

# ANALYZING FINANCIAL PERFORMANCE OF ISLAMIC AND CONVENTIONAL BANKS OF PAKISTAN: A COMPARATIVE STUDY

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## ABSTRACT

This study is conducted to analyze the financial performance of Islamic banking sector with conventional banking sector of Pakistan for the year 2015-19. For comparative analysis of Islamic banking sector with conventional banking sector 3 major and their 6 sub ratios containing liquidity ratio, capital ratio and profitability ratio over the period of 2015-2019 are used. Secondary data is used from annual Islamic Bulletin reports, Reports of State bank of Pakistan, various financial reports of conventional banking sector, World Bank forum and relevant articles over the period of 2015 – 2019. The comparison of Islamic banking sector with conventional banking sector has shown that Islamic banking sector is performing better in terms of profitability whereas, conventional banking sector is better in terms of risk absorbing ability and unexpected loss bearing. In terms of capital assets to total assets conventional banking's performance is going better with the passing years. In terms of liquidity conventional banking sector is in better position as compared to Islamic banking sector. Islamic banks need to focus on liquidity and capital asset ratios to get better results in future. Islamic banking industry is getting better with the passing years in term of profit and market share which is a positive sign. Islamic banking is expanding its network with more and more branches every year to facilitate customers. This research will guide higher management to make relevant policies that will play important role in improving growth and profitability of that indicator that is showing less profit.

**Keywords:** Islamic Banking Industry's Development; Market Share; origin of Islamic banking in Pakistan; contract types; Ratio analysis

## 1. Introduction

Globally different banking systems are working therefore the conventional and Islamic banking systems are most popular among them. Conventional banking system also known as traditional banking system is working in Pakistan since Pakistan came into existence. Conventional Banks based on interest payments. Islam is not only the religion to follow but it has a complete guide to live. Islam provides a complete set of laws and regulations in every aspect of life. Islam also has a set of codes in the field of banking and finance. In Islam interest-based (Riba) is prohibited strictly and promotes trading on a fair means. Pakistan starts working on Islamic banking very late after 1970 but now it is on heights. With the start of 21 countries Islamic banking trending not only in Muslims but in western countries because of its benefits. The Islamic banking industry starts its journey in Pakistan by inaugurating full flesh Islamic bank named Meezan bank in 2002. Within the last two decades, the Islamic banking industry's progress is very satisfactory and competing conventional banks in banking industry. Growth and development of the Islamic banking industry are analyzed through the total assets of Islamic banks, their year to year growth rate, and their market share in the overall banking industry.

We analyze the growth of the financing mix by taking a percentage share of each product of Islamic banks for 5 consecutive years. The percentage change of the financing mix gives us a clear view of the positive or negative growth. We compare performance of both banks with the help of ratios like liquidity ratio, capital ratio, profitability ratio and earnings ratio. For analysis we use secondary data from the Islamic Bulletin reports, Reports of State bank of Pakistan and World Bank forum and relevant articles over the period of 2015 – 2019.

### 1.1. Importance and Significance

Financial institutions especially banking sector plays very important role in every countries economy especially in an under developed country like Pakistan. Banking sector is like a backbone of economic activities, it collects deposits from people and provides credits in forms of loans to states, individuals and business to perform their financial activities in a good manner. Analyzing financial performance of an organization gives an idea to management about which component requires improvement. It's equally important for depositors and management. Financial ratios are measure of an organizations well-being and prosperity. This study will give a proper insight to investors, management and shareholders about the Islamic banking sector's

financial performance. Another reason of this particular study is that it will make people aware of financial position of the Pakistan's Islamic banking sector over the recent years.

## 1.2. Research Objectives

On basis of aims and objectives the following research questions will be answered by the present study:

- ✚ To compare financial performance of Islamic banking sector with conventional banking sector.
- ✚ To compare liquidity management of Islamic banking sector and conventional banking sector.
- ✚ To determine risk absorbing capacity of Islamic and conventional banking sector with the help of capital ratios.
- ✚ To determine profitability of both Islamic and conventional banking sector with respect to both ROA and ROE ratios.
- ✚ To compare financial performance of Islamic and conventional banks in terms of efficiency, liquidity, capital asset capacity and profitability with overall banking industry.
- ✚ To check the progress and market share of Islamic banking industry from 2015-2019.
- ✚ To check the finance mix percentages of different Islamic banking products such as Murabaha, Ijara, Musharakah, diminishing Musharakah, Salam, Istisna and others.

## 1.3. Problem Statement

Either the performance of Islamic banking sector is better than conventional banking sector or not?

## 2. Literature Review

In a study done by (Akram, Rafique, & Alam, 2011) examines the growth and performance of Islamic banking industry over the year 2003-2010. In which corporate social responsibility with respect to Islamic banking sector is discussed because people are becoming more aware about Islamic banking contracts. The financial indicators used are assets, deposit sources and uses of

funds in Islamic banking sector of Pakistan. Results show a rapid growth in Islamic banking sector of Pakistan during the years. The role of State bank of Pakistan is appreciated for this.

Ratios were being used in past by researcher to analyses and compare the financial performance (Saleh & Zeitun, 2006). Financial ratio analysis is the method extensively used by researcher to analyses the banks performance. Comparison of the conventional bank and Islamic bank of turkey shows that liquidity of Islamic banks are higher than conventional banks because of that international investor more in Islamic banks and it cause in increase in market share of Islamic banks (Erol, Baklaci, Aydog, & Tune, 2014).

A research of (Hassan & Bashir, 2003) compares the data of 21 countries Islamic bank and conventional banks and finds that Islamic banks have higher profit and liquidity with low risk. The resource utilization is almost same for the Islamic and conventional banks but Islamic bank earn more profit and returns than conventional banks. By using six financial ratios we analyses that Islamic banks have better profits and returns with low cost effectiveness.

(Ashraf, 2013) analyzed the growth and development of 5 Islamic banks such as Meezan bank, Al Barak Bank, Bank Al islami, Dawood Islamic Bank and Dubai Islamic bank. To compare the performance of these Islamic banks following financial indicators are used such as total assets, total deposits, total financing, total investment, total number of branches, profit generated, per share earnings, equity of shareholders and other necessary financial indicators. Results show a fast improvement in Islamic banking sector of Pakistan as compared to other countries by reviewing literature.

A study done by (Ibrahim, 2015) in Dubai to measure the growth and financial performance of two Islamic banks for the period of 2003-2007. Descriptive analysis is used to measure the results. The ratios are used to measure the liquidity, management performance, capacity, profitability and capital structure. Results show that profitability of Dubai Islamic bank is higher as compared to profitability of Abu Dhabi bank.

(Ahmad, 2010) analyzed the performance of Islamic banking sector by using 6 Islamic banks. To measure the performance non-financial indicators are used consisting of 8 item scale. The data was collected by customers of that particular bank in which they are said to rank their performance according to their experience. To collect data simple random sampling is used.

Results shows that bank are showing more importance towards profitability, quality of product and productivity to satisfy their customers and to improve their financial performance.

(Sanwari & Zakaria, 2013) analyzed the performance of Islamic banks from 2000-2009. To analyze the performance both internal and external factors are used. Panel data of seventy four Islamic banks was selected from world banking forum. Results shows that micro economic factors like liquidity, assets quality and capital are more important for banks rather than macro-economic factors which do not significantly influencing their profitability.

(Miniaoui & Gohou, 2011) analyzed the performance of Islamic banks. Their research focused on whether the Islamic banks are performing better in global financial crisis or not. For this data was collected from 37 banks of Dubai. To analyze the data balance sheets are used from their annual financial reports. Results indicated that conventional banks are performing better as compared to Islamic banks in terms of profitability.

## **2.1. Origin of Islamic Banking in Pakistan**

Pakistan came into existence in 1947 in the name of Islam. The Muslims of India want their separate space where they live their lives according to the teachings of Islam. Riba or interest is strictly prohibited in Islam according to both sources Quran and Ahadees. Islam encourages and promotes trade and profit\loss sharing (PLS) concept. On the day of 28 Feb 1948 when the founder of Pakistan Quid-e-Azam inaugurate the State Bank of Pakistan said I want Pakistan's financial system works on the Islamic social and economic ideology.

Before 1970 there is no concept of Islamic banking in Pakistan. Work on Islamic banking starts at the government level in 1980 when the banking ordinance had been revised (Khattak, 2010). In February 1979, the government of Pakistan appointed a council with the name of Council of Islamic Ideology (CII) was responsible for the implementation of Islamic law and remove the interest (Riba) from society (Kennedy, 1990). At the start of 21 century, Islamic Banking in Pakistan flourished and Pakistan's first full-fledged Islamic bank was established on March 20, 2002, with the name of Meezan Bank Limited (SBP Report, 2003). Shariah Advisory Board (SAB) is responsible for overlooking all the financial institutions of Pakistan. SECP announced a new a shariah advisory board and published Shariah Governance Regulations, 2018 which have a complete laws and regulations about shariah compliance companies.

## 2.2. Growth, development and progress of Islamic Banking in Pakistan

In true sense growth of Islamic banking industry started in 1979 when government decides to initiate a system which is totally free from riba. For this purpose different financial institutions such as ICP, HBFC and Equity bankers are given orders to take preliminary steps for its startup. During this era government took a lot of initiatives for whole banking industry especially for Islamic banking industry. In this era government gave approval to commercial banks for starting PLS accounts on profit loss sharing bases. Its time when the idea of Islamic window emerged. In next era of 1985 Islamic banking industry is prohibited by government for offering of riba based services and products. An exception is given to government currency dealings for national and in international trade accounts to continue their working on the same principle (Kaleem & Wajid, 2009). All this initiative becomes a signal for Islamic banking startup as Supreme Court of Pakistan and Islamic ideological council gives rulings for interest free economy in Pakistan. During the regime of Zia in mid of 80's solid foundation was laid for the authorization of Islamic fund elements in the Pakistan. The continuous and consistent advancement of Islamic banks proceeded and the business of Islamic money flourished as time passed (Ali, 2015).

Islamic banking industry is considered as one of the fastest growing industry in world. In 1970 the growth of Islamic banking sector is just 2% which later on increased to 15% in 1990 (Yousef, 1996). During recent times it shows an astounding growth of more than 500 (Khalid & Amjad, 2012).

Islamic banking organizations are convoluted in more than 90 country's 500 billion US Dollars investment activities. Besides this Islamic investment and banking industry has shown growth of 15% to 20% per year during the first decade of 2000's (Bose & McGee, 2008).

Islamic banking industry is getting renowned worldwide especially in Muslim countries. In 2003 there are 176 Islamic banks worldwide having more than 147 US dollar reserves in them (Ghannadian & Goswami, 2004).

Other than numerous obstacles Islamic banking industry managed progressively by Shariah council and State Bank of Pakistan generating higher revenues and better service quality providence to their customers. They performed their duties in a positive way to prosper Islamic banking industry. This is the sole reason why Pakistan is one of the fastest growing Islamic

banking industries worldwide because of its maintained legal framework, Shariah experts and government support to every possible extent.

As per Islamic Banking Bulletin report December 2015 number of branch network increased by 196 and a total exceeds by 2000 which is more than the strategic plan 2014-18. The total number of branches as per mid review is 2075 which shows a tremendous growth and development. There is a growth of 10.1% in net investments during the end of December 2015 and growth of 21.1% in financing and related assets of Islamic banking industry. As sector wise growth is considered there is a growth of 15.8% of textile sector in overall financing. Islamic banking sector consists of five pure Islamic banks and sixteen conventional and a total network of 2581 in 2017. There is a decline in net investments during 2018 by 2.7% which is 7 billion in total. There is increase in net investment by 2% and 5% in financing and related assets by 2019. During this time energy sector shows improvement in shares by 18.4% of overall financing of Islamic banking sector.

Progress in Islamic industry is gradually increasing and still happening because stakeholders like SBP are actively giving their part. For the progress of Islamic industry State bank of Pakistan has recently started a media campaign for more and more growth and development. Its purpose is to carefully control the functioning of Islamic banking sector as per Shariah rules and offering of pure Islamic contracts in terms of different products and services (Ghannadian & Goswami, 2004).

### **2.3. Different contracts in Islamic Banks**

To fulfill the financial sector needs the Islamic banking industry to introduce many types of contracts in which no interest-based transactions are used. Musharaka is one of the forms of Islamic contracts in which partners share their capital and services for a specific task and profit/loss are shares according to agreed terms and conditions (Rammal, 2004). Musharak is used in many other products like home financing, capital financing, etc. Diminishing Musharaka is a form of partnership contract in which one partner buys the whole asset at the end of the contract. Ownership is a transfer with the period of time and complete possession and ownership are transferred to the one partner at the end. Diminishing Musharaka getting very important in

the Islamic banking industry day by day (Asim, 2020). This contract is used in home financing, vehicle financing, etc.

Murabaha is the most commonly used contract in Islamic banking. Murabaha is the sale of goods at cost plus a profit margin of bank services. In Murabaha, it is compulsory to disclose cost and profit margin to the customer (Aqib Ali, 2019). Application of the Murabaha contract is in consumer financing, trade financing, working capital financing, and many others. A very useful contract for small farmers is Salam. In the Salam contract bank pays a spot full payment in cash and the product delivered in the future specific date. Payment in cash is on spot and delivery is deferred (Usmani, 2005).

Istisna is another kind of sale in which product sales before it comes into existence. Bank order a product to the manufacturer and the manufacturer needs some money in advance for production. The price of the product is fixed in contract and full payment in advance is not necessary for Istisna (Zarka, 1997). Ijara is the Islamic mean of leasing. Lessor (mu'ajjir) rent out his asset or commodity to the lessor (ujrah) for a period on which the lessor must pay rent to the lessee. Possession is transfer to the lessee but ownership is remain to the lessor for the whole period (Naqvi & Perveen, 2014).

### **3. Research Methodology**

To compare financial performance of Islamic banking sector with conventional banking sector and industry ratio researcher has used secondary data from annual reports of Islamic Bulletin reports, Reports of State bank of Pakistan, various financial reports of conventional banking sector, World Bank forum and relevant articles over the period of 2015 – 2019.

To compare the data over periods following financial indicators will be used:

1. Financing Mix (% Share)
2. Industry progress and market share

Following financial ratios will be used:

1. Liquidity Ratios
2. Capital Ratios
3. Profitability Ratios



To check the progress and market share of Islamic banking industry financing mix percentage, industry progress and market share data is used. For carrying out analysis and comparison of both banking sectors with industry ratios three major and six sub ratios are used i.e., liquidity ratios, capital ratios and profitability ratios are used.

### 3.1. Industry Progress and Market Share

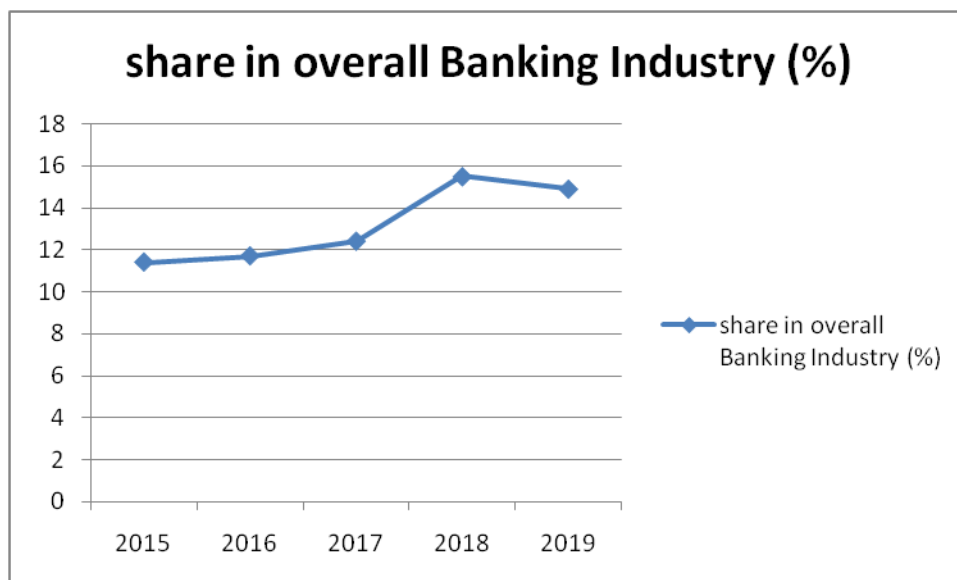
Islamic banking industry progress speedily and getting more market share day by day. Total assets of Islamic banking industry in 2015 are 1610 billion Rupees and within the 5-year period assets increased by 3284 billion Rupees almost doubled. YOY growth is 27.9% in 2015 and it decreases in next years but growth is in double digits that is a positive sign. Market share of Islamic banking industry in overall banking industry is 14.9% at the end of December 2019.

**Table 1: Industry Progress and Market Share**

years	Assets (Rupees in billion)			Deposits (rupees in billion)		
	Industry progress	YOY Growth (%)	Share in Overall Banking Industry (%)	Industry progress	YOY Growth (%)	Share in Overall Banking Industry (%)
2015	1610	27.9	11.4	1375	28.5	13.2
2016	1853	15.1	11.7	1375	14.5	13.3
2017	2272	22.6	12.4	1885	19.8	14.5
2018	2658	16.9	15.5	2203	16.9	15.5
2019	3284	23.5	14.9	2652	20.4	16.6

Graph 1 is the line graph shows the share in overall banking industry in percentage over the period of 2015 to 2019.

**Graph 1: shows the Share in overall Banking Industry**



### 3.2. Financing Mix

Islamic banks offer many contracts to the customer according to their demand and need. We analyze the percentage share of each product within the Islamic banking industry over the 5-year period 2015-2018. Most popular and rapidly used product is diminishing Musharaka with the 31.7% share at the end of 2015 and this percentage increased by 34.1% at the end of 2019. Musharaka share is 19.8% at the end of 2019. Murabaha is also sharing a huge percentage in banking industry with 24.5% in 2015 and 12.9 in 2019. Product like Ijarah, Istisna, Salam and other products are getting more share day by day detailed analysis is given in Table 2.

**Table 2: Financing Mix (% Share)**

years	Diminishing Musharaka	Musharaka	Murabaha	Ijarah	Istisna	Salam	others
2015	31.7	14	24.5	6.6	8.6	5.3	9.3
2016	34.7	15.6	15.8	6.8	8.4	4.4	14.3
2017	30.7	22.0	13.2	6.4	8.2	2.8	16.7
2018	33.3	19.9	13.6	6.2	9.1	2.4	15.5
2019	34.1	19.8	12.9	5.7	9.5	2.6	15.4

Change in percentage share of each product is given in Table 3 through which we can easily analyze the percentage change.

**Table 3: Percentage change in Financing Mix (% Share)**

years	% Change yearly Diminishing Musharaka	% Change yearly Musharaka	% Change yearly Murabaha	% Change yearly Ijarah	% Change yearly Istisna	% Change yearly Salam	% Change yearly others
2016	3	1.6	-8.7	0.2	-0.2	-0.9	5
2017	-4	6.4	-2.6	-0.4	-0.2	-1.6	2.4
2018	2.6	-2.1	0.4	-0.2	0.9	-0.4	-1.2
2019	0.8	-0.1	-0.7	-0.5	0.4	0.2	-0.1

## Ratio Analysis

### 3.2.1. Liquidity Ratios

Liquidity ratios are a measure of ability whether an organization has the capacity to pay its current debt obligations and liabilities with liquid assets or not. It further tells about the financial situation of the organization, whether it is capable to pay off its current debt or not or they need assets, inventories and securities to convert into cash to pay creditors. Liquidity ratios are used by outside investors, creditors and loan companies to recognize whether a company is able to meet its current liabilities with current liquid assets or not. The higher the value of liquid ratios the more company will be secure in term of current liabilities. Liquidity ratios above 1 are considered as good.

Two liquidity ratios are used such as liquid assets to total assets and liquid assets to total deposits.

**Table 4: Liquid asset to total assets Ratio**

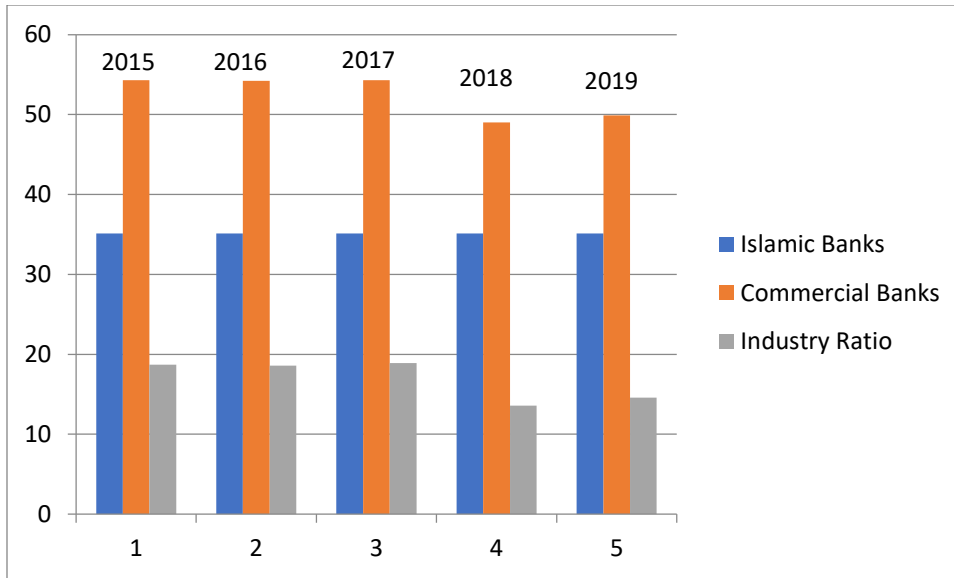
Years	2015	2016	2017	2018	2019
Islamic Banks	35.1	35.1	35.1	35.1	35.1
Commercial Banks	54.3	54.2	54.3	49	49.9
Industry Ratio	53.8	53.7	54	48.7	49.7

**Table 5: Liquid Assets to Total Deposits Ratio**

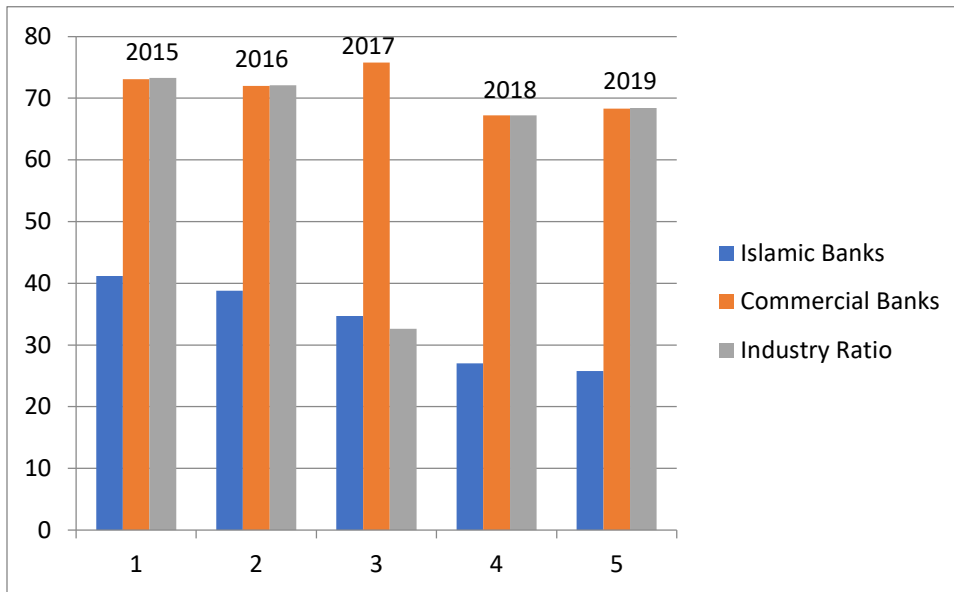
Years	2015	2016	2017	2018	2019
Islamic Banks	41.2	38.8	34.7	27	25.8
Commercial Banks	73.1	72	75.8	67.2	68.3
Industry Ratio	73.3	73.1	32.6	67.2	68.4

Liquid assets to total asset ratio of conventional banks are more than Islamic banks. Conventional banks liquidity ratio is showing a decrease as years passed on whereas no improvement is shown in Islamic banks liquid asset to total asset ratio. But conventional banking sector are showing better liquidity capacity with respect to industry ratio. Liquid asset to total deposit ratio of Islamic banking sector is quite less than conventional banking sector and industry ratio and a decrease is shown in their performance with the passing years. In terms of liquidity conventional banking sector is in better position as compared to Islamic banking sector.

**Figure 1: Comparative analysis of Liquid assets to total assets ratio of Conventional and Islamic banks**



**Figure 2: Comparative analysis of Liquid assets to total deposits ratio of Conventional and Islamic banks**



### 3.2.2. Capital Ratios

In banking industry capital ratio is used to measure the amount of risk bank can hold with respect to its capital presence against it. The higher the capital ratio the greater is the chances bank can absorb unexpected losses before becoming insolvent which shows less risky situation. Two ratios are used in capital ratio such as capital to total asset and second is total capital to total RWA.

**Table 5: Capital to Total Asset Ratio**

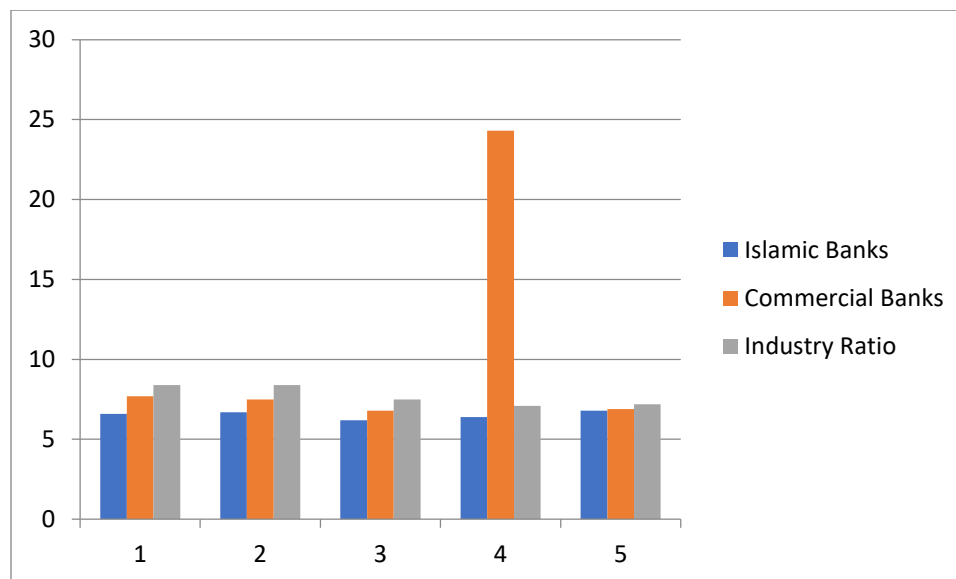
Years	2015	2016	2017	2018	2019
Islamic Banks	6.6	6.7	6.2	6.4	6.8
Commercial Banks	7.7	7.5	6.8	24.3	6.9
Industry Ratio	8.4	8.4	7.5	7.1	7.2

**Table 7: Total Capital to Total RWA Ratio**

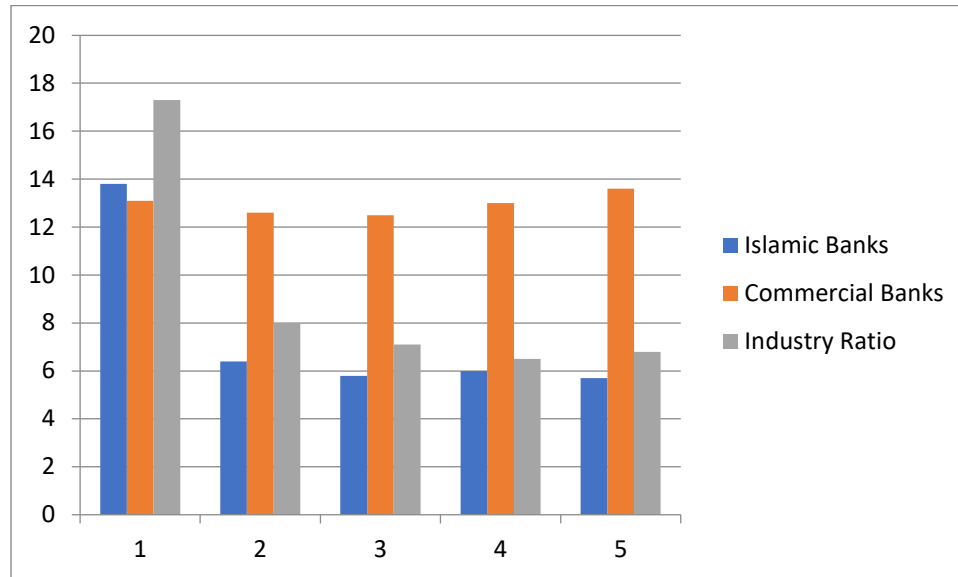
Years	2015	2016	2017	2018	2019
Islamic Banks	13.8	6.4	5.8	6	5.7
Commercial Banks	13.1	12.6	12.5	13.0	13.6
Industry Ratio	17.3	8	7.1	6.5	6.8

Capital assets to total asset ratio of Islamic banking sector shows improvement in 2019 and almost equal to conventional banking sector whereas total capital to total RWA ratio of conventional banking sector is better than Islamic banking sector and above then industry ratio as shown in table 7. It is seen that conventional banking sector has greater chances to overcome unexpected losses as compared to Islamic banking sector.

**Figure 3: Comparative analysis of capital to liquid asset ratio of Conventional and Islamic banks**



**Figure 4: Comparative analysis of capital to Total RWA ratio of Conventional and Islamic banks**



**3.2.3. Profitability Ratios**

Profitability ratio shows the amount shareholders are getting in return and organizations profit relevant to revenue. It is a measure of company’s efficiency and equally important for managers and shareholders. Two ratios are used for profitability ratios as ROA after tax and ROE after tax.

**Table 8: ROA after tax Ratio**

Years	2015	2016	2017	2018	2019
Islamic Banks	0.9	0.7	1.1	1.4	2.2
Commercial Banks	1.5	1.3	0.9	0.8	1.5
Industry Ratio	1.5	1.3	1.6	1.3	1.5

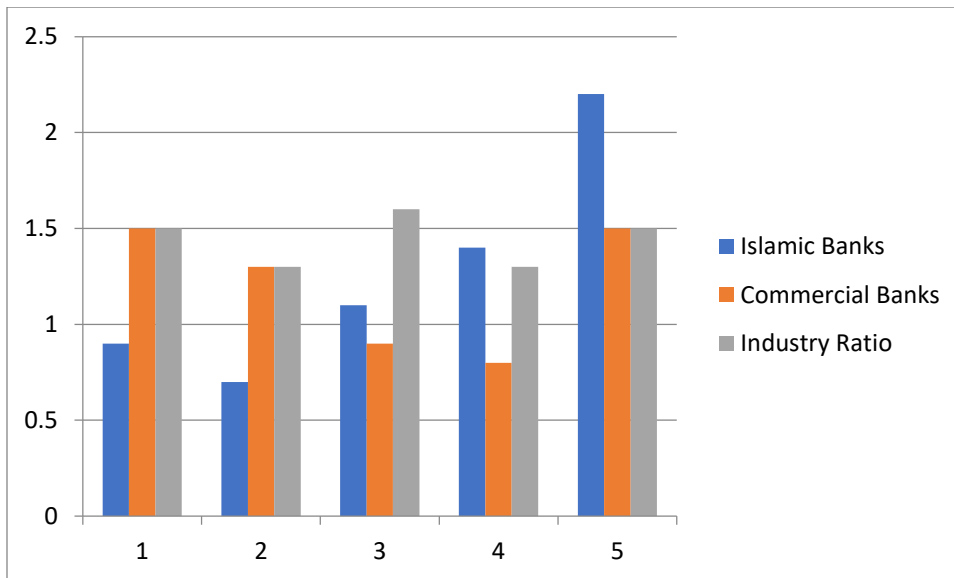
**Table 9: ROE after tax Ratio**

Years	2015	2016	2017	2018	2019
Islamic Banks	13.3	10.6	17.1	22.3	34.4
Commercial Banks	16.4	15	12	11.5	12.3

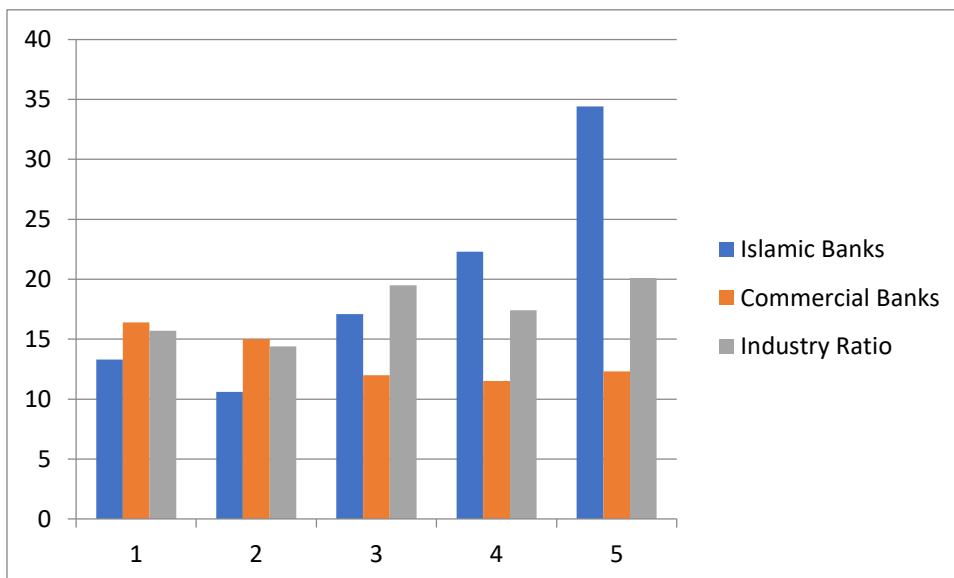
Industry Ratio	15.7	14.4	19.5	17.4	20.1
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Return on assets has shown tremendous increase as other years and high return as compared to conventional banking sector. Return on equity of Islamic banking sector is getting better as passing years and quite higher than conventional bank. So Islamic banking sector is working efficiently in terms of returns as compared to conventional banking sector.

**Figure 5: Comparative analysis of return on assets after tax ratio of Conventional and Islamic banks**



**Figure 6: Comparative analysis of ROE after tax ratio of Conventional and Islamic banks**





#### 4. Conclusions

Financial performance of Islamic and conventional banking sector is compared with the industry ratio for the year 2015-2019. Islamic banking has shown tremendous growth during recent years. Islamic banking is getting better in terms of profit. More customers prefer Islamic banking industry. Islamic banking industry is an interest free industry as per shariah rules. State bank of Pakistan and government of Pakistan has positively played their role. Market share of Islamic banking industry is 14.9% at the end of December 2019 whereas there is a decrease in 2015 but next year growth is in double digits which are a positive sign. Financing mix percentage of Islamic products has shown progress in 2018 as compared to other years.

The results of the study shows that Islamic banking sector is performing better than conventional banking sector in terms of returns such as return on assets and return on equity. Islamic banking sector is working efficiently for shareholder's return and in terms of revenue as compared to conventional banking sector. In terms of capital assets to total assets conventional banking's performance is going better with the passing years. It is seen that conventional banking sector has greater chances to overcome unexpected losses as compared to Islamic banking sector. Liquid asset to total deposit ratio of Islamic banking sector is quite less than conventional banking sector and industry ratio and a decrease is shown in their performance with the passing years. In terms of liquidity conventional banking sector is in better position as compared to Islamic banking sector.

#### Practical Implications and Recommendation

Pakistan is an under-developing country with having a concept of Islamic banking not more than 2 decades. Islamic banking needs a lot of effort and development in the field of finance so they get the confidence of the customer. This paper is only paper of its type within given time frame. It based on the comparative analysis of financial performance of Islamic banking industry and conventional banking industry with the industry ratio in the past 5 years provides help to the investors and researcher to get easy excess to the required results. As 2020 brings a big financial crises to the world. This paper works as a base paper for the researcher who wants to analyses the growth before and after the crises. It will highlight those sectors of both Islamic and conventional banking sector which needs improvement and more concern.

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