

# **DETERMINANTS OF ISLAMIC BANK PROFITABILITY**

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## **DECLARATION**

I certify that the substance of this thesis has not already been submitted for any degree and is not currently being submitted for any other degree or qualification.

I certify that any help received in preparing this thesis, and all sources used, have been acknowledged in this thesis.



**Sudin Haron**

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## **ABSTRACT**

This study has three main objectives: to investigate determinants that contribute towards the profitability of Islamic banks; to examine the profitability of these banks in monopolistic and competitive markets; and to probe the existence of profitability theories within the Islamic banking system. The profitability determinants and theories used in this study are those which are frequently described in conventional banking literature. Determinants were divided into two categories, internal and external, whereas profitability theories relevant to this study comprise efficient-structure theory, expense-preference theory and risk-aversion theory.

The data are taken from the annual reports of thirteen participating banks from various countries. Since this study involves pooling of cross-section and time-series data, a dummy variable model is applied in measuring the effects of determinants on profitability. To probe the existence of profitability theories, Smirlock's (1985) and Bourke's (1989) methodologies are used.

This study finds that internal factors such as liquidity, total expenditures, funds invested in Islamic securities, and the percentage of the profit-sharing ratio between the bank and the borrower of funds are highly correlated with the level of total income received by the Islamic bank. Similar effects are found for external factors such as interest rates, market share and size of the bank. Other determinants such as funds deposited into current accounts, total capital and reserves, the percentage of profit-sharing between bank and depositors, and money supply also play a major role in

influencing the profitability of Islamic banks. With regard to profitability theories, except for risk-aversion theory, this study finds no evidence for the existence of the expense-preference and efficient-structure theories. This study also discovers that the nature of the market, either monopolistic or competitive, does not have any linkage with the profitability of an Islamic bank. Therefore, the policy of protectionism adopted by several Muslim countries is considered an inappropriate strategy for the future development of the Islamic banking system.

Several promising areas for future research are identified by this study. The first research opportunity lies in relation to the theory and concept of Islamic banking. An analysis of the extent to which Islamic banks are upholding Islamic business principles and philosophies and an attitudinal study of the beliefs of those who are managing and patronising Islamic banks are considered fruitful fields for further investigation. The second area of research opportunity is related to laws and regulations. Research relevant to this area would include studies which examine the role of *Shariah* (Islamic law) in governing the entire Islamic banking system and the functions of *Shariah* Supervisory Boards. Finally, the operations and practices of Islamic banks deserve more detailed scrutiny. One of the most important areas in this regard is associated with asset-liability management. This study indicates that many of the profitability determinants have similar impacts on both conventional and Islamic banks. In view of this finding, it is likely that some of the tools and techniques used in studies involving the asset-liability management of conventional banks are applicable to the Islamic banking context.

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