



RESEARCH PAPER

A Theoretical Comparison of Interest-Free Banking and Interest-Based Banking: A Context of Pakistani Banking Industry

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ABSTRACT

The study was to present a comparative analysis of Islamic and conventional banking system of Pakistan. The study examines the relationship between service quality, customer satisfaction and performance of banks. This study examined the problems faced by the banking industry after the introduction of Islamic banking in Pakistan. The banking industry consists of Islamic and conventional banking systems. This research proposed a model of banking system in Pakistani environment. A structured questionnaire was created with the aid of pre-existing literature. Selected content from annual reports and interview data were analyzed. The population was based on administrative affairs officers at State Bank of Pakistan. 150 people were selected through purposive sampling. Data was collected by self-administered method using artificial sampling. Various study tools like SPSS etc. were used for content analysis. A set of regression analysis was used. The study used correlation and structural equation to test the hypotheses. The results indicate a positive and strong association among the quality of Pakistan's banking system and customer satisfaction. The results showed that the service superiority is not satisfactory and the customers are also not satisfied with the performance of the bank.

Keywords: Bank Performance, Banking Sector, Conventional Banking, Global, Islamic Banking, Quality Service, Riba

Introduction

Any society's ability to develop economically and maintain its well-being depends on the banking industry. Any country can qualify as one of the developed nations of the world by having a robust banking sector. With the advent of mass production during the Industrialized Rebellion in eighteenth century, trade and commercial undertakings expanded. The importance of banking has grown as a crucial tool for fostering commercial activity. The product, excellence facility and the client contentment can improve the act of banks for prosperous existence in today's global and borderless market.

In order to raise money and attract investment for profitable projects, banks are crucial. They accept public deposits and lend money to businesspeople in order to promote investment activities, which are crucial for a strong economy. To encourage trade and business activities, banks link units with surpluses and deficits. The following illustrates the bank's function. Financial intermediaries provide financing to investors as per their needs by allowing for the hazards and takings associated with various plans. The banks provide funds by accommodating payments from savers and deliver these reserves to businessmen

for industrious projects to produce revenues. An effective intermediation rises production and return on venture for long-term reimbursements.

The Islamic Banking (IB) and the Conventional Banking (CB) are the two types of banking in Pakistan. Based on goals, *riba*, and risk-sharing procedures, conventional banking and Islamic banking are differentiated from one another. While CB adheres to SOPs created by humans, IB abides by the Shariah principles established by Allah Ta'ala. IB creates revenue in the form of profit which is variable while CB earns from fixed interest. In Islamic banking the risk is shared between the debtor, creditor and the bank whereas CB has transferred all the risk to others. Islamic banking is a trade-based entity while CB operates in a purely financial capacity dealing on interest basis.

As described the Islamic Banking "banking and governance in accordance with the system of moral and value of Islam, in accordance with the prescribed principles of Islamic Sharia and the menace managing rules" by the State Bank of Pakistan (SBP). Islam is characterized as unconditional submission to Allah Subhanahu Wa Ta'ala. It is a comprehensive code of conduct that includes Hazrat Muhammad Mustafa's (peace be upon him) deeds as well as Allah's instructions. Every person in this world engages in social, religious, and economic activities throughout their lives. However, social and economic activities frequently begin with religious activities. Islam offers a complete road map to overcome any obstacle. Economic activities are a reflection of people's earning and spending habits, which are strongly correlated with their religious beliefs in terms of what is permitted (*halal*) and what is prohibited (*haram*). The Holy Qur'an gives clear instructions regarding business and trading activities, stating that while activities based on income (*Bai*) are permissible, those based on interest (*Riba*) are not. Economic activity includes banking, and Islam only permits usury-free banking.

In 1963, the first contemporary Islamic bank in Egypt was founded in accordance with Islamic financial principles. In 1973, in Saudi Arabia, the OIC also backed the Islamic financial system. Similar to this, many Islamic banks operating under the Philippine Amana Bank name were founded in 1973, the Faisal Islamic Bank of Sudan and Dubai Islamic Bank in 1975. Meanwhile, in 1977, the Faisal Islamic Bank in Egypt; in 1979, the Bahrain Islamic Bank; and in 2002, the Meezan Islamic Bank in Pakistan. Such as in Malaysia, in 1983 the Islamic Banking Act was conceded with the goal of converting conventional, interest-based banks into Islamic ones. Islamic banking began to be practiced in the 1990s all over the world, but especially in regions with a Muslim majority. Additionally, the start of the twenty-first century was successful for Islamic banking because many banks began offering goods and services that adhered to Shariah law. According to one theory, to reap the rewards of the Islamic banking system and ensure the welfare of humanity, a *Riba*-free, equity-based economy is required (Chapra, 1985).

Islamic banking's main goal is to conduct only *halal* (permissible) transactions and interest-free activities based on Shariah principles. Risk sharing between investors, banks, and borrowers is Islamic banking's most significant characteristic. Islamic banking prioritizes fairness and freedom as a system of centralized management and personal regulation in accordance with Allah Ta'ala's instructions. It is necessary to conduct research to evaluate the performance of Pakistan's two banking streams – conventional banks and Islamic banks.

Islam has supplies for cutting-edge technologies and methods that use *ijtihad* as the foundation for all decisions in line with the Qur'an and the Sunnah. To accept demand deposits with no interest or to invest savers' money in a general investment fund, a targeted investment fund, or both, an Islamic bank serves as a conduit. Additionally, it might manage investments (advocacy) and generate income from service fees. The goal is to maximize returns, even at the expense of society or other stakeholders, in contrast to traditional banking, where depositors are assured a encoded ratio of interest. The excessive use of debt

financing and loans in traditional banking can cause economic issues and encourage materialistic behavior that is fatal to society because it leads to exploitation.

Islamic banking's primary goal is to carry out activities that are free of interest. The goal of CB, in contrast, is to maximize incomes, even at the expense of society or other shareholders. Banking institutions make up the majority of the financial sector, which is a reflection of the economy's overall trend. In Pakistan, there are numerous conventional banks which offering a variety of products to their customers, but the widely range of these are interest based, which is against Sharia principles. By raising money for the economic development of any nation while sparing entrepreneurs (to supply these funds), an Islamic bank takes on a more active role. As a result, the unfair exploitation of various stakeholders that has previously occurred is reduced. Additionally, it supports highly lucrative welfare-based business ventures that raise living standards. According to the Shariah's principles, Islamic banks have assisted the Muslim Ummah in investing their savings for halal returns. Islamic banks benefit everyone by fostering comradery and collaboration in society, including the non-Muslim community. Islamic banks are crucial to the economy's promotion of productive activities that boost prosperity and economic growth. A stable economy is ensured by Islamic banks. Income distribution that is fair; lessen injustice. Less financial crisis due to risk sharing, promote business and production activities.

The core objectives of an Islamic Bank

Providing Sharia compliant financial services.

1. Avoiding from the all haram doings and only engaging in halal doings.
2. Pork, betting, liquor, adult entertaining, interest-based businesses, and other activities are examples of haram.
3. To get rid of Riba from transactions avoiding treating money like a commodity, maximizing its use, and securing every financial transaction with tangible assets.
4. Instead of giving maximum human worth effort in a trade endeavor, the money turn out to be capital only once money is financed in the business.
5. Effective allocation of resources and equitable distribution of income.
6. Effective allocation of resources and equitable distribution of income.
7. Focusing on productivity rather than just the borrower's creditworthiness in order to find profitable business opportunities.
8. Stimulating the economy and encouraging businessmen to be more efficient, instead of encouraging savers to invest their money instead of idleness.
9. To act in an ethical, socially and environmentally responsible manner.

Literature Review

Banks are organizations that have been given permission by the federal government to accept deposits from the public. They also offer a wide range of additional goods and services, such as lending, check and draft collection, money transfers, guarantees, foreign exchange trading, and assistance with investing for customers. The Islamic Banks play the role same as conventional banks from an economic perspective. Banks invest in their own deposits and those of their customers, as well as finance other depositors.

An Islamic bank stands out from other financial institutions because all transactions must adhere to Islamic Sharia law. Islami Bank offers every service related to commercial banking that is essentially covered by the Shariah framework. Riba, or the prohibition of interest, is the primary distinction between it and regular national banks. In Islam, currency is only used as a means of conversation and a manufacture tool for commercial purposes. Common finance, on the other hand, views cash as a article of trade with an essential worth

that enables interest, or *riba*, to be paid out at the maximum rate possible. *Riba* is an increase in a loan's principal amount that is given according to a precise calculation based on the loan's amount and its intended use. Islam forbids all kinds of interest, whether they are lesser or great, straightforward or complex.

Finding suitable alternatives to interest-based mechanisms was the main challenge in modern Islamic banking development. This has been accomplished by replacing *Riba*, or usury, in IB with a sharing machinery of profit and loss, in Sharia it refers to the transfer of financing from a moneylender or depositor or finance benefactor to real assets or investments. This helps in the need to integrate, thus income will be on the sharing of profit-loss in impartiality transactions or the determination of rent from a sale agreement at a higher price or from a lease transaction - these on real assets. Due to the emphasis and participation in the loss and profit of the financed commercial act, the Islamic banks place extra stress on business efficiency and management services rather than mere credit rating.

The modern Islamic banks, comparable CB, work to offer an effective system by monetary inter-mediation, dependable imbursement methods, actual connections to the currency and investment markets and international and industry best practices. As entirely agreements of financial in IB are tied to possessions in the actual economy, adding cost there while also dividing jeopardy and reappearance. The Islamic banking enables Muslim investors to take on the role of partners in the company rather than lenders, where both parties share in the business's risks and rewards. In traditional banking, the bank and the depositor both receive a fixed interest rate, and the only ways to incur loss are through borrowing or repayment. In contrast, when a depositor uses Islamic banking, both the bank and the borrower or businessperson share in the business's risks and rewards.

Pakistan has started Islamic banking system in 1977. The regulatory framework for Islamic banks in Pakistan has been established before Malaysia but the development was achieved by challenges such as experts and the very static nature of the regulatory framework. With its promising potential and potential, the Islamic banking system will need less than 3.5% annually to enable its share to grow to 40-50%, about 15% of the total banking system. For the convenience of their clients, Islamic banks offer a range of products through the rate process flow. The following product descriptions are based on Shariah. To launch various Islamic banking products, it is appropriate to provide pertinent literature on the various contracts that can be used. Greece encountered very sophisticated methods that temples, government agencies, and private entrepreneurs employed to raise capital, lend, and engage in book transaction.

Rome accepted and dignified Greek practices. In the second millennium, banking activities were regarded as crucial in Babylonia. The Medici Bank was established in 1397 by bankers from northern Italy known as the Lombards, who also invented the double entry system. Early in the 17th century, the Rothschild family offered commercial banking as a service to clients. The General Bank of India was founded in 1886, marking the start of undivided banking in India. Indeed, after gaining independence on August 14, 1947, Pakistan started engaging in banking activities. Due to the important role of the private bank, the banking sector of Pakistan witnessed a major change. This sector accounts for about eighty percent of banking properties (Economic Survey of Pakistan, August, 2007).

According to Al-Jarhi and Iqbal (2001), Islamic banks are financial institutions that carry out all conventional banking activities, including borrowing and lending without paying interest. It can accept demand deposits as interest-free loans and can collect reserves on a *mudbara* or *waqala* basis. According to the standards of a Shariah investment manager, it makes advances on a debt basis or deploys funds based on profit and loss. It is clear that compared to conventional banks, Islamic banks are more focused on distributing resources fairly (Sadiq, 1985).

According to Kulafa, the Arabic word *aqd* (covenant) means to tie tightly, like tying a rope. Arabs used the word to express a firm belief or determination. He used to say that "Iqd al-Thamin" means "swear". Along the same lines is "Aqd-ul-Nikah" which means marriage contract. The word `Uqd also means obligations as it is used in the Surah al-Ma'idah, verse-1.

O ye who believe! Fulfil your obligations (Al-Quran).

In Islamic jurisprudence, the word contract means obligations and agreements between two persons in a legally recognized, effective and binding manner. In Islamic banking, banks use or adapt various business contracts from Islamic literature and use them as the legal basis for products commonly known in the banking industry as wealth finance. Friedman (1969) suggested that optimal resource allocation requires a nominal zero interest rate condition. General models have determined that zero interest rates are sufficient (Charles and Wilson, 1979; Cole and Kucherlakota, 1998). Islamiat trades more people for the economy with stock-based (gain/loss) contracts compared to traditional mutual fund-based banks. Similarly, both bank streams offer product and service propositions that require comparative studies to evaluate performance based on service quality and customer base.

During the early decade of the 1990s, the service industry, especially the banking sector, was developing all over the world. Due to the spread of Islamic banking practices throughout many nations, including Bahrain, Bangladesh, Pakistan, and Malaysia and even other than Muslim regions of world and the twenty-first century carried mutually chances and pressures for the finance industry. The competition between banks to satisfy customers' expectations of long-term benefits was sparked by the presence of Islamic & conventional banks. Due to the rivalry, service quality has become more focused on meeting the needs of bank customers.

Groverrose (1982) examined in banking quality service and exploring its three scopes. Likewise, the quality service's ten scopes were categorized into five dimensions by Piaster and finally by the service innovation term (Parasarman et al., 1985; 1988; 1991). As the servicing quality remained then paired with the bank customers' perceived superiors to evaluate the association (Surishchandra et al. 2002). Due to competition in banking choice, the quality of service and customer relationship are discussed. Similarly, some studies are also inconclusive on the association amongst quality service and the performance of bank. (Lewsky & McDougall, 1996; Y. Yavas et al., 1997; L. Lasar et al., 2000, Mishkin, 2001; K. Case et al., Chong & Lin, 2007). Especially after the introduction of Islamic banking conditions, the almost non-existent partnership by the development of positive results of banking. However, no research is available that further explores the effects on consumers.

Material and Methods

Research is a systematic process of collecting and analyzing information in order to increase our understanding of phenomena of concern or interest. It is a careful research or investigation in any branch of knowledge. Research is the term for the investigation process. Research is the pursuit of knowledge. The word "search" is the most active part. It refers to the pursuit of knowledge as well as the production of new knowledge. The space between these two stages of knowledge creation and discovery is the area of research activities. Research is an intellectual activity that adds to the body of knowledge by producing new knowledge or methodically eradicating errors and misunderstandings. It gathers fresh information or knowledge from primary or first-hand sources.

According to Webster's Dictionary:

"As careful inquiry investigate or examination in search of evidences or principles; diligent examination to discover something."

According to Stephenson and D. Schlesinger:

The Encyclopedia of Social Sciences defines research as "the manipulation of objects, concepts, or symbols for the purpose of generalizing knowledge to increase, correct, or confirm knowledge, whether knowledge contributes to the construction of theory or the practice of an art. "

According to John W. Creswell:

"Research is a process of actions used to collect and analyze information to increase our understanding of a topic or problem". It consists of three steps: asking the question, gathering data to answer the question, and presenting the answer to the question.

According to Payton (1979):

Research is the process of exploring a specific question in a systematic, objective, reliable way.

According to John Best: 2012

Research is a systematic and objective analysis and recording of controlled observations that may lead to the development of generalizations, principles or theories leading to the prediction and possibly the ultimate control of events.

According to Bhattacharya: 2009

The process of gathering data and information is used for the determination of decision making in any field. Methods may include publication research, interviews, surveys, and other research techniques and may include both current and historical information.

A research methodology is a way of systematically solving a research problem. It can be considered as a science of studying how research is done scientifically. Research methodology has many dimensions and research methods are a part of research methodology. Research Methodology The scope of research methods is wide. Thus, when we research methods we also consider the logic behind the methods used in the context of our research study and explain why we are using a particular method or technique and why we are using others. Why not use it to evaluate research findings, either by the researcher or by others. It defines and examines the approaches, further highlighting their limitations and resources. A survey method was developed for this study to collect the required data. Strategic research is a step-by-step action plan that guides your thoughts and efforts, enabling you to conduct research systematically and on schedule to produce quality results and detailed reports. It enables focus, reduces frustration, increases quality and most importantly, saves time and resources.

Results and Discussion

When it comes to credit and debit cards, clients should be aware that some cards may not work in places that are considered haram, such as alcohol or pork. They are supported by five basic pillars: no interest, no uncertain speculation, no financing for socially

harmful. Goods or services considered haram, such as weapons, pork or gambling, distribution of profits and losses and understanding that all financial transactions must be backed by tangible assets. Where ideally the bank should have its own procurement department.

Linking the economy's willingness to invest in an interest-free banking system. People just can't get enough of Islamic banking on their phones with "Islamic" tagging on them. In my view, all technology is salty. The big point is different. The main point is that we cannot fulfill the true Islamic system for the Islamic economy and we cannot accept our non-Islamic lives and societies as true banks, but we cannot fulfill the Islamic economy. 2nd Level - Seasonal Interest Completely Eliminated Even by Islamic Banking System Benchmarking? (LIBOR is used as a benchmark, Islamic bank pricing methodology). The following shows how willing to take part in the risk of losses or losses. Victims because the cost of financing is immovable at the commencement of the financing agreement. A head of the Islamic trade finance once admitted to me over lunch that there is no real difference between the traditional letter of credit businesses he does now and the Murabah business he did in his previous position. After some further research I found that some Islamic banks like the Egyptian Saudi Islamic Bank have disclosed depositing their "profits" to commercial banks and collecting interest on it.

Murabahah = Contract Trinium. Now for more money after you, I with good. The end result is a contractually enforceable fixed rate of financial return for the bank starting from the time the bank purchases the good from B. Some argue that the current practice of Islamic banking looks to instruments such as contract trains to work around the religious scriptures of Afriba (prohibition of usury). But why is Islamic banking superior to commercial banking?

Islamic law, also known as Sharia law, is the foundation of the economic and financial system known as Islamic banking. It is a banking structure that complies with Shariah and Islamic law. Accepting loans, borrowing money, and paying interest—commonly referred to as "riba"—are all against Shariah law. Usury, also known as Riba, is forbidden under Shariah law because it is believed to undermine social cohesion, encourage injustice, and spark riots. All Muslims not agree that the Qur'an expressly forbids such behavior; some contend that the prohibition was only meant to stop a particular pre-Islamic custom that caused many people to become slaves. And that other types of usury are legitimate and unavoidable with Islamic Belief (2001 Qur'an). However, the main characteristic that distinguishes Islamic banking is the prohibition of usury. The apparent denial of usury in the Islamic financial sector, however, has resulted in a variety of other strategies that guarantee the profit motive is not jeopardized and have also meant the prohibition of usury. Does not adhere to the lofty social ideals it is supposed to support.

The Islamic financial sector since there is no particularly vulnerable to this liquidity risk Sharia repo market and Islamic banks might encounter a number of obstacles when using interbank instruments. Additionally, this problem forces banks to maintain excessively liquid balance sheets, which ultimately harms shareholder value by sacrificing profitability. In his article, Shaikh (2006) hypothesized that Islamic banks frequently experience two different types of liquidity issues. Because there are fewer investment opportunities, some people who have too much liquidity are unsure of where to park their money in the short term. This leads to early opportunities on excess liquidity funds, which raises the carrying cost. However, some banks experience a lack of liquidity when depositors withdraw their money and they do not have access to resources for a little time of period.

Conclusion

Even after their many differences, Islamic and conventional banking seem to work better together than in opposition to one another. The conventional banks didn't view the system of interest free as maintainable when the Islamic banking first began. As the both

types of banking eventually started working together out of necessity as Islamic banking spread across the globe over time. In both domestic and foreign financial operations, both types of banks coexist side by side. Supporting correspondence services include LC verification, advice, and negotiation; interest-free deposits and withdrawals in traditional banks; information sharing or collaboration on projects with partners and retail and corporate clients. Islamic financial system is an unquestionable trend which has swept the financial industry. Its ongoing development throughout the global economic crisis has increased the interest in it. To become the hub of Islamic finance, all of the world's major non-Muslim nations are in competition with one another. There, though, not everything is perfect. Extraordinary growth and popularity are accompanied by challenges and controversies.

One of the problems faced by Islamic banks is the lack of reliable individuals at the whole levels who have awareness of the Islamic laws and conventional banking. Meanwhile, a person who knows about the traditional banking can simply comprehend Islamic products. The unique laws of Islam allow any product to be successfully manufactured and marketed without incurring any cost. Conduct Shariah audit accordingly.

It is required of central banks to either save or spend the results of public preference. Banks were forced to borrow money from other banks due to a shortage of cash brought on by public demand. The Central Bank serves as per a creditor of latter alternative and provides money to banks if the interbank market is unable to fully meet the requirements. Unlike Islamic banks, which must offer substitute of financing as based on profit-loss such as Mudabra / Musharakah, conventional banks are required to charge interest on this loan. Such unique Shariah-compliant substitutes are typically only accessible in Muslim-majority nations with two central banks.

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