risk-reward sharing and access to finance. Similarly, specific literature focuses on social aspects and expects a contribution from the Islamic financial system towards CSR (Sairally, 2007); promotion of social values including human rights, fair business practices, and social enterprises (Obaidullah, 2005); ethical investing, poverty reduction (Asutay, 2012); and environmental protection (Saged *et al.*, 2017).

Islamic Banking Services in Pakistan

Among the modern nation-states, Pakistan is one of two countries envisioned and created on a religious basis (Israel is the other one). In 1947, Pakistan was created by partitioning British India on a religious basis because there were no safeguards in place to protect Muslims in an undivided India. Hence, the movement was started to have another country where Muslims would be able to protect their rights and interests. Over the years, Pakistan has kept its religious identity by incorporating Shari'ah laws in the legal system. According to the Constitution of Pakistan (CoP), Islam is the state religion of the country. Steps shall be taken to enable Pakistani Muslims to order their lives according to Islam (Article 2 & 31). Also, CoP declares the elimination of *ribā* (interest and usury) as a policy principle (Article 38 (f)) (CoP, 2012). Pakistan has remained at the forefront in incorporating Islamic values in the financial system.

Externally, Pakistan has remained part of multiple forums engaged in the promotion of the Islamic financial system, including the Organisation of Islamic Cooperation (OIC), Islamic Development Bank (IsDB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), and others. Internally, Pakistan has made appreciable efforts to incorporate Islamic values in the financial system, including the establishment of specialised institutions, the envisioning of an interest-free economy, and noticeable engagement in research and development activities. Pakistan is one of the three countries which experienced an Islamic financial system nationwide (in the 1980s). However, Pakistan's experience could not succeed for multiple reasons, including lack of trained human resources and political will of successive regimes. From 2000 onward, the IBSI is working in parallel to conventional banking in Pakistan. Results are impressive, as depicted by the expansion and growth of the industry, indicated in **Table 1**. Branch network and employment numbers have more than doubled, while the increase in assets is above 400 per cent within eight years (2014–21). Year-on-year (YoY) growth in assets is above 20 per cent, except for two years (2016 and 2018), during the review period.

Table 1: Selected Statistics of Islamic Banking Industry in Pakistan as at 2021

Description	2013	2014	2015	2016	2017	2018	2019	2020	2021	Average Annual Growth
Industry Size (USD Billion)	9.60	12.53	15.38	17.70	20.60	19.17	21.21	26.72	28.68	
Number of Islamic Banks	5	5	6	5	5	5	5	5	5	
Number of Islamic Banking Windows	14	17	17	16	16	16	17	17	17	
Number of Domestic Branch Offices	1,304	1,574	2,075	2,322	2,581	3,029	3,219	3,466	3,637	18.6%
Growth in Branch Network (YoY)		20.7%	31.8%	11.9%	11.2%	17.4%	6.3%	7.7%	4.9%	
Number of Employees	14,647	17,314	20,987	23,072	24,101	25,841	29,008	30,286	34,022	15.1%
Total Assets (PKR Billion)	1,014	1,259	1,610	1,853	2,272	2,658	3,284	4,269	4,884	30.0%
Total Assets Growth (YoY)		24.2%	27.9%	15.1%	22.6%	17.0%	23.5%	30.0%	14.4%	
Gross Revenue (PKR Billion)		190.7	243.2	241.8	305.2	369.6	569.7	763.3	577.5	26.0%*
Growth in Gross Revenue (YoY)			27.5%	-0.6%	26.2%	21.1%	54.1%	34.0%	-24.3%	
Capital Adequacy	14.7%	15.5%	15.3%	14.6%	14.1%	14.3%	15.8%	17.3%	16.8%	
ROE	14.4%	20.2%	19.8%	15.4%	17.6%	20.5%	33.7%	38.6%	31.4%	
Cost/Income Ratio	69.7%	66.7%	67.0%	76.2%	70.0%	64.9%	52.7%	46.3%	51.5%	
Liquidity Ratio	41.9%	36.1%	33.8%	37.5%	28.8%	23.5%	21.1%	24.2%	27.4%	

Source: IFSB (2020); *Calculated up to 2020

ANALYTICAL FRAMEWORK

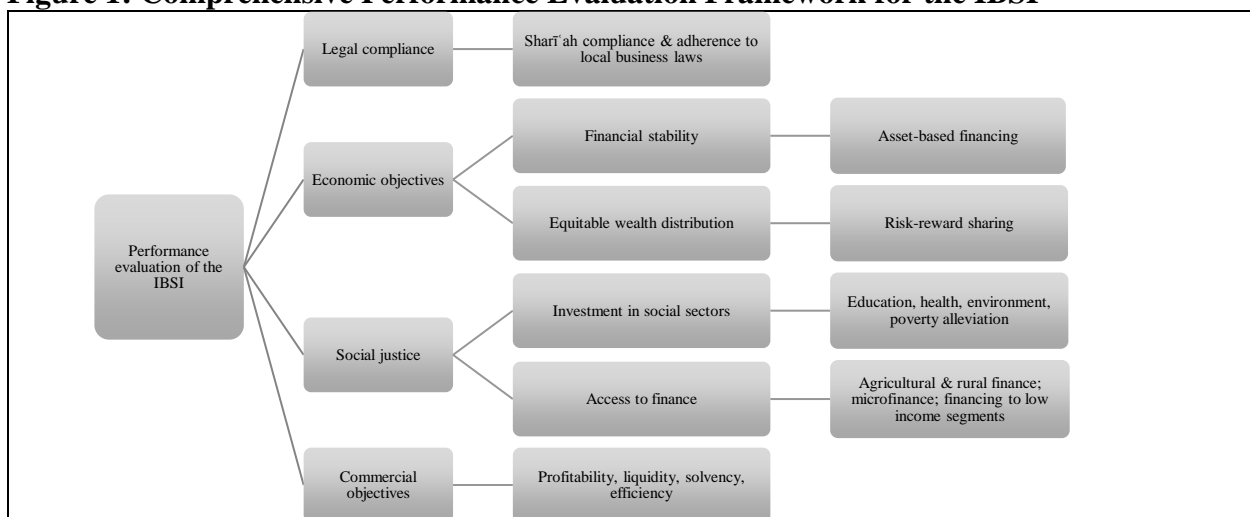
The performance evaluation framework of conventional banking is not sufficient for understanding the achievements of the IBSI on account of differences in objectives between the two streams of financing (Mohammed *et al.*, 2015; Mergaliyev *et al.*, 2021). Saleh and Zeitun

(2007) document that IBSI has to be evaluated differently by considering specific objectives (and differentiating between core banking objectives and subsidiary ones). The authors consider profit maximisation to be a core objective because without profit firms are unable to continue, while other objectives for an Islamic bank include fostering economic and social wellbeing and elimination of exploitation.

A comprehensive performance evaluation framework for the IBSI is presented in **Figure 1**, considering Islamic finance objectives. The objectives are classified under:

- **Legal compliance:** The IBSI is required to comply with the requirements of Sharī'ah in addition to local commercial laws. Sharī'ah compliance is the *raison d'être* of the IBSI (Hanif & Ayub, 2022).
- **Commercial performance:** No business can survive in the long run without satisfactory commercial performance, and the IBSI is no exception as a commercial enterprise. Traditional measures of gauging commercial/financial performance, including profitability, liquidity, solvency and efficiency, are equally applicable and desired for the IBSI (Saleh & Zeitun, 2007).
- **Economic objectives:** The IBSI aspires to achieve broader economic objectives in addition to the traditional concept of profit maximisation. The economic objectives include a contribution to economic stability and equitable distribution of wealth through risk-reward sharing and access to finance (Chapra, 2008; Ayub, 2018).
- **Socio-economic objectives:** The IBSI is expected to promote socio-economic justice as envisioned by early writers, including Maudoodi and Qutb (Maudoodi, 1941; Abdulrehman, 2000). These objectives include the promotion of social values such as human rights and fair dealings (Obaidullah, 2005); CSR (Sairally, 2007); poverty reduction and ethical investing (Asutay, 2012); and environmental protection (Saged *et al.*, 2017).

Figure 1: Comprehensive Performance Evaluation Framework for the IBSI



Source: Adapted from Hanif and Ayub (2022)

The expectation that all Islamic banks will achieve these objectives uniformly is too optimistic. These objectives may be achieved at different stages of organisational life, considering the conduciveness of the operating environment. The ranking of objectives may be conceptualised as basic, intermediate and advanced, as follows:

- **Basic objectives:** These include minimum achievements necessary for survival as an Islamic bank. Priority is given to the following basic objectives: compliance with local laws and Sharī'ah as well as commercial performance. These objectives are basic because there is no justification for establishing an Islamic bank without adhering to the legal maxims of Sharī'ah. Likewise, compliance with the law of the land is essential for the successful operation of an Islamic bank. Similarly, financial/commercial performance is an essential element for the survival of the institution.
- **Intermediate objectives:** Once the basic objectives are achieved, the next level is addressing broader economic objectives in the economy, including the adoption of financial products that contribute to economic stability (through linkage between the real and financial sectors) and equitable distribution of wealth (through promotion of risk-reward sharing and access to finance).
- **Advanced objectives:** The final stage pertains to the discharge of socio-economic responsibilities. According to AAOIFI's Governance Standard No. 7, the CSR of Islamic financial institutions (IFIs) refers to 'all activities carried out by an IFI to fulfil its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions' (AAOIFI, 2015, p. 972). Multiple areas are covered under the CSR standard including:
 - a. Mandatory CSR such as customer screening, responsible dealings, monitoring and cleansing prohibited earnings and expenditures, employees' welfare, zakat; and
 - b. Recommended CSR such as *qard hasan* (benevolent loans), environment protection, social impact investment quotas, excellence in customer service, SME savings & investments, and waqf management.

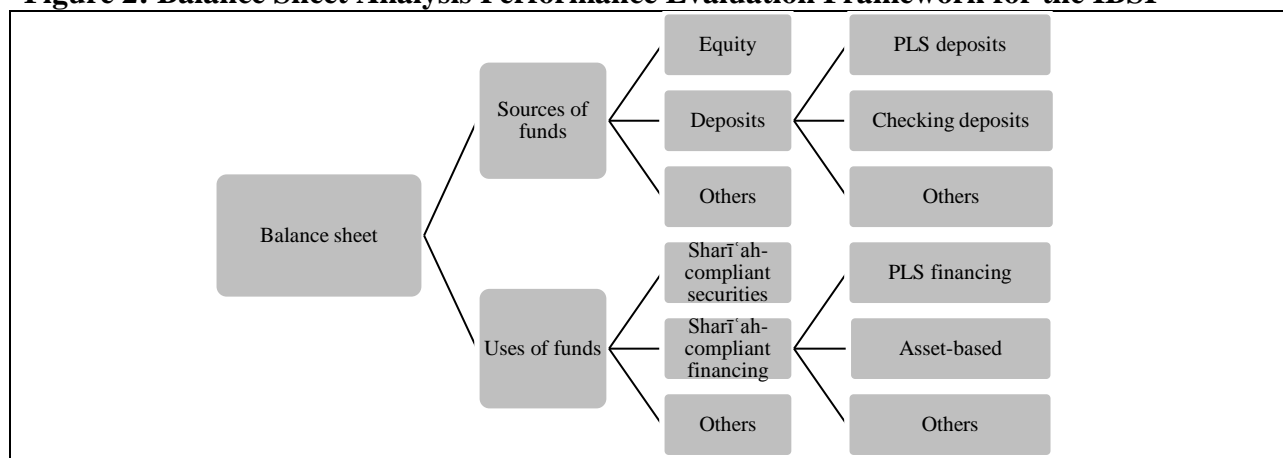
RESEARCH METHODOLOGY

The study documents the progress in the achievement of these three-level objectives through the examination of quarterly data, covering 32 quarters (2013Q4 to 2021Q3), gathered from eight years' financial reports (2013–21). The selection of the sample period is based on the sole criterion of availability of authentic data on the IBSI; however, the period is recent. Data is extracted from the database of the IFSB (2021). The study includes accounting data from both streams of the IBSI, including full-fledged Islamic banks (FIBs) and conventional banks with Islamic windows (CBIWs). The balance sheet analysis is applied to understand and document the findings. The analytical framework is depicted in **Figure 2**.

Taking into account the study objectives, the analysis starts from the balance sheet by looking at sources and uses of funds. Sources of funds are further classified as equity, deposits and others (including inter-bank liabilities and other liabilities). Furthermore, the study examines in detail the structure of deposits as profit-and-loss sharing, current accounts and other types of remunerative funding (including commodity *murābahah*). On the other side of the balance sheet, the research looks at how funds are utilised. The classification includes Sharī'ah-compliant

financing, investment in Sharī'ah-compliant securities, and others (including interbank financing and other assets). After the initial classification of uses of funds, the detailed structures of financing patterns are examined, keeping in view the specific objectives of the IBSI (including equitable wealth distribution, financial stability and social responsibility). The study further examines the data based on the sectoral allocation of financing facilities by the domestic IBSI. Data trends are depicted through graphs for 32 quarters (2013–2021) in order to strengthen the findings. The research focuses on the evaluation of three aspects of the IBSI (commercial performance, contribution to broader economic objectives, and socio-economic justice), leaving the legal compliance aspect on account of the presence of regulatory supervision and certifications by Sharī'ah boards of the respective institutions. Critical literature questioning Sharī'ah compliance from multiple angles is available elsewhere.

Figure 2: Balance Sheet Analysis Performance Evaluation Framework for the IBSI



Source: Authors' own

ANALYSIS AND FINDINGS

Sources of Funds

The combined funding structure of the IBSI for the review period is presented in **Figure 3**. The figures are calculated by combining the assets from FIBs and CBIWs. Significant contribution in funding is from Profit Sharing Investment Accounts (PSIA) (48.9 per cent), followed by Current Accounts (CA) (26.6 per cent), Other Remunerative Funding (ORF) including *murābahah* and commodity *murābahah* (6.1 per cent), Capital and Reserves (C&R) (6.5 per cent), and Interbank Liabilities (IBL) (5.9 per cent), while the rest (6.1 per cent) are All Other Liabilities (AOL). Some significant changes have taken place in the funding structure during the review period.

The share of PSIA in funding sources has decreased from 57 per cent (2013) to 43.4 per cent (2021), while the share of CA has increased from 21.5 per cent (2013) to 28.5 per cent (2021). Although variations appear in other funding sources, no major trend is depicted. Focusing on deposit collection, 59.9 per cent is PSIA, followed by CA (32.6 per cent), and the rest (7.5 per cent) is ORF.

In the case of FIBs, the results are different. PSIA (63.1 per cent) is more and ORF (4.5 per cent) is less, while CA (32.5 per cent) is almost equal to the sample results. The increased

use of PSIA in deposit management by the IBSI is appreciable and Islamic bankers in Pakistan deserve due credit for building the trust of customers in the industry. Profit-and-loss sharing works only if there is trust between the parties. Reduction in PSIA and increase in CA enables free funding to the IBSI.

Taking into account the social responsibility aspect, the IBSI needs to design a system of *qardḥasan* from CA deposits. It would not be a burden to consider utilising one-half to one-third of the average balance of CA for *qardḥasan* for social sectors, including poverty alleviation, health and education-related projects.

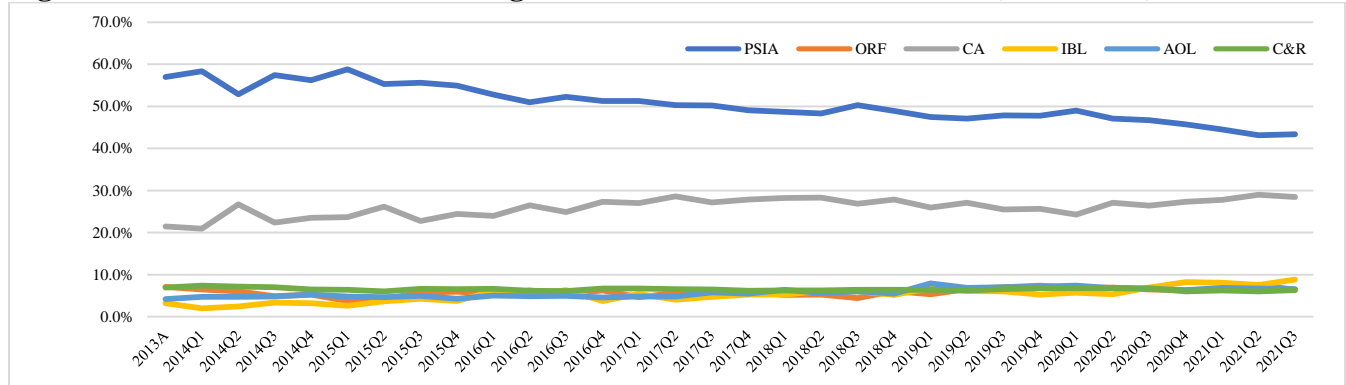
Uses of Funds

The combined asset structure of the IBSI for the review period is presented in **Figure 4**. The figures are calculated by combining the assets from FIBs and CBIWs. FIBs represent 59.4 per cent while CBIWs carry a 40.6 per cent share in assets of the domestic IBSI. Overall, Total Sharīʿah-Compliant Financing (TSCF) dominates in the asset portfolio (with 46.9 per cent), followed by Total *Ṣukūk* Holdings (TSH) (22.5 per cent), Interbank Financing (IBF) (12.5 per cent), Other Sharīʿah-Compliant Securities (OSCS) (3.9 per cent) and the rest is Total Other Assets (TOA). There is a significant change in the asset structure over the review period.

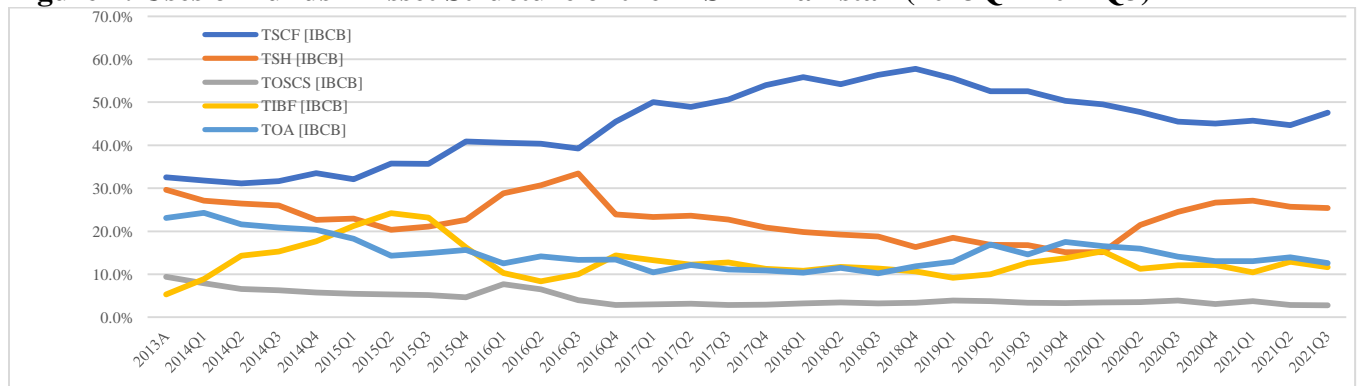
TSCF increased substantially from 32.6 per cent in 2013 to 57.8 per cent in 2018 and then declined to 47.6 per cent in 2021, while TSH reduced significantly from 29.7 per cent in 2013 to 15.1 per cent in 2019, and then rose to 25.4 per cent in 2021. Likewise, the share of OSCS in the asset portfolio reduced from 9.4 per cent in 2013 to 2.8 per cent in 2021. IBF and TOA vary across the review period. These facts indicate the progress towards maturity of the IBSI in the provision of retail banking services (increase in Sharīʿah-compliant financing). Reduction in TSCF and increase in TSH may be attributed to the COVID-19 pandemic in the final years of the study period.

Results are different for FIBs and CBIWs. Overall difference in TSCF is 1.6 per cent (47.6 per cent and 45.9 per cent), TSH –5.4 per cent (20.3 per cent and 25.7 per cent), OSCS –1.7 per cent (3.2 per cent and 4.9 per cent), IBF 5 per cent (14.6 per cent and 9.6 per cent) and TOA 0.5 per cent (14.4 per cent and 13.9 per cent), between FIBs and CBIWs, respectively. FIBs have shown more maturity than CBIWs in retail banking services (financing to customers).

As far as progress in TSCF over the period is concerned, FIBs improved from 33.6 per cent in 2013 to 44.7 per cent in 2021 (with a peak of 59 per cent in 2018). In the case of *ṣukūk*, the study notes a decrease from 32.6 per cent in 2013 to 24.5 per cent in 2021 (with a low of 12.4 per cent in 2018). These facts testify to the relatively fast trajectory of FIBs towards maturity in the provision of retail services to a broader customer base (instead of making passive investments in *ṣukūk*). Specific objectives of the IBSI (including wealth distribution) are expected to be achieved by the provision of banking services to the masses (as opposed to making passive investments, e.g., holding *ṣukūk*). In the following section, further segregation of TSCF is provided to document the achievement of objectives.

Figure 3: Sources of Funds—Funding Structure of the IBSI in Pakistan (2013–2021)

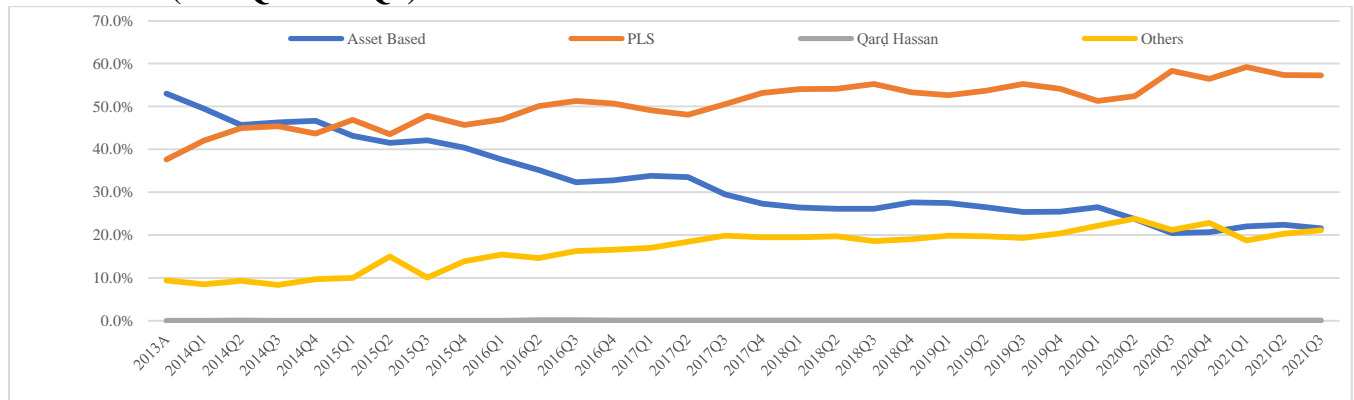
Source: IFSB (2020). Profit Sharing Investment Accounts (PSIA); Other Remunerative Fundings (ORF) including *murābahah*, commodity *murābahah*; Current Accounts (CA); Interbank Liabilities (IBL); All Other Liabilities (AOL); Capital and Reserves (C&R).

Figure 4: Uses of Funds—Asset Structure of the IBSI in Pakistan (2013Q4–2021Q3)

Source: IFSB (2020). Total Sharī'ah-Compliant Financing (TSCF); Total *Shukūk* Holdings (TSH); Interbank Financing (IBF); Other Sharī'ah-Compliant Securities (OSCS); Total Other Assets (TOA).

Sharī'ah-Compliant Financing—Financial Contracts

Figure 5 depicts trends in the objective classification of TSCF. Accordingly, the share of Profit-and-Loss Sharing (PLS) financing in the portfolio remained at 53.1 per cent; while the share of Asset-Based Financing (ABF) stood at 28.0 per cent. The share of *qardḥasan* is less than one per cent (0.04 per cent), and the rest (18.9 per cent) carries other modes of financing (not classified as asset-based and PLS). For FIBs, the results show some differences. In terms of TSCF, PLS dominates with 47.4 per cent, followed by ABF (29.8 per cent), *qardḥasan* (0.06 per cent), and others (22.7 per cent). In FIBs, the share of PLS is less (up to 5.7 per cent); the share of ABF is more (up to 1.8 per cent); the share of *qardḥasan* is more (up to 0.02 per cent), and the share of others is higher (up to 3.8 per cent) than the combined industry (FIB plus CBIW).

Figure 5: Shari‘ah-Compliant Financing—Application of Financing Contracts in the IBSI in Pakistan (2013Q4–2021Q3)

Source: IFSB (2020)

In ABF (debt creation) (representing 28 per cent of the portfolio), the application of rent-based contracts (6.1 per cent) is close to one-fifth of total ABF. Spot sales (*murābahah*), as well as forward sales (*salam* and *istiṣnāʿ*) contracts, carry almost equal application (10.6 per cent and 11.2 per cent, respectively). *Murābahah* sales lead with 10.6 per cent, followed by *istiṣnāʿ* (8.4 per cent) and *salam* (3.2 per cent). Under PLS (quasi-equity financing), diminishing *mushārakah* dominates with 33.6 per cent, followed by *mushārakah* (19.5 per cent) and *muḍārabah* financing (a partnership between capital and skill) which represents close to 1 per cent of TSCF during the review period. *Muḍārabah* could not gain popularity in the IBSI in Pakistan but has the potential to contribute to economic development through venture financing—an essential aspect of skill-based entrepreneurship. Perhaps, the domestic IBSI has avoided *muḍārabah* on account of its risks.

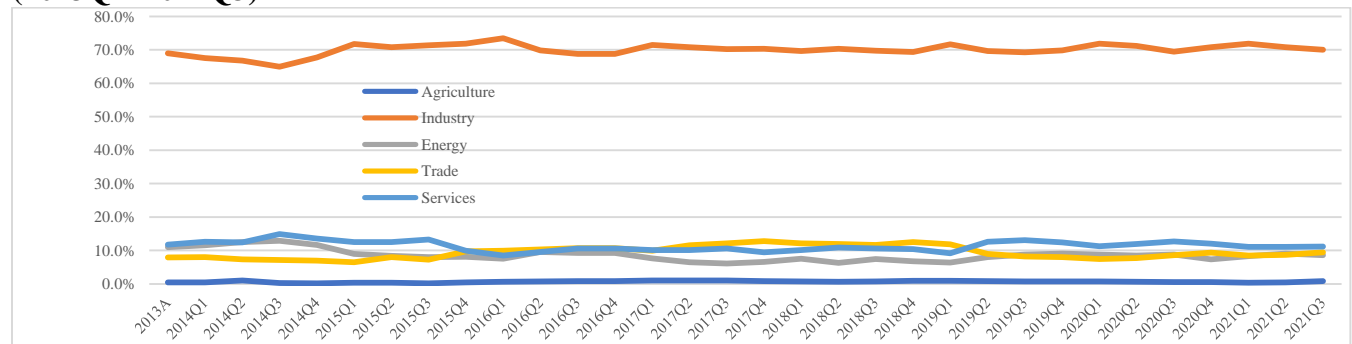
One can notice a paradigm shift in financing patterns in the IBSI in Pakistan. In the initial period of analysis, ABF dominated with a share of more than 50 per cent (53 per cent in 2013), which has gradually decreased to less than 30 per cent (25 per cent in 2019) in the final quarters of the review period. Likewise, the share of PLS in TSCF has increased from 38 per cent (2013) to 59 per cent (2021). One of the major criticisms of the Islamic financial system is the lesser application of equity-based financing, which has been addressed to a greater extent by the IBSI in Pakistan in recent years. It is a welcome state of affairs and shows the realisation of responsibility by the management of the IBSI in the domestic market. Promoters of the Islamic financial system consider the increased application of PLS a significant tool in equitability of wealth distribution (Chapra, 2008; Ayub, 2018).

Qard ḥasan is less than 1 per cent of the financing portfolio. The major contribution (95 per cent) in *qard ḥasan* is from FIBs. *Qard ḥasan* is not a commercial contract; however, the IBSI is not perceived by society as a commercial enterprise only (Obaidullah, 2005; Hanif & Zafar, 2020). The IBSI needs to contribute to the social sector through the provision of *qard ḥasan* for poverty alleviation, health and education-related projects, especially when there is an availability of a huge amount of deposits under CA (non-remunerative deposits). In the domestic banking industry, CA represents close to one-fourth (29 per cent) of total funding available to the IBSI (i.e., about PKR1,390 billion) in 2021.

Sharī'ah-Compliant Financing—Sectoral Allocations

Figure 6 depicts trends in sector-based financing by the domestic IBSI. Data for sectoral allocation is available for FIBs (which represent about 60 per cent of the IBSI in Pakistan). The classification includes agriculture, industry (manufacturing, mining and construction), energy (electricity, gas, steam and air-conditioning), trade (wholesale and retail, auto repair and real estate), and services (including transport and communications, administration and support services, scientific, education and health-related activities and other service activities).

Figure 6: Sharī'ah Compliant Financing—Sectoral Allocation of the IBSI in Pakistan (2013Q4–2021Q3)



Source: IFSB (2020)

The major share of financing (70 per cent) goes to industry, followed by services (11.3 per cent), trade (9.4 per cent), energy (8.6 per cent) and agriculture (0.6 per cent). The supply of funds to industry, services, trade and energy definitely contributes to economic growth; however, the agricultural sector is neglected by the domestic IBSI. Agriculture is a significant economic sector in Pakistan that employs close to 39 per cent of the labour force and contributes about 19 per cent to Gross Domestic Product (GDP) (GOP, 2019). Agricultural and rural financing needs to be on Pakistani Islamic bankers' agenda to meet the cherished objective of equitable wealth distribution through access to finance. Further examination of the services sector reveals a major share (more than half) of financing is extended to the transport and communication sector (7.2 per cent), while social sectors received negligible financing. The share of professional, scientific and technical services is 1.0 per cent, followed by education, health and social work (0.7 per cent each), water supply, sewerage, waste management, and accommodation and food services (0.5 per cent each). The results indicate the neglect of social responsibility by the domestic IBSI.

Commercial Performance

The commercial performance of the IBSI in Pakistan is measured through multiple aspects, including overall business generation, capital adequacy, asset quality, profitability, liquidity, and cost efficiency. Overall business generation is measured through growth in assets, branches and gross income. The domestic IBSI has shown consistent growth in all these areas. Assets of IBSI have shown growth of 30 per cent, while gross income has grown at 26 per cent per annum. Similarly, branch network growth (2014–21) was 19 per cent, and the number of employees increased by 15 per cent, annually.

On the front of capital adequacy, the domestic IBSI has succeeded in maintaining a healthy ratio within a range of 14.1 per cent and 17.3 per cent and with an annual average of 15.4 per cent (yearly average of CAR). Profitability, measured as return on equity (ROE), shows significant achievement and ranges between 14 per cent and 39 per cent, with an average of 24 per cent (yearly average of ROE). The IBSI significantly depicts cost efficiency during the review period. Cost to income ratio has reduced to 46 per cent (2020) in the final years of analysis. This ratio ranges between 46 per cent and 76 per cent with an average of 63 per cent. Finally, the IBSI has improved in terms of liquidity management by reducing extra liquidity from 42 per cent to 21 per cent (in 2019). These facts indicate growth and expansion, as well as improvement in multiple performance areas, including profitability and liquidity of the IBSI (above the survival level) during the review period (as indicated in **Table 1**). These findings are in line with results documented in earlier studies including Usman and Khan (2012), Qureshi and Abbas (2019), and are partly different from Moin (2008), Hanif *et al.* (2012) and Latif *et al.* (2016).

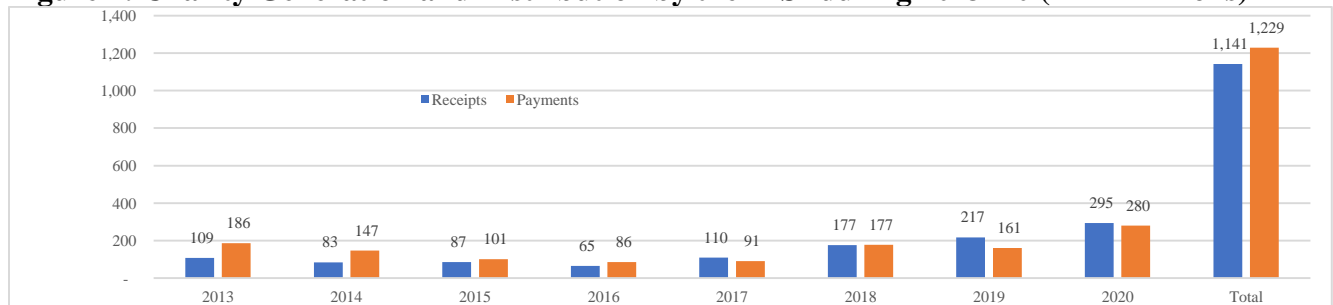
Results based on data for the 32 quarters provide the following important insights on the achievement of specific Islamic finance objectives in the Pakistani market.

- **Basic objectives:** The IBSI in Pakistan has succeeded in surviving and shows growth and maturity in commercial performance. The IBSI has demonstrated growth of over 15 per cent in branch network, volume of assets and revenue generation. Capital adequacy is close to 15 per cent and ROE average is above 20 per cent. Likewise, improvements are demonstrated in the areas of cost control and liquidity management. On the front of Sharī'ah compliance, the IBSI meets Sharī'ah-compliance requirements (in the presence of Sharī'ah supervisory structure including Sharī'ah boards and internal Sharī'ah audit) in the legal form. Controversial products (e.g. *bay' al-ṭinah* and *tawarruq*) are not very popular in the financing portfolio. A basic Sharī'ah governance mechanism is in place. However, in general, multiple question marks have been raised on operations of the global IBSI as depicted in the literature (from the economic substance perspective and gap in theory versus practice due to weak Sharī'ah governance) (see, inter alia, Ayub, 2016; Hanif, 2016; Akram, 2019; Khan, 2019; Kutty, 2020).
- **Intermediate objectives:** The IBSI in Pakistan shows a contribution towards the achievement of broader economic objectives. Risk-reward sharing contracts have crossed the mark of 50 per cent in deposit collection as well as in financing—a journey towards equitable distribution of wealth, although lesser distribution to the agricultural sector and rural finance indicates a failure on the front of access to finance. Likewise, the share of ABF is close to one-fourth of total funding—a contribution to financial stability. Whether Pakistani society achieves equitable distribution of wealth and financial stability in tandem with IBSI's increased market share of the domestic market is yet to be seen in the long run. At present, the share of the IBSI in Pakistan is about 16 per cent (IFSB, 2021).
- **Advanced objectives:** On the front of social responsibility, the contribution of the domestic IBSI is very low. The combined share in financing for agriculture, professional, scientific and technical services, education, health and social work, water supply,

sewerage, waste management, accommodation and food services is close to 5 per cent. Likewise, the IBSI receives a hefty amount of close to 33 per cent of total deposits as non-remunerative (current account), but the share of the non-remunerative loans (*qard hasan*) is less than 1 per cent of TSCF. The results indicate neglect of social responsibility by the domestic IBSI.

A related development in the area of social uplift is the generation and spending of charity funds by the IBSI (built into the business model). **Figure 7** depicts yearly trends for charity amount generation and spending for the last eight years (2013–20). The sources of funds include collection of late payment charges from customers, dividend purification, any other Shari‘ah non-compliant income, and profit on charity saving accounts. These funds are utilised for education, health, the environment and other community development projects. During the period, close to PKR1.14 billion was generated for charity, and close to PKR1.22 billion was distributed for community welfare projects (the difference is covered from opening balances/previous collections). These figures relate to FIBs, which represent 60 per cent of assets of the IBSI in the domestic market.

Figure 7: Charity Generation and Distribution by the IBSI during 2013–20 (PKR Millions)



Source: Annual reports of Fully-Fledged Islamic banks (Meezan Bank, Albaraka Bank, BankIslami, Dubai Islamic Bank and MCB Bank); Data for MCB is from 2015 onwards.

Finally, the study looks at investors' responses to the pricing of Islamic banks' equity as compared to conventional banks. To form the opinion on investors' reaction, the research calculated monthly returns for 96 months (2014–21) for the private sector listed banks in Pakistan by using the following standard equation:

$$R_t = LN\left(\frac{P_t}{P_{t-1}}\right) \quad (1)$$

Where R_t is monthly returns; LN is the natural log; P_t is a price in month t ; and P_{t-1} is a price in the previous month. After calculation of monthly returns, average monthly returns are calculated. Average monthly returns year-wise and for the whole period (2014–21) are presented in **Table 2**. Banks are ranked based upon average monthly returns for the whole period, and results are presented in the table in descending order. From the Islamic banking sector, only two FIBs (Meezan Bank and Bank Islami) are listed (for the whole review period). As per the results, Meezan Bank is ranked first with 1.74 per cent average monthly returns among all private-sector listed banks in Pakistan. Bank Islami is ranked fourth with average monthly returns of 0.68 per

cent. The average monthly returns for domestic private sector banks range between -0.53 per cent to 1.74 per cent. Results indicate investors' confidence in the performance of Islamic banks. Investment in equities of Islamic banks is open to conventional as well as Islamic investors; however, investment in conventional banking is limited to conventional investors.

Table 2: Monthly Returns of the IBSI in Pakistan (Private Sector Listed Banks) (2014–21)

Year	2014	2015	2016	2017	2018	2019	2020	2021	2014–21	Rank
Meezan Bank Ltd.	1.47%	-0.22%	3.31%	0.05%	3.46%	1.04%	1.57%	3.25%	1.74%	1
Faysal Bank Ltd.	3.90%	-0.21%	2.87%	0.59%	2.20%	-1.96%	-0.80%	2.38%	1.12%	2
Samba Bank Ltd.	3.28%	-1.28%	1.59%	-0.35%	1.20%	-0.04%	-0.54%	4.22%	1.01%	3
Bank Islami Pakistan Ltd.	2.97%	1.40%	1.25%	-3.03%	2.14%	-0.59%	0.66%	0.66%	0.68%	4
Bank Al Habib Ltd.	2.09%	-1.29%	2.91%	-0.09%	1.37%	0.85%	-0.75%	-0.11%	0.62%	5
Habib Metropolitan Bank Ltd.	3.31%	-1.69%	1.62%	-0.58%	2.36%	-1.93%	0.58%	0.73%	0.55%	6
Askari Bank Ltd.	4.16%	-0.49%	1.15%	-2.14%	1.78%	-2.12%	1.94%	-0.40%	0.48%	7
Standard Chartered Bank (Pakistan) Ltd.	-0.45%	-0.62%	1.19%	-0.48%	0.09%	-0.18%	3.25%	0.04%	0.35%	8
Bank Alfalah Ltd.	2.12%	-1.59%	2.30%	0.94%	0.41%	0.99%	-2.14%	-0.20%	0.35%	9
Summit Bank Ltd.	6.06%	-1.04%	0.94%	-3.86%	-10.14%	2.89%	3.98%	2.25%	0.14%	10
JS Bank Ltd.	3.85%	0.68%	2.77%	-3.02%	-0.17%	-2.59%	1.44%	-2.37%	0.07%	11
United Bank Ltd.	2.40%	-1.10%	3.61%	-2.00%	-3.56%	2.45%	-2.23%	0.68%	0.03%	12
Allied Bank Ltd.	2.73%	-1.55%	1.96%	-2.82%	1.96%	-0.98%	-0.94%	-0.31%	0.01%	13
Silk Bank Ltd.	0.46%	0.72%	0.14%	-1.31%	-1.95%	-2.38%	1.16%	2.46%	-0.09%	14
Soneri Bank Ltd.	1.00%	1.71%	1.28%	-2.30%	-0.47%	-2.10%	0.08%	-0.20%	-0.12%	15
Habib Bank Ltd.	2.97%	-0.65%	2.60%	-4.10%	-2.73%	2.23%	-1.45%	-1.05%	-0.27%	16
MCB Bank Ltd.	1.49%	-2.86%	0.77%	-0.95%	-0.77%	0.48%	-0.84%	-1.58%	-0.53%	17

Source: Monthly prices from Investing.com (accessed 24 January 2022)

CONCLUDING REMARKS

The study documents the IBSI's achievements in Pakistan based on Islamic finance objectives, including Shari'ah compliance, commercial performance, broader economic objectives of financial stability and equitable wealth distribution, and social responsibility. The objectives are ranked as basic, intermediate and advanced objectives. The conclusions are based on real accounting data for eight years (2013Q4–2021Q3) from the IBSI in Pakistan.

Results support achievements of two levels of objectives, including basic survival of the industry, measured as commercial performance within the Shari'ah-compliance framework and contribution to broader economic objectives (measured through risk-reward sharing and financial stability). The IBSI shows reasonably good performance in all areas, including profitability, expansion of the network, and liquidity. Also, the application of risk and reward sharing financial contracts is rising in the domestic industry, coupled with asset-based financing. However, the research shows that the IBSI could not contribute much to the social uplift of the masses by investing in social sectors. The record also shows a lesser distribution of financing to agriculture and the rural economy, resulting in low achievement on the access to finance front. The published data shows that *qard hasan* comprise less than 1 per cent. The combined investment in the social sector is less than 5 per cent. However, charity generation (a by-product of Islamic banking) and distribution above PKR1 billion is a significant contribution to

community welfare. The research also finds a higher level of investors' confidence in equities of Islamic banks.

The findings have multiple policy implications. First is the lesson from the IBSI in Pakistan for other nations engaged in the Islamic financial system. One can learn how to achieve basic and intermediate objectives with prudent portfolio make-up by applying risk and reward sharing and asset-based financial contracts without indulging in controversial products. Second, regulators of the IBSI in Pakistan need to step forward and draw a regulatory framework specific to the IBSI based on the lessons learnt through experience with a focus on the achievement of Islamic finance objectives. Third, the management of the IBSI needs to incorporate the expected/perceived role of Islamic banks in the social sector in their planning. The provision of *qardḥ hasan* to the social sector (e.g., the extreme poor and students) of up to 50 per cent of the average current deposits balance may not be a burden for the IBSI. Finally, investors may find opportunities for superior returns in the domestic IBSI.

This study includes data for 32 quarters (2013Q4–2021Q3), which is a relatively short period. However, authentic data from the IFSB is available for this period only. Nevertheless, the period is reasonable to study trends and form an opinion. Study limitations also include the legal compliance aspect, which has been left out on account of the presence of regulatory supervisions and certifications by Shari'ah boards of the respective institutions. Future research agendas may include Shari'ah compliance and performance evaluation of multiple Islamic banking markets by using the analytical framework developed in this study.

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