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IDENTIFYING THE ANTECEDENTS OF PROFITABILITY OF BANKS IN PAKISTAN: A COMPARATIVE ANALYSIS OF CONVENTIONAL AND ISLAMIC BANKS

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Abstract

The survival of the banks is mainly based upon profits earned from its loans issued to the general public. The purpose of this research is to study the impact of nonperforming loans, loan loss provisions, loan to deposit and size of the bank on the profitability of both Islamic and conventional banks of Pakistan. Secondary data was used from the annual report of the selected banks from (2007-2014). Ordinary least square regression was used and results showed that profitability of conventional banks has negative relationship with non-performing loan and positive relationship with size of the bank and loan to deposit. On the other hand, the profitability of Islamic banks showed positive and significant relationship with size of the bank while nonperforming loans, loan loss provisions and loan to deposits were found insignificant in Islamic banking sector.

Key words: *Nonperforming Loan, Loan Loss Provisions, Loan to Deposit, Return on Assets, Conventional banks, Islamic Banks, Ordinary least Square Regression*

JEL Classification: G2

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I. Introduction

Banks play an important role in the economic growth of any country. It strengthens economic activities and growth by making efficient use and mobilization of funds. Banking systems with sound profitable grounds makes economy more stable and endurable. Financial institutions from all over the world face several kinds of risks which can adversely affects their profits. The survival of the banks is based on its loan issued to the borrowers. So it becomes a mandatory practice for the banks to safeguard themselves from all the potential risks and adopt preventive measures for their survival and excel in competition.

The banking sector of Pakistan has gone through evolution since 1947. This sector has faced financial crises due to political and poor products and services. It has faced liberalization, privatization and immense structural reforms. The management of the banking sector is more concerned about generating higher returns while keeping risks in check. The economic and political situation of Pakistan has always been dwindling which adversely affected banking performances but still this sector has gone through unprecedented growth. It has shown dynamism, profitability, respectability and strength. With all these achievements, there still a need of better financial access and financial safety nets.

In the presence of highly competitive banks in Pakistan, Islamic banks have also gained popularity with operations highly based on the principles of Shariah. Islamic banking has emphasis on promoting interest (riba) free loan. The principles of Shariah prohibits fixed and effortless returns . Its product and services are based on profit and loss sharing. Islamic banking sector is new in Pakistan while other conventional banks have been operating since independence of Pakistan.

Nowadays, Islamic banking system has gained popularity as more than 300 financial institutions are operational in the world (El-Qorchi, 2005). In the year 2000, State bank of Pakistan formulated Commission for Transformation of Financial System (CTFS) which introduced the criteria of establishing Islamic banks Islamic banks. As a result, Al Meezan was established as a full fledge Islamic bank in January 2002. Later on, Pakistan showed a better performance in its establishment of Islamic banking sector and still it is in development and nurturing phase. Pakistan has shown better performance in Islamic banking than other global players like Malaysia, Bahrain and Indonesia. (Islamic Banking Review, 2007).

Presently there are 5 Islamic banks and 17 private commercial banks are operational in Pakistan. Banks are operating in the business of risk. The State bank of Pakistan offers several regulatory reforms for the banking sector so that they can protect their profits. Profits are affected by several factors, out of which few factors are analyzed in this paper which include non performing loans, loan loss provisions, loans to deposits (liquidity) and size of the bank.

No matter how fast the banking system expands, the risk of nonperforming loans is evitable. It is necessary to minimize nonperforming loans to improve economic growth. Nonperforming loans refer to the type of loan which are either default or close to being default due to non payments by the borrowers. Once the loans becomes non performing, the chances that the loan will be repaid are substantially low.

Nonperforming loan is one of the most important aspect whenever it comes to analyze banking financial conditions. It is the major indicator of bank's financial health. The huge quantity of nonperforming loans result in bank failure or bankruptcy.When nonperforming loans get accumulated, they will have an effect on the resources that are held in unprofitable areas. Consequently, nonperforming loans hinder economic growth and ultimately reduce economic efficiency (Hou, 2007).

On the other hand, loan loss provisions enables the banks to estimate expected losses in their profit and loss statements from a specific loan portfolios even before the occurrence of such losses. These loss provisions are set aside from the earnings during prosperous economic conditions as banks already anticipates such losses during economic slump. When such losses actually occur, bank draw on these reserves and continue to provide its credit services to the people. This amount set aside for the losses ultimately reduces the earnings available for the banks.

Loan to deposit ratio is the ability of the bank to cover withdrawals made by its customers. After lending loans to the customers, the bank has to maintain a certain level of reserves to meet its daily operations. If this ratio is less than 1, it means that bank has sufficient deposits cover its lending operations and if this ratio is more than 1, it shows that bank is borrowing money and relending it at higher rate. Apart from other factors, loans and deposits are most important in determining the profitability of banks.

The deposits offered banks is an important way to mobilize the funds. Deposits are the most convenient and cheapest way to mobilize the funds and it is found to have a relationship with the profitability of banks (Rasiah, 2010).

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Banks short on cash either fail or forced into mergers. Even in a countries like Canada and America , substantial amount of liquidity was given by authorities to the banks in financial crises to broaden their financial stability (Longworth 2010; Bernanke 2008).

Size is used to capture the fact that well established banks are better in achieving economies of scale in transaction and hence they tend to enjoy more profit. According to Yoke Teng et al. (2012), bank size and money supply significantly influences the profitability of Islamic banks. Size of the banks exhibits very strong very strong contribution towards bank's profitability (Idris et al. 2011).

I.1. Objectives of the study

This research is aimed to

- Analyze the impact of nonperforming loans on the profitability of banks
- Analyzing the impact of loan loss provisions on the profitability of banks
- Analyzing the impact of loan to deposit ratio on the profitability of banks
- Analyzing the impact of size of the banks on the profitability of banks

II. Literature review

Setiawan and Putri (2013) investigated bank's efficiency and non performing loans of Islamic banks of Indonesia taking into an account period of 2007-2012. The findings proved a strong relationship between return on asset and non performing loans. When NPF gets lower, the prospects of ROA gets higher.

Yosra (2009) studied Tunisia's Professional Association of Banks and Financial Institutions (APTBEF) annual reports by analyzing the period of 1999-2009. Their studies showed that high proportion of nonperforming loans result in low profitability of the Tunisian banks. Huge amount of nonperforming loans results in inefficiency and vulnerability.

Ariffin, and Tafri (2014) obtained the data of 65 fully fledge Islamic banks from worldwide for the period between 2004 and 2011 and by using generalized Least Square panel data analysis they proved that credit risk has significant impact on return on assets. However, other financial risks which include liquidity risk and interest rate risk were proved insignificant in the study.

Wangai, Bosire, Gathogo (2012) performed a study in which they analyzed non performing loans on financial performance of microfinance banks in Kenya by using structured questionnaires. The descriptive and inferential analysis was used to present the opinions of the respondents and inferential analysis was used to deduce financial performance of the banks and it proved that increase in credit risk reduces the financial performance of microfinance banks

Noman (2015) in his paper "An Empirical Investigation of Profitability of Islamic Banks in Bangladesh" revealed negative impact of credit risk, loan ratio, cost efficiency and capitalization on profitability. Masood and Ashraf (2012) found out that credit risk has a significant negative impact on profitability.

Ramlall (2009) & Miller and Noulas (1997) proved the negative relationship between credit risk and profitability. The negative relationship is due to the fact that if there is a greater risk associated with loans then high level of loan losses reserves adversely affects the profit maximization of a bank.

The study of Mustafa, Ansari and Younis (2012) examined the impact of loan loss provision and other factors on the profitability of the banks and they found out negative and significant relationship between loan loss provision and profitability of banks. The banks borrowing and lending activity pose high credit risk and banks create loan loss provisions which are created from the earnings of the banks and hence decrease the profitability of the banks.

According to Von (2005) if the banks mainly earn return from lending activities and the if the bank is maintaining high level of loan loss provisions then its lending capacity reduces and hence it also suppresses bank's earnings.

Kodithuwakku (2015) analyzed 8 commercial banks of Sri Lanka by using a timeline of 2009 to 2013. The regression model showed that non performing loans and loan loss provisions adversely affect the profitability of the banks.

A study by Akhtar et al. (2011) used multivariate regression analysis by using independent variables like Gearing ratio, NPLs ratio and asset management and size and profitability as dependent variable. The result showed that size of the bank has a significant positive relationship with profitability. The size of the bank shows ensure the market size they possess and hence amounts of profit earned from their market share.

Ramlall (2009); Sufian (2009) in their study analyzed the relationship banks size andbanks profitability and found out this relationship to be positive.

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Flaminiet. Al (2009) in recent a working paper of IMF focused on determinants of commercial banks profitability in Sub Sahara Africa. By analyzing 379 banks as sample from 41 countries, the results showed that bank's return on asset is also linked with large bank size beside credit risk.

Athanasoglou et al. (2008) in their study analyzed the relationship between the bank specific, industry specific, macroeconomic specific and profitability of Greek banks. They found that the relationship between the bank size and Islamic bank profitability is significantly positive.

Loan to deposit ratio is an important way to measure the liquidity of the banks. The significant difference between interest charged on the loans and interest on deposit serve as a mean of profitability for the banks (Borhan&Towpek, 2006).

A study by Purnamawati (2014) analyzed the impact of liquidity and capital risk on conventional banks profitability of Indonesia. By using secondary data from the Directory of Bank of Indonesia, the results showed that capital risk and liquidity have significant effect on profitability of conventional banks.

A study by Sudin (2004) was conducted to determine the factors affecting Islamic banks profitability. By using panel data analysis, he found that apart from external factors, bank size, liquidity, expenditure and investment in Islamic securities are highly related with the Islamic bank profitability. Duraj and Moci (2015) in their study of Albanian banks used NPL ratio, deposit to loan ratio, GDP and inflation. After performing multi linear regression analysis with secondary data using a sample of data from 16 banks in the period 1999 – 2014 and it appeared to be a significant variable with a negative relationship with ROE. the bad quality of loans is responsible for high level of provisions held for non performing loans which ultimately reduced the profit.

II.1. Research Hypothesis

H0: There is no relationship between non performing loan and profitability of the banks
H11: There is a relationship between non performing loan and profitability of the banks
H0: There is no relationship between loan loss provision and profitability of the banks
H12: There is a relationship between non performing loan and profitability of the banks
H0: There is no relationship between loan to deposits and profitability of banks
H13: There is a relationship between loan to deposit and profitability of banks
H0: There is no relationship between size of the bank and profitability of banks
H14: There is a relationship between size of the bank and profitability of banks

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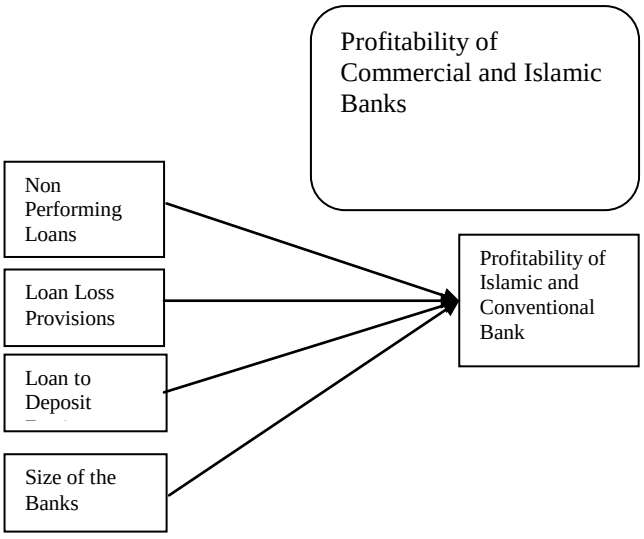
II.2. Theoretical Framework

After careful review of literature of previous studies, the following theoretical framework is built which shows the relationship between independent variables which include non performing loans, loan loss provisions, loan to deposits and size of the banks and dependent variable, which is bank's profitability.

Figure 1: Theoretical Framework



Source: Personal elaboration

III. Methodology

This paper is mainly focused on providing empirical evidence about the impact of nonperforming loans, loan loss provisions, loan to deposits, size of the bank on the profitability of commercial as well as Islamic banks of Pakistan.

III.1. Estimated Model

$\hat{y} = b_0 + b_1x + b_2x + b_3x + b_4x$

ROA= b_0 + b_1(Nonperforming Loans) + b_2(Loan Loss Provisions) + b_3(Loan to Deposit) + b_4 (Size of the Banks)

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III.2 Variable Selection

III.2.1 Nonperforming Loans:

Nonperforming loans are the loans for which the debtor has not made scheduled payments for at least 90 days. Such loans are considered default or close to being default. The proxy used for this variable as non nonperforming loans over total loans. It is expected to have a negative impact o the profitability of the banks.

$$\text{Nonperforming Loans} = \frac{\text{Nonperforming Loans}}{\text{Total Loans}}$$

III.2.2 Loan Loss Provisions

For loan loss provision, the proxy variable used as loan loss provisions over total loans. It is a measure of capital risk. If the bank is expecting non repayment of loans then it set asides loss provisions to cover the risk and hence it reduces its profitability margin.

$$\text{Loan Loss Provisions} = \frac{\text{Loan Loss Provisions}}{\text{Total Loans}}$$

III.2.3 Loan to Deposits:

Total Loan over Total Deposits is used as a for this study. This ratio represents bank's liquidity. High loan to deposits ratio means that the bank is issuing maximum of its deposits as interest bearing loan to the general public.

$$\text{Loan to Deposit Ratio} = \frac{\text{Total Loans}}{\text{Total Deposits}}$$

III.2.4 Size of the Banks

The proxy employed to measure the size of the bank as log of total assets of the banks. It is expected to have a positive relationship with the bank's profitability.

$$\text{Size of the Bank} = \text{Log (Total Assets)}$$

III.2.5 Profitability

Profitability of firm is the amount by which its revenues exceed cost (Ross et al., 2005). Profitability ratios is the capability of firm to generate earnings. In this study the profitability of the banking is being measured by return on asset. According to Golin (2001), return on asset measures how much the bank is earning after deducting taxes.

$$\text{Return on asset} = \frac{\text{Net profit after tax}}{\text{Total Assets}}$$

III.3 Data sources

This study uses data from the information extracted from the annual reports of the banks and several publications of State Bank of Pakistan.

III.4 Unit of Analysis

The unit of analysis in this study is commercial and Islamic banking sector of Pakistan. The number of commercial banks selected for this study is 8 which consist of top performing banks of Pakistan, which include, Allied Bank, United Bank, Habib bank, Bank al Habib, Alfalah Bank, Askari bank, MCB, Faysal Bank. As Islamic banking is new in Pakistan so all the 5 five existing Islamic banks are included in the study which include Bank al Islami, Albaraka Bank, Burj Bank, Meezan bank and Dubai Islamic bank. The time span is covered from 2007 till 2014. The selection of the time span is driven by availability of data.

III.5 Software Application

The software used in this study is EVIEWS for the analysis of both conventional and Islamic banking data obtained from annual reports.

IV. Empirical results

IV.1 Descriptive and Pearson Correlation Statistics

The descriptive analysis of conventional banks for all variables under study are reported in table 1 which shows the values of mean and standard deviation. Return on asset is a dependent variable among these variables.

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Table no. 1: Descriptive Analysis for Conventional Banks

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Npl	64	.27	20.25	9.5495	4.78720
LTD	64	38.02	87.33	58.5140	12.64972
LLP	64	.59	17.29	7.1501	3.68352
ROA	64	-1.39	3.72	1.3843	.91514
Size	64	8.14	9.27	8.6899	.26331
Valid N (listwise)	64				

Source: *Personal elaboration*

Table no. 2: Correlation Matrix for Conventional Banks

Correlations

		ROA	NPL	LLP	LTD	Size
Pearson Correlation	ROA	1.000	-.291	-.232	-.012	.356
	Npl	-.291	1.000	.966	-.093	.274
	LLP	-.232	.966	1.000	-.187	.331
	LTD	-.012	-.093	-.187	1.000	-.586
	Size	.356	.274	.331	-.586	1.000
Sig. (1-tailed)	Roa	.	.010	.033	.464	.002
	Npl	.010	.	.000	.233	.014
	LLP	.033	.000	.	.069	.004
	LTD	.464	.233	.069	.	.000
	Size	.002	.014	.004	.000	.

Source: *Personal elaboration*

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The correlation matrix of conventional banks in table 2 shows that return assets have negative association with nonperforming loans. The value is -0.291 which means that increase in nonperforming loans lead decrease in return on assets. Similarly loan loss provisions also have negative correlation with return on assets. This means that increase in loan loss provisions reduces the profitability of banks. The loan to deposit ratio is -0.012 which shows a very weak negative association between loan to deposits and return on assets. The size of the bank shows positive correlation with profitability of the banks which large bank size results in higher profitability.

IV.2 Regression Results

Table no. 3: Pooled OLS Regression of Conventional Banks

Dependent Variable: ROA
Method: Panel Least Squares
Sample: 2007 2014
Periods included: 8
Cross-sections included: 8
Total panel (balanced) observations: 64

	Coefficient	Std. Error	t-Statistic	Prob.
C	-21.62289	4.395055	-4.919821	0.0000
NPL	-0.129894	0.058311	-2.227612	0.0297
LLP	0.071000	0.080567	0.881247	0.3818
LTD	2.709300	0.945073	2.866763	0.0057
SIZE	2.553652	0.471507	5.415936	0.0000
R-squared	0.377049	Mean dependent var		1.384328
Adjusted R-squared	0.334815	S.D. dependent var		0.915135
S.E. of regression	0.746374	Akaike info criterion		2.327723
Sum squared resid	32.86734	Schwarz criterion		2.496386
Log likelihood	-69.48715	Hannan-Quinn criterion.		2.394168
F-statistic	8.927640	Durbin-Watson stat		0.690863
Prob(F-statistic)	0.000010			

Source: *Personal elaboration*

Estimation Equation:

==========

ROA = C(1) + C(2)*NPL + C(3)*LLP + C(4)*LTD + C(5)*SIZE

Substituted Coefficients:

==========

ROA = -21.6228851155 - 0.129894097159*NPL + 0.0709995664616*LLP + 2.7093002301*LTD + 2.55365198168*SIZE

The pooled OLS regression analysis of Conventional banks shows that non performing loans appears to have a negative and significant relationship with return on asset which is consistent with Masood and Ashraf (2012), Yosra (2009) and Setiawan and Putri (2013). The p value for non performing loans is less that 0.05 which is 0.029. It means high nonperforming loans lead to decrease in profitability of banks. The loan to deposit ratio have significant and positive relationship with the return assets which means that the conventional banks are quiet efficient in maintaining their liquidity and they are maintaining their loans in efficient manner which lead to increase in their profitability. This is consistent with Borhan & Towpek (2006) findings that significant difference in interest charged on loan and deposits serve as a mean of profitability for banks. The size of the bank also have significant and positive relationship with the profitability of banks as proved by Flamini et. al (2009) and Ramlall (2009); Sufian(2009). The independent variable loan loss provisions is found to be insignificant in this study. The R square (coefficient of determination) of this model is equal to 0.377 which means that this regression model explains 37.7% of the changes brought by independent variables into dependent variable.

The Fitted Regression Equation is

ROA = -21.6228851155 - 0.129894097159*NPL + 2.7093002301*LTD + 2.55365198168*SIZE

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IV.3 Descriptive and Pearson Correlation Statistics of Islamic Banks

The descriptive analysis of Islamic Banks for all variables under study are reported in table number 4 which shows the values of mean and standard deviation. Return on asset is a dependent variable among these variables.

Table no. 4: Descriptive Analysis for Islamic Banks

	N	Minimum	Maximum	Mean	Std. Deviation
NPL	40	.00	21.17	6.6987	5.37345
Size	40	6.95	8.64	7.7243	.37987
LTD	40	.37	1.29	.5870	.19196
LLP	40	.00	11.00	3.5981	2.87534
ROA	40	-3.09	1.69	-.1832	1.23563
Valid N (listwise)	40				

Source: *Personal elaboration*

Table no. 5: Correlation Matrix for Islamic Banks

Correlations

		roa	npl	Size	ltd	llp
Pearson Correlation	Roa	1.000	-.288	.607	-.345	-.059
	Npl	-.288	1.000	.113	-.334	.826
	Size	.607	.113	1.000	-.456	.359
	Ltd	-.345	-.334	-.456	1.000	-.404
	Llp	-.059	.826	.359	-.404	1.000
Sig. (1-tailed)	Roa	.	.036	.000	.015	.360
	Npl	.036	.	.244	.018	.000
	Size	.000	.244	.	.002	.011
	Ltd	.015	.018	.002	.	.005
	Llp	.360	.000	.011	.005	.

Source: *Personal elaboration*

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The correlation analysis in table 4 shows that return on assets of Islamic banks seems to have a negative relation with nonperforming loans as its value is -.288. It means increase in nonperforming loans leads to a decrease in return assets of the Islamic banks but this relationship appears to be weak as its value is just -0.288. However the correlation of loan to deposit ratio loan loss provision is also negative with return on assets i.e -0.345 and -0.059. The correlation of loan loss provision with return on asset is quite weak. It means Islamic banks have a better credit risk management and decline in nonperforming loans therefore which does require not require them to set aside large portion of their earnings in loan loss provisions (Islamic Banking Review, 2007). On the other hand, the size of banks have strong positive association with return on assets as its value is .607.

Table no. 6: Pooled Ordinary Least Square Regression Model for Islamic Banks

Dependent Variable: ROA
Method: Panel Least Squares
Sample: 2007 2014
Periods included: 8
Cross-sections included: 5
Total panel (balanced) observations: 40

	Coefficient	Std. Error	t-Statistic	Prob.
C	-12.25599	3.807696	-3.218741	0.0028
NPL	-0.101194	0.050617	-1.999205	0.0534
LLP	0.005645	0.099699	0.056617	0.9552
LTD	-1.542463	0.877163	-1.758468	0.0874
SIZE	1.765314	0.464044	3.804197	0.0005
R-squared	0.538253	Mean dependent var		-0.183175
Adjusted R-squared	0.485482	S.D. dependent var		1.235635
S.E. of regression	0.886319	Akaike info criterion		2.712990
Sum squared resid	27.49467	Schwarz criterion		2.924100
Log likelihood	-49.25980	Hannan-Quinn criter.		2.789321
F-statistic	10.19979	Durbin-Watson stat		1.799903
Prob(F-statistic)	0.000014			

Source: *Personal elaboration*

Estimation Equation:
==========
ROA = C(1) + C(2)*NPL + C(3)*LLP + C(4)*LTD + C(5)*SIZE

Substituted Coefficients:
==========
ROA = -12.2559867464 - 0.101194133067*NPL + 0.0056446560018*LLP - 1.54246325476*LTD + 1.76531442798*SIZE

The pooled OLS regression of Islamic banks show that size of the bank has significant relationship with return on assets of banks as proved by Athanasoglou et al.(2008). This relationship is due to increasing market share and economies of scale of Islamic banks in Pakistan.

On the other hand, loan to deposit ratio, loan loss provision and non performing loans are found to be insignificant in this study. The explanation behind this insignificance can be that Islamic banking is new in Pakistan as compared to conventional banking. A clear picture of financial soundness of Islamic and conventional bank is analyzed by employing financial ratios which showed that Islamic banks are at low risk when it comes to loans. (Sehrish, Saleem and Yasir, 2012)

The performance of Islamic banks is far better than the conventional banks in Pakistan. The profits of the Islamic banks have been less varying as compared to conventional banks (Awan, 2009).

The value of R square in this model is 0.53 which means that independent variables used in this model explain 53% of the variation in the dependant variable.

The fitted regression equation in this case is
ROA = -12.2559867464 + 1.76531442798*SIZE

V. Conclusion

The emphasis of the study was to analyze the antecedents which affect the profitability of conventional and Islamic banks. It is already understood the healthy banking system is a pre requisite for economic development. As Pakistan has always been facing high degree of uncertainty due to economic and political challenges, it is necessary

to identify the factor which affect the earnings of financial institutions in order to maintain its financial stability. Results showed that the conventional banking system of Pakistan is largely being affected by the its nonperforming loans, size and loan to deposits.

Nonperforming loans are negatively affecting the profitability of banks as such loan losses are piling up. While size and loan deposits have positive and significant relationship with the profitability of conventional banks. On the other hand, Islamic banks profitability have no significant relationship with non performing loans, loan loss provisions and loan to deposit ratio. However, size of the bank has positive and significant relationship with the profitability of Islamic banks.

Islamic banking is comparatively new in Pakistan. Currently, it may not be facing situation of high non performing loans and high loan loss provisions, however in the near future they may face loan losses as their market share grows further.

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