Chapter 65
What Are the Leading Bank-Specific and Macroeconomic Factors Influencing Islamic Bank Performance?
New Evidence From MENA Countries

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ABSTRACT

Despite the proven sustainability and growth of Islamic banks during the financial crisis period, many scholars criticise the current performance of Islamic banks. Therefore, policymakers are continuously getting worried due to inconclusive finding of different research related to Islamic bank profitability. To shed the light of raising concern, this study investigates the issue from considering both macroeconomic and bank-specific factors. The annual cross-sectional data has been collected from 46 Islamic banks in 10 selected MENA countries over the period 2015-2019. The standardized pooled ordinary least square (OLS) approach's findings revealed that bank size, capital adequacy, GDP, and inflation have a significant positive impact on Islamic banks' return on asset, but asset quality has no significant effect on ROA. In contrast, most of the variables have an insignificant effect of ROE. Investors, financial analysts, and policymakers will get benefits from this study's results to secure their investment by successfully controlling the above-mentioned leading factors.

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INTRODUCTION

In 2007-2008, during the global financial crisis, the financial world observed the limitation of conventional banking system where Islamic financial system showed its continuous sustainability and growth (Ftiti, Nafti, & Sreiri, 2013; Trad, Trabelsi, & Goux, 2017). Based on the statement published by Islamic Finance Development Report (IFDR) 2018[1], there are remarkably increased in Shariah-compliant assets which was $200 billion only during 2003 and raised to $2.44 trillion in 2017. Moreover, the Islamic financial system has been accepted by more than 80 countries and operating with around 1400 institutions, where the annual growth rate is 10 percent. However, Chowdhury, Haque, and Masih (2017) mentioned that Islamic banks' return on asset (ROA) and return on equity (ROE) have been decreasing continuously compared to prior of the global financial crisis. According to IFDR report 2018, Islamic financial institutions had experienced slow growth in 2018. Accordingly, having these conflicting statements motivate to revisit Islamic bank profitability in a relatively broader avenue through MENA countries.

Two maiden indicators could determine the profitability of any commercial bank such as return on asset and return on equity. Return on asset derived by net profit after tax is divided by total asset. ROA represents the organisational efficiency in order to manage their assets. On the other hand, ROE can be derived from the organisation's net profit after tax divided by equity capital. Investors can get profit from any investment from a bank based on the ROE. According to Ozili and Uadiale (2017), most of the banking regulatory bodies consider banks' profitability based on ROA and ROE.

In international settings, maximum number of financial institutions, generally banks, follow the traditional banking system as a benchmark of which the maiden intention is to maximise shareholders' profit regardless of borrowers' welfare. In contrary, the Islamic banking system, which is relatively new compared to conventional financing, is grabbing the researchers' attraction in many developed and developing countries because of its unique features. The Islamic banking system prohibits the interest-based transaction, which is the maiden element to increase profit of conventional banks. The Islamic bank follows the shariah rules by accepting profit and loss sharing principle between both parties. Investors in Islamic bank do not mention the profit rate while the banks receive money. So, it is evident that profit-loss sharing principle provides a better avenue for Islamic bank to sustain longer and healthy economic growth (Ibrahim et al., 2019; Mehta & Bhavani, 2017; Mokni & Rachdi, 2014).

Profit loss sharing and mark-up is commonly used as a shariah compliance principle to measure profitability in Islamic banks. As Islamic banking system completely follow the shariah principle, there should not be any transaction, money collection or payment, based on interest. In the context of profit lost sharing policy, the rate of return for any financial assets should not be pre-fixed. On the other hand, the rate of return of mark-up transaction, which is mainly used during the purchase-resale contract could be determined based on the benchmark. Therefore, the previous empirical study found that profit-loss sharing principle outperformed than mark-up principle, but most of the time Islamic bank used mark-up transaction for a short duration (Bidabad & Allahyarifard, 2019; Suzuki, Uddin, & Sigit, 2019). In the conventional banking system, the borrower is entirely responsible for any kind of risk, whereas the Islamic bank share risks with borrowers. Controlling risk is very much crucial for any bank because it directly impacts the profitability (Sobarsyah et al., 2020).

According to Akhtar, Akhter, and Shahbaz (2017), the Islamic bank's balance sheet considered depositors as shareholders of a bank, and there were no fixed liabilities existed. This feature helps Islamic bank to absorb any shock from the asset side, and it is automatically adjusted in the liability side as well. Moreover, the feature gives more uniqueness of Islamic banks to become more stable during the