

# The Impact of Investment Decision Quality of Islamic Banks in Bangladesh: A Critical Review

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## Abstract

The study investigates investment decision quality of Islamic banks in Bangladesh. Five financial ratios are selected for measuring investment performances of selected banks. Deposits and credits do not always ensure better profitability performance and operational efficiency and asset utilization. CAR and Tire\_1 ratio do not differ significantly at Islamic banks in last five years. The researchers have found that there is a satisfactory improvement in bank's credit quality in last five years despite of certain fluctuations. It is also worth mentioned that investment quality of Islamic banks is much better than that of conventional banks in Bangladesh.

**Key words:** Investment decision, LSRNPL, LSRTL, Bangladesh.

## 1. Introduction

Islamic Shariah does not support interest based banking whereas conventional banks are in favor of interest and conventional rules & regulation. In a highly competitive financial market bank performance provides signal to depositor investors whether to invest or withdraw funds from the bank. The special features of the investment policy of the bank are to invest on the basis of profit loss sharing system in accordance with the principles of Islamic Shariah. Earning profit is not the only motive and objective of the bank's investment policy rather emphasis is given in attaining social good and in creating employment opportunities. Some conventional banks operating under the Islamic shariah with named as Islamic banking branch or Islamic banking window. The level of competition has been intensified in the banking industry of Bangladesh with the incorporation of Islamic banking by conventional banks. However, it will be severe if approved additional 9 commercial banks start their operations in coming days. In this context of competitions it is natural and interesting to know the credit performance status of Islami banks. Banks no longer simply receive deposits and make loans. Instead, they are operating in a rapidly innovative industry with a lot of profit pressure that urges them to create more and more value-added services to offer to and better satisfy the customers. Risks are much more complex now since one single activity can involve several risks. Risks are inside risks. Risks overlap risks. Risks contain risks.

Islamic banks invest its money in various sectors of the economy through different modes permitted by shariah and approved by the Bangladesh Bank. The modes of investment are as follows:

Bai-Mechanism: Bai-Murabaha, Bai-Muazzal, Bai-Salam, Istishana, Leasing, Ijara, Hire Purchase (HP), Hire purchase under shirkatul Mulk (HPSM), Shirkat Meechanism: Musharaka, Mudaraba. To comply with international best practices and to make the bank's capital more resilient to unforeseen shocks as well as to build the banking industry more risk sensitive and stable, Bangladesh Bank (BB) commenced implementation of Basel II capital adequacy framework from January 2010 as a regulatory requirement for banks. It is noted that banks inside Bangladesh maintained capital on the basis of risk weighted asset in line with Basel I wherein only credit risk was taken into account. However, under Basel II, credit risk as well as market risk and operational risk are being considered for calculating minimum capital requirement. BB has fixed up minimum Capital Adequacy Ratio (CAR) and minimum capital requirement for banks 8 percent up to June 2010, 9 percent up to June 2011 and 10 percent from July 2011. It is natural for all relevant parties of commercial banks, bank customers and investors in particular, to know how Basel II implementation affects credit performance of the commercial banks in Bangladesh. The paper, thus, wants to assess empirically credit performance of commercial banks of Bangladesh.

## 2. Literature Review

Generally through lending all information are analyzed whether the loan meets the bank's risk-return objectives. To address the credit risks, banks and other financial intermediaries should focus on the probability of default of the borrowers. There are some qualitative models too. In quantitative analysis the bank usually analyze 5 C's of the customer character, capacity, cash, condition and collateral. Thus qualitative models indicate borrower specific factors and market specific factors (Saunders & Cornett 2006). They argued that an increase in capital requirement necessitates banks to substitute equity for deposit financing, reduce shareholder's surplus and found that banks with high capital ratio have low interest expenses due to less probable bankruptcy costs. Ranjan and Dhal (2003) provided an empirical analysis of commercial banks' non-performing loans (NPL) in India. The empirical result shown that expectation of higher interest rate induce rise in NPLs and maturity of credit horizon,

better credit culture, favorable macroeconomic and business conditions lead to lowering of NPLs. Ahmed and Ahmed (2004) examined the factors affecting credit risk in conventional and Islamic banks in Malaysia. The findings shown that management efficiency, risk-weighted assets and size of total assets have significant influence on credit risk of Islamic banking, while conventional banking credit risk were significantly affected by loan exposure to risky sectors, regulatory capital, loan loss provision and risk-weighted assets. Wasiuzzaman S. and Tarmizi H. B. A. (2011) attempted to examine the impact of bank characteristics as well as macro-economic determinants on the profitability of Islamic banks in Malaysia. The study found that capital and asset quality have an inverse relationship with bank profitability while liquidity and operational efficiency have a positive influence. Kargi (2011) evaluated the impact of credit risk on the profitability of Nigerian banks and found that banks' profitability is inversely influenced by the levels of loans and advances, non-performing loans and deposits thereby exposing them to great risk of illiquidity and distress. Epure and Lafuente (2012) examined bank performance in the presence of risk for Costa-Rican banking industry found that performance improvements follow regulatory changes and that risk explains differences in banks and non-performing loans negatively affect efficiency and return on assets while the capital adequacy ratio has a positive impact on the net interest margin. Chen and Pan (2012) examined the credit risk efficiency of 34 Taiwanese commercial banks over the period 2005-2008 using Data Envelopment Analysis (DEA) in term of credit risk technical efficiency (CR-TE), credit risk allocation efficiency (CR-AE), and credit risk cost efficiency (CR-CE). The DEA results show relatively low average efficiency levels in CR-TE, CR-AE and CR-CE in 2008 except one bank. The empirical result shows that credit risk is the most significant determinant of bank's performance of local Islamic commercial banks in Malaysia and other contributing factors are liquidity rate and concentration of Islamic commercial banking. Since the studies relating to the level of investment quality of commercial banks is very rear, the present study will bring a significant contribution to the Islamic Banks.

### 3. Objectives of the Study

- 1) To highlight Islamic banks (IBs) lending (Investment) decision quality.
- 2) To find out the credit performance of selected IBs.

### 4. Methods

The study is a secondary research covering a significant amount of publicly published data pertaining to the credit risk indicators. A considerable amount of data and empirical results from the academic resources including academic books, academic journals from both printed and electronic databases have been used in the study. The scope of the study is limited to the Islamic banks considering time constraint of the researchers. Five Islamic banks (IBBL, SJIBL, FSIBL, AAIBL, EXIM Bank Limited) are selected from 7 IBs.

This study uses financial ratios for measuring investment performance of Islamic banks in Bangladesh. The use of ratio in measuring investment risk and profitability performance is common in the literature of finance and accounting practices. Berger and DeYoung (1997), Al-Shamrari M. and Salirni M. (1998), Demircuc-Kunt and Huizinga H. (1999), Ahmed and Ahmed (2004), Goddard J., Molyeux P. and Wilson J.O. (2004), Ahmad and Ariff (2007), Boahene, Dasah and Agyei (2012) used ratio index in measuring credit risk and performance of commercial bank. The study has considered the six financial ratios of which five ratios relating to bank's investment decision quality and one relating to profitability performance.

Ratios relating to lending decision quality:

1. Non-performing Loan to total loan (NPLTL):  $\text{Non-performing loan} / \text{Total loan}$ .
2. Loan Loss Reserve to Total Loan (LSRTL):  $\text{Loan loss reserve} / \text{Total loans}$ .
3. Loan loss reserve to non-performing (impaired) loan ratio (LSRNPL):
4. Capital Adequacy Ratio (CAR):  $\text{Total Capital} / \text{Risk Adjusted Assets}$ .
5. Tier\_1 capital ratio (Tier\_1):  $\text{Tier}_1 \text{ capital} / \text{Risk adjusted assets}$ .

### Data Gathering Instrument

The secondary data source of the study is Annual reports of the selected banks for 5 years from 2007- 2011. The study necessitates looking into credit risk management disclosure, financial statements and notes to financial statements within the annual report. Besides this, the study collected the data from newspaper, the peer reviewed scientific articles, academic journals, online and printed published books.

In order to get a general understanding of credit risk management level of private commercial bank in Bangladesh through comparison of their investment decision quality performance in the last five years from 2007-2011, ratio analysis are adopted, together with the method of One-way ANOVA. Here, the financial ratios identified earlier part is used to determine the level of credit risk management. The major hypothesis for testing is whether there exists significant difference among the last five years' credit risk exposure and quality level of private commercial banks in Bangladesh after the implementation of Basel II in 2010. The result of the analysis is obtained in this segment by using SPSS-20 version.

We have used the capital adequacy and risk management reports of banks to collect our data. Furthermore, CAR and Tier\_1 CAR are taken from the annual reports directly in order to avoid the mistakes of calculation. However, NPLTL, LSRTL, LSRNPL are not available for all the banks in the annual reports So we have taken the amount of NPLs, LSR and the TLs from the financial statements and the related notes, and then, used the formula of NPLTL (NPLs/TLs), LSRTL(LSR/TL) and LSRNPL(LSR/NPL) to obtain the values. To ensure the accuracy of the results, we triple checked the data collection and calculation processes. Next, we have used the statistical analysis tool SPSS to obtain results and conduct analysis of the regression model that we have adopted in our study. The reliability of the SPSS results has been proved by many researchers in their studies. We have also used several articles to get the idea how to analyze the SPSS outputs.

## 5. Findings and Analysis of the Study

A comparison of five different financial ratios is made among last five years and the major results are found from the paper. [Insert table-1]

From the table 1 it has been found that null hypothesis for CAR, Tier\_1 ratios can be accepted at 5% level of significance. This means that these ratios do not differ significantly in Islamic Banks. CAR and Tier\_1 ratio of sample conventional and Islamic banks: In considering P values of these two ratios, it infers that the mean difference of these ratios in between conventional banks and Islamic banks is insignificant in last five years. By analyzing these two ratios in different years separately, it is found that CAR of commercial banks in Bangladesh is experiencing a sharp decline from 12.21% in 2007 to 10.79% in 2010 after implementation of Basel II accord in Bangladesh, but it is higher than the minimum 5% level. Here it is should be pointed out that all banks able to maintain the minimum Tier\_1 ratio in all years. Both of the two ratio analysis is the evidence of banks' performance in keeping adequate capital, which indicates that the ability of sample local private commercial banks to absorb the losses and confidence in assets is not highly satisfactory. Therefore, it is can be said that banks performance in keeping adequate capital is good and they have the ability to absorb the loss and confidence in assets quality. Besides, a little more analysis should be applied to know the level of performance of banks' credit exposure and quality of two different banking systems in Bangladesh. [Insert table-2]

From the table 2 it has been found that CAR of all sample banks is more than minimum regulatory rate of 10.0% in all years. It indicates that all banks are fulfilling BASEL II requirement in managing regulatory capital which has a significant impact in managing bad loan as NPLTL ratio of all banks under the both banking system is declining every year. But it is also can be noted that Islamic banks in Bangladesh are doing well in compare to that of conventional banks in controlling bad loans as average yearly NPLTL ratio of Islamic banks is lower. Islamic banks are keeping less reserve to total loan and non-performing loan which is the indication of Islamic banks improvement in credit exposure control over conventional banks in Bangladesh.

## 6. Concluding Remarks

Educational institutions may introduce 'Islamic Finance & Banking' & other related courses to supply need based manpower for Islamic Banks. Although the sample size depicts satisfactory result, scope for training, motivation & orientation programs for Islamic Bankers should be widened & strengthened. However, the results refer only to the sample to the study. The present study confined only the analysis of investment risk indicators. This study could be further developed by including liquidity risk, operational risk and profitability indicators with the light of Islamic Shariah. It will be more interesting to determine the effect of credit risk indicators on profitability by using multiple regression models. The study used five financial ratios as investment risk indicators such as NPLTL, LSRTL, NPLTL, CAR and Tire\_1 ratio. To sum up five banks have a steady level of investment decision quality. Besides, the ratios have in general implied that a satisfactory improvement in bank's credit quality in last five years despite of certain fluctuations.

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**Appendix:**

Table 1: Ratio Analysis in Percentage of 5 IBs of Bangladesh

Year	NPLTL	LSRTL	LSRNPL	CAR	Tier_1
2007	4.08	1.46	38.24	12.22	10.04
2008	3.22	1.24	38.52	11.80	9.66
2009	3.20	1.10	36.22	11.90	9.54
2010	2.43	0.80	33.98	10.76	7.86
2011	2.28	0.68	25.48	12.18	8.84
Sig	0.020	0.09	0.039	0.46	0.934

Table 2: Mean of the five ratios of sample banks

Year	NPLTL	LSRTL	LSRNPL	CAR	Tier_1
2007	2.75	0.85	29.18	10.92	8.54
2008	2.41	0.90	36.16	10.91	8.51
2009	2.24	0.62	28.65	11.36	8.89
2010	1.66	0.32	21.05	11.88	9.78
2011	1.77	0.40	17.86	12.48	10.39

(Source: Annual Report of Sample Banks)



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