FACTORS INFLUENCING THE PROFITABILITY OF FULLY-FLEDGED ISLAMIC BANKS IN PAKISTAN

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ABSTRACT

Islamic banks are founded on principles that constitute the guidelines governing any Islamic economic or financial dealing. There has been tremendous growth in the Islamic banking sector especially in Islamic countries with regions like GCC countries and Malaysia leading the way. The situation in the Islamic Republic of Pakistan has been quite different where there has been a steady decline in the total number of Islamic banks and their profits. It is important to identify the reason behind decline and failure of the Pakistani fully fledged Islamic banking sector. Therefore, this study purpose is to highlights the main reasons for the decline of Islamic banking profitability in Pakistan. According to SBP, Islamic Bank Bulletin 2018, there are currently four fully fledged Islamic banks operating with 14.4% market share of Pakistan's banking industry. This study encompass a period of twelve years (2007 to 2018) which shows a gradual decline in the total number of fully fledged Islamic banks in Pakistan and gradually in the reduction of their profits. This study contributes by analyzing both internal and external factors ((Back specific/Internal, Environmental/Macroeconomic and External Factors) which have led to the decline in the profitability of fully fledged Islamic banks. The study utilizes mixed method approach using the triangulation technique for the collection and analysis of data. Primary data was gathered from 203 senior Islamic banks managers and data was collected from ten major cities of Pakistan. Conclusively finding reveal that internal/bank specific, external factors have significant and positive impact on Islamic bank's profitability while Macroeconomic factors have limited contribution in Profitability generation. This is clearly evident from the empirical findings that if these factors are not addressed by the banks management and State Bank of Pakistan (SBP), in the near future there would be a further decline in the number of Islamic banks operating in Pakistan. Therefore, this study highlights and addresses the main causes for the decline of Pakistani Islamic banking sector. The study provides workable policy recommendations to be followed both by the senior banks management as well as the regulatory body (SBP). This study is important as it clearly emphasizes the core weakness within the Islamic banking sector of Pakistan and provides practical recommendations and suggestions to save this declining sector.

APPROVAL

I certify that I have supervised / read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, as a thesis for the fulfillment of the requirements for the degree of Doctor of Philosophy.

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DECLARATION

I hereby declare that this thesis is my own effort and work and it is not copied from any other source. Some information has been used from other source and they have been recognized through proper reference. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

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LIST OF SYMBOLS/ABBREVIATIONS/NOMENCLATURE/ TRANSLITERATION

IBB .... Islamic Bank Bulletin
MBL .... Meezan Bank Limited
DIB .... Dubai Islamic Bank
BIP .... Bank Islami Pakistan
ABL .... Al-Baraka (Pak Ltd)
FDIBL .... First Dawood Islamic bank Limited
BBL .... Burj bank limited
EGIBL .... Emirates Global Islamic Bank Limited
R&D .... Research and Development
LCR .... Liquidity Coverage Ratio
KPK .... Khyber Pakhtun Khwa
SCB .... State-Owned Commercial Banks
LOA .... Log of Asset
A.D .... Anno Domini
IDB .... Islamic Development Bank
GCC .... Gulf Cooperation Council
PLS .... Profit and Loss Sharing
SDWD .... Statistics & Data Warehouse Department
RCOA .... Reporting Chart of Account
KPMG .... Klynveld Peat Marwick Goerdeler
ERM .... Enterprise Risk Management
SBP .... State Bank Of Pakistan
PBS .... Pakistan Beauru Statistics
USA .... United State of America
CR .... Current Ratio
QR .... Quick Ratio
ACR .... Asset Composition Ratio
LAR .... Liquid Asset Ratio
CDR .... Cash Deposit Ratio
NPL .... Non-Performing Loans
BS .... Bank Size
NGR .... Net Gearing Ratio
GDP .... Gross Domestic Product

IR.. Inflation Rate
PCI ....Per Capita Income
SR.. Saving Rate
CA .... Competitive Advantage
RO .... Religious Obligation
SQ ....Service Quality
ROA ....Return on Asset
ROE.. Return on Equity
ROI.. Return on Investment
EPS... Earnings Per Share
CFI .... Cost of Financial Intermediation

1. CHAPTER ONE: INTRODUCTION

1.1. Introduction

In global markets, financial institutions are the major player and they play a vital role in the efficient development and management of a country's economy (Mohiuddin et al, 2018). The banking industry consists of two parts, Conventional banking and Islamic banking (Zubair & Chaudry, 2014; Ahmed, 2020). According to Masood & Javaria, (2020), there were only conventional banks operating in past with interest based banking practices, later on the Islamic banks followers showed their need to adopt shariah laws banking regulations and as a result of this conservative trend, Islamic banks begins their operations which ensure the religious soundness of Muslim economies. In 2009, the annual growth of Islamic banking sector was 10-20% and estimated funds had reached over US$500 to US$1 trillion. Pakistan Islamic banking sector reached $19.93 billion of assets in June 2018, which is only 1 percent of the global asset "$2.05 trillion" (Islamic Financial Service Board IFSB, 2020). In last 62 years, Pakistan banking industry has seen major changes. Several problems faced by banking industry include "country's socioeconomic condition, capital inadequacy and political instability/uncertainty" (Masood & Javaria, 2020). In accordance with the State Bank of Pakistan Act (1956), there are various changes made by SBP, which motivates the private sector entreprenures to setup financial institutions and banks (Wulandari & Subagio, 2015).

Conventional banks and Islamic banks operate in different ways and on different base principles (Web, 2018). Firstly, Conventional banks follow the guidelines and rules of the traditional financial industry, but Islamic banks follow the rules and regulations according to Islamic Shariah law (Faleel, 2012). Secondly, Conventional banks do not have restrictions on the nature of operation and industry they are willing to serve, whereas, Islamic banks are only permitted to engage in Halal activity or transaction or industry and must not be involved in any earning from those activities and industries that are not permissible in Islam (Haram), for instance, alcohol industry, etc (Mohiuddin et al, 2018). Thirdly, conventional banks serve as intermediaries between donors and lenders, whereas Islamic banks work as a part of the operation in most transactions and services and share their profits and losses to their customers (Wulandari & Subagio, 2015). Lastly, Conventional banks receive their profits from the interest charged from their respective customers, whereas the Islamic banks carry out interest-free transactions as charging interest is strictly forbidden in Islam by Shariah law (Onakoya, 2013; Al-Harbi, 2020).

1.2.Background of Study

In 1974, the first Islamic commercial bank "Dubai Islamic Bank" started it's operations in the United Arab Emirates (UAE). From their inception, the Islamic banking industry is continously growing from four decades. Due to increase in growth and activities, Islamic banking sector have been receiving immense global attention for investment opportunities (Masood & Bellalah, 2013; Masood, Javaria & Bellalah, 2020). Across fifty three Muslim and Non-Muslim countries in the world, Islamic banks total estimated number has reached about four hundred.

Islamic financial transactions follow certain basic principles; first, financing purposes must not include any operation that is forbidden by Islamic laws, second, it must not include any kind of riba, third, economic operation must not include any form of oppression (zulm), fourth, the operation should not consist of speculation (gharar), fifth, the zakat payments must be made, and sixth, products and services which are contrary to Islamic laws must be avoided, for instance, haram products (Inyangala, 2014 & Rasul 2013). Nowadays, there is high competition in the market place and financial institutions are required concentrate on the important aspects that enhance the Islamic banks profitability (Akter & Mahmud, 2014). These important aspects/factors can contribute to increase the performance of financial sector e.g. increased market share and greater profitability (Maqbool, 2014). Today, the key issue is the decline in profitability of the Islamic banking sector and there are various reasons that why the Islamic banking sector is not profitable as it should be (Mohiuddin et al, 2018). Therefore, this study aims to analyse the factors/reasons of Profitability decline in Islamic banking ssector of Pakistan. The important factors/reasons considered by this study include quick ratio, current ratio, non-performing loans, cash deposit ratio, liquid asset ratio, bank size, asset composition ratio, inflation rate, gross domestic product, saving rate, per capita income, religious obligation, competitive advantage and service quality), which highly influence the profitability of Islamic banking sector of Pakistan. Therefore, this study is useful in understanding the reasons decline in profitability and the low market share of Islamic banks (Masood, Javaria & Bellalah, 2020). This study would be helpful to policymakers and practitioners in developing new frameworks and policies for Islamic banks and reflecting on the major issue facing an Islamic bank.

1.2.1. Islamic Banking Sector

In the last few decades, Islamic banks have been working worldwide much like other typical banks. They finance projects and mobilize deposits based on Islamic and sharia law, that are uniquely different from the ethics of other commercial and conventional banks. Therefore, the Islamic banking sector is different from conventional banks in various ways, such as prohibiting interest-based transactions in Islamic banks and limiting the operations of banks conducted by Islamic principles and by Islamic financial instruments (Abduh, Omar & Duasa, 2011; Maqbool, 2014). However, in some way, Islamic banks offer products and services which are probably similar to products of conventional banks.

Islamic banking sector is basically non-interest-based institution that fully operates under rules and regulations of Islamic laws. Islamic banks follow Islamic law properly and have progressive and creative financial innovation to offer competitive, efficient banking, investment, trading as well as real estate financing services (Abduh, Omar & Duasa, 2011). According to Onakoya, (2013) and Kumbirai & Webb (2010), approximately 180 Islamic financial institutions and banks operating in Africa, the United States, Asia, and Europe run branches of over 8,000. These branches are contributing over USD 1.72 trillion or 71% of the asset of Islamic finance industry. Gradually many conventional banks working internationally are showing interest in the Islamic banking system (Onakoya, 2013; Kamal, Ahmad & Khalid, 1999; Bakkeri & Ali 2020). As a result, Islamic banks are facing strong competition locally and internationally that includes both Islamic and no-Islamic rivals as well (Bakkeri & Ali 2020).

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1.2.2. The Profitability of Islamic Banking Sector

The Islamic banks profitability is defined as “How much profit a bank generates in respects of its operations” or “How much bank return is against its paid taxes and other expenses (Al Hares et al., 2013; Al-Homaidi, Tabash & Ahmad, 2020). Profitability is one of the most common measeure to analyze the bank efficiency and performance (Kumbirai & Webb, 2010). Measurement of Islamic banking sector profitability enables the bank management to understand that how to tackle the expected economic shocks and to stay competitive. Many studies like Al-Hares et al., (2013); Olson & Zoubi, (2008); Khediri et al., (2015), analyzed the profitability comparison of Islamic and Conventional banking system. Studies explained that there are many internal and external factors which influence the profitability of Islamic banking sector. The profitability is a vital indicator to make sure that firm is proceeding on the line of profit or loss. The profitability of an organization is the main concern of the management and must be assured realistically that there is no negative event occurring and firm performance is maintained. The performance and profitability of an organization can be better categorized through a set of measurement tools like Return on Assets (ROA), Return on Equity (ROE), Return on Investment (ROI) and Earnings per Share (EPS) (Al-Hares et al., 2013; Ledhem & Mekidiche, 2020).

Conversely, Smaoui, & Salah, (2012) conducted analysis on profitability of conventional and Islamic banking sector. The study findings show that the conventional banking system has more opportunities than the Islamic banking system. The study also explained that conventional banks are more profitable because Islamic bank's investment opportunities are very low. The Islamic banking system is not allowed to invest in haram products as it is forbidden in Islam. However, Samad (2008) conducted study on Bahrain Islamic banks. The results of 6 Islamic banks and 15 conventional banks T-Test could not verify a profitability variation of both Islamic and conventional banking system. Support of this study also comes from Al-Homaidi, Tabash & Ahmad, (2020). The results of the study show that the profitability of Islamic banks play a vital role in Islamic banking efficiency and there are many factors in the external and internal environment which influence Islamic banking profitability from a different perspective.

1.2.3. Major Factors Affecting Profitability

The banks profitability has a significant and positive influence on the overall Islamic bank performance. It is the major indicator to identify the current market position of the bank. There are various factors such as quick ratio, current ratio, cash deposit ratio, liquid asset ratio, non-performing loans, bank size, asset composition ratio, inflation rate, gross domestic product, saving rate, per capita income, religious obligation, competitive advantage and service quality which may influence the profitability of Islamic banking sector of Pakistan.