Determinants of Islamic Banking Growth in Pakistan

Salman Ahmed Shaikh

Abstract

This study analyzes the banks’ internal factors to study the determinants of profitability and assets growth. The study also investigates empirically the reasons why Finance to Deposits Ratio (FDR) is low in Islamic banking in Pakistan. Both descriptive and inferential techniques have been used. This study uses balanced panel data for all five full fledged Islamic banks in Pakistan for the period 2007-12. We find that net markup income is positively associated with expense and assets and negatively with NPLs (Non Performing Loans). FDR ratio is positively associated with NPL to net income, net markup income and expense to net markup income. Our results suggest that assets growth is positively related with profitability ratios and is also positively influenced by deposits growth.

Keywords: Islamic Banking, Credit Risk, Bank Profitability, Bank Liquidity, Bank Solvency, ADR, NPL, CAR

JEL Codes G21, G15, E52

1. Introduction

Islamic finance is a fast growing industry all across the globe with an asset base touching $1.5 trillion. Islamic finance products are not only interest free alternatives for the financial needs of the contemporary Muslim communities wanting to avoid interest, but the products are also generating increased appeal primarily because of their financial and economic merits. The two most important problems identified in a post-financial crisis look back are perverse incentives and de-linking of financial sector growth and activities with the real sector of the economy.

In an article “What Went Wrong”, The Economist writes:

“US credit market debt was 168% of GDP in 1981 and over 350% in 2007. Financial assets were less than five times larger than US GDP in 1980, but over ten times as

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large in 2007. The notional value of all derivative contracts rose from about three times global GDP in 1999 to over 11 times global GDP in 2007. The notional value of credit default swap derivatives rose from about $6 trillion in December 2004 to $62 trillion three years later. In the US, the share of total corporate profits generated in the financial sector grew from 10% in the early 1980s to 40% in 2006."

Islamic finance principles by basing all financial products with real assets fill the gap and this feature alone is a very important risk management tool inbuilt into the system.

The first phase of Islamic banking in Pakistan during the 1980s under the patronage of Zia-ul-Haq was not successful. However, with increased participation of Shari’ah scholars in the policy making, product design, audit and supervision, the second phase has seen impressive and consistent growth since 2002. Now, Islamic banking in Pakistan is an established industry with 10% market share achieved in just over a decade.

Islamic finance is a growing industry almost everywhere. The key regional hubs of Islamic finance include Middle East, South Asia, East Asia and Europe. The industry is growing at a rapid pace and now, it has presence in Africa, Central Asia and North America. Despite the financial crisis of 2007-09 and ongoing credit crisis, Islamic finance has sustained the growth momentum and hence has appeared as a potent, resilient and possibly an alternate financial architecture for post-crisis financial markets.

The basic structure of Islamic banking can be explained as follows. First, an Islamic bank creates an asset pool which consists of bank’s equity and deposits. Deposits include two further classifications, i.e. remunerative deposits and non-remunerative deposits. Remunerative deposits are mobilized using partnership mode ‘Mudarabah’ with bank’s shareholders and depositors as partners. Profit sharing ratio is agreed at the start of this partnership. Non-remunerative deposits are mobilized using Qarz (non-compensatory loan).

This pool of assets is used to provide asset backed financing. These financing assets are based on different underlying financing contracts, i.e. Ijarah, Diminishing Musharakah, Murabaha, Imsina etc. Islamic bank does not lend money. It provides asset backed financing in which the asset is owned by the bank. These financing modes can be categorized as lease based financing or credit sale based financing. Income stream is generated either through profit on credit sale or rent for the use of asset.
Currently, Islamic banks use the same interbank benchmark rate (KIBOR) in Pakistan for pricing assets in credit sale for profit determination and computing rentals necessary to amortize the cost of asset during the lease period.

Income from the sale or lease of real assets is distributed among the contributors in asset pool, including bank’s shareholders and depositors. To achieve spreads for financial intermediation function, profit sharing is done between the bank and the depositors as per the pre-agreed profit sharing ratio.

Figure 1 shows the growth in assets, deposits and advances in Islamic banking industry in Pakistan for the period 2006-13. The exponential and uninterrupted growth is evident from this graph.

**Figure 1: Growth in Islamic Banking (2006 – 2013)**

![Graph showing growth in assets, deposits, and financings](image)

**Source: SBP Islamic Banking Bulletin, Various Issues**

According to some, this growth owes to some unique features inherent in Islamic financial products. Adel (2010) explained the economic merits of Islamic banking by pointing out that credit expansion through Islamic banking is linked to the growth of the real economy by allowing credit primarily for the purchase of real goods and services. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully.
b) When people become aware of Islamic banking and accept its status as Islamic, most people would start using Islamic banking services first by opening bank accounts than by obtaining finance.

c) It is easier for a customer to switch from a conventional bank deposit to Islamic bank deposit than to convert a conventional debt based liability to Islamic financing product.

d) Islamic banks have remained solvent and liquid and hence during and after the consumer-financing bust, people have placed more faith in Islamic banks for parking their surplus funds.

3.3. NPL to Financing Ratio

NPL to finance ratio has increased during the consumer-financing bust, but comparatively, Islamic banks in Pakistan have lower NPLs and cleaner balance sheets as compared to the conventional banks. After 2010, the ratio is decreasing for all banks in the sample. Possible reasons include:

a) Islamic banks do not provide risky financing, i.e. unsecured loans in Pakistan. 

b) Financing is always provided for the purchase of an asset whose ownership belongs to the bank.

c) Since Islamic banks can not earn profit on late payments, they only provide financing to sound clients than creating subprime financing assets.

3.4. Expense to Net Markup Margin Ratio

This ratio has remained high and it shows that Islamic banks have not achieved scale efficiency yet, but the ratio is declining for some banks and stabilizing for some other banks showing a possible reversal. Hike in this ratio could be attributed to:

a) Scale inefficiency.

b) Diseconomies of scale and scope. Each financing contract requires thorough documentation and ascertainment of genuine purchase of an asset.

c) Lack of room to provide every type of loan, like credit cards, running finance, personal finance, travel finance, education finance, health finance etc.

3.5. Net Income to Financing Ratio

Most Islamic banks in Pakistan had been in losses in their initial years of establishment. This is understandable given the heavy capital expenditure required to set up a bank. Secondly, being a small part of the overall market along with increase in the number of players in the banking sector of Pakistan during 90s and 2000s,

Table 3: Determinants of Assets Growth

| lnassets     | Coef. | Std. Err. | z    | P>|z|    | [95% Conf. Interval] |
|--------------|-------|-----------|------|---------|---------------------|
| npnl         | .438624 | .191337  | 2.29 | 0.022   | .0636104, .8136376 |
| lnmi         | .704817 | .0816414 | 8.63 | 0.000   | .5448029, .8648311 |
| f indep      | -.4207163 | .3343663 | -1.26 | 0.208  | -1.076062, .2346295 |
| depta        | 1.357937 | .7923746 | 1.71 | 0.087   | -.1950884, 2.910963 |
| _cons        | 4.686242 | .6491558 | 7.22 | 0.000   | 3.41392, 5.958564  |
| sigma_u      | 0      |           |      |         |                     |
| sigma_e      | .25299806 |        |      |         |                     |
| rho          | 0      | (fraction of variance due to u_i) |

5. Challenges for Islamic Banks in Future

Deposit mobilization had been much easier in Islamic banking in Pakistan as compared to using the deposits to provide finance. Islamic banks with assets backed financial products rely much more on formal documented manufacturing based industries where finance is required for plant and machinery, raw material and industrial equipment.

On the other hand, the financing operations that are overly dependent on asset backed debt based modes of financing create several issues.

First, in times of recession, Islamic banks in Pakistan have limited product range for firms that require finance in already ongoing projects in which lumpy investments had been made, but financing is required to meet rising variables costs of energy and utility expense.

Secondly, in recession, purchasing new assets for expansion is not the first things most firms would do or can afford to do. Hence, if Islamic banks remain stuck in debt
Finally, in section 5, we discuss challenges for Islamic banking in Pakistan which the industry has to overcome to sustain the growth momentum and realize its potential going forward.

2. Literature Review

In this section, we cite several studies that have empirically analyzed the determinants of profitability and efficiency in Islamic banks. Hasan & Basheer (2003) in an empirical study argue that high capital and loan-to-asset ratios lead to higher profitability. In their study, they found that the Islamic banks' profitability measures respond positively to the increase in capital and negatively to loan ratios. Their results reveal that larger equity to total assets ratio leads to more profit margins.

Hasan & Basheer (2003) explain that adequate capital ratios play a weak empirical role in explaining the performance of Islamic banks. Islamic Banks' loan portfolio is heavily biased towards short-term trade financing. Their loans have low risk and only contribute modestly to the banks' profits.

Using Data Envelopment Analysis, Yodistra (2003) concludes that Islamic banks suffered slight inefficiencies during the global crisis of 1998-9. He indicates that there are diseconomies of scale for small-to medium Islamic banks which suggests that M&A should be encouraged. Regarding regional differences, he concludes that Islamic banks within the Middle East region are less efficient than their counterparts outside the region. Additionally, market power, which is common in the Middle East, does not significantly have an impact on efficiency. The reason is that Islamic banks from outside the Middle East region are relatively new and very much supported by their regulators. Furthermore, publicly listed Islamic banks are less efficient than their non-listed counterparts.

Using Stochastic Frontier Approach (SFA), Mokhtar (2006) infers that cost and profit efficiencies have improved in Islamic banks and they are relatively better in controlling costs than generating profits. His results also suggest that Islamic banks in Europe are relatively more cost and profit efficient than the other group of banks. Banks in the Middle East region are significantly less efficient than Islamic banks in Africa but more efficient than banks in the Far East and Central Asia.

Mokhtar (2006) highlights that the overall efficiency level in Islamic banks has increased, but it is still lesser than the conventional banks. He infers that among the Islamic banking institutions, the full-fledged Islamic banks are more efficient than Islamic banking windows. In another study on efficiency, Masood & Ashraf (2012)
provide empirical evidence that Islamic banks with larger assets size and with efficient management are able to earn greater return on assets.

Haron (2004) in an empirical study suggests positive association between deposits growth and profitability in Islamic banks. He also finds that there is no significant variation in earnings between Islamic banks in competitive and monopolistic markets. However, there is strong evidence which indicates that firm’s and shareholder’s welfare are maximized in the monopolistic market.

Kablan (2011) in an empirical study on bank efficiency finds that countries with Islamic banking system do not necessarily display efficiency scores superior to the average. He infers that the subprime crisis seems to have impacted those banks indirectly. He concludes that Islamic banks do not benefit from scale economy.

Using cross-country panel data, Basheer (2003) shows that the Islamic banks’ profitability measures respond positively to the increase in capital and loan ratios. Their results indicate that the adequate capital ratios and loan portfolios play an empirical role in explaining the performance of Islamic banks. The results also highlight the importance of consumer and short-term funding, non-markup earning assets, and overheads in promoting banks’ profits.

Ahmad & Akbar (2011) establish through empirical research of 78 worldwide Islamic banks spread over 25 countries that the more efficient Islamic banks tend to be more profitable.

Haron (1996) in his study of the performance of Islamic banks in different competitive environments concludes that Islamic banks in competitive market earned more than those which operate in a monopolistic market.

In an empirical study of profitability determinants in Sudan, Eljelly (2013) notes that cost, liquidity and size of the bank had positive and significant effects on profitability.

A study by Wasiuzzaman & Tarmizi (2010) for Malaysian Islamic banks showed that capital, asset quality, liquidity and operational efficiency have a significant impact on the profitability of Islamic banks. Muda et al (2013) in an empirical study for Malaysia concludes that overhead expenses ratio, loans ratio, deposits ratio, technical efficiency and bank size have a positive significant effect in determining banks’ profitability. Meanwhile, the inflation rate has a negative significant effect in determining banks’ profitability. Abdul & Idrees (2013) identified that profitability determinants for Malaysian Islamic banks include assets, financial market development, market concentration and inflation.
Determinants of Islamic Banking Growth in Pakistan

Ani et al (2012) conducted a study for Islamic banks in Nigeria and the findings suggest that increase in size does not consistently lead to higher profits due to diseconomies of scale. They conclude that higher capital to assets ratio and loans and advances contribute strongly to bank profitability.

However, using data from two Sudanese banks, Bashir (1999) argues that the relationships between size and profitability measures are statistically significant, indicating that Islamic banks become more profitable as they grow in size. The significant negative effect of the risk variable implies that, as the Islamic banks grow in size, the operating risk decreases. This result strongly supports the intermediation theory, which confers a diversification advantage as size increases.

3. Descriptive Analysis

In this section, using annual data for the period 2007-12 from the published financial statements of five full-fledged Islamic banks, we present various stylized facts that emerge from the data. Five full-fledged Islamic banks taken for this study include: Meezan Bank Limited (MBL), Bank Islami (BI), Dubai Islamic Bank (DIB), Bank Al-Barakah (BA) and Burj Islamic Bank (BIB).

3.1. Finance to Deposit Ratio

Finance to deposit ratio for most banks has declined during 2007-12. The possible reasons for that include:

a) Rise in markup rates.

b) High cost of doing business, energy crisis, security crisis etc.

c) Lack of product alternatives to provide distress financing other than for purchase of assets. The demand for distress financing is more in a recession.

3.2. Deposits to Total Assets Ratio

Islamic banks have effectively mobilized deposits during the period 2007-12. Here, several possible reasons can be highlighted for strong deposits growth and mobilization.

a) Deposit mobilization has much less contractual frictions than creating a Shari’ah compliant financing asset. In providing finance, it is important that finance is provided for genuine purchase of an asset whose ownership, possession and risk has to be borne by the bank so as to be able to earn any sale premium or rents for the use of asset.
When people become aware of Islamic banking and accept its status as Islamic, most people would start using Islamic banking services first by opening bank accounts than by obtaining finance.

It is easier for a customer to switch from a conventional bank deposit to Islamic bank deposit than to convert a conventional debt based liability to Islamic financing product.

Islamic banks have remained solvent and liquid and hence during and after the consumer-financing bust, people have placed more faith in Islamic banks for parking their surplus funds.

3. **NPL to Financing Ratio**

NPL to finance ratio has increased during the consumer-financing bust, but comparatively, Islamic banks in Pakistan have lower NPLs and cleaner balance sheets as compared to the conventional banks. After 2010, the ratio is decreasing for all banks in the sample. Possible reasons include:

- Islamic banks do not provide risky financing, i.e. unsecured loans in Pakistan.
- Financing is always provided for the purchase of an asset whose ownership belongs to the bank.
- Since Islamic banks can not earn profit on late payments, they only provide financing to sound clients than creating subprime financing assets.

4. **Expense to Net Markup Margin Ratio**

This ratio has remained high and it shows that Islamic banks have not achieved scale efficiency yet, but the ratio is declining for some banks and stabilizing for some other banks showing a possible reversal. Hike in this ratio could be attributed to:

a) Scale inefficiency.

- Diseconomies of scale and scope. Each financing contract requires thorough documentation and ascertainment of genuine purchase of an asset.
- Lack of room to provide every type of loan, like credit cards, running finance, personal finance, travel finance, education finance, health finance etc.

5. **Net Income to Financing Ratio**

Most Islamic banks in Pakistan had been in losses in their initial years of establishment. This is understandable given the heavy capital expenditure required to set up a bank. Secondly, being a small part of the overall market along with increase in the number of players in the banking sector of Pakistan during 90s and 2000s,
Islamic banks at the moment cannot use price skimming to break even quickly. However, all banks taken in the sample currently are now in profits.

### 3.6. NPL to Net Markup Margin Ratio

NPL to markup margin ratio has increased during the consumer-financing bust, but, comparatively, Islamic banks have lower NPLs as compared to conventional banks due to asset backed financing. After 2010, the ratio is decreasing for all banks in the sample. Possible reasons are the same which have been discussed earlier for NPLs to finance ratio.

### 3.7. Net Income to Total Assets Ratio

Most banks had been in losses in their initial years of establishment. However, all banks in the sample currently are now in profits. The top two banks have had much stable path for this ratio during the period as compared to the new entrants. This shows that there is considerable first mover advantage in Pakistan’s Islamic banking sector.

### 4. Econometric Analysis

#### 4.1. Data & Methodology

We have selected five full-fledged Islamic banks in the sample. Annual data for the period 2007-12 on various internal financial factors, i.e. balance sheet and income statement variables is taken. We have also created variables from the reported data which are important financial ratios used commonly for the analysis of banks.

In total, there are 30 observations (N = i x t), i.e. 6 year data (t) for 5 banks (i). We have a balanced panel. We use panel data regression analysis using fixed effects and random effects. Hausman test of model selection for panel data is employed to decide between fixed effects and random effects model. Using Hausman test, we found that random effects model was more efficient and consistent. Then, we used Breusch-Pagan Lagrange Multiplier (LM) test to decide whether to use random effects or simple pooled regression. As per the results from that test, we finally rested with estimating the panel data regression using random effects GLS regression.

#### 4.2. Model Specification

##### 4.2.1. Model I: Determinants of Profitability

**Specification I**

\[
\ln n_{ii_{it}} = \beta_0 + \beta_1 \ln expense + \beta_2 \ln n_{pl} + \beta_3 \ln assets + \epsilon_{it} \quad \text{(i)}
\]

Where
Innii = Natural log of net markup income.
Inexpense = Natural log of total administrative expense.
Innpl = Natural log of total non-performing loans.
Inassets = Natural log of total assets.
e_{it} = Random error term.
‘i’ is cross sectional unit identifier and ‘t’ is time identifier.

Specification II

\[ \text{Innii}_{it} = \beta_0 + \beta_1 \text{Inexpense} + \beta_2 \text{Innpl} + \beta_3 \text{Inadvances} + e_{it} \quad \text{.......... (ii)} \]

Where

Innii = Natural log of net markup income.
Inexpense = Natural log of total administrative expense.
Innpl = Natural log of total non-performing loans.
Inadvances = Natural log of total advances.
e_{it} = Random error term.

‘i’ is cross sectional unit identifier and ‘t’ is time identifier.

Specification III

\[ \text{Innii}_{it} = \beta_0 + \beta_1 \text{Inexpense} + \beta_2 \text{Innpl} + \beta_3 \text{Incapital} + e_{it} \quad \text{.......... (iii)} \]

Where

Innii = Natural log of net markup income.
Inexpense = Natural log of total administrative expense.
Innpl = Natural log of total non-performing loans.
Incapital = Natural log of total capital.
e_{it} = Random error term.
‘i’ is cross sectional unit identifier and ‘t’ is time identifier.

Model II: Determinants of Low FDR

\[ \text{findep}_{it} = \beta_0 + \beta_1 \text{nplfin} + \beta_2 \text{niita} + \beta_3 \text{expnii} + e_{it} \quad \text{.......... (iv)} \]

Where

findep = Finance to deposit ratio.
nplfin = NPL to finance ratio.
Determinants of Islamic Banking Growth in Pakistan

niita = Net markup income to total assets.
exnnii = Expense to net markup income.
e_{it} = Random error term.
‘i’ is cross sectional unit identifier and ‘t’ is time identifier.

Model III: Determinants of Assets Growth

\[ \ln assets_{it} = \beta_0 + \beta_1 nplni + \beta_2 lnii + \beta_3 findep + \beta_4 depta + e_{it} \]  

Where

\( \ln assets \) = Natural log of total assets.
\( nplni \) = NPL to net income ratio.
\( \ln ii \) = Natural log of net markup income.
\( findep \) = Finance to deposit ratio.
\( depta \) = Deposits to total assets ratio.
\( e_{it} \) = Random error term.
‘i’ is cross sectional unit identifier and ‘t’ is time identifier.

3. Results & Interpretations

Model I: Results & Analysis

In the three alternate models for the determinants of profitability, we are able to compute important elasticities by virtue of taking natural log on all variables.

In the first specification, net markup income is positively associated with expense and assets and negatively with NPLs. These results are plausible. Assets growth has coincided with increase in net markup income. Revenue expenditure in expansion has also improved profitability. Increase in NPLs has dented net markup income growth, but only by less than 10% which is plausible and consistent with observed data.

In second specification, net markup income is positively associated with expense and advances and negatively with NPLs. These results are also plausible. Advances are the major source of markup income and apriori; net markup income should be positively associated with advances growth controlling for NPLs. Revenue expenditure in expansion has also improved profitability. Increase in NPLs has
In third specification, net markup income is positively associated with expense and capital and negatively with NPLs. This is consistent with observed data and earlier model specifications.

Table 1: Three Alternate Models for Determinants of Profitability

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model_I</th>
<th>Model_II</th>
<th>Model_III</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnexpense</td>
<td>.80009631***</td>
<td>.85654558***</td>
<td>1.1519746***</td>
</tr>
<tr>
<td>lnpl</td>
<td>-.08970562*</td>
<td>-.07760006*</td>
<td>-.10095711*</td>
</tr>
<tr>
<td>lnassets</td>
<td>.41646914**</td>
<td>.38141294**</td>
<td></td>
</tr>
<tr>
<td>lnadvances</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>lncapital</td>
<td>-2.6925351***</td>
<td>-2.4516504***</td>
<td>-3.6943337*</td>
</tr>
<tr>
<td>_cons</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>chi2</td>
<td>209.52623</td>
<td>206.32748</td>
<td>161.09522</td>
</tr>
</tbody>
</table>

Legend: * p<0.05; ** p<0.01; *** p<0.001

4.3.2. Model II: Results & Analysis

In this model, we try to find determinants of low FDR in Islamic banks. Expense to net markup income is positively associated with FDR. Hence, Islamic banks are only able to improve FDR by increasing inefficiency, i.e. increase in expense to net markup income. This suggests why Islamic banks are slightly expensive in most types of financing that are provided by both conventional and Islamic banks. FDR is positively associated with NPL to net income and net markup income. Since FDR can increase with increase in NPL to income ratio, Islamic banks have shown risk aversion and have remained satisfied with the tradeoff between low FDR and low NPL to income ratio.
Table 2: Determinants of Low FDR

<table>
<thead>
<tr>
<th>Random-effects GLS regression</th>
<th>Number of obs = 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group variable: id</td>
<td>Number of groups = 5</td>
</tr>
<tr>
<td>R-sq: within = 0.3939</td>
<td>Obs per group: min = 6</td>
</tr>
<tr>
<td>between = 0.0086</td>
<td>avg = 6.0</td>
</tr>
<tr>
<td>overall = 0.1540</td>
<td>max = 6</td>
</tr>
<tr>
<td>corr(u_i, X) = 0 (assumed)</td>
<td>Wald chi2(3) = 4.73</td>
</tr>
<tr>
<td></td>
<td>Prob &gt; chi2 = 0.1923</td>
</tr>
</tbody>
</table>

| findep     | Coef.  | Std. Err. | z     | P>|z|    | [95% Conf. Interval] |
|------------|--------|-----------|-------|-------|-----------------------|
| nplfin     | -4.241246 | 2.528002 | -1.68 | 0.093 | -9.196039  .7135476 |
| niita      | 7.030303  | 4.559222 | 1.54  | 0.123 | -1.905609  15.96621 |
| expnii     | .1382787  | .0915167 | 1.51  | 0.131 | -0.0410907 .3176481 |
| _cons      | .2262072  | .2376876 | 0.95  | 0.341 | -0.2396519 .6920663 |

| sigma_u    | 0      |
| sigma_e    | .15851828 |
| rho        | 0 (fraction of variance due to u_i) |

4.3.3. Model III: Results & Analysis

In this model, we try to find the determinants of assets growth. Our results suggest that assets growth is positively related with profitability ratios and is also positively influenced by deposits growth. Negative association between assets growth and FDR is consistent with observed data. In general, increase in FDR is a good signal when financing assets are generated through prudent provision of finance. But, during the period of study, depositors who are leading the assets growth in Islamic banks have interpreted decline in FDR as a positive sign amidst high cost of doing business, cost push inflation and high discount rate maintained by the central bank in Pakistan. Hence, they have invested more with Islamic banks considering them more liquid, solvent and prudent in provision of finance.
Table 3: Determinants of Assets Growth

| Coef. | Std. Err. | z     | P>|z|  | [95% Conf. Interval] |
|-------|-----------|-------|------|-----------------------|
| **lnassets** |           |       |      |                       |
| nplni | .438624   | .191337| 2.29 | 0.022                 | .0636104, .8136376 |
| lnii  | .704817   | .0816414| 8.63 | 0.000                 | .5448029, .8648311 |
| findep| -.4207163 | .3343663| -1.26| 0.208                 | -1.076062, .2346295 |
| depta | 1.357937  | .7923746| 1.71 | 0.087                 | -.1950884, 2.910963 |
| _cons | 4.686242  | .6491558| 7.22 | 0.000                 | 3.41392, 5.958564  |
| **sigma_u** | 0         |       |      |                       |
| **sigma_e** | .25299806 |       |      |                       |
| **rho** | 0         | (fraction of variance due to u_i) |       |                       |

5. Challenges for Islamic Banks in Future

Deposit mobilization had been much easier in Islamic banking in Pakistan as compared to using the deposits to provide finance. Islamic banks with assets backed financial products rely much more on formal documented manufacturing based industries where finance is required for plant and machinery, raw material and industrial equipment.

On the other hand, the financing operations that are overly dependent on asset backed debt based modes of financing create several issues.

First, in times of recession, Islamic banks in Pakistan have limited product range for firms that require finance in already ongoing projects in which lumpy investments had been made, but financing is required to meet rising variables costs of energy and utility expense.

Secondly, in recession, purchasing new assets for expansion is not the first things most firms would do or can afford to do. Hence, if Islamic banks remain stuck in debt
based modes of financing, they will have to start offering buyback or sale and leaseback type of products which are not preferable or ideal from the Maqasid-e-Shari’ah perspective.

Third, over-reliance on debt based modes of financing requires firms to take initiative and increase their demand for such products from Islamic banking. Hence, the supply side response by Islamic banks is hindered and they may remain ineffective in bringing an economy out of recession by providing less restricted and flexible modes of financing like Mudarabah and Musharakah.

But, Islamic banks in Pakistan seem to be content with surplus liquidity. Instead of using the deposits by providing finance, they had increased investments. This has resulted in an FDR ratio of as low as 34% in recent months. This undermines their function of financial intermediation between firms and households.

Conclusion

In this study, we analyzed the bank’s internal parameters to study determinants of profitability and assets growth. We also investigated empirically the reasons why FDR is low in Islamic banking. Both descriptive and inferential techniques have been used. We found that net markup income is positively associated with expense and assets and negatively with NPLs. FDR is positively associated with NPL to net income, net markup income and expense to net markup income. Our results suggest that assets growth is positively related with profitability ratios and is also positively influenced by deposits growth.

References


