

Sustainable Operational Performance of Pakistan Islamic Banking Sector

Ghias ul Hassan Khan

Institute of Business Administration – IBA

ghias@iba.edu.pk

Hibah Khan

Iqra University

hibahkh12@gmail.com

ABSTRACT

Purpose

The paper aims to examine the operational performance of the Pakistan Islamic banking Sector (IBS) within the context of Islamic finance objectives, focusing on financial stability, equitable wealth distribution, and social responsibility.

Method

After developing a performance evaluation framework, the research analyzes the balance sheets of Islamic banks in Pakistan till 2021. It examines fund sources, fund uses, financial contract application, and sectoral distribution of financing, presenting data trends.

Results

The findings indicate that the domestic Islamic banks have made strides in achieving primary and intermediate objectives, including commendable performance in commerce, contributing to equitable wealth distribution, and ensuring financial stability. However, the study highlights a notable gap in the industry's business models, revealing a lack of significant contributions to the social sector as a more advanced objective.

Novelty

The study reveals the growing support for Islamic finance and contributes to existing literature by developing a performance evaluation framework based on Islamic finance objectives and documenting Islamic banks' achievements in Pakistan. It recommends regulatory measures to establish a legal framework for Islamic banks' business models and urges domestic Islamic banks to diversify their financing and investment portfolios to encompass the social sector, agriculture, and rural areas.

Keywords:

Financial institutions, financial services, Islamic banking, Riba, Sustainability, Performance evaluation.

1. Introduction

The concept of Sustainable Islamic Banking and Finance combines the principles of sustainability of Islamic banks and Islamic finance, aiming to integrate ethical and social considerations with financial practices. Islamic finance operates under Sharia law, which prohibits interest (Riba) and encourages risk-sharing and ethical investments (Islam, 2022). Instead of interest-based lending, Islamic finance uses profit-sharing, partnerships, and trade-based contracts. Sustainability involves meeting present needs without compromising future generations, focusing on economic, social, and environmental aspects. It aims to create long-term value while minimizing negative impacts on society and the environment through responsible resource usage, ethical conduct, social inclusion, and climate change mitigation. Islamic banking, with its unique objectives, extends beyond conventional banking criteria. It emphasizes adherence to Sharia principles, economic stability, equitable wealth distribution, and socio-economic development of disadvantaged communities. Any assessment framework for Islamic banking must consider these distinctive dimensions, going beyond mere financial stability and profit maximization.

Islamic finance emerged as a distinct financial system rooted in Islamic religious principles, separate from conventional frameworks. Scholars emphasize its aim to integrate religious values into finance, drawing from Abrahamic traditions. Goals for Islamic finance include achieving socio-economic justice and equitable wealth distribution, as advocated by various thinkers (Islam, 2022). The system promotes economic stability by linking real and financial sectors and encourages risk-reward sharing for fair access to financial resources. Islamic finance also emphasizes Corporate Social Responsibility (CSR) and the promotion of social values, including human rights and ethical investment practices. Scholars highlight its potential contributions to poverty alleviation and environmental conservation within this framework.

1.1 Sustainable Islamic Banking and Finance

Sustainable Islamic Banking and Finance merges the principles of sustainability and Islamic finance to create a financial system that upholds ethical and economic goals. It discourages investments in sectors conflicting with Islamic values and promotes social welfare and environmental responsibility. Emphasizing risk-sharing and responsible investment decisions, it aims to manage risk responsibly. Additionally, it advocates for social responsibility, environmental sustainability, transparency, and accountability in financial practices. This approach seeks long-term value creation while addressing societal inequalities and promoting inclusivity. There's a growing interest in integrating Islamic finance with sustainability, with various stakeholders exploring ways to develop products meeting both criteria. In the evaluation year of 2020, one of the most noteworthy findings was the continued global growth of the industry's assets, which increased by over 10% to reach \$3.374 trillion, marking a 14% rise. Despite being lower than the 15% growth recorded in 2019, this achievement is still significant considering the profound impact of the COVID-19 pandemic on our societies, traditions, and economies throughout 2019. (IFDI, 2020). Nowadays, many conventional banks and financial companies are converting into Islamic banks and Islamic finance companies or opening Islamic windows separately. Ultimately, Sustainable Islamic Banking and Finance aims to harmonize ethical considerations with financial activities to foster economic growth, social well-being, and environmental stewardship.

1.2 Sustainable Islamic Banking and Finance with reference to Pakistan

Sustainable Islamic Banking and Finance advocates for ethical and responsible investments in line with Islamic principles and sustainable development goals. In Pakistan, where social challenges like poverty and inadequate healthcare persist, this approach directs funds to projects such as affordable housing and vocational training, uplifting marginalized communities and fostering social inclusion. Moreover, it addresses environmental issues through support for green initiatives like renewable energy and water management, aligning with Islamic teachings on environmental stewardship (Thohir, Gunaryo, Suwandaru, & Raharjo, 2023). By facilitating microfinance for rural populations and ensuring infrastructure projects are environmentally sustainable and socially inclusive, Sustainable Islamic Finance contributes to long-term development and economic growth. Additionally, it supports climate resilience efforts and the adoption of green technologies, promoting a more sustainable economic model. Through education and awareness, Sustainable Islamic Banking and Finance can further encourage ethical and sustainable financial practices, aligning with Pakistan's cultural and religious values while advancing its sustainable development goals.

2. Literature Review

The literature on assessing the performance of the Islamic Banking Service Industry (IBS) can be categorized into three main groups. One group evaluates IBS's financial performance using conventional models (Hanif et al., 2012; Siraj & Pillai, 2012; Islam & Zaman, 2015; Hazman et al., 2018). Another group establishes evaluation mechanisms based on Islamic financial system objectives (Mohammed et al., 2008; Mohammed et al., 2015; Mergaliyev et al., 2021; Tarique et al., 2021; Hanif & Ayub, 2022). The third group focuses on Sharī'ah-compliance ratings, particularly emphasizing Islamic Financial Services Industry (IFSI) objectives (Ashraf & Lahsasna, 2017; Hanif, 2018). In the specific context of Pakistan, studies on IBS performance reveal mixed findings (Ansari & Rehman, 2011; Hanif et al., 2012; Latif et al., 2016; Qureshi & Abbas, 2019).

Existing studies, including those in Pakistan, primarily focus on evaluating the financial performance of Islamic Banking Service (IBS). However, there's a lack of substantiated evidence on IBS's broader achievements regarding wider Islamic finance objectives, utilizing verifiable financial data from diverse Islamic finance markets. This study aims to fill this gap by developing a comprehensive performance assessment framework for IBS. It intends to measure the effectiveness of domestic IBS while considering Islamic finance objectives and utilizing publicly available financial information.

Hanif and Ayub (2022) formulated a performance evaluation framework for IBS, encompassing three key domains legal compliance, economic pursuits, and social equity. This framework was subjected to a global analysis of IBS data. However, their study lacks an in-depth analysis of specific market accounting data. In light of the persistent query regarding the effectiveness of modern IFSI in realizing its intended objectives, the necessity for an objective performance evaluation of the Islamic financial system persists (Hanif & Zafar, 2020). Moreover, a per-country examination of accounting data is needed to document the progress made toward accomplishing Islamic finance objectives (Hanif & Ayub, 2022).

The literature highlights the integration of sustainability principles into Islamic social finance mechanisms, emphasizing the long-term societal impact of instruments like Zakat, Waqf, and Takaful. This aligns with broader goals of responsible finance, including environmental, social, and governance (ESG) criteria. Studies identify limitations in standalone applications of Islamic social finance, such as fragmentation and inefficiencies. An integrated approach leveraging synergies between instruments is advocated, offering benefits like improved fund utilization efficiency, impact measurement, and access to financial resources for underserved communities. Coordination among stakeholders is enhanced, leading to a more effective response to social needs. A critical aspect of building sustainable Islamic social finance ecosystems is the establishment of robust regulatory and governance frameworks. Scholars argue that clear legal guidelines and transparent governance structures are essential to prevent misuse of funds and ensure accountability. The literature emphasizes the importance of government support in creating an enabling environment for integrated initiatives. Digital solutions have emerged as enablers for the integrated approach. Block chain technology offers secure and transparent fund tracking, thereby enhancing trust and accountability. Digital platforms also facilitate efficient collection, distribution, and reporting of Zakat, Waqf, and Takaful contributions.

The research highlights the importance of assessing the performance of Islamic banking, emphasizing the need for tailored evaluation models. One such model, the Maqāṣid-Based Performance Evaluation Model (MPEM), draws from Islamic principles to create a comprehensive framework. Developed by Mohammed et al., MPEM focuses on five dimensions: safeguarding faith, life, lineage, property, and intellect. This approach encourages Islamic banks to invest in areas like the real economy, agriculture, SMEs, technology, research, training, and CSR activities, aligning with the goals of maqāṣid al-Sharī'ah theory. Disparities in credit risk management performance within Islamic banking are evident, as explored in studies focusing on specific regions. Saleh and Zeitun (2007) analyze Jordan's Islamic banking performance from 2000 to 2003, finding progress in profitability, efficiency, and credit portfolio expansion. Similarly, Fayed (2013) compares Egyptian Islamic and conventional banks from 2008 to 2010, evaluating areas like profitability, liquidity, credit risk, and solvency using financial ratios.

2.1 Scope of Islamic Banking in Pakistan Context

Pakistan, established in 1947 after the partition of British India, is among the few modern nation-states founded on religious grounds. Islam is designated as the official state religion, and the Constitution aims to enable Muslims to live in accordance with Islamic principles. Notably, the Constitution explicitly prohibits Riba (interest and usury), highlighting this prohibition as a fundamental policy directive. Pakistan demonstrates proactive efforts in integrating Islamic values into its financial system, showcasing a steadfast dedication to religious principles in its economic framework. Internationally, the country actively participates in platforms like the Organization of Islamic Cooperation (OIC) and the Islamic Development Bank (IDB), aimed at promoting Islamic finance globally. Domestically, Pakistan has established specialized institutions and implemented initiatives to eradicate interest from its economy. Noteworthy is Pakistan's pioneering adoption of a nationwide Islamic financial system in the 1980s, illustrating its leadership in applying Islamic financial principles to its economic structure. The primary goal of the State Bank is to eliminate the interest system from Pakistan.

Therefore, Islamic banking wasn't well-known in the 1970s, it has become increasingly prevalent worldwide at the beginning of the twenty-first century, with an estimated account value of around USD 500 billion. The sector is growing at a rate of 11-15%. Islamic banking is also thriving in Pakistan, having gained significant popularity since January 1981 (Najaf, 2016). Pakistan's efforts to develop Islamic banking faced challenges, including a lack of trained personnel, and changing political priorities. Since 2000, Islamic banking has operated alongside conventional banking in Pakistan, resulting in significant growth and advancement. Branch networks and employment have more than doubled, with assets experiencing remarkable growth of over 400% between 2014 and 2021. Year-on-year asset growth consistently exceeds 20%, with only two exceptions (2016 and 2018) during the period under review.

Table 2.1: *Islamic Banking at a Glance in Pakistan from 2013 to 2021*

Description	2013	2014	2015	2016	2017	2018	2019	2020	2021
Size of the Industry (USD bn)	9.60	12.53	15.38	17.70	20.60	19.17	21.21	26.72	28.68
Fully Islamic banks	5	5	6	5	5	5	5	5	5
Islamic Banking Windows	14	17	17	16	16	16	17	17	17
Local Branch Offices	1304	1574	2075	2322	2581	3029	3219	3466	3637
Yearly growth in Branches %	-	20.7	31.8	11.9	11.2	17.4	6.3	7.7	4.9
Assets Base (PKR bn)	1,014	1,259	1,610	1,853	2,272	2,658	3,284	4,269	4,884
Assets growth %	-	24.2	27.9	15.1	22.6	17.0	23.5	30.0	14.4
Gross Revenue (PKR bn)		190.7	243.2	241.8	305.2	369.6	569.7	763.3	577.5
Growth in Revenue %	-	-	27.5	-0.6	26.2	21.1	54.1	34.0	-24.3
Capital Adequacy %	14.7	15.5	15.3	14.6	14.1	14.3	15.8	17.3	16.8
ROE %	14.4	20.2	19.8	15.4	17.6	20.5	33.7	38.6	31.4
Liquidity %	41.9	36.1	33.8	37.5	28.8	23.5	21.1	24.2	27.4

Source: IFSB 2020

Hanif et al. (2012) conducts a comparative study on the performance of conventional and Islamic banking in Pakistan from 2005 to 2009. They analyze key dimensions including profitability, liquidity, credit risk, and solvency. The study includes five Islamic banks and twenty-two conventional banks in its sample. Using standard financial ratios, the researchers aim to capture and explain the underlying dynamics of banking performance. The study reveals interesting insights into the performance of Islamic and conventional banking. Islamic banking excels in credit risk management and solvency, reflecting robust risk control measures and financial stability. However, it lags conventional banking in terms of profitability and liquidity. Hanif et al. (2012) provides valuable contributions to understanding the operations of both banking systems in Pakistan. By analyzing these key performance dimensions, their study enhances comprehension of strengths and areas for improvement in both banking paradigms.

Qureshi and Abbas (2019) meticulously document the superior performance of Islamic banking from 2010 to 2017, particularly in operating performance and liquidity, supported by relevant ratios. Their study includes two Islamic banks and fifteen conventional banks, ensuring a

comprehensive representation. Additionally, they compare the profitability of both banking systems from 2015 to 2017, each represented by one bank. The investigation reveals an equitable level of profitability between conventional and Islamic banks, as highlighted by Abideen (2019). Sohail et al. (2022) finds that Islamic banks in Pakistan exhibit comparable performance across multiple dimensions, except for return on equity (ROE). Analyzing data from three banks from 2015 to 2019, they note significant variance in ROE, highlighting it as a distinctive aspect of performance. While results from various studies vary, prevailing evidence suggests that Islamic banks often excel in management capabilities, especially in solvency and risk-related aspects. Earlier research indicates relative underperformance in profitability for Islamic banks in Pakistan, but recent evidence suggests positive trends with noticeable improvements in this area.

3. Research Methodology

This investigation meticulously tracks multi-level objectives using quarterly data spanning 32 quarters from the fourth quarter of 2013 (2013Q4) to the third quarter of 2021 (2021Q3). The dataset is compiled from authentic financial reports covering an eight-year period (2013-2021), ensuring reliability. The selection of this timeframe is based on the availability of comprehensive data regarding the Islamic Banking and Financial Services Industry (IBS), offering contemporary insights. This research utilizes data from the Islamic Financial Services Board (IFSB) database as of 2021. It covers both segments of the Islamic Banking and Financial Services Industry (IBS): Full-fledged Islamic Banks (FIBs) and Conventional Banks with Islamic Windows (CBIWs). The analytical approach primarily involves a thorough analysis of balance sheets, crucial for understanding and supporting the study's outcomes and discoveries.

The analysis begins by scrutinizing the balance sheet to understand the sources and allocations of funds, including equity, deposits, and miscellaneous sources like inter-bank liabilities. It examines deposit composition, distinguishing between profit-and-loss sharing deposits, current accounts, and other forms of funding like commodity *murābahah* transactions. The study also investigates the sectoral allocation of financing facilities provided by the domestic Islamic Banking and Financial Services Industry (IBS), visually presenting data trends with graphs covering 32 quarters from 2013 to 2021. While focusing on commercial performance, contributions to economic objectives, and socio-economic justice, it excludes legal compliance, which is rigorously overseen by Shari'ah boards. Discussions on Shari'ah compliance are available in other literature sources.

4. Analysis and Findings

Islamic banks in Pakistan utilize various sources of funds to operate and offer financial services while ensuring compliance with Islamic principles. These funds are channeled into different avenues, aligning with Shariah regulations and guidelines. Here's an elaboration on the sources and uses of funds for Islamic banks in Pakistan. Broader perspective of sources and application of Islamic made funds as reflecting in figure 1 but the detail elaboration in the next section.

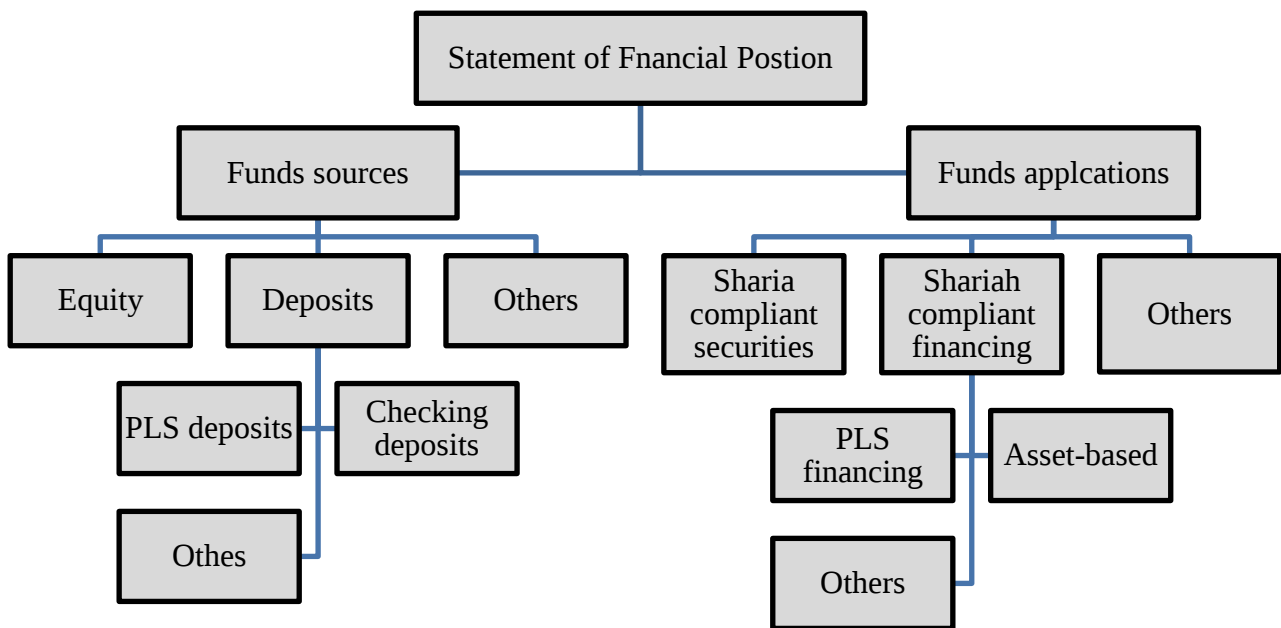


Figure 4.1: Statement of Financial Position categorical chart

Source: Develop by Author

4.1 Sources and Uses of Funds by Islamic Banks

Islamic banks gather funds through various deposit types like current, savings, and term accounts. They also offer investment accounts where customers contribute funds, and the bank manages investments using Mudarabah or Wakalah principles, sharing profits accordingly. Additionally, Islamic banks issue Sukuk (Islamic bonds) to raise funds for projects, with investors receiving returns based on asset performance. Equity financing through share issuance allows investors to become shareholders. Furthermore, Islamic banks provide trade-related funds, financing transactions through mechanisms like Murabaha and Istisna'a. whereas Islamic banks utilize funds for financing individuals, businesses, and projects through various Shariah-compliant methods like Murabaha, Ijarah, Musharakah, and Mudarabah. They invest in Shariah-compliant assets, ventures, and projects such as real estate and equities. Sukuk issuance raises funds for specific investments, with returns distributed among Sukuk holders. Funds are allocated for operational expenses, including staff salaries and technology infrastructure, and reserves are maintained as per regulatory guidelines for stability and liquidity. Islamic banks also allocate profits for charitable activities and community development projects. Savings and investment accounts contribute to generating profits through prudent investments, with returns shared with account holders. Funds are set aside for risk management to address potential uncertainties.

The numerical breakdown encompasses assets from both Full-fledged Islamic Banks (FIBs) and Conventional Banks with Islamic Windows (CBIWs). The primary source of funds is Profit Sharing Investment Accounts (PSIA), contributing 48.9%, followed by Current Accounts (CA) at 26.6%. Other Remunerative Funding (ORF), including modes like Murabaha, constitutes 6.1%, while Capital and Reserves (C&R) and Interbank Liabilities (IBL) contribute 6.5% and 5.9%, respectively. The remaining 6.1% comprises all other liabilities which brought significant shifts in the funding composition have occurred over the review period. Profit Sharing Investment Accounts

(PSIA) have seen a decline in their contribution to funding sources, dropping from 57% in 2013 to 43.4% in 2021, while Current Accounts (CA) have increased from 21.5% to 28.5% during the same period. Other funding channels show variations without a clear trend. In deposit accumulation, PSIA constitutes the largest portion at 59.9%, followed by CA at 32.6%, with Other Remunerative Funding (ORF) at 7.5%. Full-fledged Islamic Banks (FIBs) show similar trends, with PSIA at 63.1%, CA at 32.5%, and ORF at 4.5%. The shift towards PSIA in deposit management reflects efforts by Islamic banks in Pakistan to foster customer trust, as profit-and-loss sharing relies on established trust. The decline in PSIA and rise in CA provide the IBS with alternative funding avenues.

4.2 Application side of funds

During the review period, assets within the Islamic Banking and Financial Services Industry (IBS) were comprised of contributions from both Full-fledged Islamic Banks (FIBs) and Conventional Banks with Islamic Windows (CBIWs). FIBs accounted for 59.4% of total assets, while CBIWs contributed 40.6%. Notably, Total Shari'ah-Compliant Financing (TSCF) held the largest share at 46.9%, followed by Total Sukuk Holdings (TSH) at 22.5%, Interbank Financing (IBF) at 12.5%, and Other Shari'ah-Compliant Securities (OSCS) at 3.9%, with the remainder falling under Total Other Assets (TOA). TSCF experienced a rise from 32.6% in 2013 to 57.8% in 2018, then declining to 47.6% in 2021, while TSH decreased from 29.7% in 2013 to 15.1% in 2019 before increasing to 25.4% in 2021. OSCS decreased from 9.4% in 2013 to 2.8% in 2021. FIBs showed higher maturity levels compared to CBIWs, particularly in customer financing, with TSCF at 47.6% for FIBs and 45.9% for CBIWs, TSH at 20.3% for FIBs and 25.7% for CBIWs, OSCS at 3.2% for FIBs and 4.9% for CBIWs, IBF at 14.6% for FIBs and 9.6% for CBIWs, and TOA at 14.4% for FIBs and 13.9% for CBIWs.

4.3 Sectoral Analysis in Shari'ah-Compliant Financing

The analysis of sector-specific allocation of financing by the domestic Islamic Banking and Finance sector, primarily focused on Full-Fledged Islamic Banks (FIBs), reveals significant insights into the sector's priorities and strategies. Approximately 60 percent of the Islamic Banking and Finance sector in Pakistan comprises FIBs. Sectoral classification includes Agriculture, Industry, Energy, Trade, and Services. The bulk of financing, 70%, is directed towards the industrial sector, with allocations to services 11.3%, trade 9.4%, energy 8.6%, and agriculture 0.6% following. Despite agriculture's crucial role in the economy, it receives limited attention from Islamic banking institutions. Given its importance in employment and GDP contribution, prioritizing agricultural and rural financing is essential for equitable wealth distribution. Additionally, the services sector shows disparities, with significant financing directed towards transport and communication, while investments in social sectors like education and healthcare remain inadequate. These findings suggest a need for the Islamic Banking and Finance sector to fulfill its social responsibility obligations more effectively.

The findings from 32 quarters of data shed light on the achievement of Islamic finance objectives in Pakistan. In terms of foundational objectives, the Islamic banking sector has grown significantly, expanding branch networks, increasing asset volumes, and ensuring capital adequacy levels around 15% with an average return on equity exceeding 20%. The sector adheres to Shari'ah compliance facilitated by well-structured Shari'ah supervisory frameworks, with controversial financial products utilized minimally. However, concerns exist globally about weak Shari'ah governance.

Intermediate goals reveal the sector's role in advancing economic objectives, with risk-reward sharing contracts exceeding 50% in deposit accumulation and financing. Asset-Based Financing (ABF) contributes significantly to financial stability, yet challenges persist in providing finance access to sectors like agriculture and rural areas. Advanced goals highlight the sector's limited contribution to social responsibilities, with only approximately 5% allocated to sectors like education and healthcare. However, charity funds integrated into the business model support various community development projects, totaling around PKR 1.22 billion allocated over the specified period. These findings underscore both successes and areas for improvement within Pakistan's Islamic banking sector.

5. Conclusion

The research offers a comprehensive evaluation of Pakistan's Islamic banking sector in achieving Islamic finance objectives across basic, intermediate, and advanced levels. These objectives encompass adherence to Sharī'ah principles, commercial performance, financial stability, equitable wealth distribution, and social responsibility. Drawing on authentic accounting data spanning eight years from 2013 to 2021, collected from Pakistan's Islamic banking sector, the findings confirm success at two main levels. Firstly, they highlight the industry's robust survival and growth, demonstrated by its adherence to Sharī'ah-compliant principles and strong commercial performance. Secondly, the sector significantly contributes to broader economic goals, including fostering financial stability and promoting risk-reward sharing financial contracts. Notable performance metrics include profitability, network expansion, and liquidity management, alongside an increasing adoption of risk and reward sharing financial arrangements and asset-based financing within the domestic industry.

The research highlights the limited impact of Pakistan's Islamic banking sector on socio-economic advancement, particularly in social sector investments and financing for agriculture and rural areas. It suggests policy implications based on these findings. Firstly, Pakistan's Islamic banking experience can serve as a model for other nations in achieving basic and intermediate objectives through prudent portfolio composition and avoiding controversial products. Secondly, regulatory authorities should craft a tailored regulatory framework for the Islamic banking sector, informed by practical experience. Lastly, the sector should incorporate the social sector's role into strategic planning, potentially by offering *qard ḥasan* to those in need, aligning with broader social responsibility objectives.

The research concludes by highlighting potential investment opportunities within Pakistan's Islamic banking sector, based on data spanning 32 quarters from 2013Q4 to 2021Q3. It acknowledges the study's limitations, particularly the exclusion of legal compliance due to the oversight provided by Sharī'ah boards. Despite this limitation, the study provides insights into other aspects of Islamic banking performance. Future research could explore Sharī'ah compliance and its relationship with performance evaluation using the analytical framework established in this study.

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