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Muhammad Mahmood Shah Khan

iib.dir@umt.edu.pk

Director, Institute of Islamic Banking

University of Management and Technology

Johar Town, Lahore-54770, Pakistan

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وَلَا تَأْكُلُوٓا۟ أَمْوَٰلَكُم بَيْنَكُم بِٱلْبَٰطِلِ وَتُدْلُوا۟ بِهَآ
إِلَى ٱلْحُكَّامِ لِتَأْكُلُوا۟ فَرِيقًا مِّنْ أَمْوَٰلِ ٱلنَّاسِ بِٱلْإِ
ثْمِ وَأَنتُمْ تَعْلَمُونَ

And eat up not one another's property unjustly (in any illegal way e.g. stealing, robbing, deceiving, etc.) nor give bribery to the rulers (judges before presenting your cases) that you knowingly eat up a part of the property of others sinfully.

Surah al-Baqarah* 2:188

ٱلَّذِينَ يَأْكُلُونَ ٱلرِّبَوٰا۟ لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ ٱلَّذِى
يَتَخَبَّطُهُ ٱلشَّيْطَٰنُ مِنَ ٱلْمَسِّ ۚ ذَٰلِكَ بِأَنَّهُمْ قَالُوٓا۟ إِنَّمَا ٱلْبَيْعُ
مِثْلُ ٱلرِّبَوٰا۟ ۗ وَأَحَلَّ ٱللَّهُ ٱلْبَيْعَ وَحَرَّمَ ٱلرِّبَوٰا۟

Those who eat *Riba* (usury) will not stand (on the day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: "Trading is only like *Riba* (usury)." Whereas Allah has permitted trading and forbidden *Riba* (usury).

Surah al-Baqarah* 2:275

هذه المجلة تحتوي على آيات قرآنية كريمة
لذلك يجب احترام صفحاتها وعدم وضعها في مكان غير لائق بعد قرائتها

The publication carries quotations form al-Qur'an al-Karim and ahadith (traditions) of the prophet (blessings of Allah and peace be on him). Please ensure their sanctity. The pages on which such quotations appear should be disposed of in the proper Islamic manner.

*****Al-Hilali, Muhammad Taqi-ud-Din, and Muhammad Moshin Kahn. *Translation of the Meanings of the Noble Qur'an in the English Language.* King Fahd Complex for the Printing of Holy Qur'an. Madinah al-Munawwarah, 1419AH/1998CE.

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Rector's Message

The University of Management and Technology (UMT) has come a long way over a short span of time as a wide-ranging disciplines providing university on most modern lines. The university is set on the threshold of breaking in to a new era of growth and success with the aim to be among the best seats of higher learning. With the award of W4 category by the Higher Education Commission (HEC) of Pakistan, UMT is in right direction to take place among the institutions of higher learning and has won privileged distinction both in the country and abroad. UMT offers quality yet accessible higher education not only in the traditional fields but also in the emerging disciplines to meet current and future national needs.

The Institute of Islamic Banking (IIB) is one of the best examples of such emerging area of present needs. The IIB is an educational research oriented institute with the objective of promoting intellectual, logical and scientific thoughts and discussions on principles of Islam in application of Islamic banking and finance. The institute construes the Islam teachings in the framework of conventional banking development of the modern world and the foundation of such institute will give us an opportunity to pay tribute to the wealth of knowledge that comes with Islamic visualization and will help us translate it in action. The institute opens its doors to the scholars and bankers who wish to pursue academic Islamic studies at wide and are eager to know the true teachings of Islamic religion. The institute has a conducive environment that enables researchers to carry out a broad survey of the fundamentals of Islamic banking studies and ethics.

My primary concern, as Rector, is to ensure that IIB maintains its high standards and academic status and that we continue to attract the best students and staff from around the world. I congratulate all and specially the team of IIB for the initiative and wish them success in the running of institute. I hope that you will find it interesting and informative. Come join us on this exciting journey into the future to share our enthusiasm of introducing Islam in conventional financial and economic systems.

Dr. Hasan Sohaib Murad

Rector, UMT

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Islamic House Financing in Pakistan: A Demand Analysis

Muhammad Mansoor Javed
Senior Lecturer
SKANS School of Accountancy
Lahore, Pakistan.
mansoor.javed@hotmail.com

Muhammad Mahmmod Shah Khan
Director
Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.

Haris Aslam
Assistant Professor
School of Business & Economics
University of Management and Technology
Lahore, Pakistan.

Abstract

This paper analyzes the issue of the nature of demand for house financing offered by Islamic banks in the Pakistan. The paper also identifies the factors that impact demand for house financing offered by Islamic banks. The study used survey data based on convenient face to face interview of 243 respondents. The study regressed conventional demand for Islamic house financing on six regressors: Shariah compliance, convenience, bank features, product features, social influence and knowledge. The study reveals that the nature of demand for Islamic house financing is conventional. The results of the study also indicate that religious factor negatively affect the demand for Islamic house financing whereas all other factors affect it positively. The study will help managers of Islamic banks to increase their market share in house financing by focusing on those factors which significantly affect the demand for their product.

Keywords: House Financing, Islamic Banks, Social Influence, Shariah Compliance, Conventional Demand

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1. Introduction

In Pakistan, due to rapid movement of people towards larger cities, shortfall of housing has increased. Consequently, the price of houses have increased dramatically which compel people willing to buy or construct a house should take loan from different sources including financial institutions. At present, along with House Building Finance Corporation Limited (HBFCL), more than 25 commercial banks, both conventional and Islamic, and one microfinance bank are providing finance for construction, purchase and renovation of houses (Rehman, 2008). The leading Islamic banks which provide house financing are Meezan Bank, Al Baraka Bank, Burj Bank, Bank Islami Pakistan and Dubai Islamic Bank. Most conventional banks have also set up their Islamic divisions and are providing house financing under Islamic mode of financing mainly *Diminishing Musharakah* (Fauziah et al., 2008).

Diminishing Musharakah is a combination of *Ijarah* and *Musharakah* contracts. Under this approach, Islamic bank and client jointly purchase the house which is then divided into some units. Initially, bank owns majority of the units which are used by the client. Client pays the rent of these units to the bank and, at the same time, purchases the unit from bank one by one. In this way, at the end of the specified period, the client purchases all units from the bank and becomes the sole owner of the house (Umani & Usmani, 2002).

According to a report issued by the State Bank of Pakistan, Islamic banks have captured 27% share of housing finance market which is 170% higher than their 10% share in overall banking industry Furthermore, in overall housing finance market the number of borrowers has decreased during the period from March 2013 to March 2014 by 8.2%; however, in case of Islamic banks, this number is increased by 11%. Similarly, the gross outstanding in housing finance has remained unchanged or decreased over one year period from March 2013 to March 2014 for conventional banks and HBFCL; whereas, in case of Islamic banks, an increase of 5.34% has been observed (Housing Finance Quarterly Review March 2014). All these factors indicate that Islamic banking is performing better in housing finance.

The purpose of this paper is to find out how Islamic banks have succeeded to capture higher share in housing finance market as compare to their overall share in banking sector by analyzing the nature of demand for Islamic housing finance along with major determinants of such demand.

2. Literature Review

2.1 Nature of Demand

Many studies have confirmed that there is high demand for Islamic financial products not only in Muslims countries (Dusuki & Abdullah, 2007; Ghauri et al., 2012) but also in non-Muslims countries (Dar, 2004). However, there are only a few studies that analyze the nature of Islamic financial products demand (Dar, 2004; Khatim, 2009), whereas most of these scholars explore its determinants (Dusuki & Abdullah, 2007; Hamid et al., 2009; Amin et al., 2011; Cole, Sampson & Zia, 2011; Echchabi & Aziz, 2012; Echchabi & Olaniyi, 2012b; Gumel & Othman, 2013; Abduh et al., 2013).

A study done by Dar (2004) classified demanders of Islamic financial products and services into three categories: 'staunch', 'pent up' and 'conventional'. Staunch demander is loyal to Islamic financial products and always uses them even if their costs are high. Pent up demander prefers Islamic financial products only when these products are not only Shariah complaint but also competitive with their conventional alternative. Conventional demander, however, switches to Islamic financial products only when they are less expensive. The study found that only 5% Muslims are staunch demander while majority of them, that is 72%, are conventional demanders (Dar, 2004). Similar results were found in a study done by Tameme & EL (2009), which analyzed the demand and supply situations of Islamic housing finance in the UK. This study concluded that both Islamic and conventional financing are perfect alternative of each other; however, it is the price which influence the decision of the potential customer.

2.2 Determinants of Demand

2.2.1 Religious Factor

Prior studies found conflicting results relating to religious factor as a determinant of demand for Islamic financial products. Few researchers found that religious factor significantly influence the demand for such services (Metawa & Almossawi, 1998; Lee & Ullah, 2011), while other claimed that religious factor does not affect customer's decision of selecting a bank (Erol & El-Bdour, 1989; Amin et al., 2011; Ghauri et al., 2012). Some studies also found that very few bank customers select Islamic banks strictly due to religion whereas majority of them select Islamic banks due to non religious reasons (Gerrard & Cunningham, 1997; Abdul Hamid & Azmin, 2001; Sun et al., 2012).

By applying descriptive statistics and cross tabulation analysis on a data collected through questionnaire survey, a study found that customers of Islamic banks highly value Shariah compliance and incline to switch to another bank if their banks violate Shariah principles (Lee & Ullah, 2011). Similarly, a study discovered that compliance with Shariah rules is one of the important factor of patronizing Islamic banks (Ayesha Hamid & Masood, 2011). These studies confirmed the findings of Metawa & Almossawi (1998) who asserted that the most significant bank selection criterion is adherence to the Shariah principles. Similar results were found by Alam et al. (2012), who explored the impact of religion on demand for Islamic house financing and concluded that religion influences such decisions significantly. Jusoh & Khalid (2013) in their study assessed the determinants of demand for deferred sale contract which is in a way a debt based contract. The study found that sincerity with the religion is the major determinant of such demand.

However, while exploring the influence of religion on demand for phone banking services offered by Islamic banks, Sun et al. (2012) found that only faithful Muslims prefer Islamic banks due to religious reasons whereas heedlessly religious Muslims and non-Muslims consider utility attributes of the products. In Malaysia, another study explored the factors which encourage bank customer to prefer Islamic banks over conventional banks. It was found that only thirty seven percent respondents preferred Islamic banks due to religious factors whereas other claimed quality of service more important in selecting a particular bank (Abdul Hamid & Azmin, 2001). A similar study was done in Australia and the results were similar to the study of Abdul Hamid & Azmin (2001), as only twenty two percent respondents claimed that the religion was the main factor that encouraged them to prefer Islamic banks (Tahir & Brimble, 2011). Similarly, Amin et al. (2011) analyzed the effect of different factors including attitude, social influence, religious obligation, and pricing on demand for Islamic personal finance and found that the religious factor is an insignificant predictor of such demand. This confirms the finding of Erol and El-Bdour (1989) who claimed that religious obligation is not the only determinant of demand for Islamic banking.

2.2.2 Convenience

Many researchers also identified convenience as a significant determinant of demand (Amin et al., 2011; Chigamba & Fatoki, 2011; Lee & Ullah, 2011; Oliveira & Von Hippel, 2011). Dass & Pal (2011) examined those factors which affect the demand for mobile financial services. The study found that hardship faced by the customers (while acquiring similar services through existing channels) is the major determinant of demand for adoption of mobile financial services. In another study, it is asserted that convenience relating to getting the service is as important selection criteria as the quality of the service itself (Echchabi & Olaniyi, 2012a). Saini et al. (2011) study claimed that convenient location is considered one of the important bank selection criterions. Likewise, while exploring brand preference in non-conventional banking, another study found that ease of use is the most important feature which is required by the customers (Ahmad et al., 2011). Mokhlis et al. (2014) compared bank selection criteria of bank users and found that convenient bank location is one of the important criterions of selecting a bank.

2.2.3 Bank Features

Many studies found that features like bank reputation, quick service, friendly behavior of staff and confidentiality are the major criteria of selecting a bank (Erol & El-Bdour, 1989; Dusuki & Abdullah, 2007; Awan & Bukhari, 2011; Siddiqi, 2011). Efficient service and good reputation were among the five most important features considered by the customers while selecting a bank to take personal finance (Ayesha Hamid & Masood, 2011). Similarly, bank staff's behavior and the quality of their interaction with customers are the most important determinants of demand for a particular brand (Ahmad et al., 2011). Similar results were found by Narteh & Owusu-Frimpong (2011) in which students' criteria of selecting a retail bank was investigated. The study concluded that image of the bank, behavior of bank staff, service quality and technology are the major factors that influence customer's decision of patronizing a bank (Narteh & Owusu-Frimpong, 2011). Siddiqi

(2011) found that service quality positively relates to customer satisfaction while customer satisfaction positively relates to customer loyalty. Frangos et al. (2012) also discovered that service quality and infrastructure of the bank affect customers' decision to patronize that bank for personal financing.

2.2.4 Product Features

Product features are also considered important determinant of demand for financial products. Awan & Bukhari (2011) analyzed customer's behavior towards Islamic financial products and found that the most important criterion to select an Islamic financial product is the product feature followed by quality of service. Similarly, another study explored the bank selection criteria for house financing and found that product price and product flexibility are considered as the key selection criteria by the potential bank customers (Hamid & Masood, 2011). The price of the product is the most important determinant of preferring a particular financial product (Ta & Har, 2000). This claim is affirmed by another study that found price of the Islamic financial service negatively affect the intention to use Islamic personal financing (Amin et al., 2011). Another study asserted that service speed and quality is the major determinant of demand of financial products (Hegazy, 1995). In Nigeria, a study was conducted to explore the relationship between innovativeness and demand for Islamic banking. The data was collected through a questionnaire survey and by applying different statistical tests, it was revealed that innovativeness significantly influences intention to use Islamic banking (Gumel & Othman, 2013). This confirmed the findings of Thambiah et al. (2011) that suggested a conceptual model to examine determinants of demand for Islamic retail banking. The model is based on diffusion theory and claims that innovation is the key to promote Islamic retail banking.

2.2.5 Social Influence

Social influence is also considered important factor by some researchers. Amin et al. (2011) explored the affect of social influence and attitude, along with other factors, on the intention to use Islamic personal financing. Using questionnaire survey, they collected the data from 150 customers of Malaysian Islamic banks and applied factor analysis, correlation and regression analysis. They found that both social influence and attitude had significant influence on intention to use Islamic personal financing. Another study explored the factors which influence individual's decision to accept Islamic insurance. The study found that subjective norm is one of the important predictor of demand for Islamic insurance. The study claimed that the subjective norm includes social pressure for performing or not performing certain behavior (Rahim & Amin, 2011). A study investigated university students' criteria of selecting a bank and found that recommendation by friends and family is the most important factor (Chigamba & Fatoki, 2011). These studies confirmed the findings of an earlier study done by Taib et al. (2008) who determined the acceptance level of diminishing Musharakah. The study revealed that social influence was one of the important factors which affect people's decision to accept diminishing Musharakah.

2.2.6 Knowledge

A few studies also explored the effect of knowledge of a particular financial product on the demand of that product. Amin (2012) explored why customers patronage Islamic credit cards. By applying theory of reasoned action, it was found that the demand of Islamic credit card is positively affected by knowledge of Islamic credit cards and education level. The demand for Islamic financial products particularly for takaful is being increasing due to increasing awareness of this product among the people and it is expected that this product will give a fair competition to conventional insurance in near future (Hamid et al., 2009). Similarly, a survey was conducted by Cole et al. (2011) in both Indonesia and Malaysia simultaneously to assess the effect of financial literacy on demand of banking products. More than two thousands questionnaire were filled up online and by applying statistical tests it was found that the two variables were significantly associated. Another study found that amount of information about Islamic insurance positively affect the intention to use it (Rahim & Amin, 2011). According to Ringim (2013), the relationship between knowledge about Islamic bank accounts and their usage found significantly positive.

3. Research Methodology

A primary research based data study was done through questionnaire survey. The questionnaire consists of two sections. The first section relate to the demographics while the second section is sub divided into seven sections representing dependent variable (demand) and six independent variables (knowledge, Shari'a compliance, product features, bank features, convenience, social influence). Most items used in the questionnaire were adopted from earlier studies of Ayesha Hamid & Masood (2011), Hamid et al. (2009), Haque et al. (2009) and Imtiaz et al. (2013).

The population for this study is the residents of Lahore who intend to buy a house in the near future. Convenient sampling technique had been used to get sample from the population. The same sampling technique was used in some earlier studies (Abdul Hamid & Azmin, 2001; Sun et al., 2012). A sample size of 300 respondents was selected for this study. However, out of 300 questionnaires distributed; only 243 questionnaires were properly filled up. This constitutes a response rate of 81%. Respondents profile has been shown in Table 1. It can be observed that the most respondents are married male who belong to age group of 36-46 with an income level between Rs. 40000 - 80000 per month.

Table 01: Respondents Profile

	Frequency	%age		Frequency	%age
Age			**Industry**		
27 or below	00	00.0	Education	31	12.76
From 28 to 35	99	40.7	Banking & Finance	49	20.16
From 36 to 43	113	46.5	Manufacturing/Trade	39	16.05
From 44 to 51	31	12.8	Medical & Healthcare	41	16.87
52 or above	00	00.0	Engineering & IT	32	13.17
			Other	51	20.99
Gender			**Marital Status**		
Male	207	85.2	Single	37	15.2
Female	36	14.8	Married	206	84.8
			Income (Monthly)		
Qualification			Less than 40,000	84	34.57
MS or Above	22	9.10	40,001 – 80,000	97	39.92
Master	75	30.9	80,001 – 120,000	51	20.99
Graduation	95	38.7	Above 120,000	11	4.53
Inter or Less	15	6.20			
Professional Qualification	37	15.2	**House Type**		
			Owned	10	4.10
			Rented	160	65.8
			Other	73	30.0

The reliability of the questionnaire is checked using Cronbach's alpha where each scale has alpha value above 0.7. The validity of the questionnaire is examined using factor analysis with varimax rotation as most studies used the same rotation (Awan & Bukhari, 2011).

Table 2 shows the results of rotated factor analysis to check the items validity of each construct used to done the analysis. The results of factor analysis are shown in Table 3.

Table 02: Principal Component Analysis

Factors	Shari'a Compliance	Product Features	Bank Features	Convenience	Social Influence	Knowledge
Interest free	.786					
Risk is shared	.733					
Approved by *Shari'a* scholar	.708					
Free from uncertainty	.676					
Lower cost		.939				
Lower monthly payment		.917				
Amount of financing		.714				
Period of repayment		.656				
Staff friendliness			.867			
Bank reputation			.842			
Several Branches			.756			
Staff Experience			.832			
Bank Infrastructure			.777			
Quick service			.646			
Convenient bank location				.791		
Easy processing				.668		
Operating Hours				.664		
Parking Space				.620		
Recommendations by friends & family					.889	
People expectation					.758	
Used by friends and family					.757	
Knowledge of Islamic banking						.865
Knowledge of Islamic finance						.701
Knowledge of Islamic house financing						.765
Comparative knowledge						.733

Table 03: Reliability Analysis

Scale Construct	Cronbach's Alpha
Shari'a Compliance	.822
Product Features	.765
Bank Features	.806
Convenience	.815
Social Influence	.740
Knowledge	.803

4. Data Analysis

One sample T test applied to test the nature of demand for Islamic house financing in Pakistan. The results are shown in Table 4. As the mean score of the conventional demand (3.51) is higher than the test value of 3 by 0.51, and the results are highly significant at 1% level of significance, it is concluded that conventional demand exists in Pakistan.

Table 02: One Sample T test (Demand)

Test Value = 3					
Item	Mean	Std. Deviation	Sig. (2-tailed)	95% Confidence Interval of Difference	
				Lower	Upper
Conventional Demand	3.51	1.081	.000	.38	.65
Staunch Demand	2.57	1.188	.000	-.58	-.28
Pending Demand	2.91	.956	.160	-.21	.03

Table 03: Regression Analysis (Determinants of Demand)

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	-3.288	.499		-6.594	.000		
Product Features	1.016	.090	.918	11.320	.000	.218	4.589
Convenience	.293	.037	.364	7.877	.000	.673	1.486
Shari'a Compliance	-.230	.054	-.213	-4.236	.000	.565	1.770
Knowledge	.241	.072	.141	3.328	.001	.796	1.257
Bank Features	.834	.063	.532	13.157	.000	.878	1.139
Social Influence	.401	.082	.257	4.922	.000	.527	1.896
R^2 = 0.666							

Conventional demand is regressed on six regressors: Shari'a compliance, convenience, bank features, product features, social influence and knowledge. The results are highly significant at 99% confidence level and found that Shari'a compliance negatively affect the demand for Islamic house financing whereas all other factors affect it positively, as shown in the Table 5. Moreover, product features is the most important determinant of such demand followed by bank features and social influence. Collinearity Statistics shows that multi-collinearity is not an issue here.

5. Conclusion

This study investigates the nature of demand for house financing offered by Islamic banks in the city of Lahore using a survey based on convenient face to face interview of 243 respondents. The study identified the factors that impact demand for house financing in Lahore. By applying one sample T test, it is revealed that nature of demand for Islamic house financing is conventional. Staunch demand is also there for Islamic housing, but the results for pending demand are insignificant at the 99% level of confidence. The regression analysis revealed that Shari'a compliance negatively affects the demand for Islamic house financing whereas all other factors affect it positively. As the study revealed that product features are the most important determinant of demand for house financing offered by Islamic banks whereas religious factor affects it negatively, it is recommended that the managers of Islamic banks should focus on improving their product quality to increase their market share and not rely on religious factor.

6. Future Research

This study only focuses on the demand side of the Islamic house financing. There is a room for future research to explore people's perception about the supply situation of Islamic house financing. Moreover, as currently, in Pakistan diminishing musharakah is being practiced, there is a room for future research to explore what would be the affect on demand for Islamic house financing if other Islamic modes of financing are also used for house financing. Also, at present, rent earned by Islamic bank is linked with Karachi Inter Bank Offer Rate (KIBOR) which gives a perception that interest element exists in Islamic house financing; a research should be conducted to find out the effect on demand of Islamic house financing if rent would not be linked with KIBOR.

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An Alternative Islamic Mode of Finance for SMEs: A Case for *Bai Salam*

Dr. Sheikh Muhammad Ishtiaq
Assistant Professor
Department of Humanities
DHA Suffa University
Karachi, Pakistan

Hafiz Muhammad Sarfaraz Nihal
Lecturer
Department of Economics
University of Karachi (UoK)
Karachi, Pakistan

Muhammad Mubashir Mukhtar
Research Assistant
Institute of Business Administration
Karachi, Pakistan
mmukhtar@iba.edu.pk

Abstract

Financing and procurement play a vital role for the success of small and medium enterprises (SMEs), but, *riba* and *gharar*, commonly used in conventional transactions, are the barriers for the Muslims to get benefit of this deal. *Riba* is pre-determined excess return to the extended loan while *Ghrar* is a kind of uncertainty that may lead to dispute. *Gharar* includes selling of commodity which does not exist or which is not owned and possessed by a seller. *Bai Salam* is the best alternate Sharia compliant solution to *riba* and *gharar* based transaction. *Bai Salam* which is generally used in agricultural products can also be employed on non-agriculture objects. It can also be executed by way of parallel *Salam*. This paper aims to discuss *Bai Salam* and its implications on SMEs in the context of 2011 Punjab Assembly Bill.

Keywords: *Bai Salam, Parallel Salam,* Economy, Business, Small and Medium Enterprises

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1. Introduction

Small and Medium Enterprises (SMEs) are a backbone for economy, as they provides the opportunity of trade and finance to limited scale companies. In Pakistan, during the fiscal year 2012, the growth rate of SMEs had been increased by 7.5 percent (Afraz et al., 2014). This remarkable growth conceives the need of financing methodology that is equitable in every context, transforming the benefits to the stakeholders. Among the biggest challenges being faced by the Muslims is the challenge of overcoming the illusion of *riba*, the strictly prohibited deal in Islam (Al Quran 2: 278 – 279).

Islam provides its own set of financing and lending mechanisms. A genuine application of Islamic regulations would relieve the greater part of humanity from the debt and insecurity that the interest based paradigm has inflicted upon us (Diwany, 2010). The modes which Islam provides ranges from *Musharaka, Modaraba, Salam, Istisna, Qard, Murabaha, Musawamah* and others which are combination and permutation of the aforesaid.

2. Bai Salam

"*Salam* is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot" (Usmani, 1998). In a nutshell, *salam* is a 100% advance payment with the future specified date of the good to be delivered. Definitions of *bai salam* in view of different shariah jurisprudents compiled by *Lakhnavi & Lakhnavi* (2010) in *Umdatul Riaya Fi Sharhi Sharil Wiqaya* are;

- According to Sahib ul Bahar and Sahib ul Multaqa: A sale contract in which the payment is on spot and the delivery is deferred.
- According to Burjundi: A sale contract in which sale executed in order to transfer the ownership of the commodity to the purchaser in future whereas the payment is made on spot to the seller.
- According to Allama Aine: A sale contract in which the seller possess the right of receiving payment on spot and the buyer receives the good after sometime.
- According to Allama Shami who quotes from Qouhestani: A kind of sale and purchase contract in which one thing is on spot (payment) and the second thing is deferred (delivery of goods).

The concept of *Bai salam* is also stated in the Holy Quran (Lakhnavi & Lakhnavi, 2010):

هومشروع بالكتاب: وهو آيةُ المداينة، روى الحاكم في ((المستدرك))(2: 314) في تفسيرِ سورةِ البقرة، عن ابن عبَّاس قال: أشهد أنّ سَلَفَ المضمونِ إلى أجلٍ مسمّى قد أحلّه الله في الكتابِ وأذنَ فيه، قال الله تعالى: {يَاأَيُّهَا الَّذِينَ ءامَنُوا إِذَا تَدَايَنْتُمْ بِدَيْنٍ إِلَى أَجَلٍ مُسَمًّى فَاكْتُبُوهُ...} الآية [البقرة: 282]، وقال: حديثٌ صحيحٌ على شرطِ الشيخين، ولم يخرِّجاه. كذا في ((نصب الراية))(4: 44)

"O you who believe, when you transact a debt payable at a specified time, put it in writing, and let a scribe write it between you with fairness…" (Surah Al Baqarah: 282). Ibn Abbas says "I take oath that the above verses were revealed in the context of *salaf* (i.e., *bai salam).*"

Before the prohibition of *riba* in Islam, farmers used to take *riba* based loans for their need. The Holy Prophet ﷺ provided alternate solution to the *riba* based transaction by way of B*ai Salam*. Ibne Abbas expounds:

(فما روى ابن عباس) أن رسول الله (ص) قدم المدينة، وهم يسلفون في الثمار السنة والسنتين والثلاث، فقال: "من أسلف في شئ فليسلف في كيل معلوم، ووزن معلوم إلى أجل معلوم."

"Whoever wishes to enter into a *salam* contract, he must affect the *salam* according to the specified weight and the specified delivery date." (Narrated by Ibne Abbas in Sahih Al Bukhari; Book of Salam, Bab: A *Salam* contract on a specified weight), 2240, 2241, pp.174.

Bai Salam was allowed to make easiness in the economic sphere mixed with flexibility in financing requirements. Also, the "Arabs depended on seasonal trade and agriculture for their livelihood, the practice of *salam* sale with forward delivery must have been common in their life. Al Bukhari reports from Al Bara' Bin 'Azib:

"(When) the Prophet ﷺ came (to Al Madinah) we used to do *salam* sale against forward cash payment until the season. (Al Bukhari, V 4, p.269)" (Kahf & Khan, 1992). Abdullah bin

> Shaddad and Abu Burda sent me to 'Abdullah bin Abi Aufa and told me to ask 'Abdullah whether the people in the life-time of the Prophet used to pay in advance for wheat (to be delivered later). Abdullah replied, "We used to pay in advance to the peasants of *Sham* (Syria) for wheat, barley and olive oil of a known specified measure to be delivered in a specified period." I asked (him), "Was the price paid (in advance) to those who had the things to be delivered later?" Abdullah bin Aufa replied, "We did not use to ask them about that." Then they sent me to 'Abdur Rahman bin Abza and I asked him (the same). He replied, "The companions of the Prophet used to practice *salam* in the life-time of the Prophet; and we did not use to ask them whether they had standing crops or not." (Sahih Bukhari 1: 2154).

Apparently on face value *Bai Salam* seems as a void contract, because basic sale and purchase requirements are neglected in it. Such as, existence of subject matter, possession and ownership of the buyer over the commodity. But when compared in the light of Shairah, "there are still other needs for financing especially those emerging out of unforeseen circumstances. In this regard Muslim writer's usually quoting two famous sayings of the Prophet ﷺ promising an ample reward for benevolent loans. Commenting on these sayings, Ibn Qudamah argues that the purpose of lending is to relieve and assist a person who is under pressure and is facing adversity (Al Mughni, V. 4: 353). In fact as the text of the Hadith shows, the Prophet ﷺ himself indicates that a loan seeker would only ask for a loan as a result of necessity and financial despair. It should be noted that needs which require borrowing may pertain to either consumption or production. Hence B*ai Salam* was looked upon as a means of providing financial facilities to producers" (Kahf & Khan, 1992). Ijma (consensus of Shairah jurisprudents) is also held on *Bai Salam* (Lakhnavi & Lakhnavi, 2010):

> وبالإجماع: لأنّهم أجمعوا على جوازِهِ لحاجة النَّاسِ إليه، والقياسُ يأباه؛ لأنَّ المسلمَ فيه يبيعُ وهو معدوم، ولما كان بيعُ موجودٍ غير مملوك، أو مملوك غير مقدورِ التسليمِ ليس بصحيح، فبيعُ المعدومِ أولى، لكنَّا تركناهُ لوجودِ النصوصِ الصريحةِ على جوازِ ما نحن فيه من الكتابِ والسنة.

> "Due to the non existence of the subject matter and not in the ownership of the purchaser one can consider this transaction to be void but all jurisprudents consider *Bai Salam* permissible due to necessity of the people. Also the Quran and Sunnah consider it permissible."

According to the Muslim jurists who are in the favored of Bai Salam argued that there are certain strict conditions which are necessary to be satisfied otherwise the agreement of *salam* contract would be void (Usmani, 1998; Mansoori, 2008).

1- The basic idea for *salam* is that seller must be able to get 100% payment in advance from the buyer; at the time of sale agreement with no barter between the commodities like wheat and cotton etc
2- The good in the contract must not be having shortage and be available in the market from the contract to the date of delivery. *Bai Salam* agreements cannot be applicable for the particular goods whose supply is limited
3- There would be no ambiguous measurement of the commodity. The measurement of the commodities must be in the standard and usual measure in the market
4- The exact delivery date and place must be defined in the contact and they must be delivered physically
5- *Salam* contract is applicable only on those goods in which there is no ambiguity in the quality of the good because ambiguity in quality and specification may lead to dispute.
6- *Salam* should be held bilaterally
7- Until the time commodity is handed over to the buyer, the commodity will remain at the risk of seller

Parallel *salam* is also acceptable in Shariah with two conditions:

1- It is only allowed with third party
2- The two *salam* contracts neither dependent to one another nor contingent upon any other situation

The flexibility is not extended in the context of penalty, according to AAOIFI Shariah Standard number 10, "It is not permitted to stipulate a penalty clause in respect of delay in the delivery…" of the subject matter (*al-Muslam fihi*).

There are three substitutes for failing in fulfilling the contract, either the buyer waits for the delivery or terminate the contract by recovering the paid capital or take other kind of delivery which does not exceed the amount of the contract and neither the price of that commodity is more than the market price (AAOIFI, 2006). Another word of caution is that *Bai Salam* cannot be executed in those commodities that may fall in *riba-ul-hadith* (i.e., in which the delivery must be on the spot basis like sale of gold with gold or gold with silver and vice versa etc.)

3. Scope of *Salam* in Small and Medium Enterprises (SMEs)

In Pakistan, the SMEs are comparatively larger in number than large scale industries and are responsible for having competition in majority of the economic sectors. In Pakistan, the SMEs comprise almost 90% out of all enterprises because it employs around 80% of the non-agricultural labor force while its part in the annual GDP of the country is 40%. The SMEs normally face the shortages of finances and other factors of production like marketing, training of the human resource and financial development.

Small and Medium Enterprises Development Authority (SMEDA) is given obligatory services to facilitate and help small and medium businesses in Pakistan. It provides financial, marketing, technical services and supervision to the SMEs. A cluster of different SMEs are made by SMEDA in order to enhance the efficiency by undertaking cluster development programs, such as:

1- Textile (ginning technology up-gradation and development of handloom clusters)
2- Horticulture, fruits and vegetables (export processing zone, fruit processing facility and co-ordination with EPB)
3- Fisheries (establishment of shrimp farms and fish processing facilities)
4- Gems (glass work, ceramics, sanitary ware, pottery and bangles)
5- Agriculture (support services for agricultural credit and trade promotion)

In the earlier era of Islam, B*ai Salam* was introduced for small farmers to grow crops to feed their family members till their production process to be completed and other necessities to be fulfilled. But with the advancing times it started to be used to expand the businesses, to accomplish the liquidity needs and to achieve the working capital for the international trade (exports and imports) etc. This nature of transaction is constructive and beneficial for both parties which are engaged in contracts. The seller receives the prices of their products in advance for those products that have not been produced on one side while the buyers are the beneficiaries in the form of having comparatively lower prices normally for the products produce through *salam* than the prevailing market prices.

Bai Salam can be used as an alternative financing mode in the current times also. Currently, in formal sector *Bai Salam* is used by Islamic Banks, which have advanced PKR 2.7 billion under this mode of financing, (SBP, 2010). Informal arrangements can also be made by SMEs with their raw material providers. Hypothetical case is being diagrammed which highlights the flow of the contracts (see Figure 1).

Simple *Bai Salam* Case

In simple *Bai Salam* case, the SMEs pays the price of commodity in advance which it intends to purchase from the farmer or raw material provider, the seller. 100 percent advance payment of the fixed quantity and pre-determined quality must be delivered in the specified time. The needs of both the parties are fulfilled in this specific mode of Islamic financing, such that no one can be harmed with this agreement.

Parallel *Bai-Salam* Case

The Parallel *Bai Salam* (see Figure 2) case is showing the agreement of the same SME as purchaser and as a seller simultaneously, with the first seller and with the other buyer respectively. The two agreements of the same SME are not contingent to the buyer and seller directly. The first seller may be the raw material provider, farmer or other SME; these goods are purchased by the SME. The same SME will be treated as the seller for the other agreement with the purchaser who may be the large scale manufacturer or other SMEs. In this way the seller receives the money which he requires for running his business and the purchaser benefits by getting a reasonable price. *Bai Salam* helps the SMEs plan pricing, budgeting, target market and future business prospects.

Figure 01: *Bai Salam* Mode of Financing

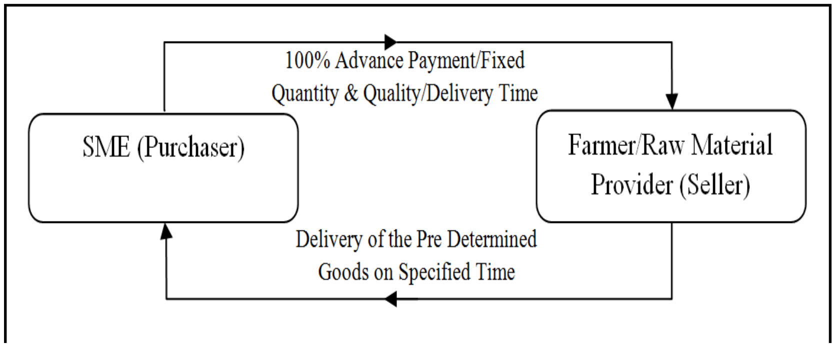
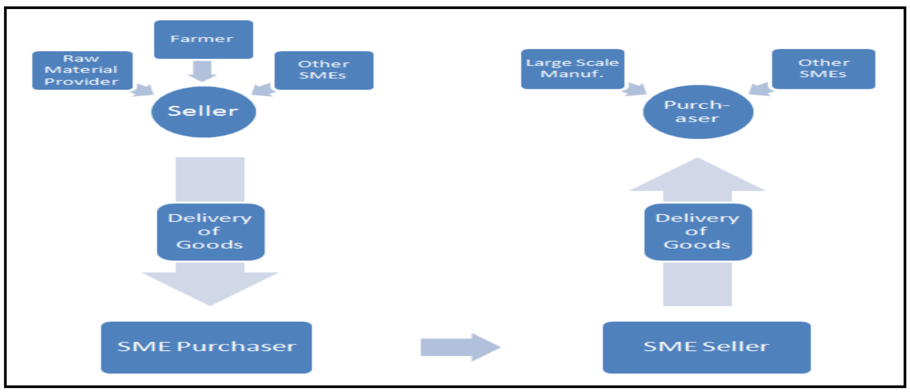


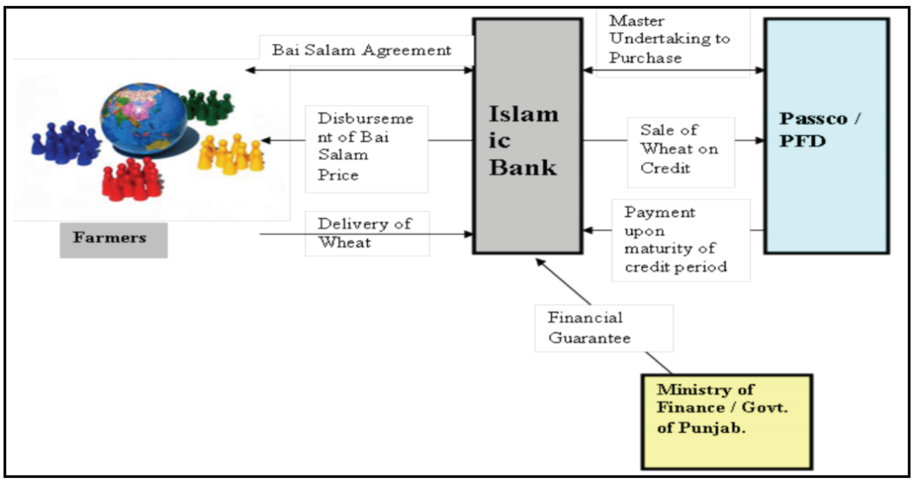
Figure 02: Parallel *Bai Salam* Financing Case



4. Summary of *Bai Salam* Bill of Government of Punjab

Punjab Assembly passed a *Bai Salam* bill which officially announced the removal of *riba* from the agricultural sector of Punjab. The credit flowing from the financial institutions to the agriculture sector comprised of only 6 percent, whereas the middle man (Aarthi) is the main source of providing financing to the farmer; 95 percent. The bill "favors the small farmers and can be effective in systemic eradication of Aarthi culture, introduce corporate farming, curb hoarding and inflation and change price mechanism." The bill intends towards a co-operative farming mechanism in which clusters of four small farmers, each having a land holding of twelve acres or less can group together and enter a *bai salam* contract (Shahid, 2011). This co-operation will help the farmers in growing major cash crops and will place them in better position to compete with larger land holding agriculturist. The government of Punjab and Islamic Financial Institutions can jointly help in this project as providing better technological equipments like solar powered tube wells, tractors and sprinkles etc. All these technologies can be given on the basis of Ijarah to the whole cluster. As the money input channels through the financial institutions or government or private sector, it will tend to increase the quality of the product, increase in research and increase in yield of the crop. By the intervention of the government through *bai salam*, the hording problem can be overcome and by the removal of *riba* the problem of inflation can be controlled, as it will be a sharing basis contract. The bill deems the government to fix a percentage of financing amount on Islamic Banks which will flow towards the farmers, through which the farmers will purchase the inputs. The Figure 3 depicts the methodology proposed in the bill.

Figure 03: Methodology of Punjab Assembly Bill on *Bai Salam*



5. Conclusion

This paper discusses *Bai Salam* and its implementation on the SMEs in context of the government of Punjab Bill of *Bai Salam*. The mechanism of *Bai Salam* is self evident in advocating the equitable and justified approach of Islam in context to the moral and social order of a society. The SMEs sector with its consistent high growth rate can benefit from *Bai Salam*, such that the seller can get advance payment for his goods which would benefit him in his business and the buyer benefits from early price setting plus the known quality and quantity of the good, which would help him in planning for his future steps in business. The Punjab government role in promoting *Bai Salam* in agriculture sector is very encouraging, as they can easily launch and run the whole system, reaping benefits for the stakeholders on the whole.

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Appendix

Definitions of *Bai Salam* by Lakhnavi & Lakhnavi (2010)

وعرَّفوه بعباراتٍ:

منها: أخذُ عاجلٍ بآجل، وهذا فاسد؛ لأنَّ السلعةَ إذا بيعت بثمنٍ مؤجَّلٍ يوجدُ هذا المعنى، وليس بسَلَم، ولو قيل: بيعُ آجل بعاجل، لكان أصوب، وقال في ((البحر))(6: 168): الظاهرُ أنّ قولهم: أخذ عاجل بآجل، تحريفٌ من النُّساخ الجهلة، فاستمرَّ النقلُ على هذا التحريف. انتهى. [قلت: هذه العبارة فيها تبديل مخلّ، فإن عبارة ((البحر))(6: 168) هي: والظاهر أن قولهم أخذ عاجل بآجل من باب القلب، والأصل أخذ آجل بعاجل وهو أولى مما في ((البناية)) من أن قولَهم أخذ عاجل بآجل تحريف من الناسخ الجاهل فاستمر النقل على هذا التحريف]

ومنها: هو بيعُ آجلٍ بعاجلٍ، ذكره في (الملتقى ص 120)
ومنها: بيعُ الشيءِ على وجهٍ يوجبُ الملكَ للبائعِ في الثمنِ عاجلاً، وللمشتري في المثمَّنِ آجلاً، مسمَّىً به؛ لما فيه من وجوبِ تقدُّمِ الثمن، ذكره البِرْجَنْدِيّ.

ومنها: هو عقدٌ يثبتُ الملكُ في الثمنِ عاجلاً، وفي المثمَّنِ آجلاً، ذكره العلاَّمةُ العَيْنِيّ [في ((الرمز))(2: 50)]

ومنها: شراءُ آجلٍ بعاجلٍ؛ لأنَّ السلَم اسمٌ من الإسلام. ذكرَه العلامةُ الشاميُّ [في ((رد المحتار))(4: 203)] نقلاً عن القُهُسْتَانِيّ [في ((جامع الرموز))(2: 39)].

وركنه: الإيجابُ والقبول، بأن يقول المشتري: أسلمتُ اليك عشرةَ دراهمٍ في كُرِّ حنطة، وأسلفت، فيقول البائع: قبلت، وينعقدُ بلفظِ البيعِ في الأصحّ، وهو روايةُ الحسنِ - رضي الله عنه - عن أبي حنيفة - رضي الله عنه -، وصورتُهُ: أن يقول: اشتريتُ أو بعتُ منك كُرَّ بُرٍّ صفتُهُ كذا، بكذا إلى كذا، على أن توفّيه في مكان، وقال زفرُ - رضي الله عنه - وعيسى بن أبان - رضي الله عنه -: لا يصحّ، وهو وجهٌ في مذهبِ الشافعيّ؛ لأنَّ السلمَ عقدٌ ثبتَ على خلافِ القياسِ بلفظِ خاصّ، فلا يعدلُ عنه. ولنا: أنَّ كلاً من البيعِ والسَّلَمِ تمليكُ مالٍ بمال، فيكونُ البيعُ اسمُ جنسِهِ فيصابُ به كما يصابُ باسمه. كذا في (كمال الدراية ق420)

Cornerstone's of *Bai Salam*

1- Offer and acceptance by the parties.
2- Fixation of price
3- Time of delivery
4- Place of delivery
5- Quality and quantity of the commodity

Performance of Islamic Mutual Funds: A Comparison with Conventional Mutual Funds

Muhammad Mahmood Shah Khan
Director, Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.

Syeda Hameeda Batool Gillani
Research Assistant, Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.
hameeda.gillani@umt.edu.pk

Sana Mansoor
Assistant Manager Finance, ViSigma Apparel Group
Lahore, Pakistan.

Abstract

Islamic finance industry has been expanded in the last decade and has branched out itself from banking to other financial sectors like Islamic Assets Management and Islamic Insurance Companies. Islamic finance industry growth over the past decade is impressive comparative to conventional sector particularly at the time of financial crisis. The focus of this research study is to assess the performance of Islamic and Conventional mutual funds in Pakistan for the period of 7 years ranging from 2007 to 2013. The research also studied the impact of NAV on mutual funds and how the volatility influences the Islamic and Conventional mutual funds. This research is based on the sample of equity funds using all Asset Management Companies in Pakistan on the basis of availability of each fund's NAV. The findings suggest that mutual funds performance led to mixed trend. The results indicates that portfolio returns of Islamic funds are more clustered around mean that shows the level of consistency in the performance of the Islamic funds, whereas portfolio returns of the Conventional funds are more volatile and inconsistent comparatively. Concerning overall performance, Islamic funds performed better than Conventional funds.

Keywords: Mutual Funds, Net Asset Value, Volatility, Returns, Performance

Khan, Muhammad Mahmood. Shah., Gillani, Syeda Hameeda. Batool., & Mansoor, Sana. (2015). Performance of Islamic Mutaul Funds: A Comparison with Islamic Mutual Funds. *Islamic Banking and Finance Review, 2*(1), 29-39. ISSN 2221-5239. © 2015

1. Introduction

Islamic finance industry has diversified from banking sector to other financial sectors in the past three decades and now it includes institutions like Islamic mutual funds management companies, Islamic micro financing institutions and Islamic insurance (takaful) companies. The growth of Islamic finance sector over the past decade remains impressive, specifically during the time of financial crisis that hit the globally functional conventional financial markets quite badly. Islamic mutual fund industry enjoys attractive investment capital from Muslim as well as non-Muslim investors. Islamic mutual fund industry also faced radical change around the world and likewise in Pakistan.

In Pakistan, currently there are 15 Asset Management Companies that are managing Islamic as well conventional mutual funds. Islamic funds are almost 12% of the mutual funds industry in Pakistan (Economic Review, 2014). The introduction of Islamic mutual funds has widened the industry by attracting the investors who were previously resistant to invest in conventional funds because of religious concerns. The traditional investment mutual funds was introduced in Pakistan in 1962, while the first Islamic fund was introduced in 2002 that is almost 40 years later. Today, total assets in Islamic mutual funds managed within Pakistan are about Rs. 58 Billion (Economic Review, 2014). In Pakistan, all categories of funds available in the conventional and in the Islamic fund side, such as stocks, money market, sovereignty, fixed income, index tracking funds protection.

Mutual funds are such investments that pools money from different investors to purchase securities. Mutual fund is actually an investment vehicle created by the Assets Management Companies that specialized in pooling hoarded money from individual investors as well as institutional investors. However, these investors have their own preferences on the basis of their different risk threshold, liquidity needs and religious requirements. Individual investors give preference to make investment in mutual funds as their preferred investment vehicle to manage the risk and return profiles. Keeping in view the various complex needs of an Islamic country, realizing the fact that our financial market is based on the interest factor that does not conform to Islamic laws of Quran and Sunnah. However, it is difficult for the Muslim investors to freely invest in it. The increasing demand of alternative investment system which conforms to Islamic laws has promoted Pakistan government to introduce Islamic investment vehicle. This research study conducted to measure the performance of Islamic mutual funds and conventional mutual funds in Pakistan. The study evaluates comparatively which fund provide better return to capitalist, the Net Asset value (NAV) influence on the Islamic and conventional funds performance and the consequences of volatility on the Islamic and conventional mutual funds. This is a comparative study that aims to examine risk and return profile of mutual funds in Pakistan for the period across 07 years from 2007 to 2013.

1.1 Significance of Study

The traditional capital market has to follow the capital funding market laws, but Islamic funds, on the other hand, are subjected not only to the capital market laws but they have to follow economics of Islamic laws under the reflection of Shariah. On this basis of strategic differences, the study objective is to provide comprehensive understanding of the two different funds in the Pakistan capital market. Compared to conventional funds, Islamic funds are relatively new. Since the offering of Islamic mutual funds the researchers are interested to measure the comparative performance of risk-return profile of such funds.

1.2 Research Question

The study intends to observe the following research questions.

- Are there any performance differences between Islamic mutual funds and conventional mutual funds in Pakistan?
- Do Islamic mutual funds outperform Conventional mutual funds?

1.3 Research Objectives

- To explore whether Islamic funds provide better return to capitalist as compared to Conventional Funds.
- To measure how NAV influence on the Islamic and conventional funds performance.
- To evaluate the consequences of volatility on the Islamic and conventional mutual funds performance.

2. Literature Review

The stock markets are mutually beneficiary for both lender and borrower and mediator of transfer financial resources from surplus to deficit respectively. The financial resources allocate efficiently since beneficiaries (public limited companies) invest in specialized productive projects which are not the potential of the funds provider (households). Stock markets are ultimate source to fulfill the liquidity requirement of the companies. The risk premium is depending on the covariation between assets return and market portfolio returns. The investor risk of variability in returns will compensate by diversified efficient portfolios (Khilji & Nabi, 1993).

Brennan et al. (1993) observed that in the same size firms, stock prices of the mostly persuaded firms by investment analysts swiftly regulated than the least delimited firms. Even most analytical firms quickly respond to market returns as compared to the least consider firms (Brennan et al., 1993). According to Sharpe (1964) typical investor incurred two types of prices, interest rate and risk. The expected rate of return is directly related to risk in conventional concepts it also capitulate inference reliability, since investor bear low return on the asset which is least responded to the economics change and vice versa. To adjust capital assets price, he has to acquire diversified portfolio because each capital asset compute independently (Sharpe, 1964). Jones & Wilson (1989) compared stocks with time to measure volatility. Increasing volatility is in fact a considerable matter to be discussed seriously. If suitable data were available for statistical inference then it will be good enough if "increased volatility" can be experimentally estimate for short term period of time (Jones & Wilson, 1989).

Most of Pakistani investors make positive returns in equity markets like other markets. The return on stocks is not normally distributed, although hypothetical models are used very carefully (Husain and Uppal, 1998). The firms with surplus cash are more likely on high risk than the low excess cash and experienced low returns when markets are in slump. There is option of elevated investment in future but not surety of profitability. Resultant high cash firms like Islamic Banks are considerably risky (Simutin, 2010). Investors should hold small stocks to avoid variations in the price of assets and returns of the stocks. Diversified portfolio is best option for the investor of Small firms, which influenced largely by the external variations (Lamont el at., 2001). The macroeconomic variables like inflation, exchange rate, money supply and industrial index have pessimistic impact on stocks returns. An appropriate monetary policy can reduce inflation and increase the industrial production, exchange rate flow and money supply, ultimately impacting on price and expected returns (Sohail & Hussain, 2009).

In competent capital market, investor's expectation regarding discount rate and cash flow manipulate the price of assets. Expected discount rate is negatively correlated to the dividend. The profitability and returns depend on each other and yield of firms dividends envisage with both. The variation in stocks prices are caused by the inverse correlation of profitability and the expected returns (Sadka, 2007). Rational investors of an economy make risk premium stock return above average if expected dividends assumed to be increased gradually than the risk free stocks with low interest rate. The noisy information stocks prices are explosive then the smooth dividends. The accurate information about firms controls the risk premium and cost of equity capital (Li, 2005).

Many Muslims reduce stock trading in the month of Ramadan due to the fact of immorality of peculation in view of Islamic rules. In Pakistan working hours reduced in month of Ramadan that is why stocks returns decline but average return does not effect at all in this holy month. This is significantly noted that least instability of the stock market observed in Ramadan and formed prosperity for investors to tackle stipulation judiciously (Husain, 1998).

3. Research Methodology

The aim of this study is to understand and promote the Islamic mutual fund industry in Pakistan. Moreover, it will ease the analysis of Islamic mutual funds in comparison with conventional mutual funds; how they work according to the principles of Islam, and how do they follow the performance of mutual funds. The research focus on equity based mutual funds and the sample consist of 05 Islamic and 05 Conventional mutual funds. Unit holder's distributed returns calculated for the period of 07 years, starting from January 2007 to December 2013. The data for the study has been taken from Mutual

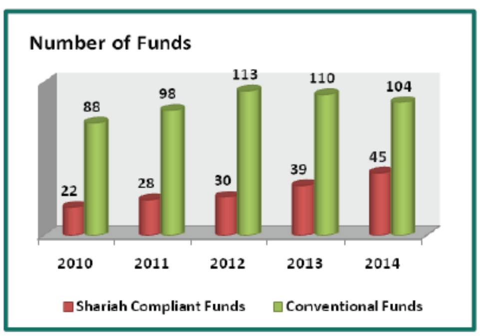
Funds Association of Pakistan (MUFAP[1]) on random basis. The study focus on the application of quantitative technique to review the data, for this purpose confirmatory data analysis technique is used to review and gathered data to make inferences on testing predetermined hypothesis. The performance is compared by the following variables: Net Asset Value (NAV), Portfolio Returns (R_p), Standard Deviation (σ), Expected Returns $E(R_i)$, Volatility (CoV). The returns on the mutual funds are derived using the rate of returns for each fund as calculated below:

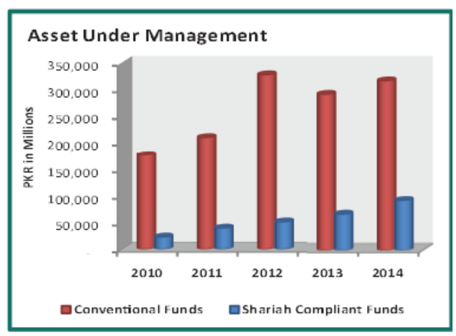
$$R_p = \frac{NAV_t - NAV_{t-1}}{NAV_{t-1}}$$

Where, Rp = Total return of a portfolio; NAVt = Net Asset Value at time t; NAVt_1 = Net Asset Value one period before time t

NAV is market value per share on behalf of fund. This is investors' price to buy/sell fund shares from the fund company. It is obtained by dividing total of all cash and securities in the fund's portfolio, minus liabilities, divided by the number of shares outstanding. NAV calculation is based on the closing market price of a portfolio of securities. Using above performance measure; the performance of randomly selected both type of mutual funds shown in graphical presentation in Table 01.

Figure 01: Number and Amount of Mutual Funds





Source: Mutual Funds Association of Pakistan (MUFAP)

Portfolio returns (calculated using daily NAVs of the of each fund) of Islamic funds are more clustered around mean which show level of consistency in the

[1] MUFAP is a trade organization for Pakistan billions of rupees in the asset management industry. Its members manage money in a variety of investment vehicles, including stocks, bonds, money market instruments, government bonds and bank deposits. Its role is to ensure transparency in the mutual fund industry's high ethical behavior and growth.

performance of the Islamic funds, whereas portfolio returns of the Conventional funds are more volatile and inconsistent comparatively. The total risk on investments is measured using standard deviation which is a measure of the conditions and the investment risks in important statistical variation; variation is a measure of investment risk. This applies not only to individual securities, mutual funds but risks as well. Distinct of the standard deviation, which is an absolute measure of variability, the coefficient of variation is a relative measure of volatility. The coefficient of variation (CoV) is the ratio that the risk associated per unit of average returns, is expressed as follows:

$$CoV = \frac{\sigma_i}{E(R_i)}$$

Where

σ_i = standard deviation (total risk) of asset *i*; and
$E(R_i)$ = average return of asset *i*.

Figure 02: Islamic Mutual Funds

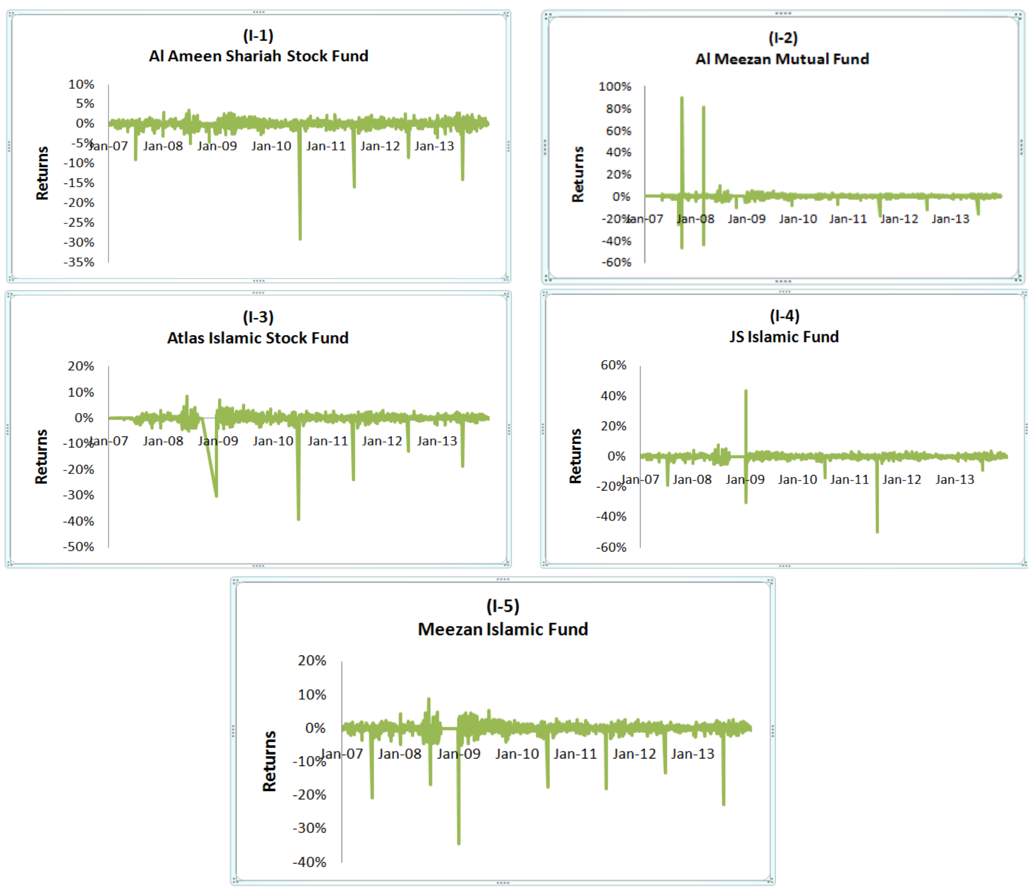
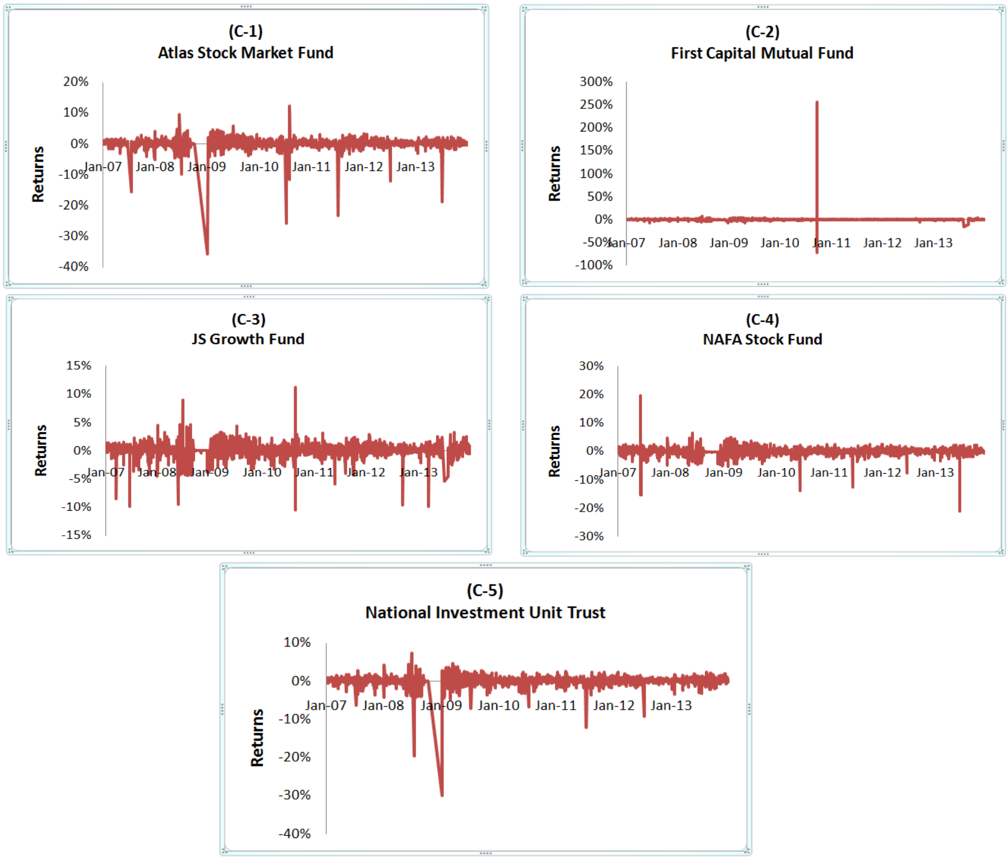


Figure 03: Conventional Mutual Funds



4. Results & Discussion

Analyzing and interpreting the performance of 10 randomly selected equity funds through Confirmatory data analysis technique using graphs and charts. It is clear that overall daily *Mean Return* $E(R_i)$ of Islamic funds shows better performance as compared to conventional funds over the years for which funds are invested. Interpreting *Standard Deviation* (σ_i), measures the dispersion of the data from its means the more data is separated, higher the difference of the norm. Using this risk measure it examined that how much return on the basis of expected returns on the fund deviates from its historical performance. Over the period of 07 years, observations showed mix trend of quantified variability. Out of total 10 mutual funds, 02 Islamic and 03 conventional funds can be considered less risky. More of Islamic funds are volatile having high standard deviation. Critically, we observe more the return more the risk.

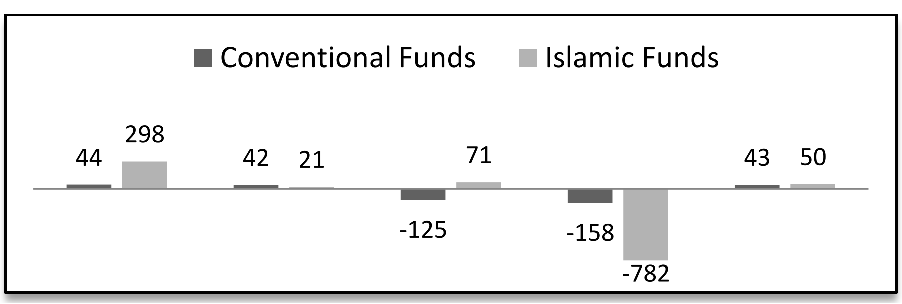
So we can say Islamic funds are performing better as their overall portfolio returns are better yet facing more risk.

Table 01: Mutual Funds Deviation, Return and Variation

Mutual Funds	Standard Deviation SD_i	Expected Return E (R_i)	Coefficient of Variation (CoV)
I-1	0.012	0.0041%	298
I-2	0.013	0.0625%	21
I-3	0.018	0.0254%	71
I-4	0.023	-0.0029%	-782
I-5	0.017	0.0349%	50
C-1	0.017	0.0388%	44
C-2	0.077	0.1866%	42
C-3	0.013	-0.0101%	-125
C-4	0.015	-0.0091%	-158
C-5	0.014	0.0323%	43

To know the dispersement of variables, volatility can be determined using variance coefficient equation (CoV). This measure tells us the degree of variation from one fund to another. A high CoV value reflects inconsistency and the level of dispersion among the samples within the group. Data of mutual funds taken in the study depicts that Islamic funds are less volatile than Conventional funds, as Islamic funds are less dispersed comparatively. Presenting the results through bar charts shows the significance of risk that a fund is assuming in comparison to its return. We can say Islamic funds trends to be more volatile on positive side whereas more of the conventional funds are negatively volatile may be facing some economic crisis. Risk and variability factor also implies that higher the funds tend to move more the volatility they have than other funds. Islamic funds are more volatile but provide better returns to investors.

Figure 04: Mutual Funds Volatility



5. Conclusion & Recommendations

Concerning returns, study strongly reject the null hypothesis in favor of research hypotheses as Islamic funds compared to Conventional funds give superior Returns to the investors. Overall expected returns (using daily portfolio returns) for each of 10 funds taken for the analysis of the Islamic fund is comparatively superior. The results regarding effect of daily NAV on fund's performance accept the alternate hypothesis because the behavior of daily price movement of the sample set has great influence on returns calculated using NAV which clearly depicts their influence on Islamic and Conventional mutual funds. The measure of variability clear indicates that the volatility affects the performance of both funds. Therefore null hypothesis can be rejected depending on results using equation of coefficient of variance, as results are not same across period ranging January 2007 to December 2013. The findings of the study may have important implications and recommendations for the investors and regulators of mutual fund industry. Research has evaluated mutual funds' performance which led to mixed trend. In view of the fact that Islamic funds had introduces 40 years later than conventional funds having limited market exposure make them a bit more volatile. Concerning overall performance Islamic funds performed better than Conventional funds; this provides good justification for the volunteer of Islamic investments vehicles. Whereas results also show some of the Islamic funds underperform, may be these funds are facing the problem of diversification of the portfolio. The need of hour is to mobilize the savings of investors through offering them investment opportunities as per Islamic laws.

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The Role of Awqaf in Modern Economic Development

Dr. Mohamad Hisham Dafterdar
Senior Advisor
International Islamic Institute of Waqf
Malaysia
dafterdar@yahoo.com

Abstract

In recent years, there has been an increasing awareness of the role of awqaf in socio-economic development. The importance of this sector is seen in terms of the huge assets it controls, in its social expenditure, in the number of people it employs, and in its significant contribution to the economy which accounts for as much as ten percent of the GDP of many countries. With such significant economic output and growth in the number of non-profit organizations entrusted with awqaf properties for social programs, the sector is no longer seen as exclusively religious. With a broader business focus, it became clear that awqaf, in an economic sense, is an industry and is being subjected to increased scrutiny by government and regulatory authorities. This paper addresses concept of awqaf with respect to the economic development starting by the giving a historical review of the role of awqaf in the Muslim society, the status of awqaf today, awqaf organizations today and their contribution to the economy. The paper also focuses on issues that are relevant for the integration of awqaf into the mainstream of the Islamic financial industry. It also addresses the matters that are of concern to regulatory authorities and stakeholders.

Keywords: Awqaf, Economic Development, Waqf, Sunnah, Profitability, Small and Medium Enterprises

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1. Introduction

The institution of waqf is a *sunnah* established by the Holy Prophet ﷺ that later became the base on which Islamic socio-economic development model was built. As a feature of the Islamic civilization, the history of awqaf is rich with impressive achievements in the field of social work and human development. Awqaf served the poor in particular and society in general. Awqaf services ranged from education and healthcare to economic development and social welfare. Masjids and shrines (holy places), major hospitals and universities, libraries and museums, animal shelters and sanctuaries were established as waqf. Awqaf also contributed to the protection of the environment and the preservation of religious and cultural heritage.

Despite these achievements, the history of awqaf is rife with turbulent events. Over the years because of number of factors including the legacy of the colonization of Muslim countries, the role of the waqf as an effective tool for socio-economic development was neglected and often forgotten. After independence, many governments considered awqaf as public property and part of the national wealth. They established ministries and directorates as government agencies to manage awqaf as a public sector instrumentality. Thus, awqaf fell into the hands of the state that gave them right of control and managing its administrative expenses from the general budget.

The government control on awqaf did more to stifle the sector than to revive it. In many Muslim countries today, awqaf has not been able to fulfill its purpose as a driver of economic growth. One of the major impediments to its growth is the lack of proper legal environment. While awqaf have generally been overlooked, a few countries did embark on developing this sector and built substantial portfolios of awqaf properties and investments (Dafterdar & Fund, 2007). They recognized the potential of awqaf as an effective economic sector with a social role to combat poverty and enhance welfare.

2. Historical Overview

The institution of waqf played a significant developmental role throughout Islamic history. The concept of endowment of property of permanent nature by a Muslim as an ongoing charity was put forward by the Noble Prophet ﷺ. The practice of waqf was known before the advent of Islam. However, Islam is the first religion to develop a comprehensive regulatory framework that promotes guides, protects and fosters the development of the institution of waqf. Everything that the West developed later on in this field is a copy.

From the earliest days of Islam, awqaf has featured prominently in the social and economic development of Muslim societies. Awqaf was the main provider of many social services that today are being financed by the state such as education, healthcare, infrastructure and national security. Awqaf was also the means of achieving equitable distribution of income and wealth and introducing inter-generational social investments in society. The foundation of waqf reached its zenith during the 16th and 17th century, as many sultans and prominent people created numerous waqf's in the form of masjids, schools, hospitals, shelters and agricultural land (Roded, 1990). It was reported by Khaf (2003) that more than half of the agricultural land of Ottoman Empire was waqf, for providing food and creating employment.

By the end of the 20th century, many Muslim governments had established ministries, directorates that placed awqaf firmly under government control. The control by governments had several negative impacts on the waqf system that led not only less development of new awqaf, but also to the expropriation of large areas of awqaf land. Many awqaf properties were left undeveloped or fell into a state of disrepair and much of the latent wealth of awqaf remains to date largely untapped. The role of awqaf as a welfare mechanism declined to such extent that in many countries it became a burden on the public purse.

The recent economic downturns have drawn attention to the Islamic economic system and its faith-based institutions of zakat and waqf (Raimi et al, 2014). Many Muslim countries embarked on reforming the administration of awqaf by separating the custody (*nazara*) function from awqaf asset management by establishing separate entities to manage awqaf properties. They conceded that the waqf has a separate personality '*thimmah*' and that awqaf funds are not to be commingled with public funds. In 1971 "Egyptian Awqaf Authority" was established in Egypt to take over the management of awqaf properties from the Ministry of Awqaf. In Sudan, the "Federal

Corporation of Awqaf" was established in 1987 and in 1993 "Awqaf Public Foundation" was founded in Kuwait. In Jordan, the Ministry of Awqaf, Islamic Affairs and Holy Places established "Awqaf Properties Investment Corporation". In Malaysia, at the federal level, the Prime Minister's Department in 2004 established the Jabatan Wakaf, Zakat dan Haji department for Awqaf, Zakat and Hajj to coordinate the activities of the states' religious councils in matters relating to awqaf development.

3. The Third Economic Sector

A number of Shariah scholars are of the view that once a property is offered as a waqf, it should remain a waqf forever (Khaf, 1992; Mohammad et al., 2006; Toraman, 2007). This condition of perpetuity of a waqf asset, has led over the years to a considerable accumulation of societal wealth that played an important role in improving the Muslim community. As a reflection of waqf increasing contribution to the economy, awqaf as a non-profit institution has come to be known as the third sector, as distinct from the government sector also known as the first sector, and the private sector sometimes called the second sector. The distinction of this third sector from the other two is based on awqaf's altruistic ethos.

Awqaf organizations are not-for-profit Islamic entities with a diversity of structure and purpose. Awqaf are not part of government although many perform a public service. Awqaf generate economic value although many of the benefits are non-quantifiable. Their operations dovetail into all sectors of the economy and include a wide range of industries including real estate, education, healthcare, social services and recreation. Awqaf play a significant role especially in areas where public services are lacking or insufficient, and where the private sector does not find it profitable to invest. Awqaf are the major force in the national economy with a huge impact on the welfare and lifestyle of the community.

4. Custody and Management of Awqaf

In principle, the *waqif* through a deed determines the objectives of the waqf and its management and succession processes. The waqf manager or trustee (*mutawalli/nazir*) holds the title of the waqf property, exercises legal control and is bound by fiduciary responsibility and moral obligation to protect and administer the waqf for the benefit of the beneficiaries in accordance with the terms of the waqf deed. *Mutawallis* are expected to comply with both the letter and spirit of the waqf condition. The importance of the conditions of the *waqif* is indicated by the often quoted maxim: "The conditions of the *waqif* have the same legal weight as the edicts of the legislator". However, some flexibility is afforded by the different schools of jurisprudence. Abu Hanifah school of thought, for example, allows changing the conditions of the *waqif* if there is an overriding public benefit (*maslaha a'ama),* or when the beneficiaries or the purpose of the waqf come to an end.

The authority of *mutawalli*s to act and make decisions on behalf of the waqf carries an immense responsibility and their duties are wider and more onerous than they were assumed to be. As trustees, *mutawallis* have the primary responsibility for prudent management of assets in their custody. As such, *mutawallis* are expected to have a certain level of business skills and investment knowledge to support their role in monitoring the safety and performance of assets under their control. However, because of the nature of awqaf, its religious message and social application, it seems logical that those who are entrusted with the custody and management of awqaf properties are more religiously conscious and therefore employ their faith when managing. But the operating environment is rapidly changing and as a consequence the role of the *mutawalli*s is also changing. *Mutawalli*s are not only required to act in good faith for the best outcomes for the waqf, but also to be seen acting diligently and ethically, and build trust among those they deal with. Due to the unscrupulous behavior of some *mutawallis* awqaf had lost much of the respect and trust of the community. *Mutawallis* have to overcome this image problem. They need to develop behavioral characteristics and bring awqaf management into line with community expectation in order to change the traditional image as persons who insular, ignorant, skeptical and are as much a business risk as being concerned mainly with disbursing money rather than managing the waqfs.

5. Creating an Enabling Legal Environment

One of the major impediments for the development and growth of awqaf is the lack of constructive legal and regulatory environment (Dafterdar, 2011). Without a good sustainable environment, it is difficult to develop an industry. Awqaf is an economic sector built on voluntary contribution of assets and services. Therefore, a regulatory environment can foster public confidence in the waqf, encourage donors, and promote ethical and proactive behavior of employees, volunteers and *mutawalli*s. The donors usually feel more comfortable with organizations whom operations are governed by clear and convincing evidence of accountability and transparency. Also, financiers are more willing to provide capital for projects that adopt the best practices of corporate governance.

Unlike commercial corporations, the services delivered by awqaf may often be intangible and difficult to measure. The companies have clear delineations about shareholders with all reporting geared towards profits. The position is not so simple in case of awqaf organizations, since many awqaf foundations consider regulatory and compliance issues of corporate governance costly and unnecessary administrative burdens. Unlike commercial corporations, staff in an awqaf foundation is comprised of low-paid professionals or volunteers who have chosen to work in awqaf for less tangible rewards. Their loyalty is more to the cause of the waqf than to the organizational entity. They are mainly concerned with the social aspects and pay little attention to financial efficiency. They claim that by legislating what is effectively an issue of faith, the foundation of awqaf will be undermined.

Strategy formulation in an awqaf foundation could be subject to a unique and complex set of influences. An appropriate strategy will be conditioned not to violate the conditions of the *waqif*, the wishes of the donors and the legal environment. The concerns of non-beneficiary stakeholders should also form part of awqaf foundations' responsibilities and as such *mutawalli*s should have the duty to act in the interest of the entire community. These days no organization is immune from public scrutiny, not even a shelter or an orphanage that does not have a blemish to its name. Therefore the impact of awqaf's performance on the community must be positive and the organization must be seen to be operating in conformity with community standards and expectations.

The major challenge faced by awqaf is ensuring that the massive treasure of awqaf is preserved, developed, continues to grow and contribute to the social and economic development of the *Ummah*. This can be met only by creating an enabling legal environment – one that creates a level playing field for awqaf managers and causes them to be transparent and accountable and enables them to strengthen their operational undertakings in order to fulfill their obligations to donors, beneficiaries and all other stakeholders.

6. The Business Face of Awqaf

Awqaf is rapidly developing as a vital economic sector accounting for a substantial share of the Islamic financial system. Being an awqaf organization does not necessarily mean being small. A considerable number of them are large-scale organizations with cross-border operations, controlling substantial assets, and employing significant number of people. Many such major hospitals, universities, museums, and nongovernmental organizations (NGOs) are waqf's. Awqaf organizations have many similarities to private sector corporations. In some ways, it seems there is very little difference to the corporate world – assets need to be managed, bills to be paid, revenues to be earned and reports to be made.

Awqaf also undertake a wide range of activities such as investment, project management, fund raising and maintenance of key banking relationships. There are, however, differences between an awqaf organization and a commercial enterprise. The companies have shareholders and boards, whereas awqaf organizations have donors and trustees. The most fundamental characteristic of an awqaf organization, compared to a commercial enterprise, is that its primary objective is to provide human services, which primarily impacts on the quality of life. The members of an awqaf organization are trustees and custodians, but not owners. Different assets are held for charitable causes and programs. In addition to the poor and needy, awqaf beneficiaries may include public utilities such as mosques, schools, cemeteries, roads, bridges and water wells.

The corporate structure of an awqaf entity underlines the need for adopting some of the concepts and practices of private sector companies. Recently, more and more awqaf organizations are adopting strategic planning and control systems as a form of operational discipline, competing to secure a market position. Awqaf organize their operations along profit and cost centers. Profit centers are created around revenue producing assets, investment portfolios, and fund raising operations. The cost centers are responsible for delivery of their services to beneficiaries.

Although many fundamental principles of commercial sector strategic planning can be applicable, a thorough appreciation of the features and complexities of the awqaf world can yield much better results (Ahmed, 2004; Dafterdar, 2007). Awqaf governance standards are enshrined in the tenets of Shariah. The Shariah provides the basis for awqaf regulations and the sector shows great concern for ethics based on fundamental values such as honesty, integrity, fairness, trust and commitment. In such areas, awqaf organizations are better placed to regulate their own activities. But awqaf has also to cope with the complexities of the business environment and the increasing demand for more transparency and accountability. Over the decade, there has been a growing realization that although the Shariah serves to provide a general framework for regulating the awqaf sector, it is becoming increasingly important to put forward a comprehensive regulatory framework that is more attuned to market demands.

7. Sustainability and Profitability of Awqaf

The dichotomy between sustainability and profitability is false. There is a misconception among people that waqf organizations don't seek profits. The main difference between awqaf and the private sector is that, in the corporate world, profit is used to create individual wealth. In awqaf, the surplus is used to accomplish a mission. Some stakeholders believe that awqaf foundations should distribute the surplus, if there is any, thus the waqf is seen as a flow-through entity or a conduit of income to beneficiaries but not a receptacle to hold it.

There is also a fundamental difference between awqaf and the commercial world in calculating the consequences of business decisions. In companies, decisions are justified in terms of their short term effect on profitability and shareholder value. Awqaf organizations, as trans-generational carriers, have different purposes for generating revenues. Responsible awqaf organizations take a long term view when investing. Their business decisions are commonly considered good if they achieve long term benefits for their beneficiaries.

However, in order to do so, awqaf organizations have to maintain a balance between their mission statement and their financial pursuits. In other words, they have to seek a balance between being financially efficient and socially effective. Likewise, an awqaf foundation that is highly effective in meeting its operational objectives, but is inefficient financially, may soon find itself unable to continue delivering services as its resources are drained. Achieving financial sustainability is a goal that all awqaf organizations should strive for. Imagine, for example, an orphanage operated by a waqf foundation. If it does not have any surplus funds to meet ongoing operating and future capital costs, the orphanage may be forced to close down. The inability to access any surplus funds from its own reserves may result in the extraction of much needed community service.

8. Awqaf Public and Private Sector Partnerships

Recently, awqaf is getting more attention from both the public and the private sectors. Governments across the Muslim world are becoming more aware of awqaf's potential as an economic driver. This sector is regarded as relatively resilient and recession proof. Awqaf organizations are resistant to market downturns because their assets are unencumbered freehold and they have access to free funds and *pro-bono* services. Their social mandate is to serve the poor, redistribute wealth and apposite the imbalance between social strata. Their business activities create jobs, produce economic output, stabilize prices and stimulate the economy.

Lately, there is also a growing level of interest and interaction between awqaf and the private sector. The private sector is attracted to the investment opportunities that awqaf business activities offer. Awqaf represent a market niche with good returns (Rahman & Dean, 2013). The awqaf sector, albeit not-for-profit, and despite its role as a welfare system, appears to have an edge over other sectors because of the many concessions and privileges granted to awqaf projects. At the same time, commercial companies may consider their involvement with awqaf as a way of discharging their corporate social responsibility. Turning a social project into a cash flow project has a special appeal. The partnerships between awqaf and the private sector are more than 'marriage of convenience[2]' where under such wedlock, it is usually one party stands to benefit more than the other. Awqaf / private

[2] A marriage or joint undertaking arranged for political, economic, or social benefit rather than from personal attachment.

sector partnerships should be win-win arrangements that bridge the worlds of private finance and awqaf social responsibility with benefit to both.

From an awqaf perspective, partnership with the private sector is a means of developing awqaf properties through self-financing of projects. The private sector can assist awqaf to deal with the complexities of the business world. The developer is expected to finance the project, carry the risks and operate the project for an agreed period during which the project's cash flow is the only source for repayment of investment and profit. At the end of the agreed period, the facilities are returned to the waqf trustees to become a permanent source of revenue for the organization. Through these partnerships, awqaf organizations are able to pare away non-core functions so they can focus more keenly on their core mission of social work.

9. Awqaf Support to Small and Medium Enterprises (SMEs)

Awqaf organizations are viewed as centers of community service and assistance. Awqaf can use the small business model to serve their objectives. Evidence from many countries points to the vital role that partnership between awqaf and small business play in community development. Awqaf can be a catalyst for growth of the small and medium-sized enterprise. Awqaf can raise capital and channel funds into the hands of competent management who have business propositions that have the best prospects of succeeding.

Awqaf's support is not a matter of just providing finance or giving loans to existing small businesses. They build in new capabilities and sustainable ventures. Awqaf organizations can be the "business angels[3]" by entering into partnerships with private entrepreneurs with start-up, early stage and developing businesses. Such partnerships can be of enormous benefit to the project, to waqf organization and to the entrepreneur.

9.1 Awqaf's Financial Support

Awqaf's financial support can be in any one of the three main Shariah compliant modes: participatory, concessionary, and project financing

[3] An angel investor or angel funder is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity.

(Hassan, 2010). Within these modes are various contractual forms that conform fully to the principle of profit and loss sharing. Participatory SME financing is the most flexible and most common as it adheres to the Islamic principles of sharing of risks and profits (Hassan, 2010). This is a process wherein awqaf instead of lending money to an enterprise, actually gets involved in the business by sharing as an investor. The more commonly used participatory modes are *musharaka* (equity participation) and *mudaraba* (trust financing). From an SME stance, participatory funding is a good alternative to higher cost borrowing. *Musharaka* participation by awqaf facilitates the transfer of a pre-determined share of the risk in return for a share in the profit. In *Mudarabah*, awqaf as the finance provider (*rabul mal*) promotes business development by extending financing to capable but cash-strapped entrepreneurs, based on awqaf carrying the financial risk and sharing the profit at a pre-agreed percentage.

Concessionary financing is money advanced, mainly in the form of, *qard hasan* (benevolent loan) where only the principal is to be repaid or loans at below-market rates - usually for a small service charge to cover administrative cost. The *cash waqf* is the main source for concessionary SME financing. Concessionary lending can only be considered in very low risk operations and with adequate safeguards to ensure repayment (Hassan, 2010). Project financing modes are usually non-profit sharing as they are based on cost plus a pre-determined mark-up. The financing contracts used include *bai muajjal* (instalment sales), *bai salam* (forward sale contracts), *ijara* (lease financing), *ijara wa iqtina* (hire-purchase), *istisna'a* (construction/manufacturing finance), and *murabaha* (procurement financing). The choice of the mode of financing and the type of contract depends on the nature and needs of the project, the risk profile and expected returns, and on the waqf organization's own investment policy and guidelines.

9.2 Awqaf's Non-Financial Support

Awqaf can also provide a range of non-financial support for the smaller enterprise. The most common in-kind contribution is land. The provision of land for a project serves awqaf developmental objectives of waqf properties and ensures permanent connection of the project to the waqf organization. In such arrangements, the appraised current market value of the land is used to determine awqaf's share in the project. Other in-kind support includes services such as consultancy and training, guidance and monitoring and insurance. Awqaf organizations can also serve as business incubators for new ventures, nurturing and helping them to survive and prosper. Awqaf can provide advice and guidance and help in areas of strategic planning which can be particularly helpful during the early stages of a business development.

10. Policy Implication

With the rise of popular movements like "human rights" and "economic equality", governments in the Muslim world assumed directly responsible for the welfare of their citizens but the role of awqaf was consequently marginalised. However, in spite of government's control, awqaf remained more firmly tied to society than to the state. Government's welfare programs have been unable to serve efficiently all of the social needs, especially the delivery of speedy aid and humanitarian support to vulnerable groups who perceived government's actions with a lot of dissatisfaction and suspicion. On the other hand, faith-based charity institutions such as waqf and zakah enjoy a higher degree of accepted trust, having grass-roots knowledge and much better access to people in need of support than any government agency. Being an act of worship, the practice of waqf as a voluntary act of benevolence gave the awqaf sector public support that contributed to a large degree in shaping its independence.

Given the apparent support for awqaf at the local and national level, the sector needs not to operate at the periphery of socio-economic activity, but should rather be mainstreamed within the state's legal, social and economic systems. The waqf has relations with all areas of social and economic development such as housing, employment, social amenities, investment and commercial activity at zero cost to the state. Therefore, a great deal of thought should go into government policies which impact on the awqaf as it integrated with other sectors of the economy. It is imperative that the impact of any policy of government on awqaf should be positive and not hindering the sector's capacity to grow. The policies which restrict free cash flow could affect awqaf's ability to be of service to its beneficiaries and ultimately to government. Since awqaf's philanthropic and social programs ease the pressure on government's budget, it is fair to assume that the government is in fact an indirect beneficiary of awqaf. It is therefore in government's interest to create the supporting environment that promotes public awareness and motivation to make more waqfs. The public and waqf institutions should be incentivized and encouraged through mechanisms such as *wassiyah* or tax relief.

Awqaf projects exhibit the combined characteristics of being socially responsible, value adding and market oriented. Islamic banks and financing institutions should be encouraged to finance awqaf projects. Both the government and the awqaf institutions should work together to dispel the myth that bankers cannot do awqaf projects and be profitable, and that financing awqaf projects is not just a good idea; it is part of a good business policy.

11. Concluding Remarks

Awqaf institutions are effective organizations for the socio-economic, cultural and religious development of a country. They generally have no direct political involvement, although they exercise considerable influence on the country's political and social life. The development of the awqaf sector is on the national agenda of many Muslim countries as a strategy to boost the economy and complement government's social programs. One of the most critical problem awqaf sector is facing is the lack of awareness among people and government as a viable and effective economic sector. Despite the sector's enormous size and significant contribution to the economy, there is hardly news about its importance in the financial pages of newspapers and magazines. Awqaf remains one of the most misunderstood sectors of the Islamic financial system. Awqaf institutions are perceived to lack the organizational discipline and the entrepreneurial acumen of for-profit corporations. This has resulted in a very slow pace of developing awqaf properties. Hence, this results in many awqaf properties often in prime locations remaining undeveloped or under-utilized.

In many countries the awqaf sector has taken steps towards reinventing itself. In doing so, it has been able to reverse the tendency to write off the sector as being inherently inefficient and has no place for entrepreneurial behavior. Today, awqaf foundations have a broad business focus. They are taking responsibility for a wider range of activities in the commercial, industrial, agricultural and services sectors. The areas where guidance is required include institutional, legal and regulatory disciplines. This entails the skilling and empowerment of *mutawallis* and managers to be effective gate keepers and responsible stewards of the assets under their control, and to enable them to charter the continued growth of their organizations. Legislative reforms and the implementation of a modernized Shariah-based model of corporate governance are needed to remove obstacles that hinder the development of awqaf as a driver of social and economic development in the country.

The renewed interest in awqaf offers an opportunity to learn from the mistakes of the past and to construct a modern regulatory and corporate governance framework. Recognizing that awqaf foundations are non-profit entities holding valuable assets and providing essential social services, government as a beneficiary should create the enabling and supporting environment for the awqaf sector to grow and be more effective. Awqaf's real reform agenda should have succinct, relevant, understandable and implementable standards that optimize efficiency and effectiveness of the sector, and the knowledge, expertise and leadership of awqaf professionals.

However, the sector remains fundamentally constrained and more work needs to be done in order to realize its tangible effect on the economy. With the precise transparency, stability, long term planning and guidance, the prospects for awqaf are great and the more the government assists awqaf, the better the awqaf sector is placed to alleviate the pressure on the public purse and contribute to the country's economic development. Awqaf foundations need a steady stream of revenue in order to fund their operations. They cannot achieve financial sustainability by relying entirely on donations. Many are finding it necessary to expand their revenue base to include steadier forms of income from assets in their custody and from other commercial activities and investments. Thus, their social work is getting more closely entwined with business interests.

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Intellectual Capital and Financial Performance: An Evaluation of Islamic Banks in Pakistan

Muhammad Mahmmod Shah Khan
Director, Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.

Farah Yasser
Assistant Professor, School of Commerce and Accountancy,
University of Management and Technology,
Lahore, Pakistan
farah.yasser@umt.edu.pk

Dr. Talat Hussain
Assistant Professor, Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.

Abstract

This study seeks to investigate the relationship between intellectual capital and bank's performance in Pakistan. A sample of five major Islamic Banks of Pakistan had taken for the period 2009-2014. Multiple regression analysis is used to show the relationship of intellectual capital and the bank's performance. The results suggest that the bank's performance (ROA and ROE) is positively and significantly related to the intellectual capital (Structural capital, Human capital and Capital employed efficiency) of Pakistani Islamic Banks. Human capital efficiency and capital employed efficiency show direct association with the bank's performance whereas structural capital efficiency shows no relationship with the bank's performance in Pakistan. Human capital efficiency is significantly and positively related to ROA, ROE, asset turnover and EPS. Physical capital employed efficiency of Islamic banks is significantly and inversely related to ROA and asset turnover; however it is positively and significantly related to ROE and EPS. Structural efficiency is significantly but inversely related to ROA and earnings per share and shows no association with ROE and EPS.

Keywords: Intellectual Capital, Structural Capital, Human Capital, Capital Employed Efficiency, Islamic Banks

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1. Introduction

This century is a century of knowledge economy, as there is a move from production era to knowledge era and from production labor to knowledge worker, which consequently enhanced the overall productivity in the economy. Due to this conversion, many companies and even countries are planning and repositioning their strategies. The banking industry is one of the knowledge-intensive industries. Intellectual Capital (IC) generally represents the critical resources in the value creation process. IC is considered crucial for the competitiveness of companies regardless of the industry. Johnson and Kaplan (1987) have suggested that IC might be the most important consideration regarding the performance of a company. Bornemann (1999) suggested correlation between intellectual potential and organizational performance. Banking sector is one of the sector that is utilizing intensive Intellectual Capital. With regards to bank performance and intellectual capital, there are some researches that study the role of Intellectual Capital on bank's performance. Brennan and Connell (2000) emphasized that intellectual capital administration is exceptional key for continuing business performance. Better competitive advantage can be accomplished if an organization oversees better intellectual capital (Bornemann, Knapp, Schneider, & Sixl, 1999). Bontis (1998) additionally specified the significance of intellectual capital in worldwide rivalry and new economy. Despite the significance of intellectual capital, money related explanations are not able to portray its esteem in the firms' performance. Firm accounting principles show hesitance in exhibiting intellectual capital part in monetary reporting (Eccles, Herz, Keegan, & Phillips, 2002).

1.1 Intellectual Capital

The meaning of intellectual capital (IC) regularly makes perplexity with intangibles. Mouritsen, Larsen, and Bukh (2001) characterized intellectual capital as a normal for impalpable assets that makes esteem. Because of reason, it is unreasonable or to the least extent liable to present IC in existing budgetary reporting framework, despite the fact that the part of IC in performance of a firm is find out. On the other hand, one of the pioneer of IC, T. A. Stewart (1997, p. xi) characterizes intellectual capital as 'intellectual materials – learning, data, experience, intellectual property – that can be put to use to make riches. It is aggregate intellectual prowess. It's difficult to distinguish harder still to send successfully. In any case, once you discover it and adventure it, you win'. Pulic (2000) contended that esteem creation efficiency of the firms can be measured by both tangibles and intangibles. Sullivan (2000, p. 17) likewise termed Intellectual capital as 'learning that can be traded into benefits'. Specialists order three primary parts of IC in particular: social capital, structural capital and human capital (Mavridis & Kyrmizoglou, 2005; Tayles, Pike, & Sofian, 2007; Holton & Yamkovenko, 2008; Yang & Lin, 2009).

1.1.1 Human Capital

Bornemann et al. (1999) perceived human capital as ability, innovativeness and creativity of representatives. Worker's information, mastery and experience assume an impetus part in boosting the efficiency and adequacy of the association and henceforth esteem expansion. These information and aptitudes are particular qualities of individual representatives like learning limit, experience, instruction and innovation, nature of association, collaboration, dedication, reliability, adaptability and preparing.

1.1.2 Structural Capital

Structural capital comprises of every single other resources that are not human assets. Bornemann et al. (1999) characterized structural capital as the information base and authoritative structure. It incorporates all firm's arrangements, strategies, rules, regulations, data technology, frameworks, duplicate rights and licenses as depicted by Bontis, Keow, and Richardson (2000). They further demonstrated the importance of these variables in choice making.

1.1.3 Relational Capital

Bornemann et al. (1999) characterized social capital as client and supplier relation. It is fundamentally the relationship of managing an account with its outer partners. A conventional business relationship can be substituted by confidence, trust, comprehension, understanding and mindfulness. Despite the fact that Pakistan has a horticultural based economy, producing division additionally assumes an imperative part in financial improvement of

Pakistan. Fabricating area comprises of 21.3% of aggregate Pakistan's GDP in year 2013-2014. Terziovski (2010) contended that assembling area is one of the massive donors in Pakistan economy. Intellectual capital is one of the essential determinants of competitive advantage (Chen et al., 2006). Accordingly, a need emerge to accentuate on information effective industry in Pakistan. Kalim, Lodhi, and Haroon (2002) additionally highlight the significance of learning based economy for the competitive advantage generally Pakistan's available offer of fare in world economy may be lost.

2. Literature Review

2.1 Intellectual capital and the bank's performance - around the world

Joshi et al. (2013) analyzed the relationship between intellectual capital and the money related performance of the budgetary area of the Australia for the time of 2006-2008. Different segment of IC like human capital efficiency, capital utilized efficiency and structural efficiency were utilized to explore. They found that intellectual capital is critical in connection with human efficiency and worth for expansion of Australian banks. Human capital efficiency is higher than capital utilized efficiency and structural efficiency on Australian claimed banks.

Khalique et al. (2013) inspected the relationship of intellectual capital and the authoritative performance of the Islamic managing an account part in Malaysia. Pearson relationship and numerous relapse examinations were connected and found that intellectual capital has positive and noteworthy association with performance of the Islamic keeping money arrangement of Malaysia. Jafari (2013) explored the relationship of intellectual capital and firm's performance of the Iranian organizations. He applied time arrangement information, unit root test and Smooth Transition Regression (STR) model, and found a positive and noteworthy relationship between intellectual capital and the monetary performance of the firm as utilized by Pulic (2000).

Djamil, Razafindrambinina, and Tandeans (2013) led study to demonstrate the relationship between the intellectual capital and the firm's stock profit for the Indonesian firms and found that intellectual capital does not have an impact on present stock return. Be that as it may, intellectual capital includes development in stock return. Darvish et al. (2013) explored Iranian associations to demonstrate the relationship of intellectual capital, learning capacities and the firm's performance. Morgan measurable table and Cronbach's alpha was computed. They found that human capital, social capital and inclining capacities are decidedly huge to hierarchical performance.

Sharabati, Naji Jawad, and Bontis (2010) examined the relationship of intellectual capital and firm's performance of pharmaceutical division in Jordan. They found that intellectual capital and sub parts of intellectual capital have noteworthy effect on the firm's performance. Ahangar (2011) utilized quality added intellectual capital system to demonstrate the relationship between intellectual capital and hierarchical performance of Iranian organizations. The outcomes recommended that the performance of an association's intellectual capital can clarify benefit and efficiency.

2.2 Intellectual capital and the bank's performance - Pakistan

F. A. Khan, Khan, and Khan (2012) considered the relationship of intellectual capital and performance of the banks of Pakistan. They found that intellectual capital has a huge association with the monetary performance. Pearson Correlation system was run to check the relationship of the variables. They found that intellectual capital has a positive and noteworthy impact on the money related performance of the banks. They also argued that the firm's budgetary performance will increment with the increment of the efficiency of the intellectual capital.

Muhammad Khalique, Shaari, Abdul, Isa, and Ageel (2011) explored the relationship of intellectual capital and performance in the electrical and gadgets division of Pakistan. They utilized Pearson relationship and numerous relapses and found that structural capital and client capital have noteworthy and positive association with the performance. On the other hand, human capital has no effect on firm's performance in electrical and hardware area of Pakistan. Latif et al. (2012) studied the relationship between intellectual capital and the firm's performance in view of gainfulness, efficiency and business valuation of Islamic and routine banks of

Pakistan. Connection and different relapse examination were connected and found a positive direct relationship exists between human capital efficiency and all segments of performance i.e. productivity, profitability and business sector valuation. If there should be an occurrence of Islamic managing an account though, a critical relationship exists between capital utilized efficiency and all parts of performance.

M. W. J. Khan and Khalique (2014a) researched the relationship of key arranging, intellectual capital and firm's performance of SMEs in Pakistan. They investigated the components of vital arranging like mission of the organization, vision of the organization, market introduction, and contender's introduction and client introductions ought to be investigated with the performance of the little scale organizations. Further, intellectual capital and its six segments have an effect on firm's performance and have an association with the firm's key performance.

Khalique et al. (2015) directed a study to survey the relationship between intellectual capital and authoritative performance of SMEs in electrical and electronic assembling division of Pakistan. They examined six parts of intellectual capital and found that client capital, structural capital, social capital, innovative capital and profound capital decidedly noteworthy with the performance of SMEs in Pakistan, although human capital demonstrated no association with the firm's performance. Human capital is a standout amongst the most essential parts of intellectual capital, and it is inconsequential for Pakistani SMEs. Then again, Pakistan confronts lack of talented and equipped workers and this is on account of absence of relationship in the middle of SMEs and governments organizations.

3. Theoretical Framework and Research Hypothesis

In this information based economy, intellectual capital generates value that is directly related to its performance (Marr, Gray, & Neely, 2003). Prior studies have found that there is a positive association between intellectual capital efficiency and corporate performance (Ahangar, 2011; Bharathi, 2010; Bontis et al., 2000; M Khalique, 2012; F. A. Khan et al., 2012). Therefore in line with the prior studies, it can be hypothesized that there is a positive relationship between intellectual capital efficiency and the bank's performance.

Hypothesis 1: There is a significant relationship between VAIC and banks's performance

Prior studies also suggested that components of intellectual capital also have association with the bank's performance. Three important components are structural capital efficiency (SCE), human capital efficiency (HCE) and capital employed efficiency (CEE). Researchers found that structural capital efficiency is an important component of intellectual capital and has a positive impact on the firm's performance (Y.-S. Chen et al., 2006; Muhammad Khalique et al., 2015; Muhammad Khalique et al., 2013; Rehman, Rehman, Rehman, & Zahid, 2011). Based on these previous studies, it can be hypothesized that there is a positive relationship between structural capital efficiency and the firm's performance.

Hypothesis 2: There is a significant relationship between SCE and bank's performance

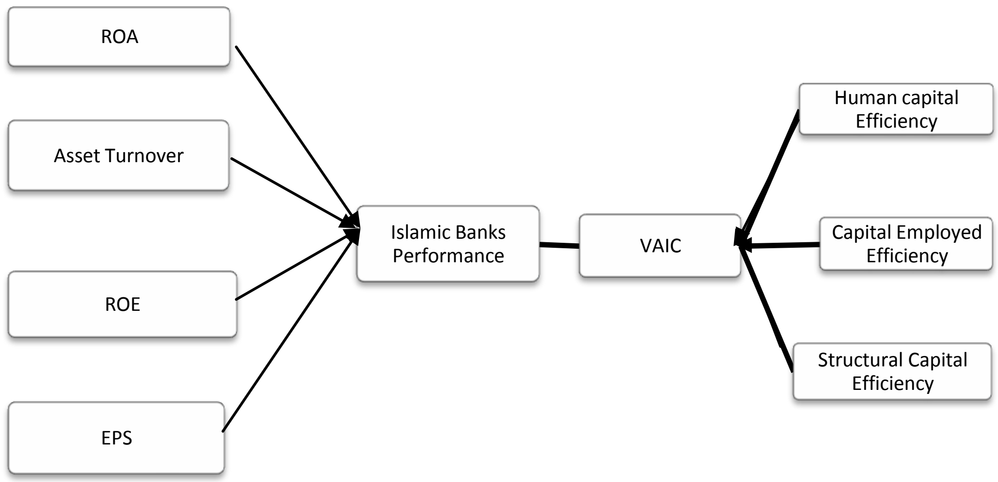
Human capital efficiency is one of the most important components of intellectual capital. Previous studies found a positive and significant relationship of HCE and firms performance (Y.-S. Chen et al., 2006; Darvish et al., 2013; Muhammad Khalique et al., 2013), therefore based on these past studies it can be hypothesized that there is a positive association between human capital efficiency and the banks performance.

Hypothesis 3: There is a significant relationship between HCE and bank's performance

Further, CEE also showed a positive impact on financial performance of the banks(Y.-S. Chen et al., 2006). Hence, the forth hypothesis can be developed that there is a positive relationship between capital employed efficiency and the banks performance.

Hypothesis 4: There is a significant relationship between CEE and bank's performance

Figure 01: Relation between Bank's Performance and Intellectual Capital



4. Research Methodology

4.1 Sampling

The data is collected from annual reports of the banks available on bank's websites for the period of 2007 to 2014. There are five banks namely Meezan Bank, Burj Bank, Dubai Islamic Banks, Albarakah Bank and Bank Islami.

4.2 Research Methodology

Multiple regression analysis used to show the relationship between intellectual capital and bank's performance. Different descriptive statistics tools were also used in this study. Based on the above hypothesis, the following regression model can be developed:

Model 1: $ROA_{it} = \beta_o + \beta_1 VAIC_{it}$
Model 2: $ROA_{it} = \beta_o + \beta_1 SCE_{it} + \beta_2 HCE_{it} + \beta_3 CEE_{it}$

Model 3: $ROE_{it} = \beta_o + \beta_1 VAIC_{it}$
Model 4: $ROE_{it} = \beta_o + \beta_1 SCE_{it} + \beta_2 HCE_{it} + \beta_3 CEE_{it}$

Model 5: $EPS_{it} = \beta_o + \beta_1 VAIC_{it}$

Model 6: $EPS_{it} = \beta_o + \beta_1 SCE_{it} + \beta_2 HCE_{it} + \beta_3 CEE_{it}$

Model 7: $ATO_{it} = \beta_o + \beta_1 VAIC_{it}$
Model 8: $ATO_{it} = \beta_o + \beta_1 SCE_{it} + \beta_2 HCE_{it} + \beta_3 CEE_{it}$

Where,

ROA = Return on Assets
ATO = Asset Turnover
ROE = Return on Equity
EPS = Earnings per Share
VAIC = Value added Intellectual Coefficient
SCE = Structural capital efficiency
HCE = Human Capital efficiency
CEE = Capital employed efficiency

4.3 Variables Definition

Value Added Intellectual Coefficients (VAIC) is a very crucial experience in this knowledge based economy. VAIC have three main components namely, Structural Capital Efficiency (SCE), Human Capital Efficiency (HCE) and Capital Employed Efficiency (CEE) which is used by Pulic (2000). This approach is used by numerous economies like Australia, China, Japan, Iran, Jordan, Malaysia, America, U.K, India and Pakistan by various investigators like (Ahangar, 2011; Banimahd, Mohammad Rezaei, & Mohammadrezaei, 2012; Bharathi, 2010; Bontis, 1998; Bontis et al., 2000; Bornemann et al., 1999; Brennan & Connell, 2000; Bukh, Larsen, & Mouritsen, 2001; F.-C. Chen, Liu, & Kweh, 2014; Y.-S. Chen et al., 2006; Darvish et al., 2013; Djamil et al., 2013; Holton & Yamkovenko, 2008; Jafari, 2013; Joshi et al., 2013; Kalim et al., 2002; Kamukama, Ahiauzu, & Ntayi, 2010, 2011; M Khalique, 2012; Muhammad Khalique et al., 2015; Muhammad Khalique et al., 2013; F. A. Khan et al., 2012; M. W. J. Khan & Khalique, 2014b; Latif et al., 2012; Liao, Chan, & Seng, 2013; Lu, Wang, & Kweh, 2014; Mavridis & Kyrmizoglou, 2005; Mehralian, Rajabzadeh, Sadeh, & Rasekh, 2012; Pulic, 2000; Rehman et al., 2011; T. Stewart & Ruckdeschel, 1998; Tayles et al., 2007; Rehman, Ilyas, & ur Rehman, 2013; Yang & Lin, 2009; Zéghal & Maaloul, 2010). They all used VAIC as a measure to evaluate the efficiency of corporations.

4.3.1 Dependent Variables

- Return on Asset (ROA) = Net Profit before tax / Total Assets
- Asset turnover (ATR) = Total Sales / Total Assets
- Return on Equity (ROE) = Profit before tax / Shareholder's Equity
- Earnings per shares (EPS) = Net Profit / Average outstanding Share

4.3.2 Independent Variables

- Output = Net Premium
- Input = Operating expenses (excluding personal costs)
- Value added = Output-Input
- HC = Personal Cost (i.e. Salaries and Wages)
- CA= Capital Employed (both physical and financial capital)
- SC= VA–HC
- HCE =VA/HC (Human Capital Efficiency)
- CEE= VA/CA (Capital Employed Efficiency)
- SCE=SC/VA (Structured Employed Efficiency)
- VAIC = HCE + CEE + SCE

5. Empirical Results

Table 1 shows the descriptive statistics of the variables. The mean return on assets of the banks is 0.0001 whereas mean asset turnover is .1169. Earnings per share show an average 0.4705 where as mean return on equity is 0.526. Mean human capital efficiency is the highest efficiency in Islamic banks in Pakistan having mean 0.9064, whereas the mean of structural capital efficiency is 0.7057 and physical capital efficiency is 0.1617.

Table 01: Descriptive Statistics

	ROA	ROE	EPS	ATO	VAIC	CEE	HCE	SCE
N	40	40	40	40	40	40	40	40
Mean	.00	.05	.47	.12	1.77	.16	.90	.71
Std. Dev.	.01	.14	1.47	.18	4.08	.22	1.10	4.08
Minimum	-.03	-.14	-2.19	.04	-13.98	-.17	-2.01	-14.05
Maximum	.08	.45	4.56	1.01	15.94	.78	2.61	16.02

Hypothesis 1: There is a significant relationship between VAIC and bank's performance

Table 2 shows the relationship between Intellectual capital and the bank's performance that is ROA, ATR, ROE and EPS respectively and shows that the models 1, 3 and 5 are significant models with F-Stats 13.236, 38.925 and 18.562 respectively. The coefficient in the table 2 shows that bank's performance i.e. ROA (p-value = 0.002), EPS (p-value = 0.000) and ROE (p-value = 0.000) is positively and significantly related to the VAIC. However, Asset turnover ratio (ATR) is not significant to VAIC of Islamic banks in Pakistan.

Table 02: Coefficients - Independent Variable VAIC

Dependent Variable	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	F-Stats	R^2	Durbin Watson
	B	Std. Error	Beta					
ROA	.917	.252	.622	3.638	0.002**	13.236	.387	1.751
EPS	2.019	.469	.668	4.308	0.00*	18.562	.447	1.59
ROE	1.515	.243	.806	6.239	0.00*	38.925	.650	2.183
ATR	-.164	.158	-.183	-0.104	.308	1.075	.034	1.409

At significance level *1%, **5% and ***10%

Hypothesis 2: There is a significant relationship between SCE and bank's performance

Tables 3, 4, 5 and 6 show the relationship between structural capital efficiency and ROA, ATR, ROE and EPS respectively and show that the models 2 and 6 are significant models with F-Stats 50.698 and 40.730. The coefficient tables 3 and 5 show that bank's performance i.e. ROA (p-value = 0.000) and EPS (p-value = 0.000) is significantly related to SCE. However, EPS is inversely related to SCE. Whereas, ROE and ATR has insignificant relationship with SCE.

Table 03: Coefficients - Dependent Variable ROA

Independent Variables	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
CEE	-.001	.001	-.126	-1.076	.292	.406	2.461
HCE	.013	.002	1.480	7.966	0.000*	.163	6.150
SCE	-.002	.000	-.594	-3.983	0.000*	.252	3.962

F-Stats = 50.698, R-Square = .854, Durbin Watson = 0.758

Table 04: Coefficients - Dependent Variable ROE

Independent Variables	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	-4.110	.572		-7.179	.003*		
CEE	.347	.080	.527	4.312	.000*	.462	2.164
HCE	.055	.017	.403	3.264	.002*	.454	2.201
SCE	3.538	.003	.001	.011	.991	.971	1.030

F-Stats = 18.699, R-Square = .718, Durbin Watson = 0.935

Table 05: Coefficients - Dependent Variable EPS

Independent Variables	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)							
CEE	3.209	.885	.477	3.627	0.001*	.740	1.351
HCE	1.813	.414	.731	4.380	0.000*	.460	2.173
SCE	-.931	.265	-.532	-3.506	0.002*	.557	1.796

F-Stats = 40.730, R-Square = .772, Durbin Watson = 0.925

Table 06: Coefficients - Dependent Variable ATO

Independent Variables	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	.111	.039		2.861	.007		
CEE	-.437	.190	-.525	-2.306	.027**	.462	2.164
HCE	.084	.039	.492	2.143	.039**	.454	2.201
SCE	.000	.007	-.005	-.035	.973	.971	1.030

F-Stats = 1.939, R-Square = .139, Durbin Watson = 1.317

At significance level *1%, **5% and ***10%

Hypothesis 3: There is a significant relationship between HCE and bank's performance

Tables 3, 4, 5 and 6 show the relationship between human capital efficiency and ROA, ATR, ROE and EPS respectively and show that the models 2, 4, 6 and 8 are significant models with F-Stats 50.698, 1.939, 18.699 and 40.730 respectively. The coefficient tables 3, 4, 5 and 6 show that bank's performance i.e. ROA (p-value = 0.000), ATR (p-value =0.039), ROE (p-value= 0.002) and EPS (p-value = 0.000) is significantly and positively related to HCE.

Hypothesis 4: There is a significant relationship between CEE and bank's performance

Tables 3, 4, 5 and 6 show the relationship between physical capital employed efficiency and ROA, ATR, ROE and EPS respectively and show that the models 4, 6 and 8 are significant models with F-Stats 1.939, 18.699 and 40.730 respectively. The coefficient tables 4, 5 and 6 show that bank's performance i.e. ROE (p-value= 0.003) and EPS (p-value = 0.000) is significantly and positively associated and ATR (p-value = 0.027) is significantly and inversely related. For an effective regression analysis, normality of variables is very much needed. In this regard two variables are normalized by taken log namely structural capital efficiency and market to book value. Rest of the variables shows the normal distribution and liner relationship. Durbin Watson value is used to check auto correlation among variables. Tables 3, 4, 5 and 6 shows that there is no auto correlation among variables or very less auto correlation ROA (0.758), ATR (1.317), ROE (0.935) and EPS (0.925). There is no multicollenearity among variables as the variable inflation factors (VIF) values are below 10 in all cases.

6. Conclusion

The findings of this study support the hypothesis constructed and showed a positive and significant relationship of the bank's performance and intellectual capital in Islamic banks of Pakistan. Human capital efficiency is significantly and positively related to return of assets, return on equity, asset turn over and earnings per share. Physical capital employed efficiency of Islamic banks is significantly and inversely related to return of assets and asset turnover ratio, however, it is positively and significantly related to return on equity and earnings per share. Structural capital efficiency is significantly but inversely related to return to assets and earnings per share and shows no association with return on equity and earnings per share for Pakistani Islamic Banks. These findings supported with earlier studies and this study has made a significant contribution toward the theory support regarding the intellectual capital and bank's performance.

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The Determinants of the Pakistan Islamic Banking Industry Profitability: Panel Evidence

Farrukh Ijaz
Officer Academics, Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.
farrukh.ijaz@umt.edu.pk

Anum Akmal
Research Assistant, ORIC
University of Management and Technology
Lahore, Pakistan.

Syeda Hameeda Batool Gillani
Research Assistant, Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.

Abstract

The financial sector plays an important role in the economic and fiscal development of a country. A well-built and vigorous banking system is a precondition for the sustainable financial growth of a country. Over the past few years, Islamic banking industry of Pakistan has been facing many problems and challenges to maintain the financial stability. To overcome this issue, it is vital to classify the factors that mostly impact the overall profitability of Islamic banks in Pakistan. Two models were used alternatively for ROA and ROE as dependent variable. A set of internal factors were considered as independent variables including: bank's size, gearing ratio, operational efficiency, asset management and capital adequacy ratio for the time period 2006-2013. The results indicate that different measures of profitability depend upon different bank specific factors. The study found that profitability of Islamic banks depends on the leverage ratio, operating efficiency, asset management and bank size. Further research can be extended to explore the above findings and to include some other internal factors such as general bank charges, doubtful loans or reserves ratios, and external factor such as GDP, exchange rate and CPI as well.

Keywords: Islamic Banks, Profitability, ROA, ROE, Bank Size, CAR

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1. Introduction

The financial sector of a country plays an important role in its economic and fiscal development. An economy can't be stabilizing until it has money-making financial system. The financial sector in Pakistan consists of Development Financial Institutions (DFI's), Commercial Banks (both Conventional and Islamic Banks), Specialized Banks, Microfinance Banks, Investment Banks, Non-banking Finance Companies (NBFC's), House Finance Companies, Leasing Companies, Mutual Funds and Modarabas. The Pakistan financial sector is well dominated by the presence of domestic and foreign commercial banks. The State Bank of Pakistan (SBP) is responsible for supervisory of these Banks and DFI's, whereas all other financial institutions are being monitored and regulated by the Securities and Exchange Commission of Pakistan (State Bank of Pakistan [SBP], 2007).

After 1997, the privatization of public commercial banks, ongoing process of mergers and introduction of Shariah based banking system bring noteworthy transformation to the financial banking system of Pakistan. The prologue of Islamic banking is an evolving field in global economic market and its development also been praise worthy during the last decade. According to one of the published report of SBP, the Islamic banks growth rate in terms of size and structure is 27% per annum (SBP, 2013). Islamic banks not only have the flexibility of providing investment banking services and also have the advantage of becoming creditors of firms. Therefore, a broad assessment of the profitability of Islamic banks is essential for managerial as well as regulatory perspectives.

Profitability measurement is a significant technique to determine the growth, vision and future prospects of organizations, firms and sectors. This gives investors, stakeholders and lenders an accurate picture of that particular sector over a period of time. The term "profitability" primarily indicates performance and operational outcomes that reflects overall financial health of the sector over a specific period of time. Although a complete assessment of Islamic banking system profitability take into account many other different kind of measures but most common performance measurement used in the field of finance is financial ratios.

Therefore, the primary purpose of this study is to address the following research question: ***"Do bank's internal factors impact the profitability of Islamic banks of Pakistan?"***

1.1 Research Objective

- To determine whether bank's internal factors impact the profitability of Pakistani Islamic banks.
- To examine the relationship between Return on Assets and bank's internal factors.
- To examine the relationship between Return on Equity and bank's internal factors.

1.2 Significance of the Study

Our study differs in two main aspects from the earlier researches. First, the study takes in to account only those factors that have major impact on the banking sector profitability. Secondly, all five full fledge functional Islamic banks, excluding currently operational conventional banks Islamic windows, considers for this study, hence, providing more appropriate and recent empirical evidence to investigate the impact of internal factors determining Pakistani Islamic banks profitability.

2. Literature Review

Islamic banks are performing several services and are functional in almost all regions of the world. However, given that the Pakistan is a Muslim country, the Pakistan Islamic banks' market share is still relatively small. Today after ten years, there are only 5 certified Islamic banks are operating in the Pakistan. The network of branches of both conventional banks Islamic window operations and Islamic banks comprise of more than 1,110 branches in over 52 cities of the Pakistan and AJK (SBP, 2013). The concept of Shariah compliance banking not just get acceptance in the Muslims but it also gets flourished in the non-Muslim nations.

This dynamic development of Islamic banking has created significant attention in the financial world. In past, many studies had been conducted to determine the factors influencing the profitability of banking sector. Few researchers considered only the bank's internal variables that are in control of management (Bourke, 1989; Williams et al., 1994; Pang, 1995), whereas others included the external environmental factors in their studies (Short, 1979; Bourke, 1989; Molyneux and Thornton, 1992). However, most studies were done on the banking system of the developed economies, and very few studies examining emerging economies such as Pakistan.

Kim and Kim (1997) measured Korean and US commercial banks profitability and found US banks perform well in terms of profitability and efficiency compared to Korean banks. They take deposit ratio, fixed assets ratio, equity ratio and reserves for loans to total assets as independent variable and examine their impact on the ROA and ROE. They found all these variables have positive significant impact on both dependent variables. A similar study was done by Ahmed and Khababa (1999) to measure the profitability of commercial banks by considering four independent variables - business risk, market concentration, market size the size of the bank. The study concluded that only bank size and market business risk plays a significant role in the bank's better profitability and performance.

Naceur and Goaied (2001) studied relationship of Tunisian banks profitability and performance with banks capitalization, capital productivity, labor productivity and portfolio composition for the period 1986-1999. They found all of them as significant positive determinants of Tunisian banks performance. Abreu and Mendes (2002) had done a study on four EU countries to determine the profitability of banks with internal and external bank specific characteristics. Chirwa (2003) investigated the Malawi commercial banks profitability using data from 1970-1994. He concluded a significant positive association between market concentration and bank's profitability.

Hassan et al. (2003) measured determinants of profitability through the ROA and ROE of 14 Islamic banks of 8 different countries for the period 1993-1998 and found loan ratios and capital have significant impact on the profitability indicators. Goddard et al. (2004) found that bank's size has had a positive impact on the banking sector performance of five European countries over the 1990s. Al-Tamimi (2005) found that bank portfolio and bank size have highly significant relation with ROA and ROE for the National bank's performance.

Athanasoglou et al. (2006) suggested that all bank specific variables have significant affect on bank's profitability. Wum et al. (2007) studied the impact of financial development, bank age, bank's size, non-interest income ratio, capitalization level, size and GDP per capita on the Chinese commercial banks. Jham and Khan (2008) found that banks profitability directly proportionate to the customer's satisfaction level. Siddiqui (2008) compared two fully Islamic licensed banks of Pakistan with scheduled banks. He found that Islamic banks in Pakistan more inclined in the direction of employing projects with long-term financing and found to have enhanced profitability.

Kosmidou et al. (2008) determines the Greek banks performance from 1990-2002 using ROA as dependent variable and found positive influence of size and GDP on bank's profitability. Flamini et al. (2009) in their study of 389 banks as sample from 41 Sub-Saharan African countries found credit risk and banks ROA are associated with larger bank size. According to Rajesh & Sakshi (2009), profitability of banks in India impact greatly by the advance deposits, assets and macroeconomic indicators. Similarly, Deger and Adem (2011) studied the impact of bank specific variables of 10 listed commercial banks on the profitability from 2002-2010 in Istanbul stock exchange and found positive impact of asset's size and non-interest income on the profitability.

Samina (2013) investigate the impact of the bank specific variables and macroeconomic indicators on the profitability of 32 commercial banks during the period of 2006- 2010. She found that there is a significant impact of asset size, leverage ratio, credit risk and interest rate on ROE and ROA. Almazari (2014) investigated the internal factors that affecting profitability of Saudi banks for the period 2005-2011, and found significant positive correlation between ROA and TEA, TIA, LQR variables. Ostadi and Monsef (2014) in their study determine the factors affecting the profitability of commercial banks in Iran. Dependent variable was indicators of profitability, that is, ROE and ROA, and bank deposits, bank size, bank capital, focus on liquidity and banking requirements were independent variables. The results indicate that the effect of bank size and bank concentration on profitability is positive.

3. Research Methodology

The panel data set covers an 8-year period from 2006 to 2013; with a sample size of 5 full fledge Islamic banks of Pakistan. The five selected banks constitute the major and most prominent part in Shariah compliance financing during the period under review (Samina, 2013). The sample data was collected from the secondary sources includes annual reports of the respective Islamic banks.

3.1 Research Hypothesis

Based on the objectives, following research hypothesis is formulated.

- H_1: There is a direct relationship between Islamic bank's profitability and bank internal factors.
- H_{1a}: There is a positive significant relationship between Islamic bank's profitability and bank's size.
- H_{1b}: There is a positive significant relationship between Islamic bank's profitability and gearing ratio.
- H_{1c}: There is a positive significant relationship between Islamic bank's profitability and asset management.
- H_{1d}: There is a positive significant relationship between Islamic bank's profitability and operational efficiency.
- H_{1e}: There is a positive significant direct relationship between Islamic bank's profitability and capital adequacy ratio.

3.2 Research Model

The research model formulated for the study is,

$$Y_{i,t} = \alpha + X1_{i,t}\beta_1 + X2_{i,t}\beta_2 + X3_{i,t}\beta_3 + X4_{i,t}\beta_4 + X5_{i,t}\beta_5 + €_{i,t}$$

Where

$Y_{i,t}$ represents ROA and ROE for bank i at time t
$X1_{i,t}$ represents natural logarithm of total asset for bank i at time t
$X2_{i,t}$ represents gearing ratio for bank i at time t
$X3_{i,t}$ represents asset management for bank i at time t
$X4_{i,t}$ represents operational efficiency for bank i at time t

$X5_{i,t}$ represents capital adequacy ratio for bank i at time t
i represents 1 to 5 banks
t represents time period from 2006-2013
$€_{i,t}$ represents error term

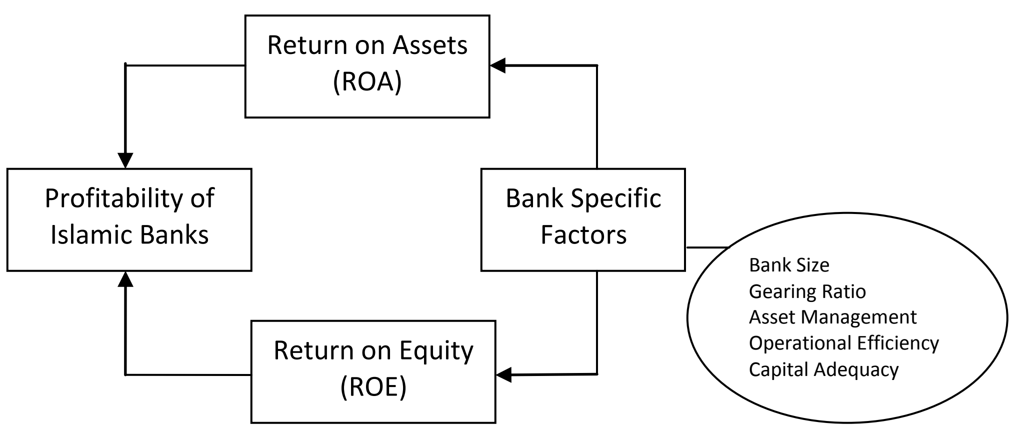
3.3 Research Variables

There are three widely known measures of bank profitability: Return on Assets (ROA), Earnings per Share (EPS) and Return on Equity (ROE). There are divergent views among scholars on the superiority of one indicator over the other as a good measure of bank's profitability. According to Naceur & Goaied (2001), anyone or a combination of the indicators can be used to measure profitability in banks depending on the objective of the user or analyst. ROA and ROE are the largely pertained ratios used to measure financial performance (Naceur & Goaied, 2001; Kosmidou, 2008; Sufian & Habibullah, 2009). Table 1 show the variables used in this study.

Table 01: Research Variables

Variables	Symbol	Proxies
Return on Asset (Y_1)	ROA	Annual net income / Average total assets
Return on Equity (Y_2)	ROE	Annual net income / Average total equity
Banks Size (X_1)	SIZE	Log of total assets
Gearing Ratio (X_2)	GR	Total liabilities / Total equity
Asset Management (X_3)	AM	Operating income / Total assets
Operational Efficiency (X_4)	OE	Operating expenses / Total assets
Capital Adequacy (X_5)	CAR	Tier I + Tier II capital / Risk weighted assets

3.4 Research Framework



4. Data Analysis and Results

4.1 Descriptive Statistics

The Table 2 explains the descriptive statistics of all the dependent and independent variables. The value of mean in column two depicts the average of the given variables taken for the study. The volatility in the data set is measured through the standard deviation. The standard deviation value shows the volatility in the data. A small standard deviation point towards that the data points are inclined to be extremely close to the mean. Skewness and Kurtosis values show the deviation in the variables value. The significance level used for this study is 0.05.

Table 02: Descriptive Statistics

	Mean	Standard Error	Standard Deviation	Kurtosis	Skewness
ROA	0.26	0.11	0.68	2.31	0.39
ROE	4.23	1.31	8.31	1.61	1.50
Bank Size	7.56	0.08	0.48	(0.21)	(0.28)
Gearing Ratio	7.42	0.77	4.84	(1.09)	0.31
Asset Management	(0.00)	0.00	0.02	(0.06)	(0.83)
Operating Efficiency	0.02	0.00	0.01	9.68	2.05
Capital Adequacy	0.25	0.02	0.15	(0.23)	1.04

Table 3 shows the pearson correlation test of all the independent variables used in the study. The test indicates the absence of multi-collinearity problem among all the factors, which means that all the factors taken in to study have no interdependency on each other and free from the issue of correlation of explanatory variables.

Table 03: Correlation Matrix

	X_1	X_2	X_3	X_4	X_5
Bank Size	1.00				
Gearing Ratio	0.54	1.00			
Asset Management	0.43	0.40	1.00		
Operating Efficiency	(0.43)	(0.47)	(0.43)	1.00	
Capital Adequacy	(0.33)	(0.37)	(0.33)	0.21	1.00

4.2 Panel Data Analysis

Table 5 and Table 6 represent the results of panel data analysis of the both models. The total number of observations in the each model is 40. The value of beta for each variable represents the positive or negative impact on the respective dependent variables, if variable is increased by 1 percent. Similarly, t-stat and p-value indicates whether the variables have a significant impact on the ROA and ROE. The R square value specifies the overall strength of the model. The F-statistics value indicates the significance of each model overall, whereas the Durbin-Watson test shows the absence or presence of autocorrelation.

The value of Durbin-Watson test indicates no autocorrelation among the variables as discussed already in the Table 3 and the resulted F-statistic shows both models are statistically significant at 95% level of significance.

4.2.1 Hausman Test

The generally accepted way of choosing between fixed and random effects is running a Hausman test. Thus, in order to choose between fixed or random effect models, we run a Hausman test (Table 4). The null hypothesis for the Hausman test is that the preferred model is random effect and the alternative is the fixed effect (Green, 2008). It basically tests whether the unique errors are correlated with the regressors. To run a Hausman test one need to first estimate the fixed effects model, save the coefficients so that it can compared with the results of the next model, estimate the random effects model, and then do the comparison. Hausman test for both models are given below:

Table 04: Hausman Test Result

Test Summary	Chi-Sq. Stat.	Chi-Sq. d.f.	Prob.
Model A	50.85	5	0.0000
Model B	70.67	5	0.0000

As the p-value of Hausman test for both the models is less than level of significance value, that is, p-value less than 0.05, therefore fixed effect model used.

4.2.2 Model "A" Results

The results of model A is stated in Table 5. The table shows that the debt to equity ratio (gearing ratio) has a negative relationship with the profitability of Islamic banks and the coefficient is statistically significant at the 95% level of confidence. The size of the bank and operational efficiency both have a positive (Ali, Akhtar & Ahmed, 2011) with the ROA. The asset management ratio also depicted a positive (Chirwa, 2003) significant relation with the ROA of Islamic banks and statistically the coefficients are significantly affected by the ROA. Similarly, a positive relationship is found between the capital adequacy ratio (Ali, Akhtar & Ahmed, 2011) with coefficient being statistically significant at 5% level of significance. The R square value explained 81 percent variation in the ROA is explained by the independent variables.

Table 05: Panel Least Square (Model – A)

Dependent Variable: ROA

Variable	Coefficient	Std. Error	t-stat	Prob.
C	-3.490419	1.624791	-2.148226	0.0396
AM	15.63784	4.477847	3.492268	0.0015
BS	0.418866	0.196291	2.133908	0.0409
GR	-0.789405	0.793638	1.998732	0.0512
CA	0.488536	0.548039	0.891426	0.3796
OE	19.92713	5.269388	3.781679	0.0007
R-squared	0.810	Prob(F-statistic)		0.000
F-statistic	16.52	Durbin-Watson stat		1.638

4.2.3 Model "B" Results

The PLS regression results of model B is stated in Table 6.

Table 06: Panel Least Square (Model – B)

Dependent Variable: ROE

Variable	Coefficient	Std. Error	t-stat	Prob.
C	-36.09164	18.10802	-1.993130	0.0551
AM	124.5338	49.90483	2.495426	0.0181
BS	4.635240	2.187627	2.118844	0.0422
GR	6.742218	3.957330	2.089346	0.0376
CA	9.682882	6.107797	1.585331	0.1230
OE	127.0139	58.72643	2.162807	0.0384
R-squared	0.843494	Prob(F-statistic)		0.000000
F-statistic	20.88436	Durbin-Watson stat		1.506669

The resulted value of R-square in Model B explained that 84.34 percent variation in the ROE is explained by the independent variables approximately at the 0.05 level of confidence. The table findings suggest that the gearing ratio (Bashir, 2003; Amor et al., 2006), operational efficiency, bank size and asset management composition (Ali, Akhtar and Ahmed, 2011) have a positive and significant relationship with the Return on Equity at the 5% level of significance, where as capital adequacy found statistically insignificant.

5. Conclusion

The study found that different measures of profitability depend upon different bank specific factors. The study found that ROA, as a measure of profitability of Islamic banks, depends on the leverage ratio, operating efficiency, capital adequacy ratio and CPI. Similarly, ROE found to be significant with the leverage (gearing) ratio, size of banks, operational efficiency and asset management ratio, but have no statistical relation with capital adequacy ratio. The study suggests that while measuring the profitability of Islamic banks, different parameters considers different bank specific characteristics Further research can be extended to explore the above findings and to include some other internal factors such as general bank charges, doubtful loans or reserves ratios, and external factor as well such as inflation, exchange rate, etc.

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Appendix

Islamic Banks in Pakistan

Meezan Bank Limited: Meezan Bank Limited is a publicly listed company incorporated on January 27, 1997 and started operations as an investment bank in August, 1997. Meezan bank has the honor of being the country's first full-fledged Islamic commercial banking license by the SBP. The main shareholders of banks are Noor Financial Investment Company, Pak-Kuwait Investment Company and the Islamic Development Bank of Jeddah.

Burj Bank Limited: Burj Bank Limited, previously Dawood Islamic bank Limited, a unique Islamic bank which offers the service level of an international bank while presenting a diverse portfolio of Islamic products. This bank got license in 2006 and starts operation in 2007. Burj Bank has a rich Middle Eastern background with financial and technical support.

Bank Islami Pakistan Limited: The SBP issued a No Objection Certificate (NOC) in no time on August 19, 2004 and Bank Islami Pakistan Limited, the second full-fledge Islamic Commercial Bank in Pakistan, was incorporated on October 18, 2004 in Pakistan. The bank is the first to receive the Islamic banking license under the Islamic Banking policy of 2003 on March 31, 2005..

Dubai Islamic Bank Pakistan Limited: Dubai Islamic Bank Pakistan Limited (DIBPL) commenced operations in 2006. Since then, DIBPL has undertaken major initiatives to expand its branch network across the country. Dubai Islamic bank launched Pakistan's first Islamic Visa Debit Card and introduced financial products covering Home Financing, Auto Financing, and Depository products.

Al Baraka Bank (Pakistan) Limited: Al Baraka Bank (Pakistan) Limited has the honor of being the pioneer of Islamic banking in Pakistan. The bank is merger of Al Baraka Islamic Bank Bahrain and Emirates Global Islamic Bank Pakistan. Over the years, the bank has successfully developed and maintained its identity as one of the leading providers of a host of banking products and services in strict compliance with Shariah principles.

Empirical Analysis of Liquidity Risk and Operational Risk in Islamic Banks: Case of Pakistan

Ramla Sadiq
Lecture, School of Business and Economics
University of Management and Technology
Lahore, Pakistan.
ramla.sadiq@umt.edu.pk

Afia Mushtaq
Lecturer, School of Business and Economics
University of Management and Technology
Lahore, Pakistan.

Dr. Talat Hussain
Assistant Professor, Institute of Islamic Banking
University of Management and Technology
Lahore, Pakistan.

Abstract

This paper aims to identify the impact of firm specific factors on liquidity risk and operational risk management for Islamic banks. The performance of Islamic financial institutions has been explored at length in regards to their operational differences, product offering and customer patronage. However, firm specific factors related to risk management have not been explored in Pakistan. This paper intends to fill that gap using empirical analysis. This study utilizes full-fledged Islamic banks operating in Pakistan during the period of 2006-2014. The ratio of capital to total assets us used as a proxy for liquidity risk and the ratio of return on assets is used as a proxy for operational risk. Size, NPL ratio, capital adequacy ratio, leverage and asset management have been used as independent variables. Results show that CAR, NPL ratio, leverage and asset management have a significant impact on liquidity risk. Size, car, and asset management have a significant impact on operational risk. The findings of this study can be utilized to create policies for enhanced risk management for Islamic financial institutions.

Keywords: Liquidity Risk, Operational Risk, Islamic Banks, Pakistan

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1. Introduction

Islamic finance is developing at a remarkable pace. Since its inception three decades ago, the number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 today in more than 75 countries. The Islamic finance industry crossed the $2 trillion mark in 2014, attributed to increasing popularity in traditional markets of Malaysia and Middle East and new market movements into non-Muslim majority markets such as Europe, Australia and China. There are more than 1500 organizations in more than 90 countries in the area of Islamic banking, finance, takaful, sukuk, Islamic funds and microfinance. 40% are in non-Muslim nations. The global takaful portion marks new entrants such as Tanzania, Namibia, Morocco and India.

This incredible growth in Islamic finance can be credited to the increasing demand of immigrant and non-immigrant Muslims for financial products and services that are Sharia-compliant. Secondly, the increasing oil-wealth and necessity for investment avenues in the Gulf has increased demand for these products in the region. Also, a third is the competitive nature of Islamic financial systems coexisting with conventional systems and offering of parallel products to attract customers. Yet regardless of this rapid growth, Islamic banking remains a very small part of the worldwide financial system. For it to take off and assume a greater part policymakers must address the most tremendous obstacle regarding regulations. Islamic banking has so far been saved from severe financial crises. All things considered, establishing trust in the industry is essential for the advancement of Islamic finance.

Keeping as a top priority the final objective to assess the Islamic financial institutions, the determining the role of fluctuations in firm specific factors and the risk exposure of this sector of the economy is essential (Helmy, 2012). Deplorable financial conditions can bring about a decrease in the estimation of the bank's portfolio, causing liquidity and operational risk exposures, which in the end cause losses for the banks (Metwally, 1997). In this way, a sound and dependable banking system is a need for accomplishing financial advancement totally through the assembly and utilization of assets. In the setting of an internationally integrated system, developing a suitable risk management system for Islamic banks is a challenging task (Abedifar, Molyneux, & Tarazi, 2013). The purpose of this study is to determine the impact of size, capital adequacy, non-performing loans, leverage and asset management on liquidity risk and operational risk. Capital to total assets is used as a proxy for liquidity risk, while return on total assets is used as a proxy for operational risk.

The significance of studying the impact of various factors on risks of Islamic banks is essential due to its growing market share in a dominantly conventional financial system (Akhtar & Sadaqat, 2011; Illias, 2012). According to the State Bank of Pakistan's Islamic Banking Bulletin (2014), the total assets have reflected a year on year growth of 24.2%, while deposits and net financing and investment have increased by 23.3% and 7.9%, respectively. In terms of financing mix, December 2014 shows a year on year increase in musharaka (including running musharaka), salam and istisna financing while a decrease has been reported in murabaha and mudaraba financing[1]. Each product indicates exposure to different risks. With appropriate identification of determinants of liquidity and operational risks, it will be considerably easier to benchmark risk exposure of Islamic financial institutions against conventional financial institutions.

2. Literature Review and Theoretical Framework

The Islamic finance system found that Islamic banks as a system depend on the principal idea of an interest free and profit and loss sharing products (Al-Jarhi & Iqbal, 2001). In examining the practices of this sector, Hull (2002) found that this sector has used aggressive practices to stay competitive with conventional banks and to reach potential customers. Previous research shows that Shariah based banking and finance is essential for academic and practical purposes because it serves as a growing system worldwide. In addition, patronage of commercial and corporate customers in this system is dependent upon customer satisfaction and service quality, where universally Islamic banking has maintained superior performance than its conventional counterpart (Mounira, 2008; Ahmad, Rehman & Saif, 2010). It is essential to note that this superior performance is attributed to relative exclusivity with clients, recognition of deposit characteristics, investment patterns and adequate risk management (Ismal, 2010). The key capacity of an Islamic

[1] Islamic Banking Bulletin, State Bank of Pakistan. October-December 2014.

banking system is like a trading house which supports exchange and enterprise to induce economic activity and generate profit. Moving past the general financial loan capacity of conventional financial institutions, the Islamic bank is reliably steadier than conventional banking system because of the aforementioned qualities.

Previous research on the tendency of market consolidation found that liquidity management is a recurrent issue and risk transfer methods require significant development (Clementi, 2001). In another study analyzing the performance of Islamic banks, the role of liquidity was studied. Findings suggest that in developing economies the inherent characteristic of profit and loss sharing is considered an attractive choice for banks (Ghannadian and Goswami, 2004). Scale and scope of financial activities play a significant role in exposure of a financial institution to liquidity risk (Gabbi, 2004). This indicates that an organization's risk exposure is largely dependent upon market conditions. In relation to size, this is important because it specifies that large banks gain additional market information and influence changes in monetary policy, whereas small banks are at a clear disadvantage in these two regards.

In addition, securities market plays a crucial role in mitigating liquidity risk for financial institutions (Franck & Krausz, 2007) and short term returns for institutions are dependent on exposure to liquidity risk (Zheng, 2006). Research suggests that flexibility and regulation are key characteristics in determining exposure to liquidity risk in specific geographical markets, indicating that more liquid markets are superior to less liquid markets (Mianelli, 2008; Sawada, 2010).

Emerging economies present relatively lower aggregate liquidity shortage due to presence of international institutions which offset lower liquidity holdings during normal economic times with higher liquidity holdings during crises (Dinger, 2009). Furthermore, Islamic banks are better at managing long term risk. However, short term liquidity risk management of conventional banks was better (Siddiqui, 2008; Akhtar, et. al, 2011). This indicates higher exposure of Islamic financial institutions in the short run, but greater stability than conventional banks in the long term (Abu Hussain & Al-Ajmi, 2012).

In measuring exposure to risk, methods such as liquidity adjusted conditional value at risk and Monte Carlo simulations yield accurate estimations (Zheng & Shen, 2008). Islamic financial institutions can utilize risk hedging techniques, such as trading in Islamic bonds (known as Sukuks) or insurance (Takaful). This allows enhanced investment opportunities to help strengthen risk management practices (Anas & Mounira, 2008).
Exposure to operational risks influences decision making in different ways in financial institutions. Therefore, appropriate management and mitigation is essential (Ray & Cashman, 1999). Findings based on regional studies show that Islamic financial institution of United Arab Emirates and Brunei Darussalam face greater exposure of credit risk and operational risk. This is due to geographic exposure and country factors (Al-Tamimi & Al-Mazrooei, 2007; Hassan, 2009). In the United Kingdom, financial institutions are exposed to higher levels of operational risks when dealing with strategic business units (Blacker, 2000). In determining the impact of operational risk on productivity of banks, Allen and Bali (2007) used risk adjusted return on capital (RAROC). They found that exposure to operational risk plays a significant role in client selection for financial institutions.

Previous research shows that in order to mitigate operational risk, financial institutions need to introduce innovative products which diminish this risk. This indicates that institutional policies regarding asset side and liability side operations require streamlining to improve risk management (Philippas & Siriopoulos, 2009; Ismal, 2010). Research indicates that analysis of operational risk is essential due to the profit and loss sharing structure of Islamic financial institutions. This structure divides certain risks between institution and depositors. However, it also renders the institution liable for risks normally tolerated by equity investors. This heightened exposure necessitates further empirical analysis (Ojo, 2010; El Qorchi, 2005).

3. Research Methodology

The literature review has provided some basis in determining the significant dependent and independent variables. The ratio of total debt to total assets is used as a proxy for credit risk, while the ratios of capital to total assets, and return on assets are used as proxies for liquidity and operational risk, respectively. The determinants will be the same for both types of risks: bank size, NPL ratio, capital adequacy, leverage and asset management.

Bank size indicates risk and is used for its indication of risk exposure and profitability. The existing literature indicates that the larger the bank, the lower the interest rate. The exception to this rule is where large banks have a significant portion of the total market which could skew the competition in the market and allow abnormally high lending rates for larger banks (Flamini, et. al, 2009). Under conditions of normal market competitiveness, it is possible for smaller banks to earn higher revenues as well. Therefore, it is clear that size impact on risk is a function of competitiveness and market power (Heffernan & Fu, 2008). The ratio of bank size is the natural logarithm of total assets. Previous literature finds mixed results on the direction of impact of size on risk.

Non performing loans ratio indicates the likelihood of default on a particular debt. It is measured as the ratio of non-performing loans to total assets and indicates the overall exposure of the institution (Bouwman & Malmendier, 2015).

Capital adequacy is a measure of the bank's capital used to determine the protection of depositors and promote the stability and effectiveness of financial systems around the globe. This standard equity evaluation allows an impartial assessment of the financial health of the institution. This measure represents a proxy for risk and regulatory cost (Flamini et al., 2009) and indicates how well a bank is capitalized.

Leverage is essential because it indicates the source of funding for an institution. Highly leveraged firms face greater risks while firms with low leverage may be forced to forego investment opportunities. The tradeoff and its direct association with risk management make this a critical variable to be studied (Athanasoglou et al., 2005). It is measured as the ratio of debt to equity.

Asset management is essential in this study. It is the ratio of total operating income to total assets. It indicates the operational efficiency of the firms because it gauges the ability to generate revenues from assets. It logically follows that a firm with higher level of efficiency should have lower exposure to risk (Berger, 1995).

3.1 Research Model

$$LR_{it} = \beta_o + \beta_1(SIZE)+\beta_2(NPLRATIO)+\beta_3(CAR)+\beta_4(DE)+\beta_5(AM)+\varepsilon$$

$$OR_{it} = \beta_o + \beta_1(SIZE)+\beta_2(NPLRATIO)+\beta_3(CAR)+\beta_4(DE)+\beta_5(AM)+\varepsilon$$

The models to be applied for this study take into consideration each of the constructs discussed previously. According to the theoretical foundations of previous literature discussed above, the following hypotheses have been formulated for this study:

H1: There is a significant impact of selected determinants on liquidity risk.
H2: There is a significant impact of selected determinants on operational risk.

4. Findings and Analysis

Complete results of empirical tests in Appendix show that both models utilize 40 observations per variable, in 5 independent and 2 dependent variables for 5 full-fledged Islamic banks across 9 years. Due to some missing observations, the total sample contains 600 observations in the panel for dependent and independent variables. Model A (Liquidity Risk) has utilized an OLS regression while Model B (Operational Risk) has a fixed effect specification with regards to both cross section and time.

The Adjuster R square is one of the extremely important indicators of regression analysis. It shows that the type of the data we have used is of nature that 97.73% variation in liquidity risk is explained by the four variables capital adequacy ratio, NPL ratio, leverage and asset management. Similarly, 82.22% of the variation in operational risk is explained by the three variables size, capital adequacy ratio and asset management. The remaining analysis of the results discusses the significance of these variables and their impact on both types of risk.

The results of the Durbin Watson stat show almost no autocorrelation among variables in the liquidity risk model. However, there is a slight presence of positive autocorrelation in the operational risk model. High F statistic for both models indicate acceptance of H_1 and H_2.

An analysis of the model results in Table 1 indicates that size has a negative correlation with liquidity risk, however it is insignificant. It is also negatively correlated with operational risk and found to be significant at approximately 95% confidence level. These findings are in accordance with previous research (Ishaq & Bokpin, 2009; Sawada, 2010). Capital adequacy ratio is significant and positively related to both liquidity risk and operational risk. It is significant at 99% confidence with liquidity risk and 95% confidence level with operational risk. These findings are in accordance with previous research, such as Ojo (2010) and Sensarma and Jayadev (2009) which concluded positive and significant impact of capital adequacy on liquidity and operational risk. NPL Ratio is found to be significant at 95% confidence level for Liquidity risk. However, it is insignificant for operational risk. These findings are in line with the work of Tarawneh (2006). Leverage was also found to be significant at 95% confidence level for liquidity risk; however, it was insignificant for operational risk. These findings are concurrent with Rosly and Zaini (2008). Asset management was found to be significant in both liquidity risk and operational risk at 99% confidence level. This strongly indicates operational efficiency as an essential element of risk management for Islamic financial institutions, as confirmed by previous research (Siddiqui, 2008). The resulting models from this study are:

$$LR_{it} = 0.056 + 0.195(NPLRATIO) + 0.009(CAR) - 0.019(DE) -0.862(AM)$$

$$OR_{it} = 15.655 - 0.982(SIZE) + 0.036(CAR) + 49.113(AM)$$

Table 01: Regression Results

	Model A (Liquidity Risk)		**Model B (Operational Risk)**	
Variable	**Coefficients**	**T-statistic**	**Coefficients**	**T-statistic**
SIZE	-0.002045	-0.288847	-0.982167**	-2.118268
CAR	0.009329***	22.88568	0.036172**	2.136315
NPLRATIO	0.195792**	2.379013	-2.690771	-0.517586
DE	-0.019381**	-2.202270	0.740356	1.504285
AM	-0.862457***	-4.192461	49.11310***	5.564507
C	0.056051	0.440779	15.65651*	1.964104
Adjusted R^2	0.977283		0.822022	
Durbin Watson	1.789147		1.316157	
F-statistic	336.5543		11.59581	
Prob(F-stat)	0.000000		0.000000	

*significant at 10% **significant at 5% ***significant at 1%

5. Conclusion

This study attempted to examine the firm specific factors which can have a considerable impact on risk management practices in Islamic banks. For the study full-fledged Islamic banks operating in Pakistan for the period of 2006-2014 were considered. Utilizing liquidity risk and operational risk as dependent variables, the impact of size, capital adequacy ratio, NPL ratio, leverage and asset management were determined. Model results show that size of bank has a significant and negative relationship with operational risk; on the other hand it has a statistically insignificant impact on liquidity risk. The capital adequacy ratio is positive and statistically significant in both models. The NPL ratio is only significant and positive in liquidity risk model. The asset management has revealed a significant impact on both risks; positive impact on operational risk and negative impact on liquidity risk. The leverage ratio was found to be significant in only the liquidity risk, with a negative relationship. The findings of this study have indicated the most significant indicators to the management of liquidity risk and operational risk for Islamic banks in Pakistan. This can contribute to the policies that are utilized by this sector in risk management and mitigation.

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Appendix

Complete Results of Empirical Tests

Table 02: Liquidity Risk

Dependent Variable: LR
Method: Panel Least Squares
Sample: 2006 2014
Total panel (unbalanced) observations: 40

Variable	Coefficient	Std. Error	t-Statistic	Prob.
SIZE	-0.002045	0.007079	-0.288847	0.7745
CAR	0.009329	0.000408	22.88568	0.0000
NPLRATIO	0.195792	0.082300	2.379013	0.0231
DE	-0.019381	0.008800	-2.202270	0.0345
AM	-0.862457	0.205716	-4.192461	0.0002
C	0.056051	0.127164	0.440779	0.6622

R-squared	0.980195	Mean dependent var	0.179509
Adjusted R-squared	0.977283	S.D. dependent var	0.134036
S.E. of regression	0.020202	Akaike info criterion	-4.828573
Sum squared resid	0.013876	Schwarz criterion	-4.575241
Log likelihood	102.5715	F-statistic	336.5543
Durbin-Watson stat	1.789147	Prob(F-statistic)	0.000000

Table 03: Operational Risk

Dependent Variable: OR
Method: Panel Least Squares
Sample: 2006 2014
Total panel (unbalanced) observations: 40

Variable	Coefficient	Std. Error	t-Statistic	Prob.
SIZE	-0.962167	0.454223	-2.118268	0.0457
CAR	0.036172	0.016932	2.136315	0.0440
NPLRATIO	-2.690771	5.198697	-0.517586	0.6099
DE	0.740356	0.492164	1.504285	0.1467
AM	49.11310	8.826137	5.564507	0.0000
C	15.65651	7.971325	1.964104	0.0623

R-squared	0.899602	Mean dependent var	-0.715348
Adjusted R-squared	0.822022	S.D. dependent var	1.563765
S.E. of regression	0.659711	Akaike info criterion	2.308135
Sum squared resid	9.574824	Schwarz criterion	3.068130
Log likelihood	-28.16269	F-statistic	11.59581
Durbin-Watson stat	1.316157	Prob(F-statistic)	0.000000

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