Profit Distribution Management: A Comparison of Islamic and Conventional Banks in Pakistan

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Dedication

To my Beloved Parents, Dearst Brother & Sister

&

My Respected Supervisor

Declaration

I hereby solemnly declare that all the literature presented in following dissertation is entirely based on research work carried out in defense of my thesis topic. This publication is pioneer in its context and has neither similarity to any previously submitted thesis nor any copied material in its contexts from any source except where due reference is clearly mentioned. All of the published data is result of my own efforts, research and analysis with support of those mentioned in acknowledgement, in specific my supervisor. If at some later stage plagiarism is detected in the submitted research based on literature, I will be fully responsible for all the consequences as per the prevailing rules and law of approval committee.

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List of Abbreviation

LA/TA	Loan Assets to Total Assets
CONC	Banking Market Concentration Ratio
FD	Financial Development
AS	Asset Spread
DS	Deposit Spread
GDPGR	GDP growth Rate
IDB	Islamic Development Bank
IBs	Islamic Banks
FIs	Financial Institutions
SBP	State Bank of Pakistan
IFSB	International Financial Standard Board
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
IRR	Investment Risk Reserve
PER	Profit Equalization Reserve
LLP	Loan Loss Provisions
ROA	Return on Asset
ROIAH	Return on Investment Account Holder
PDM	Profit Distribution Management
IMF	International Monetary Fund
IFS	International Financial Statistics
WDI	World Development Indicators

Abstract

This study examines the profit distribution management of Islamic and conventional banks using the panel data of Islamic and conventional banks of Pakistan from the time period of 2005 – 2015 by using the most frequently used econometric technique fixed effect model. The study also investigates the internal and external factors that directly or indirectly affect the profit distribution mechanism of banking system of Pakistan. The findings of fixed effects model show mixed results by using two different type of measures of profit distribution management for both Islamic and conventional banks. It is documented that the banks actually distribute their profits according to a managed rate of return. The correlation of deposit spread and asset spread shows that profit distribution management is performed by the banks in Pakistan to overcome the withdrawal risk. The findings present mixed results for the profit distribution management factors for both Islamic and conventional banks. The value of LA/TA, deposit ratio and CONC have a negative relationship with profit distribution management. The findings shows that FD have a positive significant association with profit distribution management for conventional banks whereas, it have a negative and insignificant association for Islamic banks. The findings of GDPGR also presents mixed outcomes like in AS (asset spread) there is a positive significant association towards profit distribution management, whereas in DS (deposit spread) there is a negative association between the profit distribution management and GDPGR for both (Islamic and conventional) banks.

Keywords: Profit distribution Determinants, Earnings management, Banking Industry, Pakistan

JEL classification: E44 G21 Z12

Chapter 1

Introduction

1.1 Background

Financial sector plays an important role in economy of a country. Banking system is one of the most essential part of financial sector. The development of banking system is crucial to improve and to run a strong financial system. Banking system plays an imperative role in global economy. In global financial system, two types of banking including conventional banking and Islamic banking are working at a par.

Islamic banking has grown continuously during the past four decades in respect of size and branches. Worldwide Islamic banking is practiced in more than 50 countries. Many Western banks also have either Islamic banking windows or branches to provide Islamic financial products and facilities to their customers. Islamic Banking and Finance (IBF) has converted above the year from a weaker financial idea to a main market player in global finance (Chong & Liu, 2009). According to the principles of Shariah, nobody have right to claim any reward without bearing any risk. The concept of Islamic banking is based on the belief of Profits and Losses Sharing (PLS) among the supplier and user of money. This perception of equitable sharing is a basic component in Islamic finance as it reveals the principles of Islam (Jedidia & Hamza, 2014).

The rules and principles on which Islamic banking is based are different from the conventional banks. Islamic banking is based on the concept of Shariah principles that distinguished it from the conventional banking. Islamic banks are established under the Shariah rules and operate according to the Shariah principles and guidelines which

prohibit the payment and receipt of interest. On the other hand, the profit maximization is the main purpose of conventional banks. Islamic banking system is ruled by Shariah principles which differentiate their operations from conventional banking system. Under the rules of Shariah payment or receipt of interests on commercial and financial transactions is prohibited. The interest free transactions are adopted by Islamic banks makes the investment based on profit loss sharing which makes the Islamic banking system unique. Under the principle of profits sharing, banks are required to share the returns with the customers which are resulting from these combine funds (Boulila Taktak, Ben Slama Zouari, & Boudriga, 2010). Due to principle of profit loss sharing, Islamic banks become able to bear the shocks which affect to the assets returns. According to (V Sundararajan, 2007), a considerable smooth payment of returns can be paid on investment accounts. Such smooth payment of returns affects the efficiency of Islamic banks and makes their returns less volatile than the conventional banks.

Islamic banking system is facing number of challenges in the global financial market. Islamic banking is different from conventional banking in such a way that the presence of the interest on which conventional banking is based is strictly prohibited. Islamic banks are operating as commercial banks, so they are bound to follow the conventional banking laws and also the Islamic financial laws. As a result, Islamic banks sacrifice number of profitable financial opportunities which are prohibited according to rules and laws of Islam (Samad, 2004). In this way, it is usual practice that Islamic banks have to face number of challenges as a new player in competitive financial market.

Islamic banks also perform the practices of commercial banking and like conventional banks they also depend on depositors' funds as a key source of resources. Consequently,

it is important for the Islamic banks to become aware to the factors that affect customers' preferences in decision making to deposit their funds through Islamic banks (Haron & Ahmad, 2000). As depositors are interested in returns, it is essential for the management of Islamic banks to understand the degree to which the returns on deposits impact their decision making regarding the deposits. According to the theory, the interest rate has always been considered as one of the vital component in defining the saving attitude of investors. As higher the interest rate, people are willing to save more. At higher rate of interest individuals minimize their consumption level. Management of conventional banks came to know through experience that cost of deposit can be helpful to form the type of customers, so that bank can serve best. Fluctuating deposit costs influence not only the deposit interest rates and bank loan rates but also the customer's investment and deposit decision making, which in turn affects the both, bank growth rate and profit margins (Edmister, 1982).

The Islamic banks usually maintain their investment according to interest rate. The Islamic banks are pressured to pay market rate of returns to their customers because of two main factors one is their contractual environment which is called demand side factor and the other one is banks' personal attributes which explain their communication with that contractual environment (Hamdi & Zarai, 2013a). Islamic banks place themselves in the market on the basis of their comparative advantage and this placing exposed in their operations product and service (Farook, Hassan, & Clinch, 2012).

With the passage of time, the trends of banking industry are becoming changed globally. There is intense competition between banks in term of profitability and return. Financial institutions are introducing new ways of transactions and offering new types of products

and services to meet the requirements of market and to expand their businesses in term profitability and to get better position in market. Financial institutions are focusing on the Islamic ways of transactions to get better results than conventional financial system. Islamic banking is growing since 1975 and it gets a symbolic place in financial industry. The growth level of Islamic finance is increased continuously. The expected growth of Islamic finance in term of assets is $2 trillion in 2015 (IMF, June 2015). Islamic banking is practiced around 50 countries worldwide, both Muslim and non-Muslim. In Some countries like Sudan and Iran only Islamic banking is practiced. In some countries including Malaysia, Indonesia, Bangladesh, Jordan, Pakistan and Egypt both Islamic and conventional banks are operating. Islamic countries are not only practicing Islamic banking rather, non-Muslim countries are also developing their interest in operations of Islamic banking. The Islamic Bank of Britain was the first bank which gets the license from a non-Muslim country to start operations of Islamic banking in august 2004. In the United States two banks, Devon Bank in Chicago and the [1]HSBC in Ann Arbor offer Islamic banking products to customers (Chong & Liu, 2009). According to the latest estimates it is noticed that Islamic banking is expected the growth level of 15% per annum. Malaysia is reported as largest Islamic banking market in the world (World Bank, 2006).

In 1975, Dubai Islamic Bank was established as a first Islamic bank in the world. The growth rate of Islamic banking in term of assets is 12% to 15% per year worldwide. The whole banking industry in Sudan and Iran has transformed into Islamic banking. Many

[1] Hong Kong and Shanghai Banking Corporation

large banks on international level including Citicorp, HSBC, Commerzbank and [2]BNP have introduced the Islamic banking by offering the Shariah complaint products to their customers. According to the estimates of institute of Islamic banking and insurance 277 Islamic financial institutions and Islamic banks are operating in the 70 countries of the world in 2005. South Asia region is leading in the growth of Islamic banking. The GCC region was the primary focus and growth area of Islamic banking in early 1990. In 2002, 74% assets of Islamic banking were held by the Islamic banks of GCC region (Molyneux and Iqbal, 2005). After the incident of September 11, 2001 the huge amount of deposited money of Arab countries returned back from the western banks to the banks of Middle East. Due to these circumstances, the GCC region become more dominant and strong in Islamic banking worldwide.

Islamic Banking Industry of Pakistan recorded the deposits of Rs.1,573 billion and the assets of Rs.1,853 billion at December, 2016. In banking industry of Pakistan, market share of deposits and assets of Islamic banking is 13.3 percent and 11.7 percent, respectively by the end of 2016. The amount of capital of Islamic banks is increased by Rs. 14 billion and the amount of investments is recorded at Rs.490 billion. Net profit of Islamic banks are recorded Rs.11.8 billion at the end of December 2016. The main profitability indicators like return on assets is recorded 0.7 percent and return on equity is recorded at 10.6 at the end of 2016. In Pakistan 21 Islamic Banking Institutions including 5 full-fledged Islamic banks and 16 Islamic branches of conventional banks are operating by the end of December 2016 (Islamic Banking Bulletin, December 2016).

[2] Bank National de Paris

Islamic banking industry has been developed globally since last four decades. The outstanding growth can be justified by the increasing value of assets and the knowledge of Islamic principles among Muslims (Samad & Hassan, 1999). The speedy progress and extension of the industry of Islamic banking needs an effective and competent management and helpful governing atmosphere. The management of Islamic banks use distribution of earned profits to their depositors as a return, against their investment accounts to maintain and stabilize the rate of return. Distribution of profits to the depositors is necessary to smooth the earnings of banks and to develop the confidence of customers on bank. The profit distribution is basically the allocation of profit which is earned by the bank to its customers and other stakeholders. The distribution of profits which is earned from depositors' money through financing is the responsibility of a bank (Mulyo & SITI, 2012).

1.2 Gap in the Literature

Limited studies have been conducted about profit distribution management by Islamic banks internationally. The study by V Sundararajan (2007) found that Islamic banks manage profit distribution against interest rate but the sample size was too limited in his study. Another study by (Hamdi & Zarai, 2013a) has been conducted about earnings management of Islamic banks and techniques usually used for profit distribution management. The study also investigated the impact of profit distribution management on investment decisions and interests of account holders. (Farook et al., 2012) investigated that Islamic banks manage their profit and distribute it to the account holder according to the market return rate. There are some bank specific and macro specific factors that are directly or indirectly related to the profit distribution management of banks. However, no

evidence has been found on comparison of Islamic and conventional banks regarding profit distribution management. Previous studies have also not included the factors which are related to the level to which profit distribution is managed by the banks according to the market rate and aside from the assets return rate. The aim of this study is to compare profit distribution management system between Islamic and conventional banks in case of Pakistan. The study also examines the factors that are related with the level to which profit distribution is managed nearer to deposit rate and far from assets return rate.

1.3 Objectives of the Study

The objectives of the study which we have to analyze are as follows;

1. To examine and compare the profit distribution management practices of Islamic and conventional banks.
2. To determine the factors that are related to the degree of profit distribution management of banks according to the market rate of return or asset return rate.

1.4 Research Questions

Following are the research questions of the study;

1. Whether Islamic and conventional banks are different from one another in profit distribution management?
2. Which rate is used by Islamic and conventional banks for profit distribution?
3. What are some internal and external factors and how they affect the profit distribution management of banks?

1.5 Significance of the Study

Financial sector's growth is very important for economic development of a country. Islamic banking is an emerging sector of financial industry over the last few decades. It attains a substantial rate of growth and size. Islamic banking industry is becoming a strong and attractive financial part of the economy in present time. Islamic banking plays an essential role in economic and financial development of Islamic countries. It is going to become a viable alternative to conventional banking system and its role cannot be ignored.

The basic concept of conventional banks is profit maximization but the basic principle of Islamic banking is profit and loss sharing. As the Islamic and conventional banks operate in the same competitive economic environment, they have many features and characteristics that are similar to them. This study helps us to check the profit distribution mechanism across both competitive banking systems and provide significant information as to which system is most reliable and strong. In case of Pakistan, first of all this study will helpful for the policy makers and bankers to understand the profit distribution mechanism in both systems and also to the factors which are directly responsible for the profit distribution management. Secondly, the study of profit distribution practices of both banking system will be beneficial for the customers as they can take appropriate decisions related to their investment. They can find a better Profit distribution system and rate of return by comparing the both banking systems. Thirdly, this study can be a significant contribution in literature of Islamic banking. The literature related to profit distribution management and distribution rate of profit of Islamic banks is limited.

After the few decades of establishment, Islamic banks take a strong position in financial industry. In resource mobilization, allocation, government policy implementation and in domestic and foreign trade, Islamic banks plays an active role. Pakistan, being a Muslim country wants to establish an Islamic economic and financial system. This research will be helpful for the growth of Islamic banking industry in Pakistan. As this study is related to the bank specific and macro specific factors that are responsible for the profit distribution system of banks, it can be beneficial for the government, bankers and policy makers for the implementation of strategies and policies to formulate, regulate, and stabilize the return rates for smoothing the returns to depositors and other stakeholders of banks. This study will be fruitful contribution in the existing literature of Islamic banking. It can provide comprehensive information related to profit distribution of Islamic banking and also about the factors that are related to the profit distribution of banking system.

This study may also helpful for the investors in understanding the rate of return which is offered to them by the Islamic banks against their deposits and investment. Return and profit is the main purpose of investment activity. This study is fruitful for investors as it discusses the profit and its distribution and the rate of return. An investor can get complete information about the distribution mechanism and rate of returns which Islamic banks pay against the investment and this may help the investor to make a right investment decisions. As a Muslim an investor in Pakistan, is interested to make an investment activity which is according to the Shariah rules and Islamic principles. This study is beneficial in this way as it provides a clear picture of profit distribution management of Islamic banks which operates according to the Shariah rules.

1.6 Scheme of the Study

This chapter comprises of introduction, back ground of the study, gap in the literature, objectives of the study, research questions and significance of the study. Chapter 2 covers the overview of Islamic baking in Pakistan and an overview of profit distribution management in banking sector and profit distribution management in Islamic banking. In Chapter 3 review of the literature and research hypotheses are presented while Chapter 4 discusses about methodology, econometric model, data, and variables. Chapter 5 presents the results and their interpretation. In Chapter 6, conclusion, limitations of the study, and policy implications are discussed.

Chapter 2

Overview of Islamic Banking

2.1 Islamic Banking and its Features

Societies are built on the basis of some unique thought and certain beliefs. A Muslim society is founded on the base of Islamic thoughts and beliefs. Every Muslim spends his life according to the revelation of Quran and guidelines of Sunnah. Islam provides vigorous and practical Islamic laws regarding every field of life which are based on the principles of Quran and Sunnah. Like every field of life Islam provides a complete mechanism regarding the financial affairs of Muslim communities. In a Muslim society capitalist economy cannot work because it is against the Islamic laws of business. All Muslim needs proper guidance related to economic and financial matters especially in present age when the capitalist economies and interest based system of banking and finance is leading the world's economy. Interest (Riba) is strictly prohibited in Islamic finance as it is proved from three major sources of Islamic rules including Quran, Sunnah, and the council of Islamic Fiqh Academy. As the importance of banking system cannot be abandoned and the interest free banking is prohibited in a Muslim economy, so the Muslim jurists and scholars started to explore and introduced a new and alternative banking and financial system in form of Islamic banking and finance. Islamic banking has different philosophy and operations from conventional banking. In contrast of conventional banks, Islamic banks do not deal in physical money and they do not provide

the finance in physical form of cash against a fixed rate of interest and also do not promise a fixed rate of return to depositors. The profit loss sharing concept of Islamic banking changed the attitude of banking business. It is very difficult and challenging to formulate a profit loss sharing concept in banking transaction in a conventional banking system. The lack of opportunity of risk free rate of return raises the risk vulnerability of Islamic financial institutions. In Jeddah, a conference by organization of Islamic conference was held in 1973 and it was decided in the conference to establish the Islamic Development Bank (IDB). The last quarter of the 20th century was the era in which the industry of Islamic banking and finance is promoted not only in Muslim countries as well as in all over the world and this magnificent journey has been persistent in 21st century.

Islamic banking has some unique features. These unique features are based on the rules and principles of Shariah which guide in every step of life. Although the interest based transactions were main reason of transformation of conventional banking into Islamic banking, but there are many other features in banking business which must be practiced according to the rules of Shariah. Examples of some Islamic banking features are given below (Hanif, 2011)

1. The principle business under Islamic finance must be Shariah compliant. The Islamic banks are strictly directed to avoid from receiving the deposits and providing finance to the business which are prohibited by rules of Shariah. Prohibited businesses under Shariah rules include liquor, pork, and entertainment.

2. According to rules of Shariah, profit and loss sharing is significant feature of Islamic finance. Under Islamic finance, Islamic banks cannot specify the share of profit rather

they are bound to share the loss as well. Partnership must be on profit loss sharing principle.

3. In Islamic finance the transaction which are based on futures, forwards, gambling and uncertainty are prohibited.

4. No additional amount can be charged by the Islamic banks from the customer in case of default or late payment as it falls in riba.

6. In Islamic finance principles, it is essential that the transaction must be backed by a real or physical asset.

2.2 Current Trends and Practices of Islamic Banking

In the ending quarter of 20th century, Islamic banking was initiated to fulfill the financial needs of Muslims in all over the world. Astounding growth and incredible expansion has shown by Islamic financial institutions worldwide. The Islamic financial industry has grown quickly during some last decades and in previous decade the growth rate was recorded 10% to 12% annually. The anticipated amount of assets of Islamic finance was $951billion consisting of more than 300 institutions operating beyond the 50 countries by the end of December 2008. Islamic finance shows immense growth during the period of economic decline in developed countries like Europe and the USA in 2007 and 2008. In 2007 and 2008 the recorded growth rate of assets of Islamic banking was 38% and 25% respectively. Conferring to current analysis, the Shariah-compliant assets of financial institution are valued around 2 trillion US dollars and expected to be increase to 3.4 trillion US dollars in 2018. It is observed that the growth level of assets of Islamic banking is greater than the growth of asset of conventional banking on global level. The

financial markets show the evidence and claimed that Islamic banking has a great potential to address the existing problems of poverty and unemployment (World Bank, 2015).

Islamic banking is directed to the incredible growth in both Muslim and non-Muslim countries around the world. The countries of non-Muslim world including Europe, the United States, and South Africa have also great interest towards Islamic finance. International institutions of banking like World Bank and many other councils of Islamic finance are making joint efforts to introduce the Shariah-compliant products and to promote the Islamic financial instruments. Recently in July 2015, a MoU is signed by the General Council of IBs and FIs for the expansion, development, progress and improvement of Islamic finance not only in Muslim countries rather in non-Muslims countries as well.

The Islamic banking industry has massive enlargement in the countries of GCC region including Bahrain, United Arab Emirates, Kuwait, Qatar, Oman and Saudi Arabia. In Islamic countries, like Malaysia, Sudan, Iran and Pakistan Islamic banking industry is on peak from last few decades. These countries made efforts and take forward steps for the growth of banking system which is following the principles of Shariah. In Islamic banking, demand for new products and services is increasing rapidly. Only commercial banking is not the preferable business of this industry rather it deals with other financial services including insurance, retail investments, mutual funds, public and project financing and consumer financing. Recently, Egypt and Turkey designed some new frameworks of Shariah based financing instruments to fund the small and medium size business (Olson & Zoubi, 2008).

The recent figures indicate that Islamic banking growth share has increased with the passage of time. The competitiveness report by Ernst and Young (2013) states that the growth rate of assets of Islamic banking has risen 17% in the year from 2008-2012. The report of Ernst and Young (2016) shows that the growth level of assets of Islamic banking including commercial and retail banking 16% by the end of 2015. The share of the banks operating in GCC region is approximately 34%. A significant growth of Islamic financial industry is witnessed in Malaysia, Bangladesh, Jordan, Turkey and Pakistan. The implementation of strategies by government and regulatory bodies caused the progress and growth in these countries. The government of Turkey have aim to increase the market share of 5.7 to 15% by the end of 2023. The participation share of Pakistan in the market of Islamic banking recorded 9.8% in 2014 and the central bank of Pakistan plans to increase it to 20% by the end of 2018. The size of Islamic financial market is ranging from 1.66 trillion dollars to 2.1 trillion dollars and this size is expected to be increased to 3.4 trillion dollars by the end of 2018. 1% of total global financial market is represented by Islamic financial assets.

2.3 Islamic Banking in Pakistan

Pakistan has stayed as leading proponent of Islamic banking. It is because Pakistan is the only Muslim state which formulated on the ideology of Islamic. The state religion of Pakistan is Islam. Thus, any law which is not followed by the teachings of Islam is considered void according to the constitution of Pakistan. The banking industry of Pakistan was not strong at the time of independence as a newly born state Pakistan did not have any central bank at that time to perform its banking operations. The banks that were existed at the time of partition, started migration and shift their business to India.

The situation of banking industry of the state was very critical. At last, State Bank of Pakistan was established in 1948 and filled the gap. After the establishment, state bank of Pakistan focused on the growth of banking sector in Pakistan and made policies to improve the situation of banking sector. Later on, Habib bank, Allied bank and national bank started their operations. Initially the banking system of the country was based on conventional banking system and shown a visible growth. In the ear of 1970 the Islamic banking got the attention of the government and regulatory bodies.

The council of Islamic ideology starts efforts to shift the economy of country towards Shariah based system in early eighties. The interest based banking declared haram by the federal Shariah court of Pakistan in 1991. In 1999 a commission set by the government and Supreme Court of Pakistan decided to stop interest based banking and instruct the government to introduce interest free banking to Islamize the economy of the country. State bank of Pakistan make some practical strategic plans to transform the conventional banking into Islamic banking from start of year 2000. To implement the policies and to regulate the Islamic banking, State bank established the Islamic banking department. It was arduous to stop the conventional banking suddenly, as this practice was failed once before. So, Islamic banking started and promoted parallel to conventional system of banking.

In 2002, Meezan bank got the license as a first Islamic bank of Pakistan. Gradually, this practice continued and State Bank of Pakistan had given the license to 5 banks operating as full-fledged Islamic banks and 14 branches of conventional banks operating as Islamic branches. The process of growth and moving forward is providing fruitful results. Islamic banking industry of Pakistan has shown remarkable growth in last six years. By the end

of 2016, 5 full-fledged Islamic banks and 16 independent Islamic branches of conventional banks are running their operations (Islamic Banking Bulletin, 2016). The growth level of Islamic banking in Pakistan is increasing day by day and achieved a double digit growth of 10% by the end of year 2014. For the up gradation of Islamic banking industry, SBP suggested some new policies and sort of plans. The government authorities are also paying full concentration towards this sector and engaging the economy of the country into Islamic financial dealings on global level. Islamic banking industry in Pakistan is booming and continuing its journey to success. In Pakistan, The future of this industry is quite successful and brighter. Table 2.1 presents some growth figures of Islamic banking in Pakistan.

Table 2.1: Islamic Banking Growth figures

Particulars	**Growth in billions(Rupees)**		**Growth in %**	**Share in overall banking**	
	Dec 2015	**Dec 2016**	**Dec 2016**	**Dec 2015**	**Dec 2016**
Total assets	1,610	1,853	15.1	11.4	11.7
Deposits	1,375	1,573	14.4	13.2	13.3
Total IBI,s	22	21	_	_	_
Islamic	2,075	2,322	11.9	_	_
Net profit	12.3	11.8		_	_

2.4 Profit Distribution Management in Islamic Banking

According to the rules of Shariah, nobody can claim a predetermined fixed rate of reward against capital. Rather, this rate must be vary and fluctuate according to earned outcome. An efficient framework of regulations required for the accelerated growth of Islamic banking industry and to provide a helpful environment to industry.

Islamic banks are working in a competitive environment with conventional banks. Therefore, to manage a solid place and to maintain a secure position in market they must distribute profits to their customers with a substantial ratio that can compete with the ratio of conventional banks. It is evident that Islamic banks manage their distributions of profit to their depositors under fluctuating rates. Islamic banks have constrained to provide the similar rate of return to its customer as offered by conventional banks due to overcome the competition in market (Venkataraman Sundararajan, 2008) and (Farook et al., 2012).

Muslim customers have dual concern at the time of investment. First, they want higher rate of returns against their investment secondly they want to invest their money in Shariah based modes of financing therefore, they look towards Islamic banking system as it satisfied their both requirements. The customers of Islamic banking institutions are more concerned to interest free banking based on Shariah principles than interest based conventional banking system so, the rates offered by conventional banks are not compared with the rate of Islamic banks. The depositors decided to deposit in Islamic banks due to their religious commitments rather than other elements. A Shariah loyal depositor always prefer Islamic banking for making deposit due to conformity of operations with Shariah rules and regulations and efficient services offered by Islamic banks. Even if they compare rates of two Islamic banks with each other the preferred

bank will be that which follow the Islamic rules than the bank offered a higher rates of return. The size of deposits and investments depends on the proficiency and practice of Islamic teachings in Islamic Banks (Boulila Taktak et al., 2010).

Earnings management is essential in order to attain some specific goals. Number of objectives including building customer confidence, to reduce transaction cost, tax relaxations, avoiding from defaults, offering better price and improvement of management performance are involved in earnings management and distribution of profits with the stakeholders. Management of profit distribution also influences the financial reporting incentives, financial stability and performance of Islamic banks. A smooth level of profit distribution stabilizes a bank's financial structure (Farook et al., 2012).

Islamic financial institutions may set aside, form up, and drawdown two types of reserves, Profit Equalization Reserves (PER) from the profits before the distribution of shares in those profits to IAH and to the IFS, and Investment Risk Reserves (IRR) from the profits available for distribution to the IAH but after paying the IIFS's share of profits as Mudarib, in order to smooth the returns actually paid out to the Profit Sharing Investment Accounts owned by Investment Account Holders (IAH). The buildup and draw down of these reserves can help cushion the returns paid to IAH and preserve the value of IAH funds against variations in the IIFS's income from assets invested with IAH funds, and thereby help pay market related compensation to IAH. IFS may maintain the payout to IAH at market related levels even though actual asset returns exceed market benchmark rates, by setting aside Profit Equalization Reserves and Investment Risk Reserves. (Venkataraman Sundararajan, 2008).

Islamic banks have an understood relaxation of managing profit distribution to depositors to fluctuate the management fee related to depositors meanwhile; Islamic banks have a certain responsibility to share earnings with depositors. To smooth the income and to maintain a stable rate of return to depositor, management of profit distribution is essential for Islamic banks. According to concept of finance, profit distribution is basically the sharing of profit earned from different activities with different groups of stakeholders. Profit distribution is the liability of the banks to disburse the surplus, earned from financing of depositors' funds. In Islamic banking and finance, the distribution can defined as a process of sharing the income of a venture between the mudarib and rabu-l-maal aceording to decided ratio (Mulyo & SITI, 2012). Profit distribution rate of depositors is a function of number of depositors divided by depositors fund for a specific period. The distribution rate of profit to depositors is calculated by total amount paid to depositors divided by depositor's funds for the given period. A higher digit of rate of return points out the higher return to depositors by the bank.

Banks invest the amount of their own capital and the amount of depositors which is deposited in different accounts including (current accounts and saving accounts) into different portfolio. The depositors of current account and saving account cannot claim any return against their deposits. So, profit generated from these accounts considered banks own return. However, the investor who deposits his money in an investment account is eligible to profit after a defined certain time period and can withdraw his amount at any time. The holders of this kind of account with bank have right to share the earned profit from the financing of these funds according to the ratio of their amount in total invested fund. Bank make a strategy while using these funds by retaining some

amount with it so that the withdrawal request of depositors can be fulfilled. The percentage of profit sharing is pre decided by following all Shariah rules and principles related to profit sharing to minimize any ambiguity or dispute. Shariah permits the distribution of profit to holders of current and saving accounts from the earned profit without predefined rate to inspire the holders for depositing more and making investment. Islamic banks maintain specific amount in form of reserves to fulfill the withdrawal requirement of depositors and to maintain a smooth income. This mechanism also helps to reduce the instability and volatility of return to the investors.

Chapter 3

Literature Review

3.1 Introduction

Islamic banking is an emerging sector of finance. Different aspects of Islamic banking and finance are debated in the literature. Islamic banks and Islamic financial institutions have responsibility to secure the interests and preferences of account holders and depositors by following the Shariah principles. Many empirical studies have been conducted in order to find the evidence related to income smoothing and profit sharing practices by Islamic banks (e.g., Ahmed (1995),Venkataraman Sundararajan (2008), Boulila Taktak et al. (2010), Farook et al. (2012), Mulyo and SITI (2012), Hamdi and Zarai (2013a), Noor and Sulong (2013), Imawan (2014), Lahrech, Lahrech, and Boulaksil (2014), Mulyo (2015), Mardian (2015), Hamza (2016), Wafaretta and Rahman (2016), Meslier, Risfandy, and Tarazi (2017). Some of these studies also discussed the effect of different macro specific and bank specific factors on management of profit distribution and income smoothing practices by Islamic banks.

This section covered the literature relevant to our study. We further divided our empirical literature into different sections. First section covered the literature about deposits, return, rate of return and risk. In second section, literature presented information about profit distribution system, income smoothing and earnings management in Islamic banking.

Last portion provides the evidence related to factors that effects the management of profit distribution of banks.

3.2 Deposit, Risk, and Return

For the growth of the economy of a country, development of banking sector is vital. Bank deposits are one of the essential sources of funding. For the stability of bank, deposits played central role and deposits must be there for the management of profit by a financial institution. Depositors of Islamic banks have double concern regarding their deposits as they want to deposit in Shariah based financial system to fulfill their religious concern as well as the return is also one of the most desired concern of Muslim depositors so that they can get monetary benefit by following the Shariah rules (Azmat, Skully, & Brown, 2015).

The deposit approach of a customer towards selecting among the Islamic and conventional bank as a depository institute at the time of making deposit is concerned with the exclusive features and dynamics of financing of Islamic banks. The religious commitment of depositor did not the only cause of selecting Islamic banks for deposit purpose rather profit motivation also considered as a foremost intention of a depositor (Erol & El-Bdour, 1989).

Rimsan, Hilmy, and Suraiya (2014) in their study found the religious concern as one of the most preferred reason of having deposits with Islamic banks. Even having the intention towards Islamic banks, depositors not satisfied with the present features of the most wanted Shariah compliant profit sharing contracts. The findings ultimately indicated that depositors still concerned to the products of conventional banking. They also

reported that the deposit accounts influenced by financial services provided by the bank and income gencrated against the deposits.

MOHD-KARIM (2010) examined the concems of depositors of Islamic banks of Malaysia. The findings indicated that like conventional depositors, Islamic depositors also concerned to higher rate of return. The deposits of Islamic banks structured under the Shariah approved unique feature of risk and return. The exclusive characteristics and features of profit and loss sharing deposits based on the standard and rule of IFSB and AAOIFI the main regulatory bodies of Islamic finance. Malaysian depositors concerned to Islamic banks for deposit purpose due to religious preferences. The awareness of having deposit with Islamic banks din not guarantees the clear understanding of the objectives of Shariah compliant product. Other financial aspects, including rate of return and financial services rendered by the Islamic banks becomes the important element for increasing concern towards the Islamic deposits. Maximum number of depositors have concerned to high and constant return rate.

The concept of Islamic Finance is based on profit and loss sharing. No return or profit rewarded to the depositor without sharing the risk of investment. Islamic banking deals with the intention of profit and loss distribution between the investor and user of finance. Equal distribution of profit and loss is a key element of Islamic finance and banking. Without risk sharing, taking the return by depositor violates the rule of Shariah. Fixed rate of return also not promised to the holder of deposit. As both parties are bound to share the losses as well so rate of return is determined after deducting all expenses and losses according to the share of capital or ratio of funds. The rate of return may fluctuate according to financial conditions.

Meslier et al. (2017) shed light on the competitive behavior through deposit rate between dual banking system by using the cross sectional data of conventional and Islamic banks of 20 countries over the period of 2000 to 2014. The deposit rate linked to the market power of banks. Conventional banks faced lower market power and higher competition with Islamic banks so the deposit rate of conventional banks was higher than the Islamic banks in Muslim countries. Conventional banks with higher market power set lesser deposit rate.

Jedidia and Hamza (2014) provided the evidence that the increasing amount of deposits and longer time of maturity period is crucial for the management of liquidity risk in Islamic banks. In conventional banking the liquidity risk can controlled through asset management but in Islamic banks it cannot be practiced due to some Shariah constraints. Profit loss sharing mechanism can secure both the bank and the depositors through minimizing the liquidity risk.

Elyasiani and Mansur (1998) by using GARCH model estimated that returns of bank stocks are sensitive to interest rate keeping in view that the influence of monetary policy changes on the volatility. The changes in rules of monetary policy plays essential role in process of generated outcomes and return on equity of banks. The findings of the study indicated that the bank stock returns are negatively affected by the interest rate for long term investment. The stock returns and stock risks of banks can be determined by the volatility of interest rate. The risk of return increased and possibility of returns decreased on the bank portfolio at the time of unstable interest rate.

Haron and Ahmad (2000) used adaptive expectation model to found the relationship among return paid to depositors and amount of their deposits in Islamic banks of Malaysia. The findings revealed that the holders of deposit accounts including both investment account and saving accounts motivated by the profit. The deposits of Islamic banks are influenced by the rate of return offered by Islamic banks to their account holders and conventional interest rate simultaneously. Rate of profit is offered by Islamic banks followed by the market rate of interest.

DeYoung and Roland (2001) focused on transformation of customary financing activities into fee based financial activities increased the income volatility which resulting the instability in returns. The interest income from the financing activities of a bank decreased when it involved in financial service activities. Consequently, the bank earned fluctuating and volatile level of income. The associated outcome risk with shift of activities by the banks from traditional financing activities to service activities can overcome by the profit generated from these service activities. The ratio of fee based leverage increased in total leverage. For the payment of outstanding loans a substantial amount of equity capital must retained by banks.

Shahimi, Ismail, and Ahmed (2006) focused on income of Islamic banks earned by activities other than financing activities by using bank specific panel data of Islamic banks of Malaysia covering the period of 1994 to 2004. According to the found evidences banks involved in fee income of services have a substantial size of assets and deposits and presented lower level of risk. Involvement of service activities other than the traditional financing activities have caused diversified market and minimize the risk of

investment of funds. Banks through diversified earning sources able to earn maximum income and stabilized their income and reduce the level of risk.

3.3 Profit Distribution Management and Income Smoothing Practices

Profit distribution management is an important activity performed by the financial institutions. The management of Islamic banks distributes their profits to depositors to fulfill the responsibility of return sharing. Profit distribution is crucial for the management of earnings and to smooth the incomes of financial institutions. Leuz, Nanda, and Wysocki (2003), Shen and Chih (2005), Hassan (2010), Ahmed (1995), Noor and Sulong, 2013, Hamdi and Zarai (2013b), Boulila Taktak et al. (2010), Venkataraman Sundararajan (2008), Ghafar b. Ismail, Shah Shaharudin, and Samudhram (2005), Abdullah, Bujang and Ahmad (2015), Adzis, Anuar, and Hishamuddin (2015), and Haron and Ahmad (2000) have shed light on income smoothing practices, earnings management, and profit distribution management of Islamic banks and Islamic financial institution.

Leuz et al. (2003) found a negative association of earnings management with the investors' interest in their study. It is evident that the earnings management level of insider economy is stronger and substantial than the outsider economy. Limited stock market, less protection of investor and focused ownership caused to do earnings management. Firms financial policies related to dividend and ownership secure the investor's interest. Stronger position of investors minimizes the earnings management as the control of management is limited.

Shen and Chih (2005) by using cross sectional data of 48 countries in their study found that majority of banks managed their earnings. Earnings management played essential role to cope with the expected level of risk as higher return required higher risk. Secure position of investors minimizes the need of earnings management.

Hamdi and Zarai (2013b) by using the data of 81 Islamic banks empirically found that earnings management used to communicate the confidential internal information of Islamic banking institutions related to profitability with the shareholders. Senior management of Islamic banking institutions used efficient earnings management as compared to opportunistic earnings management. Efficient earnings management improved the relationship with external parties that enhance the internal efficiency.

Boulila Taktak et al. (2010) explored the income smoothing practices with a sample of 66 Islamic banks by using the Beidleman's and Eckel's coefficients for the period of 2001-2006. The research examined the use of loan loss provisions too for earnings management. The results showed that Islamic banks smooth their income on large scale. Contrary to conventional banks Islamic banks do not achieved income smoothing through loan loss provisions. Rather reserves including investment risk reserves and profit equalization reserves used to smooth the incomes of Islamic banks. The findings denied the opinion that IRR and PER are used only to pay a stabilized rate of returns to depositors rather they also used for income smoothing as well.

Venkataraman Sundararajan (2008) found in his study that both reserves PER and IRR used for the income smoothing purpose and to stabilized the returns. The study stated that in the situation of fluctuating asset returns, IRR and PER used to provide a stable rate of

returns to investors. A suitable mixture of reserves by the management of the banks in form of IRR and PER utilized to compensate the losses occurred against the invested funds by the banks and to pay a preferred rate of return to the investors according to market rate.

Mardian (2015) measured earnings management through loss avoidance and loan loss provision by using logit regression. The study found that the earnings management that measured by the loss avoidance motivated the managers to manage the earnings. According to the loss avoidance measure, the Shariah supervisory board positively correlated to the earnings management but Shariah supervisory board was negatively correlated to the earnings management that measured by the loan loss provisions.

Ghafar b. Ismail et al. (2005) conducted a research on banks in Malaysia to check the income smoothing practices. Negative results found regarding income smoothing. Malaysian banks do not have concern to attract the investors through tempting management of earnings as they followed the regulations obligatory by the regulatory bodies not the rules of stock market. Though, a handsome amount of loan loss provisions assembled in strong economic condition employed to remove the negative impressions of slumps of economic cycle.

Abdullah et al. (2010) investigated the association of earnings management and loan loss provision using the sample of Malaysian commercial banks. Pooled Ordinary Least Square model was used For the purpose of analysis. The findings indicated a positive association between earnings management and LLP. The banks motivated to smooth their

earnings. Results of the study explored that Malaysian banks created provisions during the time of stable economic conditions to offset the complications in poor economic time.

Adzis et al. (2015) analyzed the income smoothing practices and management of capital, using loan loss provisions. The data of 15 Malaysian banks for the period of 2002-2012 was analyzed. The outcomes of the research showed that commercial banks in Malaysia smooth their incomes through LLP, but the use of LLP not evidenced for the management of capital in Malaysian commercial banks. The findings also highlighted an interesting fact that banks separated more amount as provisions during the crisis period of 2007-2009.

The study of Hassan (2010) explained that in current situation the distribution of profit earned through financing, between the depositors and banks is not pleasing and satisfactory. It is noticed that bank did not pay the rate of return to depositors of mudarbah accounts according to the return earned by bank through investing their funds in business. For the purpose of controlling credits, central bank practice the interest rate and profit sharing rate simultaneously for both banking system. The rate of profit the depositors are receiving in Islamic banks indicates that if conventional banks adopt the feature of risk sharing the religious committed depositors of Islamic banks prefer to deposit with conventional banks. The equal distribution of profit between the bank and depositors in mudarabah accounts can build the customer confidence on Islamic bank. Central bank strategies can play an important role to control the unfair distribution of profit with depositors.

The results of the study conducted by Lahrech et al. (2014) showed that performance of banks was highly associated with the profit sharing with depositors. The Islamic banks were more involved in distribution of profit to the investors and depositors. Banks with higher performance distributed more profit to depositors. The disclosure of quantitative and qualitative information increased the transparency of Islamic banking institutions. The disclosure of quantitative information helps to build the investors' confidence because the circulated information regarding their invested funds enhanced the banks' transparency.

Ahmed (1995) examined the Faysal Islamic Bank of Sudan to check the profit distribution in Islamic banking. They reported that the distribution of profit to the every investment account holder according to share of investment becomes arduous for bank. The deposits of Islamic banks combined in one pool and invested into various businesses. It makes difficult to determine the share of profit according to investment share of a depositor.

Noor and Sulong (2013) investigated the profit distribution with accompany of capital and earnings management to smooth earnings in Malaysian Islamic banks. The study investigated the sample of 16 Islamic banks of Malaysia from the period of 2008-2012. A negative association of profit distribution with capital management and earnings management founded. The findings indicated that Malaysian Islamic banks do not use profit distribution to smooth the earnings.

Hamdi and Zarai (2013b) focused on earnings management through distribution of profit by Islamic banks. They also investigated the techniques used to manage the distribution

of profits and smooth return to depositors. Islamic banks do profit distribution by following the instructions of supervisory bodies to mitigate the risk of withdrawal of deposits by the depositors and to protect the investors' interest. Investment risk reserve and Profit equalization reserve created from the undistributed profit of investment depositors and shareholders to maintain a stable profit distribution in crises period. To increase the amount reserves, funds transferred from accounts of shareholders to asset the investment depositor.

3.4 Factors Effecting Profit Distribution Management

Farook et al. (2012) in their cross sectional study reported that Islamic banks manage the profit sharing with their depositors and investment account holders according to the market situation. The mixed results showed that according to market condition of the country, banks distribute profit to their account holder on the basis of assets return rate or market return rate. The results also indicated that effect of some closely related factors including financial development, age, religiosity, deposit and concentration have significant to the management of profit distribution and on the other hand the loans asset ratio, market familiarity and reserves have insignificant association to profit distribution by the Islamic banks.

Mulyo and SITI (2012), Imawan (2014), and Mulyo (2015) conducted studies about the factors that influenced the distribution of profit to depositors by the Islamic banks using the sample of Indonesian banks. Data of different time periods and multiple statistical techniques presented contradictory and dissimilar results.

Mulyo and SITI (2012) discussed the factors influenced the management of profit distribution. The study conducted by using the data of 5 Indonesian Islamic banks through purposive sampling method. The results of the study indicated a positive effect of capital sufficiency, ratio of loan assets (LA/TA) and allowance for nonproductive assets (Reserves) on management of distribution of profit to account holders by Islamic banks. On the other hand a negative effect of amount and efficiency of depositors funds (Deposits) founded. No effect of age of bank and GDP founded on profit distribution management. Similar results founded by Mulyo (2015) by using the multiple linear regression model for the period of 2008 to 2011.

Imawan (2014) conducted a study in Indonesia to examine the effects of factors, associated with profit sharing management. Multiple regression analysis used for the sample of 11islamic banks operating in Indonesia by analyzing their financial reports from the year 2009 to 2012. The research found contradictory results with the previous study of (Mulyo & SITI, 2012) and (Mulyo, 2015). The results indicated a positive effect of capital adequacy, GDP, age and funds of depositors (Deposits). Meanwhile, efficiency of funds of depositors, risk financing, allowance against nonproductive funds (Reserves) and LA/TA negatively affected to profit distribution.

Wafaretta and Rahman (2016) stated in their study that third party funds and market share were the characteristics of banks which affected profit distribution management's tendency. Higher third party funds and lower market share indicated higher risk which certainly affected banks so that they took risk by using reserves to give more competitive distribution of profit. Even though profit earnings were low. They presented their results analyzing financial statements of 10 Islamic banks by using data for the period 2010-14.

They further elaborated in their study that the magnitude of distribution of profit would be heading in the direction of magnitude of bank's age and third party funds' effectiveness.

Hamza (2016) examined the implementation of profit loss sharing principle in process of returns to depositors against their investments. It was observed that in a small competitive banking market the rate of return decreases. Islamic banks normally used interest rate of conventional banks to decide the rate of return to investors and depositors to fulfill the depositor's expectation of higher rate of return and due to less developed Islamic rate of return. Higher rate of market concentration and GDPGR negatively affected to the rate of return to depositor as higher market concentration reduce the competition which resulted lower rate of return and during boom period of economy banks underestimate the risk which caused to decrease the rate of return against the deposits and investments.

Rashid and Jabeen (2016) investigated the consequences of some macroeconomic, bank specific and financial elements on performance of banks in Pakistan by using imbalance panel data for the period of 2006 to 2012. The GLS regression results indicated a positive effect of deposit, operating efficiency, and concentration of market on the performance of Islamic banks meanwhile reserves, operating efficiency and overhead positively associated to the performance of conventional banks. On the other hand, the interest rate and GDP showed negative association towards performance of both banking system.

The studies of Beck, Demirgüç-Kunt, and Levine (2000), Ndikumana (2005), Creane, Goyal, Mobarak, and Sab (2006), and Adnan (2011) focused on the relationship of financial development and financial structure with banking sector and financial market

development. Financial development is essential for betterment of banking and financial system. Performance and efficiency of banks are greatly influenced by the financial development.

Ndikumana (2005) investigated the effect of financial system on the trends of investment. His results indicated that only structure of financial market does not matters rather financial development influence the growth rate of investment and banking industry. Banking and financial market developed through implementation of policies to reduce investment cost and motivated the investors and creditors through increasing rate on investment on protection of investment.

Adnan (2011) developed a financial development index extracting component from 41 economies by using the principle component method for the period of 1988 to 2009. Existence of efficient market, implementation of strategies and rules for betterment of financial institutions leads to financial development. Efficient utilization of funds and risk divergence resulted from a developed financial system. Increased level of investment, higher rate of return, opportunity of better financial services and decreased possibility of loss observed in a financially developed environment. Beck et al. (2000) showed that financial development and structure of financial system highly based on the efficiency and performance of financial institutions like banks and financial institutions.

Creane et al. (2006) develop measures to check the financial development by using the cross sectional panel data of MENA countries. The findings indicated that a developed banking sector and regulatory bodies of financial institutions leads to financial development.

H_3: There is a negative relationship between the extent of profit distribution management by a particular bank and the level of concentration in banking market.

H_4: There is a negative relationship between the extent of profit distribution management and the level of financial market development by a particular bank in a particular year.

H_5: There is a negative relationship between the extent of profit distribution management towards interest rates by a particular bank and the GDP growth.

3.6 Summary

The industry of Islamic banking and finance experienced marvelous growth globally from last few decades. An impressive growth has been confirmed by growth level of assets and consciousness of Muslim customers towards Islamic values. This speedy hike of Islamic banking industry entails competent and efficient regulatory mechanism. Financial management of Islamic banks distribute profits among depositor and other stakeholder to maintain a smooth level of income and stabilize rate of return to stakeholders, investors and depositors. Islamic banks practice the activity of profit sharing and income distribution to manage their earnings and to balance their output level. Profit distribution management not exclusively secure the rights of depositors, rather this practice may preserve the rights of all involved stakeholder of bank and sustainable development. Several macro specific and bank specific factors are involved in profit distribution management. These factors directly influence the distribution of profit of banks. The studies mentioned above, have collected the mixed results about income smoothing, earnings management, and profit distribution practices of banking system. Most of the studies focused on profit distribution management to smooth the income and management of earnings. Several studies mentioned that the relationship of deposits,

return and rate of returns closely related to distribution of profit and income smoothing. Mixed results found about the relevant bank specific and macro specific factors on profit distribution management of Islamic and conventional banks.

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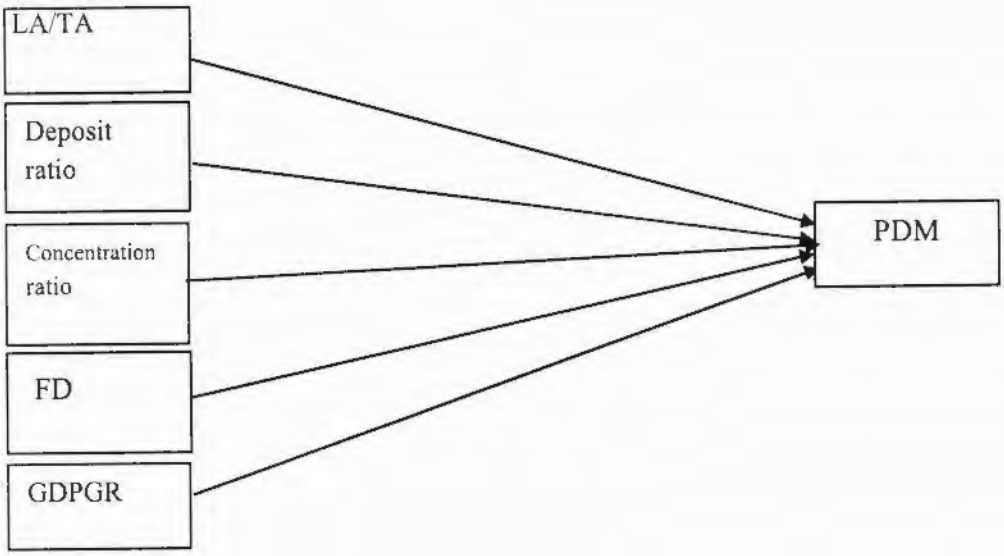
3.5 Conceptual framework and Hypotheses

Different internal or bank specific and external or macro specific factors impact the profit distribution management of banks. Some of these factors have positive effect on profit distribution and some of these negatively affect the distribution of profits by banks. To investigate the effect of these factors we have formulate some hypotheses based on previous empirical study of (Farook et al., 2012). Figure 3.1 presents the conceptual framework of the study.

Figure 3.1 Conceptual framework



H_1: There is a positive relationship between the extent of profit distribution management towards interest rates by a bank and the proportion of Islamic loan assets as a percentage of total assets.

H_2: There is a positive relationship between the extent of depositor profit distribution management towards interest rates and the extent of reliance on the depositors' funding.

H_3: There is a negative relationship between the extent of profit distribution management by a particular bank and the level of concentration in banking market.

H_4: There is a negative relationship between the extent of profit distribution management and the level of financial market development by a particular bank in a particular year.

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return and rate of returns closely related to distribution of profit and income smoothing. Mixed results found about the relevant bank specific and macro specific factors on profit distribution management of Islamic and conventional banks.

Chapter 4

Methodology, Model, and Data Description

4.1 Introduction

In past, several researches have been conducted to check the profit distribution management by Islamic banks (V Sundararajan, 2007). Islamic banks do profit distribution management and there are some internal or bank specific factors and some external or macroeconomic factors that influence the profit distribution of banks (Farook et al., 2012). This study is conducted in order to determine the profit distribution management by Islamic and conventional banks and to check the factors that are effecting the profit distribution management of Islamic and conventional banks. This section provides complete information about the methodology that is used and also gives a detailed picture of data that is used for analysis in our study.

4.2 Econometric Model Specification

The aim of this study is to ascertain the profit distribution management by Islamic and conventional banks and to determine the factors (internal or external) that effects (directly or indirectly) the profit distribution management of banks. To fulfil the objective of the study we follow the study of Farook et al. (2012), which investigated the profit distribution management of Islamic banks by using the sample of 50 Islamic banks from the time period of 1993 to 2005 from 17 Islamic countries across the world. They also

investigated the some internal and external factors that are directly or indirectly related to the profit distribution management.

To achieve the objective of the study we estimate the model given in equation (1) for whole sample (Islamic and Conventional banks).

Following Farook et al. (2012), we estimate the following model.

$$PDM_{i,t} = \beta_0 + \pi_1 \frac{LA}{TA_{i,t}} + \pi_2 DEPOSIT_{i,t} + \pi_3 CONC_{i,t} + \pi_4 FD_{i,t} + \pi_5 GDPGR_{i,t} + e_{i,t} \quad (4.1)$$

$PDM_{i,t}$ = Profit distribution management.

$LATA_{i,t}$ = Ratio of loans to total assets

$Deposit_{i,t}$ = Ratio of deposits to total assets

$CONC_{i,t}$ = Banking market concentration (Herfindahl concentration index)

$FD_{i,t}$ = Financial development

$GDPGR_{i,t}$ = GDP growth rate

$\varepsilon_{i,t}$= error term

where PDM is representing the Profit distribution management of depositors, in subscript *i* representing the Islamic banks, *t* representing the time period, β is the intercept term of the equation, LA/TA is loan assets to total assets ratio, Deposit is representing the deposit to total assets ratio of banks, CONC is representing banking concentration index (Herfindahl concentration index), FD is representing the financial development and GDPGR is representing the GDP growth rate.

Next to do the comparison of Islamic and conventional banks we run the proposed model for Islamic and conventional banks separately. In this model, we use the Islamic and

conventional dummy by using all the variables which are used in previous model. The Islamic dummy is equal to 1 if the bank is categorized as Islamic bank and 0 otherwise. Same like that the conventional dummy is equal to 1 if the bank is categorized as conventional bank and 0 otherwise.

The following is the resultant model:

$$PDM_{i,t} = \beta_0 + +\pi_1 \frac{LA}{TA_{i,t}} D_{i,t}^{IB} + \pi_2 \frac{LA}{TA_{i,t}} D_{i,t}^{CB} + \pi_3 DEPOSIT_{i,t} D_{i,t}^{IB} + \pi_4 DEPOSIT_{i,t} D_{i,t}^{CB} + \pi_5 CONC_{i,t} D_{i,t}^{IB} + \pi_6 CONC_{i,t} D_{i,t}^{CB} + \pi_7 FD_{i,t} D_{i,t}^{IB} + \pi_8 FD_{i,t} D_{i,t}^{CB} + \pi_9 GDPGR_{i,t} D_{i,t}^{IB} + \pi_{10} GDPGR_{i,t} D_{i,t}^{CB} + e_{i,t} \quad (4.2)$$

4.3 Identification of Estimation Technique

The usage of panel data provides substantial benefits. But for attaining consistent results the specification of econometric model that should be used, is very important. In the study of panel data Hausman's (1978) test is used for selecting an appropriate model between panel models. Hausman test is one of the most important test that is used to decide whether fixed effects or random effects is an appropriate model. Hausman test is used for the comparison of two models under the null hypothesis that one model gives efficient and consistent results as compare to other one. If a correlation exists between the independent variables and error term the estimates of the model would be inconsistent. We apply the Hausman test for selecting the consistent and efficient model among fixed effects and random effects model. The null hypothesis is that where the preferred model is fixed effect model verse the alternative random effect model (Sheytanova, 2015).

4.4 Fixed Effects Model

Fixed effects model is used to analyze the influence of variables that changes over the time. Fixed effect finds the relationship among predictor and resulted variables within a unit. Each unit has some unique characteristics that can or cannot impact the predictor variables. Using fixed effect model it is assumed that the individual can influence or bias the outcome or predictor variables and it should be control. This is a justification behind the assumption of correlation among predictor variables and unit error term.

According to statistics and econometrics, a fixed effect is a model that represents the explanatory variables that are observed in term of quantities. In the analysis of panel data, the fixed effects estimator term is used to mention an estimator of the coefficients in the regression model. In the assumption of fixed effects estimator, time independent effects for every unit are imposed that are possibly associated with the repressors (Torres-Reyna, 2007).

In fixed effect model the net impact of predictors on the resulted variables can measure because the effect of time-invariant characteristics is removed in fixed effect. It is also assumed that these time- invariant characteristics are different for the individuals and they should not have any correlation with any other individual characteristics. Each unit is different from other unit therefore the unit error term and the constant of a unit should not be correlated. All time-invariant differences among the units are removed under the fixed effect model. Due to omitted time-invariant characteristics the estimated coefficients in fixed-effects model are not biased

We are using fixed effect model for analyzing the profit distribution management of banks and to analyze the impact of bank specific factors and macroeconomic factors on the profit distribution management of banks.

4.5 Variables

4.5.1 Dependent Variable

- PDM

Profit distribution management (PDM) is our main dependent variable. The aim of this variable is to investigate whether banks manage their profit distribution and if they do so on which basis they distribute their profits to the depositors. There are number of measures that are used to check the profit distribution management of banks. In our study we use two measures to check the profit distribution management system of banks that are:

- Assets Spread AS = ROA- ROIAH
- Deposit Spread = National Deposit rate – ROIAH

Asset spread is calculated by spread between return on asset and return to investment account holders. Asset spread is calculated by deducting all the expenses but including the return to depositors in net income divided to total assets. Many studies (e.g., Farook et al. (2012), Noor and Sulong (2013), and Hamdi and Zarai (2013a) suggested that the Asset Spread is an important measure of the PDM since it includes all expenses and incomes and calculated the spread between the asset return of a bank and the profit distributed to the depositors.

Deposit spread is calculated by inverse of spread among the national deposit rate and return to investment account holders. Deposit spread is also an important measure of profit distribution management of banks. Several studies including Farook et al. (2012), Noor and Sulong (2013), and Hamdi and Zarai (2013a) used deposit spread as a measure of profit distribution management. It determines the degree of profit distribution towards the national deposit rate. The inverse spread makes sure that there is a consistency between the outcomes of assets spread and deposit spread.

4.5.2 Independent Variables

Independent variables which we used in our study are representing those factor which affects directly or indirectly profit distribution management of banks. These variables included some internal or bank specific factors such as loan assets to total asset, deposit to total assets and some external or macroeconomic factors like financial development (FD), banking market concentration (CONC) and GGP growth rate. Through these variables it is found that profit distribution management of banks depends on some bank's own internal factors and on some market factors.

- Loan Assets to Total Assets (LA/TA)

Loan asset to total assets is a bank specific factor that affects the profit distribution management of bank. Ratio of loan assets to total assets is calculated by loan assets of bank divided by total assets. This variable is used to check to which degree loan asset of bank affect the profit distribution management of bank. Few studies use LA/TA as bank specific factor to determine the profit distribution management (Čihák & Hesse, 2010), (Farook et al., 2012), (Mulyo & SITI, 2012), (Imawan, 2014), and (Mulyo, 2015).

- Deposit Ratio

Deposit ratio is used as bank specific factor to check the profit distribution management of bank. Deposit ratio is calculated by deposits divided by total assets of bank. This variable is utilized to check to which degree profit distribution management of a bank is effected by deposits of that bank. Several studies (e.g., Rashid and Jabeen (2016), Farook et al. (2012), Mulyo and SITI (2012), Imawan (2014), and Mulyo (2015) used deposit ratio as a measure of banks profit and as a factor that affects the distribution of banks' profit.

- Banking Market Concentration (CONC)

Banking market concentration index is used. Banking market concentration is proxied by Herfindahl concentration index. It is calculated by the sum of the squares of the market shares of each individual bank. This variable is used to investigate the relationship between the degree of market concentration of banking system and profit distribution management level of banks. Some studies like Čihák and Hesse (2010), and Farook et al. (2012) used concentration ratio as a factor of profit distribution management.

- Financial Development (FD)

Financial development is an external or macro specific factor which influences the profit distribution management of banks. It is calculated by aggregate sum of (1) ratio of broad money to GDP, (2) ratio of the assets of deposit money banks to assets of central bank and deposit money banks, (3) reserve ratio, (4) ratio of credit to the private sector by deposit money banks to GDP (Creane et al., 2006). FD is used to investigate the level of financial market development and the degree of profit distribution management by bank.

The study of Farook et al. (2012) used financial development index as macro specific factor that affects the distribution of profit by bank.

- GDP Growth Rate (GDPGR)

GDP Growth Rate is growth of real per capita gross domestic product. GDPGR is a macroeconomic variable that is used to find the degree of profit distribution management to the economic condition. The growth rate in per capita real GDP calculate by growth rate in real GDP minus growth rate of population. Few studies consider GDP growth rate as important factor that affects the profitability of banks and its distribution (Noor and Sulong, 2013), (Čihák & Hesse, 2010), (Rashid & Jabeen, 2016), and (Farook et al., 2012).

Following table provides a comprehensive description of variables that we are using in order to conduct our study.

Table 4.1: Variables' definition

Name	Definition	Formula
Dependent Variable		
PDM		
Asset Spread	Spread between ROA (Return on assets) and return on investment accounts	ROA – ROIA
Deposit Spread	Spread between national deposit rate and return on investment accounts	National deposit rate – ROIA
Independent Variable		
LA/TA	Ratio of banks' loan assets (short term and long term loans) to total assets	Loan assets / total assets
Deposit	Ratio of banks' deposits to total assets	Deposit / total assets
CONC	Banking market concentration ratio	Sum of squares of the market share of each bank
FD	Financial development index	Aggregate sum of Deposit money bank assets to deposit money bank assets and central bank assets, Broad money to GDP, Private credit by deposit money banks to GDP, Bank reserves ratio
GDPGR	Yearly GDP growth rate	Real per capita growth rate

Data

To fulfill the purpose of the study we use a dataset of selected Islamic and conventional banks of Pakistan. We use the panel of 5 Islamic and 17 conventional banks of Pakistan over the period of 2005 to 2015. The Islamic banks include the data of Al Baraka Bank, Bank Islami Pakistan, Burj Bank, Dubai Islamic Bank and Meezan Bank. The conventional banks include the data of Allied Bank limited, Askari Bank, Bank Alfalah, Bank Al Habib, Bank of Khyber, Bank of Punjab, Faysal Bank, First women Bank, Habib Bank limited, JS Bank, MCB, National Bank of Pakistan, Silk Bank limited, Sindh Bank, Soneri Bank, Summit Bank and United Bank limited. [3]In this study the selection of time period for the data is made on the basis of establishment of Islamic banks in Pakistan. We collected the annual data of all respective banks. [4]The selection of variables used is made on the basis of base study. The data of these variables are extracted from different sources. [5]Data of all bank specific variables, including net income, returns on deposits, total assets, loan assets, deposits and current accounts is obtained from annual reports of all concerned banks. Data related to other external variables including financial development, national deposit rate and GDP growth rate is obtained from IMF, IFS, World Bank from the website of WDI.

[3] Due to less develop market of Islamic banking and finance in Pakistan, the data of Islamic banks is not available so the selected data set is limited.

[4] Due to economic and financial condition of economy the Islamic banking is not strong in Pakistan so the variables selection is made on the basis of base study. And the different comparative variables for Islamic and conventional banks cannot used.

[5] Due to data constraint and no availability of data some other bank specific variables including Reserves, and age and some macro specific variables cannot use in the study.

List of Islamic Banks in Pakistan

List of Islamic banks which we used in our study is presented in the following table 4.1.

Table 4.2: List of Islamic Banks

No	**Banks**
1	Al Baraka Bank
2	Bank Islami Pakistan Limited
3	Burj Bank
4	Dubai Islamic Bank
5	Meezan Bank Limited

List of Conventional Banks in Pakistan

List of conventional banks which we used in our study is presented in the following Table 4.3

Table 4.3: List of Conventional Banks

No	Banks
1	Allied Bank Limited
2	Askari Bank
3	Bank Alfalah
4	Bank Al Habib
5	Bank of Khyber
6	Bank of Punjab
7	Faysal Bank
8	First Women Bank
9	HBL
10	JS Bank
11	MCB Bank Limited
12	National Bank of Pakistan
13	Silk Bank Limited
14	Sindh Bank
15	Soneri Bank
16	Summit Bank
17	United Bank Limited

Chapter 5

Empirical Results

5.1 Introduction

This chapter presents the results that are found in this study by using the most often used econometric technique namely fixed effects model, as discussed in the prior chapter. This study investigates the profit distribution management of Islamic and conventional banks in Pakistan. The study also investigates the internal and external factors that directly or indirectly affect the profit distribution mechanism of banking system of Pakistan. The empirical analysis is performed by using the panel data of Islamic and conventional banks of Pakistan from the time period of 2005 – 2015.

Table 5.1 presents the descriptive statistics of dependent variables for the sample of Islamic and conventional banks that provide summarize information of the data including the mean, standard deviation, minimum value, maximum value. Table 5.2 provides the summery statistics of the proxies that are used to measure the dependent variables. Table 5.3 provides the summery statistics of the independent variables that are used in the study. Table 5.4 provides the correlation matrix of dependent and independent variables. Table 5.5 provides the correlation of proxies that are used to measure the dependent variables. Table 5.6 presents the results of fixed effect model. Table 5.6 provides information about to what extent banks do profit distribution management according to assets return rate or market deposit rate. Table 5.6 also provides the information about to which extent the internal (bank specific) and external (macro) factors that are directly or

indirectly related to banks, affects the profit distribution management of banks. Finally Table 5.7 presents the comparative results of profit distribution management of Islamic and conventional banks using the fixed effect model. Table 5.7 also presents the results regarding factors that affect the profit distribution management.

5.2 Descriptive Statistics

The main objective of the study is to investigate the profit distribution management of Islamic and conventional banks in Pakistan. Table 5.1 provides the descriptive statistics of dependent variables that are used in this study, to investigate the profit distribution management (PDM) of banks using the whole sample of banks and for the sub sample of Islamic and conventional banks operating in Pakistan. Table 5.1 reports the mean, standard deviation, minimum value, maximum value for the main dependent variables that are used for profit distribution management (PDM) and its variations. Assets spread (AS) and Deposit spreads (DS) both are dependent variables that are used to measure profit distribution management (PDM).

Table 5.1: Descriptive Statistics of Dependent Variables

	All Sample				Islamic Banks		Con Banks	
Variables	**Mean**	**Std.dev**	**Min**	**Max**	**Mean**	**Std.dev**	**Mean**	**Std.dev**
AS	0.751	1.835	-11.005	10.476	0.0718	2.043	0.965	1.716
DS	2.379	1.901	-9.517	13.122	2.717	2.467	2.273	1.680

Note: The table presents the descriptive statistics of the main variations of the dependent variable using the panel data for the period of 2005-2015. AS (Assets spread), DS (Deposit spread) are measures, which are used for profit distribution management (PDM) that is dependent variable.

Conventional banks' AS (Asset Spread) is relatively higher than those of Islamic banks. It indicates that the conventional banks provide a managed rate of returns to their depositors. But overall, the values of AS (Asset Spread) are significantly higher than the DS (Deposit Spread), which indicates a higher profit distribution management. Specifically the mean values of AS and DS are 75.1 and 2.379 for the full sample of Islamic and conventional banks, respectively. The value of DS is reported in inverse to ensure the relationship and consistency between the measures of profit distribution. These average values make sense on AS (Asset spread) is relatively higher whereas, the DS (deposit spread) is relatively smaller. This reveals that the Islamic as well as conventional banks in Pakistan distribute managed returns rather than the economic returns to the depositors. As the Islamic banks are operating in a competitive environment with conventional banks, they are subject to provide managed returns to depositors to compete in the market and to fulfill depositors' requirements. The values of standard deviation of AS (Asset Spread) and DS (Deposit Spread) are 1.835 and 1.901 with the maximum value of 10.476 and 13.122 and the minimum value of -11.005 and -9.517 for AS (Asset Spread) and DS (Deposit Spread) respectively. The observations support Farook et al. (2012) who showed that banks operating in Pakistan have higher and consistent profit distribution management.

Table 5.2: Summary Statistics of Proxies of Dependent Variables

	Assets Spread (AS)		Deposit Spread (DS)
Statistics	ROA	ROIAH	Deposit Rate
Minimum	-5.481	-5.950	2.595
Maximum	13.941	8.936	8.680
Mean	5.248	4.423	6.860
SD	1.902	1.886	1.619

Note: Assets spread is measured by difference between ROA (return on assets) and ROIAH (return in investment account holder). The difference among National deposit rate and ROIHA (return on investment account holder) is used to measure the Deposit spread.

Table 5.2 presents the summery statistics of the proxies that are used to measure the dependent variable. Asset spread is calculated by using ROA (Return on assets) and ROIAH (Return on investment account holders) and the Deposit Spread is calculated by using the national deposit rate and ROIAH. The table provides the mean, standard deviation, minimum and maximum values for each proxy. The mean of deposit rate is greater than the mean of ROA and ROIAH, which indicates that the managed rate of returns are used for distribution to depositors. The mean value of ROA, ROIAH, and deposit rate is 5.248, 4.423 and 6.680, respectively. However the standard deviation is 1.902 for ROA 1.886 for ROIAH and 1.619 for deposit rate. The range of minimum and maximum value for ROA is -5.481 to 13.941, whereas, the maximum value for ROIAH is 8.936 and the minimum value is -5.950. The value 8.680 represents the maximum and 2.595 represents the minimum value for the deposit rate.

Table 5.3: Descriptive Statistics of Independent Variables

Variables	Mean	Std. Dev.	Min	Max
LATA	45.322	11.645	0.0105	70.857
Deposit ratio	54.853	15.755	1.8273	77.634
CONC	0.332	2.502	0	35.827
FD	62.821	2.496	59.743	68.327
GDPDR	3.960	1.665	1.606	7.667

Note: The table above reported the summery statistics (mean and standard deviation) of main independent variables which are used in the study for the period of 2005-2015. LA/TA (Loans to Total assets ratio), Deposit ratio (Deposit to total assets ratio), CONC (Banking market concentration ratio). FD (financial development) and GDPGR (GDP growth rate) are independent variables.

Table 5.3 provides the descriptive statistics of main independent variables. These variables include bank-specific variables (LATA, Deposit ratio and CONC) and macro variables (FD and GDPGR) that directly or indirectly affect the profit distribution management of banks. The average value of LATA is 45.322 with a minimum value of 0.010 and the maximum value of 70.857. The variation in the ratio of deposits to total assets is ranging from 1.8273to 77.634 with the mean of 54.853. The value of banking market concentration is 0.332 which is approximately 33% with a maximum value of 35.82 and a minimum value of 0. The mean value of FD is 62.821 which is highest as compared to other independent variables with a minimum value of 59.743 and maximum value of 68.327. The mean value of GDPGR is about 3.960 ranging from 1.606 to 7.667 for the period of 2005-2015.

5.3 Correlation Analysis

Correlation matrix tells whether the variables used for analysis are correlated with each other. It is also useful to examine whether the variables included in the model have any similarity. Table 5.4 presents the correlation coefficient for dependent and independent variables. Table 5.4 shows the correlation analysis between AD (asset spread) and DS (Deposit spread). A significant positive correlation between AS and DS shows that managed returns are about 34% correlated with economic returns.

Table 5.4: Correlation of Dependent and Independent Variables

	PDM						
	Assets Spread	**Deposit Spread**	**LA/TA**	**Deposit ratio**	**CONC**	**FD**	**GDPGR**
PDM							
AS	1.000						
DS	0.345***	1.000					
	(0.000)						
LA/TA	0.028	-0.149**	1.000				
	(0.684)	(0.028)					
Deposit ratio	-0.347***	-0.174***	0.233***	1.000			
	(0.000)	(0.010)	(0.000)				
CONC	-0.411***	-0.406***	-0.296***	-0.088	1.000		
	(0.000)	(0.000)	(0.000)	(0.200)			
FD	0.205***	-0.289***	0.306***	-0.113*	0.017	1.000	
	(0.002)	(0.000)	(0.000)	(0.099)	(0.796)		
GDPGR	0.306***	-0.172***	0.084	0.214***	-0.063	0.360***	1.000
	(0.000)	(0.011)	(0.218)	(0.001)	(0.354)	(0.000)	

Note: PDM (Profit Distribution Management) is the dependent variable. Assets spread and Deposit spread are measures that are used for the dependent variable using the panel data for the period of 2005-2015. *** and ** reveals that correlations are statistically significant at the 1% and 5%level, respectively.

The correlation between asset spread and deposit spread is positive and significant which shows that the banks in Pakistan manage their profit distributions to the depositors. The correlation estimate is 0.345. This positive correlation between the variables is persistent with the study of (Farook et al., 2012) who have found that a positive and significant correlation between AS and DS shows that the banks manage their profit distribution. Table 5.4 also presents the correlation between the dependent and independent variables. The correlation estimates of LA/TA are positive but insignificant with AS and they are negatively significant with DS. The correlation of deposit ratio is negative and insignificant with DS. They are negative but significant with AS. The estimates of deposit ratio are positive and significant with LA/TA. The correlation estimates of CONC are negatively significant with AS and DS and LA/TA. CONC is negatively correlated with deposit ratio. A positive significant correlation exists between AS, LA/TA and FD. FD is negatively but significantly correlated with DS. Correlation estimates of FD are insignificant with CONC and deposit ratio. GDPGR has a positive significant correlation with AS and FD. GDPGR has a negative significant correlation with DS and deposit ratio. The correlation estimates of GDPGR are insignificant positive with LA/TA and negative with CONC. The correlation between the explanatory variables is not so high to create the problem of multi- collinerity in the model. Generally we consider high correlation, when its magnitude is greater than 0.80.

A positive and significant correlation between deposit spread and asset spread indicates that banks managing their profit distribution to their depositors. We further examine the correlation between ROA (return on asset) and ROIAH (Return on investment account holder) as well as correlation between the national deposit rate and the ROIAH is

calculated. This correlation tells us whether proxies of the dependent variables exhibit any similarity. This correlation analysis is done to check the reliability of the proxies that are used to calculate the measures for the profit distribution management. The national deposit rate and the ROIAH (return on investment account holder) is used to calculate the DS (deposit spread), while ROA (return on asset) and ROIAH (return on investment account holder) is used to calculate the AS (asset spread).

Table: 5.5 Correlation of Assets Spread and Deposit Spread Proxies

	Assets Spread	
	ROA	**ROIHA**
Deposit Spread		
Deposit Rate	0.261***	0.529***
	(0.000)	(0.000)
ROIHA	0.612***	
	(0.000)	

Note: Assets spread and Deposit spread are measures, which are used for the dependent variable using the panel data for the period of 2005-2015. Assets spread is measured by difference between ROA (return on assets) and ROIAH (return in investment account holder). The difference among National deposit rate and ROIHA (return on investment account holder) is used to measure the Deposit spread. *** statistically significant at the 1% level.

The correlation estimate of ROA and ROIAH is positive and significant. The ROIAH and deposit rate have also a positive and statistically significant correlation. The positive value of correlation between ROIAH and Deposit rate shows that banks actually manage their profit distributions. The value of correlation estimates of the ROIAH and ROA is 0.612 which is greater than the value of correlation estimate of ROIAH and deposit rate which is 0.529.

The study of (V Sundararajan, 2007) found that in Islamic banks ROIAH (return on investment account holders) have a substantial correlation with deposit rate as compared to correlation with asset return rate. The stronger correlation between deposit rate and ROIAH determines that banks are systematically managing profits distributions as compare to the banks that have a high correlation between asset return rate and account holders return rate. The study of Farook et al. (2012) found mixed outcomes using cross sectional data. They found that some countries demonstrate statistically stronger correlation between the market deposit rate and the account holders return rate, indicating that banks of those countries systematically managing profit distribution. They found that the overall correlation is supporting to the high correlation between asset return rate and account holders rate of return in Islamic banks. The higher value of correlation between ROIAH and ROA is consistent with the findings of (Farook et al., 2012).

5.4 Findings of Fixed Effect Model for Islamic and Conventional Banks

The second objective of the study is to determine the factors which are related to profit distribution management structure of banks and to check the effects of some internal and external factors on profit distribution management system of banks. To investigate this objective we apply fixed effects technique to estimate our model. For the purpose of estimation, we use the annual panel data set of Islamic and conventional banks operating in Pakistan for the period 2005-2015. Table 5.6 shows the results of fixed effects model for the whole sample.

Table 5.6: Fixed Effects Model Results for Whole Sample (Islamic and Conventional banks)

Independent variables	Dependent Variable Variations			
	Asset Spread		Deposit Spread	
	Coef	t-stat	Coef	t-stat
Panel A				
LATA $_{i,t}$	-0.027*	-2.49	-0.035***	-2.92
Deporatio $_{i,t}$	-0.011*	-1.66	-0.013*	-1.89
CONC $_{i,t}$	-0.303***	7.39	-0.414***	-9.22
FD$_t$	0.119***	2.85	-0.152***	-3.31
GDPGR$_t$	0.195***	3.32	-0.178***	-2.76
Cons	-5.563**	-2.25	15.161***	5.59
Panel B				
Observations	213		213	
Number of groups	22		22	
Within R^2	0.324		0.405	
Between R^2	0.385		0.034	
Overall R^2	0.314		0.313	
F value	4.91		3.59	
Sig. F (p-valuc)	0.000		0.000	

Note: AS (Assets spread), DS (Deposit spread) are measures of dependent variable. FD (financial development), CONC (Banking concentration index), GDPGR (GDP growth rate), LA/TA (Loan assets to Total assets), Deporatio (Deposit Ratio) are independent variables. The value of withinR^2, betweenR^2, and overall R^2 shows the variations between different dependent and independent variables.
Missing values are excluded pair-wise
*Significant at the 0.10 level.
** Significant at the 0.05 level.
*** Significant at the 0.01 level.

We investigate whether banks distribute their profit to depositors, if so than on which basis they distribute their profits. We use two measures namely AS and DS to investigate whether the banks distribute a managed rate of return on the basis of market based deposit rate or an economic rate of return based on assets return rate. Five independent variables including bank-specific variables and macro variables in the models are used to check the effects of internal and external factors on banks' profit distribution management system. Bank specific variables include LA/TA (Loans to total assets ratio), deposit ratio (Bank deposit to total asset ratio), CONC (Banking market concentration ratio) and macro variables are FD (Financial development) and GDPGR (GDP growth ratio). Table 5.6, Panel B provides some additional information about within R^2, between R^2 and Overall R^2.

Our first hypothesis states that loan assets to total assets ratio is positively related to management of profit distribution for Islamic banks. It is because the Islamic bank deals with fixed rate of return instruments for investments and provides a managed rate of return to depositors according to the market changes, resulting in a profit rate risk during the interest rate changes in market. Islamic banks used the ratio of LA/TA to determine a managed rate of return to depositors according to the market changes. Consequently LA/TA has a positive and direct relationship with profit distribution management. Contrary to prediction the coefficient of the LA/TA provide a negative and significant value with profit distribution management for the whole sample of Islamic and conventional banks. It reveals that the ratio of LA/TA is not considered by a bank to determine a managed rate of return to depositors. Our results are consistent with the findings of (Čihák & Hesse, 2010).

The findings show a negative and significant relationship between the deposit ratio and profit distribution management of banks. It rejects our 2nd hypothesis. A significant relationship show that deposits effects the profit distribution management but negatively. The coefficient value of deposit ratio is -0.01 which is significant at the 10% level for AS. For DS the coefficient value is -0.013 which is significant at the 10% level. This finding suggests that banks in Pakistan depend on deposits to generate their earnings through management fee but they are subject to scrutinize their deposit accounts. The ratio of deposits is negatively linked with the performance and profit distribution management of bank (Rashid & Jabeen, 2016) and (Farook et al., 2012).

Our 3rd hypothesis is about banking market concentration ratio. The hypothesis predicts that the market concentration is negatively related to banks profit distribution management. In Table 5.6 the coefficient value of the CONC is negative and statistically significant for AS. For DS the coefficient value of CONC is statistically significant at the 1% level with a negative value of -0.414. Consistent with the prediction, the CONC has a negative significant relationship with profit distribution management. It reveals that the banks which have a significant share in concentrated market have no need to manage profit distribution management. Banking market concentration have a negative and significant impact on banks, stability and profit distribution management (Čihák & Hesse, 2010) and (Farook et al., 2012).

Our 4rth hypothesis is about financial development. The findings exert a positive and significant relation of FD with profit distribution when the banks distribute profit to depositors under economic rate of return. The coefficient value of FD for AS is 0.119 which is positive and significant at the 1% with profit distribution of banks. The

outcomes of FD for DS are negative and significant. It reveals that the banks are less likely to distribute a managed rate of return when markets are fully developed. The negative effect of FD on profit distribution management of banks is consistent with the study of (Farook et al., 2012).

A negative association is predicted between the profit distribution management and GDPGR. As the GDPGR increases the banks are less likely to provide a managed rate of return to depositors. The findings of DS (Deposit spread) show a negative association between the profit distribution and GDPGR. The coefficient value of GDPGR in DS is -0.178 which is significant at the 1%. This finding shows a positive significant association between the GDPGR and profit distribution in AS (Asset Spread). It reveals that when the GDPGR increases banks are more likely to pay an economic rate of return to depositors rather than the managed rate of return. It is because the banks are in strong financial position and earning stable returns, so they can distribute according to their assets return rate. A positive effect of GDPGR on profit is consistent among others with (Noor and Sulong, 2013), (Čihák & Hesse, 2010) and (Rashid & Jabeen, 2016). The findings of GDPGR with profit distribution is consistent with the study (Čihák & Hesse, 2010) and (Farook et al., 2012).

The value of within R^2 for AS is 0.324 and for DS is 0.405 which shows the variation between the different variables. The value of between $R^2$for AS is 0.385 and for DS is 0.034 which shows the variation between the dependent variables AS and DS and independent variables. The overall R^2 value is 0.314 for AS and it is 0.313 for DS which shows the variation across dependent variables.

5.5 Comparative Results of Fixed Effects Model Conventional Verses Islamic banks

After having established the impact of bank-specific and macro variables on profit distribution management, we do the comparison of Islamic and conventional banks in respect of profit distribution management system we run the model separately. To investigate whether Islamic banks have different perspective in respect of profit distribution management from conventional banks we estimate the effects separately for Islamic and conventional banks. We generate a dummy for conventional bank and Islamic banks and interact with all the explanatory variables to make a comparison. We perform this procedure over estimating the model separately for conventional and Islamic banks to get the benefit of higher degree of freedom. Table 5.7 (Panel A) presents the results of AS and DS for Islamic and conventional banks. These results show how bank-specific factors and macro factors affect the profit distribution management of Islamic and conventional banks.

Table 5.7: Fixed Effects Model Results Conventional Verses Islamic banks

Independent Variables	Dependent Variable Variation			
	Assets Spread		Deposit Spread	
	Coef	t-state	Coef	t-state
Panel A				
D^{IB}_i LATA$_{i,t}$	0.007	0.32	-0.019	-0.76
D^{CB}_i LATA$_{i,t}$	-0.046***	-3.38	-0.036**	-2.38
D^{IB}_i Deporatio$_{i,t}$	-0.015	-1.33	-0.011	-0.85
D^{CB}_i Deporitio$_{i,t}$	-0.005	-0.65	-0.012	-1.38
D^{IB}_i CONC$_{i,t}$	-0.252***	-5.16	-0.407***	-7.53
D^{CB}_i CONC$_{i,t}$	-0.392*	-1.65	-0.429*	-1.64
D^{IB}_i FD$_t$	0.054	0.67	-0.056	-0.63
D^{CB}_i FD$_t$	0.153***	2.98	-0.186***	-3.29
D^{IB}_i GDPGR$_t$	0.230**	1.78	-0.328**	-2.30
D^{CB}_i GDPGR$_t$	0.149**	2.13	-0.139**	-1.81
Cons	-5.563**	-2.32	15.137***	5.30
Panel B				
Observations	213		213	
Number of groups	22		22	
Within R^2	0.344		0.414	
Between R^2	0.196		0.081	
Overall R^2	0.188		0.082	
F value	4.29		2.60	
Sig. F(p-value)	0.000		0.000	

Note: AS (Assets spread), DS (Deposit spread) are dependent variables. FD (financial development), CONC (Banking concentration index), GDPGR (GDP growth rate), LA/TA (Loan assets to Total assets), Deporatio (Deposit Ratio) are independent variables.
Missing values are excluded pair-wise
*Significant at the 0.10 level.
** Significant at the 0.05 level.
*** Significant at the 0.01 level.

We analyze whether the Islamic and conventional banks are different from one another in profit distribution management and to which degree bank-specific and macro factors affect the profit distribution management of Islamic and conventional banks.

We find that the effect of LA/TA on profit distribution management is negative and significant for conventional banks, whereas, it is insignificant for Islamic banks. It is because conventional banks provide a market determine interest rate to depositor so the ratio of loan assets to total assets is not considered to decide the rate of return. On the other hand, Islamic banks invest under the fixed rate investment contracts and depositors desired the returns according to the market prevailing rate so, the Islamic banks consider the ratio of LA/TA to provide a managed rate of return to the depositor. These results show that the loan assets of conventional banks have negative affect on profit distributions and for Islamic banks they are negative and insignificant. The coefficient value of LA/TA for Islamic banks is 0.007 and for conventional banks it is -0.046 in AS and -0.019 for Islamic banks and-0.036 for conventional banks in DS. These values are significant at the 1% level of significance for conventional banks.

For both AS and DS, the deposit ratio attains a negative and insignificant value for both type of banks. The coefficient value of deposit ratio for Islamic banks is -0.015 and for conventional banks, it is -0.005 in AS and it is -0.011for Islamic banks and -0.012 for conventional in DS. It shows that the both type of banks Islamic and conventional do not relay on their deposit account to manage their profit distribution to their depositors.

CONC exhibits a negative but significant effect on profit distribution management for Islamic as well as conventional banks. The value of coefficient for CONC is -0.252

(significant at the 1%) for Islamic bank and -0.392 (significant at 1the 10%) for conventional banks in AS and it is -0.407 (significant at the 1%) for Islamic banks and -0.429 (significant at the 10%) for conventional banks in DS. These findings are meaningful as banks having a significant share in a concentrated market have less need to manage their profits. These findings shows that the CONC affects the profit distribution management of a banks, as a bank that have a strong market share have less need to manage its profit distribution.

The findings show that the effect of FD on profit distribution management is significant for conventional banks, whereas, it is insignificant for Islamic banks. The coefficient value of FD for Islamic banks is 0.054 and for conventional banks 0.153 in AS and it is -0.056 for Islamic banks and -0.186 for conventional banks in DS. These values are significant at the 1% level of significance for conventional banks. The coefficient value of FD for Islamic banks is consistent with the prediction. As it was assumed that there is an inverse association between the financial market development and the level of profit distribution management of banks. It was assumed on the perception that Islamic bank that operates in a well-developed financial market have less need to manage its distributions of profit on the market based rate of return. The findings of Islamic banks are consistent with the predictions as they have negative coefficient value. The positive significant values for conventional banks support the prediction as it is perceived that the banks operating in more developed market generate their incomes from conventional activities and the AS consider all these incomes. So there is a positive association between FD and the profit distribution management. The results support the prediction in both cases of Islamic and conventional banks.

The findings of GDPGR are consistent with the predictions. GDP growth rate is negatively related to the profit distribution management if it is based on the market rate of return. The results show that the GDPGR has a negative significant association with profit distribution management when market rate or managed rate of return is considered. The coefficient value of GDPGR is -0.328 for Islamic banks and -0.139 for conventional banks in DS which is significant at the 5% significance level. GDPGR has a positive significant effect on profit distribution for both Islamic and conventional banks if the economic rate of return AS is considered. The coefficient value of GDPGR is 0.230 for Islamic banks and 0.149 for conventional banks for AS, the significance level is 5%. The findings reveals that when GDPGR increases, banks distribute profit according to economic rate of return to depositors.

Chapter 6

Conclusion and policy Implication

6.1 Introduction

The expansion of Islamic banking has been redoubled especially from the previous three decades. The banking system which is free of interest captured the minds of the people from the whole world. Islamic banking is practiced in different countries of the world. Both Muslim and non-Muslim countries are giving the same attention to this boosting banking system. This accelerated growth of banking industry required research on different academic levels for many conducive and practical purposes. Islamic banking and finance is very warm topic for research in present time. In past, there were number of studies which were conducted about Islamic banking and those studies covered the basic topics related to principles, Shariah rules and regulations, different products and instruments of Islamic banking. In present time researchers are active in exploring the different areas of research and provide different outcomes related to profitability, risk, liquidity, and governance and provide varied results. Profit distribution is also one of the most considerable areas which are covered by the researchers and varied results are found regarding profit distribution mechanism of Islamic banks.

This study can be useful contribution in literature of Islamic banking and finance. In this study five full-fledged Islamic banks and seventeen conventional banks are used for comparison. This study expressed the attitude of banks towards profit distribution system. This study mainly targeted the profit distribution system and viewed the effects of

different factors on the profit distribution system by comparing the Islamic and conventional banks of Pakistan by using the imbalance panel data for the period of 2005-2015. To get the significant outcomes the most useful econometric technique fixed effect model is used. The aim of this research is to contribute in the existing literature by examining the profit distribution management of Islamic as well as conventional banks of Pakistan. The study also viewed the effects of some bank specific and some macro specific factors on the profit distribution management of banks. Assets spread and deposit spread is used as a measure to check the profit distribution management system of banks.

6.2 Major Findings

This study documents number of significant facts and important outcomes. The findings showed mixed results by using two different type of measures of profit distribution management for both Islamic and conventional banks. It is documented that the Deposit spread is small whereas the Asset spread is relatively high. This affirmed that the banks which are operating in Pakistan are actually managing profit distribution. The correlation of deposit spread and asset spread exhibit that the deposit rate is used as a profit distributions rate by the banks in Pakistan. Overall the LA/TA presents a negative effect with profit distribution management, but if we compare the Islamic and conventional banks, LA/TA is significant for conventional banks and insignificant for Islamic banks. The results of deposit ratio are negative and insignificant for profit distribution management for both Islamic and conventional banks. The results of CONC are negative and significant for both conventional as well as Islamic banks which shows that CONC have a negative relationship with profit distribution management. It implies that it is not essential to manage profit distribution for a bank which has a momentous share in the

markets. The outcomes of FD are mixed for both measure and for both type of banks. It shows a positive significant association with profit distribution management for conventional banks whereas it has a negative and insignificant association for Islamic banks. The findings of GDPGR also indicates mixed outcomes like in AS there is a positive significant association towards profit distribution management, whereas in DS there is a negative and significant association among the profit distribution management and GDPGR for both (Islamic and conventional) banks.

6.3 Policy Implications

This research is very influential for different segment of the economy, who may interested to develop an independent Islamic financial system. Investors, management, researchers, regulators, policy makers and government can get fruitful information and guidance from the findings of our study. The knowledge about profit sharing mechanism helps the investors about making investment decision. Depositors are expected to be more aware about the profitability and the structure of profit distribution of Islamic banks, so they can take a fruitful decision related to investment. Particularly, with the involvement of Islamic banks, depositors may change their directions from floating segment to Shariah proponent. Islamic banks distributed their profit among the depositors which fulfill the depositors, interest of getting reasonable returns by following the shariah rules and principles related to business. The management of Islamic banks can give more consideration to the principles of Shariah and take Shariah based effective strategic decisions to improve the performance of Islamic banks. Islamic banks should increase the amount of their deposits for meeting the depositors, expectations of profit sharing and fulfillment of their religious commitment. Our study enhanced our knowledge about

profit sharing mechanism of both Islamic and conventional banking system and also provide the knowledge about different factors which influence this mechanism. By comparing both banking system we are able to justify the importance of Islamic banks in a Muslim country. This study is very contributory for making and the implementation of certain policies and measures by the regulators according to evidence of this research in Pakistan. This study is capable to define the trends related to profit distribution of banking industry in Pakistan and also define the extent of effects by some closely related factors of the economy. So, the policy makers and regulators can make their policies by considering all these outcomes. These outcomes can consider being seed to the implementation of the Shariah compliance financial systems in the country. As Islamic banks are vital for the financial growth and economic development of a country, it is essential for the government to take radical steps for the improvement of banking system. The policy makers, regulators, and government should encourage Islamic banking system in Pakistan by considering Shariah principles for making investment policies. For developing a sound Islamic banking market, the prevailing market rate of return should be decided by following the Shariah rules. For the evaluation and boom of the economy it is mandatory for the government to have knowledge about the current scenarios of the Islamic banks and information related to their operations.

6.4 Limitations of the study

The data set of Islamic banks and Islamic financial institutions is limited. In Pakistan there are only five banks that are operating as full-fledged Islamic banks. Most of them start their operations in the end of 2007. Hence, the data set from the year 2005 to 2007 is

limited. So, the limited set of data and small sample size of Islamic banks will have an effect on the findings.

6.5 Areas for Future research

This study can be extended in several dimensions. Some of those dimensions are following. In our study, we find the evidence about profit distribution management system of banks including both Islamic and conventional banks by comparing them. We use only imbalance panel data of banks in Pakistan. However, it can be more expanded by conducting this study on Islamic financial institutions. In our study we use only two measures to check the profit distribution management of banks. Further studies can use more measures to check whether the banks manage profit distribution. We check the effect of limited factors on the profit distribution management. In future, researchers can use some other internal and external factors fined more reliable and efficient results. Future studies can expand the sample size by enhancing the number of years and increasing the number of observations. This study examine the banks profit distribution to depositors only, further studies can explore the profit distributions of bank to its other stakeholders. Furthermore, the study will provides guidelines to banks to adopt some policies and take new steps to increase the distribution system to develop confidence of all stakeholders.

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