Impact of Financing Modes on The Financial Performance of The Islamic Banking System in Pakistan

Salman Ali
MS Scholar, CUSIT Peshawar Pakistan
salman.ali@bok.com.pk

Dr. Muhammad Asif
Associate Professor, Business Studies Department
Bahria University Karachi Campus
drasifbaloch78@gmail.com

&

Ms. Saba Gul
Lecturer, Management Sciences Department, CUSIT Peshawar Pakistan

Abstract

The purpose of this research was to observe the impact of financing modes of Islamic Banks on their financial performance i.e. Return on Assets, Return on Equity, and Default Ratio. Secondarydata was collected from the annual financial statements of selected full-fledged Islamic Banks of Pakistan for the last 10 years from 2011 to 2020. Aside, SBP Policy rates from 2011- 2020, have also been included as a control variable. The logic behind the selection of this period was that the first decade from 2000-2010, is considered the development phase for Islamic Banks whereas during the selected period Islamic Banks have grown into independent institutions and captured handsome market share both in terms of amount & branch network. Accordingly, the variables were tested using Generalized Least Square Regression Analysis (Random and Fixed Effect Model) and the results are presented. According to the findings of this research, Murabahah (MF), Istisna (ISF), and Private Sukuk (PS), are having significantly positive impact on Return on Assets (ROA) and Return on Equity (ROE) while Istisna and Private Sukuk financings are having a significantly negative impact on Default Ratio which suggest that increase in both these financing are causes no increase in default. These findings have led to the recommendations that above said financing modes are having a significantly favorable impact on the financial performance of Islamic Banks. Therefore, the management of Islamic Banks needs to prioritize their investment towards Murabahah, Istisna, and Private Sukuk, as they are yielding better results which will contributes more towards their financial performance and ultimately towards the economy.

Keywords: Islamic Financing Modes, Financial Performance, Murabahah, Diminishing Musharakah, Running Musharakah, Ijara, Salam, Istisna, Sukuk.

INTRODUCTION

One of the five questions Muslims will be asked on Judgment Day will be: “How did you earn your wealth and how did you spend it” (Al-tirmidhi, 864/5). This forces the Muslims to generate income from Halal sources and spend it on Halal categories of expenditures. Islam is a religion that provides a complete way of life and does not restrain man from earning money & doing business rather it spiritualizes all aspects of human life whether it is social, political, economic, etc. while remaining within the divine guidelines that are generated from primary sources (Quran, Sunnah, & Hadith) and secondary sources (Ijama'a & Qiyas). The above sources of Sharia'ah guidelines provide practical and viable solutions to human economic problems. Islamic economic system works under divine guidelines which include the creation & spending of wealth in a manner that is not only beneficial to individuals but society as a whole (Ayub, 2016). Unlike other economic systems (capitalism and socialism), Islamic Economic System provides a balance solution to human needs as on one hand, it associates the concept of profit and loss sharing with capital instead of interest, while on the other hand, being secondary ownership conferred upon man, he is also guided regarding earnings & spending of wealth, which ultimately brings social welfare & justice to the society (Khan, 2016).

Historical Background of Islamic Banking

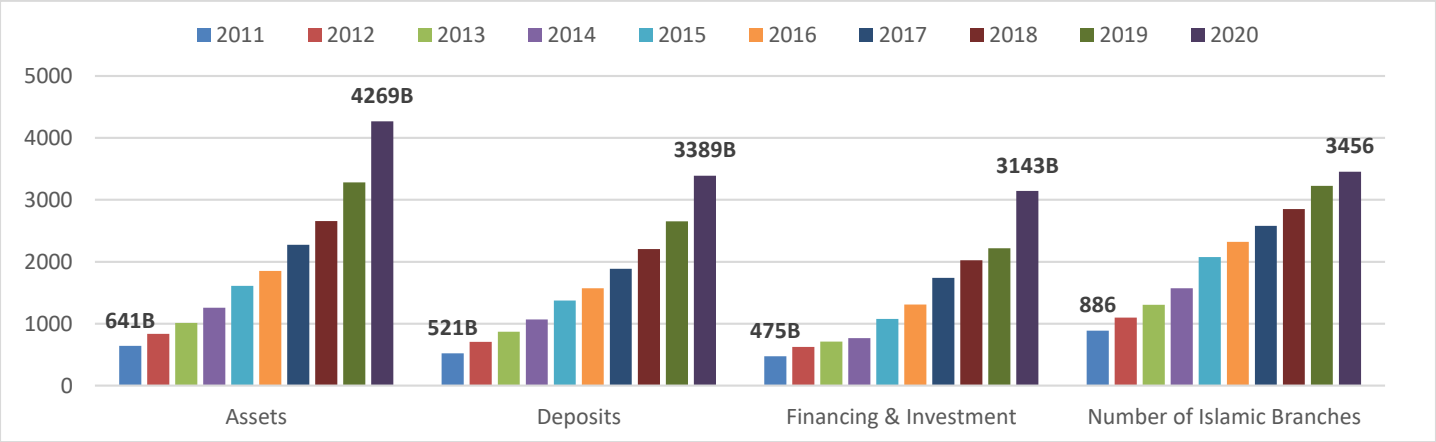
Although, the concept of Islamic economics emerged with the rise of Islam and doctrine of prohibition of interest, however, the formation of modern-day Islamic banking was a reaction to penetration of western banks in Islamic societies which disturbed the Muslim intellectuals due to the involvement of riba who opposed such banking and advised Muslims to stay away from such practices (Shinsuke, 2012).

In the middle of the 20th century, the Muslim intellectuals started looking for an alternative system as it was nearly impossible for traders to stay away from the banking system. The foundation of modern Islamic Banking was laid by "Mit-Ghamr" in Egypt in 1960 which started mobilizing deposits from Muslims based on profit sharing basis. In 1963, another financial institution was established in Malaysia to help Muslims save money for Hajj (pilgrimage), which is known as Lembaga Urusan Tabung Haji (Pilgrim Management & Fund Corporation). Both these non-banking institutions paved way for the establishment of Dubai Islamic Bank in 1975, Faisal Islamic Bank in Sudan and Kuwait Finance House in 1977. Since then several Islamic countries like Iran, Pakistan, Turkey, etc. started efforts for establishing Islamic Banks. Alongside, efforts for the development of unified financial and legal infrastructure were also made which ultimately resulted in the establishment of AAOIFI (Accounting & Auditing Organization for Islamic Financial Institutions) in 1991 in Bahrain (Hussein, 2015). Besides, in 2002 in Malaysia Islamic Financial Service Board (IFSB) was also established which is responsible for issuing regulatory and supervisory guidelines. As a result of such efforts, Islamic banking also flourished in the western world like Citi Islamic Investment Bank & Al-Rayan Bank in the UK, Lariba American Finance House in the US, Arab Bank (Switzerland), MCC Islamic Finance & Investment in Australia, Kuveyt Turk Islamic Bank Germany (Zainordin, 2016). The journey towards the development of a sustainable Islamic Financial Industry continued over the period and as of December 2020, there are 507 Islamic Banks including 207 Islamic Banking Windows and around 250 Mutual Fund & Takaful companies. The total assets of the global Islamic Financial Industry have grown to $ 2.700 Trillion by the end of 2020, posting a healthy growth rate of 10.7% over the previous year (IFSB, 2021).

History of Islamic Banking in Pakistan

In Pakistan efforts for the elimination of riba from the economy and Islamization of the banking system started in 1977-78. In July 1979, Islamization were initiated in specialized financial institutions like HBFC, ICP & NIT, followed by commercial banks, whereby, Mudarbah based interest-free instrument in the shape of Participation Term Certificates (PTC) were introduced, on the concept of Profit & Loss sharing. The funds so mobilized were invested in commodity operations of the government based on deferred sale bearing mark-up on the purchase price. Later on, financing for import bills and purchases of merchandise were also transferred to mark-up on purchase price. In July 1982, SBP allowed banks to provide finances for working capital requirements of selective industries based on Musharaka. In July 1985, all banks were directed to accept deposits only on a profit & loss sharing basis. However, all these efforts suffered a huge blow when it was pronounced as un-Islamic by Federal Shariat Court in November 1991, duly ratified by Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan, on December 23, 1999. Subsequently, the Government constituted Commission for Transformation of Financial System (CTFS) in January 2000 in SBP. Upon the recommendations of the CTFS, SBP started allowing setting-up Shariah based subsidiaries, designating Islamic banking branches and full-fledged Islamic banks. The CTFS identified major Shariah-Compliant products, model agreements and guidelines for conversion of existing conventional products and services (Ijaz, 2013). The Commission further identified different modes of Islamic financing such as Mudarabah, Murabaha, Ijara, Musharakah, Istisna, Salam, Musawama, etc. which was approved by the then Shariah Board (Ijaz, 2013). There is no doubt that the main sources of income in a bank comes from financing sources (Alzoubi,2018), yet, the investment preferences in each mode differ from one bank to another. In line with these studies, this research is aimed to analyze the impact of Islamic modes of financing on financial performance like Return On Assets (ROA), Return On Equity (ROE) and Default Ratio (DR) of full-fledged Islamic Bank in Pakistan. Since its start in 2000, Islamic Banking in Pakistan faced many challenges, yet, it has witnessed notable growth in all aspects and now we have a much more developed and improved version of Islamic Banking, though, it still needs to overcome certain drawbacks. Currently Islamic Banking represents 17% market share in the overall Banking Industry of Pakistan, in terms of assets and 18.4% in terms of deposits (SBP, Islamic Banking Bulletin, April - June 2021). As of date there are 22 IBIs in Pakistan out of which 05 are full-fledged Islamic Banks while 17 Conventional Banks are having standalone Islamic Banking setups (SBP, Islamic Banking Bulletin, April - June 2021). The below figure shows the growth of IB during the last 10 years.

Progress & Growth of Islamic Banking (Last 10 Years)



Research Gap

Since inception of Islamic banking its performance has remained the main research study of scholars & academicians interested in Islamic Banking. Considerable researches have been conducted on financial performance of Islamic Banks in the last two decades especially in Malaysia, Indonesia, Egypt, Kenya and other MENA countries. In Pakistan, however, most of the research studies are based on comparison of financial performance of Islamic and Conventional banking. (Asif et al., 2017; Journal et al., 2016; Khan & Ahmad, 2018; Moalim & Nairobi, 2015). A very small number of studies can be found which have studied the impact of Islamic modes of financing on the Financial Performance of Islamic Banks. Most of these studies have undertaken one mode of finance as study variable (Belkhaoui, Alsagr, & van Hemmen, 2020; Boyante, 2014; Ijaz, 1999). Others have analyzed financial performance of Banks with external factors like GDP, Inflation Rate and Unemployment (Anwar, 2018)

Therefore, there is a need to conduct such a study which not only consider Bank's internal factors but also take into account all the available Islamic modes of financing to explain their impact on the financial performance of Islamic banks like ROA, ROE & DR.

Research Questions

Based on the above discussion and to meet the research objective; an in-depth analysis of the research variables have been conducted to answer the following research question:

1. What is the impact of modes of financing on the financial performance (ROA, ROE, DR) of Islamic banks?
2. What are the preferences of Islamic Banks on the basis of their offering / financing?

Research Objectives

The main objectives of this research are to analyze the following:

1. To analyze the Islamic Modes of financing of Islamic Banks.
2. To find out the impact of each financing mode on the financial performance of Islamic Banks.

Significance of the Study

Since there is little research regarding the financial performance of Islamic Banks relative to financing modes, therefore, various groups can benefit from its findings. First, this study will be useful for scholars/researchers of finance interested in Islamic Banking. Second, these findings are helpful to the Management & employees of Islamic Banks in identifying which financing product is yielding better results. Third, this research can be of great help to customers as it will enable them to make informed decisions while choosing Islamic banks based on their performance.

Research Hypotheses

H_1 = Murabahah Finance has a significant positive or negative impact on ROA, ROE & DR.
H2 = Ijara Finance has a significant positive or negative impact on ROA, ROE & DR.
H3 = Running Musharkah has a significant positive or negative impact on ROA, ROE & DR.
H4 = Diminishing Musharka has a significant positive or negative impact ROA, ROE & DR.
H5 = Istisna Finance has a significant positive or negative impact on ROA, ROE & DR.
H6 = Salam Finance has a significant positive or negative impact on ROA, ROE & DR.
H7 = GOP Sukuk Finance has a significant positive or negative impact on ROA, ROE & DR.
H8 = Private Sukuk has a significant positive or negative impact on ROA, ROE & DR.

Literature Review

The basic rules and guidelines for Islamic Banking are derived from the primary source of Shari'ah i.e. Quran and Sunnah and secondary sources i.e. Qiyas, Ijma and Ijtihad, etc. Islamic Banking has to function based on certain principles while remaining within the Shari'ah guidelines and by disallowing interest, gharar, maysir as well as other unethical activities (Zainordin, 2016). Islam strictly disallows paying or charging of interest between parties as narrated in the following verses (2:278-279) of the Quran:

"278. O ye believe; Fears Allah and give up what remains of your demand for usury, if ye are Indeed believers".

"279. If ye do not, take notice of war from Allah and His Messenger: but if ye turn back, ye shall have your capital sums; Deal not unjustly and ye shall not be dealt with unjustly".

Similarly, the Prophet (PBUH) also denounced riba (interest) through various Hadiths such as Ibn-e-Masood (mAbpwh), narrated that,

"The Messenger of Allah (Peace Be Upon Him) has cursed the one who devours Riba (interest), the one who pays it, the one who witnesses it, and the one who documents it".

In addition to interest, Islam also disallows anything that allows gharar, maysir etc. (El-Gamal,2000). For example, Abu-Said Al-Khudry (mAbpwh) narrated that,

"The Prophet (Peace Be Upon Him) has prohibited the purchase of an unborn animal in its mother's womb, the sale of milk in udder without measurement, the purchase of spoils of war before its distribution, the purchase of charities before its receipt and the purchase of the catch of a diver".

In line with the above revelations, Islamic Banks cannot engage in such activities that are declared "Haraam" by Islam such as the trading of alcohol, tobacco, pork meat, or investment in constructions of casinos (Kasmani, 2013). Islamic banking is based on risk-sharing culture, which creates a nexus of the real economy with the financial sector and helps in just redistribution of wealth to eliminate imbalances (Ayub M. , 2017). (Possumah and Ahmat 2018) concluded that in Malaysia the overall efficiency of Islamic Banks has increased over time. (Mokhtar, 2008) argued that full-fledged Islamic Banks were more efficient than Islamic windows, however, comparatively conventional banks were more efficient in terms of performance than Islamic Banks.

(Belkhaoui *et al*. 2020) studied the internal factors of Islamic & Conventional Banks profitability by selecting 68 Banks (42 Islamic & 26 Conventional) from 13 MENA countries and proved that bank size, deposit to assets, equity to assets, and cash to assets contribute more to Islamic Banks profitability compared to conventional banks. Another study in Bangladesh founds that credit risk, cost efficiency and higher capitalization have significantly negative while bank size have a robust positive impact on Bank's profitability (Noman, 2015). In another study, scholars checked the impact of Islamic financing modes on economic growth and proved that except for Mudarbah all other financing modes like Ijara, Istisna, Musharakah, Murabaha, were having a significantly positive relationship with GDP (Bakhita, 2017).

Nonetheless, the profitability and efficiency of banks mainly depend upon investment strategies. There are mainly three types of investors such as a conservative investor, moderate investor, and aggressive investor (Kavitha, 2015). The same is the case with Islamic Banks in Pakistan wherein some Banks uses comparatively aggressive investment strategies while other remain moderate or conservative keeping in view their risk-return approach.

Various researches regarding factors affecting investment decisions have been conducted so far, like (Bakara, 2016) investigated the impact of psychological factors on investment decision in Malaysian stock market: "A case of Klang Valley and Pahang". Faruq (2014) analyzed the perception of bankers and customers regarding deposit and investment mechanism of Islamic and Conventional Banking in Bangladesh. Besides, (Roshayani Arshad, 2012) found a significant positive relationship of Corporate Social Responsibility with the financial performance of IslamicBanks. Similarly, Boyant (2014) analyzed the effect of Islamic modes of financing on the profitability ofcommercial banks in Kenya, wherein, he found a strong relationship between Islamic Modes of Financing and Return on Asset (ROA). However, this study also combined the investment of each financing of all the selected banks, and accordingly, its impact has been analyzed on the overall profitability.

On the national front, a number of researches have also been conducted, however, most of these researchers have considered only one aspect of Islamic modes of financing. For example, Sabir (2008), conducted research on the prospects of Ijarah and lease financing in the banking sector of Pakistan from 2005 to 2008, for which data were collected from four banks (Askari commercial bank, Bank Alfalah, Standard Chartered, and Muslim Commercial bank) by covering both their Conventional as well as Islamic banking. It was found that Ijara financing was progressively rising due to the interest-free-mode of financing as compared to conventional leasefinancing.

Javed (2011) investigated the impact of internal factors, assets, loans, equity, and deposit on a Bank's profitability in Pakistan over a period from 2004 to 2008 and found that deposits, equity and loans have a significant impact on the profitability of Banks while assets have an insignificant impact on performance. Khan (2014) found that Bank's internal factors have significant impact on profitability of Islamic Banks. Samad (2004) found that Islamic Banks have a comparatively higher level of liquidity and higher investment in government securities due to Shari'ah restrictions on some of the investment avenues.

Naqvi (2014) also researched the analysis of Growth of Ijara in Pakistan by selecting Meezan Bank as a case study, wherein she proved that there is a strong relationship between Deposit & Share Capital and Ijara investment. Khan (2018) have investigated the financial performance of five Islamic and five conventional banks by comparing their financial ratios and found that Islamic banks are less profitable, less risky, less efficient but more liquid compared to conventional banks. Ongore (2013) founds that Bank's specific factors have a strong relationship with financial performance as compared to other factors like inflation, GDP, unemployment, etc. in Kenya.

Rehman (2020), founds that there is significantly negative relationship between CSR and financial performance of Islamic Banks during the period 2012-2017. Majeed (2017), proved that Islamic Banks are less profitable than conventional banks but better capitalized, less risky and have higher liquidity.

From the above discussion it seems that, besides, limitation either on one aspect or the other, the geographical areas of most of these researches were outside Pakistan. Whereas in Pakistan most of the researchers have analyzed the relationship of overall profitability with overall investment while, some of them (Gul, 2011) have studied the relationship of overall financial performance with external factors like macroeconomic indicators.

Thus, this research will help a great deal in fulfilling the gap and answering the above questions, besides, it will help to open new avenues for researchers in the field of Islamic banking. In addition to its importance for academicians, this research will be extremely helpful to specialized bankers in devising their investment strategies which will ultimately increase the performance of their institutions.

Islamic Modes of Financing

To have a viable Islamic banking system, a different product-base has been developed by Ulemas & Shari'ah scholars both on deposit as well as financing sides which are based on participation, trade and Ijara (lease) (Anwar, 2018). Following are some of the major financing modes used by Islamic Banks across the world:

Murabahah Finance

Sale transaction wherein the seller agrees with the purchaser for selling a specific commodity by disclosing the actual cost plus profit, is called Murabahah (Usmani, 1998). In banking Murabaha, the Bank upon customer's request, acquires an asset and after assuming its ownership and possession, sells it to the customer on a cost-plus-

profit deferred payment (Khan, 2016).

Ijara Finance

Ijara is the word of Islamic Fiqhah, which means giving something on rent. An agreement wherein the Bank purchases an asset and gives its usufruct to the customer in exchange for rent. The lessor is called "Muajjir", the lessee "Mustajir" and rent is called "ujrah" (Usmani, 1998).

Running Musharakah

An agreement wherein the bank participates in operating activities of customer's business and shares the profit & loss (Usmani, 1998). This financing mode is mainly used to finance identified primary operative activities of the customer based on the principles of Musharkah.

Diminishing Musharakah

In this financing mode the Islamic Bank & the customer participates in joint ownership of a property / asset, which is divided into units. The joint asset is then rented-out to the customer for usufruct who undertakes to purchase proportionate share of the Bank along-with payment of rental for use of the asset. Thus, the share of the customer increases and at the end, owns the entire asset (Usmani, 1998).

Istisna Financing

In the Istisna transaction, the customer requests the Bank for the purchase of a specific asset /goods to be delivered on a future specified date. Subsequently, the Bank enters into a parallel Istisna contract with the manufacturer for purchase of specific product and upon completion, the seller delivers the goods either to the Bank or directly to the customer (Usmani, 1998).

Salam Finance

A sale transaction wherein the seller sells goods to an Islamic Bank to be delivered on a future pre-determined date against spot payment. The Bank sells the same to a purchaser on cash or deferred payment. However, both the transactions must be separate & independent from each other. The buyer is known as "rab-ul-salam", seller as "muslamilaih" and price as "ras-ul-mal" (Usmani, 1998).

Sukuk Finance

Sukuk is the plural the Arabic word "Sakk" which means a certificate (Khan, 2016). Sukuk is a Shariah-based product used by Islamic Banks, wherein the banks invest its capital in a Musharakah Pool to complete a joint venture /project and earn profit as per agreed ratio whereas the loss is shared according to their investment (Usmani, 1998).

Financial Performance

Financial performance is a measure that tells about the financial health of an organization. Like other institutions, the financial performance of Islamic Banks also depends upon Bank's internal factors (financing strategies, Bank size, Bank capital, etc.) as well as external factors like GDP, Inflation, etc. (Jamil Anwar, 2018). Good financial performance plays a vital role in the development of the financial and economic sector as it rewards the shareholders which ultimately induces them for more investment (Ongore, 2013). There are different metrics of financial performance however, in case of Banks Return on Assets, Return on Equity and Default Ratio are considered most valuable.

Return on Assets (ROA)

Return on assets is a financial ratio that measures how profitable a bank/company is, relative to its assets. This ratio apprehends how efficiently the business is using its assets for profit generation (Horne's, 2009) and can be calculated as: Net Profit After Tax / Total Assets

Return on Equity (ROE)

Return on Equity is a profitability ratio that measures the overall return of a firm concerning its equity. It compares a company's Net Profit After Tax with stockholders' capital (Horne's, 2009). The formula of Return on Equity is:

Net Profit After Tax / Shareholder's Equity

Default Ratio (DR)

Default ratio measures the assets quality of business and is calculated by dividing total Non-Performing Loans by Total Financing (Advances). Default ratio determines how many portfolios of loan/financing is at the risk of default.

Research Methodology

Research Type

The research is quantitative in nature and panel data has been collected from the financial statements of four full-fledged Islamic banks for the last 10 years i.e. from 2011 to 2020.

Population and Sample Size

The population of this research is entire Islamic Banks of Pakistan, out of which four full-fledged Islamic banks have been selected as sample i.e. Meezan Bank Limited, Dubai Islamic Bank Pakistan, Bank Islamic Pakistan Limited, Al-Barakah Bank Limited.

Rationale for Selecting Sample

Presently, in Pakistan there are 17 Islamic Banks, however, five of them are independent & full-fledged Islamic Banks which have been selected as sample however, since MCB Islamic Bank (MIB) is a subsidiary of MCB Bank, besides, its data for the last 10 years were also not available, therefore, it has been excluded from the sample base. The main reason for selecting full-fledged Islamic Banks as sample was due to the fact that remaining banks are having Islamic and Conventional set-ups under one umbrella i.e. Board / Management etc. Thus, their decisions in favor of Islamic Banks seems somewhat compromised keeping in view the market share, hold and easiness of conventional banking. Moreover, the rationale behind selecting this period (2011-2020) was that Islamic banking in Pakistan started since 2000, as such, the first decade was considered as development phase whereas, in the selected decade Islamic Banks have grown into independent financial institutions and witnessed considerable growth both in terms deposit, assets and market share, besides, many reforms, rules, and regulations were also introduced by AAOIFI and SBP during this period.

Data Collection

Bank's specific quantitative data with regard to the dependent variable (ROA, ROE & Default Ratio) & independent variables (MF, IJF, DM, RM, etc.) have been collected from the annual financial statements for last 10 years (2011-2020) of selected Islamic Banks. The collected data from the financials of each bank, was then consolidated variable-wise. Whereas, data regarding control variable (SBP Policy Rates) have been collected from SBP website. Control variable has been added to avoid research bias, as SBP Policy Rate act as a base while finalizing yield / return from each Islamic financing mode, whereas it is the respective spread which substantiate one mode from the other.

Description of Research Variables

S. No.	Category	Variables
1.	Dependent Variable	- Return On Assets - Return On Equity - Default Ratio
2.	Independent Variables	- Murabahah Finance - Ijara Finance - Diminishing Musharakah - Running Musharakah - Istisna Finance - Salam Finance - Government Sukuk Finance - Private / Other Sukuk Finance
3.	Control Variable	- SBP Policy Rate

Econometric Model

In order to complete this research following linear econometric models (Gujarati, 2004) have beenapplied, to measure the impact of financing modes on profitability of selected Islamic Banks:

1. $ROA_{it} = \beta_0 + \beta_1 MF_{it} + \beta_2 IJF_{it} + \beta_3 DM_{it} + \beta_4 RM_{it} + \beta_5 ISF_{it} + \beta_6 SF_{it} + \beta_7 GSF_{it} + \beta_8 PSF_{it} \varepsilon$
2. $ROEit = \beta 0 + \beta 1MFit + \beta 2IJFit + \beta 3DMit + \beta 4RMit + \beta 5ISFit + \beta 6SFit + \beta 7GSFit + \beta 8PSFit \varepsilon$
3. $DRit = \beta 0 + \beta 1MFit + \beta 2IJFit + \beta 3DMit + \beta 4RMit + \beta 5ISFit + \beta 6SFit + \beta 7GSFit + \beta 8PSFit \varepsilon$

Where,

ROAit	represent	Return on Assets
ROEit	represent	Return on Equity
DRit	represent	Default Ratio or NPL Ratio
MFit	represent	Murabaha Finance
IJFit	represent	Ijara Finance
DMit	represent	Diminishing Musharkah
RMit	represent	Running Musharkah
ISFit	represent	Istisna Financing
SFit	represent	Salam Financing
GSFit	represent	Government of Pakistan Sukuk Financing
PSFit	represent	Private Sukuk Financing

Results, Findings & Analysis

Discussion

Since the data-set of this research is panel data, therefore the Fixed and Random Effect Model has been applied to observe the behavior of dependent variables i.e. Return on Asset, Return on Equityand Default Ratio against independent variables (MF, IJF, DM, RM, ISF, SF GS, PS) over a timeperiod of 10 years. Accordingly, Hausman Test has been applied which shows that the P-Value >0.05, therefore, the null hypothesis has not been rejected, as such, the Random Effect Model is anappropriate choice, as all the variables across selected Banks are identical that vary over time only and are having a common effect on dependent variables.

Generalized Least Squares (GLS) Regression Analysis
(Fixed and Random Effect Test)

	(RE) NROA	(FE) NROA	(RE) NROE	(FE) NROE	(RE) NDR
NLNIJF	.077	.197	.183	.179	-0.010
	(.264)	(.259)	(.243)	(.267)	(0.006)
NLNMF	.308*	.139	.144*	.038	0.008
	(.174)	(.155)	(.16)	(.16)	(0.009)
NLNDM	-.544*	-.229	-.257*	-.251	0.040***
	(.32)	(.465)	(.295)	(.48)	(0.009)
NLNRM	.166	-.013	.278	.192	0.004
	(.188)	(.187)	(.173)	(.193)	(0.003)
NLNISF	.476**	.024	.294*	-.096	-0.029***
	(.238)	(.282)	(.219)	(.291)	(0.006)
NLNGS	.233	.269	.213	.18	-0.003
	(.203)	(.195)	(.187)	(.202)	(0.004)
NLNPS	.542***	.05	.529***	.174	-0.019***
	(.192)	(.227)	(.177)	(.235)	(0.005)
NLNSF	-.149	-.26	-.148	-.299	-0.001
	(.126)	(.23)	(.116)	(.237)	(0.002)
NSBPRATE	-.069	-.181	.047	-.142	
	(.44)	(.195)	(.405)	(.202)	

_cons	-.051	-.157	-.281	-.153	0.020
	(.434)	(.395)	(.399)	(.408)	(0.033)
Observations	40	40	40	40	40
R-squared	.z	.65	.z	.588	0.615
Hausman Test ($Chi^{2)}$	-	20.36	-	6.93	
Probability>Chi^2		0.1193		0.9373	

Standard errors are in parentheses

**** p<.01, ** p<.05, * p<.1*

The results presented in above table show that a unit change in independent variables causes 0.65 points variation in ROA and 0.588 points change in ROE. These results further show that the impact of most of the financing modes on dependent variables is statistically insignificant except MF, ISF, and PS. These findings are in line with previous study which proved significant positive impact of financing modes on ROA in Kenya (Boyant, 2014). The results further show that DM is having a significantly negative impact on ROA at P-Value < 0.1, as a unit change in DM, causes, a negative change of 0.544 unit in ROA. Similarly, it also has a significantly negative impact on ROE at P-Value < 0.1, as a unit change in DM, causes on the average -0.257 unit change in ROE. These findings support one of our Hypothesis i.e. H4 which says that DM has a significantly positive or negative impact on ROA & ROE. On the other hand, the results show that MF has a significantly positive impact on both ROA & ROE with P-value < 0.1, as a unit change in MF, brings about on the average 0.308 points change in ROA and 0.144 points change in ROE. Thus, hypothesis H1 has been accepted. Likewise, ISF also has a significantly positive impact on ROA at P-value < 0.05, as a unit change in Istisna Financing, causes, on the average 0.476 points change in ROA, while it is causing 0.294 points to change in ROA at P-value < 0.1. Thus, another hypothesis i.e. H5 is accepted. Moreover, the results further suggest that another independent variable i.e. Private Sukuk is having a significantly positive impact on dependent variables ROA & ROE with P-value < 0.01, as a unit change in PS brings, on average about 0.542 points change in ROA and 0.529 points change in ROE. These results support H8, which is accepted. The results also suggest that other independent variables like IJF, RM and GS are having a positive impact on dependent variables (ROA & ROE), however, these results are not significant. Similarly, the other two variables such as SF and SBP Policy rates are having a negative insignificant impact on ROA & ROE of selected Islamic Banks such as a unit change in SF causes -0.149 & -0.69 change in ROA and -0.148 in ROE. Thus, the other hypothesis like H2, H3, H6 & H7, are rejected. The results also confirm that DM is having a significantly positive impact on Default Ratio with P-value < 0.01, as a unit change in DM, causes on the average 0.040 points change in Default Ratio. This means that increase in DM is contributing towards the increase in default which is not a good sign. Moreover, ISF has a significantly negative impact on Default Ratio with P-value < 0.01, as a unit change in ISF, is causing on the average -0.029 points change in DR. This is a good sign, as increase in this financing mode causes reduction in default. Similarly, Private Sukuk is also having a significantly negative impact on Default Ratio, as one-unit change in PS is resulting on the average -0.019 points change in DR, which is also a good sign with regard to its performance. In addition, the other financing modes such as IJF, GOP Sukuk, and SF are having a negative impact on the DR, however, these findings are not statistically significant.

Pearson's Correlation

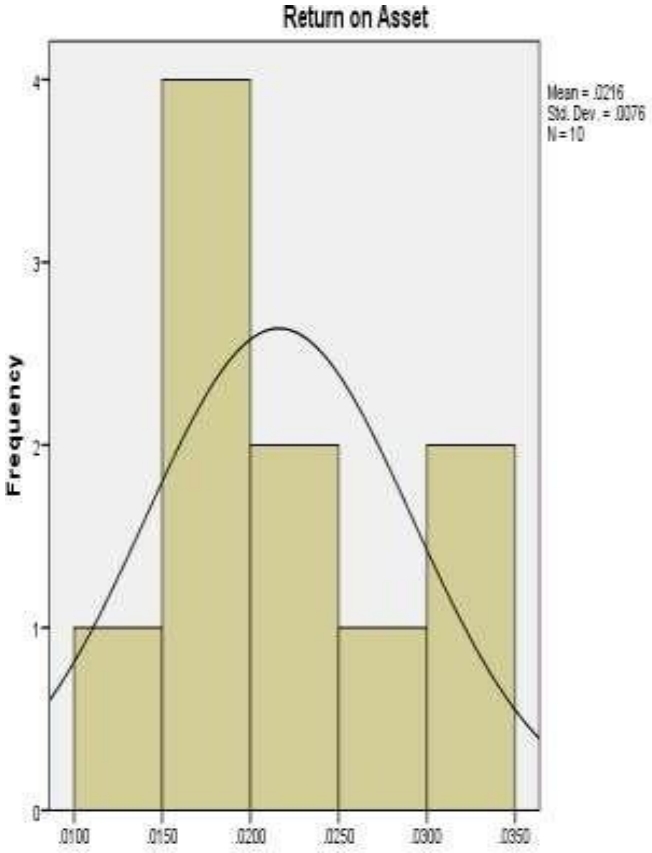
	NROA	NROE	NDR	NSBP Rate	NLN (IJF)	NLN (MF)	NLN (DM)	NLN (RM)	NLN (ISF)	NLN (GS)	NLN (PS)	NLN (SF)
ROA (1)	1											
ROE	.951**	1										
DR	-.587**	-.712**	1									
NSBP Rate	0.057	0.083	-0.055	1								
NLNIJF	.522**	.627**	-.435**	-0.067	1							
NLNMF	.405**	.364*	-0.227	-0.210	.672**	1						
NLNDM	.332*	.489**	-.406**	0.013	.460**	0.297	1					
NLNRM	.579**	.656**	-.497**	-0.063	.380*	-0.015	.459**	1				
NLNISF	.510**	.616**	-.489**	0.024	.641**	0.249	.807**	.648**	1			
NLNGS	.493**	.604**	-.368*	0.131	.529**	0.310	.471**	.338*	.499**	1		
NLNPS	.505**	.588**	-.437**	0.256	.535**	0.230	.717**	.436**	.631**	0.227	1	
NLNSF	0.011	0.067	-0.225	-0.222	0.298	0.274	.405**	0.050	0.303	0.088	.326*	1

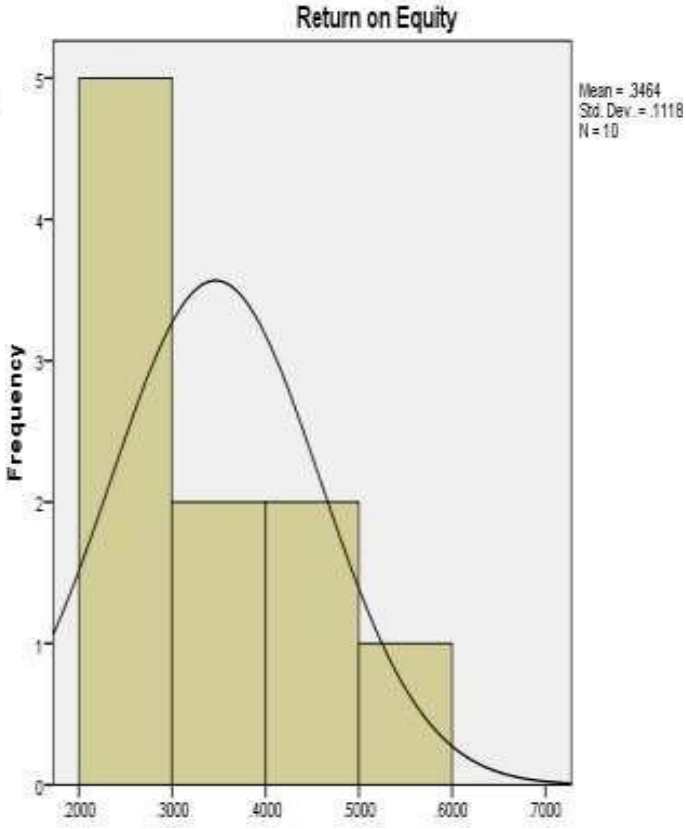
**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

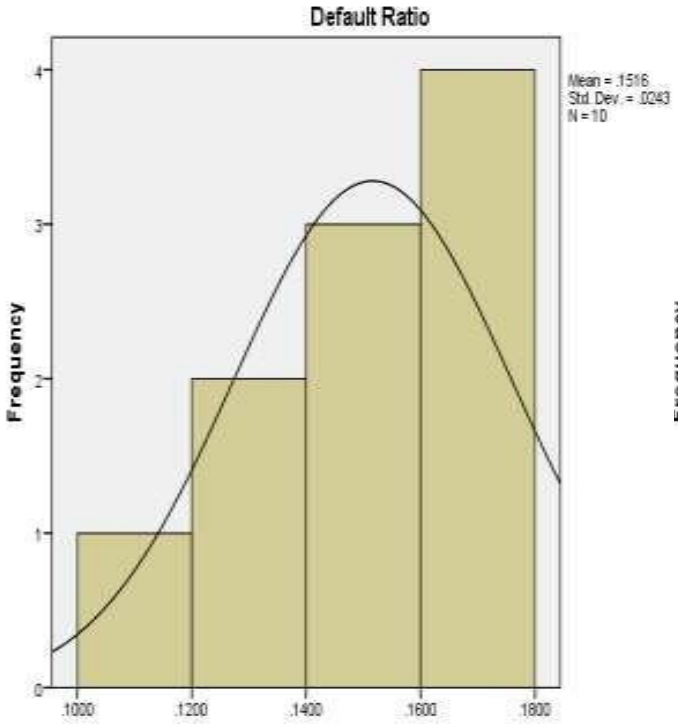
The results of Pearson's correlation presented in above table indicate that there exists an association among most of the variables at a P-value < 0.01. The results of Pearson's Correlation further indicate that there is a strong relationship between IJF and ROA with an R-value of 0.522 at P-value < 0.01. Results also shows that IJF is having a strong relationship with ROE at coefficient of 0.627 at a P-value < 0.01. Similarly, ROA & ROE are also having a strong relationship with RM having a coefficient of 0.579 and 0.656, respectively, at P-value < 0.01. Moreover, ISF & PS are also having direct significant relationship with ROA & ROE with R-values of 0.510 & 0.616 and 0.505 & 0.588 points. These significant strong relationships indicate that an increase or decrease in above mentioned independent variables is causing an increase/decrease independent variables. Besides, SF and SBP Policy rate (control variable) have a weak insignificant relationship with ROA & ROE with R-value of 0.011 & 0.067 and 0.057 & 0.083 points. Default Ratio (DR), on the other hand, is having a significantly negative relationship with all the financing modes like IJF, DM, RM, ISF, GS, PS & SF, with R-values of -0.435, -0.406, -0.497, -0.489, -0.368, -0.437. This negative relationship is also a good omen for Islamic Banks as an increase in said financing modes will have a negative impact on Default Ratio (DR). Further, the other two independent variables i.e. SF and SBP Policy Rates are having a negative but statistically insignificant relationship with Default Ratio (DR). Descriptive statistics of dependent and control variable is presented in the below table, which shows that the mean value of ROA is 0.022 while minimum and the maximum value is 0.014 and 0.034 which indicates that ROA remains stable during the period. Similarly, the average mean value of ROE is 0.35 while the minimum and maximum values are 0.0229 and 0.582, which suggest a steady ROE over the last 10 years. Likewise, the mean value and SD of DR are 0.152 and 0.0243 while the minimum & maximum values are 0.100 and 0.176.

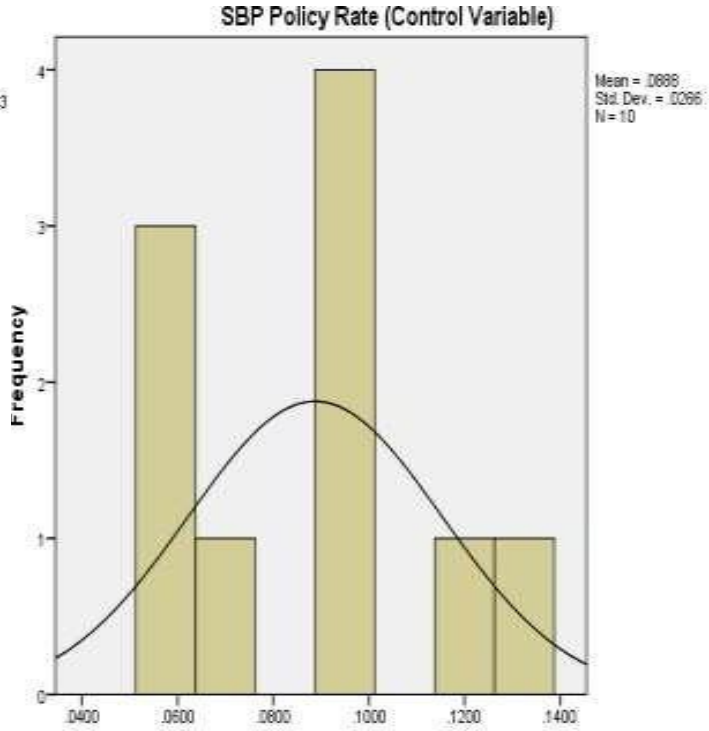
Descriptive Statistics of Return on Assets, Return on Equity, Default Ratio and SBP Policy Rate

		Return on Asset	Return on Equity	Default Ratio	SBP Policy Rate (Control Variable)
N	Valid	10	10	10	10
	Missing	0	0	0	0
Mean		0.022	0.346	0.152	0.089
Median		0.020	0.319	0.158	0.095
Mode		0.0138[a]	0.2293[a]	0.1003[a]	0.0575[a]
Std. Deviation		0.008	0.112	0.024	0.027
Variance		0.000	0.013	0.001	0.001
Skewness		0.748	1.062	-1.058	0.194
Std. Error of Skewness		0.687	0.687	0.687	0.687
Kurtosis		-1.077	0.700	0.738	-1.113
Std. Error of Kurtosis		1.334	1.334	1.334	1.334
Range		0.020	0.353	0.076	0.075
Minimum		0.014	0.229	0.100	0.058
Maximum		0.034	0.582	0.176	0.133
Sum		0.216	3.464	1.516	0.888
Percentiles	25	0.015	0.262	0.136	0.059
	50	0.020	0.319	0.158	0.095
	75	0.030	0.425	0.172	0.105


Return on Asset
Mean = .0216
Std. Dev. = .0076
N = 10
Frequency
0
1
2
3
4
.0100
.0150
.0200
.0250
.0300
.0350


Return on Equity
Mean = .3464
Std. Dev. = .1118
N = 10
Frequency
0
1
2
3
4
5
.2000
.3000
.4000
.5000
.6000
.7000


Default Ratio
Mean = .1516
Std. Dev. = .0243
N = 10
Frequency
0
1
2
3
4
.1000
.1200
.1400
.1600
.1800

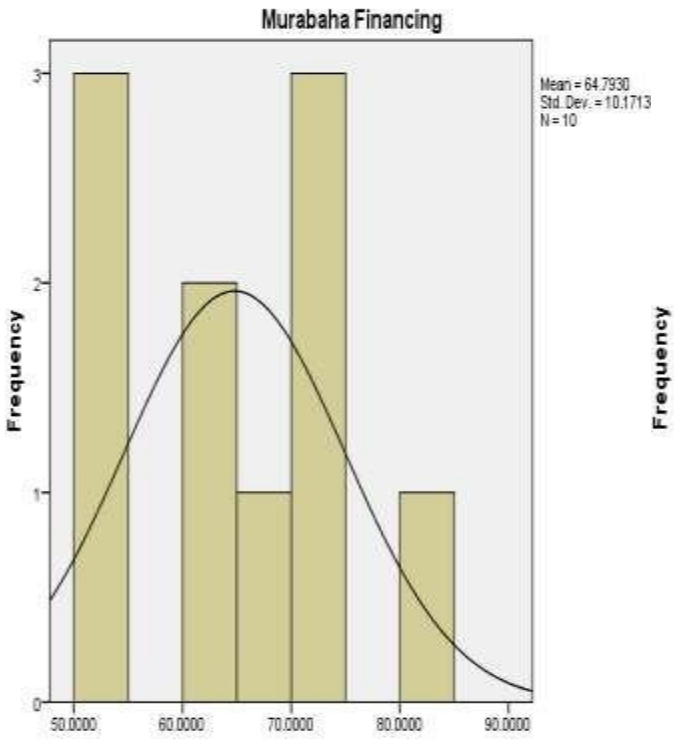

SBP Policy Rate (Control Variable)
Mean = .0888
Std. Dev. = .0266
N = 10
Frequency
0
1
2
3
4
.0400
.0600
.0800
.1000
.1200
.1400

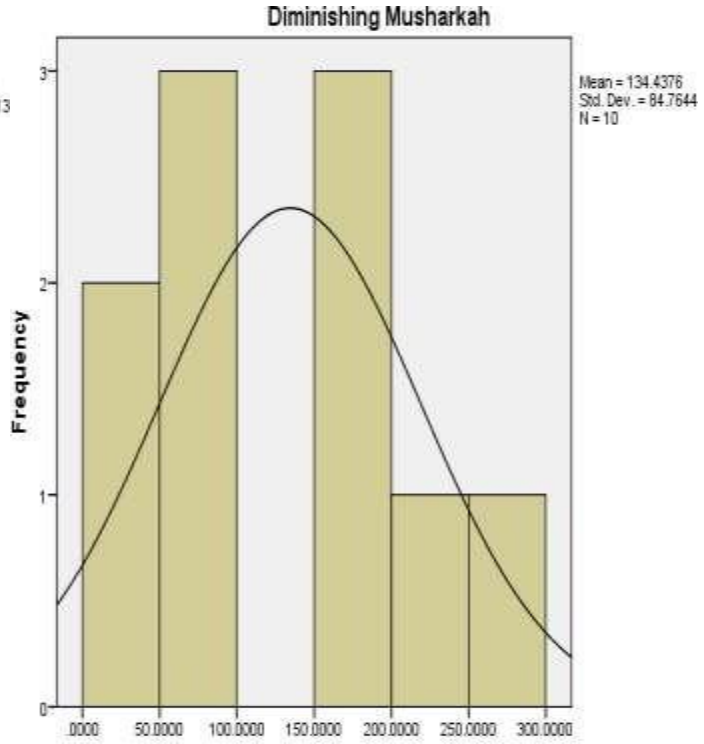
The descriptive statistics of all independent variables are presented in the below table which shows thatthe average mean value of IJF is 32.284, Standard Deviation is 19.259 while the minimum & maximum values are 11.495 and 58.435. This indicates a gradual decrease in its share over the period. Similarly, the mean value of MF is 64.79, Standard Deviation is 10.17 while minimum &maximum values are 52.17 & 81.32, which is an indication that it has a decent share in the overall gross financings of IBIs. Moreover, the mean value of DM is 134.44 and SD 84.764 while the minimum & maximum values are 36.92 and 281.48, this suggests that DM is has maintained a hefty market share over the last 10 years. Further, the mean value of RM is 103.739, SD 92.666 and minimum & maximum values are 3.750 & 222.7934. This indicates that with the passage of time RM has gained momentum and captured market share.

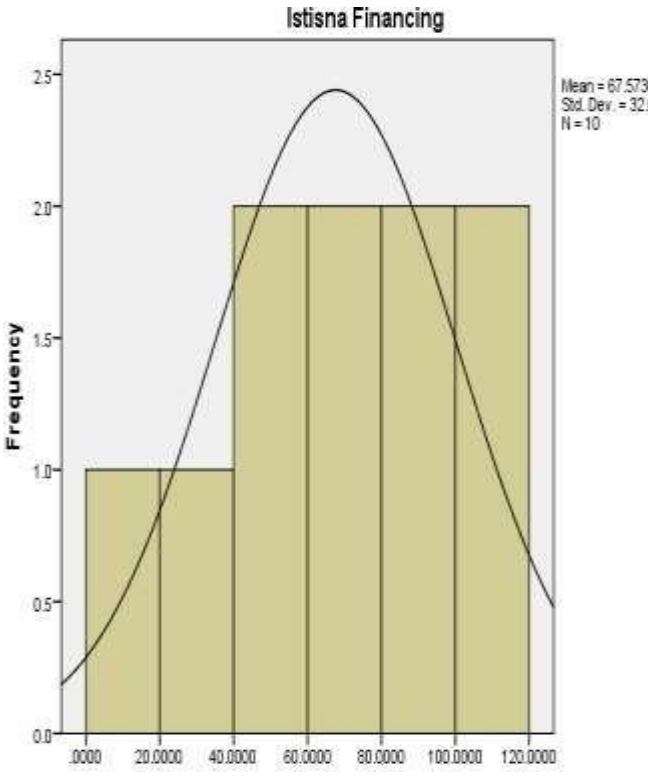
Besides, the ISF mean value is 67.57, SD is 32.6899, whereas, the minimum & maximum values are 19.92 & 111.170. this indicates fluctuation in the market share of ISF over the period. In addition to the above, the results show that GOP Sukuk has a mean value of 177.429, SD is 82.94while minimum & maximum values are 122.72 & 362.45, whereas, its skewness is 2.536 which suggest that investment in these Sukuk has increased considerably during last 05 years. Likewise,the mean value of Salam Financing is 18.003 with an SD value of 8.102 while minimum & maximum values are 4.74 & 27.61, while its skewness is -0.604. This indicates that a slight reduction has occurred in its market share.

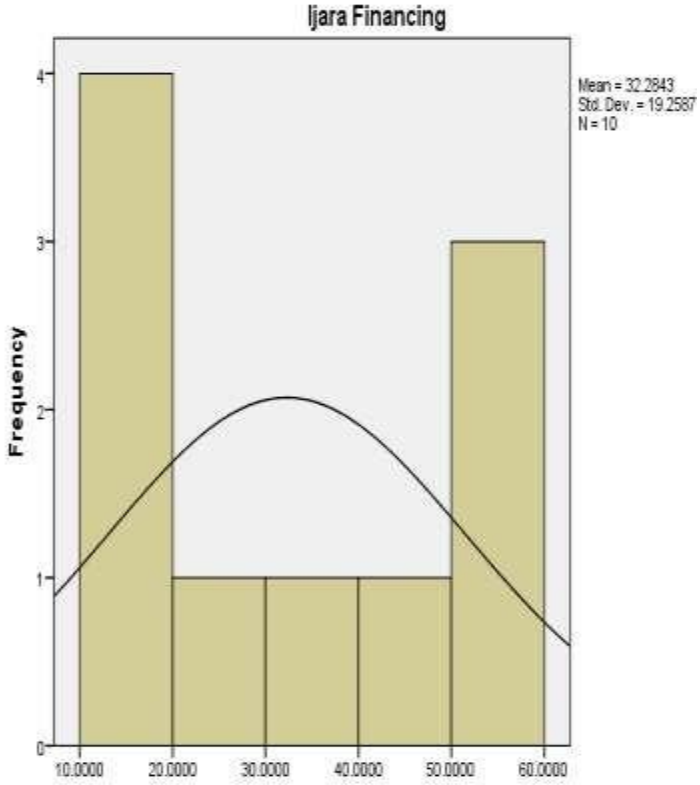
Descriptive Statistics of all Independent Variables

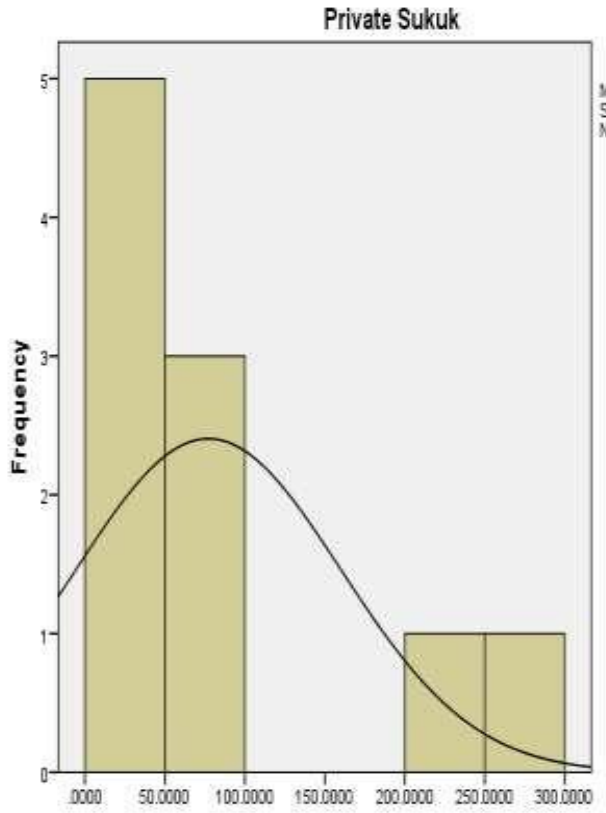
		Ijara Financing	Murabaha Financing	Diminishing Musharkah	Running Musharkah	Istisna Financing	GOP Sukuk	Private Sukuk	Salam Financing
N	Valid	10	10	10	10	10	10	10	10
	Missing	0	0	0	0	0	0	0	0
Mean		32.284	64.793	134.438	103.739	67.574	177.429	77.275	18.004
Median		27.996	64.150	129.545	77.847	63.799	157.289	46.642	20.564
Mode		11.4953[a]	52.1713[a]	36.9232[a]	3.7500[a]	19.9233[a]	122.7244[a]	20.8582[a]	4.7438[a]
Std. Deviation		19.259	10.171	84.764	92.667	32.690	68.881	82.942	8.102
Variance		370.898	103.456	7185.009	8587.105	1068.633	4744.659	6879.430	65.635
Skewness		0.326	0.149	0.471	0.253	-0.087	2.536	1.784	-0.604
Std. Error of Skewness		0.687	0.687	0.687	0.687	0.687	0.687	0.687	0.687
Kurtosis		-1.795	-1.286	-1.058	-2.037	-1.180	7.196	1.890	-0.995
Std. Error of Kurtosis		1.334	1.334	1.334	1.334	1.334	1.334	1.334	1.334
Range		46.940	29.150	244.562	219.043	91.247	239.723	236.765	22.863
Minimum		11.495	52.171	36.923	3.750	19.923	122.724	20.858	4.744
Maximum		58.436	81.322	281.485	222.793	111.170	362.447	257.624	27.607
Sum		322.844	647.930	1344.376	1037.389	675.736	1774.288	772.748	180.035
Percentiles	25	13.597	54.094	55.236	11.863	38.469	142.347	27.536	11.007
	50	27.996	64.150	129.545	77.847	63.799	157.289	46.642	20.564
	75	54.040	72.930	205.254	200.090	100.499	187.814	91.802	24.465

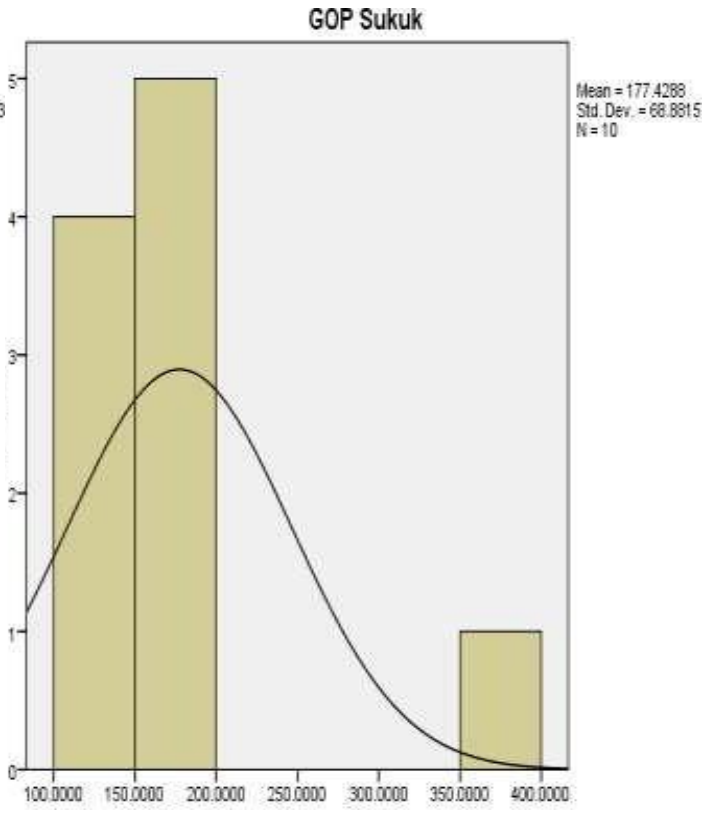

Murabaha Financing
Mean = 64.7930
Std. Dev. = 10.1713
N = 10
Frequency
50.0000
60.0000
70.0000
80.0000
90.0000

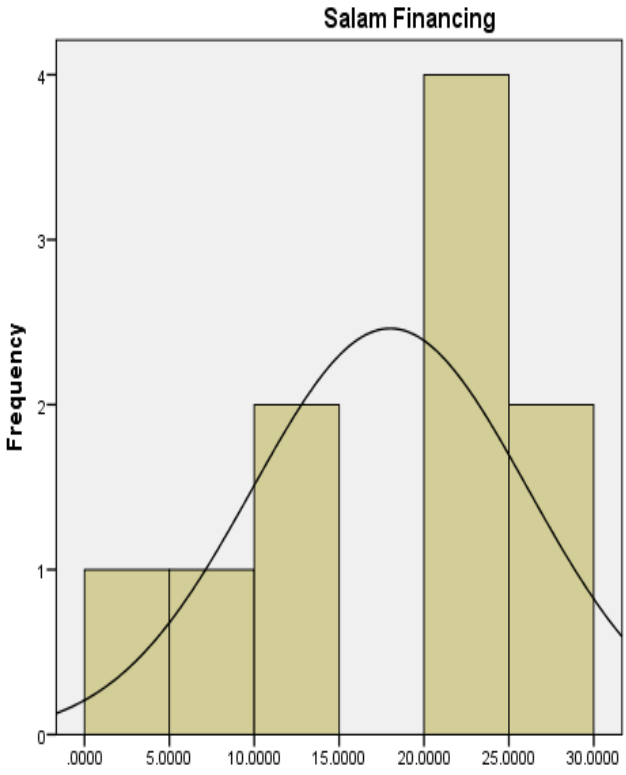

Diminishing Musharkah
Mean = 134.4376
Std. Dev. = 84.7644
N = 10
Frequency
50.0000
100.0000
150.0000
200.0000
250.0000
300.0000

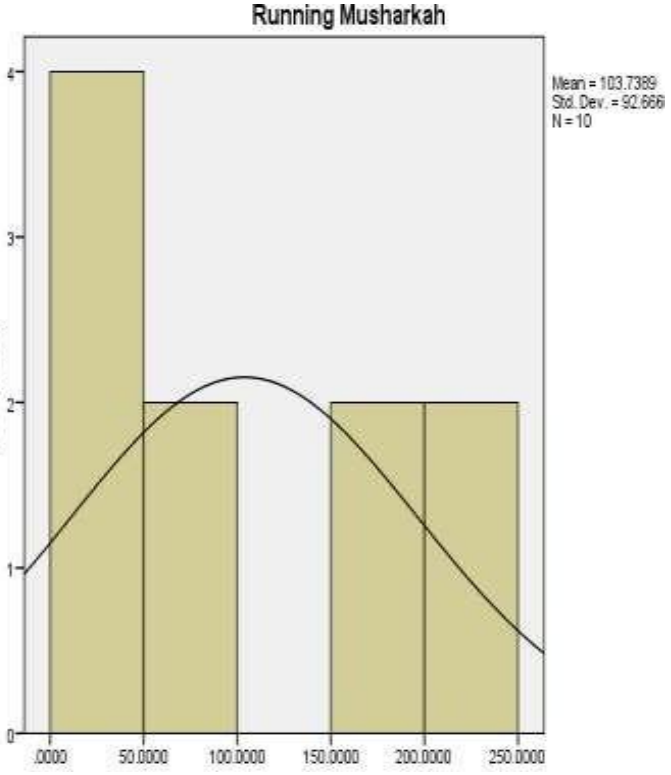

Istisna Financing
Mean = 67.573
Std. Dev. = 32.
N = 10
Frequency
20.0000
40.0000
60.0000
80.0000
100.0000
120.0000


Ijara Financing
Mean = 32.2843
Std. Dev. = 19.2587
N = 10
Frequency
10.0000
20.0000
30.0000
40.0000
50.0000
60.0000


Private Sukuk
Mean = 77.2748
Std. Dev. = 82.9423
N = 10
Frequency
0
1
2
3
4
5
.0000
50.0000
100.0000
150.0000
200.0000
250.0000
300.0000


GOP Sukuk
Mean = 177.4288
Std. Dev. = 68.8815
N = 10
0
1
2
3
4
5
100.0000
150.0000
200.0000
250.0000
300.0000
350.0000
400.0000


Salam Financing
Mean = 18.0035
Std. Dev. = 8.1015
N = 10
Frequency
0
1
2
3
4
.0000
5.0000
10.0000
15.0000
20.0000
25.0000
30.0000


Running Musharkah
Mean = 103.7389
Std. Dev. = 92.666
N = 10
0
1
2
3
4
.0000
50.0000
100.0000
150.0000
200.0000
250.0000

CONCLUSION

The main objectives of this research was to analyze the impact of different financing modes on financial performance of Islamic Banks, for which four full- fledged Islamic Banks (MBL, BIPL, DIBP & ABPL) were selected as sample. To conduct the research, Return on Assets, Return on Equity & Default Ratio were used as dependent variables while financing modes i.e. Murabaha, Ijara, Running Musharkah, Diminishing Musharkah, Istisna, Salam, Govet. Sukuk, Private Sukuk were taken as independent variables.

The findings of this research shows that Random Effect Model is an appropriate choice as the Hausman Test shows the P-Value > 0.05, which suggests that the null hypothesis has not been rejected. The results further indicate that Murabahah Financing (MF), Istisna Financing (ISF), andPrivate Sukuk Financing (PS) are having a significantly positive impact on Return on Assets (ROA) and Return on Equity (ROE). The results further suggest that Istisna Financing and PrivateSukuk Financing are having significantly negative impact on Default Ratio. These findings suggest that a unit increase in these 03 financing modes will significantly increase their financial performance.

Results further indicate that DM, is having a negative relationship with ROA & ROE, at P-value < 0.1, while Salam Financing and SBP Policy Rate (control variable) are having a negative but insignificant relationship with ROA & ROE. Besides, other financing modes like Ijarah, RM, and GOP Sukuk are also having a positive impact on ROA & ROE, but these results are not significant.

Policy Recommendations

The findings of this research prove that Murabahah, Istisna, and Private Sukuk financings are having significantly positive impact on Return on Assets and Return on Equity while on the otherhand Default Ratio are having a significantly negative relationship with these financing modes. Therefore, Islamic Banks should focus more on these aspects in order to further improve their financial performance, as these are yielding higher returns with lesser risk (chances of default).

Limitations of the Study

This study has considered the data of four (04) full-fledged Islamic Banks for the last 10 years (2011-2020) as a sample. Although MCB Islamic Bank is an independent Islamic Bank, however, its data for the selected period (2011-2020) was not available, hence it was excluded. Moreover, although, financing modes contributes lion share towards financial performance, yet, there are other sources of income generation which cannot be ignored such as now days Banks both Conventional & Islamic generate a considerable amount of earnings from treasury operations, investments in stock exchange and other non-financial earnings like fee, commission, service charges etc. which have not been considered in this research.

Suggestions for Further Research

For future research it is suggested to include more Banks in the sample list, especially, conventional banks having standalone IBBs, as presently there are 17 such Banks operating in Pakistan under the license of the State Bank of Pakistan. These IBBs are holding a significant percentage of market share, not only in terms of deposit but also in the shape of financings as wellas Branch networks.

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