A Comparative Analysis of Financial Performance Between Islamic and Conventional Banks in Nigeria

A Case Study of Jaiz Bank Plc and Gt Bank Plc

BY

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TITLE

A COMPARATIVE ANALYSIS OF FINANCIAL PERFORMANCE BETWEEN ISLAMIC AND CONVENTIONAL BANKS IN NIGERIA

(A CASE STUDY OF JAIZ BANK PLC AND GT BANK PLC)

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BEING A RESEARCH PROJECT SUBMITTED TO THE DEPARTMENT OF ACCOUNTING AND FINANCE, FACULTY OF MANAGEMENT AND SOCIAL SCIENCES. FEDERAL UNIVERSITY GUSAU, ZAMFARA STATE.

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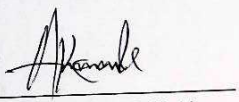
CERTIFICATION

This project report has been supervised and approved by the undersigned on behalf of the Department and Accounting and Finance, in partial fulfillment of the requirement for the award of Bachelor of Science in Accounting (B.Sc. Accounting), Federal University Gusau, Zamfara State.



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DECLARATION

I hereby declared that this project has been solely made by me under the supervision and guidance of Dr. Aminu Abdullahi of the department of Accounting and Finance, Federal University Gusau and has been presented for the award of Bachelor of Science in Accounting.

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DEDICATION

This research work is dedicated to Almighty Allah for his guidance and protection throughout my program and to my lovely mother, who through thick and thin had inculcated in me the spirit of pursing, acquiring and retaining knowledge. She is indeed a priceless jewel to me.

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All praises be to Allah the creator and sustainer of mankind, may his blessing be upon the Holy Prophet Muhammad his messenger and companions of prophet and fellow Muslim brothers and sister.

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ABSTRACT

The research work is undertaken to explore the comparative financial performance between Islamic and Conventional banks in Nigeria. A case study of Jaiz Bank plc and Guarantee Trust Bank plc. There have been several immense changes aimed at revitalizing and revolutionizing the banking industry. These changes include geographical expansion, government policies, financial performance and service proliferation. The objective of the research include; To determine the financial performance that exist between Islamic and Conventional banks in Nigeria. Secondary data were collected from the annual financial report of 2 banks for 5 years, from a period of 2014-2018. The study adopted a qualitative research design and the financial performance variables; Return on Asset ratio (Profitability), liquidity Ratio, Risk and Solvency Ratio, and Operational Efficiency Ratio were tested using Descriptive Statistics, Pearson Correlation and Multiple regression. This signifies that Islamic banks are haunted by the chronic problem of excess liquidity, since they carry surplus cash and other assets in comparison to conventional banks. Based on the findings the study recommended that instructional and operational challenges facing the Islamic banking system in Nigeria should be addressed to enable the deficit spending unit in need of funds to easily access funds from the highly liquid Islamic banks.

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Banks are instruments that facilitate economic development in any country due to their roles in the nation economy. The development of knowledge and economic systems lead to emerging of new kind of banks that offer services different from the earlier existing ones which include conventional and Islamic Banking. The conventional banking is practicing the interest based principles. Is a system which loans are given to people at fixed interest rates and more the time period taken to pay more are the amount to be repaid. It is a banking system which has grown up to mediate between the groups of people, entrepreneurs and investors. And to survive, the banks clearly need to make a profit.

On the other hand, Islamic banking generally referred to interest free banking. Free Interest rate is the core principle of Islamic Banking industries. The main pillar of Islamic finance is prohibition of interest and enhancement of partnership sharing both in dividends and lost, unlike conventional banking where interest is an integral part of the banking system. Nigeria is a mixed religious and multi-ethnic country that has come across with conventional banking since 1894 which were setup according to the British system which is totally different from Islamic doctrine of banking and transactions. This is based on profit taking and a man-made policy.

Islamic banking in Nigeria dated back around 1960 in Lagos with MUSLIM BANK WEST AFRICA LIMITED. This was ceased by minister of finance Chief Obafemi Awolowo in 1962. Since then, Islamic bank was unable to surface until 1991 during the amendment of other financial institution by (CBN). Also CBN granted license to Habib bank to deal in interest free banking product as window. Later in 2003 an Islamic bank was established named JAIZ International, it was incorporated as a public limited company. But it does not gain its popularity until 11 November, 2011, when JAIZ International received a license from

the CBN, the national banking regulator, to operate as regional bank as Jaiz Bank. The institution commenced business as Jaiz Bank on 6 January, 2012.

Nigeria has laid down the foundation for increased practice of interest free banking in response to the ongoing global trend of interest free banking, inclusion into the global financial system. In the history of the Nigerian banking law, provisions were made for a banking system that deviate from conventional banking in the banks and other financial institution decree (BOFID) No. 25 1991. In its categorization of banks in Nigeria, banks and other financial institution decree provides that the president of the federal republic of Nigeria on the recommendation of the CBN shall from time to time, determine as he may deem appropriate, the minimum paid up share capital for each category of banks. Following the promulgation of the BOFID, Habib Nigeria Bank Ltd (Bank PHB) now (Key Stone) was licensed in 1992 to offer non-interest banking services on a 'window basis' but actually commenced operations in 1999. Some of it is pioneering products include non-interest current and saving account, general purpose investment.

In every economy, there exist facilities for custodianship and distribution of financial asset and liabilities. These facilities make up the financial system in an economy of which banking is a sub sector. The banking sector is one of the most important sector of the Nigeria economy, and there exists individuals that need more resources that they cannot generate to their own, while at the same time there exist others who have more than their immediate requirements, hence there is need to create facilities for financial intermediation, and this is an unchangeable future in the banking business.

Interest free banking has been defined as banking in consonance with the ethics and value system of Islam and it is governed in addition to conventional good governance and risk management rules, by the principles laid down by Islamic Shariah CBN (2010). Interest free banking has become a global phenomena giving Muslim and non-Muslim nations deep thought either adopting it in full fledge, partially or rather discard in completely. Interest free

banking has been governing and spreading from the predominantly Muslim countries of the far east (Saudi Arabia, Jordan, Kuwait, Malysia, Pakistan, Singapore, Indonesia etc). to countries of Africa (Sudan, Nigeria, Morroco, Tunisia etc). Now in Nigeria and the European countries as the (Denmark Luxembourg etc). It is inevitable therefore that interest free banking in Nigeria has come to stay although with some accompanying issues Abdullah, (2010).

The conventional banking theories assume that banks earn profits by receiving deposits from the depositors at a low interest rate, then providing those funds to the borrowers at a higher interest rate (Santos, 2000). Therefore, conventional banks make their profits from the difference between the interest rate received from borrowers and the interest rate paid to depositors

Furthermore, interest free banking does not only negate the theory and practice of interest based banking system but also shuns all dealings that have anything to do with interest. It operation is conformed strictly within the boundaries and limits set by the Islamic Shariah. This is in contrast with conventional banking that concentrates on short and medium term loans to business, with high yield and preference given to fixed interest earnings irrespective of society's commercial or industrial needs (Yahaya, 2002).

The theoretical differences between Islamic and conventional banks do not have clear implications for total earnings, the capability to access market capital, or efficiency, higher complexity in combination with the relatively young age of the Islamic financial institutions is likely to result in higher costs and thus a lower level of cost efficiency. Even in theory, it cannot be determined with clarity whether and how the business orientation, cost efficiency, asset quality, and stability differs the Islamic and conventional banks.

1.2 STATEMENT OF RESEARCH PROBLEM:

The issues of the use of unreliable systems of banking as well as reliability of bank personnel affects the performance of the industry by wanting to override the controls and procedures instituted to ensure proper performance of the sector. This creates problem that need to be resolved i.e. toxic assets, discouragement of borrowing because conventional banks charge predetermined rate of return, lack of innovation, inflation and wide gap between rich and poor, big and small business etc. however, the introduction of interest free banking to operation alongside conventional banking is argued the solution to challenges presented by the conventional banking system as its non-interest banking policies, controls and procedures put in place are monitored to ensure proper performance.

1.3 OBJECTIVES OF THE STUDY:

The general aim of this study is to compare the performance of Islamic bank using sharia jurisprudent quoted on Nigeria stock exchange (Jaiz Bank) and that of conventional banks quoted on Nigeria stock exchange. Below are other aims to which the research intends to examine.

1. Examine the impact of liquidity on the financial performances of Islamic and conventional banks
2. Examine the effect of risk and solvency analysis on the financial performances of Islamic and conventional banks
3. Examine the efficiency of operation of Islamic and conventional banks

1.4 RESEARCH HYPOTHESES

In the light of the aforementioned specific objectives and statement of research problem, the following hypotheses are formulated in null form to guide the study:

$H0_1$: Liquidity has no significant impact on the financial performances of Islamic and conventional banks quoted on Nigeria stock exchange

$H0_2$: Risk and solvency analysis has no significant impact on the financial performances of Islamic and conventional banks quoted on Nigeria stock exchange

$H0_3$: Operational efficiency has no significant effect on the financial performances of Islamic and conventional banks quoted on Nigeria stock exchange

1.5 SIGNIFICANCE OF THE STUDY:

This research is significant to all stakeholders by providing clear picture of financial position of Islamic banking and conventional banking in Nigeria and to make comparison in order to identify which one has a better position. It also help government in policy making with regards to interest free banking in Nigeria and regulatory bodies which include, (CBN, *Nigeria* Deposit Insurance Corporation (NDIC) and Serve as a guidelines for the adequate supervision and regulation of interest free banking in Nigeria. Another importance of this research is to motivate the financial Institutions such as conventional banks that intend to operate in the interest free banking window.

Finally, this study aims at encouraging the emergence of more interest free organization so as to create avenue to those that wish to transact business on interest free basis.

1.6 SCOPE AND LIMITATION OF THE STUDY:

The scope of this research is centered on evaluating and comparing the performance of Islamic bank and conventional banks in Nigeria. Thus, the study evaluates and compares performances of the Islamic bank (JAIZ BANK) and conventional bank (GT BANK). The study covers a period of Five years (i.e. 2014 to 2018).

Financial performance is measured using profitability (ROA): liquidity is measured using current ratio: risk and solvency is measured using debt to equity ratio: while efficiency is measured using assets utilization ratio.

1.7 SCHEME OF CHAPTERS

The organization of the study is "A comparative analysis of performance of Islamic and Conventional Banks in Nigeria" is divided into five (5) chapters.

Chapter one is purely general introduction on the subject matter which contains' Background of the study, statement of the problem, research questions, objectives of the study, hypothesis of the study, significance of the study, scope and limitation of the study and scheme of chapters.

Chapter two is devoted to; reviewing the related literature on the topic by different scholars and researcher it discussion, the conceptual framework, comparison of Islamic and conventional banking framework, empirical framework, Islamic modes of finance, review of Islamic and conventional banking performance. theoretical framework. chapter summary.

Chapter three divided into: Introduction, population of the study, sampling size and technique, method of data collection, questionnaire, interview, chapter summary.

Chapter four is the study of data analyze and presentation of data and the chapter summary.

Chapter five consists of summary, conclusion and recommendation.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter is designed to provide logical and critical review of relevant literature on the subject matter. The chapter is segmented into three parts: conceptual framework, empirical literature, and theoretical framework. The specifically chapter dwell on development of conventional bank, development of Islamic bank, comparison of conventional and Islamic banks and concept of financial performance and empirical studies on comparison of conventional and Islamic banks as well as the theoretical framework relating to same.

2.2 CONCEPTUAL FRAMEWORK

Throughout the initial readings and collection of the most relevant materials, the researcher found that previous contextual studies concerning performances of Islamic and conventional bank, a number of empirical studies of the profitable business of Islamic banks in different countries. The performance of the Islamic banks and conventional bank has been judged by using different key ratios like profitability ratios, liquidity ratios, risk and solvency ratios. Sarker (2009); Samad and Hassan (2012). For example, Iqbal (2015) made trend analysis to depict the overall performance of the Islamic banks as compared to the conventional banks. According to him, Islamic banks in general are fairly stable, profitable and well capitalized. Their profitability ratios compare favorably with international standards in banking. Samad and Hassan (2012) evaluated the performance of Islamic bank in Nigeria in terms of its profitability, liquidity, risk and solvency. Financial ratios were applied to measure these performances. A comparison between the Islamic bank and other conventional banks was also made. The study revealed that Islamic bank made significant progress on return on assets and return on equity during 2011-2018.

The comparison of Islamic bank and conventional banks revealed that there was difference in economic participation between them. Adegbemi and Adekola (2013) evaluated the performance of conventional and Islamic banks in United Kingdom for the period of 2007 and 2011 in term of liquidity, profitability, risk and solvency and efficiency .They concluded that Islamic banks seem more cost-effective. The Islamic banks are less liquid in comparison with the conventional banks in terms of the loan to deposit ratio. On the other hand, the conventional banks are less liquid using the cash & portfolio investment to deposit ratio. The greater ratio of loan to asset ratio of the Islamic banks indicates greater illiquidity. The efficiency ratios performances of both bank types were epileptic during the research period. It is crucial for the banks to consistently improve on this score in order to translate their performances to improved profitability. Conventional financial institutions also eager to expand their service offerings have devised new innovative financial products channeled to customers who want to execute financial transactions based on their religious beliefs (Kevin 2009). All above studies were conducted to analyze the performance of Islamic and conventional banks but do not have same result because of differences in selected time, logical tools and conducted in different countries. The difference in results is not surprising due to the fact that Islamic banking has longer history in these countries as compared to Nigeria where full-fledged Islamic banking have not even started but just as a regional bank few years back.

In response to requests by banks and investors to establish Islamic banks or windows in Nigeria and in line with its statutory responsibilities, the CBN issued a new framework for the regulation and supervision of non-interest banks in June 2011. The new guidelines are the outcome of the review of the earlier guidelines issued in January, 2011 based on the recommendations of various stakeholders. The issuance of the Framework was the culmination of an extensive and rigorous learning and consultative process. The document has drawn on relevant standards set by international standard setting organizations like the

Council of the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), and has leveraged copiously on the regulatory practices of jurisdictions such as Malaysia and Bahrain that operate dual banking systems, conventional and Islamic. The objective of the framework is to provide minimum standards for the operation of institutions offering Islamic banking and financial services in Nigeria. The framework defines a non-interest financial institution (NIFI) as "a bank or other financial institution (OFI) under the purview of the Central Bank of Nigeria (CBN), which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services based on an established non-interest principle". For the avoidance of doubt, section 23 (1) and section 66 of the Banks and Other Financial Institutions Act (BOFIA) 1991, (as amended) explicitly provide for the licensing of Non-Interest Banks (NIBs). The CBN is obliged, by law, to issue licenses to appropriate entities for the establishment of NIBs provided they meet the regulatory requirements for licenses (CBN, 2011). The framework also sets out the legal basis for authorizing NIFIs in Nigeria and the licensing requirements. It also contains provisions and offers guidance on the establishment of windows, branches and/or subsidiaries; cross-selling of products/services and shared facilities; the execution of service level agreements in respect of shared services; intra-group transactions and exposures; Shariah governance, corporate governance; conduct of business standards; profit sharing investment accounts; audit, accounting and disclosure requirements; prudential requirements; risk management; and anti-money laundering and combating of the financing of terrorism measures, among others.

Haron (2014) examined the internal and external factors which influence the profitability of the Islamic banks. Haron (2014) found a strong correlation between the internal factors (of liquidity, the total spending, funds invested in Islamic titles, the percentage of the ratio of division (sharing) of the profits between the bank and the borrower of fund and the level of the total income perceived by the Islamic banks. The author found

more or less the same impacts on the external factors such as the size of the bank, the interest rates and the part of the market.

Izhar and Asutay (2017) concluded that the activities of financing were the source of the ways of the Bank Muamalat Indonésia (BMI) profit-seeking, whereas the service activities of the contribution to the profitability of the studied bank were not significant. The document of the authors revealed that the short-term financing was based on the average activities of financing during period 1996-2001. Izhar and Asutay (2017) confirmed a positive relation between the inflation and the measure of the profitability. Sraïri (2009) worked a sample of Islamic and conventional banks in the countries of the Gulf cooperation council (GCC) during the period from 1999 till 2006 to test the impact of the financier.

The structure, the characteristics of the bank and the macroeconomic indicators on the profitability of both modes of banks were discussed by Sraïri (2013) which noticed that the smugness of the capital, the credit risk and the operating efficiency had an effect on the profitability of both conventional and Islamic banks. However, the ratio of risk and financial liquidity has a positive effect on the alone "profitability" the Islamic banks". (Idris 2011) tried to estimate the determiners of the profitability of the Islamic banks in Malaysia.

2.3 DEVELOPMENT OF CONVENTIONAL BANKS

The first precursors of banks can be traced back to ancient times (the Middle East, Greece, Rome), with the emergence of exchange of goods in the areas rich in natural resources. In the period from 3400 to 3200 BC in the Middle East, the appearance of banks was related to religious beliefs, thus the temples were bank founders. After Hammurabi's Code on the Banks from 2500 BC, the banking changes from a religious to a commercial activity, it is taken out of the temples and the real banking industry begins. Still, the banks as we know them develop only with the emergence of money. The first beginnings of banking similar to modern conventional banking were seen in Italy, in the region of Lombardy, while Casa di San Giorgio in Genoa is considered the first bank and was established in 1407.

Interestingly, following the development of banks in Italy in the 15th century, Benedikt Kotruljević from Dubrovnik, in his book "On Trade and the Perfect Merchant" from 1458 (published in Venice in 1573), besides trading, merchants, market, monetary and commercial ethics, writes about banking instruments, credit loans and interest rates (Cerović 2012). In his book, Kotruljević describes bankers as merchants rather than moneylenders, because according to him, loans were considered support for which commission was paid, not interest, and if there is no interest, there is no usury. The development of banking through history was largely influenced by the growing human needs in the fields of production and trade. The increasing concentration of capital in production and trade resulted in an increasing concentration of capital in banking. Various economic and political conditions led to new processes in banking as we know it today, so the period between the 19th century and the 1st World War is characterized by the process of concentration of banks. The period between the 1st and the 2nd World War is characterized by bank specialization, whereas the development of modern banking is seen through the process of globalization. According to Nikolić and Pečarić (2007) this globalization process initiated de-specialization of banking operations whose goal is to create a bank as a universal financial institution which offers all services. The de-specialization process is a precondition for their survival in the globalized financial market and a way to fight off stiff competition from non-bank institutions.

Commercial banking activities started in 1892 with establishment of the African banking corporation ledger depositor and co. a shipping company based in Liverpool was instrumental in its formation. The bank was however taken over in 1984 by the bank of the British West African which later became standard bank and now first bank of Nigeria plc with the bank on observation.

The next was Barclays bank and company (now Union Bank of Nigeria plc) was established in 1917, these banks were set up to provide banking services for the British commercial interest and the colonial administration in West African when the west African

currency board (Gyasi Central Bank) was set up in 1912, the bank of British became the agent of the currency board.

The National Bank of Nigeria came into existence in1933 as the first indigenous bank that was to survive other banks that were established before that time including the merchant banks, failed as a result of inadequate capital, fraudulent practices and poor management.

After the second world was, economic activities and with high export prices, many banks grow up in the Nigeria economy between 1945 and 1947, four other indigenous bank, African Continental Bank (ACB) Agbenmagbe, Nigeria farmers and commerce bank were established but only two were able to survive the African Continental Banks and Agbenmagbe Bank (Now Wema Bank.

The period (1945-1952) was a period of free for all bankers. In the period (1905-1975) alone 18 banks were established but by 1975 most of them had gone to liquidation or close down by the police or never started business at all. A lot of factor lead to the fall of these banks must had insufficient capital, most expanded their offices too rapidly to cover trading and these were no banking regulations to specify the code of conduct.

2.3.1 DEVELOPMENT OF ISLAMIC BANKS

The establishment of the first interest-free bank in Egypt in 1963 is considered the official beginning of Islamic banking (Ahmad, 2014) and (Hadžić, 2005). In 1974, the Organization of Islamic Countries (OIC) founded an IB called Islamic Development Bank (IDB), whose goal was to promote economic development in Muslim countries and providing the funds for the development in accordance with the rules of Sharia. By the end of 1970s, several banking systems were founded in the Muslim world; first private commercial bank in Dubai in 1975, in Sudan (Faisal Islamic Bank of Sudan) in 1977 and in Bahrain (Bahrain Islamic bank) in 1979 (Institute of Islamic Banking and Insurance, The Islamic Banker). In the early stages of growth of the Islamic financial market in the 1980s, IBs were faced with the lack of quality investment opportunities, which enabled CBs from the West to become

mediators in utilizing the funds of IBs. Therefore, Western banks helped IBs to direct the funds in business and trade-related activities, by agreeing that a merchant buys goods on behalf of an IB and sells them at an interest rate margin. Western banks noticed the significance of Islamic financial markets and started to offer Islamic financial products through so called Islamic windows, attracting the clients directly, without IBs' mediation.

Although Islamic finance assets still represent less than 1 percent of global financial assets, and growth slowed somewhat in 2017, the global Islamic asset base grew from approximately US$200 billion in 2003 to an estimated US$2 trillion at the end of 2016. It is projected by some industry experts to surpass the US$3 trillion mark by 2020.

Islamic Finance industry is receiving the attention of most promoters in Nigeria. Mentioning that the evolution of modern Islamic Banking in the country is dated back to 1991 with the enactment of the banks and other financial institutions decree, which organized banks based on profit and loss sharing. Investors started applying for banking license to operate Islamic Banks between 1993 to 1995, but until 1996 that Habib Bank Plc was licensed to open a non-interest banking window, offering a limited number of shari'ah compliant product. By 2004, demands for the establishment of full-fledged non-interest banks continued from interested investors, whereby an Approval-in-practice (AIP) was granted to Jaiz International Plc. Concerning regulations of the system. several steps and processes as well as co-ordinations locally and internationally were made by the CBN, and by January 2011, the CBN released a framework for the regulation and supervision of non-interest banking as well as other guidelines. He remarked that for the effective regulation of Islamic banks in the country the framework in place should provide for monitoring controls, Shari'ah compliance, adequacy reporting, window operations investment account holders and customer disclosure to ensure that institution know their customers to prevent money laundering.

2.4 COMPARISON OF ISLAMIC AND CONVENTIONAL BANKING FRAMEWORK

Conventional banking utilizes a combination of debt and equity in financing projects. A fixed percentage of interest is expected from the debt finance. The Islamic banking system which is based on the tenets of Islamic law (Shari'a) prescribes equity participation in investment. A distinctive feature of Islamic finance is that it does not allow the creation of debt through direct lending and borrowing of money or other financial assets. Debts can only be created through the sale or lease of real assets through lease based financing schemes. The asset which is leased or sold must be real (building, property, or any other physical infrastructure) and the debt cannot be sold or transferred to someone else (Ryu et al., 2012). The broad objective of Islamic banking is to do away with unethical practices prohibited in the Islam. The Islamic system prohibits investment in the followings: alcohol, tobacco and pork related products, entertainment (hotels, gambling, cinemas, music, weapon and defense, conventional financial activities, biotechnology (human and animal genetic engineering) and trading of gold on deferred basis. This reduces the scope of investment of the Islamic banks.

According to Jill et al., (2009), growth in the Islamic banking sector has been ignited by the introduction of innovative products aimed at satisfying its customers. The Islamic bonds (Sukuk) introduced in 1978 provided access to the capital markets. The launch of the Islamic equity funds and the Shari'a- compliant life and general insurance (Takaful) introduced in the late 1990s also gave fillip to the development of the Islamic financial system. The 21st century brought about the inclusion of Islamic indexes in major stock exchanges (FTSE, Dow Jones, and Standard & Poor). The retail product offerings of Islamic system include Murabaha (cost plus sales) Under this method of sales, the buyer of the object is aware of the price in which the seller purchased the object that is to be financed; the buyer pays a percentage in addition to the original price of the object. The Musharaka is the joint venture partnership. Mudaraba is a special kind of partnership where one partner gives money

to another for investing it in a commercial enterprise. The sharing of profit and losses is based on rules that are in accordance with Shari'a. The Salam and Istisna (Islamic Forwards) forms of finance are rarely used in Islamic banking, as it is forbidden under Islamic law to sell objects that do not exist, although they help aid with specific types of business. Under Murabaha, the seller (i.e. the Islamic bank), must possess ownership of the object, as at the time in which the buyer agrees to buy it (Jeroen, 2005). Exceptions given in Islamic banking under these two contracts account for many Islamic mortgages (Jeroen, 2005). Sukuk Issues and Takaful (Islamic Insurance) constitute the bulk of Shari'a compliant investment offerings of Islamic banks (The City UK, 2011). The conventional banks provide an array of retail products which include Term Deposit which is a deposit with a precise maturity date. Mortgage is an advance collected from the bank for the purchase of a property. The money borrowed is paid back with interest over an agreed period of time and secured against the property. In the event of default, the bank sells the property in order to retrieve the outstanding sums (The Money Advice Services, 2011). The Savings Account is devised for pooling medium to long-term capital. The customer is free to withdraw and deposit money from and into the account. Cash is easily accessible from the savings accounts. Current accounts allow customers to transfer and distribute money to each other; it allows the access to cheques book and overdraft facility. Several investment products are also offered including the guarantee of the sale of stock and bond issues, investment management and advisory services to corporations on capital market activities such as mergers and acquisitions. Under conventional banking, money is traded presently against money in the future. Institutions that participate in conventional credit markets are involved in large speculative transactions, which usually turn to a considerable source of instability. These international capital flows may endanger the world economy resulting in wide spread contagion effect on other markets from a single debt market. (Salman and Ausaf, 2004). Under Islamic banking on the other hand, debt by its self cannot be traded except through the credit sale of goods and services.

The value of the debt is determined by the equilibrium mark-up rate, which is derived from the demand and supply of goods and services on credit. Under this credit market, the possibility of large and sudden movements of debt is limited, therefore the possibility of economic wide spread instability is restricted. Institutions that participate in Islamic credit markets are not allowed to carry out speculative activities such as gambling activities that Islamic financial markets help reduce activities that endanger the economy (Salman and Ausaf, 2004).

2.5 ISLAMIC MODES OF FINANCE

Islamic finance is a financial system that is based on adherence to the sharia or Islamic law. It offers services, products and instruments based on compliance to this divine law.

Sharia prohibits the payment or acceptance of interest charges (Riba) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles. Money in Islam is not regarded as an asset from which it is ethically permissible to earn a direct return. Money tends to be viewed purely as a medium of exchange. Interest can lead to injustice and exploitation in society. There are several modes of finance in Islam they include the following;

2.5.1 **MURABAHA**: Literally, it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and profit. Islamic banks have adopted this as a mode of financing. As a financial technique, it involves a request by the client to the bank to purchase certain goods for him. The bank does that for a definite profit over the cost.

2.5.2 **IJARA**: Is a contract of a known and proposed usufruct against a specified lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended. In other words, Ijara or leasing is the

transfer of usufruct for a consideration which is rent in case of hiring of assets or things and wage in case of hiring of persons.

2.5.3 **IJARA WA IGTINA:** A contract under which an Islamic bank finances equipment, building or other assets to the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease.

2.5.4 **ISTISNA'A:** It is a contractual agreement for manufacturing goods and commodities allowing cash payment in advance and future delivery. A manufacturer or builder aggresses to produce.

2.5.5 **MUDARABAH:** a form of partnership where one party provides the funds while the other provides expertise and management. The latter is refereed to as the mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital

2.5.6 **MUSHARAKAH:** Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds, which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contribution.

2.5.7 **BAI AL-SALAM:** This term refers to advance payment for goods which are to be delivered later. Normally, no sale can be effected unless the goods are in existence at the time of the bargain. But this type of sale forms an exception to the general rule

provided the goods are defined and the date of delivery is fixed. The objects of this type of sale are mainly tangible things but exclude gold or silver as these are regarded as monetary values. Barring these, Bai Salam covers almost all things which are capable of being definitely described as to quantity, quality and workmanship. One of the conditions of this type of contract is advance payment; the parties cannot reserve their option of rescinding it but the option of revoking it on account of a defect in the subject matter is allowed. It is also applied to a mode of financing adopted by Islamic banks. It is usually applied in the agricultural sector where the bank advances money for various inputs to receive a share in the crop, which the bank sells in the market. This kind of sale (salam) also used nowadays as a mode of financing that is also called 'Parallel Salam'.

2.6 REVIEW OF ISLAMIC AND CONVENTIONAL BANKING PERFORMANCE

Islamic banks which tend to be generally smaller than conventional banks are likely to be less efficient since technical efficiency tends to increase with the size of a firm in the banking industry (Bhattacharyya, 2012). The investigation by Johnes, (2012) compare the performance of Islamic and conventional banks prior to, during and immediately after the 2008 financial crisis (2004-2009) using data envelopment analysis (DEA) and found no significant difference in mean efficiency between conventional and Islamic banks when efficiency is measured relative to a common frontier. However, the result of the use of the Meta-Frontier analysis (MFA) suggests that the Islamic banking system is less efficient than the conventional one. Siraj and Sudarsan (2012) investigate the presence, if any, of similarity in the growth of chosen performance indicators of conventional banks and Islamic banks in the Gulf cooperation council (GCC) region. The study selected six Islamic banks and six conventional banks using financial ratio analysis. The analysis revealed that Islamic banks are more equity financed than conventional banks. Conventional banks registered growth in revenue during the period, but could not achieve improved profitability on account of higher

provisions towards credit losses and impairment losses. The results of the study conducted by Ryu et al. (2012) show that the Islamic financial system is less risky and more profitable than the conventional financial system. In practice, Waseem, 2008 submits that its costs of funding are almost the same as those of conventional banks since interest rates in lieu of administrative costs and share of profit are also as relevant to Islamic banks as they are to conventional banks.

The effects of the global crisis on Islamic and Conventional banks was the comparative study conducted by Hasan and Dridi (2010) which examined the impact of the financial turbulence on their profitability, credit and asset growth. They report that the style of debt creation feature of Islamic banking business model helped limit the adverse impact on profitability. In fact, Islamic banks' credit and asset growth performed better than those of conventional banks between 2008 and 2009. However, Jill et al., (2009) contend that there are no fundamental differences between the Islamic and conventional financial systems. The disparities are only operational since both systems are geared towards the provision of services to their customers following the rules and regulations of whatever state they operate in like the Financial Services Authority (FSA) in the UK.

2.7 REVIEW OF EMPIRICAL STUDIES ON ISLAMIC AND CONVENTIONAL BANKING

A number of empirical studies use conducted on the profitability of Islamic banking business in different countries. The performance of Islamic banks have been judged by using different key ratios like profitability ratios, liquidity ratios, risk and solvency ratios (Samad and Hassan, 2012). For example, Iqbal (2011) made trend analysis to depict the overall performance of the Islamic banks as compared to the conventional banks. According to him, Islamic banks in general are fairly stable, profitable and well capitalized. Their profitability ratios compare favorably with international standards in banking.

Hassan and Dridi (2010) examined the performance of Islamic banks and conventional banks during the recent global crisis by looking at the impact of the crisis on profitability, credit and asset growth, and external ratings in a group of countries where the two types of banks have significant market share. Their analysis suggested that Islamic Banks were affected differently unlike the Conventional Banks. Factors related to Islamic Banks' business model helped limit the adverse impact on profitability in 2008. Their credit and asset growth performed better thus, contributing to financial and economic stability than those of Conventional Banks in 2008–2009. External rating agencies' re-assessment of Islamic Banks' risk was generally more favorable.

Samad and Hassan (2012) evaluated the performance of Islamic banks in Malaysia in terms of its profitability, liquidity, risk and solvency. Financial ratios were applied to measure these performances. A comparison between the Islamic banks and eight other conventional banks was also made. The study revealed that Islamic banks made significant progress on return on assets and return on equity during 1984-1997. By far the most impressive argument in favour of Islamic finance has been that it integrates the financial sector with the real sector. The debt propelled conventional system fails to do so. In the Islamic financial system there is an existing or potential real asset corresponding to every financial asset. Not so in the conventional system in which financial assets based on or derived from other debt based financial assets go on multiplying, making the system more vulnerable to speculation leading to instability. Instability originating in the financial sector spreads to the real sector affecting balance of payments, employment, production and living standards. Another great argument in favour of Islamic finance is its possible contribution to stability (Siddiqi, 2013). It was shown that a financial system based on profit sharing will be more stable than one dominated by debts. This was an addition to the earlier argument in favour of an interest-free system based on profit-sharing that focused on justice and fairness, one that had more resonance in a world experiencing great instability(Abdul Gafoor, 2011).

Al-Gazzar (2014) also studied financial performance of Islamic versus conventional banks in the MENA & GCC region between the period 2009-2013, the study used the CAMEL framework of the measuring bank-specific performance; he also tested the financial performance of the top listed banks on external macroeconomics variables using GDP as a measurement proxy. The study tested the differences in performance using one-way ANOVA, regression analysis was also used to examine the major determinants of profitability of banks in region, findings revealed that Islamic banks outperformed conventional banks in terms of capital adequacy, asset quality, management quality and earnings quality, although they had a weaker liquidity position in comparison to conventional banks. There was also a significant statistical differences that existed between Islamic and conventional banks in terms of capital adequacy, management quality and asset quality

Jaffar and Manarvi (2011) collate and examined performance on conventional and Islamic banks functioning in Pakistan by using CAMEL test during 2005-09. Five banks from each sector were chosen to compare and measure their performance. Various ratios were employed to estimate every factor of CAMEL. Study concluded as Islamic banks acted better in holding appropriate capital and superior liquidity whereas conventional banks pioneered in earning ability and management quality. Asset attribute towards both types of banking was nearly the same while conventional banks registered slightly small debt loss ratio due to enhanced debt recovery policy.

Akhter, Raza, and Akram (2011) construed the performance & efficiency of Islamic banking with private & public banks in Pakistan. They used nine financial ratios under liquidity risk, profitability and credit risk while 2006-10 financial year statements were taken from banks. To check the trends of income statements and balance sheets used Trend analysis tool in their study. The paper concluded there is not much difference seen amid Islamic & conventional banking in respect of profitability. The balance sheet trend analysis of Islamic bank showed good trend and there is no difference in trend analysis of income statement.

Wasiuzzaman and Gunasegavan (2013) investigated the performance of Islamic and conventional banks in Malaysia and found that board size, ROA and bank size of Islamic banks are comparable with conventional banks. The results also found that capital adequacy, asset quality, liquidity and operational efficiency were better for Islamic banks.

Usman and Khan (2012) regarding Islamic and conventional banks in Pakistan for the year 2007 to 2009 concluded that growth and profitability of Islamic banks is higher as compared to conventional banks. Also Islamic banks have higher liquidity as compared to conventional banks. Another similar study carried out by Mughal (2015) in Pakistani context for the years 2010-2014 evidenced that profitability of conventional banks is higher than Islamic banks.

Manarvi (2014) evaluated the performance of Islamic and conventional banks of Pakistan through CAMEL test during the period of 2005 to 2009 and revealed that Islamic banks performed better and having high liquidity than the conventional banks.

Ansari and Rehman (2015) compare five Islamic and five conventional banks in order to analyse their financial performance during 2005 and 2009. For this purpose, the study uses return on assets (ROA) as a proxy and it is measured with other explanatory variables to measure the financial performance of banking industry. Descriptive statistics, correlation matrix and *F*-value are used to examine the impact of explanatory variables. The results of financial comparisons of Islamic and conventional banks are consistent with the previous studies like Sehrish (2016) compared the financial performance of Islamic and conventional banks in Pakistan from 2007 to 2011. The study has selected six financial ratios in order to make a comparison between the two banking systems. The results show that Islamic banks are less risky in terms of dealing in loans and less efficient in expense management as compared with the conventional banks. This is owing to the problem that lies with the operating expenses of Islamic banks. Despite the increase in revenues during 2007 to 2011, the expenses to generate these revenues were much greater which has put a barrier to Islamic

banks' efficiency. Nevertheless, no significant difference has been found in the profitability of both the banking sectors.

Amjad (2013) investigate the performance of Islamic and conventional banks in Pakistan. This study has selected four Islamic and conventional banks and thirteen financial ratios were estimated to measure these performances in terms of profitability, liquidity, risk and solvency, as well as capital adequacy. The data were extracted from annual reports and financial statements for the period of 2008 to 2011. To test the significance of mean differences of these ratios, independent sample *t*-test and ANOVA were used between and among banks. The study has concluded that Islamic banks have proven to be more liquid, less risky and operationally efficient than conventional banks.

2.8 CONCEPT OF FINANCIAL PERFORMANCE

Financial analysis is structural and logical way to present overall financial performance of a financial institution. It's also help to evaluate and decision making for business operation. In financial analysis process ratio analysis is the most dominant and logical structure to help business related stakeholder. Under the financial ratio analysis process there are few categories to identical area if financial institution. So business stakeholders try to concentrate to get overall business overview from profitability, liquidity, asset management and solvency ratio analysis. These ratios not only help to decision making process also emphasized on risk avoiding and profit raising related factors. To calculate this ratio need to take quantitative data from bank trading activity and other sources. The rations can be classified into dependent and independent variables.

Many indexes provided to measure the bank's performance by financial management theories. To use the ratios is one of them. In literature the use of financial ratios is quite common and extensive. Samad and Hassan (2000) also stated that banks regulators also used

financial ratios to evaluate banks performance. There are many evidences found that favors the use of financial ratio for appraising banks performance. (Saleh & Zeitun, 2006)

2.8.1 PROFITABILITY RATIOS:

Generally, accounting profits are the difference between revenues and costs. Profitability is considered to be the most difficult attributes of a firm to conceptualize and to measure (Ross, Westerfield, and Jaffe 2005). The financial ratios are used to assess the ability of the business to generate earnings in comparison with its all expenses and other relevant costs during a specific time period. Profitability ratios are generally considered to be the basic bank financial ratio in order to evaluate how well bank is performing in terms of profit. For the most part, if a profitability ratio is relatively higher as compared to the competitor(s), industry averages, guidelines, or previous years' same ratios, then it is taken as indicator of better performance of the bank. Study applies these criteria to judge the profitability of the two banks;

(a) Return on assets (ROA) ROA = net of profit after tax/total assets,

(b) Return on Equity (ROE) ROE = net of profit after tax/shareholders' equity.

(c) Profit to Expenses Ratio (PER) PER= Profit before tax/operating expense

In order to know how the bank is performing relevant to profitability, below stated ratios are regarded as primary bank ratio.

Return on Assets (ROA)

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

It ascertains that as much is firm's earning after tax for each dollar it invest in assets of firm/bank. Thus it is the given assets per unit net earnings. If a firm has higher (ROA) ratio then it indicates efficient utilization of assets and better managerial performance.

Return on Equity (ROE)

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

Return on Equity (ROE) is the indication of the profitability belong to shareholders of firm after taking into account all expenses & taxes (Van Horne & Wachowicz, 2008). If a firm has higher (ROE) then it consider being preferable managerial accomplishment.

Profit Expense Ratio (PER)

$$= \frac{\text{Profit before Tax}}{\text{Operating Expenses}}$$

It is evident from the formula that it is the indication of the operating profitability of firm as compares to total operating expenses. Samad and Hassan (2012) asserted that higher (PER) for a bank indicates that bank is efficient with regard to its cost while making higher profits.

2.8.2 LIQUIDITY RATIOS:

Liquidity ratios indicate the ability of the firm to meet recurring financial obligations. Liquidity is important for the firm to avoid defaulting on its financial obligations and, thus, to avoid experiencing financial distress (Ross, Westerfield, Jaffe 2005). In general sense, the higher liquidity ratios mean bank has larger margin of safety and ability to cover its short term obligations. Because saving accounts and transaction deposits can be withdrawn at any time, there is high liquidity risk for both the banks and other depository institutions. Banks can get into liquidity problem especially when withdrawals exceed new deposit significantly over a short period of time (Samad & Hassan 2000). Measures of liquidity are:

(a) Loan to Deposit Ratio (LDR).LDR= loan /deposits.

(b) Cash & Portfolio Investment to Deposit Ratio(CPIDR). CPIDR = Cash and portfolio investment/deposits.

(c) Loan to Asset Ratio (LAR). LAR = Loan / Total Assets Ratio.

Loan to Deposit Ratio (LDR)

$$= \frac{\text{Loan}}{\text{Deposit}}$$

Here in this study a loan is taken as advances in case of conventional banks and financing in case of Islamic banks. Because Islamic banks can't extend loans and earn (interest) Riba. Islamic banks are while conducting their banking operations also bound to follow shariah's principles. Thus Islamic banks can invest their deposit pool in only one way by offering different Islamic products. Banks considered being less risk, low profits and excessive liquidity with lower (LDR) as compared to bank with high (LDR). If a bank has high (LDR) then it is an indication that bank is taking financial stress due to its excessive loans and in future may have to sell loans at loss to meet depositor's claims.

Loan to Asset Ratio (LAR)

$$= \frac{\text{Loan}}{\text{Total Asset}}$$

In this ratio the liquidity condition of the bank is taken into account in terms of total assets. So it estimates the investment in loans (financing) with regards to percentage of total asset of the bank. The liquidity of the bank will be low if the liquidity ratio is higher. So the bank is deemed to highly liquid with low (LAR) collate to bank of higher (LAR). It means that there will be indication of high profitability with higher (LAR) and more risky.

Cash and portfolio investment to deposit ratio (CPID)

$$= \frac{\text{Cash and Portfolio Investment}}{\text{Deposit}}$$

Cash & Portfolio Investment to Deposit (CPID) is another ratio to measure liquidity of the bank. The customers (depositors) show more confidence and trust if a bank have

higher ratio because it indicate better liquidity condition of bank as contrast to bank of lower (CPIDR).

2.8.3 RISK AND SOLVENCY RATIOS:

This is a class of ratios that measures the risk and solvency of the firm. These ratios are also referred to as gearing, debt or financial leverage ratios. These ratios determine the probability that the firm default on its debt contacts. The more the debt a firm has the higher is the chance that firm will become unable to fulfill its contractual obligations. In other words, higher levels of debt can lead to higher probability of bankruptcy and financial distress. Although, debt is an important form of financing that provided significant tax advantage, it may create conflict of interest between the creditors and the shareholders (Ross, Wedsterfield, and Jaffe 2005). If the amount of assets is greater than amount of its all types of liabilities, the bank is considered to be solvent.

"Deposits" constitute major liability for any type of bank whether Islamic or conventional. To gauge risk and solvency of the bank, measures usually used are:

(a) Debt-Equity Ratio (DER). DER = total debt /shareholders 'equity.

(b) Debt to Total Assets Ratio (DTAR). DTAR = Total /total assets.

(c) Equity Multiplier (EM). EM = total asset/shareholder equity

As it is clear from the name these ratios belong to risk and solvency measure of the firm. Financial leverage or debts, gearing ratios are other names of risk and solvency ratios. To measure risk & solvency ratios of bank following usually are used.

Debt to Equity Ratio (DER)

$$= \frac{\text{Total debt}}{\text{Shareholder Equity}}$$

As it is clear from the above formula which is used by the financial institutions and it measure the extent of the debt use by the firm. It is also use to check the ability of the

capital of a bank to show the capability to absorb financial shocks. In situation where the asset value decrease or might creditors default then comes the bank capital which provide the shield against any loan losses.

Debt to Total Asset Ratio (DTAR)

$$= \frac{\text{Total Debt}}{\text{Total Asset}}$$

The above formula shows that it measures the total asset finance by the firm by using the amount of total debts. If a firm has higher (DTAR) means that bank as compared to equity financing has financed its most assets through debt and higher (DTAR) ratio is also an indication that bank has involved in more risky business.

Equity Multiplier (EM)

$$= \frac{\text{Total Asset}}{\text{Total Shareholder Equity}}$$

The above formula shows that equity multiplier measure that as much time total asset are of shareholder equity. Generally it is considered that if value of the (EM) is big than it is greater risk for a bank.

2.8.4 EFFICIENCY RATIOS:

These ratios measure how effectively and efficiently the firm is managing and controlling its assets. These ratios indicate the overall effectiveness of the firm in utilizing its assets to generate sales, quality of receivables and how successful the firm is in its collections, the promptness of payment to suppliers by the firm, effectiveness of the inventory management practices, and efficiency of firm in controlling its expenses. Higher value of these ratios is taken as good indicator which means firm is doing well. Ratios used to measure efficiency of the bank are:

(a) Asset Utilization (AU). AU = total revenue /total assets.

(b) Income Expense Ratio (IER) Income to expense is the ratio that measures amount of income earned per dollar of operating expense. IER =total income/total operating expenses Operating Efficiency (OE) is the ratio that measures the amount of operating expense per dollar of operating revenue. It measures managerial efficiency in generating operating revenues and controlling its operating expenses. OE = Total Operating Expenses/Total Operating Revenue.

This ratio gives us an idea that how efficiently and effectively a firm controlling and managing assets. If these ratios have higher values then it is taken as good indication in other words the firm is managing well. Following ratios are used for measuring the efficiency of banks.

Asset Utilization (AU)

$$= \frac{\text{Total Revenue}}{\text{Total Asset}}$$

The ratios indicate clearly from the above formula that how the firm is utilizing its all assets. If (AU) is ratio is high then bank is said to generate total revenues by effectively using its assets. Ross et al. (2005) concluded that the bank is said to be not using effectively it's to their full capacity if the (AU) indicate lower value.

Income to Expense Ratio (IER)

$$= \frac{\text{Total Income}}{\text{Total Operating Expenses}}$$

Ratio indicates that amount of income a firm earned per dollar of operating expenses. If a firm has higher (IER) ratio then it denotes the efficiency and ability of firm in creating more income when compared to its operating expenses.

Operating Efficiency

$$= \frac{\text{Total Operating Expenses}}{\text{Total Operating Revenue}}$$

The above ratio indicates amount of operating expense per dollar of operating revenue. In other way it tells how bank is efficient in its operations. If a firm has lower (OE) then it is preferred over the high because it denotes that operating expenses is less than operating revenues.

2.9 THEORETICAL FRAMEWORK

This study is underpinned by the following theories: Butter capital adequacy theory, liquidity-profitability trade-off theory and theory of change.

2.9.1 Butter Capital Adequacy Theory

The theory was propounded by Calem and Rob (1996). The theory expounded that capital adequacy ratio constrains the profitability of banks and that banks may prefer to hold a "buffer of excess capital to reduce the profitability of failure under the legal capital requirements, especially if banks capital adequacy ratio is very volatile. According to Olatunde (2015), the theory postulated that poorly capitalized banks might be tempted to take more risk in the hope that higher expected returns will help them increase their capital while the aggressive banks may try to extend the frontiers of "Imprudent management policy" by operating with less capital base. The relevance of the theory of butter capital adequacy to this study is seen in the fact that banks in the aim of creating loans and making profits is exposed to risks which can cause financial instability.

2.9.2 Liquidity Profitability Trade-off Theory

The liquidity-profitability trade-off theory is another theory that underpinned this study. The theory postulated that a trade-off exists between the liquidity and the profitability of banks, and that a firm cannot pursue the two objectives of being profitable and being liquid at the same time without automatically affecting the other. Where banks aim for profits it causes a reduction in the banks liquidity, whereas, high liquidity affects banks profitability. Therefore, the theory presupposes that where liquidity coverage is constantly checked the stability and soundness of banks can easily be predetermined.

2.9.3 Theory of Change

The theory of change is another theory upon which this study is hosted. Heider (2016) in her study adopted the simple theory of change as a means of evaluation. She affirmed that adopting the theory of change in an evaluation will shed light on success and failure, and that by doing so better decisions are taken as regards to what should be replicated and what should be stopped or avoided. It facilities taking corrective actions and hence achieves better results.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 INTRODUCTION

Basically, this chapter is concerned with the methods used in collecting, analyzing and interpreting the data for the study. Specifically, it explains the research design, the population of the study, sample size and technique, source and method used in data collection, variables of the study and techniques used in data analysis.

3.2 RESEARCH DESIGN

A qualitative research design is used basically when there are few or no earlier studies to refer to or rely upon to predict an outcome; the focus of such study is to gain insights and familiarity in the area of research for further investigation. The research is a comparative study aimed at determining the significant difference in the financial performance of Islamic banking and conventional banks in Nigeria. Data relating to independent variable and dependent variable which include profitability, liquidity, risk and solvency and operational efficiency obtained from past financial statement of the selected banks.

3.3 POPULATION OF THE STUDY

The population of the study consists of all the 20 conventional banks and the only Islamic bank quoted on Nigerian Stock Exchange as at 31st December 2018.

Table 3.1 Population of the Study

S/N	Names of Companies
1	Access Bank
2	Citibank
3	Diamond Bank
4	Eco Bank
5	Fidelity Bank
6	First Bank
7.	First City Monument Bank (FCMB)
8.	Guaranty Trust Bank
9.	Heritage Bank
10.	Keystone Bank
11.	Polaris Bank
12.	Stanbic IBTC Bank
13.	Standard Chartered Bank
14.	Sterling Bank
15.	Unity Bank
16.	United Bank of African
17.	Union Bank
18.	Wema Bank
19.	Zenith Bank
20.	Jaiz Bank

Source: NSE web site (www. nse.com.ng)

3.4 SAMPLE SIZE AND SAMPLING TECHNIQUE

Sample size is the total number of elements of the population that are selected for closer study in a research. It means taking a potion from the total population as representative of the whole population so as to have a manageable size.

The purpose of the study, purposive sampling technique is used which give the researcher a handful opportunity to select from the population the data that will help him to explain a particular phenomenon base on the nature of the study. There are twenty-one banks in total operating as conventional banks in Nigeria as at 31th December 2018 that gives the study a wide and open range of conventional banks to form a group for the study. A raffle was conducted to have one out of the conventional banks and GT Bank came up because there is only one full fledge Islamic bank in Nigeria named Jaiz bank plc. One conventional bank (GTB) and one Islamic bank (JAIZ) form the sample size of the population.

3.5 Source and Method of Data Collection

The study used secondary information obtained from published annual audited accounts of the Two (2) selected banks. Data were extracted from the Nigerian Stock Exchange factbooks and the banks' websites. These data were manually extracted from the aforementioned sources for the research coverage period of 2014 to 2018. Secondary data was used to generate information for the purpose of this research.

3.6 Variables of the Study and their Measurement

The variables of this study are financial ratios and are categorized into depended and independent variables. Profitability as the dependent variable. And liquidity, risk and solvency, and operating efficiency as independent variable. The variables are represented by their proxies as follows: return on assets (ROA), liquidity (LIQ), risk and solvency (RISK) and operational efficiency (EFF) and measured by return on assets, current ratio, debt to

equity ratio and assets utilization. These variables are selected to compare the trends of two or more company over a period of time, and also to measure the financial health and weaknesses of both company.

3.6.1 Independent Variable

While there are numerous performance measures, three are selected for the purpose of this study because of their potential impact on the dependent variable. Each of this measures different information about the company. The variables are measured as follows:

i. Current ratio: This is measured as current assets to current liabilities ratio. Current assets/Current liabilities

ii. Risk and Solvency: This is measured as total debt to total shareholders' equity ratio. Total Debt/Shareholders equity

iii. Operational Efficiency: this is measured as total revenue to total assets ratio. Total Revenue /Total Assets

3.6.2 Dependent Variable

The dependent variable was profitability measured as net profit after tax to total assets PAT/Total assets.

3.7 Techniques of Data Analysis

For the purpose of data analysis, this research used descriptive statistics, correlation and multiple regressions to analyze the data. Descriptive Statistics is used by the researcher to describe a set of data, not for further analysis, but simply to provide concise information. Correlation shows the association between two or more variables such that systematic changes in the value of one variable are accompanied by systematic changes in the other, It shows how closely two variables co-vary from -1

(perfect negative correlation) through 0 (no correlation) to +1 (perfect positive correlation). In other words, it is a technique of determining the degree of association between two or more variables. The main objective of this method of determining correlation is to find out the extent to which to two sets of ranking are similar or dissimilar.

Multiple Regressions

This shows the relationship between selected value of x and observed value of y (from which the most probable value of y can be predicted for any value of x, the relationship is expressed as an equation that predicts a response variable from a function regressor and parameters. For the purpose of this study, the ordinary least square (OLS) regression technique was used to determine the relationship between the variables. The regression formula is as follows:

$$Y= a+b_1X_1+b_2X_2+b_3X_3$$

However, the regression model of this study is expressed as;

$$ROA=f(LIQ, RISK, EFF).....1$$

$$ROA=a+b_1LIQ_{it}+b_2RISK_{it}+b_3EFF_{it}+e_{it}.....2$$

Where:

ROAit = Return on assets for the banks in period t

LIQit = Current ratio for the banks in period t

RISKit = Total debt to Total Shareholders' equity ratio for the banks in period t

EFFit = Total revenue to Total assets ratio for the banks in period t

e = error term

a= constant

b_1, b_2, and b_3 = Coefficients of independent variables

CHAPTER FOUR
PRESENTATION AND ANALYSIS

4.1 INTRODUCTION

This chapter presents analysis and the interpretation of data generated for the study. The chapter is basically divided into three sub-sections apart from the introduction, the next section presents the discussion of results, while the last section present summary of the chapter.

4.2 DATA PRESENTATION

This section presents the analysis conducted on the data collected from the annual reports of both Islamic and conventional bank quoted on the Nigeria Stock Exchange for the period of the study (2014-2018). It presents the descriptive statistics, correlation and regression results of the study.

4.2.1 Descriptive Statistics Result.

This sub section provides descriptive statistics results of the data generated on the dependent and independent variables of the study. It provides the summary statistics of the data collected which include measures of central tendency, such as mean, and measures of dispersion (the spread of the distribution) such as the standard deviation, minimum and maximum of both the dependent and the independent variables. Thus, table 4.1 presents the descriptive statistics for the dependent variables (Return on asset) and independent variables (Liquidity, Risk and Solvency and operational efficiency) of the study.

Table 4.1: Descriptive Statistics of the Variables

Variables	Obs	Mean	Std. Dev.	Min	Max
ROA	10	0.030	0.022	0.005	0.062
LIQ	10	0.998	0.748	0.416	2.579
RISK	10	4.236	0.561	2.868	4.755
EFFCY	10	0.061	0.014	0.042	0.084

Source: Generated by the researcher from STATA 13.0 based on data in Appendix 1

From table 4.1 Return on asset for quoted banks shows a mean of 0.030 with a minimum return on asset of 0.005 and a maximum of 0.062. The standard deviation of 0.022 also shows a low variation in return on assets of quoted banks during the period of the study. The table also shows that, liquidity has a mean of 0.998, with a minimum liquidity of 0.416 and a maximum of 2.579. The standard deviation of 0.748 also shows a high variation in liquidity of quoted banks during the period of the study. Similarly, risk and solvency show a mean of 4.235, with a minimum of 2.868, and a maximum of 4.755. The standard deviation of 0.561 shows a high variation in risk and of quoted banks during the period of the study. Lastly, the operational efficiency shows a mean of 0.061 with a minimum of 0.042 and maximum of 0.084. the standard deviation of 0.014 shows a low valuation in operational efficiency of quoted banks during the period of the study.

4.2.2 CORRELATION RESULT

This sub sector presents the correlation analysis results of the independent variables and dependent variable: Table 4.2 presents the correlation table.

Table 4.2 Correlation Matrix of the Dependent and Independent Variables

	ROA	LIQ	RISK	EFFCY
ROA	1.000			
LIQ	0.656	1.000		
RISK	0.269	-0.054	1.000	
EFFCY	-0.671	0.039	-0.324	1.000

Source: Generated by the researcher from STATA 13.0 based on data in Appendix 1

Table 4.2 shows the results of the correlation analysis of return on asset and the independent variables. The result shows that there is perfect positive relationship between Return on Asset and Return on Asset (1.000) and a strong positive relationship between Return on Asset and Liquidity (i.e 0.656). Result also shows that there is a weak positive relationship between Return on Asset and Risk and Solvency (i.e 0.269). Also, there is a strong negative relationship between Return on Asset and operational efficiency (i.e -0.671).

Similarly, the result shows that there is perfect positive relationship between liquidity and liquidity (i.e 1.000) and a weak negative relationship between liquidity and risk and solvency (i.e -0.054). Result also shows that there is weak positive relationship between liquidity and operational efficiency (i.e 0.039)

Subsequently, the result also shows a perfect positive relationship between risk and solvency and risk and solvency (i.e 1.000) the result also shows that there is weak negative relationship between risk and solvency and operational efficiency (i.e -0.324).

Finally the result has revealed that there is a perfect positive relationship between operational efficiency and operational efficiency (i.e 1.000)

4.2.3 Multiple Regression Results

This sub-section presents regression analysis result that is utilized in examining the impact of the independent variables on the dependent variables that would help in testing the hypotheses. Thus, table 4.3 presents the regression result.

TABLE 4.3 REGRESSION RESULTS

ROA	Coef.	Std. Err	T	P>/t/
LIQ	0.020	0.003	6.10	0.001
RISK	-0.004	0.005	0.75	0.480
EFFCY	1.078	0.192	-5.62	0.001
Cons	0.061	0.027	2.28	0.063

Source: Generated by the researcher from STATA 13.0 based on data in Appendix 1

F (3, 6) = 24.31; Prob > F = 0.009

R-Squared = 0.9240; Adj R-Squared = 0.8860

Table 4.3 Present the regression result of Return on Asset and independent variables. From the table, the result shows that liquidity has a significant positive impact on Return on Asset with co-efficient value of 0.020 and P-value of 0.001. Result also shows that Risk and Solvency has an insignificant positive impact on Return on Asset with coefficient value of 0.004 and P-value of 0.480. Similarly, result shows that operational efficiency has significant positive impact on return on asset with coefficient value of (-1.078) and P-value of 0.001.

4.4 DISCUSSION OF FINDINGS

Interpretation of hypothesis one

The liquidity coverage means of Islamic and Conventional banks are 0.416 and 2.579 respectively. Conventional bank is 7 times higher than Islamic bank when proportionately applied. This therefore means that as liquidity coverage are continued to be provided,

conventional banks is going to be 7 times higher than Islamic bank. This findings is consistent with the findings of Mona (2013).

Decision

As shown in the table above there is a positive relationship (0.020) between Islamic and conventional banks. The P-value of 0.001 < 0.05, further suggested that there is a significant relationship between Islamic bank liquidity coverage measures and conventional deposit money banks liquidity measure. Hence, we therefore reject the null hypothesis.

Interpretation of hypothesis two

The Risk and Solvency means of Islamic and Conventional bank is 2.868 and 4.755 respectively. Conventional bank is 2 times higher than Islamic banks when proportionately applied. This might have resulted due to in ability of the bank to invest in illegal investment and consequently contributed to the capital of the banks. Based on the percentage above, Conventional banks are more exposed to Risk and Solvency than Islamic banks. This is consistent with the findings of Muhammad and Ifran (2011).

Decision

As shown in the regression table above, there is a negative relationship (-0.004) between Islamic and conventional banks. The P-value 0.480 > 0.05, further suggested that there is no significant relationship between Islamic ban risk and solvency and conventional deposit money banks. Hence we fail to reject the null hypothesis.

Interpretation of hypothesis three

The Operational efficiency mean of Islamic and Conventional banks are 0.042 and 0.84. This means that the efficiency of conventional banks is twice higher than Islamic bank.

This might have resulted due to the investment in all kind of profitable ventures. Based on the percentage above conventional bank perform better than Islamic bank in term of there operation.

Decision

As shown in the table above there is a positive relationship (-1.078) between Islamic and Conventional bank. The P-value of 0.001, further suggested that there is a significant relationship between Islamic and Conventional bank. Which states that operational efficiency has a significant effect on return on asset, therefore we reject the null hypothesis.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 INTRODUCTION

This chapter comprises of the summary, conclusion and recommendations based on the conclusion drawn from the study.

5.2. SUMMARY

This study aimed at examining the determinants of financial policy of quoted banks in Nigeria. The study is divided into five chapters. A background is provided to highlight brief explanation of determinants of quoted banks in Nigeria. Also discussed in chapter one are statement of research problem, objective of the study, research hypotheses, scope and significance of the study.

The second chapter focused on the view of conceptual literature, empirical studies and theoretical framework related to the study. The chapter three addressed the issue of research methodology used in data collection. Secondary source of data collection was employed, where the data of two banks were obtained from their financial statements. It also covers the research design which is quantitative, population of the study is 21, sample size and techniques used in analyzing the data are descriptive statistics, correlation coefficient and multiple regression.

In chapter four, data extracted from the annual reports and account of the quoted banks in Nigeria are analyzed using descriptive statistics, correlation and multiple linear regression. The hypotheses formulated were tested so as to either reject or accept the null hypotheses.

5.3 CONCLUSION

Having appraised the interest free banking and conventional banking system, the conclusion have shown that conventional banking system have more adverse effect in terms of performance when compared to the interest free banking system. To this effect, interest free banking is a better alternative to the conventional banking system. The economy can only develop and grow when there is a stable monetary system which conventional banks have failed to maintain, interest free banking can provide this by designing its banking and monetary policy with the elimination of interest. The system also helps to eradicate the economic ill sin the country. Most operations in the conventional banks are carried out with absolute aim of maximization of profit through charging high interest rate which does not favour the poor, contrary to the principles of interest free banking system which is concerned with welfare maximization of the customers interest free banking display resources mobilized by them in such a manner that the objectives of the society that can make productive and effective use of bank finance have access for the banking system.

Since interest free banking is based on profit sharing, it would invariably provide and promote short-term interests free loan among others, to businessmen, government and private sector in form of investment instead of lending.

The interest free banking should improve their product and services and capitalize on opportunities of the markets that they can continue to growth and be a permanent feature. Staffs should be trained, this can be active by forming a forum that would run courses on non interest free and insurance. A lot of awareness campaign need to be carried out to eradicate customers about interest free banking and investors too need to be assured of the profitability of interest free banking so that they will be rid of all doubt and be willing to commit their resources to interest free banking.

5.4 RECOMMENDATION

Based on the major finding of this study, the following recommendations are proffered:

a. The government should open a full-fledge interest free bank and conventional banks should operate without interest but with profit and loss sharing scheme to maintain social justice and enable the real sector have a means of financing its business.

b. Findings from the study revealed that the Islamic banks have high liquidity that the conventional banks since they carry surplus cash and other assets in comparison to conventional banks holding high amount of cash results to less profitability. The Islamic banks should re-strategize and get more marketing personnel in order to create awareness, especially to small and medium scale businesses in Nigeria, this will help in boasting the economy as well as growing activities in the country.

c. The CBN promoters of interest free banking in Nigeria, deposit money banks and other shareholders should encourage by way of sponsorship, human capital development in the field of interest free banking so as to forestall the likelihood of manpower inadequacy in a fewer years to come. There are several seminars and workshops continually being organized and as well so many universities in the middle-east and Europe are offering fully fledge degree programs at all levels.

d. Most importantly, the CBN/other regulators and operators in the Nigeria financial system should collaborate in order to chart ways of dealing with the prospective interest free banking in terms of financial transaction in all the financial markets.

e. The Islamic banking system in Nigeria is still at a developing stage and needs to expand its business in order to cut across the economy. There are quite a number

of Nigeria Muslims and non-Muslims that are advocating for non-interest and interest free banking, since there is a demand and a market for profit and loss financial product and this is a great opportunity for Islamic financial system in Nigeria. It is quite evident that interest free bank or finance is to numerous advantages to start with, it efficiently and effectively allocates investible funds. Islamic banking system can offer alternatives at the micro finance level. The social benefits are obvious since the poor are often exploited by tender charging usurious rates often by conventional banks.

f. Operational and institutional challenges facing Islamic banks in Nigeria should be addressed. This is because there is a need for conventional banks to adopt some interest free banking products so as to effectively and efficiently carry out their primary functions of financial intermediation. That is, the deficit spending unit that requires funds to grow their businesses will not be skeptical in approaching a bank.

g. It is also apparent that some customers are not properly informed and exhibit a bias, claiming that interest free banking is an Islamic system only for the Muslims, the banks need to correct such wrong impressions and make such customers aware that interest free banking although has it root in Islam is open for all people to operate not withstanding their belief/religion.

h. The public especially the wealthy individuals should take the establishment of interest free banking as a challenge, it has now gained momentum being practiced in many countries including Non-Muslim countries and some of the biggest banks

i. On this note, the researcher will like to recommend further research on the same topic and similar topic but with a wider coverage such as deposit, and loan management in banks.

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APPENDIX I

TABLE OF VARIABLES

BANKS	CODE	YEAR	ROA	LIQ	RISK	EFFCY
GTB	1	2014	0.0439346	0.639869	4.7548952	0.04228172
	1	2015	0.04140512	0.5113502	4.6153411	0.04267632
	1	2016	0.04853436	0.7036854	4.479644	0.04722029
	1	2017	0.05618821	2.1611677	3.8810832	0.05848057
	1	2018	0.06153675	2.5794699	4.2976981	0.05948781
JAIZ	2	2014	0.01555933	0.5543428	3.9566469	0.06531293
	2	2015	0.0172914	1.0102893	4.6144793	0.08399325
	2	2016	0.00460327	0.7953152	4.5969274	0.07257669
	2	2017	0.00615165	0.6095667	2.8674712	0.07211903
	2	2018	0.00769267	0.4160222	4.2924515	0.06508336

APPENDIX II

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  ___/   /   /___/   /   /___/   13.0  Copyright 1985-2013 StataCorp LP
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                                    979-696-4600        stata@stata.com
                                    979-696-4601 (fax)

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Notes:
      1.  (/v# option or -set maxvar-) 5000 maximum variables

. import excel "C:\Users\OKPESON\Desktop\gfttfttftf.xlsx", sheet("Sheet1") firstrow

. summarize ROA LIQ RISK EFFCY

    Variable |        Obs        Mean    Std. Dev.       Min        Max
-------------+---------------------------------------------------------
         ROA |         10   .0302897   .0221829   .0046033   .0615368
         LIQ |         10   .9981078    .747838   .4160222    2.57947
        RISK |         10   4.235664   .5607433   2.867471   4.754895
       EFFCY |         10   .0609232   .0137687   .0422817   .0839932
```

. correlate ROA LIQ RISK EFFCY

(obs=10)

| ROA LIQ RISK EFFCY

ROA | 1.0000

LIQ | 0.6563 1.0000

RISK | 0.2694 -0.0539 1.0000

EFFCY | -0.6706 0.0397 -0.3242 1.0000

. Regress ROA LIQ RISK EFFCY

Source	SS df MS	Number of obs = 10
		F(3, 6) = 24.31
Model	.004092118 3 .001364039	Prob > F = 0.0009
Residual	.000336599 6 .0000561	R-squared = 0.9240
		Adj R-squared = 0.8860
Total	.004428717 9 .00049208	Root MSE = .00749

ROA	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
LIQ	.0203982	.0033443	6.10	0.001	.012215	.0285814
RISK	.0035428	.0047111	0.75	0.480	-.0079849	.0150706
EFFCY	-1.077656	.1917376	-5.62	0.001	-1.546821	-.6084906
_cons	.0605781	.0265675	2.28	0.063	-.0044303	.1255865