

CREDIT RISK AND PROFITABILITY OF ISLAMIC BANKS IN PAKISTAN

BY

DANIA SAEED

27324

A thesis submitted to the Department of Management Sciences,
Bahria University Karachi Campus, in partial fulfillment of the
requirements
for MBA Degree



FALL, 2019

Bahria University Karachi Campus



MBA Thesis 2nd Half-Semester Progress Report & Thesis Approval Statement

Supervisor – Student Meeting Record

| S# | Date | Place of Meeting | Topic Discussed | Signature of Student |
|----|------------|------------------|-------------------------------|----------------------|
| 1 | 16/09/2019 | Faculty Cubicle | Thesis topic | |
| 2 | 10/10/2019 | Faculty Cubicle | Variables and Data Collection | |
| 3 | 24/10/2019 | Faculty Cubicle | Issues related to data | |
| 4 | 14/11/2019 | Faculty Cubicle | Discussion about software | |
| 5 | 18/12/2019 | Faculty Cubicle | Discussion on the results | |

APPROVAL FOR EXAMINATION

Candidate's Name: Dania Saeed

Registration No.: 27324

Thesis Title: Credit risk and Profitability of Islamic Banks

I hereby certify that the above candidate's thesis has been completed to my satisfaction and, to my belief, its standard is appropriate for submission for examination. I have also conducted plagiarism test of this thesis using HEC prescribed software and found similarity index at _____ that is within the permissible limit set by the HEC for the MBA thesis. I have also found the thesis in a format recognized by the Department of Management Sciences.

Supervisor's Signature: _____

Date: 23/1/2020

Supervisor's Name: Muhammad Faisal

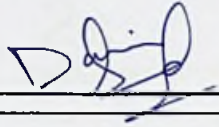
HoD's Signature: _____

Date: 23-1-2020

Declaration of Authentication

I, hereby, declare that no portion of the work referred to in this thesis has been submitted in support of any application for another degree or qualification of this university or any other institution of learning.

Student's Signature: _____



DEDICATION

I dedicate my dissertation work to my parents. My loving parents, who have always stressed the importance of education. They taught me to work hard towards achieving my goals. They not only gave me moral and emotional support but instilled in me a tireless work ethic and persistent determination to be whatever I wanted to be in life. Without their personal sacrifices and unconditional love, I would not have been who I am today and wouldn't be able to achieve whatever I have achieved in my life.

ACKNOWLEDGEMENT

I am grateful towards Almighty Allah, who gave me strength and determination to work hard to complete my thesis work with originality.

This dissertation work would not have been completed without the endless guidance and support from my thesis supervisor Sir M Faisal. I am thankful to him for giving me valuable advices whenever I needed and making time from his busy schedule to resolve my queries.

An appreciation is due to this institution which has given me an opportunity to advance in my academic qualifications and assisted me in the accomplishment of this study.

ABSTRACT

Purpose:

The aim of this study is to investigate and perform analysis to determine the effects of equity and debt financing on the credit risk and profitability of the Islamic banks in Pakistan. To understand the relationship of both types of financing on the earning of the banks, credit risk has been studied as a mediator between the independent and predicting variable.

Methodology & Design

This study is an explanatory research to determine the relationship among the variables. There are total four full-fledged IBs operating in Pakistan, all of which were part of this study. The research was performed on the data collected from year 2009 to 2018 annual reports of the IBs.

Findings

According to the results of regression analysis, the equity (PLS) does not have a major impact on the earnings and debt (NPLS) financing contracts have significant negative effects on the earning of the banks. While these two financings may have indirect effects on the profitability, as they have a positive impact on the credit risk of the banks. Thus, increase in credit risk decreases the earning of the banks.

Limitations

The limitation of data unavailability, time constraint and Islamic banks not offering similar contracts as their counterparts were faced conducting this research.

Recommendations

Islamic banks need strong and efficient risk management framework, which would identify, eliminate and control the credit risk associated with the financing contracts of the IBs. Actions must be taken for client's non-disclosure of information. Mudarabah and Musharakah contracts must be practiced more, as they are the ideal types of investment contracts without interest.

Keywords: PLS financing, NPLS financing, Credit risk, profitability, Islamic banks.

TABLE OF CONTENTS

| | |
|---|----|
| Dedication | iv |
| Acknowledgement | v |
| Abstract | vi |
| CHAPTER 1 | 1 |
| INTRODUCTION | 1 |
| Introduction | 1 |
| Background | 4 |
| Problem Statement | 5 |
| Research Objectives | 5 |
| Significance of the Study | 5 |
| Scope of the Research | 6 |
| CHAPTER 2 | 7 |
| LITERATURE REVIEW | 7 |
| 2.1 Variables..... | 9 |
| 2.1.1 Return on Assets (ROA): | 9 |
| 2.1.2 Profit and Loss Sharing (PLS) Financing Ratio: | 9 |
| 2.1.3 Non- PLS financing Ratio..... | 9 |
| 2.1.4 Non Performing Financing (NPF) Ratio:..... | 10 |
| 2.2 Relationship between PLS financing and Profitability: | 10 |
| 2.3 Relationship between Non- Profit & Loss Sharing and Profitability | 11 |
| 2.4 Relationship between Profit & Loss Sharing and Credit Risk: | 11 |
| 2.5 Relationship between Non- Profit & Loss Sharing and Credit Risk:..... | 11 |
| 2.6 Relationship between Credit Risk and Profitability: | 12 |
| 2.7 Summary of Literature Review | 13 |
| 2.8 Conceptual Framework | 14 |
| 2.9 Research Hypotheses..... | 15 |
| CHAPTER 3 | 16 |
| Research Methodology | 16 |

| | |
|--|----|
| 3.1 Approach & Type..... | 16 |
| 3.2 Research Design..... | 16 |
| 3.3 Research Population and Sample size..... | 16 |
| 3.4 Research Instrument..... | 16 |
| Data Collection..... | 17 |
| Data Analyses Method..... | 17 |
| CHAPTER 4..... | 18 |
| Results..... | 18 |
| 4.3 GLM Mediation Analyses..... | 18 |
| 4.3 Regression Analysis..... | 19 |
| 4.3 Hypothesis Testing..... | 22 |
| 4.3.1 Hypothesis 1..... | 22 |
| 4.3.2 Hypothesis 2..... | 22 |
| 4.3.3 Hypothesis 3..... | 22 |
| 4.3.4 Hypothesis 4..... | 23 |
| 4.3.5 Hypothesis 5..... | 23 |
| Summary of Hypotheses Testing..... | 24 |
| CHAPTER 5..... | 25 |
| Discussion..... | 25 |
| Discussion..... | 25 |
| 5.1.1 Hypothesis 1 Discussion..... | 25 |
| 5.1.2 Hypothesis 2 Discussion..... | 26 |
| 5.1.3 Hypothesis 3 Discussion..... | 27 |
| 5.1.4 Hypothesis 4 Discussion..... | 28 |
| 5.1.5 Hypothesis 5 Discussion..... | 28 |
| CHAPTER 6..... | 30 |
| Recommendations and Conclusion..... | 30 |
| Recommendations..... | 30 |

| | |
|----------------------------------|----|
| Limitations of the Research..... | 30 |
| Future Research..... | 31 |
| Conclusion..... | 31 |
| References..... | 33 |