MODERN MANIFESTATION OF EXPLOITATION OF INTEREST

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FORWARDING SHEET

The thesis entitled "Modern Manifestation of Exploitation of Interest Rate" submitted by Miss.Amna Safdar Cheema in partial fulfillment of MS degree in Management Sciences with specialization in Finance, has been completed under my guidance and supervision. I am satisfied with the quality of student's research work and allow her to submit this thesis for further process as per IIU rules & regulations.

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IN THE NAME OF
ALLAH, THE MOST MERCIFUL AND BENEFICIENT

DEDICATION

"To my great parents who are praise worthy for their sustenance of me on right lines because I am today, only due to their untidy efforts for my sake"

ABSTRACT

The purpose of this study is to give the understanding about the exploitation of interest rate. In this study the focus is directed towards the exploitation of depositors. Study gives the critical analysis of financial exploitation, ways of exploitation, principles and theories associated with exploitation through interest rate then emergence of interest and what can be the possible substitution of interest rate. Based on the concept of exploitation a conceptual framework proposed for evaluating the exploitation of owner of money done by the user of money by banking sector of Pakistan.Finally it examines this exploitation from banking sector of Pakistan and regulatory steps taken in this context. In this study to examine the growth of user of funds compared with the growth of the owner of funds. Growth of user of funds is determined through asset growth and leverage. Growth of owner of funds is determined through the deposit rate offered by financial intermediaries.The results indicate that owner of funds are being exploited by user of funds because they are getting benefits at the cost of owner of funds. Profit and loss ratio minimizes the risk of loss to the depositors. Depositors (owner of money) do not know where their funds are being invested. Explicitly banks are blamed to exploit the depositors; true but ultimate benefited party is user of funds. They are violating the Islamic concept of profit and loss sharing, and making paramount profits.

In Pakistan banking activities should be turned to Islamic concepts, as there is a huge gap in Islamic and conventional banking sector of Pakistan.

Key words: Exploitation, Value maximization , Islamic Banking .

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DECLARATION

I hereby declare that this thesis, neither as a whole nor as a part thereof, has been copied out from any source. It is further declared that I have prepared this thesis entirely on the basis of my personal effort made under the sincere guidenance of my supervisor.

No portion of the work, presented in this thesis, has been submitted in support of any application for any degree or qualification of this or any other university or institute of learning.

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Praise is due to Allah, Whose worth cannot be described by speakers, Whose bounties cannot be counted by calculators and Whose claim (to obedience) cannot be satisfied by those who attempt to do so. All the praises are attributed to the sole creator of the universe " the Almighty Allah", the Compassionate, the Merciful, the Source of all knowledge and wisdom, who bestowed up me health, thought, talented, sincere and cooperative teachers, friendly brothers and sisters, helping friends and power of communication and who gave me the strong courage to complete this thesis.

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CHAPTER 1

INTRODUCTION

The most important role of financial system in any economy is distribution of resources among different sectors to enhance the efficiency of capital and increase investment to achieve economic growth. Major institutional portion of any financial system is banking segment. Financial intermediation between borrowers and lenders, whether they are firms or government, improve the resource allocation and economic growth. An important part of economic activity is to borrow whether domestically or abroad. The underlying principle in the process of debt creation is that borrower always wants to get huge profits by using the money of others by paying a fix rate of return. Ultimately when the cost will be low as compare to the profits then the user of money will be better of as compare to the owner of money.

Since Great Depression, the world economy is facing hurdles in the process of human and economic development. Although the financial crises started from the most developed countries but the results of such shocks disturbed the economies of developing countries as well. There were so many interrelated and multi-dimensional factors that led towards the crisis; they were from different domains starting from political to financial (including interest rate), regulatory to economic etc. One of the reasons of financial crisis is the structural and regulatory reforms for banks in USA from 1970s to the mid of 1980s e.g. Deregulation of Depository institutions, Act of Monetary Control and Depository Institution Act of Garn-St.Germain. After the structural reforms banks were free to open branches wherever they wanted but another alarming thing was to increase the interest rate which went sky high after reforms.

Interest rate plays a role of back bone for banking sector and it can effect the operations of financial system within an economy. All commercial banks engage in creation of profits by making loans and taking deposits that's why some authors suggested calling these banks business banks rather than commercial banks (Kahf, monzer, 1982).

The word Interest however has two schools of thoughts, first one is in the favor of interest based economy i.e. conventional banking, and the other one is in the favor of interest free economy i.e. Islamic banking. Discussion on these schools of thoughts needs the clarification of the word "usury" or "interest". Word "Usury" is taken from the Medieval Latin term usuria, it means the interest or excessive amount of interest and originally meant to charge and get a fee for utilization of money (Beng soon chong , ming-hua liu,2009). It was srictly banned even before the emergence of the Abrahamic religions of Judaism, Christianity, and Islam, all of them prohibited usury as well (Iqbal, Zubair and Mirakhor & Abbas, 1987). Ban on interest has a very old history it goes back to the Code of Hummurabi in 1760 BC. From previous literature it is found that the focus of all secular and religious theories is on the overall well being of society. So it should be the point of concern that which services are being provided by financial intermediaries? Who is getting those services? At what price and what is the underlying cause?. In the absense of these clarifications financial system is quite ambiguous and left with hysteria (Chapra, M. Umer, 1982).

Interest based economy is established on the concept of profit maximization which is derived from secular theories like deontology, utilitarianism and virtue ethics. All of these theories talk about the overall welfare of society (irrespective of considering the benefits/losses to the poor class of society). Though this world is surely common for all human beings, every individual has his own vision and the degree of exploitation

explains the distance between these two. In practice, it means that a given situation can be examined completely in a different way by different persons, to the point where A's exploiters become B's exploited, inspite they agree on the apparent facts of the case (Vidhu Verma, 1998). But the end result should preferably be in the form of value maximization of society. Exploiters are usually those who get advantage from the situation, but they can be located far away from the exploited in an economic structure. And even when they confront each other their gain may seem a fair reward for their own personal efforts.So the focus of all activities within an economy should base on the concept of Islamic standard of value maximization which is based on equity and justice. Theories on exploitation like structural (Marxist, New liberal) and organizational (Neoclassical) discuss that how the power and influence of special interests work in a society. According to Marx exploitation is the name of raising the total amount of production in capitalist society, while according to Neoclassical theorist's exploitation is a form of inefficiency, which lowers the growth under capitalism. As per these theories if rent or interest is abolished from the society it would make everyone ultimately better off.

Financial sector has a variety of rules governing the products; due to this variation in rules poducts are being complexed and causing severe problem even for investors. This situation is alarming because the standard rule of interest prevails; even in Muslim countries a lot of variation in financial products is observed, resulting in financial exploitation. The process to calculate the rate of interest is so confusing as there are no proper rules and regulations to calculate, charge, compute and disclose. There is a lot of variations and sometimes these variations are just to reap unfair profit which is unethical.

1.1. Objective of the Study

It has been a general understanding that the borrower (user of money) is exploited by the lenders (owner of money). Since times immemorial the mankind has been involved in exploring different dimensions of this paradigm of exploitation. Many writers favoring the interest based financial system because the grounds are of exploitative nature and is being argued that the current banking system is not exploitative in nature as the borrower is not charged exorbitant rate of interest. Rather they are helped in their growth of business and therefore, the current interest based system is the one working as engine of growth in the economy. Yet all such studies have been ignorant of the fact that user of the money is not the only stakeholder who could be manipulated but it may be the other way round. Although there have been some empirical studies on the depositors exploitation but they have only focused on such exploitation at the hands of financial intermediaries but not from the standpoint of actual user of money. And inherent exploitative elements of "consideration" amount as "interest".

Objective of this study is to understand themultifaceted potential of exploitation inherent in the transaction where consideration is "interest" by following.

The below-mentioned queries:

1- To check the rate of return paid to the depositor and the return charged from the creditors.

2- To compare the return paid to the depositors and the return charged from the creditors.

3- To check the growth of user of funds and the growth of owner of funds.

4- To compare the growth of user of funds and the growth of owner of funds.

CHAPTER 2

LITERATURE REVIEW

2.1. Money and Usury

Human beings are used to pay for the use of property of the others. Such returns are making the history of financial system. When we look into the background, it is clear that it is an easy way to become the owner of money/property by borrowing instead of killing him/her (Jean-Michel Bonvin and Paul H. Dembinski). It gives the sunrise for modern day's financial system. Now we just gave the different names like rent for buildings/lands, hire for the use of property and interest for the use of money. Henry clews (1892) discussed that the customary practice in our conventional banking system is that the borrower agrees to repay for each ten rupee which he receives twelve rupee and a half within two or three months, or at the rate of 100 to 150 per cent, per annum. This is not interest: it is insurance against the dishonesty of the borrower (and borrowers on such insecurities are frequently dishonest) and against arrest and criminal prosecution, since such things are of constant occurrence. People who do not want to return borrowed money find no difficulty in procure warrants from police justices against their creditors who have agreed with them to commit usury. In fact, under the Penal Code the magistrate has no option. The statute is perfectly clear. The person, who gets the interest or any type of discount or consideration upon the loan/forbearance of money, goods, or things in action, greater than is allowed by statute, is guilty of a misdemeanor (Maznevski, Kemp, Overstreet, Crook, 2001). No matters he receive this extra amount directly or indirectly. "All misdemeanors are criminal, and are punishable by fine or imprisonment, or both.

2.2. Financial intermediation and lending process

According to Joseph A.Schumpeter Monetary theory of credit should be replaced by Credit theory of money which is being practically analyzed. The academic research on financial intermediation has increasingly concentrated on that. Financial system is basically a service industry. As its role is to make sure the fluent fluidity of all those transactions which are a necessary part of economic growth and contribute towards the over all best utilization of available resources (Jean and paul , 2002). Banks are in the business of selling credit. Commercial banks make their profits from the interest rate spread on the asset over the liability side of their balance sheets. The two-sidedness of bank balance sheets is very important; since the quality of loan performance and borrower collateral determines the real backing behind credit money. In financial intermediation a bank is always able to increase the level of its total assets by making additional loans (Benjamin and Wilner, 1998). When a bank grants a loan to one of its customers, it simply credits the amount to the borrower's account. As the borrower spends the proceeds, some of the recipients will leave the money on deposit with the lending bank. Through succeeding generations of transactions a lending bank will lose at clearing more and more of the deposits created by the initial loan. On the other hand, it will gain deposits from the bank's own depositors who are recipients of the funds expended by new borrowings from other banks (Michael , 2007). This relation between loans and deposits has pertinently been termed the banks' deposit retention function (James , 2009).

While granting loans generaly observed criteria are as follow:

1- Reason of getting loan

2- Amount of loan requested

3- Repayment of Loan by applicant

4- Trustworthiness of creditor

5- Chances of default

Final decision is based upon the critical analysis of loan officer whether a loan should be granted or not.

2.3. Financial Decisions and Behavioral Finance

Behavioral finance adresses the issues encountered while granting loans in the financial sector. This is general phenomenon that human decisions are being directed by their biases. Behavioral finance exposed the theories of sociology and psychology to explain the errors done while making financial decisions. Psychological prospects theory explains that human beings are being directed by their biases while making decisions. These decisions are not based upon the rationality but it happened because of biases.

Behavioral finance addresses the issues of individual investors while making financial decisions. Individual investors shift their decisions by observing the trend of decisions of mass investors in the market.

In any financial system, the two basic elements are:

1-The unit of account

2-The information system

These two elements make sure the right transactions if it would be exchange of money or gift etc, and convey the basic rights and liabilities being raised through such transactions.

Behaviraol finance explains that in a financial sector loan officer usually gathers two types of information about a creditor:-

1-Acoounting Information

2- Character information

If accounting information about an application of loan is in the favor of creditor and loan officer is satisfied with the cautiousness of the creditor (seriousness of creditor to invest and ability to generate profits) the loan is granted. But if the accountiong information about a loan is negative then loan officer do not enquire into the character information.

Allan (1969), explains that at one time financial market can-not be competitive because one party i.e. financial intermediary charge the interet rate and creates profits by paying less to the depositors. Wilner (1998) also explains that loan officer charge different rate of interest to different creditors depending on their ability to repay and their degree of dependence.

2.4. Relationship of Credit and Money

The basic element in any transaction is the level of trust and confidence. Same is true for all financial transactions between two or more parties. When someone gives loan to the other it means he/she is having some level of confidence. Credit raises the

promise to repay and the counter party is assumed to keep that promise (Andrew and Carmen, 2008). This trust and the confidence that the borrower will repay the loan after agreed time period constitutes the essence of loan. To build trust and confidence we need social relationship that's why some authors suggested that money generates the relationships as well. Aubrey (1963), explained how credit differentiates from the other relationships as this relationship is being generated through exchange of goods and services between two or more parties. So the money should also be viewed as social relation rather than just a thing.

2.5. Impact of Interest on Firm Performance and Stock Prices

Lili (2007) studied that how the firm performance is affected through banking structure. His study is based on the empirical analysis of 40 countries which include both developed and developing countries. He concluded that there is a negative effect of the banking system on overall growth and performance of firms. He also argued that the positive effects of economies of scale are negatively affected by the variation in interest rates. However, in some countries where the creditors are well protected and they have informational efficiency about their rights and obligations, their situation is other way round and the negative impact of variation in interest rate on firm performance is also low (Sudin and Norafifah, 2000). It is being observed that there are weak rules and regulations for banking sector and banking activities are left at the hands of witty bankers (Westerfield, 1934). The situation is true for all countries and even the developed nations are also facing the same situation and problems due to complex banking system. Lili (2007) suggested that the impact of variations of interest rates and there negative influence on firm's growth should be considered by policy makers especially in developing countries. Their study provides that countries with high economic development and with strong institutions are in

trouble just because of the variation of interest rates. Alam (2009) explained that for the economic development and growth of a country two basic factors are very important; first stock exchange and second the interest rate. The interest rate can effect the over all economy because it has its roots in monetary policy, the practices of risk management, valuation of financial securities and regulations towards financial markets by the policy makers. So if there is a little variation in interest rate it can lead towards the huge changes in overall financial structure. Interest rate is considered as most crucial macro economic variable which has a direct relationship with economic growth. General understanding is that when someone uses the money of other he has to pay some cost and rate is considered as a cost of capital. From the borrower view point rate of interest is the cost of borrowed money i.e. borrowing rate. And from a lender's view point, rate of interest is the fee which is charged for money i.e.lending rate). The main purpose of all investors is to get high return from their investments.

If the depositors are getting high rate of return on their deposits from bank they will definitely switch their capitals to banks from stock market. It will lead towards the decline of demand of share price and price will automatically decline. And when banks will give high rate of return to the depositors, the interest rate on loans will also be increased by banks which will further lead to low investment in an economy that is another reason of decline in share prices. So, there exists an opposite relationship between rate of interest and share price. Alam (2009) explores the relationship between rate of interest and share prices. In his study, the evidences behind the existence of the efficiency of share market based on the monthly data and also showed empirical relationship of S. Africa, Spain ,Chile, Colombia, Bangladesh, Canada Germany, Italy , Malaysia, Mexico, Jamaica, Japan Philippine, and Venezuela. He established that the stock market is not efficient in weak form. To examine the

rationale of market inefficiency and relationship between share price and interest rate, and change of share price and alteration of rate of interest were analyzed through time series as well as panel regressions. For all of the above countries it was experienced that rate of interest had clearly negative relationship alongwith share price and also for six countries it is observed that modifications of rate of interest has significant inverse relationship with changes of share price. It was concluded that if the rate of interest is noticeably proscribed for these countries, it would be the huge benefit of these countries' stock markets.

2.6. Banking Structure is right or wrong?

Ray (1934) openly discussed that United States, for the first time in hundred years, now had an opportunity to establish a sound banking structure. He said unit banking structure had failed. The bank officials, both high and low, lost their social group. The people left with no reason to consider them as expert. Even the capable officials are caught and overwhelmed by a system which is inherently weak and lacks the basic elements of stability. Major trouble lies in the banking system and the philosophy that supports it, and no remedy can come except by changing that system and ideology.

2.7. History of Interest

It is obscure to discuss banking in a financial system without a thoughtful discussion on the origin of Riba and its genesis "usury". The origin on the ban of usury goes back to 400 BC; even Usury (like any type of interest) was clearly prohibited by various spiritual scholars and leaders of old times, they include Cato, Cicero , Plato, Aristotle, Muhammad, Moses, Seneca, Plutarch, Acquinas, Philo and Guantama Buddha (Iqbal and Molyneux, 2006). Taking interest on a loan made to a borrower was considered inherently evil and immoral. If usury was truly evil, why was it not universally

condemned? .The universal prohibition on usury was imposed by the Catholic Church in 1139 (Ariff, 1988). Modern banking system justifies that interest is permissible but "excessive" interest is not permissible. By keeping in focus this definition the meaning of usury is also changed. Proclamations against the computing and charging of interest give emphasis to that poor are in trouble, but sarcastically, the poor are in fact paying the highest interest rate in the current financial economy. Modes of charging interest got reshaped with the passage of time. Charging high interest which was considered an inherently evil activity is now widely accepted as a matter of everyday economic transaction. Charging and paying interest on loans is taken for granted in modern financial transactions. Modern financial system rarely deals with free loan. A free loan is often considered to be like a free lunch, that is, suspicious. Martin (1999) said in free loans it is difficult to escape from taking or giving of interest in modern financial dealings. Even a loan that seems on the surface to be free from interest may not be so at all.

2.8. Interest in the context of Islam and Judaism

Judaism and Islam both contain strong moral and legal interdictions against the taking of interest. Taylor and Evans (1987) explained the basis for the Islamic prohibition against riba in commercial loans, it is the central belief that one should not gain profits where one has also not taken on risk. In order to ensure that economic activity and growth can continue, Islam and Judaism had developed different contractual forms of advancing funds for profitable investment that do not violate the prohibition of interest. Both systems maintain a strict attitude against interest-bearing loans to the poor. The Quranic verses (2:278–280) clearly state the prohibition of interest. Economic activity can flourish even in accordance with Quranic prohibitions against usury. Martin (1999) gave clear examples of Turkey financing houses that

operate under Quranic guidelines which had captured up to 3% of the nation's deposits, Citibank and other banks transacted more than US$10 billion in Islamic financing in 1993, and London has grown into an important Islamic finance center. Modern banking practices are violating the underlying rules for value maximization, and pamper the unethical practices i.e. exploitation through interest rate.

2.9. Theories of exploitation

Theoretical underpinnings of "Exploitation" describe it as unequal, as taking something which is uncompensated, It involves the notion of taking something which belongs to another (Verma ,1998). Theorists have categorized the exploitation into two categories:

- Structural exploitation
- Organizational exploitation

According to the Marxist view, "normal" exploitation is being done in societies by two ways; first when power and property is distributed unequally and secondly, when agent takes the advantage of the principal. Marxist explains the exploiter as free rider who unfairly uses a financial resource. Marxist and New classical theorists like Das Kapital and Karl Marx explain structural exploitation by assuming the environment of pure competition as "the scale of exploitation will be greater if there is a greater power of capital". While dealing with structural exploitation, Marx describes exploitation as raising the total amount of production as the user of a resource is getting undue advantage of the owner of that resource while in Neoliberal theories exploitation represents a form of inefficiency and exploiters have bargaining power. Structural exploitation can be controlled by using profit –sharing agreements. When

we deeply look at the Marxist idea of exploitation, it is obvious that using a debt by the user of money in a financial system is a way of exploitation of the owner of the money. User of the money is a free rider in a financial contract. According to these theories, eliminating rent or rate of interest would make everyone ultimately better off. Marxist theory define the exploiters as those who gain an extraordinary position in society by scheming an important asset and can transfer the distribution of income in its track, make poor the rest, even though their role provide no reasonable purpose. Maynard Keynes argued that non- working owners of financial wealth, who receive interest, are exploiters, though they add nothing to humanity. They just own a certain asset and have the aptitude to make money from that asset without actually performing any work by them. In this way, the earnings which are being produced by the user of money is a way of exploiting the depositors and investors in a financial system.

2.10. Theories of Ethical and Moral Behavior

When we classify Theories of Moral and Ethical Behavior, there are two systems.

Deontology....Inherent Nature

Teleology....Consequence of the act

In Deontolgical System, something is bad or good not because of its ultimate result but because of its inherent nature i.e. itself the act is good or bad. FORMALISM is an exapmle of deontological ethical system which is introduced by a great philosopher Immanuel Kant (1724-1804). Kant Emphasized on the hidden motives behind an act. His approach is that may be something is looking so good and actually be bad and vice-versa, something look too bad but really be so good.

From a telological system the consequences of something would decide the nature whether it is good or bad.

UTILITARIANISM is an example of Telological system, and idea is given by Great British philosopher, Jeremy Bentham (1748- 1832). His approach is based on "Pleasure Principal" which explains that human are always inclined to pleasure and stay away from pain. The root word in utilitarianism is "utility" it means "useful."i.e. if something is useful then its consequences must turn out to be useful in the short-run. If we see the interest in the context of moral and ethical theories the underlying cause and consequences both are not desirable in any society (Diamond ,1963).

2.11. Comparison of Islamic and Conventional Banking System

The first experience to introduce the Islamic banking was in EGYPT. Although it was not projected with Islamic image to avoid the expression of Islamic Fundamentalism. The first saving bank was established on the basis of profit and loss sharing by Ahmed Al Najar in Egypt Mit Ghamr town in 1963. This was experienced till 1967. Meanwhile, other banks were established in the country with the same ideology.These financial institutions were not involved in taking and charging interest rate.

The prominent feature of Islamic banking is the absense of interest rate from all of the operations of financial intermediaries. Chapra (1982) explains that it will lead to the healthy activities in an economy like equitable distribution of wealth and more participation by the investors in Islamic countries. Islamic teachings lead towards the rationale that Islamic economy should be free of interest.

According to the Islamic teachings no one is allowed to engage in the activities including interest. There are multiple reasons for this prohibition. Khan (1968)

explains in his study that interest is predetermined cost of production (investor is not taking any kind of risk) which lead towards the reduction of employement in a society. Further Khan (1986) concludes that the basic reason of international monetary crisis was the interest rate presense in financial sector.

A common point in all debates about interest rate is that it is exploitative in nature. Altough some are arguing that the profit under Islamic system is also exploitative. But there is a huge difference in profit and profiteering. Islam prohibits the profiteering. In an Islamic system even capital is not costless. Islam explains the capital as one of the factors of production. But one can not make a fixed claim over that capital without working anything for that.Then the question arises what should be replaced by interest in an Islamic financial system?. Kahf (1982) described the best alternative is Profit Sharing Ratio. If the enterprneurer is getting profit then he must share the reasonable profit to the owner of the capital. The only reason of acceptance of profit sharing in Islam is that it is not being fixed like rate of interest which enterprenurer has to pay even in loss. In analysis of Islamic banking we came to know that Islam does not reject that capital deserves to be rewarded as a factor of production. Islam permits the owner of capital to share in profit which is uncertain.

According to Islamic teachings, the person who is taking loan can not ask for fix rate of interest as his income from that specific project is not certain then how he would be able to pay fix interest? .In the same way the depositor is not allowed to ask for fix return as he is not sharing the risk of loss with the creditor.

There are two acceptable ways in an Islamic financial system:

1-Mudaraba

2-Musharaka

This is the criticism that how the owner of money can share the loss with user of money. The person who is taking anything extra on his principal amount without doing any effort is engaged in receipt of interest. According to the Islamic teachings, he can share his ideas with the user of money to make the invetment better off. He can share his experiences and knowledge with the user of money. Same practice was prevailing even in pre Quranic era and was permitted by Prophet Muhammad (PBUH). This kind of loan transaction is known as Mudaraba in which one person is pulling his efforts and other is pulling ideas and money.

Another mode of financing is Musharaka in which two or more parties are pooling their funds to get the economies of large scale. They share their investment with agreed proportin and then get the profit according to the predefined ratio between them.

A recent International Monetary Fund study done by Iqbal, Zubair and Mirakhor, Abbas (1987),suggests that Islamic Financial System is a good system that creates efficient resource allocation. Their study argues that financial institutions in an Islamic Financial System face limited solvency and liquidity problems than the conventional banks. In literature we have seen so many empirical studies which demonstrate the success of Islamic banking. Khan (1983) study suggests, the success of Islamic banks operations in Sudan, Bahrain, Jordan ,United Arab Emirates, Egypt and Kuwait. His study argued that these financial institutions had little problem in implementing practices according to Shariah. He demonstarted two types of investment accounts; the one in which the owner of money authorized the financial

intermediary to invest the amount in any kind of project and the second type is where the user of money had a choice of project in which he wants to be financed.

Khan explained the success of Islamic financial banks who offered the profits from 9 % to 20 %, which were competitive with the banks having conventional practices. Rate of return to owner of money was within 8% and 15%, which are comparable with the return provided by conventional banks. Iqbal, Zubair and Mirakhor, Abbas (1987) have noted that the Islamic Financial system in Iran forward less than half of its resources for making credit to the private sector, mostly were in the form of short-term funds, i.e., commercial and trade activities. One of the important points of Islamic Financial System is that it is related about the feasibilty of the investment project and the output of the operation but not the size of the security. Islamic banks can play a very crucial role in enhancing economic growth and development.

After fourty years of establishment of Islamic banks they have managed to pose themselves as financial intermediary not only playing vital role in mobility of resources ,resource allocation and utilization of resources but also activate the process of enforcing government policy. Islamic Banks are offering almost all activities of traditional banking, and also facilitate domestic and international trade. Now there are almost more than 200 financial institutions operating with interest free activities in 40 countries all over the world and rendering services that are compatible to the services provided by conventional banking institutions. Islamic financial institutions also depend on depositors' money because that is a major source of financing. For example, Bank Islami had total deposits upto 83% of total liabilities and shareholders' equity as at the end of 1998. As depositors' money is a main source of financing, it is important for the smooth activities of Islamic financial institutions to know the factors which can influence customers' decision making while depositing their money and

also looking at their concerns. Metawa and Almossawi (1997) explained religion as a main factor of customers' decision making process of Islamic bank in Bahrain. The evidence from studies done in Turkey and Sudan explained that religion is not the only reason to choose Islamic banks by. Interest Rate has always been one of the most important elements in the saving behavior of customers. According to Classical economist's savings is a function of the rate of interest. The higher rate of interest, the higher money will be saved, as at higher interest rates customers will be willing to forego present consumption. Based on the concept of utility maximization, the rate of interest is very important for modern theories of consumer behavior.

There are some authors who don't believe that there is a difference between the Islamic and conventional bank's services.

Metawally (1970) argues that people who deposit their funds to Islamic financial institutions are normally looking for monetary rewards. But the practices in Islamic banks in Muslim countries explain the other story i.e. Islamic banks do not pay more to their depositors. Paramount examples are from Sudan, where Islamic banks never paid to their current account holders and inspite of that they are the major provider of funds to these banks. Another success story is by Kuwait Finance House in 1984 when they did not pay any profit to their providers of funds but no massive withdrawals of deposit were noticed.

It concludes that the behavior of investors is based on some other aspects which should be noticed by the management of Islamic Banks. The principles which differentiate the beavior of Muslims are the belief of the day of judgment and life hereafter.

These principles have a major impact on the process of decision making of Muslim customers, and also have an impact on their perceptions about Islamic banks. Conventional financial system depends on interest. And the Islamic financial system differs from its Western counterpart. The Islamic financial system is based on a number of doctrines found in Islamic law. The vital part is the prohibition of rate of interest. Islamic finance comprises on equitable profit and loss sharing with the owner of capital by the user of money. Islamic tecahings reject the concept of taking and charging interest and allows undefined rate of return based on profit.

2.12. Financial Exploitation and Financial Crisis

Financial crises of this century reflect some serious concerns about the current structure of conventional financial system. In 1997-1998 Asian Crisis ,1994 collapse of bond market , 1995 collapse of Baring Brothers , in 1997 Asian stock Market Crash, the Mexican Peso Crisis in 1995, financial instability in Russia 1998. financial shocks in Brazil 1998, stress on the financial market of Turkey and Argentina in 2001,Global Financial Crisis 2008, and now the crisis of whole europe experienced worsely in Greece 2011.

During these shocks the picture was clearer and we came to know about the role of financial intermediaries and the rationality of depositors. These shocks reached all over the world. These shocks are not the example of competition but this is an example of lack of confidence of depositors towards the banks. Reconstruction of the International Financial Architecture indicates interest as a major cause of all financial crises. The role of financial sector is to improve the economic growth. In 2007 sub-prime mortgage crisis caused huge losses in market it brought disturbances throughout the financial markets. If we look at the given small size of the United

states sub prime market in relation to global financial markets then the scale of loss has been surprising (Bonvin , 2002).The foundation for the global financial crisis was laid in late 1960s when the deregulation took off after which the banks start trembling which were previously stable. Due to demands by the civil rights and social justice movements, government enacted Fair Housing Act (1968), the Act of Home Mortgage Disclosure ,1975 , Equal Credit Opportunity Act 1974, and Community Reinvestment Act (CRA) ,1977 all these to banned racial discrimination in lending. Financial innovation in developed countries, such as securitized mortgages, expanded credit, and poorly monitoring and regulation of financial derivative instruments. which allowed all financial intermediaries to become rigoriously exposed. And these factors have played a major role in turning the financial system more susceptible to crisis. For many developing countries it is noticed that the seven year period prior to the crisis was a period of rapid growth, rising commodity prices, improved macroeconomic situation and reduced poverty. Bonvin and Dembinski,(2002) stated that the financial crises of the late I990s in East Asia were caused by the financial institutions in the process of intermediation and in thecreation of financial fragility and instability at a system level. Khan and Mirakhor (1990) suggest that Islamic system is best suited to absorb shocks. In the aftermath of the Asian crisis, the IMF introduced a new lending behavior in an attempt to address the issues of corruption especially to deal with those countries that were innocent victims of issues created elsewhere. In fact it is proved that without a stable and well- functioning financial system, there is no other way that an economic system can grow. A well-operating financial system is the backbone of society. Because when it works we use to take it for granted and when it does not then watch out. But, as we have observed recently that financial markets and institutions can go wrong at a moment's notice. To prevent

such impacts, governments take measures to regulate and monitor the activities of financial institutions and markets. And history dictates that financial stability should be the first priority of the central bank.

2.13. Profit Maximization versus Value Maximization

At the heart of Islamic economy is the principle of value maximization based on equity and justice, which constitute just dealing and fair play for the welfare of society as a whole. Different practices prevailed in modern financial system; often questionable on ethical grounds. Different schools of thought like utilitarianism and deontologist provide people the different solutions for ethical problems andexplaining the different dilemmas like how to live a good life and the better standard of living. There are some basic rules for human life in this world to which all of the scholars from all religions are agreed. There are some principles to which there is general consensus among all scholars from differenet religions.

They believe that some acts are clearly prohibited in a society like cheating, stealing and killing (Siddiqi, 2005)

Deontologists explain that the behaviors of human being is directed by there prima facie ideals and all the decisions are based upon those ideals. Modern ideology of deontology explains that these ideals are not absoulte but universal. But when the general consensus is upon the basic rules like cheating, killing and stealing is not permitted in any society then there would be some absolute rules for decision making.

And in case of violating these set principles there shoul be fear of punishment.If lying, stealing and cheating are not accepted as a general rule then how the financial

intermediaries are getting profits at the cost of user of the money and at the same time users of the money making profits at the cost of owner of the money.

Under uilitarianism the process of getting the greatest good for greatest number is done by the analysis of cost/benefit. To get the idea about the goodness of an act all the benefits and costs associated with the act are listed down and the net result predicts the nature of act. If net result is positive the act is permissible and vice versa. But this kind of analysis ignores the underpinnings to small segments of a society. Because when we do cost and benefit analysis we get the net result, it may be possible that small segments or poor are getting fewer portions of the benefit than the large segment or rich in a society. Makiyan (2003) explains that sometimes the small portion of a society are getting huge losses but these losses are offset by the minor increase in benefits of the large segments of society and the results would be misleading.

Same is happening in banking industry as financial institutions and user of the money are getting profit, but if we apply the utilitarian cost/benefit analysis the individual saver is in loss at the end. If we have a look on the idea of deontologist, the process of charging interest brings densities in financial system. Makiyan (2003), suggested that the substitution of 'Bank Rate' by the regulation of profit sharing ratio will solve the problem of extended expansion of credit in an interest based economy and ultimately it will reduce the exploitation of depending party in a financial contract.

2.14. Foundation of Islamic banking

Noorzoy (1982) explains the role of money as a medium of exchange and as a medium to bring economic stability. He suggested that system of 'zakah' should be imposed, and interest rate should be demolished from the society. It will lead to the

true functioning of money and no one could be exploited by the way of charging exorbitant rate of interest. Ultimately, the imposition of zakah will bring harmony in the society and everyone will be better off as money will circulate from the surplus to the deficit segments in an economy. As it is observed that the current financial crises are mainly caused by the exorbitant rate of interest. The system on the grounds of Islamic teachings is suitable to absorb shocks as compared to the conventional banking system. The views about the role of money are changing with the passage of time. The debate is on the stability of an economy and money as a medium of exchange is supposed to bring this stability. Stability does not necessarily mean that interest rate should be cut off but also there should be stability in overall fiancial sector. Control on business activities, the working of commercial banks and the role of central bank to control the overall activities of financial sector depicts the stability of an economy where the medium of exchange is money.

Muhammad (2006), while explaining the expected rate of profit in the economy argues that all of profits are determined by the interest rate in modern ecnomies. While we talk about the profit and loss sharing ratio the two ratios like. the one between depositors and banks and the other is between banks and the user of money determined the profit or loss shared by these parties.

2.15. Islamic Laws on Riba (Interest)

Noorzoy (1982) states that the Islamic teachings on riba are different than the Islamic fundamentalism where argued that interest rate should be zero. Islamic teachings explain that anything which is extra on the principal amount is not allowed. There are diferent definitins of word "interest", for example Imam Razi explains that anything which is beyond what is owed that is riba and unlawfull. Modern definition of riba

explained by the Webster's new world dictionary also defines the "interest" as excessive amount on principal amount which is unlawful. The word riba is used commonly for Usury as explained by Webster's new dictionary.

2.16. Kinds of Riba

Imam Razi explained there are two types of Riba

1-Riba al nasaiyah

2-Riba al fadal

Riba Al nasaiyah is riba on the use of money as credit. And riba Al fadal is riba which is commonly charged on barter transactions. Prophet (PBUH) stated the broader implications for riba Al-Fadal rather than the riba Al-Nasaiyah. In Quran it clearly states that "Do not sell gold for gold but in the same quantity". There should be proper calcution for the barter transactions so that no party should get benefit at the cost of other.

Modern theories of business separetes the business from the religion but this is not the case in Islam. In Islamic laws, state and mosque are not separated; the rules for humanity are same for all of the society. Islam does not allow its followers to adopt the different standards for different economic activities. The basics are same as cheating, stealing and killing are not acceptale similarly to invest in a business whose outcomes are expected to be harmful for society are not allowed. Prohibited businesses are sale of alcohol, sale of pork and tobacco, gambling and prostitution as the outcomes are not favorable for over all society and humanity.

The contract of gharar is also not allowed in which the parties agree to purchase and sell the things which are not yet produced. The basic concept behind the prohibiton of

interest and the contract of gharar is the absense of the element of risk. As humans do not know always what will happen in next few days or in next few years. We can only make predictions on the basis of current happenings.

These rules are made for the betterment of humanity. In case of gharar when one party make a contract let say, the contract for the sale of fishes in ocean not yet caught or. the contract for the sale of fruits not yet grown, the ultimate party in loss is the poor one. God forbid if he can not catch the fishes or fruits would not grow on because of change in weather, Who would be responsible, of course none of the parties but the poor has to pay for such type of contracts.

2.17- Reasons for prohibition of interest

In any economy there would be two reasons of getting loan.

1- For conumption purpose

2- For investment purpose

Interest or riba is not allowed in any kind of loan. There is a rational behind that if someone is getting loan for his personal use it means he is already in need of money and if someone grants him loan for a specific time period without charging any kind of interest that would be the act of charity. So it is suggested that the persons who are having surplus money make such kind of loans to bring the harmony in society. The fundamental aspect of the Islamic financial system is achieving justice and equality among different levels of income and wealth. On consumption loans, prhibition of interest is to eliminate the vicious circle of poverty in a society and to increse the purchasing power of poor.

The rational to prohibit the interst on investment loans is that the owner of funds can get the reward for their money without extra work. Modes of financing for such type of contracts are Mudaraba and Musharaka. Such types of investments are strongly suggested rather than holding idle cash.

Current banking practices and loan facilities for rate of interest vary in the Muslim countries. Recent research at Middle Eastern countries and of Middle Eastern international financial institutions a different siuation for the role of rate of interest in banking and commercial activities. In these countries there is no hesitation to take and charge the rate of interst. International banking and financial intitutions working in the Middle East, developed with different aims of providing help to the under developed muslim countries where the activities of taking and charging interest rate vary. These institutions are not charging interest and the process of loan is so smooth for economic development. The examples are Kuwait Fund for Arab Economic Development and the others such as the Islamic Development Bank; these banks do not charge interst rate.

2.18- Islamic Banking is interest based or interest free?

Beng and Meng (2006) explained the practices of Islamic banks and made a comparison with conventonal banks. The core concept of Islamic banking is profit and loss sharing paradigm. As after the emergence of Islamic financial institutions the Islamic products are gaining attention but in practice there is a difference. Islamic banks are using the practices of conventional banks. And their products are not strictly adherent to the concept of profit and loss sharing. Beng and Meng (2006) studied the difference between the practices of Islamic banks. They found in Malaysia that a very small portion of Islamic products are based on profit and loss sharing. Even the loans

and deposits from these banks are not interst free. From a theoratical point of view the difference between Islamic and conventional banking is ineterst. Islamic banks are not allowed to induldge in the practices of charging interest. Islamic banks are subject to greater market discipline on the basis of PLS paradigm.

As the activities of Islamic banks should be based on profit and loss, so there is a great chance to lose as compared to the conventional banks. In this situation the Islamic banks are supposed to take extra effort to sort out the good and bad customers while granting loans and make the rationale decisions. Loan officer should investigate the accounting and character aspects of the borrower. Islamic banks are required to monitor the activities of borrower and make sure that they are correctly reporting there profits and losses.

Depositors of Islamic banks are supposed to select the bank after having full confidence that bank is not involved in the practices of taking and charging interest. Depositors should also monitor the activities of banks to check whether the funds are invested carefully.

2.19. Financial Development and Economic Growth

Pierre , Robert and Martin (2001) recognized allocative role of financial institutions. Argument is that banks are helpful for the investors to make good decisions for investments and better resource allocation. The loanable funds theory of Wicksell (1935) stresses the important role of credit and financial market in economic activity. It is suggested that the rate of return paid by financial intermediary may be different from the "natural" rate. As a result the excess demand for or supply of loanable funds occur which leads to economic fluctuations. The debt deflation theory of Fisher 1933 also highlights the critical role of credit. Liquidation of debt is more frequent during

recession, since banks' ability of lending is restricted (Pierre et al). Real debt grows faster in recession, owing to deflation, than in boom. The increased burden on borrower leads to lower expenditure on consumption and investment, hence falling output (Ho and Saunders, 1981).

2.20. Financial Regulations in Pakistan

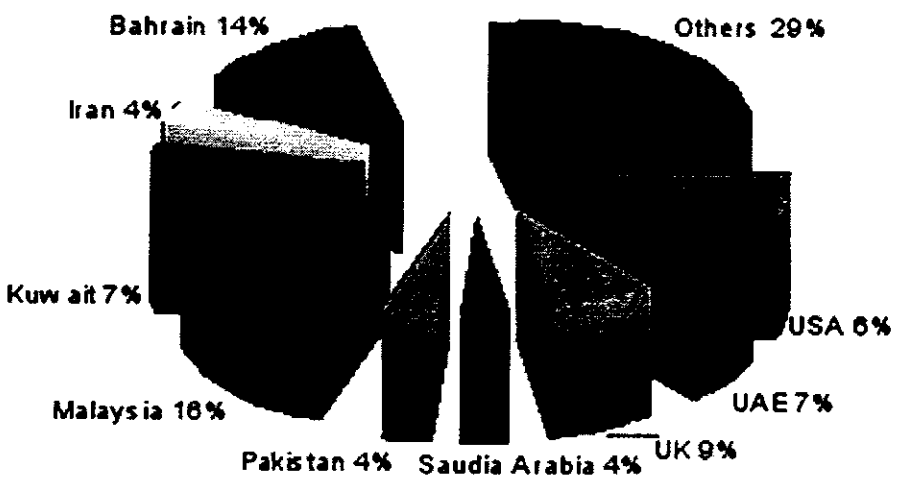
Pakistan had a process of gradual Islamization of banking sector which started in 1979. This process was carried out in two phases; in the first phase which ends up in 1985, banks were allowed to operate both the interst free and interest based activities. In second phase banks were strictly forced to operate all of the financial activities according to the Islamic teachings of profit and loss sharing (Zaidi and Ali, 1987). At this stage the only exception was the government debt and foreign currency loans/deposits.

While transforming the banking activities towards the islamization it was made sure that the basic activities of financial institutions should not be disturbed. The rate of return on profit and loss sharing deposits went high and even it varied between other financial institutions.

The introdution of Islamic modes of financing and Islamic products bring the flexibility to banks and also gain the attention of customers. It is concluded that the monetory policy in Pakistan bring the good change which did not effect the rest of the activities of financial system.

In Pakistan a lot of effort is done at government level to convert the financial system to Islamic basis. Khan (2006), explained that the high volume of interest based foreign and domestic loans were the major hurdle in the transformation process of the economy of Pakistan on interest- free basis And the interest based system is escalating the vicious circle of poverty i.e. poor is becoming more poor and richer is becoming richer.

Market Share of Islamic Banking



Despite the efforts to introduce the Islamic banking in Pakistan, still there is a huge gap in Islamic and conventional banking practices. Total market share of Islamic banking in Pakistan is 4%, representing the lowest growth of Islamic banking as compared to the other Islamic countries. Khan and Bhatti in 2006 explained the political efforts of Ziaul Haq who tried to eliminate interest from the country but at the same time he put a ten-year ban from 1980 to 1990 on the Federal Shariat Court to issue any verdict against the interest based government activities. During his period the government allowed the StateBank of Pakistan not to restrict the activities of

commercial banks to invest their interest free deposits in interest based governemnt products (Kemal, 1992).

The deposits were accepted on the Profit and Loss Sharing basis, but the rest of the process was being done on the old basis of interst bearing activities, under the cover of mark-up financing. International Institute of Islamic Economics in its report of Islamic Financial System including strategy for elimination of Riba argument is that there is no question of gradualism towards the elimination of Riba from economy; the process has to be started at once and taken to its logical end in the shortest possible time. This study will help to have in-depth look into the exploitation through banking system in Pakistan. If a country's financial system becomes more sophisticated, capital becomes more available and cheaper and it is allocated more efficiently. Low rate of interest would increase investment spending and pace of economic growth in developed and under developed countries. Although empirical evidence on the interest sensitivity of investment was mixed, economic policymakers in developing countries frequently adopted policies of low interest rates as a way of promoting economic growth.

2.21. Research Propositions

P1: Return paid to the depositors is significantly low as compared to the interest charged from the creditors.

P2: Growth of the user of funds is significantly higher than the owner of funds.

CHAPTER 3

RESEARCH METHODOLOGY

Sample and Data collection

It is general understanding that the depositors are being exploited by financial intermediaries and not by the real users of money i.e. the borrower. In this study we examined the growth of users of funds and then compared it with the growth of the owner of funds. Growth of user of funds is determined through asset growth and leverage. Growth of owner of funds is determined through the deposit rate offered by financial intermediaries. To evaluate the relationship among deposit rate and its impact on company's growth (borrowers) variable like asset growth and financial charges were taken into account. Deposit rate downloaded from official web site of "International Monetary Fund". Data is on anual basis for fifteen years , January 1995 to December 2010. Financial data of 63 firms were taken into account from KSE-100 index. Data of those firms which are not listed on KSE-100 Index uptill 2010 were not taken into account. Data includes only of those firms which are listed from 1995 to 2010 in order to check the fianncial performance.

Financial intermediaries were not taken into account as we are taking the financial intermediareis as a provider of funds. The companies rendering financial services were not taken in sample size. Data was collected from KSE official website on annual basis.

Method of Analysis

In order to draw the inferences about our propositions, the average growth rate in assets of different companies was calculated from their balance sheets and a comparison was done with the rate of return to the depositors. Growth of the assets is also compared with the interest rate paid by the borrowers to the banks.

$$Y_t = \beta_0 + \beta_{1} x_{2t} + \beta_2 x_{2t} + \varepsilon_t$$

Where,

Y_t = Deposit Rate

β_0 = = Intercept

β_1, β_2 = Slope Coefficient

x_{1t} = Financial Charges

x_{2t} = Asset Growth

ε_t = Error term/Residuals

To evaluate firm's performance Asset Growth and financial charges were analyzed. Growth of all firms i.e. Asset Growth through 1995 to 2010 was measured. And then average growth for 15 years was calculated. Data of financial charges from 1995 to 2010 for all 63 firms was collected and then average for 15 years was calculated. Change in Deposit Rates, Leverage of firms and Change in Asset Growth also analysed for all 15 years.

In order to check the relationship of growth of user of Funds and Growth of Owner of funds OLS (Ordinary Least Square) applied after the test of cointegration. To check the normality, Stationarity, Bi-directional, long run and short run relationship among variables statistical tools Histogram, Jarque Bera, graphical analysis correlogram.

Augmented Dicky Fuller Test, Granger causality, cointegration and regression analysis were taken into account.

CHAPTER 4

RESULTS AND DISCUSSION

Descriptive statistical measures were taken to evaluate the perfomance of 63 firms for 15 years. Data for 63 different firms was collected and analyzed with the help of graph from the period 1995 to 2010. Analysis is being done in following four categories:

1. Trend Analysis of Asset Growth, Leverage and Deposit Rate over 915years
2. Comparison of Asset Growth and Leverage
3. Comparison of Asset Growth and Deposit Rate
4. Examine the relationship of Asset Growth, Leverage and Deposit Rate

1-Trend Analysis of Asset Growth, Leverage and Deposit Rate over 15 years

Years	Average Asset Growth
1995	7,052,812
1996	7,572,796
1997	6,725,805
1998	7,479,516
1999	9,854,402
2000	10,301,672
2001	9,719,483
2002	10,010,185
2003	10,615,969
2004	12,002,054
2005	13,428,876
2006	16,436,963
2007	18,237,570
2008	22,760,919
2009	24,351,205
2010	9,593,171

Table 1

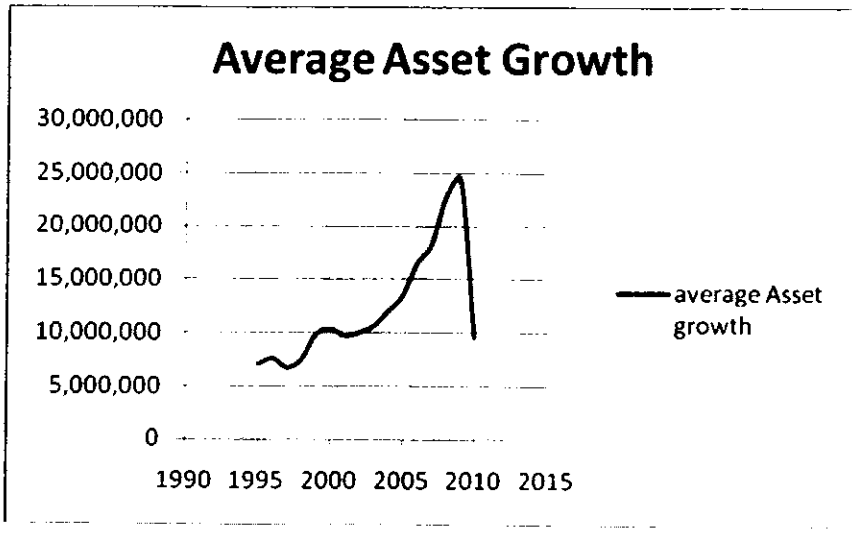


Figure 1

Table-1 explains asset Growth of firms over 15 years. The graphical analysis depicts that there was an upward trend in growth uptill 2008-09. At the start of 2009 and 2010 the growth drastically goes down. Huge change can be seen in this era. There can be so many other reasons including the rise in financial charges in this period.

Upward trend up till 2008-09 shows the growth of firms and it confirms our proposition that the firms are using the money, paying the fix rate of return to the financial intermediaries and making paramount profits at the cost of owner of funds.

Over all performance of all firms is better in all years except in 2001 and 2006 and uptil 2010 there is a declining trend.

Years	Average Fin Charges
1995	1292261.99
1996	1449586.006
1997	239672.3011
1998	220472.0561
1999	353137.2286
2000	370331.6971
2001	395648.8889
2002	392346.5079
2003	236943.3016
2004	161928.7556
2005	164275.7762
2006	1273989.706
2007	1172539.203
2008	1248322.949
2009	857850.3063
2010	22825380.13

Table 2

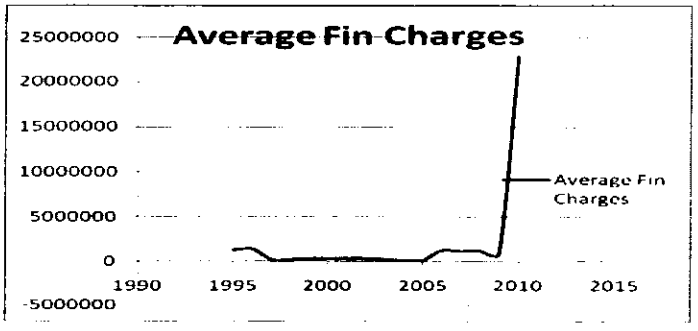


Figure 2

Table-2 explains the leverage of firms. Companies are paying nominal leverage over 15 years, except in 2006 and in the same year the growth of firms is also showing lower trend, and in 2010 leverage is also high as the rate of interest charged by financial intermediaries went sky high in this period due to the overall financial crisis all over the world. Increasing trend in leverage shows the increasing trend of debt introduction by firms. In Pakistan economy, the banking sector is the only sector which is growing from last decade just because of higher interest rates charged by banks.

Years	DepRate
1995	15
1996	17
1997	20
1998	18
1999	16.3
2000	13
2001	10
2002	7.5
2003	7.5
2004	7.5
2005	9
2006	9.5
2007	10
2008	15
2009	12.5
2010	12.5

Table 3

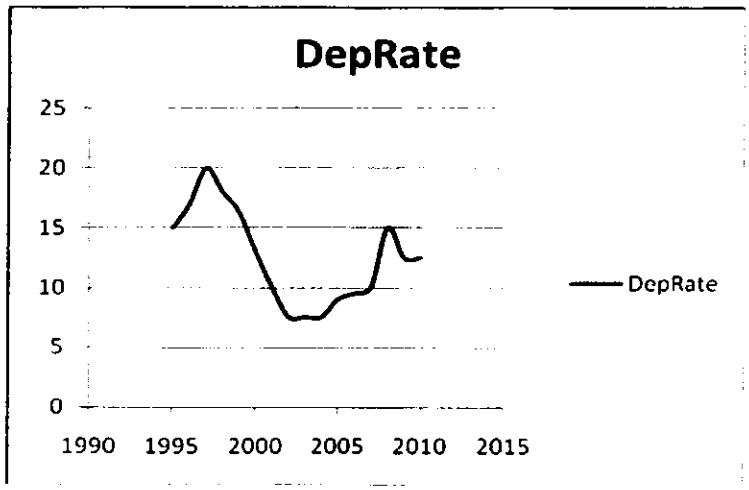
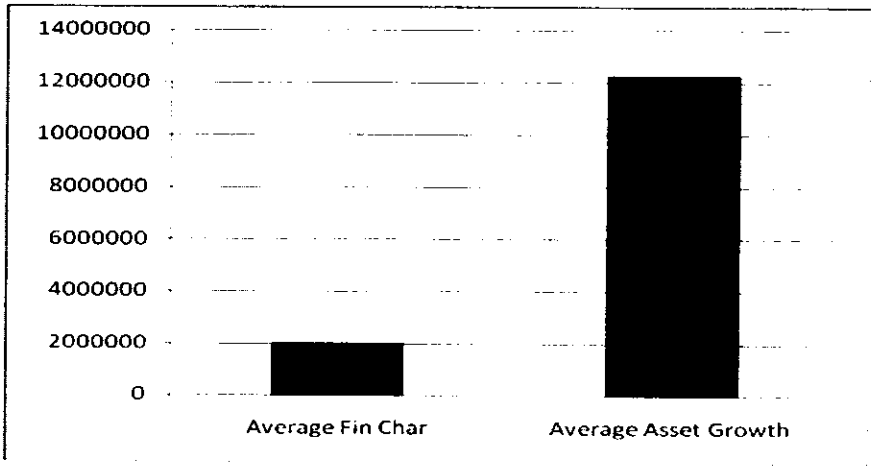


Figure 3

Table-3 explains the deposit rates over 15 years. If we compare the deposit rates which banks are paying to depositors with the interest rates what banks are getting from borrowers there is a huge difference .i.e. Interest Rate Spread(IRS). Though the main source of income of financial intermediaries is IRS but at the same time the user of these funds i.e. firms are making huge profits by using those funds. The ultimate party in loss is the owner of funds.

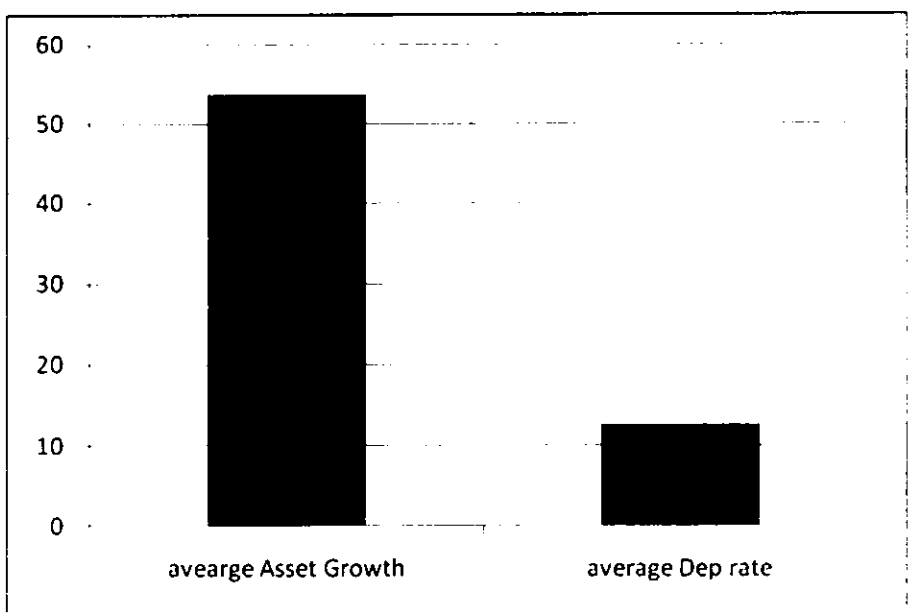
2-Comparison of Asset Growth and Leverage



Graph 1

According to above figure the firms are getting higher profits by paying fixed amount of interest to financial intermediaries. Above figure explains the comparison of leverage and profit of firms over 15 years. For leverage an average was calculated for every year and same for the profits for every year. When we compare the size of profits with the cost of capital invested, there is a huge difference. Infact the firms are paying nothing to the financial intermediaries. So these are the firms who are ultimately better off in any financial transaction of loan instead of the owner of funds.

3-Comparison of Asset Growth and Deposit Rate



Graph 2

Above figure explains the relationship of asset growth of firms and the amount what depositors are getting in return from financial intermediaries from 1995 to 2010. As the already discussed pattern of financial charges and asset growth in Graph 1 explained that the creditors are paying less to the banks and in return banks are paying

less to the owner of funds. Pakistan is a country where the banking system having the conventional practices rather than the Islamic one i.e. based on the concept of profit and loss sharing. Savings are being discouraged in an economic system where depositors are being paid less for their provided funds by the banks and other financial intermediaries.

4-Examine the relationship of Asset Growth, Leverage and Deposit Rate

a) Tests for Normality

In literature we found several tests to check the normalityof the disturbance term. μi ,but here we used three:

- Histogram of residuals
- Jarque Bera Test

Histogram of Residuals

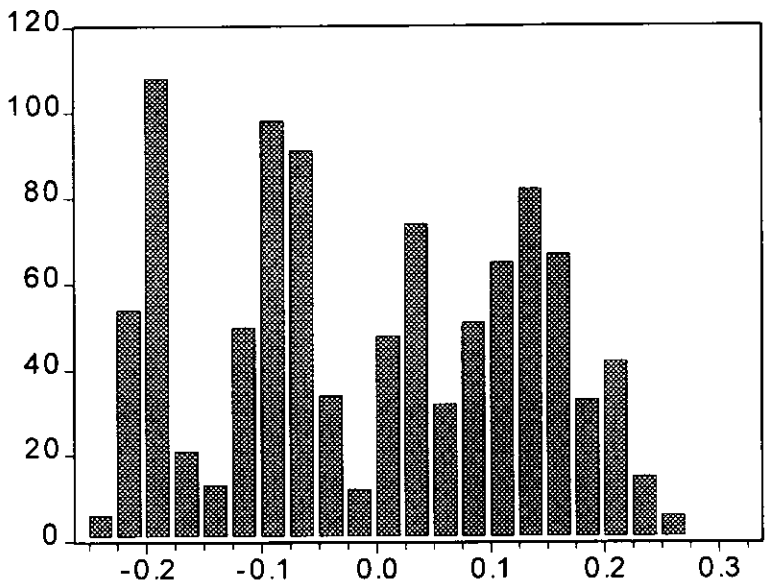


Figure 4

Series: Residuals	
Sample 1 1008	
Observations 1003	
Mean	5.59E-14
Median	0.012962
Maximum	0.305705
Minimum	-0.245373
Std. Dev.	0.134913
Skewness	-0.000300
Kurtosis	1.774923
Jarque-Bera	62.72149
Probability	0.000000

Table 4

X Axis OLS Residuals

Y Axis-Number of Distributions

A histogram of residuals is a tool to get the idea about the shape of a random varibale. On the X –axis values of OLS residuals are into intervals. The resulted shape was bell shaped normal distribution curve on the histogram which leads to the confirmation of the normality assumption.

- **Jarque Bera Test**

Jarque bera test of normality is used to check the normality of large sample test. It is also based on the residuals of OLS. This test first computes the Skewness and kurtosis measures of the OLS residuals. For a normal distribution rule of thumb is:

S = 0 i.e. S = Skewness Coeffieient

And

K = 3 i.e. K = Kurtosis

Under the null hypothesis that the residuals are normally distributed if the computed p value of Jarque Bera statistics is sufficiently high we accept the hypothesis that residuals are normally distributed.

As in this study the sample siza 1008 it is stomgly acceptable to use the Jarque Bera test for Normality. Kurtosis is 1.77 and Skewnes is -0 which also fullfils the test of normality and lead to the acceptance of hypothesis of normality

b) Tests for Stationarity

There are three types of data which can be used for analysis.

- Time Series Data

- Cross sectional Data
- Combined or Pooled Data

When we collect the random variables which are ordered in time this is known as random or stochastic process. Normaly the stationary stochastic process is used in time series analysis.

When we talk about the stationarity of data it is general rule that a data is said to be stationary data when it does not have following three things:

- Autocorrelation
- Hetereoskcedasticity
- Multicollinearity

Or we can say that all above should not be present under the assumptions of a classical linear regression model.

A stochastic process is said to be stationary if its mean and variance are constant over time and the value of covariance between the two time periods depends only on the distance between the two time periods and not the actual time at which the covariance is computed. In time series such type of stochastic process is called weakly stationary or covariance stationary.

When n'th values in the series are following patterns, it is called as autocorrelation. Cross sectional data is often having the problem of Heteroscedasticity .Technically it means that there is no equal variances in the explanatory variables. In the presence of heteroskcedasticity the results could be misleading.

While multicollinearity means the existence of "perfect" or exact linear relationship among explanatory variables in a regression model.

ADF Test Statistic	**-1.226444**	1% Critical Value*	-3.4396
		5% Critical Value	**-2.8648**
		10% Critical Value	-2.5685
*MacKinnon critical values for rejection of hypothesis of a unit root.			
Augmented Dickey-Fuller Test Equation			
Dependent Variable: D(DEPRATE)			
Method: Least Squares			
Date: 08/17/11 Time: 11:36			
Sample(adjusted): 6 1008			
Included observations: 1003 after adjusting endpoints			

To check the stationarity in data we used the prominent tests:

- Graphical Analysis (Deposit Rate)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DEPRATE(-1)	-0.002735	0.002230	-1.226444	0.2203
D(DEPRATE(-1))	0.001162	0.031662	0.036714	0.9707
D(DEPRATE(-2))	0.001162	0.031662	0.036714	0.9707
D(DEPRATE(-3))	0.001162	0.031662	0.036714	0.9707
D(DEPRATE(-4))	0.001162	0.031662	0.036714	0.9707
C	0.002863	0.002418	1.183831	0.2368
R-squared	0.001506	Mean dependent var		-7.89E-05
Adjusted R-squared	-0.003501	S.D. dependent var		0.009723
S.E. of regression	0.009740	Akaike info criterion		-6.419247
Sum squared resid	0.094577	Schwarz criterion		-6.389871
Log likelihood	3225.252	F-statistic		0.300836
Durbin-Watson stat	2.000004	Prob(F-statistic)		0.912456

Table 5

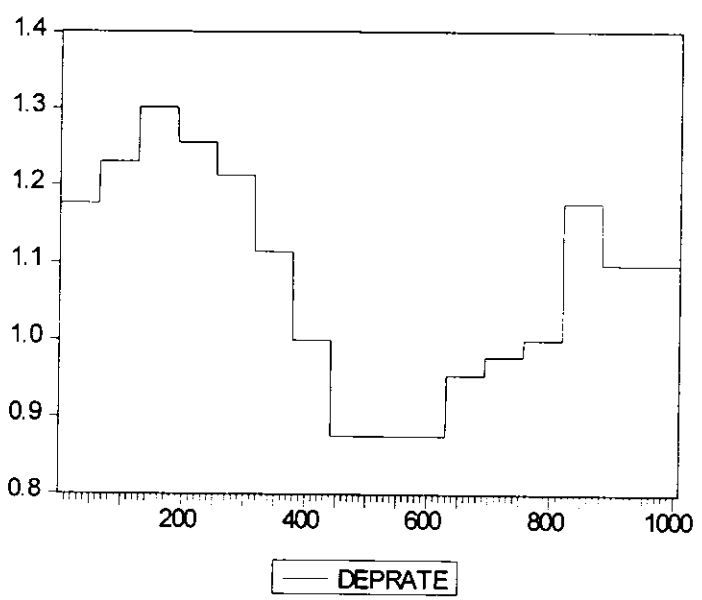


Figure 5

The test of Augmented Dicky Fuller for deposit rates shows that data is not stationary as the absolute value of t statistics i.e. **1.22** is less then the absolute value i.e. **2.86** at 5% critical value.

Graphical representation also has a trend in the data of deposit rate. It can be persumed that the mean of Deposit rate has not been changing. Thus the series is stationary.

In most of the time series the problem of inertia or sluggishness occurs. Well known time series such as GNP, Price index, employment and deposit rate exibits business cycles. Starting at the bottom of recession when economic recovery starts most of these series having upward trend. In this upswing the values of a series at one point in time is greater then its previous value. Thus there is momentum and it moves on untill something happen like major economic strucural break that can be financial crisis in this case, to slow them down.

- **Financial Charges**

ADF Test Statistic	**-8.747909**	1% Critical Value*		-3.4396
		5% Critical Value		**-2.8649**
		10% Critical Value		-2.5685
*MacKinnon critical values for rejection of hypothesis of a unit root.				
Augmented Dickey-Fuller Test Equation				
Dependent Variable: D(FINCHARG)				
Method: Least Squares				
Date: 08/17/11 Time: 12:01				
Sample(adjusted): 6 1008				
Included observations: 997				
Excluded observations: 6 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
FINCHARG(-1)	-0.357831	0.040905	-8.747909	0.0000
D(FINCHARG(-1))	-0.404051	0.044960	-8.986988	0.0000
D(FINCHARG(-2))	-0.280128	0.043423	-6.451135	0.0000

D(FINCHARG(-3))	-0.187856	0.039408	-4.766986	0.0000
D(FINCHARG(-4))	0.092342	0.031678	2.914968	0.0036
C	1.792193	0.206411	8.682644	0.0000
R-squared	0.413008	Mean dependent var		0.001744
Adjusted R-squared	0.410047	S.D. dependent var		1.307759
S.E. of regression	1.004469	Akaike info criterion		2.852795
Sum squared resid	999.8769	Schwarz criterion		2.882312
Log likelihood	-1416.118	F-statistic		139.4539
Durbin-Watson stat	2.025026	Prob(F-statistic)		0.000000

Table 6

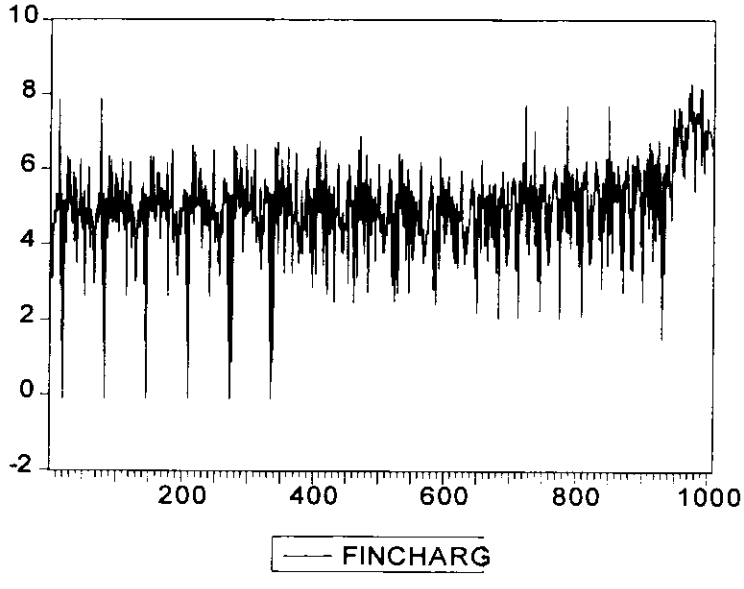


Figure 6

The test of Augmented Dicky Fuller for Financial charges shows that data is stationary as the absolute value of t statistics i.e. **8.74** is greater then the absolute value i.e. **2.86** at 5% critical value.

Graphical representation has not a trend in the data of Financial Charges. It can be persumed that the mean of financial charges has been changing. Thus the series is non stationary.

- **Asset Growth**

ADF Test Statistic	-9.728080	1% Critical Value*	-3.4397
		5% Critical Value	-2.8649
		10% Critical Value	-2.5686
*MacKinnon critical values for rejection of hypothesis of a unit root.			
Augmented Dickey-Fuller Test Equation			
Dependent Variable: D(GROWTH)			
Method: Least Squares			
Date: 08/17/11 Time: 12:03			
Sample(adjusted): 6 1008			
Included observations: 983			
Excluded observations: 20 after adjusting endpoints			
Variable	Coefficient	Std. Error	t-Statistic	Prob.
GROWTH(-1)	-0.458977	0.047181	-9.728080	0.0000
D(GROWTH(-1))	-0.333015	0.048214	-6.907050	0.0000
D(GROWTH(-2))	-0.233725	0.046378	-5.039567	0.0000
D(GROWTH(-3))	-0.069400	0.041474	-1.673342	0.0946
D(GROWTH(-4))	0.009148	0.032629	0.280347	0.7793
C	3.008383	0.310492	9.689080	0.0000
R-squared	0.391810	Mean dependent var		-0.002325
Adjusted R-squared	0.388697	S.D. dependent var		0.992668
S.E. of regression	0.776126	Akaike info criterion		2.337080
Sum squared resid	588.5165	Schwarz criterion		2.366931
Log likelihood	-1142.675	F-statistic		125.8810
Durbin-Watson stat	2.002305	Prob(F-statistic)		0.000000

Table 7

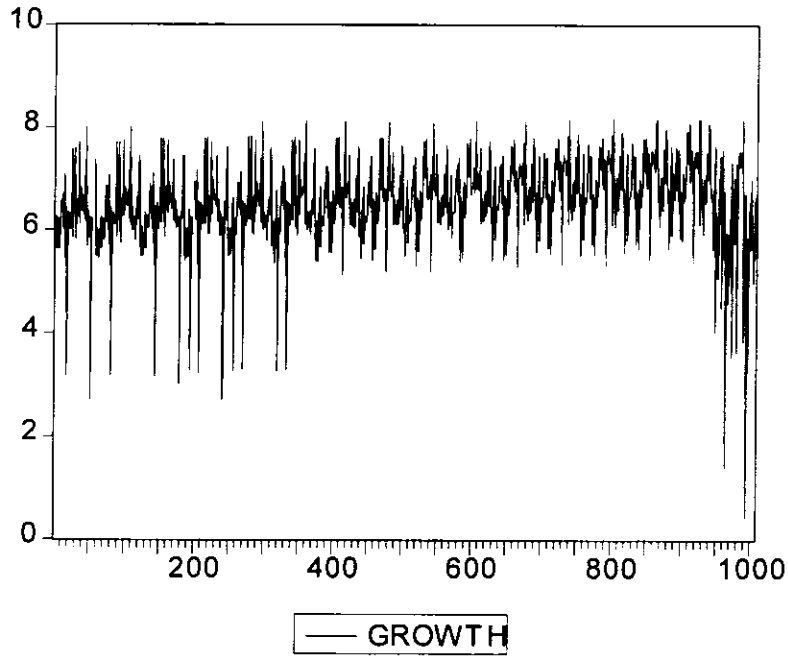


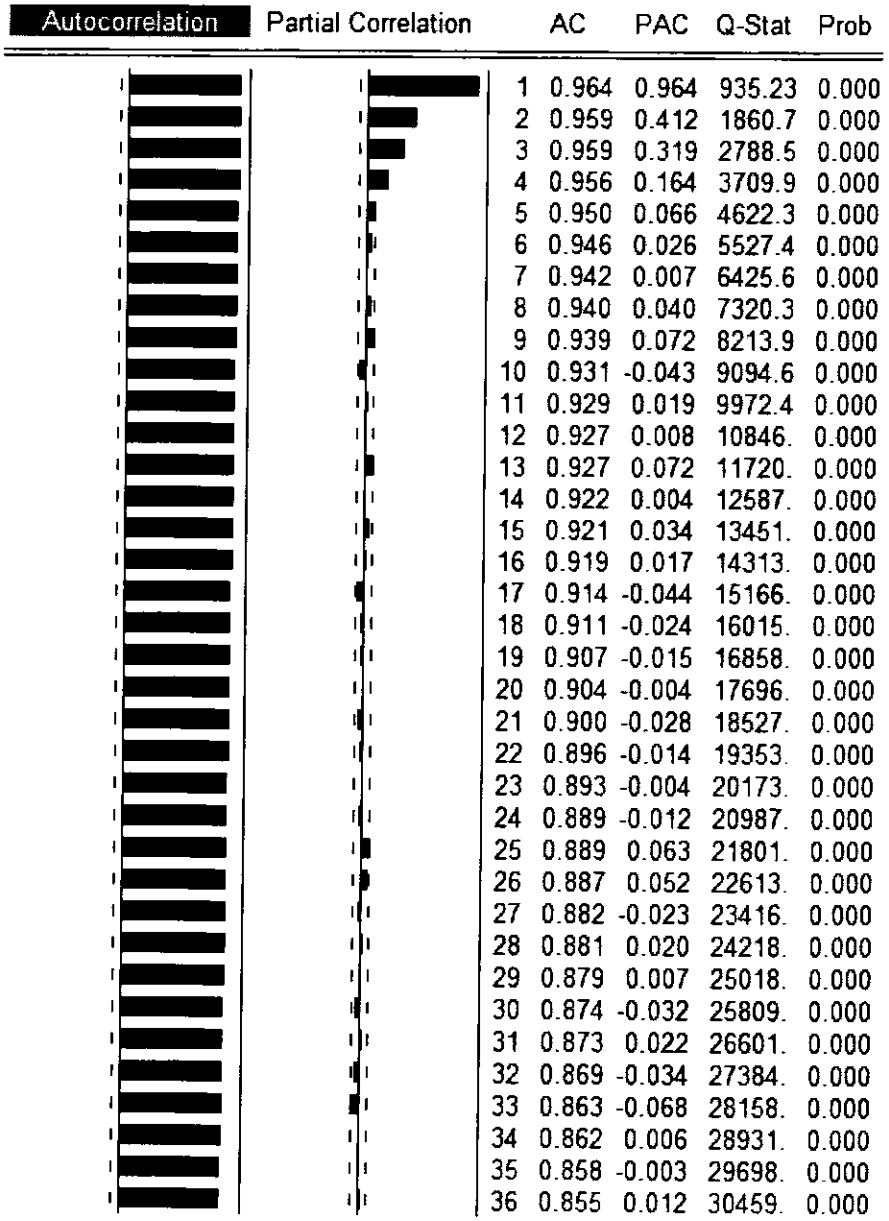
Figure 7

The test of Augmented Dicky Fuller for asset Growth shows that data is stationary as the absolute value of t statistics i.e. **9.72** is greater then the absolute value i.e. **2.86** at 5% critical value.

Graphical representation has not a trend in the data of asset growth. It can be persumed that the mean of asset growth has been changing. Thus the series is non stationary.

➢ Correlogram Test

To test the stationarity another test is based on the autocorrelation function (ACF) where we check the covariance and variance at the same time. Sample correlogram is the graphical representaion of this test.



	AC	PAC	Q-Stat	Prob
1	0.964	0.964	935.23	0.000
2	0.959	0.412	1860.7	0.000
3	0.959	0.319	2788.5	0.000
4	0.956	0.164	3709.9	0.000
5	0.950	0.066	4622.3	0.000
6	0.946	0.026	5527.4	0.000
7	0.942	0.007	6425.6	0.000
8	0.940	0.040	7320.3	0.000
9	0.939	0.072	8213.9	0.000
10	0.931	-0.043	9094.6	0.000
11	0.929	0.019	9972.4	0.000
12	0.927	0.008	10846.	0.000
13	0.927	0.072	11720.	0.000
14	0.922	0.004	12587.	0.000
15	0.921	0.034	13451.	0.000
16	0.919	0.017	14313.	0.000
17	0.914	-0.044	15166.	0.000
18	0.911	-0.024	16015.	0.000
19	0.907	-0.015	16858.	0.000
20	0.904	-0.004	17696.	0.000
21	0.900	-0.028	18527.	0.000
22	0.896	-0.014	19353.	0.000
23	0.893	-0.004	20173.	0.000
24	0.889	-0.012	20987.	0.000
25	0.889	0.063	21801.	0.000
26	0.887	0.052	22613.	0.000
27	0.882	-0.023	23416.	0.000
28	0.881	0.020	24218.	0.000
29	0.879	0.007	25018.	0.000
30	0.874	-0.032	25809.	0.000
31	0.873	0.022	26601.	0.000
32	0.869	-0.034	27384.	0.000
33	0.863	-0.068	28158.	0.000
34	0.862	0.006	28931.	0.000
35	0.858	-0.003	29698.	0.000
36	0.855	0.012	30459.	0.000

Table 8

Resulted correlogram is an example of random walk series. We observethe autocorrelation coefficient is very high upto 36 lags. This is the correlogram of non stationary series. The autocorrelation coeffiecient starts at a very high level and declines very slowly towards zero as the lag lenghten.

c) Tests for Causality

- **Granger Causality**

Regression analysis measures the dependence of one variable at the other. It does not necessarily imply causation. Existence of a relationship does not prove causality or the direction of influence. In time series data the situation can be other way round as many authors like Gary koop 2000, argues that the past event can cause the future event but future event can not cause current event. To check this type of relationship i.e. which variable is causing the other, Granger causality test is used.

Pairwise Granger Causality Tests			
Date: 08/17/11 Time: 13:57			
Sample: 1 1008			
Lags: 2			
Null Hypothesis:	Obs	F-Statistic	Probability
DEPRATE does not Granger Cause FINCHARG	1003	0.18227	0.83340
FINCHARG does not Granger Cause DEPRATE		0.18042	0.83495
GROWTH does not Granger Cause FINCHARG	992	1.55418	0.21188
FINCHARG does not Granger Cause GROWTH		**5.48713**	**0.00427**
GROWTH does not Granger Cause DEPRATE	995	0.14783	0.86260
DEPRATE does not Granger Cause GROWTH		**7.13041**	**0.00084**

Table 9

The results indicate that the deposit rate and financial charges does not cause each other as the F statisticss is < 2 and $P > 0.05$. But the financial charges and deposit rates do cause the asset growth of firms, as F statistics > 2 and $p < 0.05$.

In an economical structure deposit rates change due to the huge changes occure in an economy. Examples are political uncertainity, international financial shocks etc. So we can not say that the only change in deposit rate is due to the financial charges and vice versa.

Similarly growth does not cause the financial charges as these are predetermined cost of capital. But the higher the financial charges lower will be the growth and vice versa.

Growth of firms also independent and does not have direct influence on deposit rates. But when the deposit rates increase, it will ultimately bring an increase in financial charges which will lead towards lower asset growth and vice versa.

d) Tests for Cointegration

In order to check the inter-reltionship between variables for long term we applied the co-integration test. In order to check whether the data will lead to the spurious regression or not cointegration is applied. Cointegration test means even if time series are individually stationary, a linear combination of two or more time series can be stationary. As the author suggests that the co integration is a sort of pre test to avoid the spurious regression.

Date: 08/20/11 Time: 04:29
Sample: 1 1008
Included observations: 977
Test assumption: Linear deterministic trend in the data
Series: DEPRATE GROWTH FINCHARG
Lags interval: 1 to 4

Eigenvalue	Likelihood Ratio	5 Percent Critical Value	1 Percent Critical Value	Hypothesized No. of CE(s)
0.121948	159.9585	29.68	35.65	None **
0.032155	32.90049	15.41	20.04	At most 1 **
0.000991	0.968760	3.76	6.65	At most 2

*(**) denotes rejection of the hypothesis at 5%(1%) significance level
L.R. test indicates 2 cointegrating equation(s) at 5% significance level

Unnormalized Cointegrating Coefficients:

DEPRATE	GROWTH	FINCHARG
0.047425	0.047898	0.019014
0.069198	0.046693	-0.038656
-0.228042	0.003007	-0.001541

Normalized Cointegrating Coefficients: 1 Cointegrating Equation(s)

DEPRATE	GROWTH	FINCHARG	C
1.000000	1.009959	0.400917	-9.698576
	(0.42443)	(0.20229)	
Log likelihood	860.8015		

Normalized Cointegrating Coefficients: 2 Cointegrating Equation(s)

DEPRATE	GROWTH	FINCHARG	C
1.000000	0.000000	-2.490344	11.37536
		(4.89447)	
0.000000	1.000000	2.862751	-20.86613

Table 10

As the liklihood ratio is 159.95 > 0.05% critical values. It means there is not co-integration among variables. We will not reject null hypothesis.

e) Test of Regression

Regression analysis is used to measure the dependence of one variable , the dependent variable on one or two variables which are usually known as explanatory variables.In this study as our propsed equation of linear regression is:

$$Y_t = \beta_0 + \beta_{1} x_{2t} + \beta_2 x_{2t} + \varepsilon_t$$

Where,

Y_t = Deposit Rate

β_0 = = Intercept

β_1 ,β_2 = Slope Coefficient

x_{1t} = Financial Charges

x_{2t} = Asset Growth

ε_t = Error term/Residuals

Dependent Variable: DEPRATE				
Method: Least Squares				
Date: 08/19/11 Time: 11:34				
Sample: 1 1008				
Included observations: 1003				
Excluded observations: 5				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.253361	0.034157	36.69387	0.0000
FINCHARG	0.015820	0.004132	3.828425	0.0001
GROWTH	-0.039197	0.005718	-6.855552	0.0000
R-squared	0.45641	Mean dependent var		1.075609
Adjusted R-squared	0.43732	S.D. dependent var		0.138101
S.E. of regression	0.135047	Akaike info criterion		-1.163396
Sum squared resid	18.23780	Schwarz criterion		-1.148707
Log likelihood	586.4429	F-statistic		23.91189
Durbin-Watson stat	0.062952	Prob(F-statistic)		0.000000

Table 11

The results of regression indicate the following results

$$\text{Deposit Rate} = 1.253361 + 0.015820\ (\text{Fincharg}) - 0.039197\ (\text{Growth})$$

Here if financial charges change by 1 % the deposit rate will increase by 0.015820 by the financial intermediary. Here it proves the exploitation of depositors done by the financial intermediaries.

The coefficient of asset growth indicate that the owner of funds are being poorly paid for their invested funds as if change in growth is 1%, the deposit rate will decrease by -0.039197.

It proves our hypothesis that the user of funds making paramount profits by using the funds invested by depositors.

CHAPTER 5

FINDINGS AND CONCLUSION

5.1- Major Findings

The results measured by comparing the growth of owner of funds with growth of user of funds indicates that user of funds are exploiting the owner of funds. Users of funds are getting benefit at the cost of owner of funds. As the rate of return paid to the depositors is much less as compared to the growth of users of funds.Firms are making profits by using leverage and at the same time their rate of interest is not changing. At agreed amount of interest they are growing, and making paramount profits. The users of funds are not sharing their profits with the providers of these funds.

The interest rate effect the over all economy because it has its roots in monetary policy and regulations towards financial markets by the policy makers. So if there is a little variation in interest rate it can lead towards the huge changes in overall financial structure as experienced in Global financial crisis. Interest rate is considered as most crucial macro economic variable which has a direct relationship with economic growth. From this study we can conclude that if there would be proper strategies for rate of return to the depositors, based on the concept of profit and loss sharing it will lead to high economic growth.

Users of the money are free riders in a financial contract. Eliminating rate of interest would make everyone ultimately better off. Users of funds are gaining an extraordinary position in society and exploiting the owner of funds.

In Pakistan, Islamic banking practices are not well regulated, and the conventional banking system has varying pratices of charging interest. Depositors are not well

informed about the rates what they will get in return from financial intermediaries. On the other hand financial intermediaries are charging variable rates from borrowers. Depositors do not know where their funds are being invested. But in the Islamic banking system borrowers have the right for their funds to invest in shariah compliant projects. Under Islamic Banking system depositors are also directed to have a look at the banks for the proper projection of profit and loss reported by the user of funds. Explicitly banks are blamed to exploit the depositors; true but ultimate benefited party is the user of funds. They are violating the Islamic concept of profit and loss sharing, and making paramount profits, they kept these profits with them thus creating financial distress in an economy.

5.2- Implications

The results suggest to the policy makers to adopt the concept of value maximization instead of profit aximization, i.e. the rate of return to the depositors should be adjusted in accordance of profit and loss of the user of funds. . The study provides the analytical approach towards the exploitation done by banking system in Pakistan where varying practices are used to take and charge the interest rate

5.3- Future Research

The study can be used for further analysis of the banking sector of countries where Islamic banking practices are used in financial sector, and comparison can be done with the countries with conventional banking practices.

In this study we calculate the growth of the user of funds by their asset growth over 15 years. For further analysis we can use the technique of "data envelopment analysis" (DEA) to measure the relative efficiency of group of homogenous decision

making firms while using leverage as input and then we can compare the rate of return paid to the depositors by the different group of firms and can pinpoint the group exploiting the depositors more.

5.4- Conclusion

This study has evaluated the exploitation of depositors by the users of fund in the banking sector of Pakistan from 1995 to 2010 through the growth of user of funds and the return paid to the depositors. This study provided the understanding about the exploitation of interest rate. Accordingly with the results the growth of user of funds is higher than the growth of the owner of funds. Growth of user of funds has been determined through asset growth and leverage. Growth of owner of funds has determined through the deposit rate offered by financial intermediaries.

The results indicate that owner of funds are being exploited by user of funds because they are getting benefits at the cost of owner of funds. Profit and loss ratio minimizes the risk of loss to the depositors.

Furthemore ,the results can be inflenced by the introduction of some other variable not explained in the model i.e the change in an economic structure, change in financial and economic policies due to the international financial distress.

If the concept of profit and loss sharing is implemented in Pakistan then the banking sector can absorb the financial shocks. In this regard there is need to regulate the banking activities with sharia compliant principles.

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