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ISLAMIC BANKING AND CONVENTIONAL BANKING IN TERMS OF PROFITABILITY, LIQUIDITY AND RISK & SOLVENCY -COMPARATIVE ANALYSIS BETWEEN (2010-2014)

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ABSTRACT

The Purpose of this research study is to measure the comparative financial performance of Islamic banking sector and conventional banking sector of Pakistan in terms of profitability, liquidity and risk & solvency. This research work also facilitate to all the stakeholders of Islamic banking sector and conventional banking sector including country heads of banks, branch managers, shareholders, creditors, investors, religious segment of population and regulatory bodies of Pakistan. Sample size consist of ten banks selected by using the conveyance sampling techniques including five leading Islamic banks (Meezan Bank, Bank Islami, Burj Bank, Dubai Islami Bank and Albarka Bank) and five conventional banks (MCB Bank Ltd, United Bank Ltd, Allied Bank Ltd, Habib Bank Ltd & Bank of the Punjab). The findings of the study indicated that conventional banking stream dominating on Islamic banking sector with respect to profitability at the cost of worst liquidity and high risk. Islamic banking sector dominated on conventional banking stream with reference to liquidity and risk & solvency at the cost of low profitability.

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I. Introduction

Competition among conventional banks and Islamic banks dramatically increasing day by day with reference to profitability, liquidity, risk and solvency due to this all the stakeholders of conventional and Islamic banks intends to observe the critical evaluation of conventional banking and Islamic banking financial performance. According to Hassan & Bashir (2003) critical evaluation of conventional banks and Islamic bank performance having equal importance for all stakeholders whether they are depositors, investors, branch managers and regulators bodies. This research work will be a source of information for regarding taking decision whether depositor should invest or withdraw funds from the banks, branch manager can also used the findings of this study while taking decision and to intends the past performance with reference to loan deposit services and financing. Regulatory bodies can also use this study to observe the safety and soundness of conventional and Islamic bank.

The aim of this study is the evaluate and observe the performance of conventional banks and Islamic banks, for this five leading conventional banks and five leadings Islamic banks of Pakistan were taken as sample of the study. Five conventional banks selected for this study including Habib Bank Ltd (HBL), MCB Bank Ltd, United Bank Ltd (UBL), Allied Bank Ltd (ABL) and Bank of the Punjab (BOP) whereas five Islamic banks selected for this study including Meezan Bank, Bank Islami, Burj Bank, Dubai Islami Bank and Albarka Bank. Ratio analysis techniques will be used in this study to access the financial performance and comparative analysis of conventional banks and Islamic banks. According to Samad & Hassan (2000) one of the common indicators used for intra and inters banking performance analysis is the ratio technique. Financial performance of all mentioned leading

Islamic banks was observed in this study with reference to their profitability, liquidity and risk & solvency.

1.1. Profitability Ratios

Profitability ratios used to observe the capacity of the business to earn profit with reference to its all expenses, direct and indirect cost during the given specific accounting period. According to Van Horne (2005) all direct expenses, indirect expenses, income taxes, operation efficiency, policies regarding prices, efficiency of assets and equity will be taken into consideration for calculation of profitability ratios. Profitability ratios one of the basic ratio to observe the performance with reference to its ability to control the cost and expenses. Performance of bank will be considered better and satisfactory if the profitability ratio of specific banks will be higher as compared to their competitors, industry average in case of cross sectional analysis or previous year in case of time series analysis. In this study to make a comparison between the Islamic banks and conventional banks criteria apply to observe the profitability through various types of profitability ratio including: *Return on Assets (ROA)*, *Return on Equity (ROE)* and *Profit to Expense Ratio (PER)*.

1.1.1. Return on Assets (ROA):

Return on assets is referred to as the value of inflow against the value of outflow in assets or efficiency of its assets with reference to generating input or how efficiently company used its assets to generate profit. According to van Horne (2005) profitability against the value invested in assets after taken into consideration the all direct and indirect cost and expenses is referred as return on assets. Samad & Hassan (2000) mentioned how efficiently a bank used its assets and convert it into earning. Generally higher the value of return on assets ratio indicate the efficient utilization of company assets whereas lower the value of ratio indicate the worse

performance with reference to utilization of company assets. Return on assets can be increased by increasing profit margin or through turnover on assets but due to more competition and trade off between turnover and profit margin it's not practicable for the company. ROA can be calculated by using the following formula.

$$ROA = \frac{\text{Net profit after tax}}{\text{Total Assets}}$$

1.1.2. Return on Equity (ROE)

Return on equity is referred as the earning of firms after deducting tax through each dollar invested in equity (Van Home, 2005). Return on equity earning against the equity capital (Samad & Hassan, 2000). Return on equity (ROE) normally used to analyze the managerial performance of organization (Sabi, 1996). Higher managerial performance associated with the value of return on equity (ROE) as higher the value of return on equity (ROE) leads to better managerial performance with reference to the utilization of equity capital whereas lower the value of return on equity (ROE) indicate the worst managerial performance with reference to equity utilization. According to Sabi (1996) return on equity (ROE) can be calculated by using the following formula.

$$ROE = \frac{\text{Shareholders' Equity}}{\text{Net profit after tax}}$$

1.1.3. Profit to Expense Ratio (PER)

Operating profit availability to meet the operating expenses of the firms is referred as profit to expense ratio. Operating profit can be calculated by deducting all expenses except taxes and interest. Profit to expense ratio indicate the basic criteria regarding bank efficiency to control the operating expenses. Higher the value of price to expense ratio indicated that banks is cost efficient and earning high profit to meet the operating expenses whereas lower the value of price to expense ratio referred as the banks is not cost efficient and facing problems to meet its operating expenses from its profit (Samad & Hassan, 2000). Price to expense ratio can be calculated by using the following formula.

$$PER = \frac{\text{Operating Expenses}}{\text{Profit before tax}}$$

1.2. Liquidity Ratios:

Liquidity ratios are referred as the capacity of banks regarding payment of its current liabilities and obligation. Liquidity is an important element with reference to avoid defaulting and financial crisis and financial distress (Ross, Westerfield, Jaffe, 2005). Liquidity position of banks can be maintained by strengthening the cash position and proper management of debtors. Generally the higher the value of liquidity ration except loan to deposit ratio indicate the greater margin of safety and its ability regarding smoothly payment of current liabilities and current obligations. In banking sector especially with reference to savings accounts highly risk exist for banks and depository institution as the depositors at any time can withdrawal its amount from his bank account. Liquidity of banks adversely affected by the more withdrawals as compared to the deposit over the short period of time (Samad & Hussain, 2000). Liquidity of conventional banks and Islamic banks can be measured through *Loan to Deposit ratio (LDR)*, *Current ratio (CR)* and *Current Assets Ratio (CAR)*.

1.2.1. Loan to Deposit Ratio (LDR):

Loan to deposit ratio (LDR) is the most important ratio used to observe the liquidity positions of conventional banks and Islamic banks. Here, term loan means the amount of advances for conventional banks whereas for Islamic banks term loan indicate the financings. Islamic banks used terms financing

instead of loan as the Islamic banks do not charge any interest (Riba) according to the Islamic banking principles. According to the Islamic banking principles Islamic bank cannot use the amount of deposits for sanctioning loan but used the deposit amount for investment in various Islamic products that are mentioned in Islamic banking principles. Lower the value of LDR indicated the better liquidity position and less risk with lower the value of profitability. However higher the value of LDR indicate the higher risk as the banks in case taking more financial stress, higher risk and higher profit as well. LDR can be calculated by using the following formula.

$$LDR = \frac{\text{Total Loan/Total Financing}}{\text{Total Deposit}}$$

1.2.2. Current Ratio (CR):

Current ratio (CR) is another important ratio widely used to observe the liquidity position of conventional banks and Islamic banks. Current ratio indicates the percentage of total deposit kept by the banks in form of cash or in others banks. Higher the value of current ratio indicate that banks kept high percentage of deposit and used less amount of deposit for sanctioning loan in case of conventional banks and incase of financing for Islamic bank. Higher the value of CR indicates the low profitability as well as low risk but high liquidity position as well. However lower the value of CR represented that higher percentage of total deposit used for sanctioning loan or financing by conventional banks and Islamic banks respectively. Lower the value of CR indicates higher profitability, high risk and low liquidity. CR can be measured by suing the following formula.

$$CR = \frac{\text{Cash \& Accounts with Bank}}{\text{Total Deposit}}$$

1.2.3. Current Assets Ratio (CAR):

Current assets ratio (CAR) is another important ratio widely used to observe the liquidity position of conventional banks and Islamic banks. Current assets ratio indicates the percentage of total current assets against the value of total assets. Higher the value of current assets ratio indicate that banks kept high percentage of current assets and maintain lower percentage of long term assets and fixed assets. Higher the value of CAR indicates the low profitability as well as low risk but high liquidity position as well. However lower the value of CAR representing higher percentage of long term and fixed assets against the value of total assets, which indicate that less ability of banks regarding payment of their current obligations as its major portion of assets depends upon the long term and fixed assets. Lower the value of CAR indicates higher profitability, high risk and low liquidity. CR can be measured by suing the following formula.

$$CAR = \frac{\text{Current Assets}}{\text{Total Assets}}$$

1.3. Risk & Solvency Ratios

Risk and solvency ratios widely used to observe the risk and solvency of conventional and Islamic banks. These ratios also referred as gearing ratio or financial leverage ratios. Risk and solvency ratio also explain the capital structure of banks with reference to debt financing and equity financing. Higher the value of risk and solvency ratios indicates the higher profitability, higher risk of default and financial distress. Debt financing is an important part of capital structure as its leads to higher profitability and significant tax advantage as compare to equity financing besides this it's also creates conflict of interest among creditors and shareholders (Ross, Wedsterfield, and Jaffe, 2005). Solvency of banks will be considered better if value of assets exceeds from the all types of liability.

Measure used to observe the risk and solvency of conventional banks and Islamic banks including: *Debt Equity Ratio (DER)*, *Debt to Total Assets Ratio (DTAR)* and *Equity Multiplier (EM)*.

1.3.1. Debt Equity Ratio (DER):

Debt equity ratio (DER) indicates the extent of debt used by the conventional banks and Islamic banks. Debt to equity ratio (DER) indicates the ability of firms regarding facing the financial shocks. Banks provide shield against the losses if the creditors fail to pay back their loans. Higher the value of debt to equity ratio (DER) indicate the higher risk and higher chances of default whereas lower the value of debt to equity ratio (DER) indicate the lower risk and less chances of default due to the nonpayment by the creditors. DER can be calculated by using the following formula.

$$DER = \frac{\text{Total Debt}}{\text{Shareholders' Equity}}$$

1.3.2. Debt to Total Assets Ratio (DTAR)

Debt to total assets ratio (DTAR) indicate the amount of debt used to finance the total assets. Debt to total assets ratio (DTAR) indicate the capacity of organization to obtain the additional financing to attract the investment opportunities. Higher the value of debt to total assets ratio (DTAR) banks used more debts to finance the total assets therefore higher value indicates the higher risk. Lower the value of debt to total assets ratio (DTAR) indicate that firm used less debts to finance the total assets therefore lower the value debt to total assets ratio (DTAR) indicate the lower risk. Formula of DTAR is given as under.

$$DTAR = \frac{\text{Total Debts}}{\text{Total Assets}}$$

1.3.3. Equity Multiplier (EM):

Equity multiplier (EM) explains the relationship among the shareholder equity and total assets. It also indicates how many times the total assets are of the shareholder equity. . In other words, it indicates the amount of assets per dollar of shareholders 'Equity. Higher the value of equity multiplier (EM) means that bank used more debt for conversion of its assets with share capital. Positive association was observed between the equity multiplier (EM) and risk & solvency. If the value of equity multiplier (EM) is greater it leads to greater the risk whereas lower the value of equity multiplier (EM) leads to less riskiness banks. Equity multiplier can be find out by using the formula stated including $EM = \text{Total assets} / \text{Shareholder equity}$.

$$EM = \frac{\text{Total Assets}}{\text{Total Shareholders' Equity}}$$

Literature Review

As discussed by Iqbal (2001) profitability can be observed by using the return on assets (ROA), return on equity (ROE) and Profit to expense ratio (PER). According to Samad & Hassan (1999) risk and solvency position can be measured by using the debt equity ratio (DER), debt to total assets ratio (DTAR) and equity multiplier (EM). According to Samad (2004) comparative analysis between conventional banks and Islamic banks can be conducted on the basis of profitability (ROA, ROE & PER), Liquidity (LDR, CR & CAR) and risk & solvency (DER, DTAR & EM). According to Tihomir (2001) profitability can be observed by using the different criterion including return on assets, return on equity and profit to expense ratio. As discussed by Moin (2008) profitability, liquidity and risk & solvency ratios can be used to make a comparison between the conventional banks performance and Islamic banks performance. Metwally (1997) observed that

key indicator used to measure the performance of banking sector is the ratio analysis that includes profitability ratio, liquidity ratio and risk & solvency ratio. As discussed by Iqbal (2001) profitability, liquidity and risk & solvency position of banks can be observed by using the profitability ratio, liquidity ratio and risk & solvency ratio.

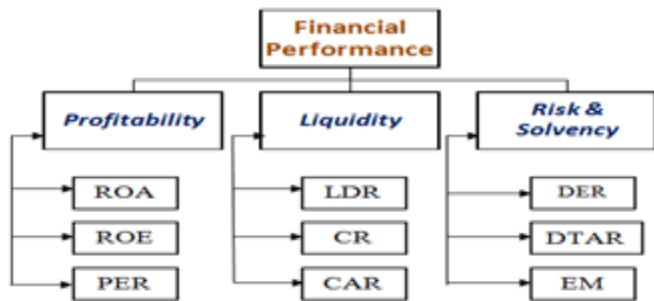
As discussed by the Moin (2008), Sammad (2004) and Hassan (1999) risk and solvency position of banking sector can be observed by using the debt to equity ratio (DER), debt to total assets ratio (DTAR) and loan to deposit ratio (LDR). Higher the value of mentioned ratio indicates the higher risk and vice versa. As discussed by the Awan (2009) decision regarding merger and acquisition can be taken on the basis of performance indicators with reference to profitability, liquidity and risk & solvency. According to Javaid et al. (2011) all the financial statements including profit and loss accounts, balance sheet, retain earning statement and cash flow statements can be used for ratio analysis. According to the study conducted by Javed et al. (2011) one of the key indicators used to access the performance of banking sector is the profitability ratio including return on assets (ROA), return on equity (ROE) and profit to expense ratio (PER). According to Gul et al. (2011) return on equity referred to as the efficiency of equity to generate profit. Higher the value of return on equity means bank used its capital very effectively and efficiently. According to Hassan & Bashir (2003) liquidity position bank can be observed by using the loan to deposit ratio (LDR), current ratio (CR) and current assets ratio (CAR). According to the study conducted by the Hempel and Simonson (1998) ratio analysis techniques is widely useable for comparative analysis of conventional banks and Islamic banks as the ratio analysis used as the disparities in terms of sizes with reference to financial strength. According to the Flaming et al. (2009) return on assets (ROA) is the key ratio used to make the comparison between the performance of conventional banks and Islamic banks. As discussed by the Alexandru et al. (2008) profitability of conventional banks and Islamic banks can be observed with reference to its assets efficiency, equity efficiency and availability of profit to meet the expense by using the return on assets ratio (ROA), return on equity ratio (ROE) and Profit to expense ratio (PER) respectively. According to the Khrawish (2001) return against the every unit of money invested by the investors and shareholders in equity can be accessed by using the return to equity ratio (ROE). Another widely useable ration to access the amount of input against the value of each unit invested in assets observed by using the return on assets ratio (ROA). According to the study conducted by Moin (2008) financial analysis of conventional banks, Islamic banks and microfinance with reference to profitability, liquidity and solvency can be observed by using the different types of ratio.

2. Methodology

Ratio analysis techniques widely used for inter banks comparison. According to the study of Lader and Asarpota (2007) ratio analysis techniques can be used for inter banks comparison. This study was conducted to make an inter banks comparison of all leading Islamic banks and conventional banks working in Pakistan. In this study inter banks comparison of all leading Islamic banks and conventional banks was conducted by using the various types of ratio with reference to profitability, liquidity and risk & solvency. According to the study conducted by Samad & Hassan (2000) inter banks financial performance of conventional and Islamic banks can be observed by using the various types of financial

ratio including Profitability ratio (ROA, ROE & PER) liquidity ratio (LDR, CR & CAR) and risk & solvency ratio (DER, DTAR & EM).

2.1. Theoretical Framework



3.2. Objectives of the Study

This study helps in channelizing resources in future regarding deposit, finances, investment & others banking resources. However the key objectives of the study are given as under.

- Which of the banking sector is relatively more profitable?
- Which of the banking sector is relatively more liquid?
- Which of the banking sector is more solvency and risky?

3.3. Sample of the Study

Table .1

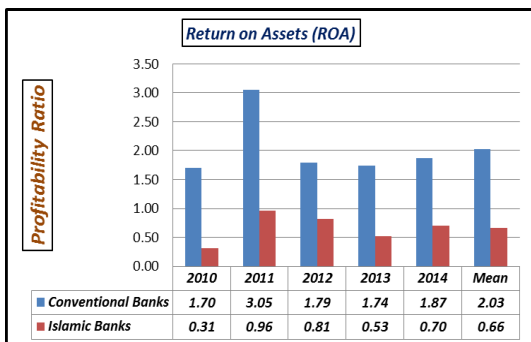
Sr.#	Conventional Banks	Islamic Banks	
1	MCB Bank Ltd.	Meezan Bank	Data from 2010 to 2014 used for ratio analysis
2	United Bank Ltd (UBL).	Bank Islami	
3	Allied Bank Ltd (ABL).	Burj Bank	
4	Habib Bank Ltd (HBL).	Dubai Islami Bank	
5	The Bank of the Punjab (BOP).	Albarka Bank	

Finding and conclusion

2.2. Return on Assets (ROA)

The following results indicate important elements of conventional banks and Islamic banks. ROA of conventional banks is greater than Islamic banks throughout the years from the period from 2010 to 2014. Mean value indicating the overall average results. According to the means values results as the mean of ROA of conventional banks are 2.03 whereas the ROA means value of Islamic banks is 0.66. So, following results indicated that with reference to ROA conventional banks dominating on Islamic banks. ROA of conventional banks is greater than the Islamic banks as the Islamic banks invested its resources in less risky project as compare to the conventional banks therefore conventional banks get more benefits against the value invested in assets.

Table .2

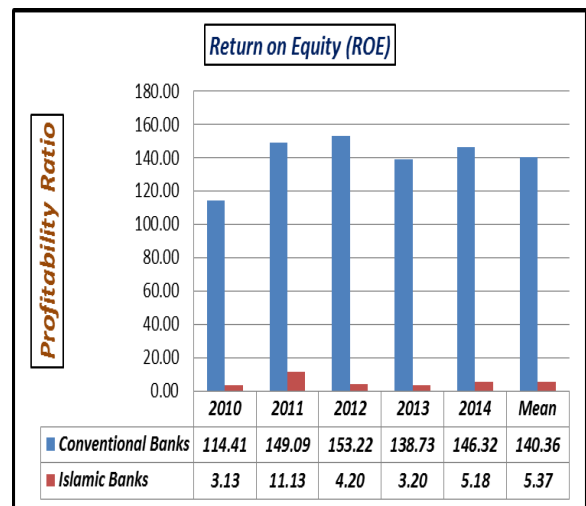


2.3. Return on Equity (ROE):

ROE also indicating the important aspects of profitability of conventional banks and Islamic banks. Following results

indicated that ROE of conventional banks consistently higher than the Islamic banks from the period from 2010 to 2015. Mean value of ROE indicating that conventional banks dominated on Islamic banks with reference to ROE throughout the observed period as the ROE means of conventional banks is 140.36 whereas the ROE mean of Islamic banks are 5.37.

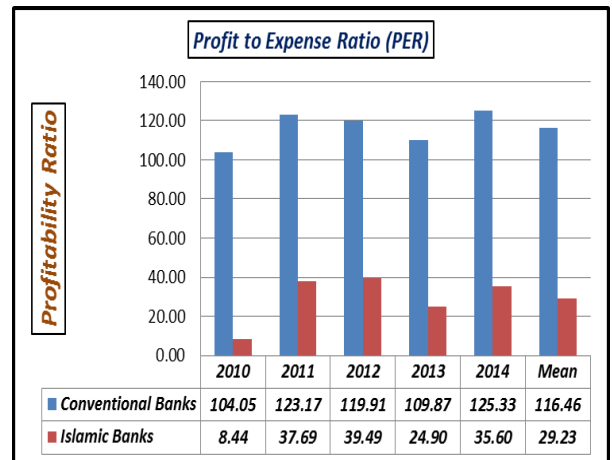
Table .3



2.4. Profit to Expense Ratio (PER):

Conventional banks dominated on Islamic banks on the basis of another measures of profitability that is PER. The following results indicated that conventional banks have more available profit to meet the operating expenses. Conventional banks better managed and controlled its operating expenses as compare to the Islamic banks as conventional banks profitability in terms of ROE is greater as compare to the Islamic banks.

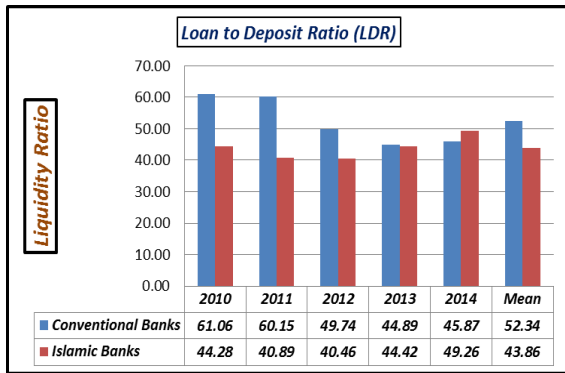
Table .4



2.5. Loan to Deposit Ratio (LDR)

High value of LDR indicated the less liquidity and vice versa. According the results that are given as under conventional banks have high value of LDR as compare to Islamic banks from the year 2010 to 2013 it means during this period liquidity position of Islamic banks are better than the conventional banks. In 2014 liquidity position of conventional banks is better than the Islamic banks on the basis of LDR as the LDR conventional banks is less than the conventional banks. Mean value of observed period also indicated that conventional banks are less liquid as compare to the Islamic banks as the means value of LDR of conventional banks 52.34 as compare to Islamic banks as the value of Islamic banks are 43.86.

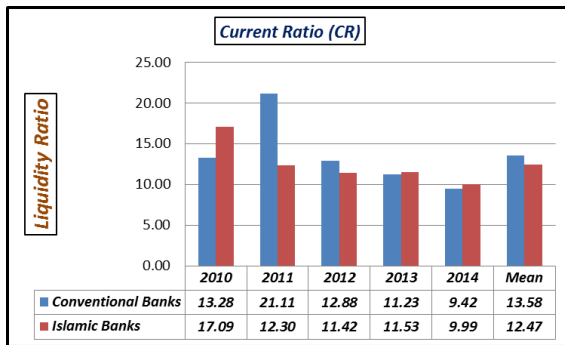
Table .5



2.6. Current Ratio (CR)

CR is the important aspects to observe the liquidity position of conventional banks and Islamic banks. High value of CR associated with the better liquidity and vice versa. Under mentioned results indicated that in liquidity position on the basis of CR of conventional banks is better in 2011, 2012 as the value of CR in mentioned period of conventional banks is greater whereas 2010, 2013 and 2014 Islamic banks liquidity is better as the value of CR in this period of Islamic banks is greater. Overall liquidity position on the basis of CR on Conventional banks is better as the mean value of CR of conventional banks 13.58 as compare to mean value of Islamic banks CR.

Table .6

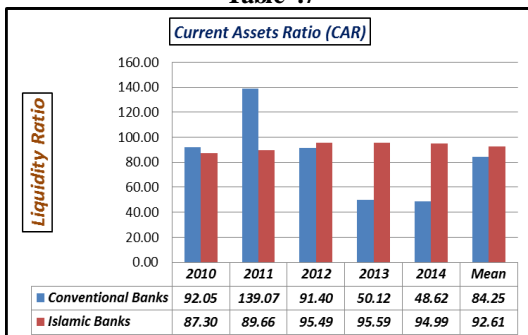


2.7. Current Assets Ratio (CAR)

Current assets ratio (CAR) is another important indicator to observe the liquidity position of banks as it indicates the percentage of current assets against the value of total assets. Higher the liquidity position of banks associated with the higher value of current assets ratio (CAR).

Following results indicated that liquidity position of conventional banks in 2010 and 2011 is better as in this period CAR of conventional banks is high. In 2012 to 2014 Islamic banks liquidity position increased as the value of CAR is greater than the conventional banks. According to the mean value with reference to CAR Islamic banks having better liquidity positions as mean value of CAR of conventional banks is 84.25 and Islamic banks 92.61.

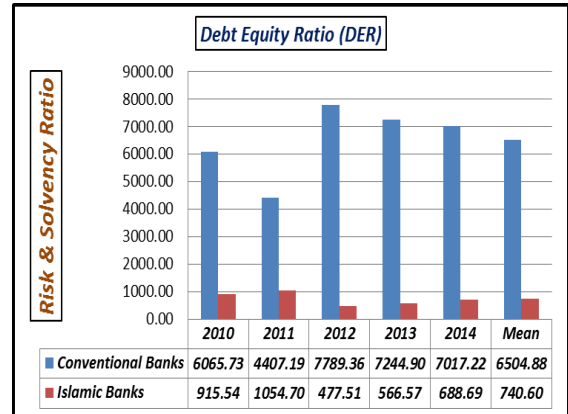
Table .7



2.8. Debt Equity Ratio (DER)

Debt to equity ratio (DER) an important aspects that is used to observe the risk and solvency position. High value of DER associated with high risk and vice versa. The under mentioned results indicated that DER of conventional banks from 2010 to 2014 is higher it means with reference to DER conventional banks are more risky as the profitability of conventional banks also better as the conventional banks take more risk and get maximum return as compare to the Islamic banks. Mean value supported that conventional banks highly risky than the Islamic banks.

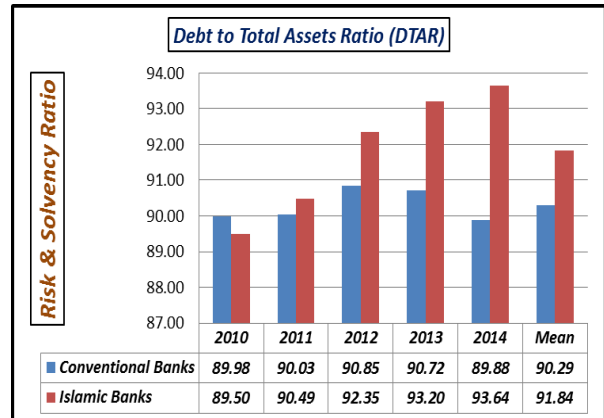
Table .8



2.9. Debt to Total Assets Ratio (DTAR)

Another important aspect used to observe the risk and solvency position of the conventional banks and Islamic banks is the DTAR. High DTAR associated with the high risk as well and vice versa. According to the following results conventional banks risk factor in 2010, 2012 and 2013 as during this period DTAR of conventional bank greater, whereas in 2011 and 2014 risk factor was greater than the conventional banks. The mean value of DTAR of conventional banks is 90.29 and Islamic banks are 91.84. According to the mean value of DTAR risk factor was high in conventional banks.

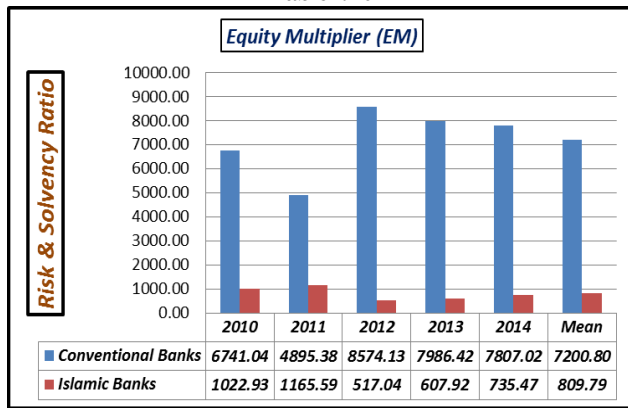
Table .9



2.10. Equity Multiplier (EM)

Equity Multiplier (EM) indicating that how many times the total assets are of the shareholder equity. It showing amount of assets per rupees of shareholders equity. Lower the value of EM indicates the lower risk and vice versa. As per following results Islamic banks succeed to reduce the risk factors with reference to EM as the EM value of Islamic banks from 2010 to 2014 is less as compare to the conventional banks. Meal value of EM of conventional banks and Islamic banks also indicate that conventional banks position regarding risk factor especially with reference to EM is worst as compare to Islamic banks.

Table .10



2.11. Conclusion

According to the final results conventional banking sector dominating on Islamic banking sector with respect to profitability as the mean value of profitability ratio of conventional banking is 86.28 and Islamic banking sector 29.33. According to the mean value of liquidity ratio and risk & solvency ratio Islamic banking sector dominating on conventional banks as the mean value of liquidity ratio of Islamic banking sector 20.41 whereas the mean value of liquidity ratio of conventional banks is 15.16. Risk and solvency ratios means of Islamic banking sector 547.41 and conventional banking sector 4598.66 that represents that Islamic banking sector is less risky as compare to the conventional banking stream. Following results are supported by the Van Horne (2005) as high profitability leads to lower liquidity and high risk factors. Low profitability leads to high liquidity and lower risk factors as well. So, according to the results of this study conventional banking sector profitability better but its liquidity and risk & solvency position is worst. On the other side Islamic banking stream liquidity and risk & solvency position is better but its profitability suffers due to higher liquidity and lower risk factor.

Table .11

RATIO	Conventional Banks	Islamic Bank	Remarks
ROA	2.03	0.66	Conventional Banking Sector Dominating On Islamic Banking Sector With Respect To Profitability
ROE	140.36	5.37	
PER	116.46	29.33	
Mean	86.28	11.78	
CR	13.58	12.47	Islamic Banking Sector Dominating On
CAR	84.25	92.61	
LDR	(52.34)	(43.86)	Conventional Banking Sector With Respect To Liquidity
Mean	15.16	20.41	
DER	6504.88	740.60	Islamic Banking Sector Dominating On
DTAR	90.29	91.84	
EM	7200.80	809.79	Conventional Banking Sector With Respect To Risk And Solvency
Mean	4598.66	547.41	

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