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Islamic Banking Service Quality and Deposit Withdrawal Risk: Evidence from Brunei Darussalam

Muhamad Abduh[1]

Abstract

This paper aims to evaluate the service quality of Islamic banking and to explore the withdrawal behavior of Islamic banking depositors based on their evaluation towards its service quality in the context of Brunei Darussalam. A total of 180 Islamic banking customers in Brunei Darussalam were involved through a direct survey. Factor analysis is used to uncover the key dimensions of Brunei Islamic banking service quality. Afterwards, the importance and performance analysis (IPA) was employed to evaluate the importance and performance level of Brunei Islamic banking service quality. The five key dimensions of Brunei Islamic banking service quality uncovered here including assurance, reliability, tangibles, empathy, and rates and charges. Interestingly, only three dimensions survive and two are rated high in importance and low in performance. These are empathy and rates and charges. Therefore, bank management is required to give more attention and priority on how to improve the situation.

***Keywords*:** service quality, deposit withdrawal, Islamic banking, Brunei Darussalam.

Introduction

Fifty years ago, Egyptian *Mit-Ghamr* bank was set up as the first Islamic bank in the history of modern economy. The world is now witnessing tremendous growth of the industry especially for the last two decades. The IFSI Stability Report of IFSB (2016) recorded that the global Islamic financial services industry reached an overall total value of USD1.88 trillion as of 2015. The Islamic banking sector continues to be the dominant segment of banking. The report has also mentioned that Islamic banking sector accounts for almost 80% of the global Islamic financial services industry. Assets in full-fledged Islamic banks, subsidiaries and windows amount to approximately USD1.5 trillion as at first half of 2015.

Brunei Darussalam is a pioneering country in Islamic banking. Bank Islam Brunei Darussalam is the only bank in Brunei Darussalam that serves all sectors and segments within the retail banking market. The bank started operations in 1981 as the Island Development Bank. It was converted to a full-fledged Islamic bank in January 1993 and changed its name to Islamic Bank of Brunei. Through a merger with Islamic Development Bank of Brunei, Bank Islam Brunei Darussalam was formed in 2005.

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Despite Islam as the official religion of the country and the religion of majority of the Bruneian, the understanding about riba is still low. Particularly young people, working or studying at universities are unaware of riba. Furthermore, Islamic and conventional banks operating in Brunei are offering similar products and following almost similar regulations set by the monetary authority of Brunei Darussalam. Abduh (2011) claimed that if the banks offer more or less similar products / services and competition intensifies, it is the customer's satisfaction on service quality that influence the performance of an Islamic bank and determine its success. Therefore, it is very important to evaluate and improve the service quality of Islamic banking, particularly in Brunei Darussalam. Since Islamic banking’s foci is on profit and loss sharing, hence, in order to be successful it has to keep deposits stable and in a large volume (Abduh, 2011).

The present research study is an attempt to make two major contributions. Firstly, although Islamic banking industry started more than 20 years ago in Brunei Darussalam, academic studies related to the development of the industry are still scant, especially studies pertaining to the behavior of customers. Therefore, this paper is expected to significantly contribute in the literature of Islamic banking in Brunei. Secondly, unlike its conventional counterpart, Islamic principles forbid Islamic banks to take any interest-based income and thus make deposits an important source of fund for operation and financing. The situation is worsened and creates withdrawal risk when other banks offering higher return on deposits (Abduh, 2014). This paper provides insights on withdrawal behavior of Islamic banking customers in Brunei Darussalam.

2. Literature Review

2.1. Service Quality

Parasuraman, et.al. (1990) mentioned that service quality is an extrinsically perceived attribution based on the customer’s experience about the service. Service quality is not only involved in the final product and service, but also involved in the production and delivery process. Thus employee involvement in process, redesign and commitment is important to produce final products or services.

Due to cultural differences, various dimensions of service quality have been revealed in this area of study. Parasuraman et al. (1985), for instance, identified 11 dimensions of service quality; reliability, responsiveness, competence, access, courtesy, communication, credibility, security, competence, understanding the customer, and tangibles. Berry et al. (1985) and Zeithaml and Bitner (1996) indicated that service quality consists of five dimensions: tangibles, reliability, responsiveness, assurance, and empathy. In the area of Islamic banking, the study done by Abduh (2011) reveals five key dimensions of Indonesian Islamic banking service quality, including reliability, bank-customer relationship, tangibles, shari`ah issues, and rates and charges.

2.2. Customer Satisfaction and Withdrawal Risk

Bolton and Bronkhurst (1995) defined the switching behavior as the decision of a customer to stop purchasing particular services or patronizing the service completely. Abduh (2014) argued that to date, the term switching behavior is used inter- changeably with withdrawal behavior. However, Ahmed (2002) argued that the term withdrawal behavior is more appropriate to be used in Islamic banking framework due to the fact that Islamic banking has two types of customer; clients with account in only Islamic bank and clients with accounts in both Islamic and conventional banks. For religious customers, switching to conventional banks is not an option as it is against their faith, and thus the term withdrawal behavior is better to be used here.

There are not many studies on the relationship between customer satisfaction and withdrawal action in the area of Islamic banking and finance. The study done by Abduh (2011) explained five key dimensions of Islamic banking service quality in Indonesia. These are; reliability, bank-customer relationship, tangibles, shari`ah issues, and rates and charges. Interestingly, shari`ah and tangible are declared as the most influential factors for Indonesians to withdraw their funds from Islamic bank. The study also found that despite their high level of importance, shari`ah and tangible were perceived poor in performance. Therefore, withdrawal risk exists and should be mitigated properly.

In Indonesia, Suryani and Chaniago (2011) conducted a field survey among Islamic bank customers in Surabaya city. The survey aimed to find causes of switching behavior of the Islamic bank customers. By using exploratory factor analysis, the results indicated that there are five factors underlying customer switching behavior in Islamic banking services. These are; bank-customer relationship, Shari'ah compliance issues, service quality, switching cost and risk perceived by the customers. Abduh et.al. (2012) investigated the dimensions of customer satisfaction in Indonesia Islamic banking industry and how those dimensions could affect the customers' switching behavior. Respondents involved were 732 Islamic bank customers from the area of Jakarta. The methods used were factor analysis and logistic regression model. Factor analysis successfully uncovered the five dimensions of Indonesia Islamic banking customer satisfaction. These dimensions are; profitability, bank staff, accessibility, costs, and bank's physical appearance. Afterwards, logistic regression evidenced that four dimensions are significantly affecting Islamic bank customers' intention to switch to other banks. These were; bank staff, bank's physical appearance, accessibility, and costs. Surprisingly, profitability was perceived less important by respondents with regard to bank-switching issues.

Another study was done in Malaysia by Abduh et.al (2013) with the objective to evaluate factors causing switching behavior of Islamic banking customers, in the case of Malaysia, based on the Shari'ah compliance issues. Using logistic regression, the results showed that the customer's religion, type of account, and whether or not s/he have account in conventional bank are the significant factors to influence their switching behavior when they encounter non-Shari'ah compliant products and practices in their Islamic bank.

3. Data Collection and Methods of Analysis

3.1. Data Collection

Primary data used in this study was collected using 300 self-administered questionnaires. The questionnaires were distributed among Islamic bank customers in Bandar Seri Begawan from January 2016 to June 2016. Out of the 300 questionnaires distributed, only 180 questionnaires were dully filled by the respondents. Hence responses of 180 respondents are analyzed in the present study. The collected data consists of fifteen attributes of service quality and demography. Before going to the main analysis, the data will be analyzed using descriptive statistics including cross-tabulation chi-squared independent test, cronbach's alpha reliability test, and principle component analysis based factor analysis. The main method of analysis is importance and performance analysis.

3.2. Importance-Performance Analysis

Importance and performance analysis (IPA) is the visual-empirical analysis used in this study in order to uncover Bruneian assessment on Islamic banking services. Customers' views are plotted onto importance-performance grids which offer the researcher a straightforward, graphic illustration of service dimensions considered to be salient and well-addressed by current installations of Islamic bank services. The points will fall into one of four quadrants labeled "keep up the good work", "possible overkill, "low priority", and "concentrate here" (see figure 1).

The general understanding of "keep up the good work" is when one point is plotted within the area of high importance and high performance. When one point is viewed less important but too good in performance, it will be plotted in "possible overkill" quadrant, while "low priority" quadrant signifies area with low importance and low performance. Finally, items rated high in importance but low in performance in "concentrate here" quadrant implies that overkill has occurred and therefore, improvement must be done for items plotted here.

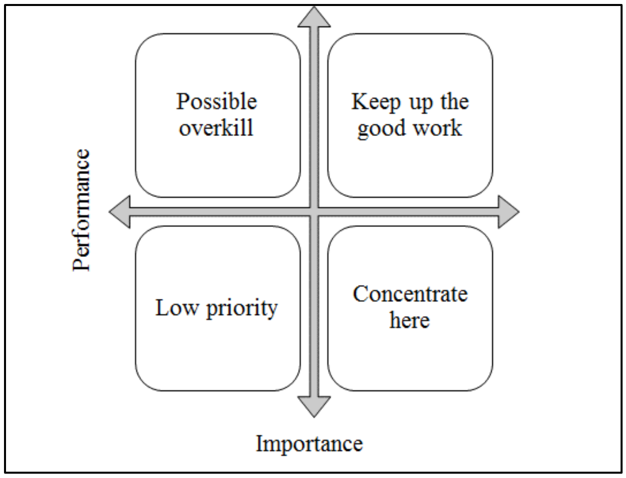

Figure 1. Importance-performance analysis matrix

In order to confirm the level of importance of the 5 dimensions, initially mean importance rating were computed for each dimension. For example, for 'Empathy' dimension, get the mean importance rating from items related to "Empathy". After computing the mean for all dimensions, get the grand mean by dividing the total of mean scores across dimensions by 5. The dimensions whose averages exceeded the grand mean were labeled as 'high importance' and those with lower means compared with the grand mean were labeled as 'low importance' dimension. Similar procedures were applied to determine the higher and the lower performance.

4. Findings and Discussion

4.1. Descriptive Analysis and Chi-Squared Independent Test

Table 1 shows the demography of respondents involved in this study. Based on the statistic displayed, 20 percent of the respondents are male and 80 percent are female. The age group shows that 58.3 percent are below 25 years old and 41.1 percent are between 25 and 35 years old. It can be argued here that the study has chosen the right age group distribution since the age groups of the respondents are representing the future customers of banking industry in Brunei Darussalam.

As many as 87.2 percent are Muslims and 96.1 percent are not married. Another important statistic is the respondents' level of education. It is shown in Table 1 that 107 respondents (59.4%) are postgraduate degree holders and 73 (40.6%) respondents are undergraduate degree holders.

One of the most important findings in this section is that there is evidence of the existence of religious and rational depositors in Brunei Darussalam. Rational depositors are those who deposited money in both Islamic and conventional banks. By diversifying their investment portfolio, they only expect to get better return from it and has never considered Shari'ah issues as the main reason to patronize Islamic bank. Religious depositors, on the other hand consider Shari'ah issues as the main reason to patronize an Islamic bank. According to Table 1, respondents with multiple banking accounts are 107 (59.4%) and the respondent with single banking account are 73 (40.6%).

Table 1

Demography of Respondents

Variable		Frequency	Percentage (%)
Gender	Male	36	20
	Female	144	80
Age	< 25 years	105	58.3
	25 – 35 years	74	41.1
	> 35 years	1	0.6
Religion	Islam	157	87.2
	Others	23	12.8
Marital Status	Married	7	3.9
	Not Married	173	96.1
Level of Education	Undergraduate	73	40.6
	Postgraduate	107	59.4
Having conventional bank account	Yes	107	59.4
	No	73	40.6

Abduh (2014) asserted that three main reasons may lead to withdrawal action; non-Shari'ah compliant issues, uncompetitive rate of return, and rumors about incoming global financial crisis that could affect the performance of their patronized Islamic bank. However, due to the fact that Brunei was not really affected by the global financial crises in 1997-1998 and 2007-2008, this study adopted the first two reasons and changed the third reason to service quality problem.

Table 2
Reasons for Withdrawal Action

Decision	Reason		
	Non-Shari'ah compliant issues	Uncompetitive rate of return	Low service quality
I will withdraw	100 (55.6%)	101 (56.1%)	143 (79.4%)
I will not withdraw	80 (44.4%)	79 (43.9%)	37 (20.6%)
Total	180	180	180

Table 2 shows the statistic of the main reasons for deposit withdrawal by the respondents. With regard to the issue of non-shari'ah compliant products and services, 55.6 percent of the respondents decide to withdraw from Islamic bank while another 44.4% remain loyal. Meanwhile, 56.1 percent of the respondents say that they will withdraw due to uncompetitive rate of return from Islamic bank and 79.4 percent of the respondents indicate to withdraw due to the issue of low service quality of the bank.

Awareness about the status of bank interest from the Islamic point of view has a significant impact towards the decision of many Muslims on their bank selection in Indonesia, Kazakhstan, and Mauritania respectively (Abduh et.al., 2012; Abduh and Omarov, 2013; Mahmoud and Abduh, 2014). As displayed in Table 3, this paper provides deeper analysis by doing chi-squared independent test via cross tabulation between the respondents' main reasons of patronizing Islamic bank and their deposit withdrawal decision.

Table 3 shows that there is enough evidence to say that respondents who put "to avoid bank interest" as their main reason in patronizing Islamic banks will withdraw their funds if they find out that their Islamic bank is involved with non-Shari'ah compliant issues including doubtful products and hidden charges. Similarly, there is statistically significant evidence that respondents who consider Islamic bank as an alternative to gain more profit will withdraw their funds from Islamic bank due to lower rate of return given to them. Interestingly, there is also statistically significant evidence that respondents who consider service quality above any other reasons will not only withdraw their funds from Islamic bank due to low service quality, but also due to non-Shari'ah compliant issues. This is perhaps because they consider Shari'ah issues are not only about the products per se but also services provided by Islamic banks. Table 2 and Table 3 provide evidences that withdrawal risk is one of the most potential risks to be mitigated in the future.

Table 3
Crosstab and Chi-Squared Independent Test between Main Reasons of Patronizing Islamic Bank and Withdrawal Action

		Non-Shari'ah compliant issues		χ^2-Stat	Uncompetitive rate of return		χ^2-Stat	Low service quality		χ^2-Stat
		W	N-W		W	N-W		W	N-W	
To avoid bank interest	Yes	85	50	12**	71	64	2.72	104	31	1.92
	No	15	30		30	15		39	6	
Competitive Rate of Return	Yes	50	43	0.25	64	29	12.6**	77	16	1.32
	No	50	37		37	50		66	21	
Good Service Quality	Yes	54	64	13.3**	68	50	0.32	100	18	5.89*
	No	46	16		33	29		43	19	

Note: "W" means Withdraw, "N-W" means Not Withdraw

4.2. Reliability Test and Factor Analysis

Cronbach's Alpha is used to test the reliability of the research instruments. The acceptable value of cronbach's alpha should be greater than 0.7 (Nunnelly and Bernstein, 1994). The result in Table 4 shows good estimation of the internal consistency reliability as the cronbach's alpha for "Importance" is 0.911 and for "Performance" is 0.875.

Table 4
Reliability Analysis

	Cronbach's Alpha
Importance	0.911
Performance	0.875

Principle component analysis based factor analysis is used to confirm that the observed variables are loaded correctly to their related latent variable. Table 5 confirms that all fifteen variables are loaded correctly to their related latent variable. Some are actually cross-loaded to other latent variables with various loading values. However, due to the highest loading values are still towards its related latent variables, thus the observed variables are said to be categorized correctly to its related latent variables. The findings from factor analysis that is the grouping of observed variables towards their latent variables are supported by previous findings by Zeithaml and Bitner (1996) and Abduh (2011).

Table 5
Factor Analysis

Items	V-1	V-2	V-3	V-4	V-5
The bank provides customers the services as promised	.873				
The bank provides accurate service to customers	.850				
The bank honor their commitments when dealing with customers	.837				
Customers can feel a sense of security during the transaction process		.896			
Staff understand the concept of Islamic contracts		.870			
Staff can provide customers prompt and appropriate services		.845			
Staffs show compassion when handling complaints from customers			.943		
Staffs have enthusiasm to listen the customer needs			.883		
Staffs consider customers' needs first before anything 1else			.857		
Spacious parking area at the bank location				.895	
Easy and fast to reach the bank's ATM location				.841	
The bank's facilities and designs make customers feel				.840	

comfortable	
Bank charges for fund transfer or fund received	.929
Bank charges for transactions using other banks' ATM	.912
Rates of return provided on deposit accounts	.852

Note: Kaiser-Meyer-Olkin Measure of Sampling Adequacy is 0.845
Bartlett's Test of Sphericity is 1795.116 (df = 105; Sig. = 0.000)

4.3. Importance-Performance Analysis

After confirming the latent variables, the observed variables were then grouped accordingly and merged into one variable by calculating the arithmetic average. Furthermore, in order to get the coordinate for all four quadrants, the grand arithmetic mean is calculated from both importance data as well as performance data. The grand arithmetic mean for importance and performance are 4.35 and 3.26 respectively.

Figure 2 shows that assurance and reliability dimensions fall into quadrant one which is "keep up the good work". It applies that the two dimensions have delivered their promises and fulfilled the expectation of the customers at these aspects. Interestingly, none of the service quality dimensions tested fall into quadrant two; possible over kill and area of high importance and high performance. Tangible is rated low in importance as well as in performance which makes it fall into quadrant three, that is low priority.

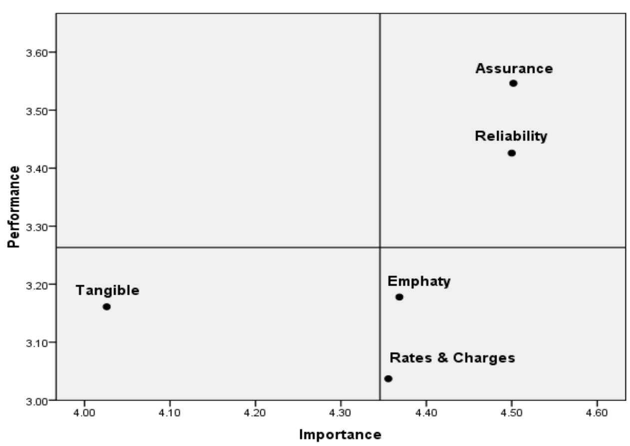

Figure 2. Output of importance-performance analysis

However, empathy as well as rates and charges dimensions were rated high in importance but low in performance and thus fall into quadrant "concentrate here". This implies that overkill has occurred and therefore, improvement must be done by Islamic banks for those dimensions. This situation must be catered wisely and properly due to the fact that there are more rational depositors than religious depositors patronizing Islamic banks in Brunei Darussalam. These depositors can anytime withdraw their fund and switch to conventional banks.

5. Conclusion

This study aimed at investigating the level of Brunei Darussalam Islamic banking service quality from the perspective of customers and its relationship with the customers' deposit withdrawal behavior. Using self-administered questionnaires distributed among Islamic banking customers in Bandar Seri Begawan, five dimensions service quality dimensions were confirmed by confirmatory factor analysis. These dimensions are; assurance, reliability, tangibles, empathy, and rates and charges.

Firstly, this study reveals that deposit withdrawal behavior is statistically and significantly influenced by the intentions of depositors in patronizing Islamic banks.

Secondly, out of the five bank services dimensions studied here, two are rated as high in both importance and performance; assurance and reliability. One is rated low in both importance and performance that is tangibles. Two are rated high in importance and low in performance; empathy and rates and charges.

Henceforth, this study provides findings that may benefit both Islamic banking practitioners and regulators by evaluating the quality of services provided so that they can take necessary actions to mitigate recurring bad situations.

Furthermore, any researchers interested to replicate this study in different geographical locations may get more robust findings by increasing the number of respondents and employing more sophisticated statistical methods such as logistic regression and structural equation model.

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Islamic Social Financing Institutions: A Proposal for Achieving the Poverty Alleviation and other Objectives of Shari'ah

Mehboobul Hassan[1]

Abstract

Majority of Muslims expressed unprecedented interest in Islamic Banking and Financial Institutions (IBFIs) believing that IBFIs, having the holistic approach of social-welfare behind their establishment, will harbor the rights of the poor and underserved people of the society, and will cater needs of poor on priority basis. But, the situation of poverty is so complex and distressing that no major change has come yet; a large segment of society is still unbanked and living under the poverty line. Poverty and underdevelopment are co-related issues are coping with these two issues is the prime objective in policies of all the developing and developed countries. Using a social welfare approach, this study theoretically demonstrates that, in today's challenging environment, where the government is confronting on geo-political conflicts, globalization, disruptions, human deprivation and poverty, the importance of establishment and promotion of Islamic social financing institutions have become more significant than the past. A financing institution with non-commercial approach can effectively address the socio-economic problems of individuals, communities and societies and can contribute to the achieving of poverty alleviation, socio-economic justice and human development better than the formal financing institutions. Islamic social financing institution operate with the holistic spirit of human dignity and socio-economic development approach for ending the hunger, economic inequality, illiteracy, unemployment, poor healthcare, financial inclusion and sustainable economic growth. It also provides the opportunity to the poor to employ their full capacity in economic productive projects and bring a substantial change in the state of economic and social conditions. This paper highlights the socio-economic problems of Pakistan, and proposes for expanding the horizons of Islamic economics by establishing Islamic social financing institutions.

Keywords: human development, Islamic social financing institutions, poverty alleviation, socio-economic welfare, sustainable development.

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Introduction

1.1. Poverty as Global Issue

Societal challenges and violation of human rights are closely interlinked with poverty and poverty is one of the main problems of the developing countries like Pakistan. It is considered the most distressing economic and societal issues since the birth of human civilization. World Bank proposed a charter, called as MDGs 2000, for the elimination of poverty and securing the human rights along-with the increase the living standard of poor people. In this charter, eight goals were specifically set to be achieved till 2015 and to half the poverty level in the world till 2015 was one of these objectives. Poverty has so many forms and multiple dimensions that, despite the immense number of efforts, it is still present in all over the nations, regions and countries in the world. Muhammad Younas, the pioneer of Grameen bank, describes that "poverty exists, when someone is jobless, illiterate, homeless, or in the lack of capital and have insufficient food. Moreover, there are numerous indicators of poverty, consisting of low income, homelessness, unawareness, helplessness, short life expectancy, hunger, less production, unemployment, poor infrastructure, high maternal mortality rate, powerlessness, and poor social services like poor health, education, financial services and lack of clean drinking water.

One of the major causes of the poverty and many other societal problems is lack of access to finance to feed-up the basic needs for livings of the poor. Around two billion (around 38%)of the world population do not have access to the formal financial services; 73% poor of the world population are unbanked, or they do not use banks because of costs, travel distances, and often-burdensome requirements involved in opening account in formal banking and financial institution.

The economists and policy makers, equally, believe that the access to financial services is the pathway towards developing the entrepreneurship opportunities, creating new business possibilities, and eases the curses of poverty by creating new job opportunities and employments, and eliminates the income and economic inequalities at gross root levels of the society. Financial exclusion and poverty are closely interlinked and are considered among the real problems of economy both in the developed and developing worlds. In most of the countries, financial services are available only to a limited number of the population and a large segment of the bankable adults do not have access to the banking and financial institutions for meeting their financial needs.

Bringing the unbanked into the banking network is the key agenda at every forum of the discussion and has taken the attention of scholars, policy makers and economists. United Nation launched comprehensive program for developing the policies for financial inclusion and the year 2005 was celebrated as the International Year of Microcredit. Building an Inclusive Financial Sector was the main agenda to achieve the Millennium Development Goal (MDGs) of the UN. Financial inclusion of individuals, entrepreneurs and small scale firms has become the central focus of many local, federal and international authorities and government policies and debates. Especially, Microcredit and Micro-takaful financing for the small and individually owned businesses are the catchphrase for the policy makers and the authorities. Microcredit and Microfinancing were the focused policy tools emphasized in the Millennium Development Goals (MDG 2000), in which all the member countries of UN agreed to bring the poverty to half the total population by the year 2015. Un Secretary General, Mr. Kofi Anan in the year 2003 announced the year 2005 as the international Year of Microcredit while addressing in the following words: “the stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector. We can and must build inclusive financial sector that help people improve their lives” (Annan, 2005).

Dissemination of Financial Inclusion Indicators was among the top endorsements of the G-20 leaders of Seoul 2010 Summit. World Bank too addressed the financial inclusion issues in its second series of the Global Financial Development Report (WorldBank, Global Financial Development Report, 2013). This increased interest of the academia and the authorities in this socio-economic issue. Finally, financial inclusion is now one of the main themes of policy and regulatory debates and applied researches, and the agenda of government policies and plans.

1.2. Poverty in Islamic World

Islamic world exhibits the poor level of economic and social livings. Short life expectancy, hunger, less production, unemployment, poor infrastructure, high maternal mortality rate, powerlessness, poor health, education, financial services and lack of clean drinking water, financial illiteracy and underdevelopment are some the contributing elements in this picture. More than 2/3 population of the Muslim world consists of the young adults and this large workable human resource can a power generating hub for the Muslim world if employed properly in the economic activities.

In the South Asian Muslim countries, especially in Pakistan and Afghanistan, the picture is much darker. In both of these countries respectively, only 13% and 10% of the adult population has account in scheduled banking and financial institutions. A large part of the population is deprived of employment, the right to work, adequate standard of living, health care and education, triggering poverty; the biggest challenge to socio-economic development. The stark reality is that the number of young population in both of these countries counted as much as 70% or more of the total population. So, in very reserved measurement, more than three quarter of the population have no accounts or other kinds of financial transaction with the banking or financial institutions (WorldBank, 2016). Absolute poverty in its all vicious faces in the developing world especially in the Islamic countries is prevailing, or in other words it can be said that poverty is remained un-addressed issue or it was addressed without an Islamic approach. Financing to poor was not considered as right of the poor, rather it was considered as benevolence from the banks and authorities to the poor. UN claimed in year 2015 review report that global poverty rate fell below 10% as compared to 37.1% in 1990. In other words, approximately out of 2,800 million in 1990, now only 702 million people are living under $1.90 per day. This progress is declared as “best news in the world today” by World bank Group President (WorldBank, Global Financial Development Report , 2015). But the other side of the picture shows a sad depiction too as majority of these 702 million poor are residing in South Asia and Sub-Saharan Africa, undoubtedly majority is Muslim. And in further depiction of this sad picture, we find only 11% of these poor have bank account in a formal banking and financial institution.

To explain the role of financial sector in addressing the poverty and other societal issues, next section explores the importance of financial sector and highlights the complex set of constraints that must be addressed in order to foster the financial market development, align with the Islamic vision of financial sector.

1.3. Significance of Financial Sector

Financial sector plays a significant role in the sustainable economic growth and societal development and the access to well-functioning and efficient financial services can generate positive externalities; it leads to increase the savings, empowering individuals economically and socially, allowing them to better integrate their services and potential into economy and its growth and development.

The significance of a purposefully designed financial system can help the society and the economy in the following ways (Hassan, Access to Finance: Is this a Right of the Poor or Benevolence from the Bank, 2016).

- It implants the savings habits among the peoples; leading to increasing in the savings, investments and thereby spurs the process of economic growth.
- It encourages the saving habits in the households and provides a platform to those who are living constantly under financial duress because of absence of savings, which make them vulnerable folk of the society.
- Financial inclusion creates avenues of formal credits to the unbanked lots of the society who are otherwise dependent on exploitative informal sources of credit for their financial needs.
- In-time provision of adequate and properly designed financial schemes, goods and service, will inculcate entrepreneurship spirit and skill in the households and eventually will increase output and spurs the process of economic growth.

- Financial inclusion has been viewed as a successive strategy for swift and fair provision of government benefits and subsidies to the needy and deserving lots of the society. Transfer of government benefits directly to bank account of the recipient is also considered as a remedy to overcome the leaks in distribution of government benefits and subsidies.

Thus, the core of the whole discussion is that a well-developed and deep-rooted financial sector will reach to those who were unbanked; it will channelize their savings from depositors to the potential entrepreneurs, ease the economic problems of the poor, spurs the socio-economic development and will lead to the growth prosperity of the country. “Financial services for the poor” refers to microfinance and other financial products for the underserved lower-income segment of the population (Imboden, 2005). In a broader sense, it implies to bridge the gap between the unbaked and the already banked segment of the population.

1.4. Constraints to Financial Inclusion

Financial inclusion means bringing the bankable population into banking and financial services network. Financial services in forms of microcredit, microfinance, safe savings, loans and stipends, on one hand is an effective tool to help the poor in building the income and assets stocks, managing risks, and try to come out of poverty, and on the other hand, it is considered as having the powerful implications in promoting economic activities, reducing unemployment by creating new jobs and opportunities for the low-income and most likely poor segments of the society and economic development (Hassan, Access to Finance: Is this a Right of the Poor or Benevolence from the Bank, 2016).

While, despite the fact that real economy of the world is shrinking because of various reasons including the peace and security, financial sector is expanding in terms of assets, profits and financial products and services. However, the sad reality is that these assets are concentrated in few fortunate hands that already are better off in many terms. Financial sectors today are exclusive of the vast majority of the population. Many social, economic, political and geographical factors are held responsible for this high rate of financial exclusion, including; belief, family bindings, religions and personal perceptions. Moreover, reasons are varying from region to region and impact differently on the people while considering age, class, gender, geographic location, family, profession, and race. These reasons deter the potential client of banking sector from understanding and utilizing the range of the banking and financial product and services available to them.

We can classify these constraints causing low rate of financial inclusion into the following categories (Hassan, Constraints in the way towards the Financial Inclusion, 2015).

1.5.Constraints to Financial Inclusion (Demand Side)

Voluntary Reasons	Involuntary Reasons
No Need of Banking	Identity Requirements
Wrong Perception (Banks are for Rich)	Insufficient Incomes
Not Interested in Banking	Complex Banking Terms and Conditions
Religious Belief, and Family Bindings	Fear of Discrimination or Unfair Treatment
No Experience of Bank Dealings	Lack of Information about the Market
Lack of Confidence about the Project	Fear of Coming under Taxation network
Lack of Trust on Banking Institutions	Complex Processing
Miss-understanding About Banking Schemes	Limited Banking Services/Products/Schemes
Social and Cultural Believes	Collateral Problems
Geographical Reasons	Transactions Costs
Dominance of In-Formal Sector	Physical Access to bank

1.6.Constraints to Financial Inclusion (Supply Side)

Internal Factors	External Factors	
Owners Priorities	Socio-economic System	Non-Banking Clients
Banking Policies	Religious Belief	Limited Interaction
Priorities of Management	Political System	Limited Outreach
High Risk	Fear of Nationalization	Illiteracy in the Society
Low Profitability	Regulations Taxation	Competitors
Market Information	Feasibility of the Project	Geographical Reasons
Failure to understand the customer Needs	Lack of Trust between the Banking Clients	Complex Judiciary and Legal Procedure
Depositors/Investors Influence	Lack of Infrastructure	Dominance of Informal Sector

2. Financial Sector in Islamic Perspective

Islamic Banking and Financial Institutions were established during the last quarter of 20th century as a result of the emergence of Islamic moral economics; started as an emergent movement in the 1960s to develop an economic system to incorporate the Islamic values of social justice, reciprocity and the material wellbeing of all. Since then Islamic banking and financial institutions demonstrated exceptional and unprecedented performance in growth in assets and investments and have transformed the base financial base of the Muslim societies. Islamic banking and financial institutions took shape to cater the needs of those who were reluctant to use the conventional banking system. Having this holistic features and high expectations from the Muslims, Islamic banks have to operate with a holistic spirit and human oriented approach in entirely different paradigm from the conventional banking. Islamic banking and financial institution are expected to work for expanding their range, products and service accessible to a large segment of the society especially to the poor and financially vulnerable lots of the Muslims. One of the expected practices of IBFI was to open their doors for extending financial services to those segments of the Muslim societies who, because of any reason, are out of the banking network. Moreover, IBFI were believed to work to achieve the economic objectives of Islamic Shari'ah (Maqasid-ul Shari'ah), i.e. equal and balanced economic growth, shared prosperity, poverty elimination and economic well-being of the society.

There is no deny in accepting this reality that IBFIs showed a tremendous growth over the past two decades, especially after the great financial depression, in terms of efficiency but the stark reality is that a large segment of the population is still without banking facilities, which means that IBFIs had very little impact on society in term of effectiveness. We see there are massive publications and advertisements from the IBFI on their performance about the increase in assets/deposits, financial portfolios and other operational aspects, but fruit of this growth is limited to few and these assets are concentrated in hands of few. IBFIs are excessively focused on efficiency and profitability at the expense of effectiveness, equity and well-being of individuals and could not achieve the goals of their foundation.

One of the logical reasons of this poor achievement can be attributed to the failure of Islamic banking and financial institution in implying a paradigm shift in recognition of the poor people as beneficiaries to the clients and their excessive inclination towards achieving the efficient performance and profit orientation, while ignoring their founding objectives. IBFI are held responsible to operate as power houses for the sustainable socio-economic development, and have to recognize the need of the masses and address the financial demands and requirements with an inclusive approach. Financing to those who are neglected or ignored in the conventional banking and financing institutions is considered an obligation on the Islamic banking and financial institutions on the basis of their founding. Microfinance to these destitute and needy is not an exercise of charity or given as an act of alms, it is their right as Allah SWT has mentioned in the Quran that the right of needy and destitute is put in the wealthy and well-off. And if Islamic banking and financial institutions properly sanction to these ignored and financially excluded, they will became mature entrepreneur and this attitude of Islamic banking and financial institutions will attract other banking and financial institutions too to enter this market. Meanwhile, the objectives of contributing to equitable growth, shared prosperity and poverty reduction will be achieved countrywide. Over time, the role the Islamic banking and financial institutions towards growth and development of the society will also increase exponentially and the perception towards Islamic banking and finance will change correspondingly.

Access to financial services means an opportunity for the meeting the current financial needs and plan for the future in form of investments in education, healthcare and a cushion in time of crises. The poor will feel secure against the economic shocks that would lower their consumption or reduce their savings, and will able to credit acquisition and able to earn additional incomes which will lead to more consumption, spending into capital goods, health, education and skills-development and productivity. This will lead to household well-being and increase in the quality of human capital and productivity in longer run (Hassan, Constraints in the way towards the Financial Inclusion, 2015).

In Islamic perspective, a financial system can be said inclusive if it demonstrates the following features (Hassan, Islamic Perspective about Financial Sector, 2016):

a) Time-based Provision of Shari'ah compliant products: A full access of households, including entrepreneur, to a full variety of Shari'ah compliant products such as credit for capital expenditures, financing for short-and-long, small savings-based-investment schemes, pension collections, domestic and international remittances, financing for seasonal and periodical projects, insurance and protections in case of the failure of the projects and or against the destruction of the capital goods and investments; and
b) Cost Efficient: A low cost provision (service on lower than the regular cost) of the banking and financial services. It includes the services charges, consultancy, and survey and feasibility fee.

By ensuring both of the above features as an integral part into the policies and plans of the Islamic financial institutions, the financial service will reach to the vast segments of Muslim population and the level of financial deepening in the society will increase significantly along-with the achievements of the optimal employment rate, skill development and poverty elimination.

The complexity of the challenges is such that without insertion of socio-economic development and ethical approach into the policies of the financial institution, the objectives of Shari'ah cannot be achieved.

3. Islamic Social Financing Institutions: A Proposal

The low rate of a large percentage of the workable adult population in financial transactions is serious concern from economic and well as social perspective. It is the need of the time to address this issue on priority basis and develop and implement a targeted and objective oriented policy, both at governmental and banking institutional levels, to bring unbanked people into banking network with an Islamic perspective. While the potential of IBFIs for developmental initiatives is huge the actual outcomes of benefits from existing IBFIs as also the mobilization of new IBFIs is far below its potential. This gap can be bridged only through determined efforts to prioritize the major challenges to the creation, growth and sustainability of IBFIs and find solutions thereto.

The need is to inculcate the sense of serve the social obligations at the banking and financial institution side which enable the workable unbanked adult people to have access to financial instruments including savings, capital accumulation, credit and running financing for their daily operations of family life and businesses. It will inspire families concerned for savings and investments and, simultaneously, will force economies to plan and design a financial system to incorporate the needs and demand of these unbanked people on priority. A financial system, where the Islamic banks do not operate purely for commercial interest, rather they operate as Islamic Social Financing Institutions with an approach to bring the neglected segments of the society into the banking network and work hand to hand with their client for achieving the poverty alleviation and other objective of Shari'ah (Hassan, Searching for Customers' Perceptions and Behaviours towards Islamic & Conventional Banking in Pakistan, 2010Vol. Vol. 14, No. 1).

This strategy will result substantially positive and will accomplish the following:

3.1. Increase in the Demand of Banking and Financial Institutions

A positive image and good will of financial institution will be developed among the people and a greater sense about the importance financial institution will be realized by those who are still reluctant to use banking and financial institutions for their financial purposes. This will lead to a greater demand and functioning of the financial institutions in the society. The greater demand eventually will inspire the other stakeholders to enter in this market resulting a wider outreach of the banking and financial institutions.

3.1.1. Product Development of Banking Operation. To bring a larger share of the population into banking network, a wide variety of banking and financial services, will be an essential requirement. This approach will inspire the research and product development division of the bank to find the financial solution to the problems of the potential client. Eventually it will expand the range of activities and increase the coordination between banking departments in terms of developing and structuring the products and services to offer.

3.1.2. Deepening the Banking Business. By incorporating this approach into banking practices wide outreach of the banking and financial intermediation can achieve. Moreover, and a large-scale mobilization of small savings into financings can also be possible. Branch expansion program and direct lending will enhance the output and economic performance of the small scale firms.

3.1.3. Realization of Ethical and Social Responsibility. From social responsibility point of the business organizations, achieving the wider objectives of balanced growth and sharing profits, just income, equal distribution of income from a wider bottom line will be add significant value to the cause of Islamic economics and the objectives of the Maqasid-al-Shari'ah.

3.1.4. Higher level of integration between banking sector and the clients. Developing a wider range of the products for a targeted group of people will bring banking institution closer to those targeted people which will increase the integration level of financial sector and the workforce in the economy. Continues financing to poor, along-with the technical support and supervisory services will increase the frequency of banking use to the poor. This will inspire them for business initiatives and will enable them to take the risk with confidence.

3.1.5. Engage the wide range of professional and expertise. Financial inclusion of the poor requires a sincere cooperation and working of the wider range of professional and experts to solicit their expertise and practices for structuring a constructive financial system to address this global policy and application concern.

3.1.6. Increased integration of different authorities. Financial inclusion of the socio-economically marginalized will require an increased integration for the provision of supporting physical ad informational infrastructure (Buildings, roads, the regulations for accounting, disclosure, transparency, and distribution).

A series of steps at banking and authority levels are required to bring the unbaked people into banking network. In the developing economic environment of Islamic world that necessitates access to financial services; effective inclusion requires substantial reforms in the approach of the bankers, internal policies of the banking and financial institutions, targeted allocation of resources from the banks, modified banking models and operations, and measuring the banking operations on the basis of effectiveness instead of efficiency. In the following passage we discuss these attempts in details. Meanwhile, it must be bear in mind that lack of any of these factors will impede the financial access of the poor to IBFIs.

4. Operational Strategy to increase the Financial Inclusion Level

4.1.Financial Inclusion of Individuals

4.1.1. Financial Literacy. Increase in financial literacy through institutional and social media sources can eliminate the misunderstanding level about the banking institution from the society and increase the understanding level and realization of the significance and importance of the baking institution in the society. Especially, the financial literacy to the unbanked people educating them that borrowing and lending money is not disliked in religion (rather Prophet SAW frequently borrowed food and other stuff from his Muslim companions and non-Muslims neighbors). Increasing the literacy about the credit and the role of baking institution can be leading to a higher level of financial inclusion. More and more unbanked people will be encouraged towards utilizing the range of banking products and services.

4.1.2. Changing in the Perception about Banks (Banks are for Rich only). Educating the unbanked people that banks work as quasi-public goods for the poor, and are not limited to the rich only. Utilizing banking institution and availing the banking products and services is the right of every one and it is not benevolence to poor. This attempt can enhance the financial inclusion, regardless of whether IBFI are present in their surrounding or not.

4.1.3. Making the Banking Process Easier. Many recent studies show that one of the main reasons for unbanked is the complex process for availing the banking services. Many customers believe that banking process is complex and require many identification, attestation, guarantees, and references, for opening a bank account, and demand further requirements for remittances and loan applications. While in informal sector there are no such requirements. To address this one of the main problems of unbanked, the banking processes needs a revision and has to make as easier as possible to attract new clients and to boost the banking activities/transaction level of the existing clients.

4.1.4. Protecting the Client (Voluntarily Bearing the Maximum Risk-weight). To encourage the customers to take initiative for risky projects and business ventures, banking institution can sanction the financial sums to on the basis of Musharkah mode of Islamic banking with full coverage of risk at banks expense. This will significantly develop the confidence level of the customer and their willingness to take business initiatives.

4.1.5. Protecting the Clients (IBFIS as Guaranteeing the Assets of Clients). As we discussed, many potential bankable individuals are voluntarily abiding the bank dealing because of the fear of losing their owned assets in case of the failure of their proposed business project or business venture goes unsuccessful. In such cases, IBFI can assure the guarantee that the assets will remain under the ownership the clients.

4.1.6. Provision of an Income Generating Assets besides the Principle Financing/Credit. IBFI can give a second/side income generating asset in form of cattle, machinery or creating a job for the family of the client, besides financing to his principal project, so that he may earn some additional income apart from his principal. This practice will help in increasing the earnings of the client, and he will feel happy with the bank and can focus more efforts on the project; the risk of business failure will decrease that will eventually assure the safe return of the finance of the bank, and bring the IBFI close to their clients at personal and family level and will develop a mutual and pleasant relationship.

4.1.7. IBFI as Incubator of Entrepreneurship. For incubating the entrepreneurship skills, IBFIs can sanction financial sums the targeted potential individual with no service or administrative charges. This long-run investment for developing the most important factor of production in the form of human resource is essential for initiating the economic activities in the society.

4.1.8. Investments in Infrastructure Provision. Supporting elements such as infrastructure are essential for the success and growth of a business project and or an industry. IBFI infrastructure can support the existing business project and or an industry by providing a supporting infrastructure to that business project or industry.

4.1.9. Granting Non-recoverable Loans (Qard-al-Hassan). IBFI can greatly help towards the poverty elimination and financial inclusion by providing financial services for the poor of the poorest (who have high likelihood for growing out of poverty or those poor who are on the borderline poverty whom if not assisted have a high likelihood of falling into poverty). This practice is expected on the holistic foundation of IBFI, i.e. to contribute for the socio-economic development of the neglected ones of the society.

4.1.10. IBFI as Future-oriented, Socio-economic Development Institutions. IBFI by applying the holistic approach of Islamic Shari'ah to achieve the greater objective of sharing development, equitable distribution of income, mutual prosperity, increase in education and health of the people, sustainable development, and equally keeping the strategy for, long-run success, can sanction financial service through a special Islamic socio-economic provisions to those who are most like to extreme poor and unable to return the capital amount granted to them. This changed institutional position can be for the provision of shelter, means of income earning, health care, earning education and training, and to initiate a vending shop or kiosk. This socio-economic development based practice will enable these extreme poor to come out of the poverty trap and will surely become part of the banking sector in future. This practice will lead achieve the greater objectives of Shari'ah such as elimination of poverty, sharing development, equitable distribution of income, mutual prosperity, increase in education and health of the people.

4.1.11. IBFI as Micro-financing Institutions. Microcredit and Micro financing institutions have long history of their existence than the IBFI, and their role in economic growth and development is exhibited in many countries. Generating a small sum of money as loan or credit for a specific economic and social purpose to a targeted group of people has shown a significant impact on the economic and social living standard of individuals. Microcredit can be of tremendous potential for financial inclusion in the many parts of the world. IBFI can increase their outreach to a large number of population my incorporating this financing and credit segment into their operation which will eventually increase the financial inclusion level.

4.2. Financial Inclusion of Business Firms

4.2.1. Proportionately higher risk-weight on the IBFIs side. For bringing the business firms into banking net-work, IBFI can voluntarily cover more riskweightage if the borrowing firms have small capacity of collateral and asset basis. This will encourage the borrowing firm to increase the production and the economic activities in the economy. On the other hand, the accountholders/investor of IBFI will eventually bear more risk on their investments, so they will more cautious about the operation of the invested firm which will lead to an increased level of information sharing among all the stake holders. In summing up, the sharing of information and transparency in business operations will lead to higher trust level among the partners and success rate of the projects.

4.2.2. Provision of additional services. From Supply side, the IBFI, will likely be more desiring of the success of the project and will be motivated to extend technical assistance and professional advisory and if needed provide the market forecast too to its clients. This will lead to a provision of wider range of services apart from mere financing which will increase the positive linkage and integration between financial sector and the real sector in the economy. IBFI's provision of the technical support advisory and supervisory services will increase the frequency of banking and client interaction, eventually a more transparent and trusted relationship and business conducive culture will develop in the society. Business firms and management will inspire for further business initiatives and opportunities and to take the risk with confidence.

4.2.3. Exchange of information. On provision of consultancy and supervisory service to the recipient firm, the investors of IBFI will be regularly informed more about the operations of recipient firms. This will lead towards the development of awareness and education about the business in the society. And the borrower will feel a strong integration with the bank and will employ his full capacity for the success of the project.

4.2.4. Reforms in IBIFs competition. The core concept of the establishment of IBFI is to provide financial services to the unbanked and financially excluded people. Islamic banks are established and working in a different paradigm. Islamic banking and financial institutions merely compare with their counterparts in terms of performance and outcomes, for example the worth of accumulated assets, percentage of market shares, number of banking branches, number of shareholders, and so no. Conventional banking is neither the competitor nor the rival of Islamic banking. So, for IBFI there is no need to compare their performance and growth with the conventional banks on accounts of increase in assets, profit earnings, dividend per share, etc. Rather, their performance and competition is fight against the economic unjust, poverty, and underdevelopment. So, there is a need of reforms in understanding and recognition of the real opponents of IBFIs (those are poverty, underdevelopment, illiteracy in context of financial sector, unemployment and financial exclusion) and then to compete with these.

5. Conclusion

In this paper, we discussed the alignment of financial inclusion measures with Islamic values that can positively impact on individuals, families, societies, firms and economy. Financial exclusion and poverty are closely interlinked issues and are considered as the real problems for both the developed and developing worlds. Islamic world exhibits the high rate of financial exclusion, illiteracy, unemployment, underdevelopment and many other economic and social problems of its adult population. Islamic Banking and Financial Institutions were established in 1980s as part of Islamic revival movement of the 1970s. The founding objectives of these institutions were to structure a financial system that incorporates the Islamic economic and social values of justice, reciprocity and the wellbeing of all, especially those who are neglected and ignored by conventional banking system. Having this holistic features and high expectations from the Muslims, Islamic banks have to operate in different paradigm with the human oriented approach and to work for expanding their range products and service accessible to a large segment of the society especially to the poor and financially less fortunate adult Muslim population. In the developing economic environment of Islamic world that necessitates the access to financial services more than ever; effective inclusion requires substantial reforms in the approach, internal policies of the banking and financial institutions, targeted allocation of resources from the banks, modified banking models and operations, and measuring the banking operations on the basis of effectiveness instead of efficiency. Lack of any of these factors will impede the financial access to IBFIs. While the potential of IBFIs for developmental initiatives is huge the actual outcomes of benefits from existing IBFIs as also the mobilization of new IBFIs is far below its potential. This gap can be bridged only through determined efforts to prioritize the major challenges to the creation, growth and sustainability of IBFIs and find solutions of poverty, underdevelopment and other challenges. Indeed, there are challenges at all levels and requires shifts in paradigms at all levels. At macro level, there is a need for realizing and identifying the foundation objectives of IBFIs as largest potential for socio-economic development and achieving the Shari'ah objectives and to develop appropriate modes of financing to the potential entrepreneurs of Muslim youth so that these may provide a sustainable source of funds for addressing various social needs. There is also a need for efficient and effective management of IBFIs for enhancing their credibility, social acceptability through improved transparency and better governance. At a macro level, there is a need for better network and advocacy, provision of education and training of the employees for bringing the change in the customer treatment; from a perception of considering of poor people as beneficiaries to the treatment of people as client and from providing credit-only to providing a range of financial services adapted to the need of clients.

IBFIs can widen their outreach to larger segment of population by prioritizing the socio-economic objectives of Islamic Shari'ah and addressing the demands, choices and preferences of the underserved Muslim population of their locality. In addition to these attempts, incorporating the accords of protecting the dignity of the consumer, protecting their asset and bearing proportionately higher risk-weight and providing the risk-free credits to these poor can create significant respect for the IBFIs and will eventually enlarge the financial market share of the IBFIs.

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Islamic Banking and Economic Growth: A Case of Pakistan

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Abstract

Islamic banking in Pakistan has gained recognition in last ten to eleven years. It offers many products which are different from conventional banking and the most significant constituent is zero interest. Currently, a chunk of people have motivation towards Islamic banking compared to conventional banking in view of its growth in terms of assets, investment and deposits. This growing number of Islamic banking institutes indicates an increased trend of Islamic banking in Pakistan. People's trust on the legitimacy of Islamic mode of banking motivates different conventional banks to open Islamic windows besides full-fledged Islamic branches to cater the increasing demand of people in Pakistan. The present study investigates short run and long run relationship between Islamic finance development, its various products and economic growth in Pakistan. Using quarterly data for the period of 2006-2013, the study applied bound cointegration test and error correction models (ECMs) developed within an autoregressive distributed lag (ARDL) structure. The study found that there is a supply side relation between economic growth and Islamic banking in Pakistan. The study also found that Islamic banking industry exerts significant impact on economic growth.

Keywords: economic growth, Islamic Banking, co-integration, ARDL, Pakistan

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Introduction

Islamic banking sector is a captivating sector for capital investment in many countries because of its interest free products. There are certain features of Islamic banking which gives a base for larger percentage of risk sharing, lesser dependency on loan instruments and restrict the gap between short term and long term financing. Even in the era of recession, Islamic banking industry has remained strong because of being asset based, also more capital investment is being observed in products by Islamic banks (Rogoff, 2011). Hence, various observers suggest that conventional banking has some prospects to learn from Islamic banking.

In last couple of years, Islamic banking has significantly grown by 16 percent of average annually and its asset base has been over Rs. 1 trillion till December 2014 as stated in Islamic Banking Bulletin of State Bank of Pakistan (2014). Islamic banking shares the deposits of 10.7 percent in the entire banking sector. Profitability of the Islamic banks has been registered at Rs 3.2 billion by the end of March 2014 (SBP, IBB, 2014). Consequently, the increasing number of banks and rise in investments and financing represent the importance of Islamic banking sector in Pakistan (Imam & Kangni, 2010).

Currently, people have motivations towards Islamic banking compared to conventional banking keeping in view the growth of its assets, investments and deposits (Hassan & Lewis, 2009). Table 1 shows the number of Islamic banks branches with each province market share (in percentage) for the Islamic banking sector. SBP report also indicates an increasing number of Islamic banking institutes in 2013-14 with an increase in the trend of Islamic banking in Pakistan.

Table 1

Province Wise Branch Network (March 2014)

Province	Total Number	Share (Percent)
Punjab	574	43.7
Sindh	443	33.7
Khyber Pakhtunkhawa (KPK)	146	11.1
Baluchistan	55	4.2
Federally Administered Tribal Areas (FATA)	04	0.3
Federal Capital	72	5.5
Azaad Jammu Kashmir (AJK)	15	1.1
Gilgit Baltistan	05	0.4
Total	**1,314**	**100**

Source: SBP, Islamic Banking Bulletin, 2014

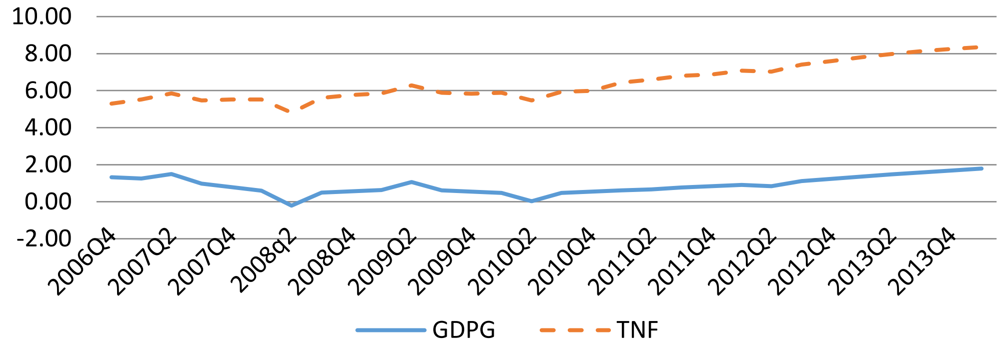

*Figure1***.** Economic Growth and Islamic Net Financing

* GDP growth and Islamic Net Financing (TNF) are in log and percentage

The exceptional increase in Islamic banks assets and deposits has made distinguished contributions in the financial sector and economic growth (Ali, Akhtar & Ahmed, 2011).

Diminishing Musharakahh has been the most flourishing product along with Ijarah. Though Ijarah lost its demand among investors as Murabah and Diminishing Musharkah gained the favors for investing and financing in the corporate sector with the passage of time. As it is shown in Figure 2 below

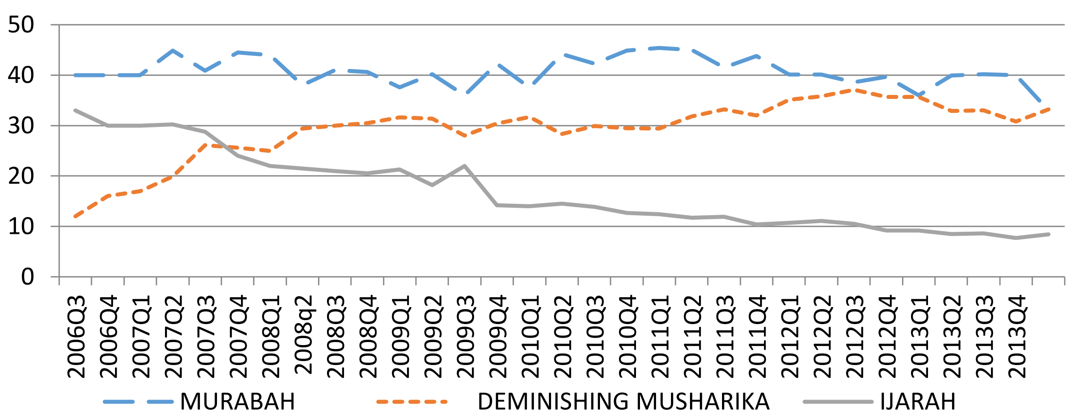

Figure 2: Islamic Banking Products (Trend Analysis)

Source: SBP Islamic Banking Bulletin, 2014.

* Murabah, Diminishing Musharakah and Ijarah are expressed in percentage

Although extensive research has been conducted in assessing the relation between the financial sector and economic growth (Shahbaz, Ahmad & Ali, 2008) but limited research could be found in the framework of Islamic banking sector. The present study is conducted to explore the causality among Islamic banks net financing, its products and economic growth for the period of 2006-2013. The research is distinctive in terms of exploring short run and long run relationship between Islamic finance development, its different products and economic growth particularly in Pakistan.

1.1. Research Objectives

- The study addresses the following research objectives;
- To examine the impact of total net financing (TNF) of Islamic banks on economic growth of Pakistan.
- To examine the impact of gross fixed capital formation (GFCF) of Islamic banks on economic growth of Pakistan.
- To examine the impact of different Islamic banks products on economic growth of Pakistan.

This study is divided into five sections: Section I provides a brief overview of the study. In section II, literature review of previous studies has been examined and concluded to formulate the research hypothesis and to point out research gap in literature. Section III explains the methodology for conducting the research. It also gives a description of the econometric models and statistical tools for the analysis of the researched data. Section IV covers the results and findings of the study. Finally, section V concludes the key findings of the study.

2. Literature Review

The improvement in financial sector of an economy has various effects on its real output growth. This results in the increment in the investment capacity and savings volume of the economy (Goldsmith, 1969). During the 19th century, the importance of banking system has been argued relatively to the national income level and growth rate towards the economic development of a particular nation along with the productive investment paradigm (Shumpeter, 1934). Lately, this respective analysis has been further tested empirically with the intention of exploring particular indicators for describing causal relationship between financial and economic growth.

The emerging economies are thus taking into consideration the nexus of financial and economic growth perspective that has attained a global attention in present era. Although the financial sector has been developed and financial institutions are getting attention day by day, still there are divergent views concerning the role of financial mediators towards the persistent economic growth of a nation in long term scenarios. The financial sectors play central role in facilitating funds reallocation deposited by individual with excessive capital in order to obtain investment opportunities. Those funds are then allocated to the corporate firms that are facing the shortage of resources. This infers two effects on financial development: First is the reduction in inclusive cost of capital with transaction cost of investment as well saving is reduced. Secondly, cost of cash flows would be reduced by financial sectors. This is because the adverse selection and the moral hazard problems faced by the firms are overcome with the support of financial markets and respective financial institutions (Rajan & Zingales, 1998).

King and Levine (1993) conducted a study to explore the causality relationship between the financial development and economic growth variables. By following the post hoc and ergo propter hoc technique they found that economic growth can be predicted up to next 10 to 30 years by the predetermined elements of the development of financial sector. However, correlation observed in the study data cannot be found invalid, but still these results were not able to test the uncertainties about causality relationship. It has been observed that financial sector mediators are one of the causes of rapid growth of economy for developing Asian frugal. Therefore, banks are preferred over security markets by these frugal for the purpose of financial intermediation (Bosworth, 1998).

Garson (1998) examined and depicted financial mediators as the main locomotives for economic growth. This is because the money is able to circulate in the economy due to the functioning of these intermediaries, as they actively seek deposits by the individuals and these mobilized funds are then lent to the parties in need of credits. These credits are however, regarded as growth engines but not the inputs. It has also been posit by few researchers that economic growth and development of finance has a bidirectional relationship. Financial improvements are the cause of economic growth in emerging frugal while growth is the cause of financial improvement in established frugal (Levine, Loayza & Beck, 1999).

Levine, Loayza & Beck (2000) again conducted a research to assess the following dimensions; (a) Does the Economic growth tend to be influenced by the external constituents of financial mediator development in the financial sector? (b) Does the differences in the level of development of financial sector explain legal as well as accounting structures across the countries, such as, rights given to the creditors, enforcement of the contract and standards & canons of accounting? The study used cross-sectional traditional techniques that contain instrumental variable data and also the recent procedures of dynamic panel data. The findings documented positive association between external constituents related to financial mediator development and economic growth. Further, the second notion supported that development level differences of financial sector were explained by legal and accounting structures across the countries. Collectively, these results proposed that accounting and legal restructuring tend to accelerate financial development and eventually economic growth.

The Islamic banking theory is centered on the notion of interest free banking, since interest is forbidden in Islam. Islam has given principles related to the banking structure and functioning. The core norm of the banking system, based on Islamic teachings follows the trade and profit stratagem though interest remains forbidden (Farahani and Hossein, 2012). In today's era, the mounting progress of Islamic banking has improved itself proved ahead the conventional banking system and an effective alternative to the conventional banking. In Muslim as well non-Muslim countries, this promising banking system has been rapidly emerging since last two decades. It has now been operating in more than 60 countries across the world and has logged extreme growth rates. Therefore, bankers and practitioners tend to predict that 50% of Islamic countries' savings will be controlled by Islamic banks in coming decades (Muhammad et al., 2012).

Islamic system of financing is based on the products offered by Islamic banks. Many researchers have discussed the products of Islamic banks (Ringim, 2013). Ayadi et al. (2015) also discoursed the products offered by Islamic banks and related them to the theory of financial intermediation. Subjective evidence of study demonstrated less difference than expected between Islamic and conventional banks. This was due to the evidence which displayed conventional products could be conscripted as products based on *Shariah* teachings. The researchers found new noteworthy differences when conventional banks were compared with Islamic ones while controlling country and other banks attributes. These differences were in the form of orientation of business, its quality of assets, competence and appropriateness. However, there have been evidences greater than capitalization of Islamic system of banking, thus during financial crisis Islamic banking system has relatively better performance explained by the capital cushion and greater reserves of liquidity (Khattak, 2010).

The role of development of Islamic system financing towards economic growth is acknowledged by limited literature available in this arena. Scharf (1983) stated that Islamic banking system had a noteworthy contribution towards growth and development of economy particularly when there is recession, decline or lower growth. This is because the operations of Islamic banks are concerned with productive investment. Also, the banking system operating on *Shariah* rules are feasible, profitable and practical compared to conventional banking system.

In Malaysia, Islamic banking sector has resulted in positive change in the financial performance of the economy. By the end of 2005, Islamic banking assets contributed 60.2% in total financing and ultimately impacting economic growth (Furqani & Mulyani, 2009). Furqani and Mulyani (2009) elaborated that all banks should adopt the rules and regulations presented by Islamic banking system to restore their client's confidence especially after the global financial crises.

Goaied & Saifallah (2010) applied GMM estimation technique for dynamic panel data of 16 frugal in MENA region. The study results found non-significant association between growth and Islamic banking system, thus ultimately strengthening the concept of nil contribution of banks in economic growth. Further, the results revealed negative relation of bank indicators with growth factor under certain stipulations. It was also notified that Islamic banks were not exceptional in financial markets and were weakly correlated to economic growth but somehow these banks act positively when demonstrated theoretically.

Abduh and Omar (2012) targeted Indonesian economy for the causality relationship of growth dynamic and development of Islamic financial sector. Bound testing cointegration approach and error correlation models (ECM) were used to measure the association among growth dynamic and Islamic financial sector development. The study outcomes confirmed significant association in short term and long run between growth and Islamic finance development dynamics. However, the relationship was not unidirectional as stated by Schumpeter based on supply-leading and Robinson based on demand-following theory. These findings were similar to the research work of Abduh and Chowdhury (2012). They focused on Bangladesh economy to test the association between growth dynamic and total financing as well as deposit structure of banking sector operating in Islamic setups. Time series quarterly data covering time span from Q1:2004 up till Q2:2011 was used in the research. The outcomes of the research study revealed positive association in long run and also the direction was appeared to be bidirectional.

3. Methodology and Data Description

The objective of the study is to examine the impact of net financing of Islamic banks, gross fixed capital formation and Islamic banking products on economic growth. The data for GDP and GFCF is taken from World Economic Indicators. For Islamic net financing and Islamic banking products data is taken from State Bank of Pakistan from the time period of 2006 to 2013 on quarterly basis. Granger causality test is used to analyze the causality and to explore the long and short run effects. This study will use Autoregressive Distributed Lag (ARDL) modeling approach put forward by Pesaran, Shin and Smith (2001).

3.1 Research Model

The graphical, symbolic or verbal representation of a phenomenon or relationship between the two or more variables is called research model or equation. The following research model is proposed for the study

$$G = f\,(NF, IBP_1, IBP_2, IBP_3, GFCF) \quad (A)$$

Long run Equation:

$$G = \alpha_o + \alpha 1NF + \alpha 2IBP1 + \alpha 3IBP2 + \alpha 4IBP3 + \alpha 5GFCF + € \quad (B)$$

Short run Equation:

$$\Delta G = \theta_o + \theta 1\, \Delta NF + \theta 2\Delta IBP1 + \theta 3\Delta IBP2 + \theta 4\Delta IBP3 + \theta\, 5\Delta GFCF + \delta 1(G_{-1} + \alpha 1NF_{-1} + \alpha 2IBP1_{-1} + \alpha 3IBP2_{-1} + \alpha 4IBP3_{-1} + \alpha 5GFCF_{-1}) + e \quad (C)$$

Where,

G = GDP constant (lcu) in terms of log,

NF = Net financing and investment of Islamic banks in Pakistan in terms of log,

IBP 1 = Murabah as percentage share of investment by Islamic banks

IBP 2 = Diminishing Musharakah as %age share of investment by Islamic banks

IBP 3 = Ijarah as percentage share of investment by Islamic banks

FCF = Gross fixed capital formation as a percentage of GDP.

4. Results and Discussion

4.1 Unit Root Test

In this section, unit root test using Augmented Dickey Fuller (ADF) and Philips Peron (PP) tests are applied to see the nature of the series under consideration for the study. It was observed that all of the variables were I(0) or I(1), as shown in Table 2.

Table 2
Unit Root Tests

Variable	Augmented Dickey Fuller Test			Philips Peron Test		
	Intercept	Intercept & Trend	Result	Intercept	Intercept & Trend	Result
**Growth	1.745 (0.99)	0.087 (0.995)	I(1)	-1.49 (0.5200)	-3.28 (0.0904)	I(0)
ΔGrowth	-6.905 (0.00)	-4.44 (0.011)	I(0)	-6.12 (0.00)	6.67 (0.00)	I(1)
GFCF	-0.469 (0.882)	-2.525 (0.314)	I(1)	-0.629 (0.848)	-1.723 (0.713)	I(0)
ΔGFCF	-2.63 (0.099)	-2.57 (0.295)	I(1)	-2.62 (0.1007)	-2.558 (0.3002)	I(1)
**Net fin	-2.197 (0.2114)	-1.58 (0.774)	I(1)	-2.141 (0.230)	-1.711 (0.720)	I(0)
ΔNet fin	-4.195 (0.002)	-4.72 (0.004)	I(0)	-4.25 (0.0025)	-4.75 (0.0037)	I(1)
*Diminishing Musharakah	-3.05 (0.041)	-2.67 (0.25)	I(0)	-3.461 (0.0167)	-2.165 (0.276)	I(0)
ΔDiminishing Musharakah	-5.49 (0.0001)	-6.12 (0.0001)	I(1)	-5.497 (0.0001)	-6.191 (0.0001)	I(1)

*Murabah	-1.41 (0.56)	-1.74 (0.705)	I(0)	-3.689 (0.0098)	-3.927 (0.0236)	I(0)
∆Murabah	-10.037 (0.000)	-10.135 (0.000)	I(1)	-10.201 (0.0001)	-10.27 (0.0002)	I(1)
*Ijarah	-1.629 (0.454)	-3.76 (0.033)	I(0)	-0.521 (0.8730)	-4.017 (0.0194)	I(0)
∆ Ijarah	-8.13 (0.000)	-8.052 (0.000)	I(1)	-10.8705 (0.000)	-28.6313 (0.000)	I(1)

* Murabah, Diminishing Musharakah and Ijarah are in percentage

**GDP and Islamic net financing are in log form

*** Lag values are based on SIC; Probabilities are in parenthesis ( )

4.2. Test for Co-integration

Co-integration test is used to measure the existence of long run association among the variables in the present study. The F - statistics is computed for this reason and if the calculated value of F - statistic in the model (C) is greater than the upper critical bound, it means there exists a long run association between the variables at the 5% level of significance.

The hypotheses for co-integration test are:

H_0: $\alpha_1 = \alpha_2 = \alpha_3 = \alpha_4 = \alpha_5$: No long run relationship exists

H_1: $\alpha_1 \neq \alpha_2 \neq \alpha_3 \neq \alpha_4 \neq \alpha_5$: Long run relationship exists

Table 3

Long Run Cointegration (Causality) Test

	Value	Df	Probability
F-Statistic	3.85303	(6,13)	0.0198
Critical value	(2.45, 3.61) for I(0) and I(1) variables at 5%		
	(2.12, 3.23) for I(0) and I(1)Variables at 10%		

Table 3 shows the existence of long run association among the operating variables as the calculated F – statistic value is greater than the upper critical bound (3.8 > 3.61) and (3.8> 3.23) at the 5 % level of significance, respectively. Therefore, it is concluded on the basis of above table that there exists a co-integrating relationship in the present study for the period of 2006 – 2013; hence confirming existence of long run relationship between gross fixed capital formation (GFCF), Islamic banking total net financing (TNF) in Pakistan.

4.3. Long Run Coefficients

Table 4 indicates that Murabah, diminishing Musharakah, Ijarah and Islamic net financing (TNF) are significant at 0.01 level of significance. In the long run, Murabah and diminishing Musharakah are not affecting on growth positively. TNF and economic growth are positively related and significant at the 0.01 level of significance. The similar results were found by Abduh and Omar (2012) in Indonesia and Farahani and Sadr (2012) for Indonesian and Iran economy. Murabaha and Diminishing Musharakah remained the most focused modes as these modes aggregately contributed almost 63 percent of general financing (SBP, Islamic Banking bulletin, 2014). Nonetheless, regardless of seeing increment in total sum, Murabaha and diminishing Musharakah financing declined amid the quarter finishing December 2014 in Pakistan. This was chiefly because of moderately higher development in financing modes like Musharakah, Salam and Istisna bringing about an increase in their shares in general financing amid the quarters under audit. These results represent the actual growth relations that may contribute more if investment mode of financing is expanded with corporate sector in Pakistan rather than diminishing Musharakah and Murabah.

Table 4

Determining Long Run Coefficients

Growth	**Coefficient**	**Std Error**	**T - stat**	**Prob.**
GFCF	-0.0030	0.0030	-0.948	0.353
TNF	0.0150	0.0030	4.310**	0.000
Murabah	-0.0005	0.0002	-2.132*	0.044
Diminishing Musharakah	-0.0006	0.0002	-2.309*	0.030
Ijarah	0.0009	0.0002	2.968**	0.001
Intercept	-0.4542	0.1250	-3.6066	0.001
R-squared = 0.69	F - stat = 10.007		Prob (F-stat) = 0.00004	

* Significant at 5% ** Significant at 1%

4.4. Short Run Coefficients

In short run, only last year's net financing growth and Ijarah are significant. All other variables are insignificant at 0.01 level of significance. This shows economic growth variable is significant due to the forward linkages of economic activities with the previous year. The variable Ijarah is also participatory in trade and investment and therefore stimulates growth in short run also.

Error term with lagged parameter (ECM) is an adaptive parameter measuring the short term spreading from long term equilibrium. In short run, the variables may disperse from one another which cause the given structure in equilibrium. Hence, the statistical significance of the coefficient associated with the ECT provides us the verification of an EC mechanism that derives the variables back to their long term relationship.

Table 5

Determining Short Run Coefficient

GROWTH	Coefficient	Std Error	T - stat	Prob.
Δ Growth(-1)	0.1700	0.188	0.902	0.3785
Δ GFCF	-0.0108	0.005	-2.1343	0.0468
Δ Net Investment and financing	0.0048	0.006	0.7339	0.4724
Δ Murabah	-1.76E-05	0.0003	.067921	0.9466
Δ Diminishing Musharakah	2.48E-05	0.0002	-.059477	0.9532
Δ Ijarah	0.00094	0.0003	2.8827	0.0099
Intercept	-1.13E-05	0.00078	-.01443	0.9886
ECM (-1)	-0.907	0.257	-3.527	.0024
R-squared = 0.62	F-stat = 4.30252		Prob(F - stat) = 0.005	

Table 5.1

Determining Short Run Coefficient

White TEST : Hetroskedasticity			Breusch-Godfrey LM Autocorrelation	
Obs*R-squared	**Prob. Chi-squared**	**Lag**	**Obs*R-squared**	**Prob. Ch-Square**
5.15914	0.2328	1	5.048231	0.0801

* CUSUM and CUSUM Sq charts also confirm the stability of coefficients

4.5. CUSUM Test for Stability

The Figure 3 shows that CUSUM test value is stable as the regressed line is within the range. This shows that mean of error term is constant for the Model A.

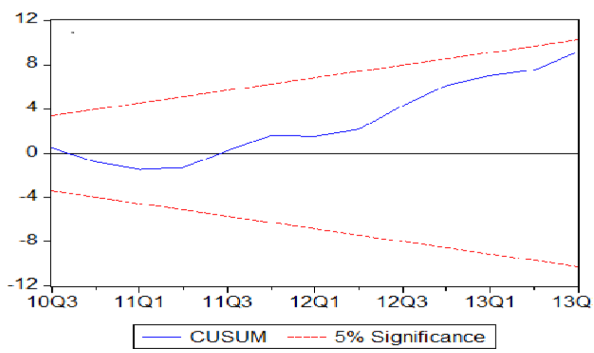

Figure3. CUSUM Test for Stability

The Figure 4 shows that CUSUM test value is stable as the regressed line is within the range. This shows that variance of error term is constant for the Model A.

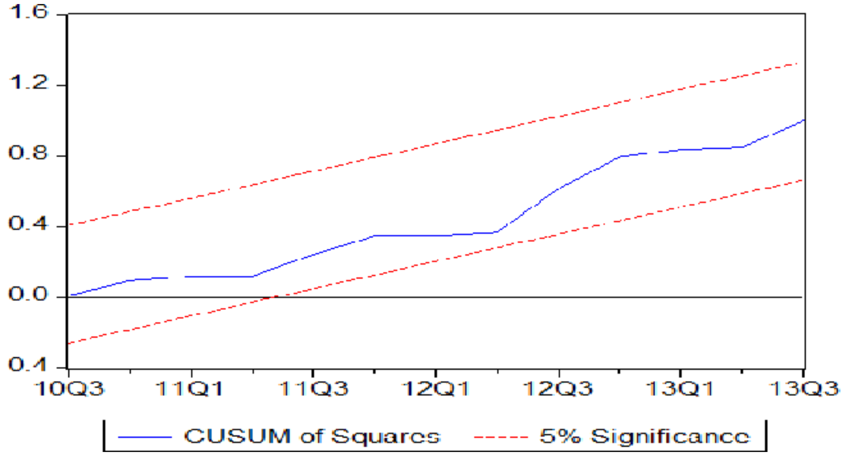

Figure4. CUSUM of Squares Test for Stability

4.6. Causality Tests

In order to examine causal relationship between economic growth, GFCF and net financing of Islamic banks, we applied pair wise granger causality test (Table 6).

Table 6

Ganger Causality Test

Null Hypothesi	F-Stats	Probability
GFCF does not Granger Cause GROWTH	4.5798	0.0427
IJA does not Granger Cause GROWTH	8.6230	0.0072
MUR does not Granger Cause GROWTH	0.8430	0.3676
MUS does not Granger Cause GROWTH	7.1796	0.0131
NETFIN does not Granger Cause GROWTH	12.393	0.0017

The short run causality tested through pair wise granger causality in Table 6 shows that the Islamic net financing and investment, GFCF, Diminishing Musharakah and Ijarah granger cause growth. It was found that Murabah does not granger cause growth.

5. Conclusion and Recommendations

5.1. Conclusion

The study was conducted to find out the impact of net financing of Islamic banks, gross fixed capital formation and Islamic banking products on economic growth for the time period of 2006 to 2013. The findings of the study conclude that there is a long run cointegration among the variables of Model A. This study finds evidence that in the long-run, Islamic financial investment is positively and significantly correlated with economic growth and capital accumulation, similar to the findings of Abduh andOmar (2012) and Farahani and Sadr (2012)**.** In the analysis of Islamic banking products, the economic growth is positively stimulated by Ijarah. Murabah and diminishing Musharakah and found to be negatively related with economic growth. Ijarah is found to be the only Islamic banking product significant both in short run and long run.

The study also finds Islamic banking net financing, GFCF, diminishing Musharakah and Ijarah cause economic growth in case of Pakistan. Similar causal effect was also explored by Abduh and Omar (2012) for Indonesian economy. The study represents a participatory role of Islamic banking towards the economic growth. It has shown the potential of boosting economic growth even with a small percentage in the banking industry.

5.2. Recommendations

Islamic banking is more impactful to the economy. As a corollary to this, the government first needs to encourage and promote establishment of more Islamic commercial banks, Islamic windows, and Islamic rural banks whilst at the same time encourage existing Islamic banks to establish more branches. Secondly as the number of Islamic banks and Islamic financial institutions has increased there is also a need to have sufficient skilled manpower to manage these institutions. There is a need to re-look at the current regulations and guidelines in order to bring it at par with the development of Islamic banking worldwide. For example, the judiciary must have a dedicated unit to handle Islamic banking legal cases that whether those cases should go to the court for adjudication or not. Finally, as the relationship is found to be supply side, Islamic banking may not be able to contribute fully to economic growth if there is low expansion in Islamic banking sector.

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Comparison of Disclosure Level among Islamic Banks and Its Effect on Performance

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Abstract

Revealing accurate and complete information of the business is the prime focus of Islamic finance as it proposes to avoidance any sort of Gharar (uncertainty). Lack of disclosure could lead to exploitation of the information by few members in the market at the expense of others. The difference between Islamic Bank and Conventional Bank is that Islamic bank takes disclosure of governance status as a religious obligation as compared to disclosure of conventional banks based upon legal obligation of the country. Similarly, Islamic banks put efforts in disclosing information of Shari'ah governance and social responsibility as per religious obligation as compared to voluntary disclosure by conventional banks. This study is built on the idea that if Islamic Bank considers Shari'ah disclosure and social responsibility as voluntary disclosure then it is expected that there will be a significant difference between all present Islamic banks. Lastly, this study has generated an overall disclosure index using principal factor analysis and evaluated its impact on the performance of the banks to reveal that disclosure entails positive impact on performance.

Keywords: shari'ah advisory board, corporate governance, social responsibility

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1. Introduction

Capital markets are seriously affected by how and what information is being shared by the firms to the participants (Ho and Wong, 2003). Investors always demand correct and in-time information to reach efficient investment decisions. This information could be gathered using several ways. One of the most important, trustable and easy method is the corporation's annual financial reporting. The foremost and important purpose of the annual reports of a firm is to provide useful, correct and timely information to the shareholders, stakeholders and investors. Hence, helping them to access the financial performance and position of a firm along with its future forecasts is essential in order to make final decisions regarding the investment. The two types of information; mandatory and voluntarily are supplied by the firms in their annual reports. Compulsory/mandatory disclosure is important for companies and investors both. Mandatory disclosure is a fundamental market claim for information demanded by various regulatory bodies and laws and has been linked at regional or national level by government authorities or professional organizations. Firms disclose this information through management discussions, financial footnotes, financial statements and other regulatory filings. On the other side, voluntary disclosure, intemperance of compulsions, shows free choice on behalf of managers to supply information to the users of annual reports(Yuen, Liu, Zhang, and Lyu, 2009). In voluntary communication, some firms present conferences, management forecasts, analysts' presentations, internet sites, press releases and other corporate reports. In addition to the regulatory and voluntary disclosure, there could be disclosures regarding firm activities by information intermediaries including industry experts, financial analyst and financial press etc.

Currently, banking industry of Pakistan is facing competition between Islamic banks and conventional banks. The conventional banking proponents argue that Islamic banks are superficial. Whereas Islamic banking proponents provide a wide array of structural and faith related reasons to justify the difference. Islamic banks form a relationship with its clients both from deposit and financing. This practice is far more respectful as compared to creditor and debtor relation formed by conventional banks. The fundamental functions of the Islamic banks promote real asset creation as compared to mere cash rotation by conventional banks. Islamic banks are acting as a facilitator of sale and purchase of real products. It also ensures the usage of funds in the real production process as compared to unconditional loan provision by conventional banks. However, the Islamic banks in Pakistan, have formed the apparent look similar to conventional banks due to federal and central banking regulations for banks and secondly for reducing the cost they access the same market.

Disclosure of governance structure is another major difference between conventional banks and Islamic banks. Conventional banks only disclose their governance structure because of country regulations while they are only voluntarily bound to disclose their social responsibility. The conventional banks are not concerned that their unconditional funds forwarded to clients may lead to exploitation and social injustice. In comparison to this, Islamic banks disclose their information regarding governance, Shari'ah and social responsibility not because of country regulations; it is because of the divine rules provided by Allah in Islam.

Islamic banks are offering a wide range of financial services in which a few are apparently similar to the conventional banks and some other are distinct. Since these products are supporting social welfare, this sector is growing significantly all over the Islamic world. Islamic banks are different from the conventional banks in many aspects. For example, the goal of an Islamic bank is to create a partnership with the depositors and the investors and use the available funds and capital to perform a ritual of finding acceptance of God(Janahi, 1995). Whereas, the conventional banks are profit-making organizations not affiliated to a religious body / religious jurisdiction.

This study is important because it is associated with Islamic banks as it makes itself accountable for fulfilling their social and ethical role in the society. It is mandatory for the Islamic banks to disclose their information related to Shari'ah Advisory Board, social responsibilities and corporate governance. Since Islamic banks are under religious obligation for disclosure, hence a critical analysis is required to probe how much these Islamic banks are similar to each other in terms of their efforts to disclose. This study will also explore whether or not the overall disclosure efforts are translated into the performance of banks

Numerous studies have been conducted on mandatory and voluntary disclosure through annual reports of companies. However, most of the studies have been conducted on the non-financial and financial (conventional banking) sectors operating in developed countries. This study aims at probing the following aspects of Islamic banks in Pakistan;

1. Whether they are significantly disclosing information regarding Shari'ah Advisory Board, social responsibility and corporate governance.
2. Whether they differ in terms of their disclosure of Shari'ah Advisory Board, social responsibility and corporate governance.
3. What is the ranking of banks in terms of the disclosure and the effect of the disclosure index on return on equity (ROE) and earnings per share?

2. Literature Review

One of the prominent differences between Islamic financial institutes (IFI) and non-Islamic institutes is that IFIs make Shari'ah Advisory Board (SAB) mandatory. SAB focuses on the financial transactions in terms of their compliance with the

Shari'ah rulings. This practice enables IFI to become a better partner with the depositors and firms/companies(Hassan and Dicle, 2007). The reliance of the investors on the Islamic financial institutions will have an immediate impact on stability and the capability to act as a financial intermediate and positively affect the performance of Islamic financial institution (Pellegrini and Grais, 2006). The role of Shari'ah Advisory Board in the business is to check and verify that each and every transaction is in compliance with Shari'ah. According to Haqqi(2014), every financial institute needs an Advisory Board, like Ikhlas Finance House (IFH) of Turkey, which can help in avoiding a collapse of a reputable Institute.

The Shari'ah Advisory Board becomes part of every board meeting and it is independent of any internal or external influence. This board guides the IFI in preparing policies, regulations and financial transactions in accordance with the Shari'ah rules. This board has expertise of Islamic legal and Fiqhi resources. As compared to the board of governors, the members of Shari'ah advisory board have all members having almost same qualification which helps to transfer knowledge in a faster and clearer way to the policy makers. The objectives of the board include religious compliance of the business, providing counseling to stakeholders, regulators and central bank(AAOIFI, 2004; Daoud, 1996). In light of Shari'ah Advisory Board's role and importance, the present research aims to probe whether all the Islamic banks are same in terms of their disclosure status and does this status has some association with the profit of the bank.

The following verses indicate the appointing of a Scribe Committee which will look over all the financial transactions and this committee must be independent of the influence of the management:

> "O you who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. Let no scribe refuse to write as Allah has taught him. So let him write and let the one who has the obligation dictate. And let him fear Allah, his Lord, and not leave anything out of it. But if the one who has the obligation is of limited understanding or weak or unable to dictate himself, then let his guardian dictate in justice. And bring to witness two witnesses from among your men. And if there are not two men [available], then a man and two women from those whom you accept as witnesses – so that if one of the women errs, then the other can remind her. And let not the witnesses refuse when they are called upon. And do not be [too] weary to write it, whether it is a small or large, for its [specified] term. That is more just in the sight of Allah and stronger as evidence and more likely to prevent doubt between you, except when it is an immediate transaction which you conduct among yourselves. For [then] there is no blame upon you if you do not write it. And take

witnesses when you conclude a contract. Let no scribe be harmed or any witness. For if you do so, indeed, it is [grave] disobedience in you. And fear Allah. And Allah teaches you. And Allah knows of all things." (Al-Quran 2:282).

"So by the mercy of Allah, [O Muhammad SWT], you were lenient with them. And if you had been rude [in speech] and harsh in heart, they would have dispersed from around you. So pardon them and ask forgiveness for them and consult them in the matter. And when you have decided, then rely upon Allah. Indeed, Allah loves those who rely [upon Him]." (Al-Quran3:159).

Recent researches showed mixed relationships such as a negative relationship (Wright and Ferris, 1997), positive relationship (Waddock and Graves, 1997), and no relationship(McWilliams and Siegel, 2001) of corporate social responsibility. From the past few years, academic researchers and businesses are similarly showing an improved level of interest for CSR(Mackey, Mackey, and Barney, 2007).

Some scholars such as Swanson (1999), Whetten, Rands, and Godfrey (2002) and businesses have claimed that organizations have a responsibility toward a society that works well beyond just maximizing the shareholders. Whereas some other scholars claimed that such a narrow vision could direct management to overlook other important stakeholders including customers, suppliers, employees and society at whole. However, sometimes it happens that the interest of stakeholders succeeds the interest of the organization's equity holders in decision making phase of management, even if this trimmed down the present cash flow value of firm(Clarkson, 1995; Donaldson and Preston, 1995; Freeman, 2010; Mitchell, Agle, and Wood, 1997; Paine, 2003; Wood and Jones, 1995).

This conflict could be resolved by observing that at times socially responsible behavior might augment the present value of the company's future cash flows and that might be consistent with the wealth-maximizing concentrations of the company's shareholders(Mackey et al., 2007).

The aspect of social responsibility is a mandatory characteristic of all Shari'ah compliant businesses and IFIs. Usmani (2002), asserted that it is the social role of the Islamic bank to support social justice and practice accountability to ensure that the business transactions are connected with morality, so it is clear that banks must disclose their social responsibilities. This leads to the answer of the second research question; whether different Islamic banks differ in terms of their social responsibility disclosure. Below illustrated verses of Holy Quran place emphasis on the need of business to proceed to spend on social welfare moderately and pay Zakah.

"And whatever you give for interest to increase within the wealth of people will not increase with Allah. But what you give in Zakah, desiring the countenance of Allah – those are the multipliers.” (Al-Quran30:39).

“And if someone is in hardship, then [let there be] postponement until [a time of] ease. But if you give [for your right as] charity, then it is better for you, if you only knew. “(Al-Quran 2:280).

“And do not make your hand [as] chained to your neck or extend it completely and [thereby] become blamed and insolvent.” (Al-Quran 17:29).

“Here you are – those invited to spend in the cause of Allah – but among you are those who withhold [out of greed]. And whoever withholds only withholds [benefit] from himself; and Allah is Free of need, while you are the needy. And if you turn away, he will replace you with another people; then they will not be the likes of you.” (Al-Quran 47:38).

“Righteousness is not that you turn your faces toward the east or the west, but [true] righteousness is [in] one who believes in Allah, the Last Day, the angels, the Book, and the prophets and gives wealth, in spite of love for it, to relatives, orphans, the needy, the traveler, those who ask [for help], and for freeing slaves; [and who] establishes prayer and gives Zakah; [those who] fulfill their promise when they promise; and [those who] are patient in poverty and hardship and during battle. Those are ones who have been true, and it is those who are the righteous.” (Al-Quran 2:177).

According to Flack (2007), annual reports have facilitated the organizations to improve their accountability among stakeholders, shareholders and other interested people because annual reports were recognized as the behaviors of a corporation towards its annual reporting activity. Disclosure in annual reports is a tactical instrument, which has the capacity to raise the organization’s capital at the lowest achievable cost (Healy and Palepu, 1993; Lev, 1992). Information disclosure in annual reports is applied as a source of communication with all the stakeholders, shareholders, investors and concerned parties both qualitatively and quantitatively(Al-Shammari, 2008).

Annual reports issued by companies provided insufficient information to its users (Baker and Haslem, 1973;Chang, Most, and Brain, 1983;Wallace,1988;Yusoff and Mohd Hanefah, 1995; and Yuen et al., 2009). Many annual reports showed very little and less information in actuality as we can say that these reports remained confined to the mandatory disclosure and did not move towards the voluntary disclosure (Haw, Qi, and Wu, 2000;Hooks, Coy, and Davey,2002). A lot of information ranked very crucially by stakeholders and investors to reach their investment decisions is missed in actual reported annual reports by the companies. This could be covered and extended voluntarily in their voluntary disclosure section to improve the quality of information sharing in order to meet the required items ranked important (Haw et al., 2000; Hooks et al., 2002).

Akhtaruddin (2005) examined the effect of company specific characteristics comprising profitability, industry size, company age and company status on the level of mandatory disclosure holding a sample of 94 listed companies in Bangladesh. The study reached the conclusion that listed firms showed only 49% of the items of information which ensured that the existing regulators are inefficient monitors for compulsory disclosure. The results showed that industry size measured by sales has a significant effect on mandatory disclosure. The study concluded that company status, profitability, and age are insignificant and do not affect mandatory voluntary disclosure.

Alsaeed (2006) found the level of voluntary disclosure of the companies having characteristics including ownership dispersion, firm size, profit margin, return on equity, audit firm size, industry type and company age. He analyzed a sample of Saudi Stock Exchange using one year data while covering non-financial listed companies. The study found that the company size has a significant impact on the level of disclosure and rest of the variables had no effect.

However, unlike conventional businesses, financial institutes and banks, which are only voluntarily putting efforts for the social responsibility with no benchmark; the Islamic banks of Pakistan are provided clear guidelines from Shari'ah regarding how the social welfare spending should be conducted.

The third aspect of the IFI is the structure and transparency of the corporate governance. According to Cadbury (1993), the objective of the corporate governance is to create a balance between the financial and social responsibility of the business. Higher transparency of the business structure will make the clients more confident. Furthermore, the transparency of information will not allow anyone to illegally exploit the market at the expense of other clients. Moore, Archibald and Greenidge (2003) explained the four principles of corporate governance which were developed by Organization for Economic Co-operation and Development (OECD) in 1999.

Corporate governance is an arrangement of control mechanisms that are particularly designed to ratify and monitor management decisions in order to guarantee the effective operation of a corporation on behalf of its stakeholders(Donnelly and Mulcahy, 2008).

Corporate governance directly influences the economic development of a country. However, it is essential to design corporate governance mechanism for efficient decision making. Corporate governance covers a number of diverse economic relations and corporate ownership structure impact on its performance is one of these. Current studies on governance proposed that cultural, social and economic factors of a country have an impact on corporate ownership structure which in result influence the firm performance (Zeitun and Gang Tian, 2007).

Usually, firms show their annual reports to transfer information over and above what is mandatory. The academicians study such (voluntary) disclosures with relation to characteristics of corporate governance(Ajinkya, Bhojraj, and Sengupta, 2005; Arcay and Vazquez, 2005; Barako, Hancock, and Izan, 2006; Chau and Gray, 2002; Cheng and Courtenay, 2006; Eng and Mak, 2003; Haniffa and Cooke, 2002; Ho and Wong, 2001; Lim, Matolcsy, and Chow, 2007; Makhija and Patton, 2004). On the whole, the results of these studies were mixed that the relationship between voluntary disclosure and corporate governance are conflicting.

Corporate governance influences the operations of the corporation and consequently improves the operating activities. It procures higher expected returns and more effective operations compared to those which did not maintain governance mechanisms(Black, Jang, and Kim, 2006). Jensen and Meckling (1976), also concluded that high-quality governance creates investor confidence and goodwill about the company. It is also inferred that the probability of bankruptcy is associated with poor characteristics of corporate governance (Dalton, Daily, Certo, and Roengpitya, 2003).

In many countries, religious faiths are regarded as a personal matter (Rice, 1999) and are alienated from daily life business practices. However, there is the propagation of handsome empirical literature which tried to link different perspectives of businesses with faith and beliefs (Angelidis and Ibrahim, 2004; Cavanagh and Bandsuch, 2002; Giacalone and Jurkiewicz, 2003). Recently the dominant Islamic financial service industry (The application of Shari'ah principals to financial practices) is a clear example of this faith-business practices connection. Some researchers have connected the business practices with Christianity (Jones, 1995; Lee, McCann, and Ching, 2003) and Judaism (Pava, 1997, 1998), even though there is no real use of the main beliefs of these two faiths to contemporary business dealings except a small number of faith-based funds, for example Roman Catholics' Ave Maria Rising Dividend etc. Nevertheless, we have noticed a small but increasing awareness about Islamic ethics in business in current scholarly research works (Beekun, 1997; Graafland, Mazereeuw, and Yahia, 2006; Rice, 1999; Wilson, 1997, 2006).This concept of corporate governance is not new in Islam as it can be seen through the verses of the Holy Quran

> "And if you are on a journey and cannot find a scribe, then a security deposit [should be] taken. And if one of you entrusts another, then let him who is entrusted discharge his trust [faithfully] and let him fear Allah, his Lord. And do not conceal testimony, for whoever conceals it – his heart is indeed sinful, and Allah is Knowing of what you do."(Al-

Quran2:283).

"O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful. (Al-Quran4:29).

"And do not consume one another's wealth unjustly and send it [in bribery] to the rulers in order that [they might aid] you [to] consume a portion of the wealth of the people in sin, while you know [it is unlawful]." (Al-Quran 2:188).

"And O my people, give full measure and weight in justice and do not deprive the people of their due and do not commit abuse on earth, spreading corruption." (Al-Quran 11:85).

It can be seen from the above verses, that book keeping with the implicit message of the need for transparency and disclosure in the business dealings. This leads to the third research question of the study; does the corporate governance disclosure differ in between the Islamic banks and does it have any association with the profit of the bank.

Considering the Shari'ah based regulation for disclosure, this makes Islamic banks unique as compared to the conventional banks. Al Quran states that it is sure that the man who follows Allah cannot be the same as who asks for the wrath of Allah:

"Is the man who follows the good pleasure of Allah Like the man who draws on himself the wrath of Allah, and whose abode is in Hell? – A woeful refuge!" (Al-Quran 3:162).

3. Research questions

Based on the research objectives following are the research questions which this study will try to answer in order to achieve the objectives.

1. Does an Islamic bank significantly disclose information regarding Shari'ah advisory board, social responsibility and corporate governance?
2. Do the Islamic banks in Pakistan differ in terms of their disclosure of Shari'ah advisory board, social responsibility and corporate governance?
3. What is the ranking of the banks in terms of disclosure index?
4. What is the effect of the disclosure index on ROE and earnings per share?

4. Methodology

4.1. Sample

This study will use the financial reports of 2013-14 of the Islamic banks in Pakistan. These banks include Meezan Bank, Dubai Islamic Bank, Albarka Bank, Burj Bank and Bank Islami. These financial reports will be used to extract the qualitative information as named below.

4.2. Data Collection

This study will check various indicators for its disclosure under the following headings established by Paino et al. (2011).

4.2.1. Shari'ah Advisory Board.

a) Performance overview
b) Roles and responsibilities of SAC
c) SAC composition
d) SAC remuneration
e) Zakat obligation
f) Zakat amount
g) SAC reports
h) Profit equalization reserves
i) Classification of deposit in terms of mudarbah and non-mudarbah
j) Placement from banks
k) Detail presentation of income statement on sharing of deposits and profit

4.2.2. Social Responsibility

a) Employee welfare
b) Screening clients for Shari'ah compliance
c) Responsibilities dealing with clients
d) Earning and expenditure prohibited by Shari'ah
e) Zakat
f) Qard-ul-Hasan
g) Reduction of adverse impact on environment
h) Social development and environment based quotas
i) Customer service
j) Micro, small business and social investments
k) Charitable activities
l) Waqf management

4.2.3. Corporate Governance

a. Director responsibilities
b. Director composition
c. Directors remuneration
d. BOD information on CEO
e. Size of BOD
f. Composition of BOD
g. Appointment of BOD
h. Directors training
i. Relationship of BOD to management
j. BOD committees
k. BOD reports
l. Chairman statements
m. CEO statements
n. Audit committee responsibilities
o. AC reports
p. AC activities

4.3. Analysis

The data gathered is the qualitative dummy variable for each bank showing disclosure or non disclosure of the characteristic. Each bank will have11 dummies for the disclosure of Shari'ah advisory board, 12 dummies for the disclosure of social responsibility and 16 dummies for the disclosure of corporate governance. The data for the profitability of each bank is also collected for the year 2013-14.

Table1
Descriptive Statistics

	Obs.	Mean	Std. Dev.	Skewness	Std. Error of Skewness	Kurtosis	Std. Error of Kurtosis
Shariah Advisory Board	5	0.4909	0.21894	-0.601	0.913	-0.945	2.000
Social Responsibility	5	0.3571	0.23690	-0.685	0.913	1.132	2.000
Corporate Governance	5	0.5176	0.38213	-0.322	0.913	-2.486	2.000

Table 1 provides the skewness and kurtosis statistics, and their standard deviation. Using both we can determine whether there is any tendency or outliers in the data. While analyzing the skewness values, the T values are calculated with the reference of no skewness (skewness = 0) value, here the null hypothesis is that there is no skewness in the data. In table – 2 we can see that all of theT values are smaller than T = 2 in magnitude. This shows that there is a tendency in the data; all the banks are located symmetrically around the mean disclosure value.

While analyzing the excess kurtosis values (kurtosis – 3), the T values are calculated with the reference of no excess kurtosis (kurtosis = 3), here the null hypothesis is that there are not too many outliers as compared to a normally distributed data. We can see that all the values are smaller than T = 2 in magnitude, which shows that considering the differences in the banks, none of the banks is anoutlier for the three disclosure indexes.

Table2

Skewness and Kurtosis T Test

	Skewness T value	Kurtosis T value
Shari'ah Advisory Board	-0.65	-0.47
Social Responsibility	-0.75	0.57
Corporate Governance	-0.35	-1.24

4.3.1. One Sample T test

The group of dummies for each bank will be analyzed in one sample T test to see whether there is any bank which is different from others in terms of its level of disclosure. This will enable us to see if the Islamic banks in Pakistan are homogeneous in terms of their disclosure status.

This study will check for the disclosure of the above criterions of Pakistani Islamic banks. First, the T test method is applied to see whether all the banks are similar to each other in terms of the three categories provided.

Table 3 shows the disclosure status variable for each bank shows disclosure of Shari'ah advisory board, social responsibility and corporate governance. The T test shows that all the banks are different from 0 which means that all the Islamic banks are putting their significant efforts to disclose the information for their customers as depicted by the Shari'ah.

Table3

One-Sample Test

Mean		Sig. (2-tailed)	Mean Difference	Confidence interval Lower	Upper
Meezan Bank	0.7	0.013	0.770	0.39	1.15
Albaraka Bank	0.1	0.184	0.119	-0.14	0.38
Bank Islami	0.5	0.013	0.540	0.27	0.81
Burj Bank	0.6	0.025	0.610	0.19	1.03
Dubai Islamic Bank	0.24	0.123	0.236	-0.16	0.63

Figure 1 consists of box plot showing the ranking of each bank in terms of its disclosure status. It can be seen that Meezan Bank is ahead of all its counterparts, which is followed closely by Burj Bank and Bank Islami. In this box plot, Dubai Islamic Bank and Albaraka Bank are following the leaders but lagging behind significantly.

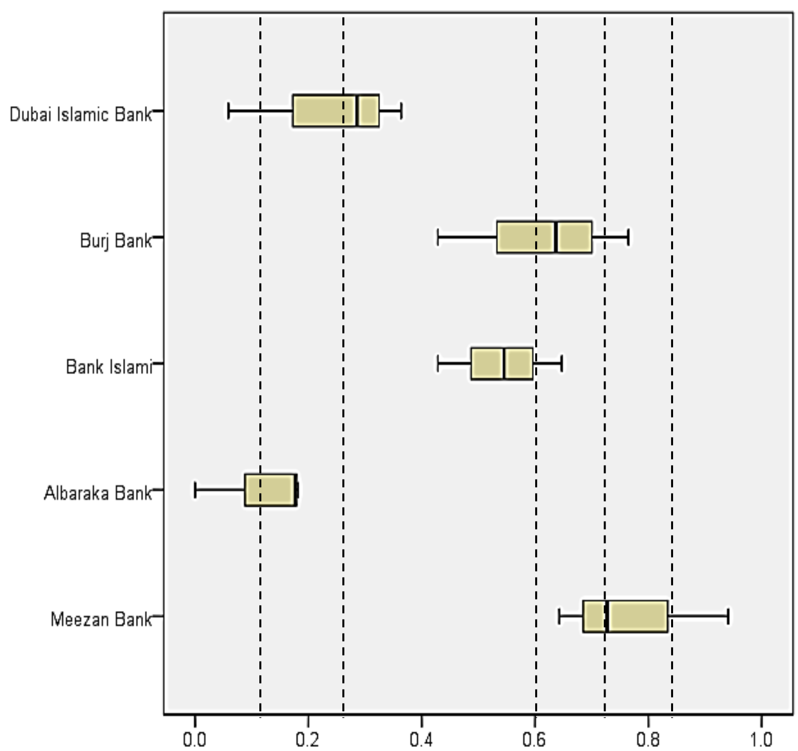

Figure1.Box Plot of Disclosure of Banks

Table 4 checks the disclosure level of Islamic banks from another angle. Here each disclosure status of Shari'ah advisory board, social responsibility and corporate governance for all the banks is checked. It can be seen that all the T values are higher than 2 means that the disclosure status is significantly different from 0. It means, all the banks are jointly ensuring that they are disclosing their status related to Shari'ah Advisory Board, social responsibility and corporate governance.

Table 4
One-Sample Test

Variables	Mean	Std. Error	Sig. (2-tailed)	Mean Difference	Lower	Upper
Shari'ah Advisory Board	0.49	0.1	0.007	0.491	0.22	0.76
Social Responsibility	0.36	0.1	0.028	0.357	0.06	0.65
Corporate Governance	0.52	0.17	0.039	0.517	0.04	0.99

Figure 2 consists of the box plot showing the comparison of disclosure status. Here we can see that corporate governance is the most disclosed status, which is followed by Shari'ah advisory board and social responsibility. It can also be observed that Albaraka Bank has appeared as an outlier in the social responsibility because its social responsibility disclosure status is 0.

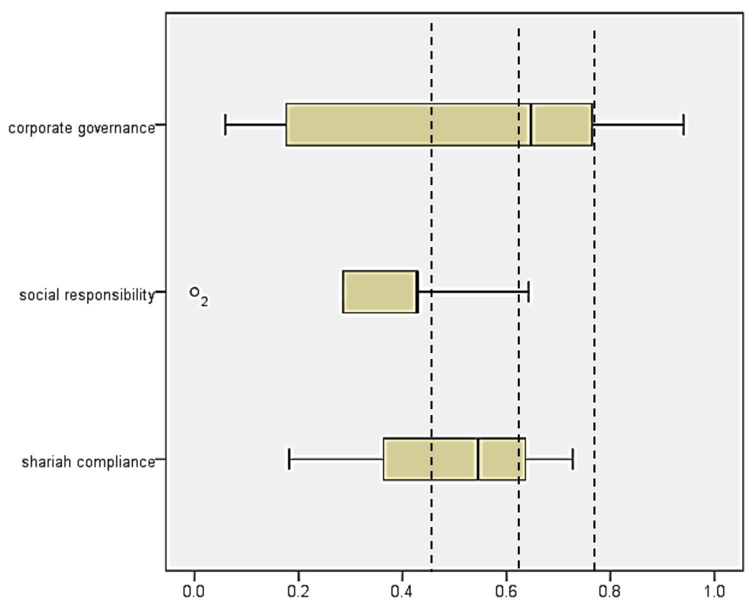

*Figure2***.** Box plot of Disclosure Type

4.3.2. Factor Analysis

Each group of dummies is analyzed using factor analysis to create an index of the disclosure. This index is created from the individual disclosure indices of Shari'ah advisory board, social responsibility and corporate governance. The first advantage of an index is that we have one number for each bank showing their disclosure status as compared to other banks. Higher the number means higher the degree of disclosure of that bank. The second advantage is that it makes the qualitative information to form quantitative data which can be used in further analysis.

Table 5 shows that when one index is constructed from the principle factor analysis that factor explains 93.9% of the variation in the three indexes. This very high value represents the reliability of the disclosure index as it will be comprehensively representing the disclosure status of the Islamic banks in Pakistan. The component matrix in table – 6 shows that the disclosure status of Shari'ah advisory board is 99.4% similar to the disclosure index. Disclosure status of social responsibility is 96.6% similar to the disclosure index and disclosure status of corporate governance is 94.6% similar to the disclosure index.

Table 5
Total Variance Explained

Component	Initial Eigen values			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2.816	93.88	93.88	2.816	93.88	93.88
2	0.170	5.68	99.56			
3	0.013	0.44	100.00			

Extraction Method: Principal Component Analysis.

Figure 3 consists of the disclosure index plotted in a bar chart. It shows how banks are different to each other. Here we can see that Meezan Bank leads the chart, followed by Burj Bank, Bank Islami which has positive value while Dubai Islamic Bank and Albaraka Bank are showing a negative value. While analyzing the box plot (figure 4) we can see that while considering the dispersion of the disclosure index none of the banks is considered as an outlier.

Table 6

Component Matrix[a]

Component	1
Shariah Advisory Board	0.99
Social Responsibility	0.97
Corporate Governance	0.95

Extraction Method: Principal Component Analysis.
a. 1 component extracted.

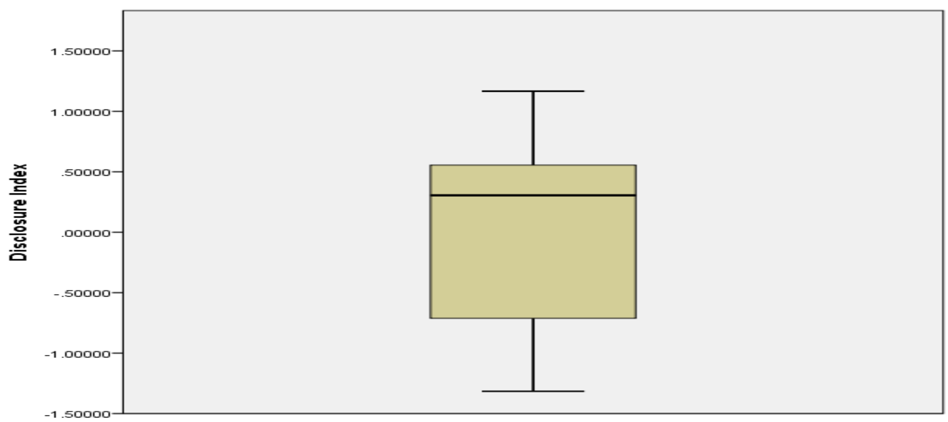

*Figure4.*Box plot of Disclosure Index

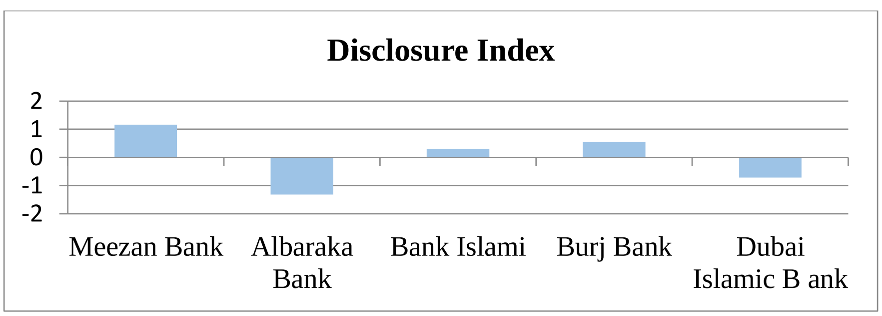

*Figure3.*Comparisons of Banks

The above indices will then be used to check association with the profit of the bank. It is expected that higher the disclosure leads to higher customer confidence and hence higher profitability. Here we will have three indexes so we will be able to rank which index has a higher association with the profit.

4.3.3. Correlation Analysis

The correlation of the disclosure index is checked against earnings per share and return on equity of the banks. In table 7 we can see that the index is positively correlated with both the performance and profitability indicators of the Islamic Banks, also this correlation is significant for the case of ROE. Hence the improvement in disclosure index is strongly similar to the improvement in the ROE.

Table 7
Correlation Index

		Disclosure Index	Earnings per share	ROE
Disclosure Index	Pearson Correlation	1	0.542	0.714
	Sig. (1-tailed)		0.172	0.088
	N	5	5	5

4.3.4. Curve Estimation

We have plotted the curve which shows the impact of disclosure index on each of the profitability indicator. Table 8 shows that if disclosure index is increased by 1% then the earning per share of the firm is increased by 1.07% on average which is also shown in the graph (figure. 5).

Table 8

Model Summary and Parameter Estimates

Dependent Variable: Earning per share

Equation	Model Summary					Parameter Estimates	
	R Square	F	df1	df2	Sig.	Constant	b1
Linear	0.29	1.25	1	3	0.34	1.104	1.071

The independent variable is Disclosure Index.

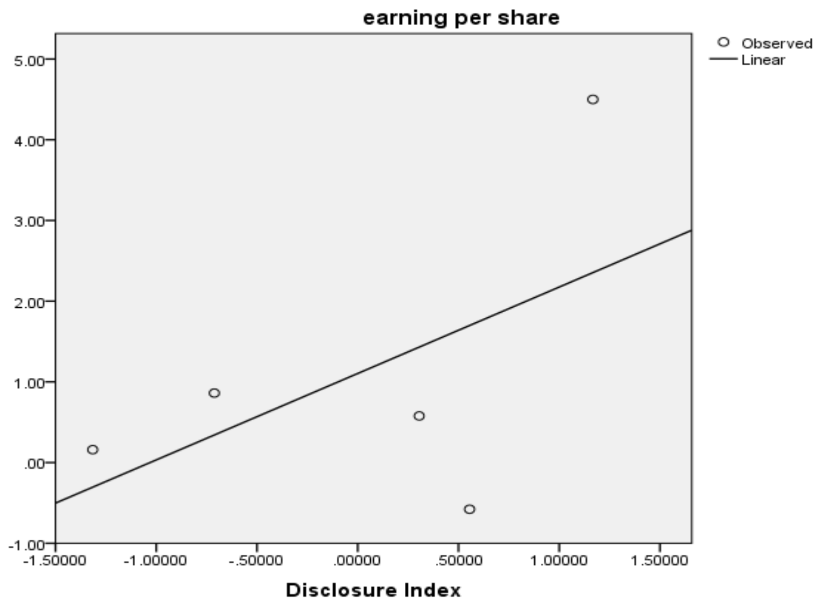

Figure 5 – Curve fitting of Earning per share

Table 9 shows that if the disclosure index increases by 1% then the return on equity will increase by 6.86% on average which is represented by the graph (figure6).

Table 9

Model Summary and Parameter Estimates

Equation	Model Summary					Parameter Estimates	
	R Square	F	df1	df2	Sig.	Constant	b1
Linear	0.51	3.11	1	3	0.18	5.518	6.856

The independent variable is Disclosure Index.

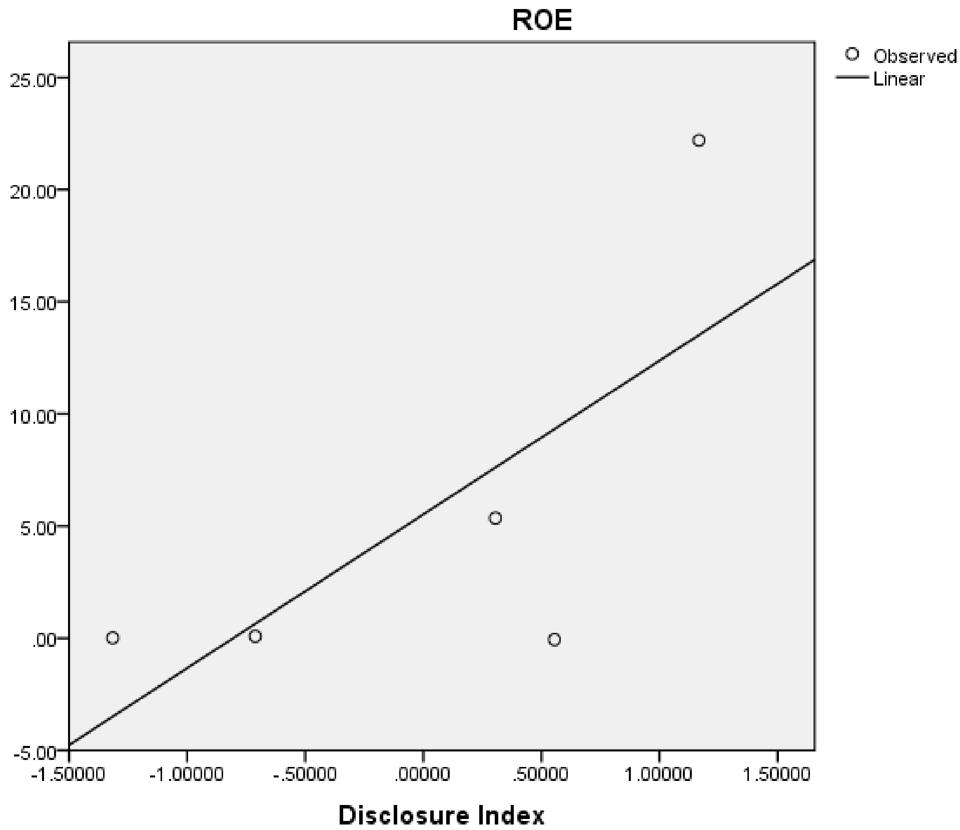

Figure 6.Curve fitting of return on equity

5. Conclusion

This study explained that divine Shari'ah law impels Islamic banks to disclose the information of corporate governance, Shari'ah advisory board and social responsibility in order to reduce uncertainty to the highest extent possible. On the other hand in conventional financial institutes, social responsibility is only considered moral obligation or voluntary action and is done for the sake of improvement in the image of the Institute. This practice makes Islamic financial institutes more transparent and prone to promote social welfare.

This study has proposed a procedure to calculate the disclosure index for Islamic banks using the data of Shari'ah advisory board, corporate governance and social responsibility disclosure. The principle factor analysis was deployed to construct the disclosure index. The benefit of forming the index is that this makes all the banks comparable to each other. This index showed that Meezan Bank beat its counter parts in terms of the overall disclosure.

The results of the study reveal that because of the fact that Islamic banks are bound to disclose their dealings as per Shari'ah law which is mandatory, and ensures that all the Islamic banks are similar to each other in disclosing their accounts and dealing. This applies that Islamic banks and Institutes are more trust worthy while handling our savings as they comply with the rules set by Allah. Also, higher disclosure means that in Islamic market, access to information will ensure saving people from any sort of exploitation.

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Does Working Capital and Financial Structure Impact Profitability of Islamic and Conventional Banks Differently?

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Abstract

One of the essential factors for the financial growth of a country is a stable banking system. Over the past few years, Islamic banking industry of Pakistan has grown substantially. However, it faces many challenges regarding its financial stability. The present study attempts to examine the impact of working capital and financial structure on Pakistan banking sector profitability. The study used generalize least square (GLS) estimation analysis on 5 Islamic banks over the period 2006 to 2014 and 15 conventional banks from 2008 to 2014. Return on assets (ROA), return on equity (ROE) and net income (NI) are used as dependent variables. Working capital and proportion of funds provided by bank creditors are used as independent variables. Bank size, deposit ratio, gross domestic product (GDP) and inflation (CPI) are used as control variables to control heterogeneity and co-linearity among variables. Study found an increase in working capital results decrease in the profitability of Islamic and conventional banks. However, financial leverage has statistically significant positive impact on profitability of Islamic banks and vice versa for conventional banks.

Keywords: **f**inancial structure, working capital, Islamic banks, conventional banks, Profitability

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Introduction

Banking sector plays an important role in growth of financial system, but nowadays banking industry is facing many challenges, such as regulatory, liquidity and working capital requirements, that influence the banking industry significantly. These challenges demand prudent decisions to solve the problems, important for existence of any institution for their sustainable prolongation. Thus, not only bankruptcy risk maybe reduced but also the profitability of the banks may also be enhanced. There is conflict of interest between two groups; ones who provide funds to the banks (depositors/investors) and look forward to high profitability on their investments. Secondly, bank management which faces difficulties to manage the balance of liquidity to attain the higher profitability by overseeing and investigating financial leverage and working capital, and with deep contemplation to accomplish better results on the spending money. An organization, either profit oriented or not, regardless of its size and business nature requires critical measure of working capital (Mukhopadhyay, 2004).

Working capital is one of the most crucial factor for maintaining liquidity, profitability, and sustainable growth in the business (Gul et al., 2013). Raheman and Nasr (2007) recommended that organizations that manage their cash, inventories and accounts' receivables are able to build most from their resources. Moreover, Ricci and Vito (2000) stated that motivation behind working capital management is to deal with the company's present records to achieve financial harmony during profit (return) and loss (risk) phase. The working capital management is seen as one of the key mechanism to meet the short term objectives of an organization. Generally, working capital is measured by cash in hand, receivables, account payable and cash conversion cycle.

Financial structure defines the debt to equity formation of the organizations. Financial structure is ratio of total liabilities (short term and long term liabilities) over the company's shareholders equity. This ratio focuses on liabilities and equity and is effective to describe how organizational finances and operations are growing through various sources of funds (Modigliani & Miller, 1958). Shubita and Alsawalhah (2012) recommended that a firm with high profit depends excessively on equity as its main financing decision. Organizations must keep up an optimal level of working capital by overlooking few dynamic speculation opportunities and enduring fleeting liquidity crisis rather holding lower working capital. In contrast, if organizations hold working capital more than required, it will illustrate the company management inefficient and weaken to take benefit from short term investments (Nazir and Afza, 2009). Bagchi&Khamrui (2012) found positive association between the working capital and profitability of organization.

Deloof (2003) and Juan García-Teruel and Martinez-Solano (2007) opined that profitability of an organization, either estimated by return on equity (ROE) or return on asset (ROA), could be enhanced by the efficient management of working capital and optimized capital structure. The aforementioned researches are conducted in Western countries and the results may not be applicable to the banking sector and organizations of Pakistan. Therefore, the present study is conducted to investigate the impact of working capital and financial structure on profitability of Islamic and conventional banks in Pakistan. The study used number of internal and external factors to check their potential impact on Islamic and conventional banks' profitability which allows bank's management and regulatory bodies to steer these factors in their favor.

The paper is composed of five sections. Section 1 provides the significance and objective behind conducting the study. Section 2 provides a background of the existing research studies, relating bank profitability to its determinants that have been stated to formulate the current research hypothesis. Section 3 describes research methodology; data, variables and research method of the study. Section 4 presents findings of the study. Conclusion is offered in the final section.

2. Literature Review

Working capital and financial structure are the central components of corporate finance as they are significantly important for the business development and imperative to financial wellbeing of small as well as large organizations (Nyamao, Patrick, Martin, Odondo, &Simeyo, 2012). Moreover, working capital management lies in efficient assets and current liabilities treatment so that it maintains strategic detachment from undue interests to assure the returns (Mehmet &Eda, 2009). Earlier studies suggested that working capital management enhances the profitability of the firms (Deloof, 2003; Mathuva, 2009; Bagchi&Khamrui, 2012). In contrast, many studies found negative relationship between the profitability and working capital management (Juan García-Teruel& Martinez-Solano, 2007; Raheman& Nasr, 2007; Raza, Bashir, Latif, Shah & Ahmed, 2015).

Now a days, working capital management and financial structure have been considered as the focal issues in the financial administration by the official/chiefs (Haider et al., 2011; Lamberson, 1995). Harris (2005) observed that working capital management and financial structure is a basic way of guaranteeing firm capacity in short term to subsidize the disparity between a product and customer. Filbeck and Krueger (2005) scrutinized that keeping up an ideal parity among all working capital segments is the significant goal of working capital administration. The success of an entity vigorously depends on the financial administration ability to proficiently deal with working capital and financial structure.

Bashir (2003) investigated the determinants of profitability in 14 Islamic banks of 8 nations (UAE, Egypt, Kuwait, Jordan, Bahrain, Sudan, Qatar and Turkey) for the period 1993-1998 via ROA and ROE. The OLS regression reported that high capital-to-asset and loan-to-asset ratios lead to higher profitability. The regression results also found that taxes affect the bank profitability negatively. Hadi (2004) examined the impact of accounting ratios on the profitability of the firms traded on the Kuwait exchange market. The study chooses the banking sector because of its large market capitalization in the Kuwaiti economy. Eight banks were selected as a sample for the period 1997 to 1999 with total of 24 observations. ROA, ROE and earnings assets ratio (EAR) were used as a proxy for measuring profitability. The study findings revealed that accounting information has been very useful for the analysts and shareholders as all financial variables (size, total deposits, working capital and leverage) have positive association to the profitability.

Al-Tamimi (2005) studied the determinants of UAE banks'profitability from 1987-2002 and found that banks'portfolio and size have statistically significant impact on performance and profitability (ROA and ROE). Filbeck and Krueger (2005) emphasized that the success of any business depends deeply on its ability to effectively and efficiently managing the working capital, say account receivables, inventory and payables. Singh and Sharma (2006) measured influence of corporate financial fundamental factors on profitability of the Bombay Stock Exchange listed companies for financial year 2001 to 2005. Multiple regression analysis utilized to confirm the relationship and found that all variables, that is, earnings (EPS), dividend coverage (DCR), financial structure (D/E ratio), total deposits (TD), book value ratio (PBS) and firm size (TA) have positive and significant association with the profitability.

Athanasoglou, Delis and Staikouras (2006) measured the selected determinants effect on banks profitability in the South Eastern European (SEE) region from 1998 to 2002 period. The study found positive relationship of concentration and inflation on the bank profitability, whereas banks' profits are not significantly affected by real GDP fluctuations. Atrill (2006) found that numerous small scale entities are dire at dealing with working capital requirements. Berger and Bouwman (2013) found that mismanagement in working capital often caused by the owner's inability to manage it efficiently, considering it as one of the greatest challenge that small and medium enterprises face.

Faridl (2007) investigated the relationship of financial structure and total size to profitability partially as well as simultaneously from 2005 to 2007. The findings show that;(a) simultaneously, all independent variables have significant and positive association to the profitability, (b) partially, only financial structure has the direct relationship with the profitability measure. Wum, Hsiu-Ling, Chen, Chien-Hsun, Shiu, Fang-Ying (2007) investigated the impact of bank's age, bank's size, financial change, the level of monetization, non-interest ratio, extent of capitalization level and GDP per capita on the profitability of 14 Chinese banks from 1996-2004. The results showed that higher levels of financial change will result into better ROA for banks. The results exhibited a negative impact of per capita GDP and a longer bank existence on the ROA. A study by García-Teruel and Martinez-Solano (2007) underlined that organizations can generate returns by decreasing their number of days of inventory receivable and by achieving the optimal capital structure accordingly, affirmed to the finding of Deloof (2003).

Sufian&Habibullah (2009) in their study focused on the internal and external factors influencing the profitability of banks in Thailand from 1999 to 2005. ROA and ROE were used as dependent variables. The study concluded that size, economic growth, and capitalization have positive impact on profitability whereas non-interest income, GDP, credit risk and overhead costs have negative relationship with profitability of banks. Mathuva (2009) also found negative relationship between profitability and average collection accounts, and additionally discovered negative net profit and working capital in Nairobi stock exchange using fixed and pooled OLS estimation techniques. This is similar to the earlier findings of Raheman and Nasr (2007), who also found negative significant relationship of firm's profitability and working capital in Pakistan.

Gill, Biger, and Mathur (2010) determined working capital relationship with the profitability of firms in New York stock exchange, USA. Their study discovered positive significant association between the profitability and working capital. However, Karaduman, Akbas, Ozsozgun, and Durer (2010) in Istanbul and Ding, Guariglia, and Knight (2013) in Vietnam found highly negative significant relationship of working capital and profitability. Michalski (2012) examined that an increase in receivables accounts level of an organization also increments the net working capital and the associated expenses of holding and overseeing receivables, thus leading to a diminishing organization profit and net revenue.

Ostadi&Monsef (2014) focused on the factors influencing the profitability of business banks in Iran. Dependent variable was profitability (ROE, ROA), and bank deposits, bank size, bank capital, liquidity concerns, and keeping money prerequisites were independent variables. Results showed that the impact of bank size and bank concentration on profitability were statistically significant. Ijaz, Akmal&Gillani (2015) investigated the influence of bank's internal factors on the profitability of Islamic banks in Pakistan during 2006 to 2013. ROA and ROE were used as a proxy for dependent variable (profitability). By using panel analysis technique, the estimated results showed that leverage ratio, operating efficiency, asset management, and bank size had positive and significant relationship to the profitability of Islamic banks.

To abridge, a review of the former writing on the relationship between working capital management, financial structure and profitability recommends that there are strong linkages among the profitability of banks and its internal and external factors as identified by several research studies. However, results varied significantly due to the environmental changes and data included in the analysis.

3. Hypothesis

H1: There is a negative relationship between working capital and profitability of Islamic and conventional banks.

H2: There is a direct significant relationship between financial structure and profitability of Islamic and conventional banks.

4. Methodology and Data Collection

The population of this study is Islamic and conventional banks of Pakistan. The sample is a balanced panel dataset of 5 Islamic banks covering a time period 2006 to 2014 and 15 conventional banks covering a time period 2008 to 2014, consisting 45 observations for Islamic banks and 105 observations for conventional banks respectively. Some of the conventional banks are excluded from the sample due to missing relevant information. A total of 7 internal variables and 2 external variables are used for the research study on annual basis. An advantage of using panel data is that more observations on the explanatory variables are available (Hsiao, 2007). This helps in overcoming the inherent multicollinearity which probably exists among the independent variables. The data on internal variables is collected from annual reports of selected banks, whereas data on external variables is collected from the World Bank (www.worldbank.org/).

ROA and ROE are the largely pertained ratios used to measure financial performance or profitability (Naceur&Goaied, 2001; Sufian&Habibullah, 2009). The profitability of banks is measured from three dimensions, that is; ROA, NI and ROE. Internal explanatory variables include working capital, financial structure, bank size and deposits, whereas external explanatory variables are GDP and CPI taken for the study. The study analyzes the data through Generalize Least Square (GLS) with the help of STATA software to test the relationship between dependent and independent variables. Sufian&Habibullah (2009) argued that to avoid heteroskedasticity and biasness in the data, one must use control variables and GLS model to resolve such problems in the data set.

Table 1
Definitions and Notations of the Variables

Variable	**Symbol**	**Measure**	**Reference**
Return on Assets	ROA	Operating Income / Total Assets	Bashir, 2003; Wum et al. 2007; Sufian&Habibullah, 2009; Ostadi&Monsef, 2014; Ijaz et al., 2015
Return on Equity	ROE	Operating Income / Total Equity	Deloof, 2003; Bashir, 2003; Hadi, 2004; Al-Tamimi, 2005; Olson &Zoubi, 2011
Net Income	NI	Total Income – (Cost of Goods Sold + Expenses - Taxes)	Uddin, 2009; Sufiyan&Habibullah, 2009
Working Capital	WC	Current Assets – Current Liabilities	Raheman& Nasr, 2007; Danuletiu, 2010; Mohamad&Saad, 2010; Valahzaghard &Taherinejhad, 2012; Enqvist, Graham, & Nikkinen, 2014; Farhadi et al., 2015
Financial Structure	D/E	Proportionof fundsprovidedbycorporate creditors	Harris, 2005; Singh and Sharma, 2006; Raheman& Nasr, 2007
Banks Size	TA	Log of total assets	Goddard, Molyneux & Wilson, 2004; Wum et al., 2007; Flamini, Schumacher & McDonald, 2009
Total Deposits	TD	Totalamount received by the bank in form of current/saving accounts	Ostadi&Monsef, 2014, Ijaz et al., 2015
Gross Domestic Product	GDP	Annual GPD	Wum et al., 2007; Kosmidou&Zopunidis, 2008; Mehmet
Consumer Price	CPI	Annual CPI	Deloof, 2003; Gul, Irshad &

The research model of the study is as follows

$$\sum_{3}^{K} Perf_{it} = \beta_0 + \beta_1(WC)_{it} + \beta_2(\frac{D}{E})_{it} + \sum_{3}^{L} X_{it} + \varepsilon_i + \mu_t$$

Where

i denotes banks,

t denotes number of years,

Prof represents profitability variables,

WC represent working capital,

D/E represents the debt to equity ratio,

X represents the set of control variables (banks size, total deposits, GDP, CPI),

ε and μ represents the error term

Banks

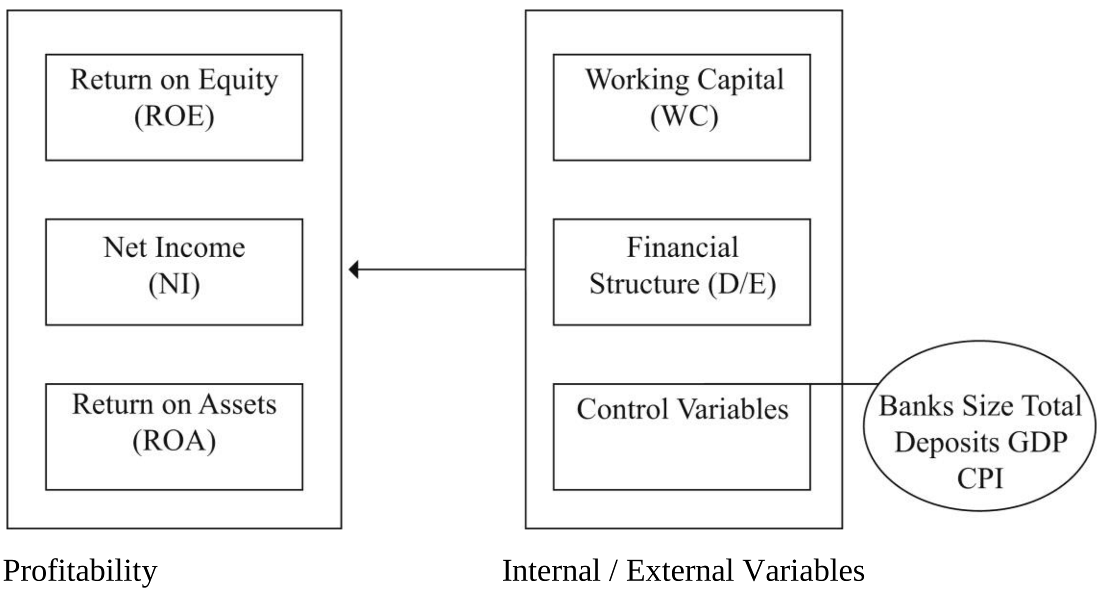

Figure 1.Research Framework

5. Results and Discussion

5.1. Descriptive Statistics

Table 2 explains the descriptive statistics of all the dependent and independent variables. The value of mean depicts the average of the given variables taken for the study. Standard error is the average dispersion inherent in large number of samples. The volatility in the data set is measured through the standard deviation. A small value of standard deviation means that the data points lie close to the mean value. To overcome the issue of normality in banks size, GDP and CPI, the study takes logarithm of banks size (total assets), GDP and CPI after applying the Test of Normality. Last two columns show the minimum and maximum values of the variables taken for study. The significance level used for this study is 0.05 with confidence level of 95%.

Table 2
Descriptive Statistics

	Islamic Banks				**Conventional Banks**			
Variables	**Mean**	**Std. Dev**	**Min**	**Max**	**Mean**	**Std. Dev**	**Min**	**Max**
NI	0.36	1.45	-2.19	4.56	15.24	1.72	11.4	19.75
ROA	0.43	1.27	-1.84	7.63	1.83	4.5	-25.2	9.12
ROE	4.39	8.34	-9.93	28.18	11.72	105.99	-28.1	40.53
WC	15.58	1.23	12.2	18.46	16.33	1.8	12.21	20.7
D/E	7.5	5.16	0.09	17.77	11.2	12.25	0.04	66.78
TA	17.52	1.13	14.8	19.89	18.96	1.59	15.52	23.12
TD	0.57	0.25	0	1.29	0.96	1.09	0	6.24
Log GDP	26.54	1.73	25.54	29.78	25.62	0.06	25.54	25.74
Log CPI	4.56	0.29	4.08	4.95	4.68	0.2	4.34	4.95

5.2. Multi-Collinearity Analysis

Table 3 shows the multi-collinearity test of all the variables used in the study. The test indicates the absence of multi-collinearity problem among all the factors. This means that all the factors taken in to study have no interdependency on each other and are free from the issue of co-relation of explanatory variables. The results show that the data can be utilized for the regression because the problems do not exist among its variables. The rule of thumb of variance inflation factor (VIF) test states that VIF value should be less than 10 (Gujarati, 2003). As all the values of VIF are below 10 which mean we reject the null hypothesis and conclude that there is no multi-collinearity among explanatory variables.

Table 3
Variance Inflation Factor Test

Variable	Islamic Banks		Conventional Banks	
	Tolerance	**VIF**	**Tolerance**	**VIF**
NI	0.98	1.02	1.31	0.76
ROA	0.36	2.76	0.36	2.76
ROE	0.4	2.48	0.53	1.86
WC	0.67	1.48	0.63	1.56
D/E	0.57	1.73	1.15	0.86
TA	0.76	1.31	0.81	1.23
TD	0.81	1.23	0.7	1.41
Log GDP	0.8	1.25	0.73	1.35
Log CPI	1.32	0.75	1.24	0.8

5.3. Panel Data Analysis

Panel data provides more accurate inference of model parameters (Kiviet, 1995), controls impact of omitted variables (Heckman, Killingsworth and MaCurdy, 1981), generates more accurate predictions (Hsiao, 2003), and analyze non-stationary time series (Binder, Hsiao & Pesaran, 2005). After testing the co-relation test among variables, generalized least square (GLS) regression has been applied to check the influence of independent variables on dependent variable. The advantage of pooling is that more reliable estimates of the parameters in the model can be obtained. Table 4 and Table 5 represent the GLS regression results for all the three models for Islamic and conventional banks. The number of observations in each model is 45. The coefficient for each variable represents the positive or negative impact on the respective dependent variables, if variable is increased by 1 percent (or unit). Similarly, p-value indicates whether the independent variables have significant impact on the profitability (NI, ROA and ROE) at 1%, 5% and 10% significance level respectively.

5.4. Regression for Islamic Banks

Table 4 shows that there is a negative relationship of working capital, total deposits, GDP and CPI with the NI. However, NI found to be positively associated with financial structure (D/E ratio) and bank size. The findings also show that only bank size (Ali, Akhtar& Ahmed, 2011), total deposits (Chirwa, 2003) and CPI found to be statistically significant to NI. Moreover, working capital has negative but significant relationship with the ROA and ROE, similar to the earlier findings of Deloof (2003) and Raheman& Nasr (2007).

Table 4

GLS Regression for Islamic Banks

Variable	NI	ROA	ROE
WC	-0.01	-0.04***	-0.03***
D/E	0.22	0.00***	0.06***
TA	4.81***	0.12***	0.02***
TD	-6.44***	-0.08***	-0.25***
Log GDP	-0.03	-0.00**	-0.01**
Log CPI	-12.36***	-0.47***	-0.22***
Constant	-8.67	0.70***	0.25***

* 0.05 significance level ** 0.01 significance level *** 0.001 significance level

Similarly, financial structure and bank size have statistically positive relationship with the ROA and ROE. These outcomes are similar to the work of Bae, Kang, & Wang (2011), Ruan, Tian, & Ma (2011) and Saeedi&Mahmoodi (2011). Thus, it indicates that larger the size of banks, higher the investment of the bank, which ultimately increases the return (profit) of the banks. Total deposits are negatively significant with all profitability measures. It illustrates that when the deposits increase, the profitability of the Islamic banks will decrease. In addition, GDP and CPI also show negatively significant (Sufian&Habibullah, 2009) relationship with the profitability of Islamic banks.

5.6. Regression for Conventional Banks

Table 5 depicts the relationship between working capital, financial structure and other control (internal/external) variables with the profitability measures of conventional banks. The findings show that the variable of working capital has positive relationship with NI but it is not statistically significant. Moreover, working capital was found to be negative and statistically significant with the profitability indicators of ROA and ROE, similar with the findings of Falope&Ajilore (2009)**.** Financial structure (D/E) has negative significant relationship with all three measures of profitability, supported by the earlier research of Cheng (2009) but contradicted to the findings of Wum, Hsiu-Ling, Chen, Chien-Hsun, Shiu, Fang-Ying (2007)**.** This indicates that an increase in bank's financial structure, results in decrease of profitability in conventional banks. It means companies with higher level of debt, are usually perceived to be doing risky investments, possibly affecting wealth transfer from debt holders to shareholders.

Similarly, the study found positive relationship of bank size (total assets) with all profitability measures. In addition, total deposits and CPI show positive relation with the three models; however they are only statistically significant with NI. GDP impact statistically significantly and negatively on NI, but found to be positive insignificant association with ROA and ROE. This is also supported by Athanasoglou, Delis and Staikouras (2006).

Table 5
GLS Regression for Conventional Banks

Variable	NI	ROA	ROE
WC	0	-0.16***	-0.01
D/E	-0.01**	-0.04***	-0.00*
TA	1.19***	0.25*	0.03***
TD	0.69***	0.34	0
Log GDP	-1.65**	1.11	0.05
Log CPI	0.25	1.27	0.05
Constant	32.63**	-23.29	0.97

* 0.05 significance level ** 0.01 significance level *** 0.001 significance level

6. Conclusion

Financial officials of corporations regularly distinguish that working capital management and financial structure is very important for the banking profitability. This study was an attempt to understand that to what extent working capital and capital structure affect banking profitability of Islamic and Conventional banks in Pakistan. The study found that working capital has negative and statistically significant relationship with the profitability in both Islamic and conventional banks, in line with the findings of Falope&Ajilore (2009) and Raheman& Nasr (2007). On the contrary, debt to equity ratio is negatively related with profitability measures of conventional banks, supports the argument of Mesquita& Lara (2003), who indicate that long-term debts are generally more costly and henceforth bring about low profitability. However, debt equity ratio impacts positively and significantly on profitability of Islamic banks, is supported by earlier finding of Grossman & Hart (1986), who contend that larger amounts of debt in the association's capital structure will be connected with higher levels of profitability. These outcomes have potential approach suggestions for the regulators of Islamic and conventional banks and other financial organizations that might need to add an indigenous financial framework. Further research can be extended to explore the above findings and to include some other factors such as doubtful loans, reserves ratios, capital adequacy ratio, inflation, exchange rate, etc.

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