

## **EMPIRICAL EXAMINATION OF THE FINANCIAL PERFORMANCE OF ISLAMIC BANKING IN NIGERIA: A CASE STUDY APPROACH**

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### **Abstract**

This study examines the financial performance of Jaiz Bank Plc, the only Islamic bank licensed to operate in Nigeria, over a period of two years (2013 – 2014). It examines the financial performance of the bank in terms of profitability, liquidity, leverage and growth. Time series data were collected and analysed by way of Gray Comparative Index. The study finds positive relationship between profitability, leverage, growth ratios and financial performance. There is sufficient evidence also that shows that the relationship between liquidity and financial performance is negative. The study therefore recommends that bank managers should take measures to improve profitability by taking advantage of leverage and growing their banks. They should be careful in keeping liquidity beyond desirable level since liquidity and financial performance have negative relationship. Bank regulators should take measures to ensure stable economic conditions.

**Keywords:** Islamic banking, Jaiz Bank Plc, Financial Performance, Nigeria.

### **1. Introduction**

The success of deposit money banks is very crucial to any economy. They provide a balance between deficit and surplus sectors. In the case of Islamic banking, it is even more important because of the controversies that surround it when it was introduced. Many pundits talk about the coming death of Islamic banking in Nigeria even before it started. They simply questioned how the bank would survive without interest – the heart of Islamic banking. It is within this context that a study of this nature in Nigeria is apt and strategic.

Financial performance refers to the act of performing financial activity. In broader sense, financial performance refers to the degree to which financial objectives being or has been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries

or sectors in aggregation. Financial performance is a desirable objective for all profit-oriented firms. The absence of it can indeed spells failure. Typical measures of financial performance are profitability, leverage, liquidity and growth.

Profitability can be defined as the final measure of economic success achieved by a company in relation to the capital invested in it. This economic success is determined by the magnitude of the net profit accounting (Pimentel, Braga & Casa Nova, 2005). To achieve an appropriate return over the amount of risk accepted by the shareholders, is the main objective of companies operating in capitalist economies. After all, profit is the propulsive element of any investments in different projects. The assessment of profitability is usually done through the ROA (Return on Assets = Net Income /Total Assets) and ROE (Return on Equity = Net Income/Equity), which is the ultimate measure of economic success. Profitability or the lack of it is the reason why a number of firms fail. Profit is essential because the continued absence of it can indeed spells failure. This leads to hypothesis one, which states that:

H<sub>1</sub> = Profitability and financial performance are positively related

Leverage (gearing) is another very important measure of financial performance. A number of studies (Modigliani & Miller, 1958, 1963; Ball & Brown, 1968) have proposed that a mix of debt in the capital structure of a firm offers leverage. Although, this has been seriously disputed, financial leverage has continued to be part of financial performance literature. The relationship between leverage and financial performance has been well empirically tested. It has been shown that for banks, there is a positive relationship between financial leverage and return on assets (Hutchison and Cox, 2014). The analysis is extended to determine the relationship between return on equity and leverage. The evidence supports the hypothesis that there is a positive relationship between financial leverage and return on equity. This leads to the following hypothesis:

H<sub>2</sub>: Leverage and financial performance are positively related

According to Shim and Siegel (2000), liquidity is the firm's capacity to liquidate maturing short-term debt (within one year). Maintaining adequate liquidity is much more than a corporate goal. It is a condition without which it could not be reached the continuity of a business. Solvency and liquidity are two concepts that are closely related and reflect upon the actions of firm's working capital policy. A low liquidity level may lead to increasing financial costs and result in the incapacity to pay its obligations (Maness & Zietlow, 2005). It is common to find reference to the fact that it is desirable to keep the company liquidity ratio higher than 1.00. That would prove the firm's ability to repay short-term commitments, with the liquidation of short term assets. Any ration below 1.00 may mean that the business may not be generating cash enough to meet the short term obligations (Morrel, 2007). Liquidity or the lack of it is another reason why firms simply fail. For a firm that has potential to become multination corporation, it must be able to pay salaries, monthly utility bills and raise sufficient working capital to carry on day to day activities. Anything in the alternative is a disaster waiting to happen. This leads to the following hypothesis:

H<sub>3</sub>: Liquidity and financial performance are negatively related

Unlike conventional deposit money banks, Islamic banks share profits with equity investment accountholders. This is against the conventional charging of interest or payment of interest on deposit accounts. This leads to hypothesis four as follows:

H<sub>4</sub>: The relationship between equity of investment accountholders and financial performance is positive.

Growth is an important part of every organization. It is a natural phenomenon for organizations to aspire to grow. A common measure of growth is size. Certain firm characteristics are associated with high performance of firm. These include size (Love and Rachinsky, 2007), growth rate, and liquidity (Gurbuz, Aybars & Kutlu, 2010) and revenue (Forbes, 2002). The firms that have better growth rate can afford better machinery, and then gradually the assets and size of the firm will increase. Large firms attract better managers and workers who in turn contribute to the performance of the firm. This leads to the following hypothesis:

H<sub>5</sub> = Growth and financial performance are positively related

The remaining sections are divided into literature review, data and methodology, results and conclusions and recommendations.

## **2. Literature review**

### **2.1 Islamic banking**

The concept of Islamic banking is relatively new in the academic literature particularly in Nigeria. Non-Interest Banking is a profitable growing global phenomenon practiced in nearly 70 countries across the world including the United Kingdom, Canada, the United States of America, the United Arab Emirate, Malaysia, China, Singapore, South Africa, Kenya etc. Global Banks like HSBC, Citibank, Barclays Bank etc. are also offering it. It is an alternative financial service offering which is open to all irrespective of race or religion. It is based on the ethical principles of fairness, transparency and objectivity. Non-Interest Banking offers almost all the services of conventional banks.

The difference is that non-interest Islamic Banks do not give or receive interest, nor finance anything that is harmful to society like alcohol, tobacco, gambling etc. They also seek to avoid gharar-speculation, uncertainty deception and more. Currently, about 41% of Nigeria's total population of 174 million craves for such Non-Interest banking services. These people are desirous of ethical banking services which provide for socially responsible investment outlets. In a nutshell, Non-Interest Banking is a profit and loss sharing arrangement where the mode of financing is mostly on mark-up, leasing and partnership basis.

### **2.2 Financial Performance Analysis**

The firm and its various interested groups: managers, shareholders, creditors, tax authorities, and others seek answers to the following important questions: (a) what is the financial position of the firm at a given point of time? (b) how is the financial performance of the firm over a given

period of time? These questions can be answered with the help of financial analysis of a firm. Financial performance analysis involves the use of financial statements. A financial statement is an organized collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of the firm. It may show a position at a moment of time as in the case of a statement of financial position, or may reveal a series of activities over a given period of time, as in the case of a statement of comprehensive income.

Thus, the term financial statements generally refer to two basic statements: the statement of financial position and the statement of comprehensive income. The statement of financial position shows the financial position (condition) of the firm at a given point of time. It provides a snapshot and may be regarded as a static picture. It is a summary of a firm's financial position on a given date that shows total assets = total liabilities + owner's equity. However, the statement of comprehensive income reflects the performance of the firm over a period of time. It is a summary of a firm's revenues and expenses over a specified period, ending with net income or loss for the period.

However, financial statements do not reveal all the information related to the financial operations of a firm, but they furnish some extremely useful information, which highlights some important factors: profitability, liquidity, leverage and financial soundness. Thus analysis of financial statements is an important aid to financial performance analysis. Financial performance analysis includes analysis and interpretation of financial statements in such a way that it undertakes full diagnosis of the profitability and financial soundness of the firm. The analysis of financial statements is a process of evaluating the relationship between component parts of financial statements to obtain a better understanding of the firm's position and performance (Mirza & Javed, 2013).

The financial performance analysis identifies the financial strengths and weaknesses of the firm by properly establishing relationships between the items of the statement of financial position and statement of comprehensive income. The first task is to select the information relevant to the decision under consideration from the total information contained in the financial statements. The second is to arrange the information in a way to highlight significant relationships. The final step is interpretation and drawing of inferences and conclusions.

### **2.3 Jaiz Bank Plc**

Jaiz Bank Plc was created out of the of the former Jaiz International Plc, which was set up in 2003/2004 as a special purpose vehicle (SPV) to establish Nigeria's first full-Fledged Non-Interest Bank. It is an unquoted public company owned by over 20,000 shareholders spread over the six geographical zones of Nigeria. Jaiz Bank Plc obtained a regional operating license to operate as a Non-Interest Bank from the Central Bank of Nigeria on the 11th of November 2011 and began full operations as the first Non-Interest Bank in Nigeria on the 6th of January, 2012 with 3 branches located in Abuja, Kaduna and Kano. The regional license allows the bank to operate geographically in a third of the country. Also, based on recommendations from Islamic Development Bank (IDB), which is also a shareholder of the bank, Jaiz Bank Plc partnered with

the Islamic Bank Bangladesh (IBBL) for Technical and Management Assistance. Currently, Jaiz Bank is the only full-fledged Non-Interest (Islamic) Bank in Nigeria. It started with only three branches in 2012 and had since expanded its branch network to 17.

#### **2.4 Empirical Studies on the Financial Performance**

Few studies have been conducted on the financial performance of banks. Traditional studies have focused on the financial performance of interest-bearing banks in US, Europe, Asia and Africa. Nerlove (1968), Baker (1973) and Taub (1975) also found significantly positive relationship between leverage ratio and measures of profitability. Petersen and Rajan (1994) also identified positive association between leverage and profitability but for industries. Roden and Lewellen (1995) established a significantly positive relation between profitability and total leverage as a percentage of the total buyout-financing package. Marques and Braga (1995) confirmed the inverse relationship between liquidity and financial performance. Hutchinson (1995) in his scholarly works argued that, financial leverage had a positive effect on the firm's return on equity provided that earnings' power of the firm's assets exceeds the average interest cost of leverage to the firm.

Murinde and Kariisa-Kasa (1997) analyse retrospectively the financial performance of the East African Development Bank. Three methods of analysis, derived from a selective review of the literature, are applied, namely the standard financial ratios; statistical moments such as the mean, range and standard deviation of balance sheet and related accounts; and the Subsidy Dependence Index. The results show that the bank's historical performance has been disappointing. It is suggested that the bank should engage proactively in the identification, promotion and post-evaluation of projects.

Smith and Begemann (1997) studied if the maximization of the firm's returns could threaten its liquidity, and the pursuit of liquidity had a tendency to dilute returns. They analyzed the relation between working capital measures and return on investment (ROI) for a sample of firms listed on the Johannesburg Stock Exchange (JSE). Statistical test results showed that a traditional working capital leverage ratio, current liabilities divided by funds flow, displayed the greatest associations with return on investment. Traditional liquidity ratios as current and quick ratios registered insignificant associations. Thus the Optimal level for liquidity would be obtained by a trade-offs between the low return of current assets and the benefit of minimizing the need for external finance (Kim, Mauer, & Sherman, 1998).

However, some studies have shown that leverage has a negative effect on firm profitability. Fama and French (1998), for instance argue that the use of excessive leverage creates agency problems among shareholders and creditors and that could result in negative relationship between leverage and profitability. In a polish study, Hammes (1998) also found a negative relationship between leverage and firm's profitability. Majumdar and Chhibber (1999) found in their Indian study that leverage has a negative effect on performance. Gleason, Mathur & Mathur. (2000) support a negative impact of leverage on the profitability of the firm. Blatt (2001), also called a negative relationship between liquidity and financial performance, measured by Dynamic Model and financial performance.

In another study, Hammes (2003) examined the relation between capital structure and performance by comparing Polish and Hungarian firms to a large sample of firms in industrialized countries. He used panel data analysis to investigate the relation between total leverage and performance as well as between different sources of leverage namely, bank loans, and trade credits and firms' performance measured by profitability. His results show a significant and negative effect for most countries. He found that the type of leverage, bank loans or trade credit is not of major importance, what matters is leverage in general. Mesquita and Lara (2003), in their study found that the relationship between rates of return and leverage indicates a negative relationship for long-term financing. They however, found a positive relationship for short-term financing and equity.

Eljelly (2004) examined the relation between financial performance and liquidity measured by current ratio and cash gap (cash conversion cycle) on a sample of joint stock companies in Saudi Arabia using correlation and regression analysis. They found a negative relationship between financial performance and liquidity indicators, and it was found that CCC had a bigger impact over financial performance than Current ratio. Also it was observed that there was great variation among industries with respect to the significant measure of liquidity.

However, Perobelli, Pereira and David (2007) argue that on the long-term there is a necessity to achieve a balance between the financial and economic profile. For these authors, liquidity and financial position reflected in return on equity, which also contains the effect of financial leverage, are two sides of a coin which is the economic and financial health of companies. One thing to note is that the appropriate return allows the self financing of business operations through the retained portion of net profit. Thus, good financial performance increases the liquidity and marketability promotes proper growth and future financial performance. García-Teruel and Solano (2007) studied the effects of working capital management over companies ROA. They observed 8872 enterprises and found out that shortening cash conversion cycle had significant effect over companies' financial performance.

Raheman and Nasr (2007) studied the relationship between Working Capital Management and financial performance for 94 Pakistani companies listed on Karachi Stock Exchange. Between their findings, it was observed that a significant negative relationship between companies liquidity and financial performance. Abor (2007) in his scholarly works on leverage policy and performance of Medium Sized Enterprises found the effect of short-term leverage to be significantly and negatively associated with gross profit margin for both Ghana and South African firms. This indicated that increasing the amount of short-term leverage would result in a decrease in the profitability of the firms.

Pratheepkanth (2011) analyzes the relationship between leverage and financial performance during 2005 to 2009 of business companies in Sri Lanka. The results shown the relationship between the leverage and financial performance is negative. Martis (2013) find evidence suggesting a negative link between leverage ratios and financial performance. Alazzam (2014) measures the effect of some variables on the financial performance of industrial companies in Aqaba city and found three determinants of a positive impact on financial performance:

indebtedness, automation and growth rate, while the two variables found to have a negative impact: liquidity ratio and the rate of turnover in accounts receivable.

### **3. Data and Methodology**

Data was collected from Jaiz Bank Plc annual reports and accounts for the December 2013 through December 2014 period. Annual measures of capital (defined as the quarterly average value of equity divided by assets), return on equity (ROE, defined as net income divided by average equity) and return on assets (ROA, defined as net income divided by total assets) were collected for each of the two time periods. The raw data is utilized in the Gray Composite Index. We transformed large values by scaling them to less than one percent. An OLS regression model is estimated and tested using the Gray Composite Index:

$$FP_t = \alpha + \beta_1 ROA_t + \beta_2 ROE_t + \beta_3 ROR_t + \beta_4 EPS_t + \beta_5 EITA_t + \beta_6 GRE_t + \beta_7 NIM_t + \beta_8 CR_t + \beta_9 QR_t + \beta_{10} CFPS_t + \beta_{11} EISF_t + \beta_{12} TLSF_t + \beta_{13} CLTA_t + \beta_{14} TA_t + \beta_{15} INV_t + e_t$$

Whereas:

FP = financial performance measured by the predictor variables

ROA = return on assets, used to measure financial performance, calculated as profit before tax over total assets

$\alpha$ ,  $\beta$  are constant and coefficients respectively.

ROE = return on equity used to proxy profitability, calculated as profit after tax over equity capital

ROR = return on gross earnings (revenue), used to proxy profitability, calculated as profit before interest and tax over gross earnings

EPS = earnings per share used to proxy profitability, profit before tax over equity shares

EITA = equity of investment accountholders over total assets

GRE = log of gross earnings used to proxy profitability

NIM = net income margin used to proxy profitability, calculated as net income over total assets

CR = current ratio used to proxy liquidity, calculated as current assets over current liabilities

QR = quick ratio used to proxy liquidity, calculated by cash and marketable securities over current liabilities

CFPS = cash flow per share is cash from operations over equity shares

EISF = equity of investment accountholders over equity capital

TLSF = total liabilities over shareholders fund (equity capital) used to proxy leverage

CLTA = current liabilities over total assets used to proxy leverage

TA = log of total assets used to proxy size

INV = log of investment used to proxy investment activities

e = error term

t = time subscript

### **4. Results**

The financial performance of Jaiz Bank Plc is reported in tables 1 to 5 as follows:

#### **4.1 Profitability Analysis**

The profitability of the bank is measured by return on assets, return on equity, return on gross earnings, earnings per share, return on equity of investment accountholders, gross earnings and net income margin. The bank profitability ratios are reported in table 1 as follows:

**Table 1 Profitability Ratios**

Variable	Proxy	2013	2014	Gray Comp Index 2013 & 2014
Return on assets	ROA	-0.02	0.02	0.04
Return on equity	ROE	-0.07	0.06	0.13
Return on revenue	ROR	-0.81	0.24	1.05
Earnings per share	EPS	-0.12	0.01	0.13
Return on equity of investment accountholders	ROEI	0.02	0.04	0.02
Gross earnings	GRE	0.09	0.29	0.20
Net income margin	NIM	-0.14	0.01	0.15

Source: Extracts from 2013-2014 Annual Reports & Accounts of Jaiz Bank Plc

Table 1 shows that the bank return on assets in 2013 was (2%). This, however, increased to 2% in 2014. Similarly, the return on equity in 2013 was (7%). This, however, increased to 6% in 2014. In the same vein, the return on revenue (gross earnings) in 2013 was (81%). This increased to 24% in 2014. Earnings per share in 2013 was (0.12), this increased to 0.01 in 2014. Return on equity of investment accountholders was 2% in 2013. This, however, increased to 4% in 2014. Gross earnings increased from 9% in 2013 to 29% in 2014. Finally, net income margin in 2013 was (14%). This, however, increased to 1% in 2014. Taking the profitability ratios together, there has been overall increase in profitability of the Bank. Thus, hypothesis one, which states that the relationship between profitability and financial performance is positive, holds and the null hypothesis is thereby rejected.

#### **4.2 Liquidity Analysis**

The liquidity performance of the bank is measured by current ratio, quick or acid test ratio and cash flow per share ratio. The bank liquidity ratios are reported in table 2 as follows:

**Table 2 Liquidity Ratios**

Variable	Proxy	2013	2014	Gray Comp Index 2013 & 2014
Current ratio	CR	2.63	1.59	-0.74
Quick (acid test) ratio	QR	1.97	0.77	-1.20
Cash flow per share	CFPS	1.76	1.05	-0.71

Source: Extracts from 2013-2014 Annual Reports & Accounts of Jaiz Bank Plc



Table 2 shows that the bank current ratio, which is calculated by dividing current assets by current liabilities in 2013 was 2.63. This, however, fell to 1.59 in 2014. By rule of thumb, a current ratio of 2.0 is desirable. Similarly, the bank quick or cash ratio in 2013 was 1.97. This, however, fell to 0.77 in 2014. By rule of thumb, quick ratio of 1.0 is recommended. Benchmarked against these results, it shows that the bank current ratio is very good but the bank quick or acid test ratio is not strong. Also, the bank cash flow per share in 2013 was 1.76. This, however, fell to 1.05 in 2014. Taking the results together, the liquidity ratios of the bank fall between 2013 and 2014. Hypothesis 2 which states that the relationship between liquidity and financial performance is negative is accepted and the null hypothesis is rejected.

#### **4.3 Leverage Analysis**

In achieving profitability firms employ a variety of techniques. One such technique is financial leverage. Essentially, a firm can adopt high or low financial leverage. Given a constant positive return on assets (net profit divided by total assets) the greater the equity multiplier (total assets divided by total stockholder's equity) the more is the return on equity from the DuPont Model. That is, banks have an incentive to minimize the amount of equity invested in order to maximize their return on equity. This intended result assumes there is no interaction between financing and the operating performance of the firm. Leverage or gearing is measured by total liabilities to shareholders fund and current liabilities to total assets. The bank leverage ratios are reported in table 3 as follows:

**Table 3 Leverage Ratios**

Variable	Proxy	2013	2014	Gray Comp Index 2013 & 2014
Total liabilities to shareholders fund	TLSF	0.90	1.47	0.57
Current liabilities to total assets	CLTA	0.29	0.37	0.08

Source: Extracts from 2013-2014 Annual Reports & Accounts of Jaiz Bank Plc

Table 3 shows that the bank total liabilities to shareholders fund in 2013 was 90%. This, however, increased to 147% in 2014. Similarly, the bank current liabilities to total assets was 29% in 2013. This, however, increased to 37% in 2014. These results are not surprising because it is typical of deposit money banks to have high leverage ratios, particularly total liabilities to shareholders fund. This is because the bulk of bank financing is provided by customers and equity accountholders in the case of Islamic bank. Taking the results together, hypothesis 3, which states that the relationship between leverage and financial performance is positive holds and the null hypothesis is therefore rejected.

#### **4.4 Equity of Investment Accountholders Analysis**

The bank equity of investment accountholders performance is measured by equity of investment accountholders to total assets and equity of investment accountholders to shareholders fund. The ratios are reported in table 4 as follows:

**Table 4 Equity of Investment Accountholders Ratios**

Variable	Proxy	2013	2014	Gray Comp Index 2013 & 2014
Equity of investment accountholders to total assets	EITA	0.39	0.38	-0.01
Equity of investment accountholders to shareholders fund	EISF	1.20	1.49	0.29

Source: Extracts from 2013-2014 Annual Reports & Accounts of Jaiz Bank Plc

Table 4 shows that the ratio of equity of investment accountholders to the bank total assets in 2013 was 39%. This, however, falls to 38% in 2014. Similarly, the ratio of equity investment of accountholders to equity capital in 2013 was 120%. This rose to 149% in 2014. These results are typical of deposit money banks where the bulk of the money is provided by depositors or in the case of Islamic bank by equity of investment accountholders. Taking these results together, it is evident that the empirical result is mixed. While, equity of investment accountholders to total assets and financial performance is negative, equity of investment accountholders to shareholders fund is positive.

#### **4.5 Growth Analysis**

The bank growth performance is measured by growth in total assets and investments. The ratios are reported in table 5 as follows:

**Table 5 Growth Ratios**

Variable	Proxy	2013	2014	Gray Comp Index 2013 & 2014
Total assets	TA	0.34	0.44	0.10
Investments	INV	0.05	0.12	0.07

Source: Extracts from 2013-2014 Annual Reports & Accounts of Jaiz Bank Plc

Table 5 shows that between 2013 and 2014, the bank total assets grew by 10%. Similarly, the bank total investments in assets held for sale, Ijarah and Istisna grew by 7%. Taking the results together, hypothesis 6, which states that the relationship between growth and financial performance is positive holds and therefore the null hypothesis is rejected.

#### **5. Conclusions**

We have demonstrated that for Jaiz Bank Plc, there is a positive relationship between profitability, financial leverage, growth and the financial performance for both the 2013-2014 periods. We have also demonstrated that the relationship between liquidity and financial

performance is negative. Nevertheless, the results are sensitive to data measurement issues. Furthermore, the proportionality of profitability, financial leverage, growth to financial performance appears to have been more or less maintained in 2014 as opposed to 2013 financial year. Moreover, when viewing the return on assets relationship a similar pattern as the return on equity to financial performance relationship is observed. That is, ROA is positively related to financial leverage.

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