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Abstract

The objective of this study is to examine the impact of bank-specific and major macroeconomic factors on the profitability of the biggest two Islamic banks in Palestine over the time period 1997-2018. It employs Pooled Regression analysis to investigate the effect of bank's asset size, capital, loans, liabilities, operating cost, economic growth and inflation on key bank profitability indicators; return on assets (ROA) and return on equity (ROE), respectively. The main findings show that size and capital have positive impact on ROE. Loans are positively correlated with both ROA and ROE. Liabilities are negatively related to ROA and operating cost has negative impact on both ROA and ROE. Moreover, Islamic banks not benefited significantly from both the inflationary environment and economic growth.

Keywords: Islamic Banking Profitability, Internal & External Factors, Pooled Regression
JEL Classification: G12, C23

1.INTRODUCTION

Since the med 1990s, the Palestinian banking sector has achieved a steady growth in terms of assets size, deposits and lending to the private sector. Notwithstanding, the sector plays a limited role in financing of the Palestinian economy due to the cautiousness of banks which reflects several structural problems such as the lack of suitable collaterals and the uncertainty of the outcome in debt (World Bank, 2012).

Banks in Palestine are generally in sound financial condition and products are well developed as is the regulatory infrastructure. However, the sector remains vulnerable due to its dependence on the Jordanian banking system and from operational point of view on the Israeli one.

As in most developing countries, the Palestinian banking sector dominates the financial sector. By 2017 the banking sector comprises 14 banks, licensed by Palestine Monetary Authority, of which 7 are local and other 7 are coming from Jordan and Egypt.

Of these local banks 3 are Islamic banks and the rest 4 are traditional ones. The two biggest Islamic Banks started in the med 1990s are Palestine Islamic bank (PIB) and Arab Islamic Bank (AIB) and the newly third one, Alsafa Bank started in 2016. The assets of PIB and AIB together constituted about 10 per cent of total assets of the whole of Palestinian banking sector in 2017.

Recently, a number of studies have examined internal factors or internal and external factors affecting bank performance or efficiency in Palestine (e.g., Alkhatip (2012) and Abadi and Abu Rub (2012)) and (Abugamea, 2018). The first two studies examined the impact of internal factors on leading traditional banks whilst the third study examined internal and external factors affecting the whole banking sector performance.

Motivated by these empirical studies, we directed attention to examine the impact of internal and external factors on the performance (profitability) of Islamic banks, a case not researched yet, by using a pooled data set for the biggest two Islamic banks in Palestine.

This paper organized as follows: Section 2 presents an overview of selected literature. Methodology, data and descriptive statistics of the employed variables are explained in

Section 3. Next, Section 4 covers empirical results. Finally, Section 5 discusses the main findings of the paper.

2.LITERATURE REVIEW

Over the past two decades there had been numerous studies done on determinants of Islamic banks profitability. Mainly, factors that influence the profitability of Islamic banks as in case of conventional ones be divided into bank specific characteristics and macroeconomic indicators.

Among the earlier studies which examined the effect of internal characteristics on Islamic bank profitability are Bashir(2000; 2003), Haron (2004), Izhar and Asutay (2007), Srairi (2009) and Wasiuzzaman and Tarmizi (2010). The bank specific characteristics that related to bank's profitability are size, capital, liquidity, financial risk and operation efficiency.

Within these studies, Bashir (2000) found that size negatively affected the profitability of Middle East Islamic banks. However, Haron (2004) and Srairi (2009) found size affected the profitability of the banks studied positively. Further, Wasiuzzaman and Tarmizi (2010) found insignificant relationship between Islamic bank size and profitability of Malaysian Islamic banks studied.

In the mentioned studies, it was found that well capitalized banks show profitability except of Izhar and Asutay (2007) and Wasiuzzaman and Tarmizi (2010). Izhar and Asutay (2007) found an insignificant negative relationship between capital and profitability. Wasiuzzaman and Tarmizi (2010) also found a negative relationship, which explained that Islamic banks in Malaysia should not focus increasing the equity performance to increase profitability.

Haron (2004) and Wasiuzzaman and Tarmizi (2010) found a significant positive relationship between profitability and liquidity. However, Izhar and Asutay (2007) and Srairi (2009) found a significant negative relationship between liquidity and profitability. They believe that Islamic banks are more liquid than conventional ones.

Bashir (2003), Srairi (2009) and Wasiuzzaman and Tarmizi (2010) found a significant positive relationship between profitability and exposure to credit risk. Bank loans are the main sources of revenue, therefore if borrowers are able to repay their debt, the higher will be banks profitability. However, Izhar and Asutay (2007) found a significant negative

relationship between credit risk (loans to total assets) and profitability as Islamic bank portfolio is heavily biased towards short term trade financing loans.

Haron (2004) and Wasiuzzaman and Tarmizi (2010) found a significant positive relationship between profitability and operation efficiency of the banks, meanwhile Bashir (2003) and Izhar and Asutay (2007) found a positive but insignificant relationship between profitability and operation efficiency of the bank.

Moreover, there are a number of the mentioned studies which examined the effect of external factors (macroeconomic indicators) on Islamic bank profitability. Bashir (2003) found that economic growth or GDP growth has a positive impact on profitability of Islamic banks. This was followed by Srairi (2005) and Waziuzzaman and Tarmizi (2010) in their studies on determinants of Islamic bank profitability in Gulf countries and Malaysia, respectively. Both of these studies found that GDP growth has significant positive relationship with Islamic banks profitability. Furthermore, Bashir (2003), Haron (2004) and Izhar and Asutay (2007) found a positive significant relationship with inflation and profitability of Islamic banks. However Sriari (2009) found that inflation has no significant effect on the profitability of Islamic banks.

Recently, numerous studies have examined the impact of both internal and external factors (macroeconomic variables) on the profitability of Islamic banks. Abduh and Idress (2013) investigated the impact of bank specific as well as industry specific and macroeconomic indicators upon Islamic banks profitability, proxied by the return on average assets, in Malaysia over the period 2006-2010. The internal factors includes; size (log of total assets), capital (total equity over total assets), liquidity (loans to total deposit and short term funding), credit risk (loan loss reserves to gross loans), financial risk (total liability over total assets) and operation efficiency (cost over income) . The external factors consists of GDP and inflation. They used a pooled regression analysis for 10 Islamic banks. The results show that the bank size is a vital importance (significant) in affecting bank profitability. Moreover, capital, liquidity and financial risk have insignificant negative impact on banks profitability meanwhile operation efficiency has insignificant positive impact on profitability. Also, financial market development and market concentration have significant positive impact on profitability. For macroeconomic variables, inflation has a significant positive impact on Islamic banks profitability.

Asadullah (2017) examined the impact of size (log of total assets) , liquidity (loans to total deposit), GDP and inflation on the profitability of Islamic banks of Pakistan, proxied by return on asset, for the period 2006-2015, by employing panel fixed effect regression analysis. It was found that liquidity has a positive significant impact on Islamic bank profitability while size has negative significant effect on profitability. Both GDP and inflation have insignificant impact on bank profitability.

Widarjono (2018) examined the profitability of Islamic banking, proxied by return on asset and profit, using both internal and external factors. The internal factors include; size (log of total assets), liquidity (finance deposit ratio), credit risk (non- performing financing) and operational efficiency ratio (operational expenses to operational revenue). The external factors consist of GDP, inflation and exchange rate. The study used Autoregressive Distributed Lag Model methodology with monthly data for the period 2011-2017. An important variable affecting profitability were the bad financing, while the external factors influencing the profit of Islamic banking were the exchange rate and inflation. The estimation results show that in long run condition internal variables of asset, finance deposit ratio and operation cost have a positive impact on bank profitability, while non-performing financing has a negative effect on profitability.

Further, there is a strand of literature which examined factors affecting bank performance in Palestine using regression estimation method and correlation analysis procedures. Alkhatip (2012) assessed the financial performance of five Palestinian commercial banks listed on Palestine Security exchange (PSE) over the period from 2005 to 2010. Financial performance is measured using three indicators: i) internal measure of performance proxied by ROA, ii) market measure of performance measured by Tobin's Q model (Price/Book value of Equity) and iii) economic measure of performance proxied by economic value added. The study revealed that there exists statistically significant effect of bank size, credit risk, operational efficiency and asset management on financial performance of Palestinian commercial banks.

Abbadi and Abu Rub (2012) examined the effect of capital structure on the bank efficiency measured by using two indicators: accounting one measured by ROE and market one measured by Tobin's Q. Total deposits to assets, total loans to assets and total loans to deposits were used to measure capital structure. The study employed a dataset for eight commercial banks listed on Palestine Security Exchange during the period 2007-2010. Mainly, it was found that leverage (total deposits to total assets) has a negative effect on bank

profits (ROE), an increase in each ROA and deposits to assets increases bank efficiency (Tobin's Q). Leverage has a negative effect on market value measured by Tobin's Q. It was also found that there were a positive and strong relationships between market value and ROA and bank deposits to total assets as well as a weak correlation between loans and return on equity and loans and market value.

Abugamea (2018) evaluated the impact of bank-specific and major macroeconomic factors on the profitability of banking sector of Palestine by using the aggregate bank balance sheet data over the time period 1995-2015. The study employed the Ordinary Least Square method to investigate the effect of bank's asset size, capital, loans, deposits, economic growth and inflation on key bank profitability indicators, i.e., return on assets (ROA) and return on equity (ROE). The main conclusions show that size has positive impact on ROE. Capital is positively related to ROA. Loans are positively correlated with both ROA and ROE. Deposits are negatively related to both ROA and ROE. Also, banking sector has not benefited significantly from both the inflationary environment and economic growth.

In view of this background, this study aims to investigate the relationship between bank-specific and key macroeconomic characteristics and Islamic bank profitability. This study distinguished from studies related to the performance of Palestinian banking sector by extending its analysis to the performance of Islamic banks, a case not researched yet, and by using a pooled data set for the biggest two Islamic banks in Palestine and hence it gives a better forecasting of Islamic bank profitability in particular.

3.METHODOLOGY AND DATA

1.1 Methodology

The determinants of banks profitability are usually divided into internal and external factors. Internal factors include such bank-specific factors as bank size, capital, loans, liabilities and operating cost, while external factors consist of such macroeconomic variables as economic growth represented by GDP per capita and inflation.

Our objective is to test the effect of internal and external factors on the bank's profitability. Based on the objective, the present study seeks to test the hypothesis that there is a direct relationship between both of internal factors and external factors and bank's profitability.

The basic estimation procedure is to use a pooled dataset of the two Islamic banks and apply a panel fixed procedure. The study uses panel data to gain the advantage of given more information data as it consists of both the cross sectional information which captures individual variability and the time series information, which captures dynamic adjustment. Also, in this case we follow fixed effect model due to the case that we have a lesser number of cross sections compared with coefficients to be estimated. Thus, we introduce the following regression equation.

$$Prof.i,t = \alpha + \beta_1 Xi,t + \beta_2 Zt + \varepsilon i,t$$

Where profitability represented by ROA and ROE for bank i in year t, α is a constant, Xi,t represent bank specific characteristics of bank i in year t, Zt represents macroeconomic indicators in year t, βi are regression coefficients to be estimated and ε is the error term.

Data

The bank-specific data is extracted from both income statements and balance sheets of the two Islamic banks published in their electronic web pages. The data set for PIB cover 22 years from 1997-2018 and for AIB span over 10 years from 2008-2018. By pooling together all the data 33 observations were collected. The data for macroeconomic variables was taken from the Palestinian Economic & Social Monitor over the period of study. Table (1) describes the variables employed in this study.

Table (1) The description of the variables employed in this study

Category	Variable	Description
Dependent Variable	ROA	Return on Assets = Net Income / Total Assets
	ROE	Return on Equity = Net Income / Total Equity
Independent Variables: Internal Factors	Size (x1)	Bank Size = Natural Logarithm of Total Assets
	Capital (x2)	Capitalization = Total Equity / Total Assets
	Loans (x3)	Liquidity = Total Loans / Total Assets
	Liabilities (x4)	Financial Risk = Total Liabilities / Total Assets
	Operating Cost (x5)	Operation Efficiency= Total Operating Cost / Income
Independent Variables: External Factors	GDPPC (x6)	Economic Development = GDP per capita in constant prices (USD)
	Inflation (x7)	CPI-based

The model includes the list of bank's internal and external factors commonly used in the literature. The description of variables is as follows:

A. Dependent variable: Profitability as measured by ROA and ROE

- **ROA** is a ratio of the net income over total assets. It measures the profit earned per dollar of assets and reflects how well bank management uses the bank's investment resources to generate profits (Naceur, 2003). Also, according to Flamini et al (2009), ROA is better key proxy than ROE because it not neglects financial leverage.
- **ROE** measures the rate of returns on the ownership interest (shareholders' equity) of the common stock owners. It measures a firm's efficiency at generating profits from every unit of shareholders' equity. Returns on equity is the ratio of net income to total equity (Fraker, 2006).

B. Independent variables: The internal (bank-specific) factors:

- **Size** is measured by log of total assets. It is used to capture the fact that larger banks (banking sector) are (is) better placed than smaller ones in taking advantage of economies of scale in transactions to the plain effect that they will tend to enjoy a higher level of profits. Accordingly, a positive relationship is expected between size and profits. Molyneux and Thornton (1992), Bikker and Hu (2002) and Goddard et al. (2004) find that size is positively related to profitability. However, for banks that become extremely large, the effect of size could be negative due to bureaucratic and other reason (Abduh and Idress, 2013).
- **Capital** is the ratio of equity to total assets. It is expected that greater capital level drives the profitability higher since by having more capital, a bank can easily adhere to regulatory capital standards so that excess capital can be provided as loans (Berger, 1995). We also expect that the higher is the equity to asset ratio in Islamic banks, the lower is the need for external funding and therefore higher profitability(Abreu and Mendez, 2002). It is also a sign that well capitalized bank face lower costs of going bankrupted and the cost of funding is reduced.
- **Loan** is the main source of income of a bank which is expected to have a positive impact on bank performance (Demirguc-Kunt and Huizinga, 1997). However, since most of the Islamic banks loans are of profit and loss sharing(PLS) (loans with equity features), the loan performance relationship depends significantly on the expected change of the economy. During a strong economy, only a small percentage of the PLS loans will default, and the bank's profit will rise. On the other hand, the bank could be severely damaged during a weak economy, because several borrowers are likely to default on their loans (Hassan and Bashir,

2000). Thus, banks should capitalize on favorable economic conditions and insulate themselves during adverse conditions.

- **Liabilities** is the ratio of total liabilities to total assets which is a measure of financial risk. For Islamic banks we expect a positive relationship between ROA and ROE and this ratio. However, in the absence of deposit insurance, high risk taking will expose the bank to the risk of on solvency(Srairi, 2009). Therefore, the ratio may have a negative impact on bank profitability.
- **Operating Cost** is used as a measure of efficiency. It is normally measured by cost over income. Operating cost reflects total amount of wages and salaries as well as the cost of running branch office facilities. A high operating cost ratio is expected to impact performance negatively because efficient banks are expected to operate at lower costs. On the other hand, the usage of new electronic technology has caused the wage expenses to fall (Hassan and Bashir, 2000). Therefore, a lower operating cost ratio may impact performance positively.

C. Independent variables: External factors include GDP per capita and inflation

- **GDP per capita** to denote level of economic development. Here, we expect a growth in GDP per capita to generate direct positive impacts on profitability of Islamic banks (Demirguç-Kunt and Huizinga, 1999).
- **Inflation** affects banks pricing behavior, and hence if banks expect general inflation to be higher in the future, they may believe that they can increase their prices without experiencing a decline in demand for their output (Driver and Windram, 2007).

4.2. Empirical Results

Descriptive Statistics

Before introducing empirical analysis it is useful to comment on some preliminary features of our data. Table (2) shows descriptive statistics for the profitability (ROA) and (ROE) and the bank specific and macroeconomic variable employed in this model. In average, both the return on assets and the return on equity of the two Islamic banks are positive with values of 0.0012 for ROA and 0.0318 for ROE, during the period of study. However, both ROA and ROE shows negative values of 0.0735 and 0.2563 during the period of study, a situation reflected difficulties which faced the Palestinian banking sector under political economic

condition in the Palestinian lands in the West Bank and Gaza Strip. Also, the mean of all other independent variables are positive.

The mean of size is the largest 19.178. It is followed by operating case 0.677, liquidity 0.438, liability 0.383 and capital 0.204, respectively. Over the period of study the average of GDPPC of Palestine 2070.023, while of inflation is 3.309.

Table (2): Descriptive Statistics

	ROA	ROE	Size	Capital	Loans	Liabilities	Oper.Cost	Inflation	GDPPC
Mean	0.0013	0.032	19.178	0.204	0.438	0.383	0.677	3.310	2070.023
Median	0.0074	0.056	19.534	0.133	0.444	0.349	0.605	2.930	1705.550
Maximum	0.0268	0.176	20.823	0.852	0.667	0.713	1.843	9.900	3254.000
Minimum	-0.0735	-0.256	16.030	0.072	0.089	0.148	0.317	-0.220	1181.800
Std.Dev.	0.0205	0.096	1.445	0.173	0.135	0.119	0.280	2.484	734.930
Mean/Std.Dev.	0.063	0.332	13.272	1.179	3.244	3.252	2.417	1.333	2.817
Obs.	33	33	33	33	33	33	33	22	22

Taking the ratio of Mean to Standard deviation as a measure for variation shows that the highest variation per unit of standard deviation are for Size, Loans and GDPPC. The variation of size and loans reflects an increasing trend, whilst the variation of GDPPC exhibits fluctuation in the Palestinian economic growth over the period of study (Abugamea, 2016).

Empirical Analysis

Table (3) below presents the pooled regression estimations for both ROA and ROE, respectively. In case of ROA and ROE models, we include all internal factors and external factors.

In Table (3), all models have noticeable explanatory power with R-Squared ranging between 67% and 71% and with adjusted R-Squared ranging between 60% and 61%. The Durbin-Watson statistics with values close to 2 shows that models to a large extent free of serial correlation and the F-statistics with probability value shows the significance of these models.

Table (3): Pooled Estimation Results

	ROA		ROE	
	(1)	(2)	(3)	(4)

Constant	0.0975	-0.0663	-0.6673	-1.4746*
C	(0.1200)	(0.1723)	(0.5466)	(0.7853)
	(0.8121)	(-0.3849)	(-1.2208)	(-1.8778)
Size	-0.0045	0.0044	0.0349	0.0840*
LTA	(0.0059)	(0.0094)	(0.0269)	(0.0427)
	(-0.7597)	(0.4740)	(1.2957)	(1.9682)
Capital	-0.0134	0.0223	0.2096	0.4258*
EQTA	(0.0350)	(0.0469)	(0.1596)	(0.2139)
	(-0.3837)	(0.4749)	(1.3133)	(1.9957)
Loans	0.0979**	0.1123**	0.2898**	0.2899**
LONTA	(0.0280)	(0.0299)	(0.1276)	(0.2899)
	(3.4943)	(3.7547)	(2.2713)	(2.1265)
Liabilities	-0.1027**	-0.0928**	-0.2147	-0.1800
TLBTA	(0.0307)	(0.0311)	(0.1398)	(0.1420)
	(-3.3466)	(-2.9794)	(-1.5353)	(-1.2679)
Oper. Cost	-0.0159*	-0.0156*	-0.0853* *	-0.0934**
OCST	(0.0090)	(0.0091)	(0.0411)	(0.0414)
	(-1.7670)	(-1.7155)	(-2.0766)	(-2.2569)
Inflation		0.0007		-0.0056
		(0.0013)		(0.0061)
		(0.5167)		(-0.9271)
GDPPC		-1.19E-05		-7.39E-05
		(1.07E-05)		(4.87E-05)
		(-1.1155)		(-1.5168)
R^2	0.6753	0.7053	0.6861	0.7146
Adjusted R^2	0.60003	0.6070	0.6114	0.6195
F-Statistics	9.0098**	7.1788**	9.4115**	7.5118**
(Prob. Value)	(0.00002)	(0.00008)	(0.00002)	(0.00005)
D.W Statistic	1.5546	1.7493	2.1698	2.0295

Notes: The values in the parenthesis are standard errors and t-statistics values, respectively.
* and ** denote t-statistic values, significance at 10 % and 5 %, respectively.

The results, in case of including both bank specific factors and external ones, suggest that only loans (PLS) has significant positive relation with ROA, However, liabilities and operating cost have significant negative effect on ROA. Further, size and capital have positive but insignificant effect on ROA which imply that Islamic banks not exhibit economies of scale. Results related to the sign of effect of size (positive) is found similar to that of the Malaysian case by Abduh and Idress (2013) but differed of the Pakistani case by Asadullah (2017) with a negative sign. Liquidity impact (loans) results are similar to that of the

mentioned Pakistani case and differed of the mentioned Malaysian case. Moreover, results related to the effect of operation cost (negative) is differed from the Indonesian case by Widarjono (2018) and by the Malaysian case by Abduh and Idress (2013) with a positive sign in these cases.

Column (2) denotes insignificant positive impact of inflation and insignificant impact of economic growth, proxied by GDP per capita, on ROA. These results are similar to that found for Pakistani case by Asadullah (2017) and the result related to the impact of inflation is differed from the Malaysian case by Abduh and Idress (2013) and the Indonesian one by Widarjono (2018).

Moreover, each of size, capital and loans (PLS) have significant positive impact on ROE, whereas operating cost is negatively related to return on equity. Also, liabilities have negative but insignificant effect on ROE. In this case, results related to the effect of size and loans on Islamic banks profitability are in line with that to the whole Palestinian banking sector case by Abugamea (2018).

Column (4) denotes insignificant negative impact of both inflation and economic growth on ROE.

Constant coefficients are negative in both ROA and ROE cases and significant in case of ROE, a case denotes a declining in Islamic bank profitability irrespective of explanatory variables.

We notice a positive relationship between size, capital and loans and both measures of profitability, ROA and ROE, meanwhile a negative relationship existed between liabilities and operating cost and ROA and ROE.

Also, neither inflation nor economic growth have significant impact on ROA and ROE.

Thus, overall results show that size, capital, loans are the key factors affecting the profitability of Islamic banks as measured by ROA or ROE. It confirms that banks with large size, capital and loans achieve a higher ROA or ROE. The Islamic bank profitability is inversely related to liabilities and operating cost. By reconciling between results of the effect of size on both ROA and ROE, it could be concluded that this effect supports the significant scale economies of these banks partially. Also, Islamic banks not benefited significantly from both inflationary environment and growth cycle. Furthermore, the overall internal and external factors or variables can be taken as the main determinants of Islamic bank profitability.

2. CONCLUSIONS

This study investigates the impact of banks' internal and external factors on the profitability of Islamic banks in Palestine over the 1997-20118 period. The empirical results have found strong evidence that internal factors (size, capital, loans, liabilities and operating cost) are significant determinants of the profitability measured by both ROA and ROE. This confirms that banking institutions with large size, capital and loans can achieve a higher ROA or ROE. The main findings show that size and capital have positive impact on ROE. Loans are positively correlated with both ROA and ROE. Liabilities are negatively related to ROA and operating cost has negative impact on both ROA and ROE. Moreover, external factors as inflation and economic growth have no significant effect on the profitability of Islamic banks. Results imply a number of policy implications which includes: banks should maintain sizable volume of lending activities (PLS) to increase profits, banks should seek to reduce operating cost and Islamic banks should improve the forecasting of both inflation and economic growth rates, consequently, this could help them in making decisions with regard to the rate of profit sharing, loan quantity and asset quality.

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