FACTORS AFFECTING THE PROFITABILITY OF ISLAMIC BANKS IN GCC COUNTRIES

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ABSTRACT

This study investigates the impact of internal and external factors on Islamic bank's profitability in GCC countries for a year period from 2006 to 2012. The study used three profitability measures namely, ROA, ROE and NIM. The study used a balanced panel data set of 175 observations of Islamic banks in 5 countries from the GCC. Seven independent variables are used in this study. These are divided into internal variables (size, management efficiency, loan, asset management and capital) and external variables (inflation and GDP). The results of the study indicate that management efficiency, loan, and GDP have positive and significant relationships with ROE. The study also finds that asset management and capital are positive and statistically significant with ROA, ROE and NIM. Inflation has a positive influence on bank's profitability as measured by ROA and NIM. The study shows that size has a significant negative impact on bank's profitability. Overall, the study finds that all internal variables and macroeconomic variables tested have significant impacts on bank's profitability. The findings from this study provide valuable information not only to bank managers, but also to other parties such as government, shareholders, and potential investors with a better guideline and understanding to enhance Islamic bank's profitability in the GCC.

Keywords: bank size, management efficiency, loan, asset management, capital, gross domestic products, inflation, bank profitability, GCC Islamic banks.

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LIST OF ABBREVIATIONS

Abbreviation	Description of Abbreviation
AM	Asset Management
BAJ	Bank Al-Jazira
CPI	Consumer Price Index
DIB	Dubai Islamic Bank
GDP	Gross Domestic Product
INF	Inflation
KSA	Kingdom of Saudi Arabia
LNTA	Natural Logarithm of Total Assets
MGTEFF	Management Efficiency
NIM	Net Non-Interest Margin
PLS	Profit-Loss Sharing
QIB	Qatar Islamic Bank
ROA	Return On Asset
ROE	Return On Equity
SEE	South East Europe
UAE	United Arab Emirates
UUM	Universiti Utara Malaysia

CHAPTER ONE

INTRODUCTION

1.0 Background of the Study

Banking system has changed since the last few decades from general conventional banking to Islamic banking as it fulfills the needs and requirements of riba (interest) free society according to the Islamic teaching. Islamic economics is followed under the principle of Islamic law or "Shari'ah". Shari'ah is the Islamic law that governs a Muslim daily life. It is derived from Al-Quran (The Holy Book) and Al-Hadith (the sayings of Prophet Mohammed Peace been upon him). The main important tenet of Sari'ah in doing business or economy is prohibition of riba (interest).

Islamic banks are known as financial institutions are also operated under the Islamic law. The most significant code that differentiate the profitability or losses and abort the collection (giving and charging) Interest or "riba". The traditional banking system are those financial institutions which are offering their services such as debit and credit of customer cash flows, providing long and short term loans to their customers and other business services. These conventional banks are basically governed by the strategy to maximize their profitability on the basis of interest is not acceptable in Islamic way of operations as it is prohibited in Islam.

According to the Islamic principle of financial institutions, all the investments and trading on the basis of riba are prohibited. Under the Shari'ah ethical code of conduct, riba in any case should not be included as a profit. The investments can only be allowed

if they are invested within industries which are again followed the Islamic ethical standards. Similarly, funding in a general context is based on the investment potential and the weakness or the strength of a particular potential business model, unlike the traditional type of conventional credit, which is widely operated by the creditworthiness of the borrower. As to the matter of fact under Islamic banking these rules and procedures are considered as to be not speculative, conservative as well as encouraging entrepreneurship and equal distribution of wealth. Financial industry is facing a critical time as there is a recession and unemployment all around the globe. Islamic financial industry is also affected accordingly, for example, Islamic bond or sukuk which is required in GCC countries and probable to grow in the coming future to attain high profits.

Islamic banking is becoming more recognized and reported as one of the growing areas in finance and banking. Islamic banking is not only appreciated by Muslims but also non-Muslims who are involved in tremendous investments in Islamic financing system (Sufian, 2007).

1.1 Overview of GCC Countries

There is council of Arab states which is known as Gulf Cooperation Council (GCC) is an alliance or a political and economic platform for Arab states which include Gulf peninsula and Persian Gulf. The countries which are included in this domain are United Arab Emirates, Kingdom of Saudi Arabia, Oman, Qatar, Bahrain and Kuwait. Morocco and Jordan are excluded from GCC but they are invited to join the alliance. Due to the

instability in Arab democratic countries, GCC and its six members on March 6th 2012 have also noticed the increasing pressure and influence of Iran in the region. GCC countries announce that Iran would be evolved from a local bloc to a union. This decision is powerfully supported by Saudi Arabia, but there is a doubt that there might be some other countries to influence this decision (Olson & Zoubi, 2008).

Persian Gulf states were created on 25th May 1981, include United Arab Emirates, Kingdom of Saudi Arabia, Qatar, Oman, Bahrain, and Kuwait and the original council is comprised of 630-million-acre (2,500,000 km²). On November, 1981 a unified economic agreement was signed between the GCC member countries in Abu Dhabi. All the GCC States are the known as the member countries.

Following are the GCC objectives:

- To formulate same regulations in many sectors such as trade, economics, finance, customs, tourism, administration and legislation.
- To jointly do the development in technical expertise and scientific research, local industries, mining, water, gas, minerals, agriculture and livestock resources.
- To establish scientific research and development institutes, centers and universities.
- To set up joint ventures.
- To have joint collaboration between military (Peninsula Shield Force).
- To appreciate correlations among the GCC private sector.

- To strength interrelations among the people.
- To establish a mutual platform of a common currency.

In addition, on December 2006 Oman disclosed that they failed to meet their dated targets. In May 2009 UAE which is the second and so far the last state to withdraw from the monetary union project tentative agreement because the location of monetary union will be set in Riyadh. The name of the currency is proposed to be "Khaleeji". It is identified that GCC union would be looking forwards that the measurement of gross domestic product (GDP) after the common currency will be introduced as there are other competition currency like Europe.[1] Furthermore, since 2013, there have been no significant developments have been announced and the project has been quietly postponed.

Bashir and Hassan (2003) have conducted a study that measures the factors influencing the productivity of Islamic institutions among the eight member Middle Eastern Countries for the period 1993–1998. The findings have suggest that there a significant role of oil export and economic development within the GCC region. Qatar holds the position to produce largest contribution for national gas and Qatar is mostly dependent on Oil export. Bahrain and Oman have comparatively less dependence on oil. The entire GCC countries are Islamic states and majority of them belong to Muslim faith. In GCC region most of people are Muslims and a person who does not follow Islam has possibility to be punished by the state. In most of the states the penalty for apostasy is

[1] IMF, IIF, National Accounts, Samba (2010)

death. GCC countries legal and political infrastructure is based on Islamic religion. Shari'ah law or Islamic law is practices and applicable on all the people of GCC countries. The GCC countries share common reforms. Black gold is the basic source of income of these GCC countries and the revenues is generated from oil exports and this is how they stabilize their currencies and control their price levels (Laabas & Limam 2002).

This study investigates the profitability and performance of GCC Islamic banks. Islamic banking institutions are the sample of this study. There is 15% of the local banking system controlled by Gulf. The Islamic banks which operate under GCC countries have already become more diverse. In 1970s huge pioneers which came into being co-existed with the latest entrants. These are the previous traditional financial institutions, which are now known as Shari'ah compliant banking bodies.

Some conventional banks established Islamic banking windows to provide Islamic products and services. There is a high competition among the Islamic banking in Gulf and other countries looking for commercial be fortified, strengthening their brands, improving relevant business models and reputation and offering innovative solutions to a growing client base who are attracted by the concept of interest-free banking[2]. In Saudi Arabia, Bank Al-Jazira (BaJ) operates under traditional commercial bank, extending credit and raising deposits to both its corporate franchise and retail. In the kingdom there is more competition in the credit sector, from either fully Islamic banks or the Islamic

[2]Moody's Global Banking report issued in 2008

windows of traditional financial institutions. BaJ has substituted into brokerage margin loaning and leveraged finance on behalf of their banking clients.

The head quarter of Al Rajhi Bank (Al-Rajhi) is in Saudi Arabia, as it major-market, retail oriented Islamic bank, taking the opportunity from funding that a huge customer deposit. As the strategy of Al Rajhi was to offer their services with very cheap service charge and in 2006, it recorded a 1% funding cost, as compared to 3% on average for approximately all the Islamic financial institutions. It has improved the performance and profitability of Al Rajhi and consequently the bank has maintained a good reputation and has improved it asset management capabilities[3].

Furthermore, Qatar Islamic Bank (QIB) has also followed the same strategy to obtain a general banking status and their core financial activity includes the asset management and investment banking. On the other hand, Dubai Islamic Bank (DIB) has also improved their standing among the Islamic investment banking with its unique brand integration under a different set of fund and asset management, listing, private equity and legal entity handling advisory. Even the commercial banking and Islamic financing retains the dominance and growth as the demand of financing and investment in the region started to increase and become more specific. The newcomers in the Islamic banking industry such as Masraf Al Rayan has availed the opportunity with US$ 1 billion equity with in just 18 months has surpassed the pressure of competition and explored more avenues globally[4].

[3] GCC Banks & Financial Institutions Equity Fund (Amwal). http://www.gulfbase.com
[4] GCC Outlook 2011, Samba Financial Group.

Al Rajhi, QIB and Kuwait Finance House (KFH), have started their operations in Malaysia, as they are looking for more Islamic financial opportunities to specifically target the Muslim banking customers in Asia. In United Kingdom also there are many GCC based banks which have taken successful initiatives towards Islamic finance. European finance house and European Islamic investment both have banking investors and shareholders from the Gulf.

1.2 Problem Statement

In the GCC, the financial sector is generally dominated by the banking sector. Islamic banks have grown in the current years to become an eminent source of the financial intermediation in the GCC countries. It also controls on average 24% of the Gulf banking system assets (Al-Hassan, Oulidi, and Khamis, 2010).

A recent report, issued by the Secretariat of Islamic finance in Britain (2013) states that the size of global Islamic finance assets will reach two trillion dollars by the end of 2014 compared with 1.46 trillion dollars in 2012. The report pointed out that the Islamic banks in GCC countries grew faster than their conventional counterparts, and have a huge assets base. In the same vein, Standard & Poor (2013) report that GCC region is one of the largest Islamic banking markets, and that the sector is performing properly, suggesting that Islamic banks in the GCC countries will maintain their growth rates that exceed the conventional banks. However, despite all these positive indicators, profitability advantage enjoyed by Islamic banks compared with its conventional counterparts began to fade (Akhtar , Ali and Sadaqat, 2011; Gul, Irshad and Zaman, 2011).

According to Akhtar , Ali and Sadaqat (2011), most of Islamic banks faced losses in recent years. Gul, Irshad and Zaman, (2011) find that Islamic banks profitability has been affected which makes access to profits slightly difficult and exposure to crisis risks increased. In the GCC context, recent reports issued by Standard & Poor as well as the Secretariat of Islamic finance stress that profitability advantage enjoyed by Islamic banks began to erode. Therefore, the determinants of Islamic banks profitability have attracted the interest of academic researchers, bank management, and investors. These issues have attracted the interest of this study to examine factors that influence Islamic banks profitability.

Although there have been a significant number of studies conducted on the efficiency of Islamic banking globally, there is still relatively scant quantitative examination of Islamic bank's profitability in general and that of Islamic banks in the GCC in particular. Thus, this present study attempts to examine the profitability determinants of Islamic banks in GCC region. It focuses on the influence of internal factors that are bank-specific factors namely bank size, management efficiency, loan, asset management and capital as well as external factors macroeconomic variables namely inflation and gross domestic product on the variation of the profitability across Islamic banks in GCC.

1.3 Research Questions

1) What are the internal factors that affect Islamic banks' profitability of GCC countries?
2) What are the external factors that influence Islamic banks' profitability of GCC countries?

1.4 Research Objectives

1) To examine the internal factors that affect Islamic banks' profitability of GCC countries.

2 To investigate the external factors that influence Islamic banks' profitability of GCC countries.

1.5 Significance of the Study

This study provides several benefits to Islamic banking practitioners such as banks managers, investors, shareholders, government, and the academics. The study the study contributes to Islamic banks of GCC region by identifying the internal and external factors that influence Islamic bank's profitability through a rigorous examination. This study is helpful in providing important information to practitioners such as bank management, regulators, and researcher to construct a sound management policy that would enhance Islamic banks to attempt higher profit.

Bashir (2003), Naceur (2003) and Gul, *et al.* (2011) have conducted studies to investigate the profitability determinants of conventional banks. Some limited research such as

Haron (2004) and Zeitun (2012) investigate the factors that influence Islamic bank's profitability of GCC countries.

Hence, this study provides an identification of significant factors that affect Islamic banks profitability in the GCC counties and recommendations for bank managers. The study also identifies these factors to develop appropriate solutions and promote factors that would maintain profitability and improve performance in order to achieve success in Islamic banks of GCC countries.

This study contributes to the knowledge and practice by investigating those factors that influence Islamic bank's profitability. This study participates in a vital role in enhancing the profitability of Islamic banks that helps boost Islamic economy. It also encourages Islamic countries to change their banking system from conventional banking to Islamic banking as and this this is a step ahead towards an interest-free society.

1.6 Scope of the Study

This study is conducted on Islamic banks in the GCC countries. It examines the impact of internal and external factors in influencing the GCC countries Islamic banks profitability from 2006 to 2012. This study uses secondary data such as financial statements of those Islamic banks included as the sample.

1.7 Organization of the Study

This study is divided into five chapters. Chapter one discusses the background of the study and provides an overview of the GCC countries as well as stating the problem statement and the research objectives and questions. Chapter two reviews the relevant literature on bank profitability in GCC countries and other empirical studies in other countries. Chapter three describes the research methodology, while chapter four discusses the results. Chapter five provides the summary, limitation and the contributions of the study.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This presents a review of previous studies related to the determinants of bank's profitability. The literature focuses on bank-specific characteristics and macroeconomic indicators that affect a bank's profitability in the world and particularly in Islamic banks in GCC countries.

In recent years, Islamic banks have played important role in the banking industry. Investors and financial analysts have recognized that Islamic banks are safer than interest based banks. Furthermore, Islamic banks contributed more profit to investors. Many studies have been conducted to identify the factors that influence the profit of the conventional and Islamic banks (Abdullah, 2009).

Most of previous researchers measured banks profitability by using return on equity (ROE), return on assets (ROA) and net none-interest margin (NIM). The explanatory variables that represent the bank-specific characteristics and macroeconomic trends that have impact on bank's profitability were different from one study to another.

2.1 Theories of Bank Profitability

The study selected two theories related to banks profitability. The theories determined how the degree of concentration that affects bank's profitability. The first theory is structure conduct performance (SCP) suggests that greater marker power provides more concentrated sector and safer bank's profitability. The higher degree of concentration increased market shares. The second theory related to bank's profitability is efficiency theory which suggests that there is a direct relationship between profitability and concentration as an indirect consequence of efficiency. According to the efficiency theory the better managed banks are more efficient and profitable. Berger and Humphrey (1997) found that the cost efficiency theory played an important role than the market power theory in determining bank's profitability.

2.2 Bank Profitability

Hassan and Bashir (2003) examined bank specific factors that affect the performance of Islamic banks. They examined the internal variables and external variables to determine profitability of Islamic bank's worldwide during the period of 1994 to 2001. The result revealed that bank with higher capital and loan to asset seems to have more profitability. The study also found that external factors such as inflation and GDP had positive significant associated with bank profitability.

Bashir (2003) also identified the factors of profitability in 14 Islamic banks in the Middle East countries by focusing on eight banks from the Middle Eastern countries for the

period from 1993 and 1998. He found that banks which had loan to asset and capital to asset ratios had higher the bank profitability.

Haron (2004) investigated the internal factors and external factors that influenced banks profitability. The study revealed that external factors such as market share, interest rates and money supply had a significant and positive relationship with bank profitability.

Athanasoglou, Brissimis and Delis (2005) examined the effect of bank-specific characteristic, industry-specific, and macroeconomic indicators on bank's profitability in Greece. The authors used panel data the period a year of 1985 to 2001. They found that capital variable had highly significant effect and reflected the good financial condition of Greece banks. The study also indicated that size of a bank was not significant on bank profitability.

Kosmidou, Tanna, and Pasiouras (2005) identified the relationship between industry-specific, macroeconomic, bank-specific characteristics, and the profitability of commercial bank in UK for the period from 1995 to 2002. The authors found that the more capital of these banks seemed to have a significant and positive impact on bank's profitability. The study also found that management efficiency was positively related and has contact on profitability. The study indicated that bank size had a significant and positive relationship with bank profitability. Finally, the study found that macroeconomics factors such inflation and GDP had significant and positive relationships with profitability.

Vong and Chan (2009) investigated the influence of bank-specific characteristics and macroeconomic indicators on the profitability of Macao banks. The study showed that capital has positive relationship and significant impact with profitability and more capital lead to more profitability. The study found that a good capitalized - bank apparently lead to lower risk and an increased profitability. Furthermore, the study showed a significant and positive relationship with banks profitability.

Ghazali (2008) studied the impact of bank-specific characteristic and macroeconomic factors on Islamic banks profitability. The study used a sample of sixty Islamic banks around the world during the period from 2002 to 2007. The study applied three regression models which represented profitability measures of ROA, ROE and NIM. The result of the study indicated that the main factors that affected bank profitability were capital strength and efficiency factor. The study also showed a positive and significant relationship between Islamic bank's profitability and macroeconomic trends such as inflation and GDP. The author concluded that the Islamic banks determinants of profitability was similar to interest based – banks. This provides strong evidence that many of the techniques and tools used in interest based - banks can be used for Islamic banks.

Aburime (2008) examined external factors effects of banks profitability in Nigeria for the period of 1980-2006. The findings of the study indicated that inflation, real interest rate, monetary policy and exchange rates had positive and significant relationships and with bank profitability in Nigeria.

Sufain and Chong (2008) examined the determinants of Philippines banks during profitability the period from 1990 to 2005. The result of the study found that bank size had a significant but negative impact on bank's profitability. The study revealed that inflation also had a negative influence on bank's profitability.

Al-Ademi (2009) investigated the profitability factors of Malaysian commercial banks after the 1997 financial crisis during the period from 2004 to 2008 and found that loan and inflation had a significant and positive relationships with bank profitability.

Vlastarakos (2009) identified the significance of bank-specific, industry-related and macroeconomic indicators on bank profitability .The study used panel data for eight countries of South East Europe (SEE) during the period of 2001-2007. The result of the study indicated that capital strength and liquidity significantly determined banks profitability in the selected countries of SEE. The study found GDP also had positive and significant with bank profitability, indicating that the increase in GDP reflect improvement in bank profitability. Bank size did not provide any effect on bank profitability.

Kosmidou (2008) investigated the determinants of bank's profit of Greece banks during the European Union (EU) financial integration of 1990 to 2002. The study revealed that a well-capitalized bank had a significant and positive relationship with profitability. Bank size had positive and significant impact only when macroeconomic variables entered the models. Finally, the study found that GDP was positively and statistically significant with bank profitability while inflation negatively impacted on bank profitability.

Sayilgan and Yildirim (2009) analyzed the determinants the profitability of banks in Turkey for the period 2002-2007. The study indicated that capital had a significant and positive relationship with bank profitability. The study also found that inflation had a significant and positive relationship with bank profitability. Bank size had negative effect on bank profitability and was statistically significant.

Wasiuzzaman and Tamizi (2010) investigated the influence of bank-specific characteristics and macroeconomic variables on of Islamic bank's profitability in Malaysia. Using ordinal least squares (OSL) method, the study found that capital and asset quality had inverse influence with Islamic bank profitability. The study also indicated that liquidity and operational efficiency have positive influence on bank's profitability. Finally, the study revealed that macroeconomic such as inflation and GDP have positive and significant relationship on Islamic bank's profitability.

Karim, Sami and Hichem (2010) studied the elements that affected the profitability of Islamic banks in Africa during the period of 1999 to 2009 using panel data. Result of the study indicated that bank characteristics, financial structure and macroeconomic trend variables influenced Islamic bank's profitability. Bank size and capital affected Islamic bank's profitability positively. The study indicated that macroeconomic factors such as inflation and GDP had a significant and positive relationship on Islamic bank's profitability. Finally, the study suggested that the higher bank development leads to lower bank's profitability.

Akhtar, Ali and Sadaqat (2011) examined the impact of bank-specific factors that affect the profitability of Islamic banks of Pakistan for the period 2006 to 2009. The study used ROA and ROE regression models. The study indicated that capital had a positive and significant relationship at the 5% level. The study also found that asset management had a positive and significant relationship with ROA model but insignificant with ROE, while a significant and positive relationship was seen in both models. The study indicated that bank size had a negative and insignificant relation in both models and that indicated that Islamic banks faced losses during the period of study. Capital adequacy was found to have a significant relationship in the both models.

Gul *et al.* (2011) investigated the impact of bank specific and macroeconomic trends for commercial bank's profitability of Pakistan during the period from 2005 to 2009. The study revealed that bank's size and loan had a significant and positive relationship with bank profitability. Inflation and GDP were found to have a significant and positive relationship with bank's profitability.

Another research conducted by Akhtar *et al*. (2011) evaluated the elements that affecting the profitability of commercial banks in Pakistan for the period from 2006 to 2009 by using bank level data. The study used ROA and ROE regression models. The result found that asset management has significant and positive effects on commercial bank's profitability in both models. The study also indicated that Bank's size have a positive and significant relationship with ROA model. However, an insignificant relationship is seen with ROE model.

Husni, Khrawish, and Siam (2011) investigated the factors that affect Islamic bank's profitability in Jordan during the period from 2005 to 2009. The study revealed that total equity to total asset had significant and positive relationship with Islamic bank's profitability. Furthermore, the study found that bank size had a negative and statistically significant relationship with bank's profitability. Finally, the macroeconomic variables such as inflation and GDP factors had a negative and statistically significant on bank's profitability.

Javaid, Anwar, Zaman, and Gafoor (2011) identified the factors that influence the performance of banks in Pakistan for the period of 2004 to 2008. The study showed that higher loan contribute towards bank's profitability but the impact was not significant and the study found that higher assets might not necessarily lead to higher profitability.

Ali, Akhtar and Ahmed (2011) studied the profitability factors of commercial and public banks of Pakistan during the period from 2006 to 2009. The study found that there was a positive relationship of efficient management and economic growth on profitability. The study showed that operating efficiency had a significant and positive relationship with bank's profitability. The results of study also indicated that capital and asset management were significantly and positively related to the bank's profitability. Banks size had a negative and significant relationship on bank's profitability. Regarding the macroeconomic factors, only GDP had a significant also positive relationship with banks profitability.

Nor Hayati and Akbar Noor (2011) investigated the determinants of banks profitability of 78 Islamic banks in 25 countries during the period of 1992-2009. They found that capital and asset management had a significant with positive relationship to the bank's profitability. The study also found that the 1998 Asian financial crisis and 2008 global financial crisis had a negative effect on Islamic bank's profitability.

Idris, Asari and Taufik(2011) examined the factors that influence the profitability of Islamic banks in Malaysia. The study used panel data for nine Islamic banks, which consisted of local and foreign banks during the period from 2007 to 2009. The results revealed that only size of a bank has a significant and positive relationship with banks profitability.

Olweny and Shipho (2011) examined the impact of bank-specific factors on commercial banks profitability of Kenya during the period of 2002 to 2008. The study used multiple linear regressions method. The study found that capital adequacy, asset quality liquidity, and operational cost efficiency had a statistically significant impact on bank's profitability in Kenya.

Ayadi and Boujelbene (2012) identified the factors that affect the bank's profitability of Tunisian deposit banks, during the period of 1995 to 2005. The study discovered that the bank size and capital had a significant and positive relationship with bank's profitability. The study revealed that macroeconomic variables had no significant impact on bank's profitability.

Syafri (2012) analyzed the factors that affected the profit of commercial banks in Indonesia. Using pooled data from commercial banks listed on the Indonesia Stock Exchange (ISE) between 2002 and 2011, bank profitability was measured by ROA. The study showed that loan and capital have a positive effect on profitability. The study also indicated that inflation rate, and bank's size had a negative effect on profitability. Economic growth and non-interest income to total assets have no effect on bank profitability.

Schiniotakis (2012) investigated the factors that influenced the profitability of Greece commercial and cooperative banks for the period of 2007 to 2009. The study used multiple regression analysis for determining which factor influences the profitability of Greece banking sector. The study found that well-capitalized banks influenced bank's profitability. The study also found that cost efficiency had a significant and positive relationship with bank's profitability.

Tan and Floros (2012) examined the determinants of banks performance in China and evaluated the effects of inflation to bank profitability. The study used a sample comprising a total of 101 banks for the period of 2003 to 2009. The result exhibited a significant and positive influence between inflation and bank's profitability. The study also found a positive relationship between cost efficiency and bank's profitability.

Alper and Anbar (2011) examined bank – specific characteristics and macroeconomic indicators of the profitability of banks in Turkey during the period of 2002 to 2010 .The study used ROA and ROE as measurement of bank's profitability. The study indicated

that bank size had a significant and positive relationship impact with the bank's profitability. However, loan had a negative relationship on bank's profitability.

Abera (2012) examined the bank-specific characteristics and macroeconomic trends that affect bank's profitability in Ethiopia. The stud sample was the commercial banks and the period was from 2000 to 2011. The findings of the study showed that capital strength, income diversification, bank size and gross domestic product had statistically significant and positive relationship with banks' profitability. On the other hand, variables like operational efficiency and asset quality had an inverse and significant relationship with profitability measurements. However, the relationship for liquidity risk, concentration and inflation were found to be statistically insignificant.

2.3 Bank Profitability in GCC Countries

Zeitun (2012) investigated foreign ownership, banks characteristics, and macroeconomic variables on Islamic and conventional banks in GCC countries for the period 2002-2009. The study used two samples in this study; the first sample contained 38 conventional banks and the second sample contained 13 Islamic banks. The study found that bank's equity was important in explaining and increasing conventional bank's profitability only. The cost-to-income had an inverse and significant influence on Islamic and conventional bank's performance. Additionally, the study showed that size had a significant influence on Islamic banking using the ROE, while it was not significant for conventional banks.

Al-Omar and Al-Mutairi (2008) studied the determinants of Kuwait banks profitability for the period from 1993-2005. The result indicated that capital, loan, asset management

and bank size had significant and positive relationships with bank's profitability. Consequently, the results stressed the need for improving capital adequacy in order to improve bank's profitability. The study indicated that increasing bank size lead to higher profit.

Smaoui and Salah (2011) examined the determinants of Islamic banks profitability of GCC region. The study used panel data of 44 Islamic banks for the period from 1995 to 2009. The result of the study indicated that capital, asset quality, and larger size had significant and positive relationships with bank's profitability and led to higher profitability. Finally, the study found that inflation and GDP had a positive impact and significant relationship with bank's profitability.

Elsiefy (2013) investigated the determinants of conventional and Islamic bank's profitability in Qatar during the duration from 2006 to 2011. The study used ordinary least squares (OLS) regression .The study used three profitability indicators: ROA, ROE and NIM. The study showed that capital strength and cost efficiency had a negative influence on conventional bank's profitability. In addition, the study found that liquidity was negatively and statistically significant on Islamic bank's profitability. Finally, macroeconomic was found insignificant for both Islamic and conventional banks.

The present study attempts to investigate the factors that affect the Islamic bank's profitability in GCC countries. Internal and external factors were regressed with bank's profitability. The study used ROA, ROE and NIM as measures of profitability. These are common ratios used to measure financial performance (Naceur 2003).

2.4 Hypotheses Development

Akhtar *et al*. (2011) found that the size has a negative and insignificant relationship with ROA and ROE. (Gul *et al* 2011; Abera, 2012) found that size of a bank has a positive and significant effect on bank's profitability.

H1: *There is a significant and positive relationship between size and profitability.*

Ali, *et al.* (2011) found that management efficiency has a positive and significant influence on bank's profitability.

H2: *There is a significant and positive relationship between management efficiency and profitability.*

Gel *et al* (2011) found that loan had a significant and positive relationship with bank profitability.

H3: *There is a significant and positive relationship between loan and profitability*

Akhtar *et al* (2011) found that there is a positive and significant association between asset management with both ROA and ROE.

H4: *There is a significant and positive relationship between asset management and profitability.*

Al-Omar and Al-Mutairi (2008) indicated that capital which was measured by equity over total asset had a significant and positive relationship with bank profitability.

H5: *There is a significant and positive relationship between capital and profitability.*

Athanasoglou *et al*. (2008) found that GDP has a significant and positive relationship with bank profitability. Furthermore, Hassan & Bashir (2003), Kosmidou *et a*l. (2005), and Smaoui & Salah (2011) found a positive and significant relationship between GDP and bank's profitability.

H6: *There is a significant and positive relationship between GDP and profitability.*

Vong and Chan (2006) and Abera (2012) found that inflation has a significant and positive impact on profitability.

H7: *There is a significant and positive relationship between inflation and profitability.*

2.5 Conclusion

The review of the literature reveals that there is still a lack of studies on the factors affecting banks profitability, particularly in GCC region. Most of the empirical studies in the literature have focused on European Union and some on emerging markets in Asia and the Middle East. Moreover, the literature review also reveals the existence of controversial conclusions from the different studies. Furthermore, very scanty work has been done on identifying the factors affecting the Islamic bank's profitability in GCC countries.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

This section introduces the research methodology for this study by chapter addressing important variables that are used in the regression models. The study used linear regression method by using SPSS 19 version econometric software package to find out the relationship between banks specific characteristics namely bank size, management efficiency, asset management, loan, and capital and bank profitability. The study also investigates two external variables which are gross domestic product and inflation to identify their impact on Islamic banks' profitability in GCC countries for the period from 2006-2012. The adopted methodology examines the sensitivity of internal bank characteristics and external variables that affect the Islamic bank's profitability.

3.1 Sample and Data Collection

3.1.1 Sampling

The study population is all the Islamic banks in the GCC countries namely Kingdom of Saudi Arabia, United Arab Emirates, Bahrain, Qatar, and Kuwait. The study does not include Sultanate of Oman because there are no Islamic banks operating in this country during the period of study. Conventional banks that have Islamic windows which provide products and services according to Islamic principles are also excluded. This study only focuses on Islamic banks in GCC countries.

There are 80 free-interest banks in the region according to the reports. The sample of this study includes 25 because these banks' data are available in their annual reports which can be downloaded from their websites and other data were obtained from data steam of Universiti Utara Malaysia.

The study used panel data because panel data have many benefits since it controls for heterogeneity that is found in individuals, firms, states or countries. Time series and cross-section studies do not control for heterogeneity. In addition, panel data gives more variability, is more informative, and shows less co-linearity among the variables (Baltagi, 2008).

Table 3.1: List of Islamic Banks by Country (2006 -2012) (25 Banks)

Country	Names of Islamic Banks
Kingdom of Saudi Arabia	1. Al Rajhi Bank 2 .Bank Albilad 3. Bank Al-Jazira 4. Alinma Bank 5. Samba Financial
Qatar	1. Boubyan Bank 2. Kuwait Finance House 3. Kuwait International Bank
Kuwait	1. Boubyan Bank 2. Kuwait Finance House 3. Kuwait International Bank
United of Arab Emirates	1. Dubai Islamic Bank 2. Abu Dhabi Islamic 3. Sharjah Islamic 4. Emirates Islamic Bank 5. Dubai Bank
Bahrain	1. Ahli United Bank 2. Albaraka Banking 3. Al Salam Bank 4. Arab Banking Corp 5. Bahrain Islamic Bank 6. Gulf Finance House 7. Ithmaar Bank 8. Khaleeji Commercial 9. National Bank

3.1.2 Data Collection

Data were collected from 25 Islamic banks for the period from 2006 to 2012. The sample was selected 25 Islamic banks in GCC countries. Annual reports of the banks and the data obtained from the financial statement such as the balance sheets where included in the sample. Additionally, data were also obtained from the data stream of Sultanah Bahiyah Library of the Universiti Utara Malaysia (UUM). Macroeconomic data was taken from economic reports (issued annually) of the GCC countries which are issued annually. The annual reports were downloaded from the websites of the Islamic banks.

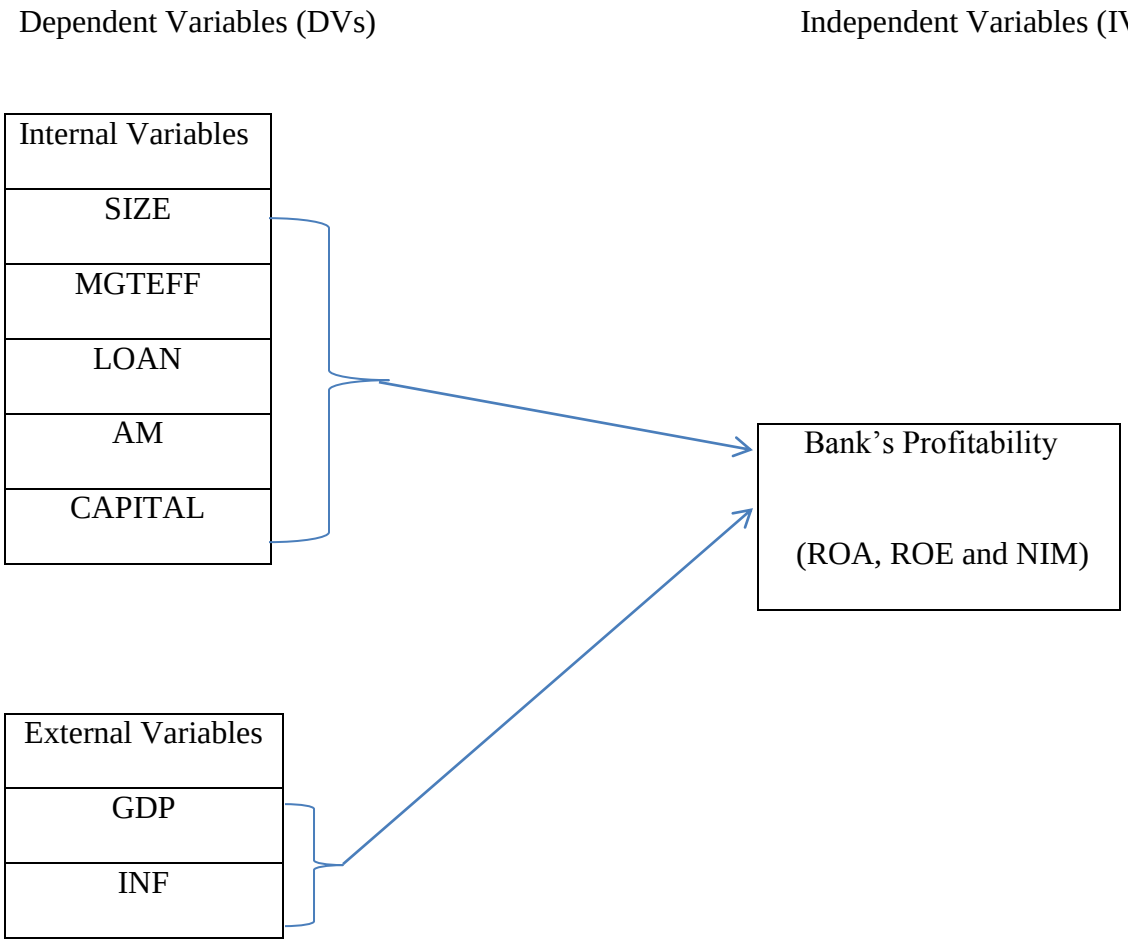

Figure 1.0 **Conceptual Framework**

3.2 Definitions of Variables

This section presents and explains the variables which are included in the study. The dependent variables consist of return on assets (ROA), return on equity (ROE) and non-net interest margin (NIM). The independent variables included bank size, management efficiency, asset management, loan, capital, gross domestic product and inflation.

3.2.1 Dependent Variables

3.2.1.1 Return on Assets (ROA)

Return on assets is calculated as net income divided by total assets. It is one of the most important financial ratios that is used to measure the profitability of a bank. ROA is used to assess the profitability of net income after tax and total assets. It represents the bank's ability to generate profit and it indicates bank's management efficiency that is how efficiently the bank's top management converts bank's assets to be profitable. Shareholders seek achieve a high profit and the profitability of a bank is most important for them (Tarawneh, 2006)

In the literature, there are many indicators of profitability such as ROA, ROE and NIM. ROA and ROE are largely used ratios to measure banks profitability and performance (Berger, 1995; Naceur 2003, Gul, *et al.* 2011). In this study, profitability is measured by ROA, ROE and NIM which represent the dependent variables. Bashir-Hassan (2004) included ROA and ROE in their studies as measures indicator for banks profitability.

3.2.1.2 Return on Equity (ROE)

Return on equity (ROE) can be calculated as net profit divided by total equity. ROE reveals the capability of a bank management to create a profit from total equity of the bank. The higher ROE indicated that a bank has good performance and profitability and vice versa (Tarawneh, 2006). ROE is one of the best bank's profitability measurements and it used by many researchers such as Gul *et al.* (2011) used ROE to examine the relationship between bank characteristics variables and macroeconomic trends and bank's profitability of Pakistani banks. Akhtar *et al*. (2011) identified the impact of bank specific indicators on profitability of Islamic banks in Pakistan by using ROA and ROE to measure banks profitability.

3.2.1.3 Net Non-Interest Margin (NIM)

The NIM is defined as the net income accruing to the bank from non-interest activities (including fees, service charges, foreign exchange, and direct investment) divided by total assets (Hassan and Bashir, 2003). These new income items include, among others, ATM fees, credit-card fees, and fees from the sale of mutual funds. Non-interest revenue constitutes the lion's share of Islamic bank's operating income. The higher the NIM, the higher the profit margin the bank is commanding. However, Net Income Margin (NIM) for Islamic banks is profits from interest-free lending contracts and Islamic banks profit depends on the return of the projects. Smaoui and Salah (2011) used net non-interest margin (NIM) as a measurement of the profitability of Islamic banks in GCC countries.

Table 3.2 Variable Definitions, Proxies and Expected Signs.

Variables	Description	Notation	Expected Sign
Dependent Variables		ROA	
Return on Asset	Net income/Total assets	ROE	
Return on Equity	Net Profit/Total Equity		
Net Non- Interest Margin	Net income from non - interest activities/ Total Assets	NIM	
Independent Variables			
A. Internal Variables			
Bank Size	Natural Log of Total Assets	LNTA	(+)(-)
Efficiency Management	Earning Management/Total Asset	Loan	(+)
Loan	Total Loan /Total Asset	AM	(+)
Asset Management	Operating Expenses/Total Asset	MGT	(+)
Capital	Total Equity/ Total asset	Capital	(+)
B. External Variables			
Gross Domestic Product	Annual GDP Growth	GDP	(+)
Inflation	Consumer Price Index	INF	(+)

3.2.2 Independent Variables

The explanatory variables used for this study were divided into external and internal variables. The external variables were inflation and gross domestic product (GDP). The internal variables were bank size, management efficiency, loan, asset management, and capital.

3.2.2.1 External Variables

As mentioned above, the external variables used in this study the macroeconomic factors which are normally found in the annual macrocosmic reports. Inflation is based on the Consumer Price Index (CPI) and inflation rate of change of CPI. GDP is a measure of all the goods and services produced domestically. Therefore, to calculate the GDP, one only needs to add together the various components of the economy that are a measure of all the goods and services produced.

3.2.2.2 Internal Variables

i) Bank Size

Size of a bank is measured by natural log of total assets. It reflects the bank's valuables including tangible assets such as properties and equipments as well as intangible assets for example, goodwill. The bigger the size of a bank indicates higher total assets.

ii) Management Efficiency

Management efficiency plays an important role in achieving bank's profitability. A bank with high management efficiency seems to be more profitable. Management efficiency can be calculated by dividing earnings management over total assets.

iii) Loan

Loan is represented by total loan divided by total assets. It is used as the liquidity of bank being higher the total loan over total assets the less liquid bank. Conventional bank operations depend heavily on loans. However, Islamic banks depend on the profit and loss sharing (PLS) which is interest-free lending. Prior studies on conventional banks found that there was a positive relationship between total loan over total assets and bank profitability (Demirguc-Kunt and Huizinga, 2000). In this study, total loan over total assets is included as independent variable to compare performance of interest-free lending of Islamic banks in GCC countries. This variable is expected to have a positive relation with profitability.

iv) Asset Management

Asset management plays an important role in determining the operational performance and profitability of a bank that have assets as part of its core business. It is the management of assets of a bank and it can be calculated as operating income divided by total assets. Many researchers such as Akhtar *et al.* (2011) have used asset management as independent variable in their studies to examine the factors that affect bank's profitability.

v) Capital

Capital represents the ratio of equity capital divided by total assets. The higher capital leads to higher profitability meaning that the banks which have more capital are expected to have more profitability (Berger, 1997).

3.4 Model of the Study

To identify the internal and external factors that affecting the profitability of Islamic banks in GCC countries. The study has adapted the profitability models:

$$Y_{1it} = \beta 0 + \beta\text{-}X1_{it} + \beta\text{-}X2_{it} + \beta\text{-}3X3_{it} + \beta\text{-}X4_{it} + \beta\text{-}X5_{it} + \beta\text{-}X6_{it} + \beta\text{-}X7_{it} + U_{it}$$

Where

Y1 = Profitability measures (ROA, ROE and NIM)

β0 = Constant coefficient

X1 = Bank's Size (LNTA).Natural Log of Total Assets for bank (i) in year (t)

X2 = Efficiency Management (MGTEFF)

X3 = Loan

X4 = Asset Management

X5 = Capital

X 6 = Gross Domestic Product for the country (i) in year (t)

X 7 = Inflation rate for the country (i) in year (t)

Uit = Error term

CHAPTER FOUR

RESULTS AND DISCUSSION

4.0 Introduction

The purpose of this section is to present the findings of the study by identifying which variables that have an impact on Islamic bank's profitability in the GCC. Linear regression method was been applied in this study using SPSS version 19 to identify how bank characteristics such as bank size, management efficiency, loan, asset management, and capital affect Islamic bank's profitability. Furthermore, the study investigated how external variables such as GDP and inflation influence the Islamic bank's profitability in GCC countries.

In this chapter the answers for the questions and objectives of this research are provided. This chapter comprises of 4 sections. The first section introduces the descriptive statistics of the data. The second section presents the correlation analysis between dependent variables and independent variables. The third section discusses the results of regression analysis for the three dependent variables ROA, ROE and NIM separately. This chapter ends with a brief conclusion.

4.1 **Descriptive Statistics**

Table 4.1 presents the outcomes for the descriptive statistics for all dependent and independent variables which included in the regression model. The table shows the outputs on the minimum, maximum, mean and standard deviation.

Table 4.1 Summary of Descriptive Statistics

Variables	**25 banks (7 years)**	**Minimum**	**Maximum**	**Mean**	**Std. Deviation**
ROA (%)	175	-27.600	18.140	2.154	4.222
ROE (%)	175	-127.150	57.520	9.543	21.953
NIM (%)	175	-7.620	30.430	3.393	2.834
LNTA (%)	175	18.325	24.621	22.125	1.4294
MGTEFF (%)	175	.147	.951	.7618	.207
LOAN (%)	175	.003	.9123	.616	.209
AM (%)	175	-.442	.141	.012	.055
CAPITAL (%)	175	5.700	90.170	17.274	10.651
GDP (%)	175	-4.400	26.800	6.140	4.963
INF (%)	175	-4.900	15.100	4.645	3.231

Source: Financial Statements of Islamic banks of GCC countries (2006-2012)

Table 4.1, shows the 175 observations for all variables and profitability measures applied in this study namely ROA, ROE and NIM which are indicated the dependent variables in the study. For the total sample, the mean of ROA was 2.154 percent with a minimum of -27.600 percent and a maximum of 18.140 percent. This means, that most profitable bank among the sampled banks earned 18 percent of profit and that indicate a high rate of profit. On the other hand, the least profitable bank of the sampled banks earned -27 percent of profit before tax. The standard deviation statistics for ROA was 4.222 percent which indicated a low profitability variation between the sampled banks.

ROE shows a mean of 9.543 percent with a minimum of -127.150 percent and a maximum of 57.520 percent and the standard deviation was 21.953 percent which is the highest standard deviation among all dependent variables and that revealed variation of the profitability between the selected banks is very high.

The mean for NIM is 3.393 percent with a minimum of -7.620 percent and a maximum of 30.430 percent and the standard deviation is 2.834 percent and that indicated the profitability variation between the selected banks is slightly low.

The study applied seven independent variables which included the internal and external variables. The mean of bank size measured by natural log of total asset was 22.125 percent with a minimum of 18.325 percent and maximum of 24.621 percent. The standard deviation of 1.429 percent which is slightly low and that revealed the profitability variation between selected banks was slightly low.

Management efficiency has a mean of .761 percent while minimum and maximum .147 and 22.281 percent respectively with deviation of 1.324 percent. In addition, the mean for loan was .616 percent while the maximum and minimum are .9123 and .003 percent respectively and it has a standard deviation of .209 percent.

Asset management mean is .012 percent while minimum and maximum -.442 and .141 percent respectively .The standard deviation of asset management was .055 percent which is slightly low and that revealed the profitability variation between selected banks was slightly low. Table 4.1 showed capital with mean of 17.274 percent with a minimum of -127.150 percent and a maximum of 57.520 percent and the standard deviation was 10.651 percent which is the highest standard deviation among all independent variables and that revealed the profitability variation between the capital selected banks is very high.

Table 4.1 also shows the external variables which are gross domestic product (GDP) and inflation (INF). The mean of GDP is 6.140 percent with a minimum of -4.400 percent and a maximum of 26.800 percent and it has a standard deviation of 4.963 percent.

The other macroeconomic variable employed in this study is INF and it has a mean of 4.645 percent with a minimum of -4.900 percent and a maximum 15.100 percent and it has somewhat a lower standard deviation 3.231 percent compared to GDP this implies that inflation rate in GCC countries during the study period of study remains somewhat stable.

4.2 Correlation Analysis between Variables

Appendix A shows the correlation between all dependent and independent variables. Referring to the correlation matrix in appendix A, ROA has significant relationships with NIM, AM, and INF, with 1% significant level.

Next ROE has significant and positive relationship with management efficiency and GDP. This all statistically significant was at the 1% level. ROE also has a significant and positive relationship with loan, asset management and inflation. The statistically significance was at the level 5%. This result is consistent with previous findings by Kosmidou (2008) who found that GDP had a significant and positive association on ROE.

There is a significant and positive relationship between NIM and inflation which is statistically significant at the level 5%. This suggests that profitability increases with high inflation. In addition, NIM has a positive association with GDP with significance level of 5%.

Next LNTA which is the proxy of bank size has a significant relationship only with MGT which statistically significance at the level of 1 %. MGT also has a significant and positive relationship with LNTA, GDP and ROE by significant at the 1% level.

Referring to Appendix A can be seen that loan which is calculated as total loan divided by total assets has a significant and positive relationship with ROE. This positive correlation between loan and ROE suggested that profitability increase with higher loans.

This result is similar with the previous findings by Ghazali (2008) which suggested the bank with high loans lead to high profitability.

Capital is found to have no significant correlation with all variables. GDP has positive ROE, MGT and INF with 1 % level of significant. In addition, GDP has a positive correlation with NIM with significant level of 5%. Finally, inflation has positive correlations with ROA, NIM, and GDP with significant at the 1% level, and positively and significantly at 5% level with ROE.

4.3 **Regressions Results**

4.3.1 Return on Assets (ROA)

Table 4.2:

The Estimated Model Summary for ROA

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.502[a]	.252	.221	3.7277559

a. Predictors: (Constant), INF, LNTA, LOAN, CAPITAL, AM, GDP, MGT

According to Table 4.2 the R-squared was 25.2% and the adjusted-R squared was 22%. The result indicates that the total assets, loan, management efficiency, asset management, capital, inflation, and GDP collectively explain 22.1% of the changes in the dependent variable. Asset management, capital and inflation collectively explain 22.1% of the changes in ROA. Since the R-square statistics is slightly low, it means there are other

bank characteristics and macroeconomic factors 77.8% of changes that could have impacted Islamic bank's profitability in GCC countries.

4.3.2: **Regression Results for ROA**

Table 4.5:

Coefficient Analysis of Return on Equity (ROE)

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	7.280	4.938		1.474	.142
	LNTA	-.415	.248	-.140	-1.674	.096***
	MGT	.793	1.745	.039	.454	.650
	LOAN	.915	1.363	.045	.672	.503
	AM	27.081	5.142	.356	5.267	.000*
	CAPITAL	.057	.027	.143	2.103	.037**
	GDP	.003	.064	.004	.055	.957
	INF	.342	.092	.262	3.703	.000*

a. Dependent Variable: ROA
b. *, **, *** denoted 1%, 5%, and 10% level of significance respectively.

Table 4.3 the study reveals that bank size has a significant impact on bank's profitability with negative relationship indicating that Islamic banks profitability in GCC countries began to decline. This finding is consistent to the previous study by Akhtar *et al.* (2011) who proved that bank size has a negative impact on profitability. The study suggested that high total asset did not lead to high profitability and that the smaller asset could achieve a higher profit. This result is contrary with the suggested hypothesis 1 which stated there is significant positive association between size and profitability. Therefore, H_1 is failed to be accepted.

The result also indicated that there is a high significant and positive association between asset management and ROA with 1% level of significant. This result is constant with previous study done by Akhtar *et al*. (2011) who found that asset management has a significant and positive influence on bank's profitability when it regressed against ROA and ROE. This findings support hypothesis 4 which stated that there is a significant positive relationship between inflation and profitability.

In addition the study indicated that inflation has impact influence on Islamic bank's profitability since there is a positive and statistically significant association with ROA with significant level of 1%. The study suggested that high inflation lead to high profitability. This finding is similar with the prior studies such as Haron (2004) who found that inflation had a positive relationship with all profitability measures but their relationships were not significant. Hasan and Bashir (2003) indicated that inflation is only significant with ROA. Their result is similar to the current study which revealed that inflation has positive and statistically significant only on ROA. This result supports hypothesis 7 which stated that there is a significant positive relationship between inflation and profitability.

Furthermore, the study revealed that bank's profitability is influenced by the capital positively. This finding is similar to the previous study by Kosmidou *et al.* (2005) as they indicated that well - capitalized Islamic banks have a lower need for external funds and therefore higher the profitability of the bank. This finding supports hypothesis 5

which stated that there is significant positive relationship between capital and profitability.

4.3.3 Return on Equity (ROE)

Table 4.4:

The Estimated Model Summary for ROE

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.438[a]	.191	.158	20.1492857

a. Predictors: (Constant), INF, LNTA, LOAN, CAPITAL, AM, GDP, MGT

Table 4.4 shows that the R-squared statistics is 19.1% and the adjusted-R squared statistics is 15.8%. The result indicates that the variations in the independent variables explain 15.8% of the changes in the dependent variable. Since the R-squares are slightly low it means there are other bank characteristics and macroeconomic indicators that influence Islamic bank's profitability in GCC countries. The remaining 84.2% of changes is described by other variables which are not encompassed in this model.

4.3.4: **Regression Results for ROE**

Table 4.5
Coefficient Analysis of Return on Equity (ROE)

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	16.711	26.691		.626	.532
	LNTA	-1.982	1.340	-.129	-1.479	.141
	MGT	26.946	9.432	.254	2.857	.005*
	LOAN	19.466	7.365	.186	2.643	.009*
	AM	56.053	27.793	.142	2.017	.045**
	CAPITAL	.253	.146	.123	1.733	.085***
	GDP	1.011	.344	.228	2.939	.004*
	INF	.352	.500	.052	.704	.483

a. Dependent Variable: ROE
b. *, **, *** denoted 1%, 5%, and 10% level of significance respectively.

As indicated by table, the study indicated that bank size has a negative impact of bank's profitability but is insignificant. This finding is evidenced by previous studies such as by Akhtar *et al.* (2011) who found that bank size has a negative and insignificant relationship with ROA and ROE. The study suggested high total asset does not lead to high profitability and the smaller asset could achieve a higher profit.

The study also shows a significant and positive relationship between management efficiency and ROE. This is something new related to bank's profitability and this finding can contribute to the literature by examining a new variable that influences the Islamic bank's profitability in GCC countries. This finding supports hypothesis 2 which stated

that there is a significant positive relationship between management efficiency and profitability.

The study also found that loan has a strong influence on profitability which indicated a positive and significant relationship with ROE. This finding is evidenced by previous studies (Hassan & Bashir 2003; Gul *et al*, 2011) found that loan has a strong impact on profitability. Higher loan ratio is revealing of a high profitability because it increases the interest income.

The findings of the study indicated that there is positive and significantly relationship between asset management and ROE. This finding is consistent with Akhtar *et al*. (2011) found that asset management has a significant effect on bank's profitability when it regressed against ROA and ROE. This findings is consistent with hypothesis 4 which stated that there is a significant positive relationship between inflation and profitability

Furthermore, the study revealed that bank's profitability is influenced by the capital positively. This finding is similar to the previous study by Kosmidou *et al.* (2005) as they indicated that well capitalized Islamic banks have a lower need for external funds and therefore higher the profitability of the bank. This finding supports hypothesis 5 which stated that there is significant positive relationship between capital and profitability.

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Finally, the study indicated that GDP has a strong impact on bank's profitability. GDP is considered as macroeconomic factor and that rise in the real growth rate can be boost bank's profitability. The significant and positive impact of GDP on profitability supports hypothesis 6 which proposed that there is a significant and positive relationship between GDP and profitability. This finding is confirmed by previous studies such as Kosmidou *et al.* (2005) and Hassan and Bashir (2003) who found that GDP growth has a significant and positive relationship with profitability.

4.3.5 Net Non-Interest Margin (NIM)

Table 4.6
The Estimated Model Summary for NIM

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.400[a]	.160	.125	2.6514169

a. Predictors: (Constant), INF, LNTA, LOAN, CAPITAL, AM, GDP, MGT

As per Table 4.6 the independent variables have no much affect for example, R square for NIM is lower than ROA and ROE. R-squared statistic for NIM model was 16% and the adjusted-R squared statistics was 12.5%. The result indicates that the variations in the explanatory variables explain only 12.5% of the changes in the dependent variable. Loan and inflation (INF) collectively explain 12.5% of the variations in NIM. The remaining 87.5% of changes is described by other variables which are not encompassed in this model.

4.3.6 Regression results for NIM

Table 4.7:

Coefficient Analysis of Net Interest Margin (NIM)

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	1.198	3.512		.341	.733
	LNTA	-.037	.176	-.019	-.208	.835
	MGT	1.265	1.241	.093	1.019	.310
	LOAN	1.919	.969	.142	1.980	.049**
	AM	6.210	3.657	.122	1.698	.091***
	CAPITAL	.034	.019	.129	1.785	.076***
	GDP	.067	.045	.117	1.478	.141
	INF	.241	.066	.275	3.669	.000*

a. Dependent Variable: NIM

b.*, **, *** denoted 1%, 5%, and 10% level of significance respectively.

As indicated by table 4.7 size has a negative impact of bank's profitability but insignificant with all profitability measures. The study also showed that loan has positive and significant association with NIM. This finding is consistent the previous studies by (Hassan & Bashir (2003) and Gul *et al.* 2011) who found that loan has a strong impact on profitability. Higher loan ratio reflects higher profitability and meaning that it increases the net income.

Furthermore, the study revealed that bank's profitability is influenced by the capital positively. This finding is similar to the previous study by Kosmidou *et al.* (2005) as they indicated that well capitalized Islamic banks have a lower need for external funds and therefore higher the profitability of the bank. This finding supports hypothesis 5

which stated that there is significant positive relationship between capital and profitability.

The findings of the study indicated that bank's profitability is influenced by asset management which represent a positive and significant association between NIM and asset management which is significant at the 5% level. This result is similar with Akhtar *et al*. (2011) found that asset management has a significant effect on bank's profitability when it regressed against NIM. This findings is consistent with hypothesis 4 which stated that there is a significant positive relationship between inflation and profitability

The study also indicated that inflation has a strong impact on Islamic bank's profitability since there is a significant and positive association with NIM with significant level of 1%.The study suggested that high inflation leads to high profitability. Our result is similar with the previous studies such as Haron (2004) who found that inflation had a positive relationship with all profitability measures but their relationships were not significant. Hasan and Bashir (2003) indicated that inflation is only significant with ROA. Their result is similar to our result which revealed that inflation has a positive and statistically significant relationship only with ROA. This result supports hypothesis 7 which proposed that there is a significant positive relationship between inflation and profitability.

4.4 Conclusion

The study identified factors influencing bank's profitability. The study revealed that some of the factors have significant influence on Islamic bank's profitability in the GCC. Based on the regression results, it is seen that asset management, capital, management efficiency, and inflation have a positive and significant influence on ROA which is one of the measurements of profitability. Based on the previous analysis it is concluded that Islamic bank's profitability in the GCC countries are not influenced by size of a bank which is found to have a negative and insignificant effect except with ROA which shows a significance relationship at 10% significant with 10% significant level. The findings of this study imply that Islamic banks with more total assets seem to achieve a lower profitability compared to a bank with small total asset. This is consistent to the previous study by Akhtar *et al*. (2011) who found that bank size has a negative and insignificant relationship with ROA and ROE. In addition, the study finds that management efficiency, loan, asset management and GDP have positive and statistically significant relationships when regressed against ROE. The study shows that loan, AM, Capital, and inflation have positive significant relationships with NIM. Finally, macroeconomic variables seem to stimulate higher profits since results show that both inflation and GDP have strong positive impact on the profitability measures. Overall, the results indicate that both internal and external variables have significant impacts on bank's profitability.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

The study aims to investigate the internal and external factors that affect Islamic bank's profitability. Using a panel data consisting of 175 observations of Islamic banks in 5 countries, for the period from 2006 to 2012 and three profitability measures (ROA, ROE and NIM) as dependent variables. The study investigates which factors that have significant influence on the profitability of Islamic banks of GCC region.

5.1 Conclusion of the Study

This section concludes the results found in the study in answering the questions stated in chapter one. The study also provides valuable recommendations for Islamic bank's managers and shareholder. The results of the study indicate that ROE model has the highest exploratory power among the three profitability measures. This result serves as indicator that the internal and external variables selected for this study provide a better explanation when regressed against ROE rather than ROA and NIM.

The analyses provide evidence that the relationship between size and measures are negative but insignificant except with ROA. It is significant at 10% significant level. The study suggests that Islamic banks with bigger total asset seem to achieve a lower profitability compared to a bank with small total asset. The finding is consistent to the previous study by Akhtar *et al*. (2011) who found that bank size has a negative and

insignificant relationship with ROA and ROE. The present study suggests that high total asset does not necessarily lead to high profitability and that smaller assets can achieve a higher profit.

The study identifies factors influencing bank's profitability. Findings show that some of the factors have significant influence on profitability. Based on the regression results, it is seen that asset management, capital and inflation have positive and significant influences on ROA which is one of the measurements used for profitability. In addition, the study indicated that management efficiency, loan, asset management and GDP have positive and statistically significant relationships when regressed against ROE. Finally, the study shows that loan and inflation have a positive significant relationship with NIM. Overall, the result indicates that both internal and external factors have a significant impact on bank's profitability.

Finally, macroeconomic variables seem to stimulate higher profits meaning that both inflation and GDP have a strong positive impact on the profitability measures.

5.3 Limitations of the Study

The limitations of this study are that it only focused on two groups of variables bank-specific factors and macroeconomic factors such as GDP and inflation that affect bank's profitability on Islamic banks operated in the GCC countries. Industry characteristics, financial structure and taxation variables on the Islamic bank's profitability in the GCC countries were however not included.

5.4 Contribution of the Study

The research provides Islamic bank's managers the factors that influence bank's profitability. The outcome of this study provides useful knowledge for bank management to make the appropriate decision in order to enhance the profitability of Islamic banks in GCC countries. The also provides valuable investigation and understanding of the internal and external factors that influence the bank's profitability. The study benefits managers of the banks, shareholders and investors. The most important findings of this study are that factors affecting interest-free banks are similar to those of interest-based banks. That mean techniques and tools which have been developed in conventional banks are suitable for Islamic banks.

The main contribution of the study is that it identifies the factors that influence bank's profitability in improving and enhancing Islamic bank's profitability. There is a need to improve and increase the profitability of Islamic banks and this is important because it will improve Islamic economy and that will flourish Islamic countries, and eventually provide better life for Muslims. The study provides techniques for Islamic banks to gain more profits and increase in performance in appropriate manner.

Future research should focus on more profitability measurements such as industry characteristics and financial structure, and should cover more countries and for a longer period of time.

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