

Why Islamic Banks are not Competitive in Islamic Country: An Empirical Evidence from Pakistan Islamic Banking Sector

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Abstract: Islamic banks are founded on principles that constitute the guidelines governing any Islamic economic or financial dealing. There are almost 180 Islamic financial institutions operating all over the world with 8,000 branches contributing to 71%, or USD 1.72 trillion, of the Islamic finance industry's assets¹. 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 Pakistani fully fledged Islamic banking sector. Therefore, this study purpose is to highlight the main reasons for the decline of Islamic banking profitability in Pakistan. According to SBP, Islamic Bank Bulletin 2018², there are currently four fully fledged Islamic banks operating with 12.9% 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. Study is quantitative in nature and primary data was collected from 508 senior managers of Pakistani Islamic banks. Conclusively, finding reveal that internal/bank specific, external factors have significant and positive impact on Islamic bank's profitability. The study provides clear, workable policy recommendations to be followed both by the senior banks management as well as the regulatory body (SBP). This study is truly unique 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.

Keywords: *Bank specific factors, Internal factors, Environment specific Factors, External Factors, Profitability, Quantitative Research, Fully Fledged Islamic Banks, Senior Managers, Islamic Bank Bulletin, Primary Data Analysis*

INTRODUCTION:

In global markets, financial institutions are the major player and they play a vital role in creating and running country's economy efficiently [19]. The banking industry is divided in two parts; one is Conventional banking system and second is Islamic banking system [30].

¹ Onakoya, (2013); Kamal, Ahmad & Khalid, (1999); Masood, (2013); Dublin (2019) Global Islamic Finance Markets Report 2019, "Global Islamic Finance Market Growth, Trends, and Forecast", Source: Research and Markets

² State Bank of Pakistan, Islamic Banking Bulletin: April-June 2018, Islamic Banking Industry - Progress & Market Share

In past decades, there were only conventional banks which perform operations based on interest. Islamic banks were introduced as the result of conservatism trend, in which Islam followers show their need to follow banking practices in light of Sharia laws and ensure the soundness of their Muslim economies as explained by Masood, (2013)[18].

In today's environment where high competition is prevailing in the economy, in order to retain customer in the competitive economy, financial institutions are focusing on some essential aspects which enhance the Profitability of Islamic banking sector [3]. These important factors lead towards a greater performance of financial sector i.e. bigger market share and better profitability [16]. Today major problem faced by Islamic banks is the decline in their profitability and there are various reasons that Islamic banking sector is not as much as profitable as compared to conventional banks [19]. So, focus of this study is to analyze the reasons and factors which influence the Islamic banking sector profitability in the long run. This study is considering eight major factors (Quick Ratio, Cash Deposit Ratio, Non-Performing Loans, Net Gearing Ratio, Asset Composition Ratio, Service Quality, Religious Obligation and Competitive Advantage), which may influence the Islamic banking sector profitability. This study is helpful to understand the reasons of Islamic banks profitability decline and low market share [18]. The study will be useful for policy makers and practitioners to make new policies for Islamic banks and to focus on major problem faced by Islamic banks [13].

Islamic Banks Profitability: The most common measure used to examine the efficiency of a bank is called profitability analysis [15]. The profitability of the Islamic Bank is defined as how much profit a bank generates in respect of its operations. The profit of banks describes how much bank return is against its paid taxes and other expenses ([17][28]). The most common measure of bank performance and efficiency is called profitability analysis [15]. Measuring the profitability of Islamic banking sector is very important as it enables the banking system to stay competitive and finance the operations of banks. Several researchers anticipate the Islamic banking sector to be more profitable than the conventional banking system of the country [4][20][14].

Purpose/Motivation of Study: The banking sector plays a vital role in development of economic system [23]. 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 reasons behind decline and failure of the Pakistani fully fledged Islamic banking sector. Therefore, this study purpose is to highlight the main reasons for the decline of Islamic banking profitability in Pakistan. According to SBP, Islamic Bank Bulletin 2018³, there are currently four fully fledged Islamic banks operating with 12.9% 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 is very important in nature because it identifies the reason that why Islamic banks are getting bankrupt in an Islamic country of "Islamic Republic of Pakistan". According to previous theoretical background and current scenario, this paper has identified various factors/reasons of Islamic banks profitability decline. The factors identified by present study are Bank specific/Internal Factors and External factors. This study has tried to include all aspects and problems which influence the Islamic banking industry internally and externally.

The motivation behind this study is to identify the problem/reasons that why Islamic banks are not competitive in an Islamic country "Pakistan". In 2007 there were 7 Islamic banks including Meezan Bank Limited, Dubai Islamic Bank, Bank Islami Pakistan, Al-Baraka (Pak Ltd), First Dawood Islamic bank Limited (FDIBL), Burj bank limited, Emirates Global Islamic Bank Limited (EGIBL) were working in Pakistan (SBP Islamic Bank Bulletin, 2007⁴). Currently there are only four fully fledged Islamic banks working in Pakistan. According to previous studies and pilot testing results, this study has identified various factors/reasons of decline in Islamic banks profitability and these factors include Bank Specific/Internal factors (Liquidity Ratios) and Environment specific/External Factors. Lack of liquidity management (such as marketable securities, treasury bills) is one of the important issues faced by Islamic banks in Pakistan. These securities could be utilized either to manage liquidity excess or to cover the shortage of liquidity [3]. This issue is aggravated since many Islamic banks of Pakistan are working under different operational procedures from those of the conventional banks; the resulting non compatibility prevents the "State Bank of Pakistan" from giving support or controlling the activities of

³ State Bank of Pakistan, Islamic Banking Bulletin: April-June 2018, Islamic Banking Industry - Progress & Market Share

⁴ State Bank of Pakistan, Islamic Banking Bulletin: April-June 2007, Islamic Banking Sector

Islamic banks if a shortfall in the liquidity occurs [27]. So, the liquidity management issue must come under the scrutiny and active discussion by the involved authorities in Islamic bank sector of Pakistan.

Aims and Objectives of this study are:

“To identify reasons of decline in profitability/bankruptcy of Pakistan fully fledged Islamic banks.”

“To find the significant relationship between Bank Specific/ Internal Factors (Non-Performing Loans, Net Gearing Ratio, Asset Composition Ratio, Quick ratio and Cash Deposit ratio) and Islamic bank’s profitability.”

“To examine that weather External Factors (Competitive Advantage, Service quality and Religious Obligation) have significant and positive influence on Islamic bank’s profitability.”

“To identify difference between four sampled Islamic banks in relation to their internal, external and macroeconomic factors”

I. LITERATURE REVIEW:

Literature Review chapter explains the theoretical foundation of study. In Pakistan, there is a set of mixed background in context of ethnic and religion. The banking system in Pakistan started in 1947 after independence, but Islamic banking started in the 1980s when the government had identified the needs of its customers [30]. Literature review chapter explains the current situation of Islamic banking system in Pakistan and how different internal and external factors effect Islamic bank’s profitability. This chapter is divided into three sections where section one explains the Islamic banking sector background and current situation of Islamic banks in Pakistan. Section two explains relationship analysis and third section provide theoretical support/foundation of study.

SECTION 1: ISLAMIC BANKING SECTOR AND CURRENT SITUATION OF PAKISTAN ISLAMIC BANKS

1.1. DIFFERENCE BETWEEN ISLAMIC AND CONVENTIONAL BANKING SYSTEM:

The main objective of all organization is to minimize their cost and maximize the profit [17]. Performance/Profitability analysis is the main step to measure the efficiency and development of financial institutions. The main goal of interest-based banks (commercial banks) is to earn profit and to achieve this key objective of profit maximization; they

continue their operations and provide their services to customers [16]. While on the other hand interest-free Islamic banks also do have profit earnings as their key objective for operating, but these banks seek to achieve social and economic prosperity without the exploitation of their customers [1]. As the interest-free and interest-based banks are operating at different principles. The study findings discovered that in term of profitability/ performance of both banks (interest based and interest free) there is no significant difference, while in term of credit performance there is significant difference of interest based as compare to interest free banks[32].

1.2. HISTORY OF ISLAMIC BANKS IN PAKISTAN

In 1980, Zia-ul-Haq a President of Pakistan has developed the Islamic financial system under Zia’s Islamisation process. For this purpose, economical and financial segments were designed to innovate with Islamic Shariah principles [13]. At that time banks were supposed to start their operations but some Islamic Scholars and Ulmma gave reservations on Islamic banking principles. At the end in 1991, the Supreme Court of Pakistan decided about Riba under Shariah law. Zaidi (2003) [11] stated that after this historic decision, the government of Pakistan was ordered to execute the Islamic financial system in the country. The main purpose of Islamic financial institutions in Pakistan was to initiate the Islamic policies. According to Islamic Shariah law, it was decided that to promote Islamic banking parallel to the conventional banking system. Moreover, Akhtar, (2007)[3] has stated that the State bank of Pakistan also promote and permit Islamic Shariah branches in each of the conventional banks[31].

1.3. CURRENT SITUATION OF ISLAMIC BANKING IN PAKISTAN

Being a Muslim country, Pakistan has a favourable ground for Islamic banking to grow and explore more opportunities. As per the teaching of Islam Riba (Interest) is strictly prohibited, it was a solid ground to practice Islamic banking after the independence of Pakistan. After independence, the country had no trained and skilled workforce and there was also no infrastructure available [28]. The country has been faced with many problems and challenges, and most focus has been paid to these challenges.

The country was following traditional banking and left by Islamic ethics and norms [13]. It has recently been accepted that Islamic banking system laws, standards, and ethics are being ignored in Islamic

State. Therefore, the focus has been directed towards the Islamic banking system and the laws for Islamic banking have been formulated [11]. An extensive growth was witnessed in the Islamic banking sector from 2002 to 2010. Although the growth-share of the Islamic banking industry was only 5 percent, this growth was expected to increase in the coming years by about 15 percent [10]. Yet, the expectations did not meet outcomes and the Islamic banking industry did not flourish as expected to be in the next five years after 2010. In Pakistan, the Islamic banking sector accounted for just 12.9 percent of the total banking sector's market share, while conventional banking accounted for the remaining 88 percent in 2018 (SBP, Islamic Banks Bulletin, 2018).

There were lots of challenges faced by Islamic banking sector during transition, at the same time this sector invites many opportunities for stakeholders and scholars to explore the new dimension of banking [30]. There were many studies conducted on Islamic banking sector which were utilized as per need of country/Pakistan [18].

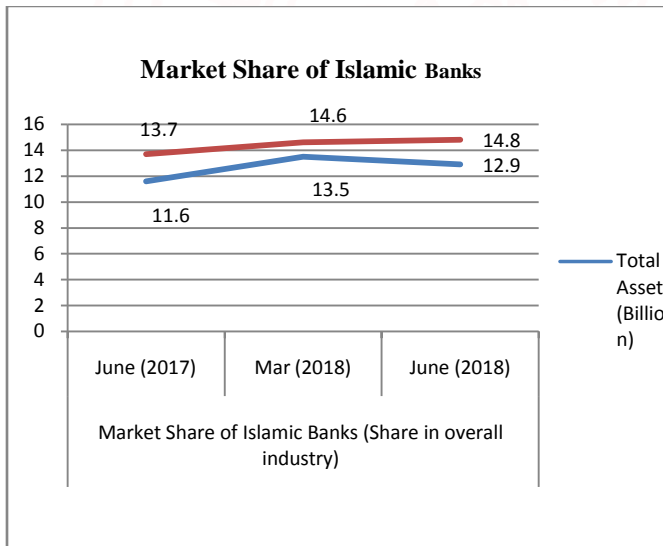


Figure 1 Source: SPB, ISLAMIC BANK BULLETIN, (2018)

According to the SBP report (2018), the market share of Islamic banks (deposits) increased by 14.8 percent in 2018, while the assets base decreased by 12.9 percent (Figure 1).

SECTION 2: THEORETICAL AND RELATIONSHIP ANALYSIS

1.4. IMPORTANCE OF PROFITABILITY IN ISLAMIC BANKS

The profitability of Islamic banking sector defined that how much a bank is generating profit with respect to its operations. The profit of banks describes that how much bank return is against its paid taxes and other expenses [4]. The most common measure of bank performance and efficiency is called profitability analysis [15][33]. Measuring the profitability of Islamic banking sector is very important as it enables the banking system to stay competitive and finance the operations of banks. There are number of researches which expect that Islamic banking industry should be more profitable than conventional banking system of country [4] [14] [20]. By applying the non linear, linear and generalized movement method statistical tests, researcher found the evidence regarding their hypothesis. It is analyzed that the Islamic banks higher profitability stems from their restricted access of inter-bank market equity financing. Thus, Islamic banks have to rely on safer and cheaper source of investment financing like investment deposits etc [4]. Conversely, Samad (2008) [25] conducted his study on Islamic and conventional banks profitability analysis through ratio analysis of return on asset, return on investment and earnings per share. The finding of study shows that conventional banking system has more opportunities than Islamic banking system and conventional banks are more profitable since Islamic banks opportunities of investment are very low and they are not allowed to give or take interest rate from depositor and lender.

1.5. RELATIONSHIP ANALYSIS

INFLUENCE OF QUICK RATIO ON ISLAMIC BANK'S PROFITABILITY: Alshatti (2015)[5], in his study, use quick ratio in addition with some other ratios. He calculated quick ratio by subtracting current assets and inventory and then dividing it by current liabilities, and found that quick ratio positively and significantly associated with profitability of Jordanian interest based banks.

H1: Quick ratios is important factor to influence the Islamic Banks Profitability

INFLUENCE OF CASH DEPOSIT RATIO ON ISLAMIC BANK'S PROFITABILITY

Rasul (2013)[23], use the cash deposit ratio to measure the liquidity of Islamic banks of Bangladesh. Study examined the data of 11 years (from 2001 to 2011), and found a significant relation of this variable with the profitability.

H2: Cash Deposit ratios is important factor to influence the Islamic Banks Profitability.

INFLUENCE OF NON-PERFORMING LOAN ON ISLAMIC BANK'S PROFITABILITY

Bhattarai (2016)[8] stated that there is significant influence of non-performing loans on profitability of commercial banks working in Nepal. Study found that nonperforming loan has negative influence on organization return on asset whereas the ratio of nonperforming loans positively influences the return on equity of bank.

H3: Non-Performing Loans is important factor to influence Islamic Banks Profitability

INFLUENCE OF GEARING RATIO ON ISLAMIC BANK'S PROFITABILITY

Study conducted by [21] investigated the listed companies of sugar in Pakistan stock exchange. Researcher analyzed the association between debt to equity ratio/ gearing ratio and profitability of firm (Return on asset and return on equity), the results of study showed that there is negative and significant relationship between gearing ratio and return on equity while positive influence of gearing ratio and return on asset.

H4: Net Gearing Ratio is important factor to influence the Islamic Banks Profitability

INFLUENCE OF ASSET COMPOSITION RATIO ON ISLAMIC BANK'S PROFITABILITY

The study conducted by [24] explained that asset composition ratio highly influence the profitability of firm. The study shows that this ratio explains whether asset of bank includes high debt or not. High debt to asset ratio is not good for organization as it has negative influence on the profitability of firm.

H5: Asset Composition Ratio is important factor to influence the Islamic Banks Profitability

INFLUENCE OF COMPETITIVE ADVANTAGE ON ISLAMIC BANK'S PROFITABILITY

Study conducted by [10] results revealed that the entrant of new comers will not affect the existing banks profitability when there is huge competition prevail in the economy. Researcher stated that competitive advantage of banks help them to gain long term profit in the market.

H6: Competitive Advantage positively influence the Profitability of Islamic Banking sector

INFLUENCE OF SERVICE QUALITY ON ISLAMIC BANK'S PROFITABILITY

The quality of service generated is highly depends upon customers and their ability to participate in process of service and also on the ability to recognize the service quality generated. According to [6], Service quality positively and significantly influences the profitability of Islamic bank as better quality of services is always preference of customer.

H7: Service Quality positively influence the Profitability of Islamic Banking sector.

INFLUENCE OF RELIGIOUS OBLIGATION ON ISLAMIC BANK'S PROFITABILITY

Yusoff and Azurah (2014)[29] asserted that in order to figure out the Muslims' behavior regarding traditional services and suitability, the most essential element is religion. Based on previous studies, [7] defined Islamic ethical behavior. This study is Pakistan based and according to this study customer choose Islamic bank because it avoid interest which is prohibited in Islam. The study found positive relationship between religious obligation followed by banks and customer preference also positive association found with bank profitability.

H8: Religious Obligation positively influence the Profitability of Islamic Banking sector.

SECTION 3: THEORETICAL SUPPORT/ FOUNDATION

In this section, selected topic is supported by various theories which are used to define nature of relationship existence.

1.6. THE ANTICIPATED INCOME THEORY

The theory of anticipated income was developed in 1944 and author of this theory was H.V. Prochanow. Prochanow in 1949 regarding liquidity management by the banks; according to this theory banks should offer short term as well as long term loans. The banks need to keep more liquid assets (Quick Ratio and Cash Deposit Ratio); neither needs to invest in short term marketable securities for their liquidity management but they should manage their liquidity on the basis of anticipated income of the borrowers.

1.7. THE ASYMMETRY INFORMATION THEORY

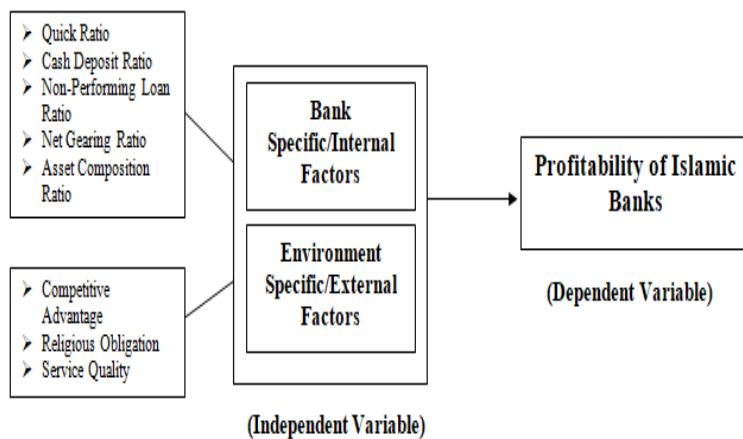
The Asymmetry information theory supported the concept of non-performing loans factor selected by present study. According to current study non-performing loans of bank has serious impact on the profitability of organization. Asymmetry information theory supported this concept and explained that

reasons of non-performing loans are wrong and irregular information flow between buyers and sellers and it cause low profitability of bank.

1.8. THEORY OF REASONED ACTION

According to this theory our every action is based on some reason and theory of reasoned action model predict the behavioral intention of individual [12] [27]. So, customer action of making decision regarding Islamic bank product is based on bank's excellent competitive advantage, service quality and religious obligation (following Shariah complaints).

1.9. CONCEPTUAL FRAMEWORK



II. METHODOLOGY

Methodology section shows the research approach, specification, data collection process and details of data in order for it to be examined. Ramamurthy (2011)[22] describes that primary data source provides efficient information, and the researcher is able to examine new updated information. Study utilized the primary data collecting technique. Survey was conducted from senior managers of Islamic banks in order to examine the internal and external factors influence on Islamic banks profitability. Researcher also gets input from senior managers regarding role (factors ranking) of internal factors in generating the profitability of Islamic banks. This is the major contribution of present study, is identifying the various factors external and internal from profitability analysis of Islamic banks. Another contribution of methodology is that study collected data from fully fledged Islamic banks the data was

collected from ten big cities of Pakistan. No study has been conducted to explore the reason of profitability decline and bankruptcy of Islamic banking from last ten year. The present study focuses on fully fledged Islamic banks and data was collected from major ten cities of Pakistan because these cities are business centers and every Islamic bank has their many operational branches in these cities. The sample of four fully fledged Islamic banks includes Meezan Bank Limited, Dubai Islamic Bank, Bank Islami Pakistan, Al-Baraka (Pak Ltd). The study is quantitative in nature and deductive [9] reasoning is applied to test the hypothesis. Lastly, study's methodology contributed in sampling techniques of study, a multi-stage probability sampling process was used. For this study researcher made strata of four provincial capitals and one federal capital (Punjab, Sindh, Baluchistan, KPK and Islamabad federal capital area). Further, researcher made sub-strata (from big five strata) of ten big cities of Pakistan includes Karachi, Lahore, Faisalabad, Rawalpindi/Islamabad, Gujranwala, Peshawar, Multan, Hyderabad, Quetta and Bahawalpur. Reason of first ten big cities choice is that, these cities are business centers in Pakistan and have large population that's why banks mostly target their branch network in these big cities so they can easily access their customers. After making sub-strata of big ten cities, the researcher was focused on Disproportionate Stratification [2] in which the size of each stratum is not proportional to its size in the population [26]. So for this study, sample of 417 senior bank managers who were able to provide time and easily accessible were used.

Econometric Equation:

$$\text{Pro (DV)} = \alpha_0 + \beta_1 \text{QR} + \beta_2 \text{CDR} + \beta_3 \text{ACR} + \beta_4 \text{NPL} + \beta_5 \text{NGR} + \beta_6 \text{CA} + \beta_7 \text{RO} + \beta_8 \text{SQ} + e$$

The description of the models used in the current study is provided as below:

Pro (DV) = Profitability

QR = Quick ratio

CD = Cash to deposit ratio

ACR = Asset Composition Ratio

NPL = Non-Performing Loan Ratio

NGR = Net Gearing Ratio

CA = Competitive Advantage

RO = Religious Obligation

SQ = Service Quality

2. RESEARCH ANALYSIS

2.1. DEMOGRAPHIC ANALYSIS

The purpose of demographic analysis is to examine the sample characteristics of the study. This analysis includes age, gender, professional training and year of experience in Islamic banking sector. Basically, demographic analysis is used to analyze the personal data regarding participant of study.

TABLE 1: DEMOGRAPHIC ANALYSIS

Questions	Options	Percent	Obs
Gender	Male	63.05%	417
	Female	36.95%	
Age	Below 20	0.49%	417
	21-30	16.75%	
	31-40	49.26%	
	41 & Above	33.50%	
Highest Educational Degree	Bachelors	10.34%	417
	Master	40.89%	
	Professional Degree	36.45%	
	Doctorate	0.49%	
	Others	11.82%	
Marital Status	Single	48.77%	417
	Married	51.23%	
Year of Experience	1-5 Years	28.08%	417
	5-10 Years	39.90%	
	10-15 Years	25.12%	
	>15 Years	6.90%	
Professional Trainings	1-5 Years	22.17%	417
	5-10 Years	36.45%	
	10-15 Years	27.59%	
	>15 Years	13.79%	
Islamic Bank	Meezan Bank Limited	26.60%	417
	Dubai Islamic Bank	24.63%	
	Bank Islami Pakistan	24.63%	
	Al-Baraka (Pak Ltd)	24.14%	
Position/ Role in Bank	Senior Loan officer	10.84%	417
	Branch Manager	14.29%	
	Senior Direct Sales Representative	11.33%	
	Senior Relationship Manager	15.27%	
	Data processing Officer	12.32%	
	Customer Relationship Manager	12.81%	
	General Manager	11.82%	
	Bank Marketing Representative	10.84%	
Branch Name	Lahore	10.34%	417
	Karachi	9.85%	
	Faisalabad	11.82%	
	Rwp/Isb	11.33%	
	Gujranwala	10.34%	

Peshawar	9.85%	
Multan	8.87%	
Hyderabad	9.36%	
Quetta	8.37%	
Bahawalpur	11.33%	

Table 1 shows the demographic analysis of primary data. In sample of this study, majority of senior manager of Islamic banks were male. The highest educational degrees of most of the manager were “Master” as shown in the table. The answer of marital status question shows that most of the senior branch managers of bank were married. After this researcher asked for the year of experience they have in banking industry and it shows that most of the manager 40% have between 5 to 10 year experiences. According to sample of Islamic banks, most of the “Senior Bank Managers” were working at Meezan Bank Limited. There were 27% of senior banks managers who belong to Meezan Bank Limited. There are eight positions in bank which are analyzed as senior post/ role in the banking sector. So, researcher collected data from those senior bankers for further analysis. Most of the senior manager position / role in bank were Senior Relationship Manger which was about 15% in Islamic banks. The last question was about their Branch name and address where most of the data about 12% was collected from Faisalabad.

2.2. RELIABILITY ANALYSIS

Reliability analysis shows the consistency and stability of item used to conduct the study.

TABLE 2: RELIABILITY ANALYSIS

Variables	No of items	Alpha	Mean
Competitive Advantage	5	0.928	2.871
Religious Obligation	3	0.783	2.674
Service Quality	4	0.630	2.434
Quick Ratio	4	0.929	2.359
Cash Deposit Ratio	4	0.705	2.539
Non Performing Loans	4	0.929	2.431
Net Gearing Ratio	4	0.664	2.468
Asset Composition Ratio	4	0.648	2.589

Table 2 shows the Reliability Analysis which shows that all items understudy are reliable and consistent. So, the analysis shows that all item values are greater than 0.60 and lies above from the alpha range so it is stated that all items are reliable and accurate for further analysis.

2.3. NORMALITY ANALYSIS

Test of Normality analysis is conducted to measure that data lies in normal distribution range and also to know that whether data is well-modeled.

TABLE 3: NORMALITY ANALYSIS

Variables	Skewness	Kurtosis
Competitive Advantage	0.510	-1.107
Religious Obligation	0.333	-1.082
Service Quality	0.570	-0.295
Cash Deposit Ratio	-0.399	-0.070
Quick Ratio	0.007	-0.677
Non Performing Loans	-0.218	-0.405
Net Gearing Ratio	0.098	-0.873
Asset Composition Ratio	-0.094	-0.688

Table 3 shows the normality analysis of study. This method is used to check the normality of data through value of Skewness and Kurtosis. The skewness and kurtosis values of all variables understudy lies between -1 to +1 and +3 to -3 respectively and it shows that data lies in range of normality and it is normally distributed.

2.4. SURVEY ANALYSIS OF INTERNAL AND EXTERNAL FACTORS

TABLE 4: INTERNAL AND EXTERNAL FACTORS ANALYSIS

	Very Un-Important	Un-Important	Neither Important Nor Un-Important	Important	Very Important
Cash Deposit Ratio and Profitability	6.25%	16.38%	11.25%	41.13%	25.00%
Quick Ratio and Profitability	15.38%	29.88%	21.38%	20.50%	12.88%
Non Performing Loans and Profitability	8.00%	11.75%	17.38%	39.25%	23.63%
Net Gearing Ratio and Profitability	14.25%	38.00%	14.00%	16.00%	17.75%
Asset Composition Ratio and Profitability	9.75%	23.63%	22.13%	34.50%	10.00%
Competitive Advantage and Profitability	0.00%	1.00%	10.25%	40.50%	48.25%
Service Quality and Profitability	0.00%	3.63%	15.38%	50.25%	30.75%
Religious Obligations and Profitability	0.00%	4.13%	19.75%	54.38%	21.75%

Table 4 provides the details of Senior Bank manager response regarding influence of internal and external factors influence on Islamic banks profitability. Internal factors which influence the islamic bank profitability are quick ratio, cash deposit ratio, non-performing loans, asset composition ratio and net gearing ratio. Quick ratio is a measure of the company's ability to meet its obligations in the short term. Data collected from the senior manager of Islamic banks revealed that quick ratio is an unimportant factor of Pakistan Islamic banks. So, 12.88% or 13% of the respondent (senior bank managers) stated that quick ratio is very important to influence the profitability of banks. Study explained that quick ratio has little contribution in generating Islamic bank's profitability. In commercial banks customer are attracted with high interest rate on deposits while in Islamic banking system this activity is *haram*. So, Islamic banks need to provide range of products which are acceptable in Islamic *Shariah* and help to increase customer interest. This activity help to increase the Islamic banks cash deposit ratios and ultimately influence the profitability of Islamic banks. So 25.00% or 25% of the respondent (senior bank managers) stated that cash deposit ratio is very important to influence the profitability of banks, 41.13% or 41% sated that cash deposit ratio is important for Islamic banks. The analysis of non-performing loans ratio and profitability shows that

most of the respondent agreed on the statement that non-performing loans ratio has negative influence on profitability of Islamic banks. Data collected from the senior manager of Islamic banks revealed that non-performing loans is an important factor of Pakistan Islamic banks. So, 23.63% or 24% of the respondent (senior bank managers) stated that non-performing loans ratio is very important to influence the profitability of banks, 39.25% or 39% stated that non-performing loans ratio is important for Islamic banks. When dues are already exposed to creditors of firms, they understand that company might not be able to pay back its debts. But in case of Islamic banks gearing ratio plays very small role as Islamic banks cannot make extra capital. Islamic banks need to utilize their equity and they cannot rely on debt. So, 17.75% or 18% of the respondent (senior bank managers) stated that net gearing ratio is very important to influence the profitability of banks. The analysis of asset composition ratio and profitability shows that most of the respondent agreed on the statement that asset composition ratio has positive influence on profitability of Islamic banks. Data collected from the senior manager of Islamic banks revealed that asset composition ratio is an important factor of Pakistan Islamic banks. So, 10.00% or 10% of the respondent (senior bank managers) stated that asset composition ratio is very important to influence the profitability of banks, 34.50% or 35% stated that asset composition ratio is important for Islamic banks.

External factors which influence the Islamic bank profitability are Competitive Advantage, Service Quality and Religious Obligation. In case of Religious Obligation, many of the senior managers stated that customer have lack of awareness regarding Islamic banks products. They explained that most of the customers think that Islamic banks are not following religious obligation and they are charging hidden charges from customer which is equivalent to interest rate. The respondent (Senior bank managers) explained that it is very important for Islamic banks to follow religious obligations, sharia complaints, in order to become more profitable. So 32.17% of the respondent (senior bank managers) strongly agreed that religious obligation have major influence on banks profitability. In case of Service quality, The senior manager describe that they are trying to

provide excellent services to their customer but their services are not competitive to non Islamic rivals/ Conventional banking sector of Pakistan. Reason behind this phenomenon is, Islamic banks need to be sharia compliant and they cannot offer financing for “Haram Product” which highly influence the profitability of banks. So 51.75% or 52% of the respondent (senior bank managers) strongly agreed that service quality has major influence on banks profitability. There is huge competition exist in banking sector of Pakistan and having competitive advantage matter most for the Islamic banks. Islamic are not facing only Islamic rivals but they also need to compete with non Islamic / conventional banking rivals. So 37.80% or 38% of the respondent (senior bank managers) strongly agreed that their competitive advantage have major influence on banks profitability.

OPEN ENDED QUESTIONNAIRE: IN YOUR OPINION WHAT ARE OTHER MAJOR FACTORS AND REASONS OF DECLINE IN PROFITABILITY OF PAKISTAN ISLAMIC BANKING SECTOR?

Researcher stated last question as open ended in questionnaire and asked for Senior Management opinion regarding Islamic banks profitability decline. There are eight factors identified in this study and researcher asked the Senior Managers of Islamic banks to identify factors other than variables understudy. Different Senior Managers identified different factors as reason of Islamic banks profitability decline. The major focused factors are given below:

- ✓ Low Awareness of Islamic banking products and procedure (lack of clarity of Shariah compliance and awareness of Islamic banking practices)
- ✓ Fear of wrong use of customer money in Non-Sharia products.
- ✓ High liquidity keeping
- ✓ Lack of Trust
- ✓ Not competitive like conventional banks
- ✓ Staff is not highly trained so cannot convince customer (Need Training)
- ✓ Customer religion sentiments does not match the Islamic banks product offering

Low inner satisfaction/faith cause less acceptability of Islamic banks as compare to conventional banking sector.

TABLE 5 : RESULT SUMMARY

Hypotheses	Theoretical Support/Results	Graphical Representation Results	Results/Reason
H1: Quick ratios is important factor to influence the Islamic Banks Profitability	<u>Positive and Sig Relation</u> <i>Alshatti (2015), Malik et al. (2016), Ishaq et al. (2016)</i>	33.38 Percent Senior Bank Managers agreed with this statement	<u>Less contribution but Significant</u>
H2: Cash Deposit ratios is important factor to influence the Islamic Banks Profitability	<u>Positive and Sig Relation</u> <i>Mansoor Khan, Ishaq Bhatti, and Siddiqui (2008), Shahchera (2012)</i>	66.13 Percent Senior Bank Managers agreed with this statement	<u>Positive and Insignificant</u>
H3: Non-Performing Loans is important factor to influence Islamic Banks Profitability	<u>Negative and Sig Relation</u> <i>Bhattarai (2016), Kiran and Jones (2016), Lata (2015)</i>	62.88 Percent Senior Bank Managers agreed with this statement	<u>Negative and significant</u>
H4: Net Gearing Ratio is important factor to influence the Islamic Banks Profitability	<u>Positive and Sig Relation</u> <i>Nirajini and Priya (2013), Mwangi, et al., (2014), Sabin & Miras, (2015)</i>	33.75 Percent Senior Bank Managers agreed with this statement	<u>Less Contribution but Significant</u>
H5: Asset Composition Ratio is important factor to influence the Islamic Banks Profitability	<u>Positive and Sig Relation</u> <i>Burki & Niazi, (2010), Riaz, (2013), Ijaz et al. (2015)</i>	44.50 Percent Senior Bank Managers agreed with this statement	<u>Positive and significant</u>
H6: Competitive Advantage positively influence the Profitability of Islamic Banking sector	<u>Positive and Sig Relation</u> <i>Heikal, Malikussaleh, Khaddafi & Malikussaleh, (2016); Healy, Serafeim, Srinivasan & Yu, (2014)</i>	61.30 Percent Senior Bank Managers agreed with this statement	<u>Positive and Significant</u>
H7: Service Quality positively influence the Profitability of Islamic Banking sector	<u>Positive and Sig Relation</u> <i>Wijenunge, (2016); Warde, (2010); Al-Tamimi (2010); Khan and Fasih (2014)</i>	88.75 Percent Senior Bank Managers agreed with this statement	<u>Positive and Significant</u>
H8: Religious Obligation positively influence the Profitability of Islamic Banking sector	<u>Positive and Sig Relation</u> <i>Yusoff and Azurah, (2014); Awan and Azhar (2014)</i>	87.34 Percent Senior Bank Managers agreed with this statement	<u>Positive and Significant</u>

III. CONCLUSION

Banking system is essential for the growth and development of any economy. Islamic banks are an important part of the banking industry. Islamic banks follow the teaching of Islamic *Sharia* in their operations and practices. The Interest free banks' earnings are not dependent on any kind of interest; instead they largely depend on the liquidity for their survival and capital enlargements. This study aims to trace the reasons behind enlargement or shrinkage of financial performance of Islamic banks. In a nutshell, the aim of study was to identify the reason behind decline in the profitability of Islamic banking sector in Pakistan. Conclusively finding reveals that internal/bank specific, environment specific/external factors have significant and positive impact on Islamic bank's profitability. Overall study found that Islamic banks try to balance the internal and external factors in order to prevent themselves from bankruptcy and to perform smooth operations. These results highlighted important issues faced by Islamic banks nowadays in order to maintain their good profitability level. The study found that Islamic banks cannot achieve expected profits enlargements without confirmation of its proper Bank specific/liquid asset (liquidity level not too high, nor too low). According to statistics there is increasing trend found in nonperforming loans of Islamic banks which is alarming situation for Pakistani Islamic banks. Results of study are helpful for practitioners and policy makers to understand the customer needs of Islamic product who follow the religious obligation and customer sentiments. Awareness of Islamic product is also very important factor as it is very important for high religious sentiments customer to understand that offered Islamic product is not fake. The major reason of profitability decline identified by this study is "Non-performing Loans". Banks should develop specific techniques and tools to differentiate genuine and willful defaulters. Banks must take first step of "Client Profiling" to improve the Non-Performing Loans management.

Recommendations and future suggestions of study:

As per this study results and State Bank of Pakistan (SBP) report of September, 2019, Islamic Banks deposits dropped Rs 8 billion in three months. The reports shows that Islamic Bank deposits were Rs

2,407 billion in month of September, as compare to Rs 2,415 billion in month of June, 2019⁵. According to senior managers of Islamic banks, IB's liquidity is spilling over since existing rules and regulations does not allow the bank to lend money to agriculturists, industries and other private sector. There is need to revise the policies of Islamic banks and minimize the unnecessary over regulations imposed by SBP. According to senior manager of Bank Islami Pakistan, "We are having Rs 600 billion in surpluses, but we cannot use it to finance the private sector due to limited Sharia Compliant products. We are unable to disperse the surplus amount; there is dire need for new innovative financial regulation and product diversification in Islamic banking sector". Islamic banks should focus on products which are already Sharia Compliant such as Islamic mortgages. As stated by "Ahmed Siddiqui", Head of product development and Shariah compliance at Meezan Bank Ltd "Islamic mortgage is one of the big investment opportunities for Islamic banks as these mortgages are different and better than traditional home loans. Islamic mortgages don't involve paying interest, as it is strictly forbidden under Sharia law. In order to qualify for a Sharia mortgage, you will typically need a deposit of at least 20% of the property". The current State Bank of Pakistan (SBP) policy as well as Government policy is determined to develop the Pakistani mortgage market (House Loans). In the current Pakistan government under the leadership of Prime Minister "Imran Khan" the government along with the State Bank of Pakistan has set up a target for commercial banks to give 5% of their total loans portfolio for home loans. This is an excellent market prospect and Islamic banks should use this opportunity to develop this product offering for Pakistani customers. Islamic Banks can collaborate with construction companies to establish housing schemes in urban areas. It could be a combination of mortgage based project financing.

⁵ Data submitted by banks under quarterly Reporting Chart of Account (RCOA), Islamic Banking Department State Bank of Pakistan, 2019

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