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Conventional Banks Specific Determinant on the Financial Performance: Evidence from Pakistan

Abstract: *The determination for the study is to find the impact of the Islamic banks (IB) determinant on their profitability. The research is taken the date form the time period of the 2007 to 2017 of the 11 year Islamic banks of the Pakistan to the check the impact of the Islamic banks performance (IBP). The multiple regression approach was use in this research study. Descriptive, Correlation, ANOVA and regression analysis used in the research study. The Islamic banks were measured through the Return on asset (ROA). The SPSS statistical tools were used in the research study. The finding of this research study is that the all determinant of the Islamic banks is playing a significant role of the Islamic banks profitability/performance. The bank's asset management, operating efficiency, total asset (size) and bank age has significant impact on the Islamic profitability.*

Key Words: Asset, Age, Management Size, Capital Adequacy Ratio Profitability and Pakistan

Introduction

Islamic banking a new phenomenon, started in 1960's in Egypt. Different experiments of Islamic banking were tried in different Muslim countries. The Islamic banking was introduced In Pakistan during 1979-80. After Supreme Court's Judgment the Islamic banking was launched in 2002, Meezan Bank was first Islamic bank of Pakistan. Nowadays there are four full fledge Islamic banks and almost every conventional bank in Pakistan has launched it Islamic banking branches. (Shahzad and Hameed, 2018)

There is a rapid growth rate of Islamic banking in Pakistan, the increasing financial performance of institution is based on the three principal's factors to improve financial performance of financial institutions i.e. Size of the financial institution, assets management and operational efficiency. Since the 1st Islamic financial institution, this industry spread in almost all Muslim country and some non-Muslim countries as well. Islamic banking system is based on Profit and loss sharing instead pre-determined interest. There is also difference in the investment modes of the IB and conventional banking system (CBS). The IB offer financing on different modes through participatory modes, trade based modes and rental based modes on the other hand the conventional banks provide loan on interest basis.

Profitability is "ability of the business organization to maintain its profit year after year". Profitability of the any banking institution shows the achievement of the management. The profitability can be considered one of the most important indicator to measure the performance of a specific business organization. Variations in the profitability also indicates the economic progress, profits also effects the asset and saving choices of the corporations. It positively impact flow of cash (Menicucci&Paolucci, 2016).

In a competitive market profit is essential in banking institutions at micro level which is a requirement to measure the growth in the financial market. To launch any business product it is primary objective of the bank management to

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increase its profit for existing, growth and business survival. Besides at Macro level any profitable banking institution is in position to bear any shock and can positively contribute for the stability of the financial industry. (Rajan&Zingales, 1995). In the twenty years, the banking and financial industry has practiced worldwide main conversions in operating context in internal and external issues which is impacting the structure as well as performance.

Statement of Problem

The literature reexamine that the Islamic banking is quickly growing in Pakistan. Islamic banking and Islamic finance sector growing quickly all over the world. The research study examines that the determinant of Islamic banks on their profitability in Pakistan. There limited research to find out that the internal determinant and external determinants to check the bank performance. We can't find that any research study has checked the determinant of Islamic banks in Pakistan. However many research study conducted on the conventional side.

Research Objectives

1. To investigate the connection between BS and the ROA of the Islamic banks.
2. To examine connection between AM andthe ROA of the Islamic banks.
3. To analysis connection between OE andthe ROA of the Islamic banks.
4. To analysis connection between CAR andthe ROA of the Islamic banks.
5. To analysis connection between BA andthe ROA of the Islamic banks.

Research Questions

As research questions are developed through research Objectives following are the research questions

1. Whether BS has some significant impact on ROE of the IB?
2. Whether AM has some substantial influence on RoE of the IB?
3. Whether OE has some substantial influence on RoE of the IB?
4. Whether CAR has some substantial influence on RoE of the IB?
5. Whether BA has some substantial influence on RoE of the IB?

Importance of the Study

The current research study, conducting on the internal factor that effects the enactment of IB in Pakistan.This research also examine that the determinant of IB has substantial influence on banks profitability.

Objectives of the Study

The goal of this study is to analyze the influence of various factors on the performance of Islamic banks. It is similar to studies that have been conducted on similar subjects in the Islamic financial sector.

The five chapters of this study are divided into two. The first one focuses on the introduction of the study and the second one on the analysis of the factors that influence the performance of an Islamic bank. The third chapter provides an introduction to the study and the terminology used in the research. The fourth chapter will elaborate on the data analysis and link between the variables and the bank indicator.

Litrature Review

Anne N, J (2011) studies that microfinance industry is changing with fast paste as capital market is also involving. The business need profit which is unable to relay on NGOs investment. The study purpose was to analyze the factors for profitability and whether interest really provides high profit. Expenses, portfolio, deposits, efficiency, age were compared with profitability. Yield on gross profit was insignificant relationship with the profit.

Alemayehu, O,(2016)reviewed the performance and challenges faced by the rural financial institutions in Ethiopia. Secondary data was used to measure outreach to the poor, financial sustainability and welfare impact.

Result showed the reach of MFI was increased 22.9%, financial sustainability was measured through return of asset and return of equity and also women response was increased.

Ali, et al (2017) evaluated the performance of microfinance industry of Pakistan. Researchers analyzed profitability, productivity, efficiency and credit risk. Data was gathered through PMN in annual quarterly form. Thirty microfinance providers were included for the year 2002-2012.Ordinary least square method was used .Results showed that growth in outreach increases profitability but asset utilization has no impact on profitability. Credit risk can reduce by providing group loans and efficiency can increase by decreasing expenses.

Alharbi(2016) used longitudinal data from the year 1992-2008 and investigated the factors. The empirical results indicated bank size, other operating income, GDP and capital ratio showed positive affect on profitability while GDP growth, insurance and foreign rights had negative effects.

Ali.M, (2016) investigated the Pakistani banking sector after 2008 crisis using internal and external determinants. Sample data was based on all 26 banks including 5 Islamic banks. Time period of data was from 2009-2013.ROA and ROE were used to calculate profitability of banks.Internal factors showed significant results and external factors showed insignificant results.Non-performing loans, GDP, liquidity and operating efficiency showed negative impact while financial risk, asset management and banks size, loans to total assets showed positive impact.Bank size, asset quality and inflation showed negative impact on equity. The results showed Pakistani banks are managing well to avoid impact of external factors on profitability.

Aslam.E, (2014) studied to assess the factors affecting on the profitability of IB industry of Pakistan. Data was taken for the year 2007-2014.ROA, ROE and Earing per share were used as dependent variables. The key factors that influence a bank's Return on Assets (ROA) are the leverage ratio, deposit ratio, capital adequacy ratio, and operating efficiency. Asset loan composition affect EPS and CPI affect significantly ROE and EPS.

Bashir (2003) studied determinants of Islamic bank with the cross country data. Data was taken from the year 1993-1998 from 14 Islamic banks of 8 countries of Middle East. ROE and ROA were taken as dependent variables. Regression analysis was used to analyze the results. The results showed negative relationship between tax and profitability while stock market impact was positive.

Bahsir at el (2005) examined the performance of Islamic banks of the world using data from 1994-2001.Results show that loan to assets ratio have greater profitability. Whereas, a negative impact of the Implicit and explicit taxes.

Bourke (1989) was the first one to analyze the profitability of banks determinants on cross country data. Capital ratio, liquidity ratio, and staff expense, were used as independent variables. The results showed that all internal variables were positively affecting the profitability.

Chong,Razali.(2008) examined the effect of determinants on Philippines banks profitability for the years 1990-2005.The finding suggested that bank size, credit risk and expenses impacted negatively on banks profitability. External factor, inflation has negative impact on bank's profitability. Economic growth, market capitalization and money supply has no significant impact on Philippines banks.

Daniel at el (2015) took forty-four Kenyan banks for the year 200-2009 for checking the internal factors on net interest margin taking as profitability. The empirical results showed that credit risk and operating expense have significant effect on NIM.

Determinants of profitability are of two types: internal factor and external factors. Profitability is calculated as return of asset, return of equity or net interest margin. Philip (1989) explained the relationship of profitability and equity to asset ratio. Study found that higher the equity ratio higher the profitability of a bank. Other internal factors are mentioned by Bell et al

(1969),Haslam at el(1968), Kwast et al(1982) are loan expenses, equity to liquidity ratio, deposit and loan ratios.

Kunt (1999) analyzed the banking performance of 80 countries for the year 1988-1995.He tool both developed and developing countries data and found out that developing countries have low profitability as compare to developed countries but the relationship between profitability and capital ratio was positive.

Esubaluew (2009) examined the relationship between competition and the performance of microfinance institutions .Lerner Index was used to access market power. Outreach, loan repayment, efficiency and performance were measured. From seventy three counties, 362 micro financial institutions were taken for the year 1995-2009. Results showed negative association of competition with performance.

Godwin C.O (2010) analyzed the factors affecting the economy of Nigeria and poverty. Author gathered the data from National Bureau of statistics. He used regression analysis to identify the factors. Author found five factors high prices of commodities, lack of initial investment, low profit rate, inflation and low rate of business success are the reasons of poverty. In second phase, he analyzed the impact of micro financial institutions those are reducing the poverty rate.

Haslem (1968) studied the profitability of the banks. The management tests showed the importance of management performance on profitability. Management performance should be encouraged. Size also affects the profitability and operating relationship. Location also affects the significance of regional diversity.

Zoellner and Hester utilized the number of branches as an independent variable to analyze profitability. In 1987, Emery examined the link between profitability and bank branches.

The results showed different levels have different impact on profitability of banks. Similarly Vernon (1971) studied the impact of location and found significant relationship.

Hoi. C, (2006) examined the impact of internal banks determinants and external macro factors on Macao banking industry. Panel data regression was used for the period 1993-2006.The results showed that a well-capitalized bank faces low risk and high profitability. Loan loss provisions affect banks adversely and large retail deposit taking network do not achieve high profitability as compare to small network. Inflation as macro factor shows significant relationship.

Ines et al (2015) analyzed the factors affecting Tunisian banks for the year 2003-2012.Resulsts showed size, increase in capital affected positively on bank performance. Private Banks performance was better than private banks and the revolution of 2011 affected negatively on the banks performance.

Khan (1983) conducted a study on the competition between Islamic and conventional banks in profitability its results explained that in the long-run the return on profitability of islamic banks will be higher than the interest rate.

Kingori et al(2017) found out that there is hard competition between commercial banks and microfinance Banks. Authors examined the determinants of financial performance of MFB. Secondary data was taken of 7 banks for the year 2011-2015.Data was analyzed by using regression and correlation.

Muhammad W.C (2015) analyzed the purpose of microfinance institutions whether they were able to fulfill the purpose of MFIs which is the reduction of poverty. Primary data was used for the study through structured questions. Data was collected from Tameer Microfinance Bank. Author applied multiple linear regression and t-test.The results indicated the positive impact of micro financing on financial situation of business and children education. The results were mix for house expenses. The result also shows that high number of income earners has positive impact on microfinance customer.

Naceur S.B (2003) took ten banks of Tunisia and used net interest margin as profitability, Data

was collected for the year 1980-2000.The factors which affected negatively were bank size and loans. Staikouras et al (2003) and Bashir et al (2003) both showed negative effects of loans on profitability

Robert et al (2009) analyzed the world largest 245 micro financial institutions and the relationship between profitability and outreach for borrowers specially women. Ordinary Least Square regression was used. The results show cost increases for outreach.

Sadaqat at el (2011) used the data of Islamic banks for the period 2006-2009 and investigated the effects of the performance of Islamic banks. Results showed that capital adequacy ratio showed positive impact for ROA and ROE. Bank size impacted negative on both models.While capital adequacy showed significant results for both models.

Saladin G (2017), many banks in Indonesia moved towards micro financing with profitability goals. The author used regression and found out that profitability relates with the equity to total assets, fixed asset ratio, bank size. Operating efficiency shows opposite relationship. Therefore more cost efficient microfinance banks are needed.

Saira et al (2011) analyzed the banks in Pakistan. As banks are very vital for the growth of economy. Authors identified the factor and determinants that influence the profitability of banks. The data was taken for the period 2004-2008.The data was collected from top ten banks of Pakistan. Pooled Ordinary least Square model was used. The factors were ROA, deposit, loans and equity. The results the high influence on profitability other than assets.

Sufian and Habibullah (2010) used DEA and multivariate regression analysis to analyze the efficiency of banking sector of Thailand. The data was used for the year 1999-2008.The results showed that high capitalization and higher loan intensity affects the banks efficiency.

Shahnaz et al (2009) reviewed the growth strategy and its impact on the performance of microfinance sector of Pakistan. Study shows that at the beginning intensive growth strategy is better as it improves performance efficiency and productivity. Usage of extensive strategy increased cost on infrastructure and management of branches. Outreach is only up to urban areas and financial performance is very weak.

Tamimi (2005) studied the determinants of commercial banks of UAE between foreign and national banks. Data was collected for the year 1887-2002.Regression analysis was used to find the results. For national banks, banks size, bank portfolio showed significant results for national banks. Capital productivity, economic conditions and capitalization should more significant results for foreign banks while liquidity showed negative results.

Umair at el (2012) studied that Islamic banks, internal factors like, expenditure, invested funds, liquidity and profit sharing ratio and funds borrowed are highly co-related. Rate of interest, market share and bank size are also correlated with the income of the banks.

Wolley at el (2008) analyzed the question that whether microfinance banks can remain financially sustainable while providing services to the poor community. For this purpose panel data was used using OLX regression. Studies showed that GDP has no significant relationship with performance. So microfinance banks are helpful even in low GDP growth.

Zeynup (2006), examined the financials of four commercial microfinance banks including Grameen Bank Bangladesh, Bank of Khyber Pakistan, BancoSolidario Ecuador and Mibanco Peru for the year 2001-5.The results showed that all four banks were showing increase in ROA and ROE. But Grameen and Bok both were showing negative net interest margin. The bank main purposes are both providing loans and self-sufficiency. International funding and training to credit agents are necessary.

Hypothesis

The hypotheses which we are going to investigate are given below.

Ho = there is irrelevant relation b/w BS and profitability of IB of Pakistan

H_1 = there is a substantial relation b/w Bank Size and profitability of IB of Pakistan

Ho = there is an irrelevant relation b/w Asset Management (AM) and profitability of IB of Pakistan

H_2 = there is a substantial relation b/w AM and profitability of IB of Pakistan

Ho = there is an irrelevant relation b/w the Operating Efficiency (OE) and profitability of IB of Pakistan

H_3 = there is a substantial relation b/w OE and profitability of IB of Pakistan

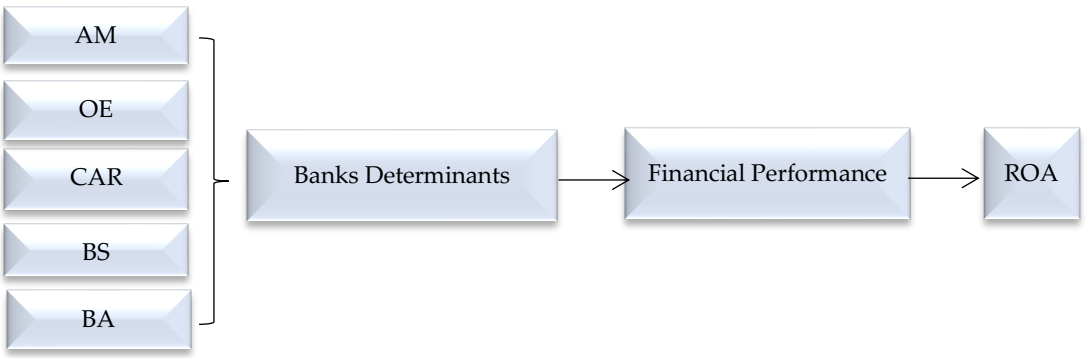
Ho = there is irrelevant relation b/w Capital Adequacy Ratio(CAR) and profitability of (IB) of Pakistan

H_4 = there is an substantial relation b/w CAR and profitability of IB of Pakistan

Ho = there is irrelevant relation b/w Banks Age and profitability of IB of Pakistan

H_5 =there is an substantial relation b/w Banks Age and profitability of IB of Pakistan

Conceptual Framework



Theoretical framework shows that financial performance of the dependent variable where the performance is calculated by its indicators as; ROA. The IB determinants are independent variable which is clear from the model that determinants been indicated by Bank size (BS), Assets management (AM), Operating Efficiency (OE), Capital Adequacy ratio (CAR), Bank Age (BA). The banks determinants have any impact on the financial performance it is our main objective of the study, and these determinants been selected from the past literature.

Research Design and Methodology

Population, and Sample size of Study

The study examine the Impact of Bank causes on the profitability and the panel data examined by applying the E-views as statistical tool where multiple regression is applied to check the impact of IV on the DV. There is only one model tested where the profitability is the dependent variable and the determinants are the independent variables. For the profitability ROA is taken as the dependent variable which been evident from the past literature (See the Ramlall, 2009; Sufian&Habibullah, 2009), researchers indicates the ROA as the best indicator for the financial performance and bank's profitability that shows the efficiency of the bank management by utilizing its assets as resources to earn profit.

Dependent and Independent Variables

The previous studies indicate three indicators for profitability of the banks as;ROA, ROE and the net interest margin (Sufan and Habibullah, 2009; Ramlall, 2009). In our study we selected one as the dependent variable return on assets (ROA) which is the most used and suitable among these variables. The independent variables are the determinants of the bank which contains; Bank

Assets Management, Operating Efficiency, CAR, Bank size and age of banks and these variable also used by the prior studies (See Demirgüç-Kunt et al., 2004; Javaid, 2011)

Statistical Model

Research Models

$Y = \alpha + \beta_1 X1 + ….. + \varepsilon$ … … … … … (1)

$ROA = \alpha + \beta_1 BS + \beta_2 AM + \beta_3 OE + \beta_4 CAR + \beta_5 BA + \beta_6 GDP + \beta_7 IR + \varepsilon$ …… (2)

Source: State bank of Pakistan

Measurement of the Variable

Following is the list of variables used for the research and the formulas for the calculation.

Table 1.

	Variables	Formula
1	ROA	Net Income /Total Assets
2	BS	Bank Size proxy by logarithm of total assets (Log Assets)
3	AM	Asset management proxy by operating income / Total assets
4	OE	OE proxy by Total operating expenses / Total assets
5	CAR	CAR proxy by Tier 1 Capital + Tier 2 Capital / Risk weighted assets
6	BA	Banks age proxy by Number of years since the bank was first started

Table 2. Measurements Procedure

Variables	Proxy	Reference
Performance	ROA = Net Incomce/Total Assets	(Al-kassim (2005)
Banks size	Ln Total assets	(Bikker and Hu (2002)
Banks age	ln of total age	
Asset management	Operating income / total assets	
Operating Efficiency	Total Operating Expenses/Total Assets	
Capital Adequacy	Capital / Risk Weighted Assets	

Ratios Interpretations

- Profitability-ROA: It defines the profit of the business in relation with assets. It indicates how well the company is earning through its assets invested in the business.
- Bank Size- Log Assets: The bank size is used to measure the saving of cost.
- Asset Management- AM: It is measured
- Operating Efficiency- OE:
- Capital Adequacy Ratio- CAR:
- Banks Age- BA:

General Linear Model: ROA versus Asset Manage, Operating Ef, Capital Adeq, Total Assets, ...

Method

Factor coding (-1, 0, +1)

Table 3.

Regression Model				
No of Observations are 40				
Dependent Variable is ROA				
Independent Variables	**Coefficient Value**	**Standard Error**	**T-Statistics**	**Prob.Value**
Constant	-0.3148	0.0811	-3.88	0.001
Asset Management	-0.1977	0.0619	-3.20	0.003

Regression Model				
No of Observations are 40				
Dependent Variable is ROA				
Independent Variables	**Coefficient Value**	**Standard Error**	**T-Statistics**	**Prob.Value**
Operating Efficiency	0.524	0.108	4.85	0.000
CAR	-0.0172	0.0204	-0.84	0.405
Total assets	0.01557	0.00420	3.70	0.001
Bank Age	0.01508	0.00525	2.87	0.007

Author compilation through SPSS R-squared= 69.42%, Adjusted R-squared= 60.25% Prob (F-statistics) = 0.003

The above result in table 4.1 explains the impact of independent variables on Islamic banks of Pakistan and to obtain the required results multiple regression model is applied. The probability value of the independent variable asset management which is 0.003 explains that it has strong significant impact on the dependent variable at 1% significant level but the co-efficient value explains that there is negative relationship between them and if there is 1 unit increase or decrease in the independent variable it will affect the dependent variable by -0.1977 units. Hence on the basis of the above results we accept itsalternative hypothesis and reject itsnull hypothesis.

The second independent variable of the study which is operating efficiency of Islamic banks explains that it also has statistically strong significant impact on the dependent variable of the study at 1% significance level and the coefficient value explains that they have positive relationship between them and if there is 1 unit increase or decrease in operating efficiency of Islamic banks of Pakistan it will increase or decrease the dependent variable of Islamic banks of Pakistan by 0.524 units. So, on the basis of the above results we accept its alternative hypothesis and reject its null hypothesis.

The third independent variable of the study which is capital adequacy ratio does not have any significant relationship with the dependent variable of the study because the probability value of it is 0.405 which means that it is more than 5% so we admit its null hypothesis and reject its alternative.

The fourth independent variable of the study which is total assets of Islamic banks explains that it also has statistically strong significant impact on the dependent variable of the study at 1% significance level and the coefficient value explains that they have positive relationship between them and if there is 1 unit increase or decrease in total assets of Islamic banks of Pakistan it will increase or decrease the dependent variable of Islamic banks of Pakistan by 0.01557 units. So, on the basis of the above results we accept its alternative hypothesis and reject its null hypothesis.

The fifth independent variable of the study which is bank age of Islamic banks explains that it also has statistically strong significant impact on the dependent variable of the study at 1% significance level and the coefficient value explains that they have positive relationship between them and if there is 1 unit increase or decrease in bank age of Islamic banks of Pakistan it will increase or decrease the dependent variable of Islamic banks of Pakistan by 0.01508 units. So, on the basis of the above results we accept its alternative hypothesis and reject its null hypothesis.

Moreover the r-squared value explains that the model is good fit and around 69.42% of variation in DV is explained by the IV of the study. The Probability (F-statistics) value explains that the overall model is significant at 1% significance level.

Conclusion

Pakistan is a developing country where approx. 50% population is living below poverty rate. Banks are the major component of an economy and Islamic banks can play strong role in economy growth. Pakistani economy is passing through many ups and downs since last many decades. To tackle internal and external factors for growth and profitability is a big challenge for Islamic banks.

Limitation of the Study

- The current research study only limited to the Islamic banks
- The research only limited to the few year of Islamic banks
- The is no comparative study with the conventional banks
- The study research study only check few determinant of Islamic banks
- The research study only check the internal determinant of the Islamic banks of Islamic banking
- The study could be improved by comparing it with the different countries by using different framework but availability of previous published studies in comparison was limited.
- Due to unavailability of annual reports, few banks data is not included.

Future direction of the Study

This research checked impact the Islamic banks determinant of the performance the Islamic banks. The 1st direction for the further research is to examine the both internal and external determinant of the Islamic banks performance. The 2nd future direction the further study is the comparative study with the other country. The 3rd direction for the further research study is the comparative study with the conventional banks of the Pakistan. For the Further research also on the other performance variables such as ROI, ROE and EPS.

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