

Determinants of Profitability: An Empirical Study about Profitability Improvement in Islamic Banks of Pakistan

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ABSTRACT--- *With a variety of instruments, Islamic Banking institutions are growing worldwide. Islamic Banking network expanding now significantly their network in Islamic countries included Pakistan to drum up the large amount of funds to upgrade the economy under Islamic rules and laws. The involvement of Islamic Banks in social and economic activities, there have been each time the questions about the financial constancy. The respective study is concerned about the determination of profitability determinants by taken into account the financial statements of Islamic banks of Pakistan. With ration analysis on profitability determinants, a reliable estimation of performances of Islamic banks will be evaluated.*

Keywords--- Islamic bank, Economy mobilizing, Profitability Determinants, Performance Estimation

1. INTRODUCTION

Increasing trends of trade across the globalization has made the concept of efficiency both for financial and non-financial institutions. Banking sectors plays the dominant role in the life blood of the modern trade and commerce to provide the major sources of finance to the society (Gul, et al., 2011). It is one of the most regulated financial industry in the world who provide a sound, stable and healthy financial system (Haron, 2004). The economy is heightened and financial systems growth when banking organizations are profitable. Over 62 years, there are radical changes observed in banking sectors of Pakistan in the form of categories of banking organization. The county Pakistan is came into being on Islamic rules and laws therefore the besides conventional banks Islamic banks also get enhancement.

The banking industry had now grow and expand with the new revelation of Islamic banking system. The first Islamic bank was developed in Pakistan in 1950 with the aim to make the society interest free with the primer of administrative fee in against. Throughout the Islamic world, Islamic banking system got reputation being its provision of banking services under Islamic rules and fair laws (Haron, 2004). There were many concerned literature with convention of profitability of Islamic banking system with respect to market structure. Currently, there are 24 conventional and 5 Islamic banks creating competitive environment in Pakistan (Ali, et al., 2011). After the first conventional bank in 1963, Islamic banking systems have gained a griped over banking organization in almost every Muslim country and in a few non-Muslim countries. Islamic Banks not only providing the profit share on Islamic rules but also the Islamic banking facilities to increase the trade which gain the intense importance in religion Islam (Haron, 2004).

The efficiency of conventional and Islamic banks tended to become the inefficient when the operating with dual banking environment. Some of the aspect of Islamic banking system determine the profitability of the banking organization to know about the performances. Financial rations played dynamic part in exceeding out the enactments of banking organization by applying on controlled and un-controlled variables (Hesse, 2008). The economic conditions of a country are considerably grounded on the profitability of banking organization. In banking terminologies, the elements of profitability are perceived and explored but the description of profitability varies in many studies. In past, researchers tried to find out the factors of profitability for banking sector and certain researchers measured only the banking characteristics while others involved the financial structure and macro-economic aspects as well (Javaid, et al., 2011).

The current research study is concerned with evaluation of the determinants of Islamic banking profitability with addition to practically implications of research founded elements into practicality for their applications into Islamic banks. The direct effect will gave push in formation of the elements that have practical revelations to enhance the profitability. The determinant s of profitability of banking systems were divided into two categories of internal and external on the basis of bank management control on it as per the financial and non-financial aspects. The aspects on the

basis of banking profitability was determined were the financial aspects that had direct impact on income statement and balance sheet (Bashir, 2003). External variables were those components that were beyond the control of the management of the bank that were competition, regulation, attention and market share, ownership, shortage of capital and money supply (Bashir, 2003).

2. LITERATURE REVIEW

The amended financial system was the indication of success for banking organization of any country and put emphasis on the elements grit for improved financial base of the banks. The connotation of profitability of the banks can be esteemed at both the micro and macro periods of the economy. The economic growth also cracked out to be more important and it was assured that share of banking organizations in the financial system increased the role of the banking sector in micro-economic and macro-economic stability. On the micro level, profits was the essential condition of an aggressive banking organization and the supply of funds. (Ali, et al., 2011).

The nations of Muslims needed finance facilities as much as anyone in order to finance their business projects to ease capital investment and to assume transaction actions. Muslims world tried to reorganize their monetary subsists on the basis of Islamic law and consequently to find out the resources to fulfill their financial necessities in view of exclusion of interest in a world where the whole financial system was based on interest system (Ahmad, 2011). The determinants to make a just moral and informally inclusive financial and business system through the broad range of society. It was therefore the major contest was to restructuring the financial institutions' products and services, appliances and contracts on an interest free basis in order to bring them in agreement with the prescriptions of Islamic law and within the restraints of Islamic regulations (Ahmad, 2011).

Islamic banks profitability was a significant tool to know about the performances of banking organization by assessing banking procedures and defining management plan to help in increasing the chances for the Islamic bank to endure in viable market. The determinants of profitability were important to enhance the economy as they contribute towards economic growth and stability. Organizational profit as being considered a significant assessment tool for the performances of the organization based on internal and external variables (Gul, et al., 2011). The internal variables were banking industry specific variables controlled by the management while external variables were embedded in the micro or macro-economic environment. The determinants of profitability of Islamic banking system were had seen to be positively affected with bank size, operational efficiency and asset management while banks profitability was negatively affected with capital and credit risk (Gul, et al., 2011).

The operating ratios techniques were used in to measure the special effects of management, Bank size, location and timing of banking organization on profitability of commercial banks. All variables tested were expressively connected to profitability. Market share was considered as a profitability element under the assumption that firms will obtain a better market share and rise their profitability with greater effectiveness (Haron, 2004). The macro-economic determinants were taken into account of 16 Islamic banks of Malaysia during 2005-08 and explored that capital and assets quality had indirect relationship with bank profitability and on the other side liquidity and operational efficiency had a positive impact. (Wasiuzzaman, 2010).

Certain trends in financial markets, industrial development and financial innovation generating certain challenges for the banking organizations. (Gul, et al., 2011) The factors of bank profitability were frequently classified into internal and external factors. Certain studies were country explicit and few of them considered sections of countries for studying the determinants of profitability. Bank effectiveness had come out as a multi-dimensional thought which had been deliberated broadly in the literature. (Gul, et al., 2011).

The management assisted in improving the profitability of the banking organizations and regulate the inclusive organizational activities. The profitability determinants were affected and controlled internally with management of banking corporations. The external determinants were the developed with cause and effect relationships show its result to economy (Haslem, 1969). The profitability of Islamic and conventional banking in many countries was inspected and had measured both internal and external factors as factors of ROA, ROE and NIM and proposed that quality of conventional banks was better than Islamic banks. Interest free advancing communicates to profitability in Islamic banks and total expenditures affect conventional bank profitability adversely. (Javaid, et al., 2011)

Consequently, in order to inspect the development possibility of Islamic banking and its traditional borders of Muslim economies, the determinants were analyzed for profitability of the Islamic banks to make the economy strengthen (Athanasoglou, 2008). The first principle stated that the bank was permitted to profit from a given loan under the complaint that the bank was willing to share the investment risk. The second contract under Islamic law stated that bank may purchase a good or deliver a service for a margin but the contracts were based on the principle included debt based financial model (Murabaha, Istisnaa and leasing) and referred to as fixed return from investment (Hesse, 2008).

Islamic banking system involved the banking activities and operations as for the same purposes as conventional banking institutions but the lending out the capital in Islamic banking organizations involved the Islamic laws and regulations. They had to follow the rules under Shari’ah to ensure the interest free banking systems (Hesse, 2008). The advances were sanctioned to industries through the sharing of or financing the purchasing of services and goods. Therefore, Islamic banks asked for severe security in order to defend themselves against evasion and thus the bought item was listed to the name of the buyer from the start of the deal in form of Murabaha funding (Hesse, 2008).

The measures of profitability of the Islamic banking was very comprehensive. The spat that Islamic banks must compute their markup based on curiosity denoted to a situation where the profits of all projects accessible to the Islamic bank for backing were known with inevitability in development (Wasiuzzaman, 2010). It was almost unbearable to calculate the actual profit received on the interest free payments. It was also difficult to determine the amount of cost had been experienced on the placement of deposits (Wasiuzzaman, 2010).

3. RESEARCH PROBLEM

Islamic banking worked in consonance with the beliefs and value system of Islam and governed to the conservative governance and risk managing rules under Islamic Sharia. Besides operations and working structure of Islamic banking they also have to generate the profit for the economy as well as for the organization. There are many factors that affect the financial position of the Islamic banking which were explored but had not been demonstrated with their direct impact on profitability. The current research study referred to the problem ascends from the determinants which effect the profitability of the Islamic banking corporations. Many studies had explored the determinants of profitability but their effects are still unevaluated. This research is concerned in determining the impact of the various financial factors on profitability and suggestions to improve the profitability of Islamic Banking organization, which will ultimately lead to an increase in the net profits, dividends and share price as well.

4. AIMS AND OBJECTIVES

The aim of the research is to reveal the applied practices of profitability determinants and its effect on the financial positions of Islamic banking corporations in Pakistan.

5. OBJECTIVES

- To examine the relationship between the determinants/factors of profitability with market structure, to find;
 - The exposure of determinants/factors of profitability of Islamic Banking
 - The impact level of determinants/factors on profitability in Islamic Banking
 - The better use of those determinants/factors to improve the profitability of Islamic Banking in Pakistan

6. METHODOLOGY

The determinants of profitability of Islamic banks of Pakistan are examine on the basis of the following equation:

$$Y = a_o + b_1d_1 + b_2d_2 + b_3d_3 \dots b_n d_n$$

Where:

Y = independent Variable (profitability)

a_o = Intercept

$b_n d_n$ = Independent Variables

The above equation indicated the regression model of the profitability of islamic banks by taken into account the determinents ‘d’ and slope ‘b’. The determinents included in the study are:

Serial #	Internal Variables
1	Total Deposits in bank (saving account, Investment, PLS account)
2	Capital Reserves
3	Income
4	Total Expenditures
5	Expenditures on loan

	External Variables
6	Market Share
7	Discount Rates of country
8	CPI (Consumer Price Index)
9	Growth in Money Supply (M_2)

The table shows some of the determinants that have influences on the profitability of the banking organization. In the banking industry, there are many ratios that had been used to extent the bank performance with respect to evaluation of profitability. Within the respective research, the following five ratios are evaluated to know about the determinants of performance evaluation.

- Total income as a percentage of total assets
- Bank's share of income as a percentage of total assets
- Net profit before tax as a percentage of total assets
- Net profit before tax as a percentage of capital and reserves
- Net profit after tax as a percentage of capital and reserves

7. ANALYSIS

The collected data from the financial statement of ten Islamic banks of Pakistan. These banks are:

1. Meezan Bank
2. Al-Baraka Islamic Bank
3. Bank Islami
4. Dubai Islamic Bank
5. Burj Bank

The ratio analysis is performed to know about the extent of forte of the particular variables on other variables to determine the strong determinant of profitability.

Table 1: Anova statistical Analysis

Ratios	F-Value	P-Value	Adj. R ²
Total income as percentage of total assets	204.34	0.01	0.0881
Bank's share of income as percentage of total asset	152.58	0.01	0.895
Net profit before tax as percentage of total assets	19.3	0.00	0.583
Net profit before tax as percentage of capital & reserves	15.0	0.00	0.628
Net profit after tax as a percentage of capital & reserves	13.12	0.02	0.398

Income earned by the Islamic banking organizations had direct significant relationship with liquidity and on the other side, it had no significant relationship with capital and reserves. As specified in above table, each 1% escalation in total financing increased total income as percentage of total assets by 0.088%, Bank's share of income as percentage of total asset by 0.0895% and net profit before tax as percentage of total assets by 0.583%. The inverse relationship merely means that any inoculation of capital into a bank capital structure would decrease these profitability measures. In the case of Bank's share of income as percentage of total asset and Net profit before tax as percentage of total assets for every 1% increase in capital, the percentage of Bank's share of income as percentage of total asset would growth by 0.0583% and 0.0628% for Net profit before tax as percentage of total assets. A negative relationship between Net profit before tax as percentage of capital & reserves and Net profit after tax as a percentage of capital & reserves suggests that a cumulative amount of capital did not lead to an increase in income to shareholders. Instead of producing more income, the prevailing level of income was shared by both existing and new shareholders.

Almost all deposit structure variables had no substantial relationship with the profitability ratios Deposits structure was characterized by three variables, i.e. current, savings and investment accounts. Total deposits in current accounts was the only variable which had a significant relationship with Bank's share of income as percentage of total asset and Net profit before tax as percentage of total assets. Each 1% rise in the current account holdings will increase the bank's revenue by 0.034% and profit before tax by 0.0398%.

A significant relationship at a 10% level was originate only with Net profit before tax as percentage of income. This specified that before tax deflated by total capital and reserves, Islamic banks effective in a monopolistic market were improved by 45.715% than those working in a competitive market. Equation total income as percentage change in total assets proposed that Islamic banks in a monopolistic market make more than banks in a competitive market. Islamic

banks in monopolistic market were enhanced its performances by 0.0823% than their complements in competitive markets.

Table 2: Descriptive Statistics

Variable	Mean	Median	Std. Deviation
Return on Equity	0.319	0.0278	0.0168
Capital and Reserve over assets	0.0728	0.0748	0.0178
Liquidity over assets	0.295	0.282	0.133
Technical Competence	0.845	0.873	0.148
Annual Inflation Rate	0.024	0.0178	0.027
Bank Size	9.369	9.33	0.638
Bank Age	1.318	1.208	0.876

The above table shows the descriptive statistics analysis on the financial statements of the Islamic Banks of Pakistan. The descriptive analysis is performed on the following ration analysis:

- Return on Equity
- Capital and Reserves over Assets
- Liquidity over Total Assets
- Technical Competence
- Annual Inflation Rate
- Bank Size
- Bank Age

The analysis depicted the result that associated to the return on equity for Islamic banks were cost-effective during the period with respect to independent factors associated with profitability. The mean value of the capital and reserves and liquid assets specified that if it were highly capitalized and were on the low risk side. With the lower value of bank size they could be edified up the dimensions for better competition in the market. On the other side, the data also depicted that the mean value of technical efficiency is greater banks in the market which showed that Islamic banks have been more effectual.

8. CONCLUSION

The respective study give a reflection on profitability of the Islamic banks with usage of profitability ration analysis with in context of lender and user of funds. The ration in between bank and user of the funds indicated the mutual advantage and positive relationship with profitability and total expenses incurred. The result about assets-liability managing and profitability for usual characteristics of banking corporations. The market share of the banks and money supply have to be founded as negative relationship with profitability. The result of the respective study concluded with no significant variation in profitability with respect to competitive and monopolistic markets but except shareholder. The results of this study designated that Islamic banks in a viable market were better accomplished profitability than then their complements. Consequently, formation of more Islamic banks will give more assistances to the investors.

9. FUTURE PROSPECTIVE

There are many points of study which are similar in conventional and Islamic banks to conduct research within comparison of them with assets-liability. So, more studies which involved asset-liability managing of an Islamic bank are deliberated one of the more stimulating and added promising areas for future research.

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