



Impact of conversion on deposits and operational cost of Faysal Bank: A case of Pakistan

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ABSTRACT

Theme: The Islamic financial industry is showing remarkable growth and has earned the confidence of both investors and creditors. Conventional banks are converting their business into Islamic around the globe and Pakistan is much ahead in this regard since it has to convert all its conventional banking into Islamic. This study is about the comparison of the performance of Faysal Bank before and during conversion, the largest conversion globally rated as ‘first of its scale’ by IIRA and AAOIFI.

Methodology: Using secondary data (2002-2022) from the annual reports of Faysal Bank t-test was performed, and a graphical analysis was done to compare the performance of the bank before and during the conversion process of the bank.

Findings: The Findings of the study are that the conversion affects deposits of the bank positively also, the bank is performing far better than before conversion.

Research limitations: This study focuses on deposits and operational costs of the bank before and during conversion. Many other factors can be studied alongside the strategies Faysal Bank adopted for this massive conversion.

Significance: The study will help to reveal the effect of conversion on a Bank’s deposits and operational cost during conversion. Since this is the first full-fledged conversion of a Pakistani bank, so will be an addition to the existing literature on conversion.

Keywords: Operational cost, deposits, conversion.

1. INTRODUCTION

Conversion of conventional banks into Islamic banks is not a new thing in the world. The process is started with the Prophet Hood of the Holy Prophet Hazrat Muhammad SAW as Riba based financial system was rejected in the Holy Quran (Al Baqrah:278). This conversion process continues. It is not certain how much it will take to overcome the conventional system completely, but the world is observing a rapid conversion of conventional banks to Islamic Banks.

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1.1. Background of the Study

In Pakistan, Islamic banking is the talk of the town. In a conventional economic system like Pakistan, the emergence of Islamic banking is really amazing. There are many factors behind this rapid growth, e.g., interest-free halal products, customer satisfaction, and State Bank's policy to Islamize the banking sector till 2025. Along with Muslims, a number of non-Muslims are also found using Islamic banks. According to a report by the State Bank of Pakistan more than 300 Islamic financial institutions are working in almost 75 countries.

After the Supreme Court's historical judgment (19th December, 1999), a Commission was formed for the transformation of the financial system, and this commission emerged as a new approach to the Islamization of the financial sector in Pakistan. The establishment of full-fledged Islamic Banks, Islamic Banking subsidiaries of existing banks, and standalone branches for Islamic Banking were included in this approach. The ultimate purpose of this approach was to develop a parallel Islamic banking system that is Sharia-compliant and compatible with the existing conventional system.

1.2. Problem Statement

It is a general assumption about Islamic banking that it costs more as compared to conventional counterpart, which is true, but we have seen that higher management of banks also think that conversion can bring a set back to their deposits.

1.3. Research Question

Does conversion bring set back to bank deposits and increase the operational cost?

1.4. Research Objectives

- 1- To study the impact of conversion on deposits.
- 2- To identify the effect of conversion on operational cost.

1.5. Significance of the Study

This study will help to learn the effect of the conversion process on deposits and operational costs of Faysal Bank along with techniques and policies that helped Faysal Bank in a successful conversion and will be a guiding line for the bank planning conversion worldwide.

2. LITERATURE REVIEW

Many studies have been done over the years to reveal and investigate the pros and cons of conversion in the financial industry. Here are some more relevant studies regarding the conversion of conventional banks into Islamic banks.

The conversion process is based on the belief that there is a need to make the right change. There is always a religious and financial motivation behind conversion. Independent Sharia Supervisory Board should adhere to all the conditions mentioned by AAOIFI for successful conversion (Ahmed and Hussainey 2015).

Zulfiqar (Hasan 2016) explains the impact of the conversion on objectives, products, operating expenses, source of funds, and use of funds. The study mainly focuses on rules, regulations, processes, and effects of conversion.

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A study highlights the problems faced by management during conversion. Lack of a comprehensive framework of conversion, human resources, Islamic financial products, and technical banking staff with sharia knowledge are some main issues. Also, this study suggests a gradual process of conversion (Shafii, Shahimi, and Saaid 2016).

Conversion to Islamic banks has a positive effect on the market share of the banks (Al Arif et al. 2023). The author used the penal regression technique with ROA, Operational Efficiency Ratio, and capital Adequacy ratio as independent variables. Market share was taken as a dependent variable. Conversion policy was taken as a dummy variable as 1 after conversion and 0 before conversion. The results showed that ACEH bank's share grew from 1% to 7% while NTB bank grew from 0.5% to 2% after conversion. The overall market share of the Islamic banking Industry grew from 5% to 6.7% after conversion by the end of 2021.

“Conversion of Conventional Bank into an Islamic bank: risks and challenges” by Nasir, H. (2021) is a study about the conversion of Faysal Bank. The findings of this study are that the bank faced a number of challenges during the conversion process from human resources to Islamic products/ operational strategies and financial issues.

A study (Awan 2009) utilized ratio analysis to compare Islamic and conventional banking in Pakistan. The author focused on a sample of six Islamic and six conventional banks of equal size operating in Pakistan between 2006 and 2008. Awan calculated various performance and profitability ratios, including ROA (Return on Assets), ROD (Return on Deposits), ROE (Return on Equity), EPS (Earnings per Share), Equity to Total Assets ratio, Debt to Asset ratio, Cash to Deposit ratio, among others. The results of the ratio analysis indicated that most of the profitability ratios for conventional banks were negative during the study period, implying low performance. Conversely, the profitability ratios calculated for Islamic banks showed superb consequences, indicating high returns for the banks and their shareholders.

Moreover, the assets of Islamic banks witnessed a significant growth of approximately 78% compared to a mere 57% in conventional banks' assets from 2006 to 2008. The marketplace proportion of Islamic banks expanded from 2.5% to 5%. Additionally, the ratio of non-performing loans in Islamic banks was notably decreased than that of conventional banks. Moreover, Islamic banks had greater provisions for bad debts as compared to their conventional counterparts.

The findings concluded that the general performance of Islamic banks was that of conventional banks. The study also revealed that the outcomes achieved by Islamic banks were not a result of exploiting depositors or shareholders; in fact, Islamic banks supplied better returns to their investors than conventional banks. The price of finances for Islamic banks stood at 6.5% in comparison to 4.5% for conventional banks, as Islamic banks shared 50% of their profits on a Modarabah basis with depositors. Additionally, the volatility of profitability in Islamic banks turned lower than that in conventional banks in Pakistan. Collectively, all measures taken into consideration for Islamic banks verified fantastic results, leading the writer to suggest that Islamic banking could serve as an ultimate solution to the recent global financial crisis.

3. METHODOLOGY

To check the impact of the conversion on deposits and operational costs of the Faysal Bank, data was compared before and during the conversion in the form of a graph, and a paired t-test was performed. A paired t-test is employed for comparing the means of two populations with two samples in which each observation in one sample is paired or matched with a corresponding observation in the other sample (Daya 2003).

4. DATA AND SAMPLING

Secondary data on deposits and operational costs was taken from the annual

reports of Faysal Bank from year 2002 to 2022.

5. HYPOTHESIS

H1: Conversion increased the operational cost of Faysal Bank.

H1_o: Conversion did not increase the operational cost of Faysal Bank.

H2: Conversion had a negative impact on deposits of Faysal Bank.

H2_o: Conversion did not have a negative impact on deposits of Faysal Bank.

6. RESULTS

Following are the results from the data collected from Faysal Bank's Annual reports (2002-2022).

6.1. Impact on Operational Cost:

The graph line shown in Fig 1 shows a continuous increase in the operational cost of the Faysal Bank. We can see that the upwards trend is not confined to the conversion years, i.e., 2016 to 2022; rather, it is continuous. However, we can see a greater increase during conversion years, proving our hypothesis that conversion increases the operational cost of the bank. So, through results it is proved that conversion to Islamic bank increases operational cost.

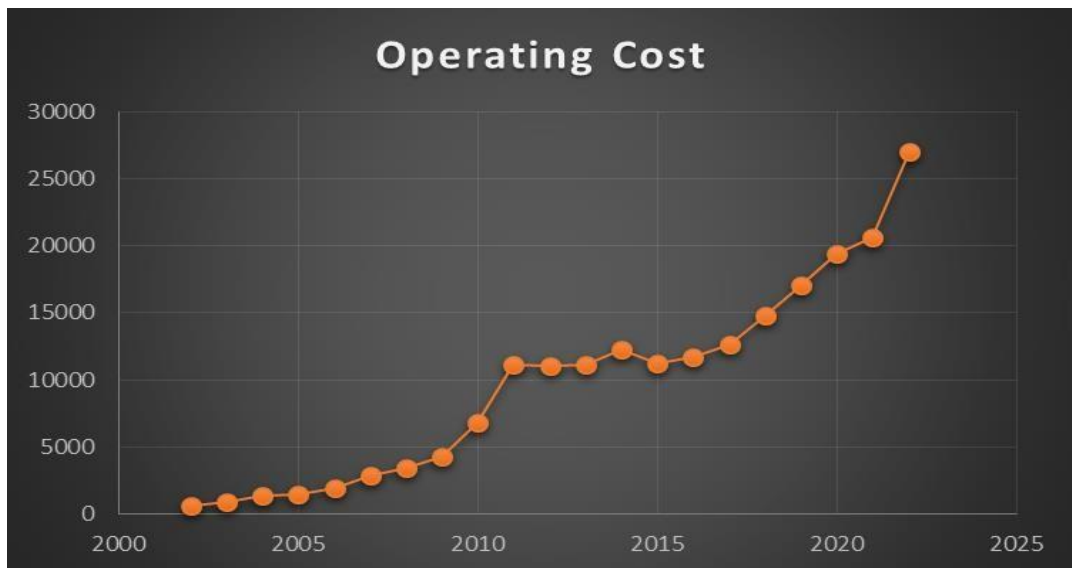


Figure 1: Operational Cost of Faysal Bank

6.2. Impact of Conversion on Deposits

The graph in Fig 2 shows a remarkable increase in the deposits of Faysal Bank during the period of conversion. Deposits are amazingly doubled from 2018 to 2022, and the trend shows the continuity of this growth. So, the results have rejected our accepted null hypothesis H2, i.e., conversion did not have a negative impact on deposits. Contrary to this, conversion doubled the deposits for the bank, and Faysal Bank did not face a setback.

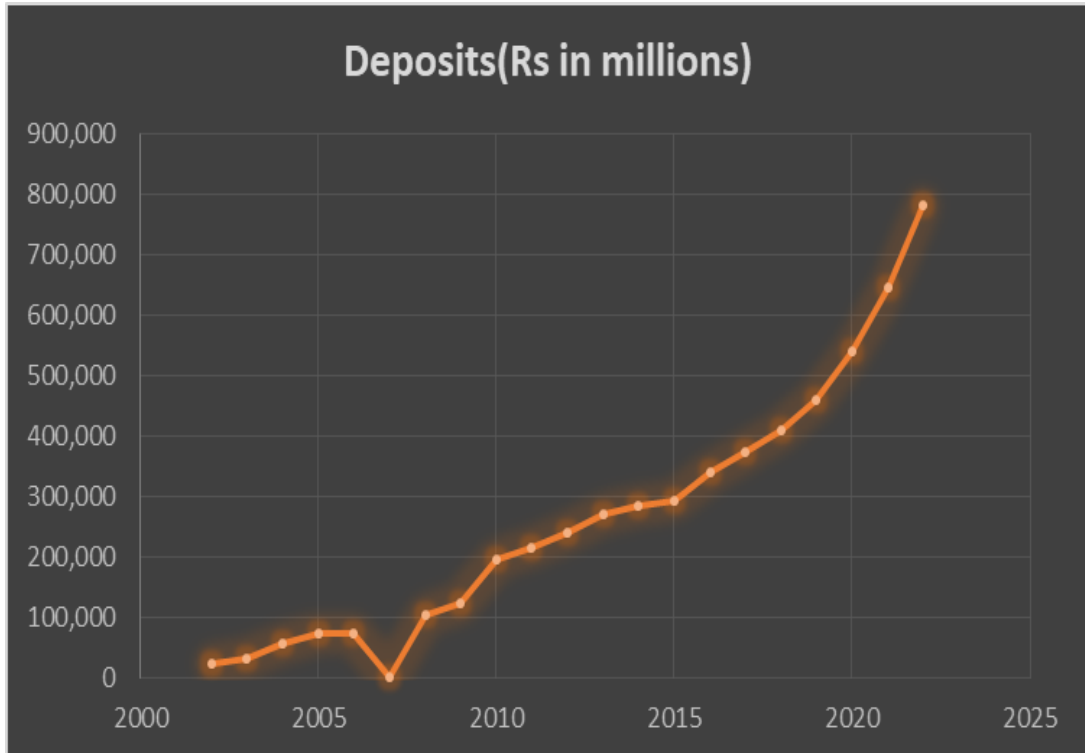


Figure 2: Deposit trends

6.3. t-Test Results

Paired two samples for means was done. A comparison was made between the data before and during the conversion process, and the results are as under.

6.4. Operational Cost

The test shows insignificant p-values for the operational cost (table 1). It shows that conversion to an Islamic bank does not have a significant effect on the operational cost of the bank, rejecting the null hypothesis H1.

Table 1: t-Test (operational Cost)

t-Test: Paired Two Sample for Means		
	<i>operating cost before conversion</i>	<i>operating cost during conversion</i>
Mean	9683.857143	107940.4286
Variance	8700796.143	55915371344
Observations	7	7
Pearson Correlation	-0.796065857	
Hypothesized Mean Difference	0	
df	6	
t Stat	-1.088532695	
P(T<=t) one-tail	0.159069575	
t Critical one-tail	1.943180281	
P(T<=t) two-tail	0.318139151	
t Critical two-tail	2.446911851	

6.5. Deposits

Significant p-value shows that conversion had a significant impact on the deposits, i.e., deposits increased during the conversion process (table: 2) Accepting the null hypothesis, i.e., conversion did not have a negative impact on deposits.

Table 2: t-Test (Deposits)

t-Test: Paired Two Sample for Means		
	<i>Deposits(Rs in millions) before conv</i>	<i>Deposits(Rs in millions) during conversion</i>
Mean	231558.2857	506693.7143
Variance	3540439268	25497524326
Observations	7	7
Pearson Correlation	0.861382691	
Hypothesized Mean Difference	0	
df	6	
t Stat	-6.467152278	
P(T<=t) one-tail	0.000324271	
t Critical one-tail	1.943180281	
P(T<=t) two-tail	0.000648542	
t Critical two-tail	2.446911851	

7. DISCUSSION

The above results show that conversion proved beneficial for Faysal Bank, and hence, their successful and fruitful conversion is an inspiration for other banks in Pakistan and across the world. Conversion in Faysal Bank is one of its kind because it is the largest conversion in the world with 600 plus branches. The increase in deposits is quite obvious from the results, showing the public's trust in Islamic

banking, including Non- Muslims. Islamic banking is not only religiously satisfying, but it is also financially beneficial as compared to conventional banking (Ahmed and Hussainey 2015).

Although an increase in operational cost is seen for the bank, it was not because of Islamic banking; rather, it was because of the increasing assets. So the increase in the operational cost is not significant. Also, it was the best policy steps taken by the management of the Faysal Bank that decreased the cost and did not add to the expenses that caused trouble for the management.

8. CONCLUSION

To conclude, conversion is beneficial for the bank and not harmful. The study found that the conversion of a conventional bank can be successful without incurring significant costs. Also, the bank's growth and reputation improved after the conversion (increased deposits). With all the benefits of conversion to an Islamic bank, of course, there are also some challenges for the converting banks, e.g., new products, change of banking culture, need for trained staff. However, we can see that the benefits of converting a conventional bank into an Islamic bank outweigh the challenges. Faysal Bank's example shows that banks planning for the total conversion must do it as soon as possible following Faysal Bank's strategies to get more profit and sustainability.

9. FUTURE RESEARCH

In the present study, we have discussed only two aspects, i.e., deposits and operational costs. Many other factors can be studied alongside the strategies Faysal Bank adopted for this massive conversion that is rated as 'first of its scale' globally by IIRA and AAOIFI.

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