

Determinants of Islamic Banking Profitability in Malaysia

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Abstract: Islamic banks were experiencing tremendous growth by showing high profitability level and less affected by the financial turmoil. Thus, the objective of this paper is to investigate the impact of bank-specific as well as industry-specific and macroeconomic indicators upon Islamic banks profitability, particularly in Malaysia, for the period of 2006 to 2010. Using pooled regression analysis, and by taking 10 Islamic banks/windows, the result shows that the bank size is a vital importance in affecting its profitability. In addition, financial market development and market concentration has a significant positive impact in determining profitability. Finally, from the macro-economic variables, inflation has a significant positive impact on Islamic banks' profitability which shows the different nature between Islamic and conventional banks.

Key words: Profitability, Islamic banking, inflation, pooled regression.

INTRODUCTION

Malaysia is one of the most progressive and attractive Islamic financial sector in the world. The first Islamic bank in Malaysia was established in 1983, named Bank Islam Malaysia Berhad (BIMB). The establishment of BIMB is a major step towards an Islamic financial system in Malaysia. In 1993, commercial banks, merchant banks and finance companies begun to offer Islamic banking product and services under Islamic banking scheme. However, these financial institutions offering Islamic banking product and services have to separates the funds and activities of the Islamic banking transactions from the conventional banking. Currently, there are 16 Islamic banks/windows in Malaysia.

Over the past decade, number of literature on determinants of Islamic banking profitability had been increasing. Bashir (2003) and Haron (2004) investigated the factors effecting profitability of Islamic banks in Middle East as well as across the globe. This was followed by Izhar and Asutay(2007) which empirically analyze the performance of Bank Muamalat Indonesia in terms of its ROA and Srairi (2009) which compare the factors contributing to Islamic banks profitability with conventional banks profitability. In Malaysia, Wasiuzzaman and Ahmed Tarmizi (2010) has examined the impact of bank characteristics as well as macroeconomic determinants of on the profitability of Islamic banks.

Although, there had been many literature on determinants of profitability of Islamic banks and conventional banks, main focus of these literatures are on internal characteristics of the bank that affect profitability. On the other hand, many include only few external variables that might affect profitability. Therefore, the objective of this paper is to analyze the bank-specific, industry-specific and macroeconomic indicators which could affect the profitability of Islamic banks in Malaysia.

The rest of the paper is organized in six sections. Section 2 gives an overview of literature done in the area of determinants of banks profitability across the globe. Section 3 identifies the data sources and defines the variables used in the regression estimation. Formulation of model and discussion of possible link between profitability of Islamic banks and industry-specific and macroeconomic indicators are in Section 4. Section 5 represents empirical results and discussion of findings, and conclusions are given in Section 6.

Review of Literature:

Over the past decades, there had been number of studies done on factors effecting profitability of commercial banks. However, there are very few studies done on determinants of Islamic banks profitability. Factors that influence the profitability of Islamic/conventional banks can be divided into bank-specific characteristics, industry-specific and macroeconomic indicators. Therefore literature divides into these three categories.

Among the researchers who have studied the effect of internal characteristics on Islamic bank profitability are Bashir (2003), Haron (2004), Izhar and Asutay (2007), Srairi (2009), and Wasiuzzaman and Ahmed Tarmizi, (2010). Researches are conducted using different countries data's. The bank-specific characteristics that relate to bank's profitability are capital, liquidity, credit risk, financial risk, operation efficiency, and bank's size. Abreu and Mendez (2002) found that well capitalized banks faced lower expected bankruptcy costs that enhance profit, thus showing a positive relationship capital and profitability. The same results were found on studies done on Islamic banks mentioned above except for Izhar and Asutay (2007), and Wasiuzzaman and

Ahmed Tarmizi (2010). Izhar and Asutay (2007) found an insignificant negative relationship between capital and profitability, which shows that equity is a small proportion of total assets. Wasiuzzaman and Ahmed Tarmizi (2010) also found a negative relationship which they explained that Islamic banks in Malaysia should not focus increasing the equity performance to increase profitability.

Haron (2004) and Wasiuzzaman and Ahmed Tarmizi (2010) found a significant positive relationship between profitability and liquidity. Similar findings can be found in Molyneux and Thornton (1992) and Steinherr and Huveneers (1994). However, Izhar and Asutay (2007) and Srairi (2009) found a significant negative relationship between liquidity and profitability. They believe Islamic banks are more liquid than conventional banks.

Bashir (2003), Srairi (2009), and Wasiuzzaman and Ahmed Tarmizi (2010) found a significant positive relationship between profitability and exposure to credit risk. Bank loans are the main sources of revenue; therefore if borrowers are able to repay their debt and profit (interest), the higher will be banks profitability. Abreu and Mendez (2002), Naceur (2003), and Kunt and Huizinga (2000) also found similar results. Interestingly, the study done by Izhar and Asutay (2007) found a significant negative relationship between loans to total asset (credit risk). This indicates that Islamic bank portfolio is heavily biased towards short-term trade-financing loans.

Abreu and Mendez (2002), Haron (2004), Naceur (2003), and Wasiuzzaman and Ahmed Tarmizi (2010) found a significant positive relationship between profitability and operational efficiency of the banks. Even though the result was insignificant, Bashir (2003) and Izhar and Asutay (2007) also found a positive relationship between profitability and operational efficiency of the banks. However, Ramadan *et al* (2011) found a significant negative relationship between profitability and cost management based on studies done on Jordanian banks.

Bashir (2000) found size to negatively affect the profitability of Middle Eastern Islamic banks. This relationship also found by Sufian and Habibullah (2009) for conventional banks. However, Haron (2004), Srairi (2009), Athanasoglou *et al* (2005) found size to positively affect the profitability of the banks studied. Wasiuzzaman and Ahmed Tarmizi (2010) did not find a significant relationship between Islamic banks size and profitability of Malaysian Islamic banks studied.

Economic growth or GDP growth is one of the main macroeconomic indicators that affect the profitability of Islamic banks. Based on 14 Islamic banks in 8 countries, Bashir (2003) identified that, using return on asset (ROA) and return on equity (ROE) as dependent variables, profitability and economic growth have significant positive relationship. This was followed by Srairi (2009) and Wasiuzzaman and Ahmed Tarmizi (2010) in their studies on determinants of Islamic profitability in GCC countries and in Malaysia respectively. Both studies also found that GDP growth has significant positive relationship with Islamic banks profitability. Ramadan *et al* (2011) studied the determinants of profitability of Jordanian banks over the period of 2001-2010. They found a positive but insignificant relationship with GDP growth and profitability. Kunt and Huizinga (2000) and Vong and Chang (2006) found that there is an insignificant relationship between profitability of banks and economic growth. Sufian and Parman (2009) identified the determinants of non-commercial banks/financial institutions profitability, and they found a negative significant relationship between GDP growth and profitability.

Izhar and Asutay (2007) said that the effect of inflation on bank profitability was first discussed by Revell (1980), who held that inflation could be a factor in the causation of variations in a bank's profitability. Studies by Wasiuzzaman and Ahmed Tarmizi (2010), Bashir (2003), Athanasoglou *et al* (2005), Izhar and Asutay (2007), Vong and Chang (2006), Kunt and Huizinga (2000) and Haron (2004) found a positive significant relationship with inflation and profitability of Islamic bank as well as conventional banks. However, Srairi (2009) and Naceur (2003) found that profitability of banks does not have any significant relationship with inflation.

Utilizing bank level data, Bashir (2003) examined the performance indicators of Islamic banks across eight Middle Eastern countries for the period of 1993-1998. Varieties of internal and external banking characteristics were used to predict the profitability and efficiency, and he found that GDP per capita growth has a positive significant relationship with Islamic banks profitability. However, Naceur (2003) studied on profitability of Tunisian banking industry for the period of 1980-2000 and found no significant relationship with GDP per capita growth and profitability of 10 commercial banks in Tunisia.

Srairi (2009) examined the impact of bank characteristics, macroeconomic indicators and financial structure on the profitability of conventional and Islamic commercial banks operating in the Gulf Cooperation Council (GCC) countries for the period 1999-2006. He concluded that money supply growth has a significant positive relationship with profitability of Islamic bank as well as conventional commercial banks. In addition, Haron (2004) also found a positive but insignificant relationship with growth of money supply and profitability of Islamic banks.

Other macroeconomic indicators of profitability of Islamic banks can also be interest rates and unemployment. In one of the earliest conceptual research on the profitability of Islamic banks, Nienhaus (1983) said that Islamic banks have been using market interest rate as a basis for calculating their profit-sharing ratio

and he further recommended that the profit-sharing ratio be equivalent to the interest rate offered by conventional banks. Haron (2004) found that there is a positive significant relationship between profitability of Islamic banks and interest rates. Abreu and Mendes (2002) and Heffernan and Fu (2008) found that unemployment rate positively affects the profitability of banks.

Financial sector development or stock market capitalization over GDP has positive and significant relationship with profitability of banks in studies done by Srairi (2009), Naceur (2003), and Kunt and Huizinga (2000). However, Bashir (2003) found a negative but insignificant relationship between profitability of Islamic banks and financial market development. Srairi (2009) found that banking sector development had a positive but insignificant relationship with profitability. He also found that market concentration has a positive and significant relation with profitability. However, studies by Ramadan *et al* (2011) and Naceur (2003) identified a negative and significant relation with concentration and profitability of banks.

Departed from previous researches, the objective of this paper is therefore to analyze the impact of bank-specific, industry-specific and macroeconomic indicators towards the profitability of Islamic banks in Malaysia.

MATERIALS AND METHOD

Data:

In this study, the performance or profitability of a bank is measured by its return on assets (ROA). The ROA, defined as net income divided by total assets, reflects how well a bank's management is in using the bank's real investment resources to generate profits. According to Flamini *et al* (2009), ROA is better key proxy than ROE because an analysis on ROE neglects financial leverage. As for the determining factor of bank performance, they are divided into bank specific, industry specific and macroeconomic indicators. The description of them is provided in the following section.

Bank Specific Characteristics:

The bank specific indicators have more ability to influence the profitability of banks. The bank size, capital, liquidity, credit, financial, and operation efficiency are variables considered independent which can influence profitability internally.

Capital ratio is measured by total equity over total assets. It shows how equity of a bank influences the profit made. We expect a positive relationship between capital ratio and Islamic banks profitability. This is because higher the capital ratio, there will be less need of external funding and there for higher profitability (Abreu and Mendez, 2002). Well capitalized banks are predicted to be less risky and hence lower profit (Athanasoglou *et al*, 2005)

Liquidity ratio is measured by loans to total deposit and short-term funding. This ratio shows the relationship between liquidity management and bank performance. Loans are the largest components of interest bearing assets of a bank and are expected to have a positive impact on profitability (Vong and Chang, 2006). Profits are expected to be higher, when more deposits are transferred into loans. Hence, it is predicted a positive relationship between this ratio and profitability.

Credit risk is measured by loan loss reserves to gross loans. Though loans are the main sources of banks revenues, it is also considered a largest source of credit risk. Theory suggest that increased exposure to credit risk is normally associated with decreased profitability and, if borrowers are able to repay debt and interests, we can say from the evidence that higher this ratio is, the higher the profitability of banks (Srairi, 2009). Bashir (2003), Srairi (2009), and Wasiuzzaman and Ahmed Tarmizi (2010), found a strong positive relationship between liquidity ratio and bank profitability.

Financial risk is measured by total liability over total assets. For Islamic banks we expect a positive relationship between ROAA and this ratio. However, in the absence of deposit insurance, high risk-taking will expose the bank to the risk of insolvency (Srairi, 2009). Therefore this ratio may have a negative impact on bank profitability.

Operation efficiency is normally measured by cost over income. However, due to lack of data on cost to income ratio in Bankscope, this study uses net interest margin ratio of all the banks studied. Bankscope classifies the ratio as the cash-flow of its interest-free lending. The ratio of net interest margin could represent bank efficiency on how successful the investment made by banks is compared to its debt situation (Wasiuzzaman and Ahmed Tarmizi, 2010). The higher the ratio the less risky the bank will be, which will be directly affecting the bank's profitability. There is a mix relationship between operation efficiency and Islamic banks profitability. Bashir (2003), Haron (2004) and Wasiuzzaman and Ahmed Tarmizi (2010) found a significant positive relationship between the ratio, while Srairi (2009) found a significant negative relationship.

The size of the bank is measured by log of total assets. The relationship between size of the bank and profitability are mixed. Generally, the bigger the size of the bank, the higher the profitability. The reason is that large size may result in economies of scale that will reduce the cost of gathering and processing information or in economies of scope that result in greater loan product diversification and accessibility to capital markets

which are not available to small banks. However, for banks that become extremely large, the effect of size could be negative due to bureaucratic and other reasons. Haron (2004) and Srairi (2009) had found a positive relationship between size and profitability, while Naceur (2003) and Vong and Chang (2006) found negative relationship or diseconomies for larger banks.

Industry Specific Indicators:

This study includes two industry specific indicators that might affect Islamic banks profitability. They are financial market development and bank concentration.

As a proxy of financial market development, this study uses the ratio of stock market capitalization to gross domestic product (SMGDP). This ratio measures the overall level of development of the financial market and its importance in financing economy. This ratio is expected to influence positively bank performance. Naceur (2003), Srairi (2009), and Kunt and Huizinga (2000), found a significant positive relationship between financial market development and banks profitability.

Most of the results obtained by the literature of the relation between concentration and profitability are generally conflicting, and relied on two approaches. They are structure-conduct-performance (SCP) hypothesis and efficient structure (EFS) hypothesis (Ramadan *et al.*, 2011). While the SCP investigates the relation between highly concentrated market and the profitability, the EFS investigate if the efficiency of larger banks affects its profitability. Following Naceur (2003) we measure concentration using the three bank concentration ratio defined as the ratio of the largest three banks’ assets to total assets. It is expected higher the concentration ratio, the more monopoly power there is in the banking system.

Table 1: Description of Variables

Variables	Notation	Description	Expected Sign
Dependent			
Profitability	ROAA	The return on average total assets of the bank	
Independent			
<i>Bank-Specific</i>			
Capital Ratio	CAPR	Total equity over total assets	+
Liquidity Ratio	LIQR	Loans to total deposits and short-term funding	+
Credit Risk	CRER	Loan loss reserves to gross loans	+
Financial Risk	FINR	Total liability over total assets	+
Operation Efficiency	OPEF	Cost over income	+/-
Bank Size	TA	Log of total assets	+/-
<i>Industry-Specific</i>			
Financial Market Development	SMGDP	Stock market capitalization over GDP	+
Concentration	CONC	Assets of the three largest banks over total assets	+/-
<i>Macroeconomic</i>			
GDP Growth Rate	GDP	GDP is general index for economic development	+
Inflation	INF	Growth of Consumer Price Index	+/-

Macroeconomic Indicators:

The economic condition and the specific market environment would obviously affect the bank’s profitability (Bashir, 2003). Four macroeconomic indicators were used in this study. They are gross domestic product (GDP) growth rate, GDP per capita growth rate, Inflation, and Money supply growth rate.

Firstly, it is expected GDP growth affect banks profitability positively. This is because the default risk is lower in upturns than in downturns. Besides, higher economic growth may lead to a greater demand for both interest and non-interest activities, thereby improving the profitability of banks.

Secondly, inflation is associated with higher costs as well as higher income. If a bank’s income rises more rapidly than its costs, inflation is expected to exert a positive effect on profitability. On the other hand, a negative coefficient is expected when its costs increase faster than its income. The following table shows a summary of descriptive variables.

Methodology:

The bank specific variables being examined in this study are derived from both income statements and balance sheets of 10 Islamic banks/windows published in Bankscope database. The data set cover 5 year period from 2006 – 2010. By pooling together all the data 50 observations were collected. The study used only 10 Islamic banks/windows because of the limited availability of data. The data for macroeconomic variables was retrieved from the IMF International Financial Statistics (IFS) database and Bank Negara statistics. Industry specific data’s were collected from Bloomberg database and Bank Negara Malaysia website.

The study used panel data regression techniques to analyze the determinants of profitability of Islamic bank in Malaysia. Panel data are commonly used because of the following reasons. First, it has the advantage of

giving more informative data as it consists of both the cross sectional information, which captures individual variability, and the time series information, which captures dynamic adjustment. In short, panel modeling helps to identify a common group of characteristics while, at the same time, taking the account the heterogeneity that is present among individual units. Second, this technique allows for the study of the impact of macroeconomic and financial industry developments on profitability after controlling for bank-specific characteristics, with less collinearity among variables, more degree of freedom and greater efficiency.

In panel data regression techniques, there are two models, fixed effect model and random effect model. Random effects estimation requires number of cross sections to be greater than coefficients' for between estimators for estimate of random effect innovation. Therefore this study used only fixed effect model.

To study the determinants of profitability of Islamic banks, this study adopt the following regression equation

$$ROAA_{i,t} = \alpha + \beta_1 X_{i,t} + \beta_2 Xt + \beta_3 Mt + \epsilon_{i,t}$$

Where $ROAA_{i,t}$ is the return on average assets for bank i in year t , α is a constant, $X_{i,t}$ represent bank-specific characteristics of bank i in year t , Xt represent industry-specific indicators in year t , Mt represents macroeconomic indicators in year t , β_1, β_2 , and β_3 are regression coefficients, and $\epsilon_{i,t}$ is the error term.

Results:

Descriptive Statistics:

To analyze the result of the study, first it is useful to comment on some preliminary features of our data. Table 2 shows descriptive statistics for the profitability (ROAA) and the bank-specific, industry-specific and macroeconomic variables used in our model. In average, the return on average asset of 10 Islamic bank used in this study are -0.32. However, the mean of all other independent variables are positive.

The mean of liquidity ratio is the largest (54.17) and varies greatly across banks (max = 95.01 and min = 5.75). In average total equity over total assets is 12.52 and standard deviation is 16.37. As of credit ratio, financial risk, and operation efficiency shows a mean of 4.22, 0.87 and 3.42 respectively. Among industry-specific indicators in average financial market development ratio is 0.42 and market concentration ratio is 0.54. Over the period the average gross domestic product growth rate of Malaysia is 4.50%, while inflation is 2.67%.

Table 2: Descriptive Statistics

	ROAA	CAPR	LIQR	CRER	FINR	OPEF	TA	SMGDP	CONC	GDP	INF
Mean	-0.32	12.52	54.17	4.22	0.87	3.42	3.89	0.42	0.54	4.50	2.67
Median	0.60	8.15	50.40	2.98	0.92	3.46	3.97	0.46	0.54	5.85	2.03
Maximum	2.00	96.85	95.01	16.08	1.02	6.99	4.56	0.61	0.58	7.20	5.40
Minimum	-25.78	-1.90	5.75	1.46	0.03	0.00	2.46	0.25	0.51	-1.71	0.60
Std. Dev.	4.07	16.37	21.84	3.25	0.16	1.58	0.43	0.13	0.03	3.25	1.69
Skewness	-5.26	4.06	-0.19	2.06	-4.06	-0.13	-1.35	0.04	0.35	-1.27	0.48
Kurtosis	32.33	19.78	2.50	7.09	19.78	2.80	5.34	1.60	1.71	2.93	1.93

Regression Results:

This section shows the regression analysis of Islamic bank's profitability and its internal variables and external variables. Using fixed effect model, the regression are run using E-views 6. Return on average assets are regressed with 10 independent variables taken from the period of 2006-2010. The table below shows the result.

Table 3: Regression Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
CAPR	-15.22104	132.2729	-0.115073	0.9092
LIQR	-0.018362	0.046554	-0.394416	0.6961
CRER	0.006835	0.284904	0.023989	0.9810
FINR	-1525.078	13226.33	-0.115306	0.9090
OPEF	0.247512	0.508184	0.487052	0.6298
TA	16.63805	5.720685	2.908401	0.0068
SMGDP	30.14872	14.34870	2.101146	0.0441
CONC	169.1728	87.04231	1.943570	0.0614
GDP	-0.119422	0.171965	-0.694454	0.4927
INF	1.002808	0.553430	1.811988	0.0800
C	1353.037	13243.23	0.102168	0.9193
R-squared	0.677080	Mean dependent var		-0.324020
Adjusted R-squared	0.472565	S.D. dependent var		4.069589

S.E. of regression	2.955529	Akaike info criterion	5.294406
Sum squared resid	262.0545	Schwarz criterion	6.059216
Log likelihood	-112.3602	Hannan-Quinn criter.	5.585650
F-statistic	3.310651	Durbin-Watson stat	1.171382
Prob(F-statistic)	0.001674		

The results in Table 3 relate to regressing ROA on the set of bank-specific variables, industry-specific variables and macroeconomic variables. From the table, R-squared is 0.677080, which shows that about 67% of independent variables explain the dependent variable ROAA. The adequacy of a model as predicting is validated by the F-test. As indicated in Table 3, the value of F-stats is statistically significant which has confirmed that the models applied are useful for measuring the relationship between ROA and independent variables.

As mentioned early 6 bank-specific variables are used in this study. However the result shows that only bank's total assets has a significant impact on the profitability of Islamic banks in Malaysia. At 1% significant level bank's total assets are positively related to ROA. It is identify in the literature well capitalized banks are less risky and hence more profitability, but this study shows a negative insignificant relationship with profitability. Even though this study shows a negative relationship with liquidity as expected it is not significant. Credit risk, financial risk and operation cost are insignificantly correlated with ROA.

At 5% and 10% significant level, both of the industry-specific indicators are significantly related with Islamic banks profitability. At first SMGDP is significantly positively related at 5% significant level, and CONC is also highly positively related with profitability at 10% significant level. In addition, based on the two macroeconomic variables used in this study GDP growth rate and inflation, only inflation has a significant relationship with profitability. It is expected a positive relationship between profitability of Islamic banks and GDP growth rate. However, this study shows a negative but insignificant relationship.

Discussions:

The results show that total assets, financial market development, market concentration and inflation are the determinants of Islamic banks profitability in Malaysia. Many researchers have found that little cost saving can be achieved by increasing the size of the banking firm and others have reported significant scale economies for banks whose assets extends well into the billion range. Therefore, based on the literature it expected the size of the banks may either be positively related or negatively related with Islamic banks profitability. This study found a positive and significant relationship between the total assets of the banks and its profitability. This means that the bigger the size of the Islamic banks, the higher the profitability, which emphasize economies of scale(Naceur, 2003).

Financial market development ratio measures the overall level of development of the market and its importance in financing economy. It is expected a positive relationship between financial market development and Islamic banks profitability. The similar results were found by Srairi (2009), Naceur (2003), and Kunt and Huizinga (2000). Bashir (2003) found a negative but insignificant relationship between profitability and financial market development. This study shows a significant positive relationship between profitability and stock market over GDP. This indicates that there are complementarities between banks profitability and equity market development. As stock markets enlarge, improved information availability increase the potential number of customers to banks by easing the identification and monitoring of borrowers (Naceur, 2003).

Kunt and Huizinga (2009) found that lower market concentration led to lower profitability. This was confirmed by Flamini *et al* (2009) who found a positive relationship between market concentration and bank profitability. However, Naceur (2003) found a significant negative relationship between market concentration and banks profitability. Some researchers have suggested that in higher concentration markets bank profitability tends to be lower due to aggressive non-price competition, and the behavior of managers as risk-averse. However, as expected from the literature, this study shows a significant positive relationship between Islamic banks profitability and market concentration ratio. This confirms that market structure has a positive impact on growth of Islamic banks in Malaysia.

The empirical result shows that only one macroeconomic variable is significant in explaining Islamic banks profitability in Malaysia. This study evidences a significant positive relationship between Islamic banks profitability and inflation. Similarly, Wasiuzzaman and Ahmed Tarmizi (2010), Bashir (2003), Athanasoglou *et al* (2005), Vong and Chan (2006), Kunt and Huizinga (2000) and Haron (2004), also found positive correlation between inflation rate and profitability and the inflation rate plays an important role as a macro variable in affecting the profits. The positive relationship implies that, bank income increases more than its cost during the inflation time. In other words, banks that forecasted future change in inflation correctly resulted in acceptable adjustments in interest rates and margin, which helped in increasing their profits. However, when taking into consideration that Islamic finance does not deal with interest rates, it could be assumed that by forecasting and predicting the inflation rate it could help the bank in making decisions with regards to the rate of profit sharing, loan quantity and asset quality instead.

Conclusions:

The proceeding empirical analysis allows us to shed some light on the relationship between bank characteristics as well as industry and macroeconomic indicators and profitability of Islamic banks in Malaysia. Using panel data regression analysis, this study shows that bank total assets, financial market development, market concentration and inflation are determinants of Islamic banks profitability in Malaysia. Some of the findings were different from the previous studies done in Malaysia e.g. Wasiuzzaman and Ahmed Tarmizi (2010) which evidenced that capital, asset quality, liquidity and operation efficiency have a significant impact on the profitability of Islamic banks. However, this study shows only bank size significantly affecting the Islamic banks profitability. This study also shows that bank ability to predict future inflation has a significant impact on the performance of Islamic banks in terms of profitability.

As a matter of policy implications, we need to draw several proposals at the bank and nation levels. At the bank level, this study shows that size of the bank has a significant impact on the performance of Islamic banks. Therefore, Islamic banks in Malaysia should focus more on expanding the banks in order to achieved full benefits of economies of scale. At the same time Islamic banks should also focus on predicting future inflation in the country. The ability of the banks to predict future inflation helps banks to determine its interest rate above the inflation. However, when taking into consideration that Islamic finance does not deal with interest rates, it could be assumed that by forecasting and predicting the inflation rate it could help the bank in making decisions with regards to the rate of profit sharing, loan quantity and asset quality instead. At nation level, it indicates the need to boost the development of the equity market in order to improve bank's profitability as bank and stock market was found to be complementary.

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