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Impact of Profitability on Market Size of Islamic Banking of Pakistan

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Abstract

The purpose of study is to highlight the main core issues of Islamic banking profitability and market size. The paper is focus on Islamic financial system and provides a link between the depositors and investors. The study is conducted for reducing the financial risk. Financial ratios are the best gauge to analyze the overall profitability of the bank. Various financial ratios: Return on Asset and Return on Equity as a dependent variable and Asset turnover, Gearing ratio, Payout ratio, EPS as an independent variables for the enhancing the capital of Islamic bank. The objective of study is to investigate the link between the profitability and market size of Islamic Banking of Pakistan. The research is based on 100 observations and the sample size is collected for ten years from 2007 to 2016. Regression and Assumption test applied in order to check the relationship between dependent and independent variables. The overall results of study are significant less than 0.05%. The study results show that payout ratio having a negative relationship with return on asset and having positive results with return on equity. The study finalized significant results by taking neutralizing the other external variables that the factors of profitability impact on the market size of Islamic banking. The result approves the study is significantly correlated with profitability and market size of Islamic Banking.

Keywords: Profitability; Market size; Islamic banking; Pakistan

Introduction

Islamic banking system is containing Islamic banking services, activities (commercial and share banking), Islamic takaful, another Islamic investment markets, Islamic microfinance and non-bank institutions are older more than a century. The Sharia rules and regulations firstly developed by Mit Ghamr Money-Savings plan inaugurated in Egypt in 1963. Mit Ghamr provided the deposits into the small loan forms. From that point forward, Islamic Finance (IF) created an amazing profit in number (more than 400 organizations all over the world), earned ($750 billion in resources), and in development rate (10%-15% for each annum). Islamic Finance is working in more than 75 nations (ADB-2009), in the five continents; mostly Islamic Financial Institutions (IFIs) are working in the GCC and Southeast Asia. Asia and the Middle East is a good market for Islamic Banking. Besides, interest for Islamic fund items presents development patterns could see as much as $24 billion in investment funds for every year streaming to Islamic reserve funds items from family units by 2020.

Islamic banking in Pakistan

From the past 63 years Pakistan improves the Islamic Banking financial system. Formerly it undertakes lack of capital and wavering due to established political and socioeconomic catastrophe. Resultant adjustments were needed to measure the power and function of State Bank of Pakistan from side to side. State Bank of Pakistan Act 1956 encourages the private sector to organize financial institutions and Banks. In buildup privatization developments in the banking sector which begin in 1992 motivated local investors and motivated foreign banks. A network of the banking system in Pakistan amounted to PRs. 638 billion in 2008-2009, which was PRs. 131 billion in 2003-2004. While total assets for the banking sector amounted to PRs. 5595 billion in 2008-2009, those were PRs. 3003 billion in 2003-2004. At present 5 Islamic banks and 24 conventional banks are participating in the extremely competitive atmosphere [1].

However, with an expanded investment of Sariah researchers in the arrangement made, result design, review moreover supervision, the second stage for Islamic banking since 2002 need to be seen great and reliable growth. Business for 12% business stake attained on barely over a decade. Ultimately at the year-end 2015 downright, Islamic banking advantages in Pakistan remained during PRs 1.3 trillion same time aggregate Islamic saving money stores remained in PRs 1.1 trillion. In the budgetary sector, liquidity is also manageability [2]. Assumes a huge role, liquidity will be the capacity of budgetary organization with meet those commitments of its lenders (short-term) as an effect from claiming this commitment. It might be vital for a monetary organization to hold a sizeable add up to their benefits to trade should meet their transient commitment. An association needs a sensible liquidity level for it with a chance to be aggressive also reasonable. Thus, firm necessity chooses those the majority ideal level of the liquidity in place to guarantee. The investment of deposits and asset reflects a shortage of diversification, which make a risky market. Islamic banks invest the amount in physical products. An average, the study indicated that Islamic bank put their investments in trade 32%, industry 18%, Real estate 15%, Services sector 11%, Agriculture 5% and beverages 17%. These modes of investments show financial the behavior of Islamic banking [3].

Objectives of the Study

Based on the above-designed questionaries' the present studies have structured objectives formed as follows:

- To investigate that ROA has a significant and positive impact on Islamic Banking Asset Turnover.
- To investigate that ROA has a significant and positive impact on Islamic Banking Earnings per share.
- To investigate that ROA has a significant and positive impact on Islamic Banking Gearing Ratio.
- To investigate that ROA has a significant and positive relationship on Islamic Banking Payout Ratio.
- To investigate that ROE has a significant and positive impact on Islamic Banking Asset Turnover.
- To investigate that ROE has a significant and positive impact on Islamic Banking Earnings per share.
- To investigate that ROE has a significant and positive impact on Islamic Banking Gearing Ratio.
- To investigate that ROE has a significant and positive relationship on Islamic Banking Payout Ratio.

Literature Review

As the theory of conventional banking system explains that the market larger the more the profit will earn by the banks in comparison with the Islamic Banks. This research focus on the external factors depends on Islamic mode of financing. The theory of conventional banking is not fit for Islamic Banking. As discussed conventional bank monopolized the market, but Islamic banks can easily managed the competitive market. That trade which works in competitive environment gets the changes and creates innovations. The researchers findings are conventional banking perform well in monopolistic environment and free from all the religious restrictions and rules but Islamic banks perform in competitive businesses [4]. Islamic Banking analysis in eight different countries, the researcher selects the macroeconomic factors and monetary structure as an independent variable to gauge the performance of Islamic sector. In the study he selects the research area of fourteen Islamic Banks from Middle East countries like: Jordan, Bahrain, Qatar, Turkey, Sudan, UAE, Kuwait, and Egypt. The sample of research period he selected between 1993 and 1998. He selected the variables return on asset (ROA), return on equity (ROE), Non-interest margin (NIM) as a performance measures. The researchers also used both internal and external variables. The inner factors were known as Bank Size, Capital Adequacy Ratio, lending's, here and now financing, overhead costs and capital [5]. The external independent variables were GDP, regulation and stock exchange. The consequences of the study were providing a relationship between performance and macroeconomic factors. The results of research reveal that the macroeconomic factors and the overhead expenses for Islamic Banks have a positive as well as favorable relationship with the profitability. Because expenses increase profitability also increases. The study method used is relative percentage method. The writer explains that forces of the demand and supply explain the ratio of profit loss sharing between the users and suppliers of capital. The conclusion is to use the Islamic approach to money, Banking and Monetary policy [6]. Greek bank profitability system which measures the efficiency of medium and big size banks in Greece. The ratios that the researcher uses are ROA, ROE and Net Margin Ratio (MARG). The study comprises total 23 numbers of banks and data is collected from 1990-1991. The findings of study explain a positive relationship of ROA and ROE. Islamic Bank prohibited trading those commodities which destroy the moral values and system of Islam. Case in point, Islamic banks will not financially support wine, tobacco, a bar, a dance club or the activities which banned by Islam or are damaging to the society [7]. Return on asset (ROA) and returned on equity (ROE) shows the performance of banking sector and the descendant explains the returns to the owner. Due to the grave factors, the researcher used these two measures of profitability. According to Sinkey, these two measures are the best variables for the profitability of banks. The Dividend payout ratio and gearing ratios were used as an independent variable these two variables were shown positive relationships according to previous studies these two are the greater impact on firm's profitability. Darsono said, "The debt to equity ratio explains the proportion of provisions finance by the shareholder to the creditor." The superior portion of obligation used for investment stature. These ratios are liquidity covering ratios. According to previous studies, it has a positive relationship with the profitability factors i.e., Return on Asset and Return on Equity [8].

Research Methodology

Sample and data collection

The research uses financial numerical figures for that are derived by the banking sector. The type of this research is secondary based research. The total population of Islamic and commercial banks working in Pakistan is thirty-three in numbers. The research takes the sample in present study five full-fledged Islamic Banks that are currently working and five conventional commercial Islamic window banks are operating in Pakistan [9]. Total 10 Islamic Commercial banks selected as a sample of this research study. The list of Islamic banks and Islamic Windows are mention in below Table 1, and the list of dependent and independent variables are mentioned in Table 1 [10].

Statistical model

The research uses SPSS software and this data is collected through financial reports. Along with that he uses time-series Regression model and perform t-test and analyze data by using P-value and F-statistics [11]. The model is an arrangement of statistical rapport of financial and cost-effective amounts to display their dependency and impartiality on each other (Figure 1). It founds the connection among the variables in term of dependent and independent quantities in an equation. The model of present study is as follows:

$$ROA = \alpha + X1\beta1 + X2\beta2 + X3\beta3 + X4\beta4 + €$$

$$ROE = \alpha + X1\beta1 + X2\beta2 + X3\beta3 + X4\beta4 + €$$

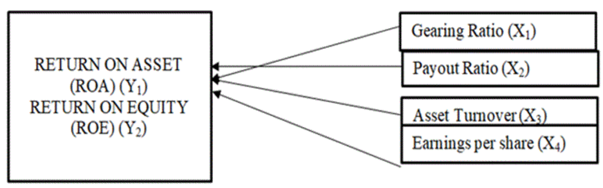

Figure 1: Model of present study.

Hypothesis

The researcher alternate hypothesis estimates a positive impact in profit margin and market size. There are H1 and H2 are arranged in the following manner:

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H1: ROA is positively correlated with the impact of profitability and market size of Islamic banking

H2: ROE is positively correlated with the impact of profitability and market size of Islamic banking

α=5%

Decision Criteria=Reject H0, if P value is less than α. Or "Accept" H0, if P value is greater than α.

Empirical Analysis

Descriptive study

Table 1 exhibit the descriptive statistic of all under study variables for the time period of 10 years 2007 to 2016. The total number of observations is 100 for every variable. The mean of all variable is described in a numerical form in below the table. The mean of return on asset shows 2.27% which shows that on an average bank 2.27% from their assets [12]. The Islamic banks will earn 14.47 returns on equity by investing 1 PRs. Gearing ratio has a mean value of 10.6% shows a highly liquid fund and able to meet short-term debts. The payout ratio has a mean value of 56.23% which shows that banks have the ability to pay a high dividend to their shareholders. Earnings per share of all banks on average stay 5.07 percent describes that 5 percent banks pay the dividend to their ordinary shareholders. The mean value of asset turnover is 0.27% which has the least impact on the revenue of bank by investing in the asset.

First regression model

$$ROA = \alpha_i + \gamma(\text{Gearing ratio})'_{it} + \gamma(Payout \quad ratio)'_{it} + \gamma(Asset \quad turnover)'_{it} + \gamma(EPS)'_{it} + \varepsilon_{it}$$

First regression model finding shows that dependent variables have a significant relationship with explained variables. By applying the linear regression model the estimated values of dependent variable ROA with four independent variables significantly correlated. The results show that the value of overall model with Pro. (F-statistic) is 0.000 lesser than 0.05. Payout ratio estimated value is 0.053 which is slightly greater than 0.05 and shows an insignificant behavior. The profitability has a positive and insignificant impact on dividend payout ratio. The dividend payout ratio is negatively related to the bank's profitability or return on asset. The coefficient of determination, R-Square, explains the portion of a variation of data from its origin. The value of R-Square is 66% explained variation by explanatory variables and 34% variations are not explained by these explanatory variables [13]. The coefficient of the goodness of Fit demonstrate i.e. R square portrays the variety clarified by noteworthy factors and confines the client for including insignificant free factors. Variation in data is explained 54% and 46% unexplained. Durbin Watson model is used for gauging autocorrelation is 0.806; the variables have no tricky serial-correlation. Asset turnover positively relationship with the profitability and the earlier researchers explain a perfect correlation between Asset turnover and profitability. The relationship of asset turnover or operating efficiency can be supported by the preceding studies discussed in the literature. Earnings per share are positively correlated with the return on asset. Gearing ratio is negatively related to the asset ratio and return on capital and the statistical coefficient is to be significant at the level of 5% in all specifications according to literature. The estimated model having the value of F statistics is 47.110 with a probability of 0.000000. ROA is used to measure the changing behavior with respect to earning per share is 0.079 which shows that banks will earn more issuing more outstanding share of common stock. The greatest change in gaining per share calculated for by ROA i.e., 0.079 per unit change and least for by payout proportion i.e.0.012. Standard errors alluded to the standard deviation of specific example circulation, and depict that how much variety exists in information from its focal measure. The payout ratio has a maximum variation in data and standard error describes Asset Turnover has a maximum variation [14].

Second regression analysis

$$ROE = \alpha_i + \gamma(\text{Gearing ratio})'_{it} + \gamma(Payout \quad ratio)'_{it} + \gamma(Asset \quad turnover)'_{it} + \gamma(EPS)'_{it} + \varepsilon_{it}$$

In this case, the dependent variable is ROE. Second regression analysis is run only including the significant variables in the model. Significant variables obtained from analysis were the gearing ratio, Asset turnover, Payout ratio and EPS. Regression results showed that all variables of the model are significant as their T-statistics Probability is 0.000 lesser 0.05. The F-test estimated value is 0.000 and significant. The coefficient of determination R square is 45 percent that means 45% changed is elucidated by the analyst. The coefficient goodness of fit for the model is also 45 percent [15-17]. The financial leverage or Gearing ratio can be positively affected. It shows a significant relationship with the ROE because the feasible debt increases the bank profitability. Payout Ratio is negatively related with the return on Equity it shows a significant relationship. Asset Turnover shows a positive relationship with the return on Equity which having a sig. level of 0.0000. More the Asset invested more will be the Equity generated. According to the previous literature, ROE is a significant relationship with the Asset turnover. EPS is positively related to the ROE. Thus the banking companies are improving the corporate performance level to pay a major attention to Earning per Share and Return on Equity because both variable simultaneously having a significant effect on stock prices and profitability [18,19].

Hypothesis for Model (1): ROA	
Gearing ratio	H_0 is accepted it has a significant value 0.049<0.05, Gearing ratio has a negatively effect on ROA
Payout Ratio	H_0 is rejected it has not a significant value 0.053>0.05, Payout ratio a positive influence on ROA
Asset Turnover	H_0 is accepted it has a significant value 0.000<0.05, Asset turnover a positive impact on ROA
EPS	H_0 is accepted it has a significant value 0.004<0.05, EPS has a positively affected on ROA

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Hypothesis for model (2): ROE	
Gearing ratio	H_0 is accepted it has a significant value 0.00<0.05, Gearing ratio has a negatively effect on ROE
Payout Ratio	H_0 is accepted it has a significant value 0.04<0.05, payout ratio has a positively effect on ROE
Asset Turnover	H_0 is accepted it has a significant value 0.000<0.05, Asset turnover a positive impact on ROE
EPS	H_0 is accepted it has a significant value 0.000<0.05, EPS has a positively affected on ROE

Table 1: Hypothesis Test.

Conclusion

In the current analysis of the study, banks profitability is a relationship of Return on Asset and Equity. Independent ratios are Gearing Ratio, Payout Ratio, Asset Turnover, EPS; they directly impact on the profitability. Descriptive statistic of data shows that on average total profitability are 2.3% of all Islamic banks. ROE indicated that banks get 14.47 by investing 1Rs and 2.3 from the investment of assets. G.R deliberates that bank is a highly liquid investment and S.D is 10. The dividend payout ratio shows a highly pay dividend 56 percent. Earnings per share value are 5 percent indicates bank pay dividend to their ordinary shareholder. As to the OLS regression model, according to the first model gearing ratio, Asset turnover, EPS are significant variable while payout ratio is insignificant. Regression model explains that gearing ratio, Asset turnover, EPS are independent variable is positively related to ROA dependent variable. The payout ratio is negatively correlated. The second regression model is run only on significant variables and it is found that coefficient of determination R square is 45%. The coefficient of Goodness of fit is also 45%. The correlation analysis method is applied to detect correspondence independent variables over the period of study. Durbin Watson shows there is autocorrelation in the residuals of model and also shows there is no autocorrelation among the data by running regression model. It is to be concluded of market size of banks on profitability. Gearing ratio clarifies the productivity of the capital structure of a bank, if a bank depends on its value more than an obligation.

Ratios used to gauge the earning of a bank for a particular time, high productivity implies banks are utilizing its advantages effectively to deliver more income; supplementary benefits are utilized for re-speculation purposes the development of market size of banks. Liquidity ratios measure the short-term liabilities. Better liquidity empowers banks than settle on risk barriers and meets crises that manufacture their generosity among their leases and different partners. Performance has significant impact on bank's size but it explains only 45 percent variation in bank size. Besides good performance other internal and external factors are determinant of firm's size, so unexplained variation of Performance in relation to firm size is 55%. The data clarify that growth of bank size and profitability are significant towards the variables. The overall results of Islamic banking shows there is a positive correlation between profitability and market size.

Limitation of Study

- This research do not explains the external factors i.e., customer knowledge, management, political and economic structure can affect the profitability of Islamic banking.
- The research sample is based on the 10 Islamic banks of Pakistan and results can be varies by increasing the sample size.
- The research area is based on the limited number of financial ratios.

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