HOW FINANCING DIFFERENT INDUSTRIES INFLUENCES THE ISLAMIC BANK PROFITABILITY? UAE AND KSA IN FOCUS

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Abstract

One of the most important roles in Islamic banking operation today is profitability and its performance. Islamic banks use the different modes of financing in order to achieve its profitability. The aim of this paper is to test the effects of Islamic financing in different sectors in KSA and UAE. Paper shows investing in which sector can lead to more profitable investment and positive impact on the profitability of Islamic banks. By using OLS multiple regression analysis paper shows that possibility of investment diversification is the highest in the United Arab Emirates. Particularly in investments in the sector mining and quarrying can cause losses in profitability. While investments into agriculture, forestry, hunting and fishing, construction, financial and insurance activities and real estate activities have positive impact on the profitability in United Arab Emirates. Similarly regarding to investment in KSA paper shows that the most profitable sectors are agriculture, forestry, hunting and fishing.

Key Words

Islamic banking; profitability; profit; investment; industrial sectors.

INTRODUCTION

Since Islamic banks are free of interest financial services, the financial arrangements between customers and the Islamic bank should be free of charge of interest financial contracts and it should adhere to the values of Sharia. The banking industry typically plays a vital role in the growth and progress of the improving the economic state, if not all, by financing most of enterprises. Islamic banks follow Islamic values that could be declared as banks compliant with the Shariah. Islamic banks in KSA are the largest in Islamic financing, in this way commercial banks operate easy with Islamic banks. Most of commercial banks has Islamic windows that enables to the conventional banks deal with Islamic modes of financing. Similarly, majority of commercial banks in GCC have a dual system of banking that includes both Islamic and conventional banking system. United Arab Emirates is the first country who entered dual banking system. First Islamic bank is established in UAE in 1973. This was one of the reasons why now in UAE there is 8 banks that operate as Islamic banks. Saudi Arabia is pioneer of Islamic banking but when it comes the expansion United Arab Emirates are lead country. Moreover, both Islamic and secular banks have the biggest assets of Saudi Arabia and best amongst Gulf Cooperation Council States (GCCs) Arab countries level. In Saudi Arabia traditional and Islamic banks operate side by side for the sake of optimizing benefit, the Arab industry. Fast technological changes and globalization had a positive impact on the banks size and its needs to finance different industries. The present study discusses both internal and external factors leading to the viability of Islamic banks in the area of Saudi Arabia and UAE in the period between 2013 and 2019. In determining the viability of Islamic banks, banking characteristics, industry characteristics and macroeconomic variables are significant. Empirical findings show that both indicators of profitability reflect the solid financial position of UAE and Saudi banks. In addition, the study highlights optimal bank policies that help policymakers, bank managers and managers boost overall performance and sustain sound profitability in Islamic banks in Saudi Arabia and UAE.

LITERATURE REVIEW

Islamic banking today is not a new phenomenon and with all its features it is tightly related to sustainable economic development show in their research (Osmanovic et al., 2020). Countries of Middle East represents heart of Islam and hence they are one of the strongest with Islamic finance industry including Islamic insurance and Islamic bonds or sukuk.

When we talk about the profitability of Islamic banks, in the literature we can find two ways of measurements: profitability of Islamic banks or comparison with conventional banks. One of the most important factors for the profitability of Islamic banks is environment. If the environment is not supporting the Islamic banking system what is the case of some countries, the banks will not be profitable. Bashir and Hassan (2004), study the economic condition and its impact on the profitability of Islamic banks. He concluded that good economic condition has a positive impact on the Islamic banks' profitability.

Al-Kayed et al. (2014) in his research observed 85 Islamic banks and investigated the impact of capital structures on Islamic banks. He came to know with results that there is positive relationship between Islamic banks and profitability. Similar research has been done by Zarrouk (2014) he investigated the impact of financial crisis on 43 banks of MENA countries. His research shows that Islamic banks in GCC seems to be less profitable compared to the rest of MENA countries. Financial crisis had a negative impact on the profitability of Islamic banks in GCC. Kader and Asarpota (2007) in their research compared performance of Islamic and conventional banks in the United Arab Emirates. According to the results of the research Islamic banks show more profitability, they were less liquid and more efficient.

Moin (2008) conducted research about profitability, liquidity, risk, and efficiency for the period of 2003-2007 between Islamic bank in Pakistan that is Meezan Bank Limited (MBL) and five conventional banks. His results show that Islamic bank is less profitable compare to conventional banks. Further in his research he found that Islamic bank is less risky than conventional banks.

Parashar and Venkatesh (2010) examined the performance of Islamic and conventional banks in GCC countries in the period of from 2006 to 2009. They conducted ratios analysis and concluded that financial crisis had more impact on Islamic banks taking capital ratio, leverage, and return on average equity, and conventional banks was affected more in terms of return on average assets and profitability.

Ferhi and Chkoudali (2015) in their comparative study between Islamic banks and conventional banks in MENA region in the period of 2007-2010, revealed the results that Islamic banks showed more stability in terms of profit efficiency results compared to the conventional banks. Ahmed and Khababa (1999) conducted the research about the banking sector determinants in Saudi Arabia. They used the percentage of change in earnings per share, ROE and ROA in order to show the profitability of the banks. The research shows that the main determinants of banks in KSA are business risk and the size of the banks.

Kocherlakota (1998) in his research investigated money with a constraint cash in advance, he released that zero nominal interest are very much important if we need the optimal allocation of resources. If that is the case, where interest rate is zero, investors will try to manage real resources with a money or cash, and it will boost investment. In this way, Islamic banks will operate based on Islamic modes of financing, like Musharaka, Mudaraba or Murabaha. All this will lead to increase profitability of Islamic banks.

Zaki (2012) in his research investigated determinants of the UAE's financial market and measured the impact of government bailouts of United Arab Emirates in its Economy. UAE government protected the banks who were in the loss through government activity. He concluded that there was significant development in the banking sector in UAE, and Islamic banks shows noticeable profitability.

Loghod (2008) investigated the performance of Islamic banks compared to the conventional in the period from 2000 - 2005. His results show that there is no significant difference in the way of profitability both conventional and Islamic banks. His finding shows that Islamic banks has less chance to be impacted by liquidity risk while conventional banks depend more on external liabilities then Islamic banks.

ISLAMIC BANKING IN UAE AND KSA FOLLOWED BY PLS MODEL

During last years in MENA region Islamic banking has been growing rapidly, Osmanovic and Stojanovic (2019). The main impact on the growth of Islamic banking was a fast increase in the price of oil of these countries and it has a positive impact on wealth of the nation through their salaries and income per capita. Nation saving capacity resulted in the development of the modern Islamic banking and its profitability. Modern banking follows the theory of traditional interest. The theory of free interest is based on Islamic banking and Profit-and - Loss (PLS) output distribution theory. Islamic finance in theory varies considerably from traditional finance. Sharia-compliant banking, in fact does not allow interest rates to be paid. Although the price is permissible only for goods and services, does not encourage speculation and forbids precise financing operations. This indicates strong funding gaps Islamic and secular banks' operation systems. Many countries in the world are seeing what has happened known as dual banking, in which banks are free of interest using traditional banks side by side. Like every other traditional, this bank performs regular business, but the bank is not investing or collecting interest. It acts on it Principles of profit-sharing under Islamic rule (known as Shariah), barring any sort of involvement transaction. The Dubai Islamic Bank was founded the formation of a large number of banks followed working on the same in different parts of the world principles. The UAE as a key region of the GCC is explained by the experience of these countries. A large growth rate of the number of banks Global financial reserves compliant with Shariah, and decent financial stability leads to boost banking sector of UAE.

The government of Saudi Arabia does not levy tax payments on local citizens and national corporations. Banking system of Saudi Arabia is monitored by Saudi Arabian Monetary Agency, SAMA, that is established 1952. Saudi Central Bank is monitored by the law of SAMA. With the fast growth of the oil sector in 1970s banking sector of Saudi Arabia shows more expansion. Nowadays banking sector of Saudi Arabia represents the largest market for Islamic finance when it comes to the size of assets, concluded in his research Melaty (2008). Instead of zakat is a discretionary duty that is to be withheld from dividends of shareholders. Thereby, Zakat does not tax nor is excluded from the combined financial statement of profits Gross dividend paid or charged as an appropriation of net profits to shareholders revenue without allocation of a dividend (NCB Financial Report 2009). On the other side, joint International bank projects must pay both zakat and taxes on an undisclosed capital budget.

According to Kamco-Invest, profitability and top lines of Islamic banks are projected to be reduced in the KSA and UAE relative to traditional lenders in the country. In its latest study the UAE-based institution said that the rise in the reserves and deposits of Islamic banks was roughly 8 per cent in 2019 vs. 2018, compared to 10 per cent in conventional banks. "In the short term, the downturn in economic activity led by Covid-19 would influence traditional banks more in terms of growth rates than Islamic banks. In comparison, the earnings of Islamic banks are projected to be less than traditional banks based on their higher loan-to - deposit relationships.

This refers to Saudi Arabia, which use deposits far more than the UAE banks, which have a higher ratio to traditional banking. In addition, the loan-to - deposit ratio of the GCC-based banks is considerably conservative in relation to global levels at the overall regional level. This allows them the opportunity to provide extra buffers to cope with tension in the industry in times of crisis. Stressing that the Gulf Islamic banks continue in many indicators to outweigh their traditional peers, the Shariah-based banks in Saudi Arabia has a higher asset use, with loans-to-deposit ratios greater than conventional banks. The profitability of Islamic banks in the area also reflected a higher loan-to - deposit ratio. As regards total lending operation in the country, the Covid-19 pandemic will impact both traditional and Islamic banks. In other words, the extent of influence will be determined by the performance of the individual banks. In addition to the pandemic, it was said that traditional banks will be more dominant than Islamic lenders as regards growth rates than GCC banks in a comparatively stronger position to withstand the short-term effect of the Covid-19 because of the enough capital and liquidity buffer. It was reported that the (regional) banking industry would play a key role in the recovery from this crisis and would benefit from the expanded presence of the private sector in the overall economy. In the first quarter of this year, GCC banking posted healthy lending growth, as Covid-19's economic effects were felt close to the end of the quarter.

Islamic lenders have retained good income in all GCC participants thanks to low borrowing costs and marginally increased in 2017, due to higher prices and good cost controls.

OPERATING PROCESSES FOR P/L OF GCC BANKS

In describing Islamic banks operating procedures of UAE and KSA Islamic banks, the theoretical models of Islamic banking focused attention to the rules regulating the profit-sharing relationships between banks and deposit holders and between banks and banks' customers. Equity and Mudarabah deposits were considered in earlier models to be the Islamic bank's only two payable liabilities and the holders of Mudarabah deposits to be regarded as one homogeneous group. In the following directions, the benefit share agreements were envisaged between the two large capital groupings. It shall split the bank's aggregate benefit from the overall money concluded Ariff (2012). After such a split, the Bank will keep a negotiated share of the benefit, and holders of Mudarabah deposits will receive the remainder. In the shared consensus of the parties involved, the share of the benefit portion is decided.

The loss shall be shared by the two parties in strict proportion to the money given by each party if the bank experiences a loss. The overall amount of loss suffered in a loss scenario for a holder of the Mudarabah deposit is restricted to the amount of its investment. Later contributions in Islamic banking literature accept that agreements for benefit sharing within an Islamic bank's payable liabilities might take different forms and stay within the Shari'ah parameter. It was thought that versatility in benefit share percentages was highly justified based on the amount of liability at which different forms of financial liabilities were subjected according to Al-Arabi (2016).

In the profit-sharing agreements, the Mudarabah deposits of longer maturity might be reduced to deposits of shorter maturity. Likewise, the allocation of a higher return to the non-returnable equity supplier may be distinguished from the non-returnable capital provider. With regards to the arrangements for profit-sharing between the bank and bank fund users, Muslim banking models adhere to the basic concept developed in the Shari'ah that the income from the Mudarabah company will be divided between the money supplier (the bank) and the bank fund user on the pre-settled basis of proportions. For any entity, no set fee should be charged. The supplier of funds shall accept damage, if any, unless the recipient of the bank funds has incurred error or breach of the terms of the contract. For the purpose of a profit / loss share in Musharakah market, a common denomination would be rendered by a multiplication of sums by the number of days in which each component, such as a company's equity capital, its current cash surpluses, the suppliers and the bank's funding, would be the capital commitment of the parties used for different purposes. Profit / loss sharing has been the core feature of almost all previously established Islamic banking models. Some researchers show that production of credit cannot be used by Islamic banks. They claim that making loans makes it possible for banks to produce unwarranted income that exploit a small community. There are those who see no objection to Islamic banks providing credit and think that it is necessary to find ways to guarantee a fair sharing of the profits from complete banking operations. For some researchers it is important that small, localized entities operate in the Islamic spirit for the Islamic banks.

Islamic banks should be compelled to share some of their demand deposits for the government to offer interest-free lends to support projects of social value that cannot obtain the required funds on a profit-sharing basis. As the funds made available to a bank through demand deposits are held by the public and banks do not refund those deposits, part of them can be used to serve the government's financial needs. It was also proposed that a portion of the demand deposits could be used to provide interest-free loans to satisfy the real needs of people's consumption in both the countries (KSA and UAE). Others claim that the central bank of the country should offer interest-free lending to the government rather than exchange banks.

RESEARCH METHODOLOGY

The paper shows how using the Sharia's-compliant financing impact the level of profit of Islamic banks. Paper shows the analysis of conventional and Islamic banks in UAE and KSA and its realized profit in these two countries. In order to see which sector is more profitable to invest, we used a quantitative method of linear regression in two steps. To examine the effect of bank investment on the profitability we applied linear regression analysis.

Paper uses the data from secondary sources of UAE and KSA in the interval period from 2013 until 2019 and apply OLS multiple regression analysis. In order to test research hypotheses, we set up our linear regression model used within both steps for overall and partial regression analyses:

$$Y_{(a;\, a1)} = \alpha + \beta_1(X_1) + \beta_2(X_2) + \beta_3(X_3) + \beta_4(X_4) + \beta_5(X_5) + \beta_6(X_6) + \beta_7(X_7)$$

Table 1: Research variables

Independent variable	
$Y_{(a;\, a1)}$	profit in full regression; profit in partial regression
Dependent variables value (or percentage) of Sharia's-compliant financing by economic activity	
X_1	agriculture forestry hunting and fishing
X_2	manufacturing
X_3	construction
X_4	wholesale and retail trade
X_5	financial and insurance activities
X_6	financial and insurance activities
X_7	real estate activities

Source: Own survey.

RESULTS OF THE RESEARCH

During the research, two countries were observed, Table 1 presents the ratio of Islamic and conventional banks operating in these countries.

Table 2: Islamic and conventional banks in UAE and KSA

Country	Islamic banks	Conventional banks	Total
UAE	8	41	49
KSA	4	20	24

Source: Own survey.

Islamic finance operations in UAE and KSA will be monitored by the profit. In the Table 2 it can be seen the data movement of profit in the period of the fourth quarter of 2013 to the third quarter of 2019. By the realized profit observation, it can be seen that the highest realized average profit are having banks in Saudi Arabia (with the mean = 11022.79), while the lowest realized average profit have banks in UAE (mean = 9215.38).The largest total profit in the individual observation period came by Islamic banks operating in the UAE (max. 18333.90). The value of the standard deviation shows the dispersion of the realization of average incomes in the observed countries. The highest observed dispersion in realized revenues shows Islamic banks operating in UAE (St. Dev. = 3934.58), while the smallest dispersion is with Islamic banks in KSA (St. Dev. = 2179.19).

Table 3: Descriptive analysis of realized profit

Country	Realized Profit							
	Mean	St. dev.	Min	Max	Mean	St. dev.	Min	Max
KSA	11022.79	2179.19	4692.40	15268.00	17406.41	9731.28	10132.00	35684.00
UAE	9215.38	3934.58	3869.90	18333.90	15037.95	3397.52	10754.20	25423.00

Source: Own survey.

Research shows how investing in different economic activity will impact the profit. Hence, the variable realized profit is dependent variables in this model. The activities listed in the models of multiple regression analysis were taken as independent variables. During testing the first hypothesis of this research, the realized profit was taken as a dependent variable. The test results of this hypothesis showed that there is a positive impact that the observed activities have on the movement of realized profits (F (test) = 41.499, sig. = .000). The model explained 76.70% of the dependent variable, which shows the coefficient of determination (R2 = .767). There is large correlation of the observed variables and shows the coefficient of multiple correlation (R = .876).

Results of the research shows that investing in these activities affects the realization of profits. For manufacturing sector (Beta = .925, t-test = 6.329, p = .000), financial and insurance activities (Beta = .385, t-test = 3.745, p = .000) and agriculture forestry hunting and fishing sector (Beta = .287, t-test = 3.170, p = .002) there is a positive influence on the direction of the regression function. These activities contribute to the growth of the realized profit. However, this is not the case for all activities. In the construction activity, there is a significant negative impact on the direction of regression analysis (Beta = -.639, t-test = -3.743, sig. = .000). By investing in this industrial activity, banks have negative effect on the realized profits. In addition to this, the activity of mining and quarrying (Beta = -.155, t-test = -1.889, sig. = .062), and wholesale and retail trade (Beta = -.012, t-test = -.080, sig. = .937), but in these activities there is no significant statistical impact on the increase in the profit.

Table 4: Regression analysis - testing the impacts of industrial sector on the profit

Model Summary: R = .876, R^2 = .767, Adjusted R^2 = .749, F(test) = 41.499, sig. = .000			
	Beta	t-test	Sig.
Agriculture forestry hunting and fishing	**.287**	**3.170**	**.002**
Mining and quarrying	-.155	-1.889	.062
Manufacturing	**.925**	**6.329**	**.000**
Construction	**-.639**	**-3.743**	**.000**
Wholesale and retail trade	-.012	-.080	.937
Financial and insurance activities	**.385**	**3.745**	**.000**

Real estate activities	.082	.922	.359

Source: Own survey.

In order to examine the impact that these economic activities have on the realized profits, a partial analysis of this impact will be performed for each country individually. Observing the results of Islamic banks operating in UAE, it can be noticed that there is a significant impact of these activities on the realized profits (F (test) = 74.563, sig. = .000). In two sectors of the economy there is a significant negative impact on the direction of the regression function in mining and quarrying (Beta = -.163, t-test = -3.264, p = .004) where the real estate activities has (Beta =.276, t-test = -5.433, p = .000), we could see that there is significant negative influence on the direction of the regression function. In two other sectors, agriculture forestry hunting and fishing (Beta = .535, t-test = 2.213, p = .038) and wholesale and retail trade (Beta = .110, t-test = 1.973, p = .61) there is a positive impact on the direction of the regression function. Partial results for Islamic banks in Saudi Arabia show that there is a significant impact of the observed sectors of the economy on the realized profits (F (test) = 4.544, sig. = .006). In two sectors there is a significant impact on the direction of the regression function, namely in the sector of agriculture forestry hunting and fishing (Beta = 1,069, t-test = 4,094, p = .001) where there is a positive significant impact on the direction of the regression function and in the wholesale and retail trade (Beta = -1.223, t-test = -2.337, p = .033) in which there is a negative influence on the direction of the regression function. The specificity for this country is that there are more negative effects than the positive effects of the sector on the direction of the regression function.

The results obtained for studying the impact of the observed sectors of the economy on the realized profits of Islamic banks in the UAE show that there is a significant impact of these sectors (F (test) = 74,563, sig. = .000). It is this impact that is strongest in relation to other observed countries. In six sectors there is a significant impact on the direction of the regression function, namely in the sectors of agriculture forestry hunting and fishing (Beta = .535, t-test = 2.213, p = .038), manufacturing (Beta = .733, t-test = 3.586, p = .002), construction (Beta = .125, t-test = 2.177, p = .041), financial and insurance activities (Beta = .309, t-test = 2.351, p = .028) and real estate activities (Beta = .276, t-test = 5.433, p = .000) where there is a significant positive impact on the direction of the regression function and the mining and quarrying sector (Beta = -.163, t-test = -3.264, p = .004) in which there is a significant negative impact on the direction of the regression function.

Table 5: Partial Regression Analysis - Examining the impacts of industrial sector on the Profit

Country	KSA			UAE		
Industry	Beta	T-test	Sig.	Beta	T-test	Sig.
Agriculture, forestry hunting and fishing	**1.069**	**4.094**	**.001**	**.535**	**2.213**	**.038**
Mining and quarrying	-.358	- 1.248	.230	**- .163**	**- 3.264**	**.004**
Manufacturing	.507	.350	.731	**.733**	**3.586**	**.002**

Construction	1.442	1.088	.293	**.125**	**2.177**	**.041**
Wholesale and retail trade	**-1.223**	**-2.337**	**.033**	.110	1.973	.061
Financial and insurance activities	-.302	-1.506	.151	**.309**	**2.351**	**.028**
Real estate activities	-.280	-.657	.520	**.276**	**5.433**	**.000**
Model Summary:	F(test) = 4.544, sig. = .006			F(test) = 74.563, sig. = .000		

Source: Own survey.

After the testing hypothesis of this study, research shows observation of the individual impact of the economic sector on the direction of the regression function in three sectors, there is a significant statistical impact on the direction of the regression function, namely: construction (Beta = .522, t-test = 3.478, p = .001) and real estate activities (Beta = .478 , t-test = 6.118, p = .000) in which there is a positive significant impact on the direction of the regression function and the sector of financial and insurance activities (Beta = -.185, t-test = -2.045, p = .044) which negatively significantly affects the direction of the regression function.

CONCLUSION

In the MENA region we can see very fast development of Islamic finance industry today. This development can be seen in United Arab Emirates and Kingdom of Saudi Arabia. Very fast increase in the oil price since 1970's impacted nation saving and big rise in per capita income, what led the high increase of the development of banking sector, particularly in GCC countries. Followed by the development of Islamic finance sector. Islamic investors are very much encouraged to invest in different industrial sectors and to get profit allowed by Islamic way of financing. Islamic finance is based on a basic rule that forbids trading present at the premium for future capital. This essentially removes debt servicing, although it does not preclude the availability of voluntary interest-free loans. Financing is given in exchange for equal or share rights in negotiated benefit proportions by equity or profit and loss sharing (PLS). It is also supplied in exchange for the obligation to refund the valuation and its usufruct later via the sales and leasing of properties. It is also toward an obligation to import or produce products. The paper shows in which way investing in different activities effect profitability of Islamic financing. The highest investment diversification is greatest in the United Arab Emirates, while in Saudi Arabia research shows different way of profitability that is impact of Sharia's-compliant financing.

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