Impact of Rate of Return (Interest Rate) on Islamic Methods of Finance: Evidence from Pakistan

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Abstract: The study develops a rate of return on Islamic methods of finance that effects in Pakistani financial organizations. It is necessary that we can understand the rate of return and their implications in Islamic way. This research is created a central role on basis of this research that we have sustained the same idea but focused on rate of return of the Islamic financial institutes with respect to general interest rates of other institutes. This was completed by examine the investors working situation, as an experience and as a progression. This study includes and relates to procedural approach, which we have expressed like “science by doing”. This aims of this study is to clear Market Discipline of different Institutions such as banks, financial institutes offering different Islamic Financial Services to the customers. These Islamic organizations, goods and their services planned to fulfill with the Islamic law and prohibit the interest rate. It is one of the mainly fast rising parts in the monetary services. It gives a synoptic inspection of the relatively few experimental perceptions, attitudes and familiarity of Islamic finance. Human being consumer, business firm and financial institution feelings to Islamic finance are inspected the economic services and products. This has significant suggestions for the capability of Islamic finance firms to fight in commercial banking and extra services. It has stimulated from a mere hypothetical idea to a sensible reality. Islamic finance is therefore tackling some new and some old, but changed, challenge on the rational and factual plains. ‘IB’and Finance in modern times developed out of the Muslims’ desire to find out the customs and income to accomplish their financial necessities in view of prevention of interest. Interest based money had become the leading scheme during the grand period and sustained to be so in many Muslim countries.

Key words: Interest Rate • Islamic Methods of finance • Financial Institutes

INTRODUCTION

The study develops the relationship with rate of interest received by the different financial institutes. The general rate of return shows different rates but having no sense of Islamic rules. Unfortunately in Muslim societies and countries, numbers of investors are investing their money without any Islamic assumption. Even in the public and private organization the Islamic investment concept is so weak. This study clears with investment concept by announce a return on deposits, based on the proceeds in Quran evidence that what is an importance of Islamic rules and when to apply these methods. The Islamic finance is more beneficial and fulfills the Islamic living standard.

Quran and Sunnah are two most important resources of Shariah which shape the basis of Islamic finance. Those who eat Riba will not put (on the Day of renaissance) apart from like the positioning of a person compressed by Satan foremost him to insanity. So it is because they say: "Trading is only like Riba," while Allah has allowed trading and prohibited Riba. So whosoever obtains reproach from his Lord and stops consumption Riba shall not be reproved for the past; his case is for Allah (to judge); but whoever returns (to usury), such are the residents of the Fire they will put up with there in [1]. Aggressive markets this allotment of capital is attained with effectiveness and capital is concerned to where it will earn the maximum rate of return [2]. The bank offering saving places would supply no agreement on their nominal rate and they would not pay a permanent
rate of return [3]. A competitive rate of return if offered by Islamic finance and banking institutions to attract and retain investors as fund providers, can create additional legal risk under US law [4]. RR is to investigate depends on the present value of the revenues accruing to the sale of the knowledge produced, the abstractly suitable rate of reduction is the rate at which the approvable revenues turn down for the pioneering firm [5]. Islamic ‘nance is a money exchange system, the elementary aim of which is to ful?ll the educating of the Holy Quran, as disparate to gathering maximum returns on financial assets. The fundamental standard in the Sharia Islamic frequent Law is applied that the unequal agreements based on Riba interest or usury that involve risk or speculation Gharar are unenforceable [6]. To obey the first situation of justice, Islam entails both the investor and the capitalist to justifiably share the profit as well as the failure. For this reason, it is one of the essential philosophies of Islamic finance is: ‘No gain, no risk.’

Review of Literature: At the macroeconomic level, Islamic finance evades the use of interest based loan. The rate of attention is returned by the rate of earning on equity and profit distribution finance, markups on credit acquire finance and by hire rates on leasing finance [7]. Mudaraba ‘Trustee ?nance contract’ or inactive partnership; one party gives finances while the other supplies knowledge and administration; pro?ts accumulated are communal on a pre decided basis; losses are borne only by capital supplier. Musharakah is an equity contribution contract providing for pro?t/loss allocation in the cooperative business; the ?nancier provides a part of the total funds and all partners may participate in organization; pro?ts are distributed in pre granted ratios but wounded are borne severely in quantity to personal capital assistance [8]. Contemporary Islamic banking has taken a while to enlarge.

The idea of macroeconomic of Qur’anic, of communal fairness, generated the so called interest free Islamic banking at a small level of economy. In Islam, the regulation comes from the belief, so to comprehend one we will have to recognize the other. All the muslims of the world follow the Qur’an. For the Muslim, it was exposed to the Prophet Mohammed from God throughout the angel Gabriel. Mohammed was ordered to deliver and the verses of the Qur’an were the result of that recitation. Consequently the Qur’an is measured to be the word of God. Shari’ah as it is called in Arabic has two main foundations, the Qur’an and the Sunnah, which is the way of life of Prophet Mohammed [2]. In the case of lessening market interest rates, the conventional bank is capable to regulate both the deposit and base lending rates downwards hence upholding its profit edge. It is motivating to note that the Islamic bank would also diminish the rates of return on deposits in line with the conservative deposit rates [9]. Like conventional banks, Islamic banks also based on depositors’ money as a major foundation of funds, Therefore, the management of Islamic banks is clear to pursue the market rate when declare the rate of income to their clientele, vice versa [10]. The charity can be grouped into three groups, works connecting to the nature of riba and its Islamic substitutes, Islamic business shapes and their rules and the market atmosphere which makes the possessions of firms detachable and tradable [11]. The major sources of funds for Islamic banks would be two shapes of deposits deals deposits and investment deposits. Such deposits are straight connected to dealings and payments and can be observed as corresponding to demand deposits in conventional banking systems. Although a bank would assurance the nominal value of the deposit, it would pay no interest on this type of responsibility. The bank contribution investment deposits would supply no guarantee on their nominal value and they would not pay a permanent rate of return [3]. In addition, interest is banned due to its disappointing effects on venture. If one who wants to spend money to earn profit, Islam has permitted trade over lending for interest. If one does not want to invest money for return, but has some additional funds, Islam has positive expenditure in charity over lending for interest (Al Baqarah: 276). Imam Malik is of the view that the liquidity of capital is not a situation for the validity of Musharakah, so, it is allowable that a colleague supplies to the Musharakah in kind, but his share shall be resolute on the basis of appraisal according to the market price common at the date of the agreement [12].

Islamic finance relaxes on the general idea of make bigger tenets of Islamic spiritual faith to economic activity in a way that improves social wellbeing. Islamic contracts are usually stranded on asset based and it must be obey with the Shari’ah, which forbids elements of riba, gharar, maisir (gambling) and non halal behaviors. These exclusions are clearly declared in the Qur’an and Hadiths and must be severely stucked to the financial institutions [13]. Mudaraba is a convention in which a sponsor, say a bank, provides funds to an entrepreneur for investing in a business project to share profits in an agreed quantity, the loss declining on capital alone. This sight entails what we may call a pure mudaraba model where the financier is
understood to provide the whole capital to an empty handed capitalist; even today to small partnership businesses to commence detailed projects [14]. Although traditional finance theory always suggests that investors’ investment decisions are based on their objective evaluation of risks and expected returns, psychological factors towards risk perception may play critical role in investors’ investment decisions [15].

**Schematic Diagram:**

**Table 1.1**

<table>
<thead>
<tr>
<th>Rate of Return</th>
<th>Islamic Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>Islamic finance</td>
</tr>
<tr>
<td>Required rate of return</td>
<td></td>
</tr>
</tbody>
</table>

**Hypothesis Development:**

**Hypothesis:** There is an optimistic Association between Rate of Return and Islamic Mode of finance.

**Methodology:** The methodology of this paper is based on the different variables. The variables use the model as previous study of fama and schewert (1977). The regression equation is used in it.

\[ Y = C + \beta X_1 + \beta X_2 + \beta X_3 + \ldots + \beta X_n + \mu \]

\[ Y_u = \alpha_u + \text{Return of Return} + \beta + \text{Islamic Finance} + \beta + \mu_u \]

Where \( \alpha_u \) are the consequences of banks with time period of \( t \), \( \alpha_u \) is the intercept (constant). \( \beta \) is the change in dependent variables with respect to change in independent variable. Where \( \beta, \beta \) are the variables changes w.r.t time. Where \( \mu_u \) is the random error with the change of time.

**Sampling Size:** Total employees surveyed are \( n=150 \) but the responses were 130. We administered our questionnaires to make the sample size more suitable to understand the effectiveness of investors and brokers. Rawalpindi / Islamabad are selected sample area in our research. In this paper, we used a simple random sampling technique.

**General Profile of the Sample:** Sample was divided into four groups, Gender, Age, Education, Experience and Society (\( n=130 \)). Table 1 shows the percentage of gender; Table 1.2 demonstrates Age with percentage, Table 1.3 describes Gender, Table 1.4 shows the Education, Table 1.5 shows Experience and Table 1.6 shows Society with percentages.
Reliability of Measures: Table 2 shows Cronbach’s alpha reliability coefficients of one dependent variable i.e. Rate of Return (RR) and independent variable Islamic Finance was obtained which are as follow:-Reliability test of all the variables shows the rate of Cronbach’s Alpha used for maximum variables is 0.774, considered to be excellent for internal reliability of data. According to Glien (2003) Range of Cronbach’s alpha is between 0 and 1. In reliability test.70 is acceptable value of alpha but.8 is expected to be a required target which shows a good consistency of internal scale of the items.

Descriptive Statistics: Measuring Mean and Standard Deviation: In descriptive statistics means and standard deviations were inspected for dependent and independent variables. The consequences are shown in Table 3. On a 5-point scale, the Mean of RR is 4.1103 and Islamic Finance is 4.1637. So, this research shows that data is more reliable and near to 4 in the scale i.e. agreed by respondents in an average. Standard deviation is below 1.0. So it shows strong impact on Islamic Finance.

Correlation: All the outcomes of Pearson correlation matrix are exposed in table 4.

Regression Analysis: The chart 5 lists four autonomous variables which are put in the regression model and R (0.662) is the positive correlation of I.V with the D.V, inter correlations amongst these six sovereign variables are considered. The model summary of table 5, R Square is (0.438), that is explained R , actual the square of the Adjusted R Square (0.434).

ANOVA: Table 6 shows the results of ANOVA. Through ANOVA table we concluded that our model is goodness of fit because the significant value is 0.109, if the sig rate is < the level of consequence (0.05) it shows, model is goodness of fit. It also shows that at least one of the coefficients is not zero. If p-value is > 0.05, such as 0.5,0.9,0.8 then it is not significant.

Coefficients: This can be expected whether if there is a small change in (X1) then there may be a large change in Y'. These are the regression coefficient which shows the unstandardized and standardized beta.
DISCUSSION

Table 1.2 shows that Question (n = 130) were almost consistently divided by gender, that is, the distribution of demographics variables. The study is based on both male and female. Male are 66.2 per cent while females are 33.8 per cent in participation. We have collected data only from combined cities Rawalpindi and Islamabad Pakistan. The age lies between 20 years to 50 years from experienced Muslims and non Muslim investors. Table 1.3 shows the gender which explains the percentage of male and female and their validity. Tale 1.4, 1.5 shows education and experience with respect to their ages and work. Mostly people are graduate and having much awareness about Islamic finance. The data and their values provide practical information that is close to reality. These variables are tested by regression, using SPSS student Version 21.0 Factor analysis was calculated on the foundation of the societies with each other and at person source of predictors and dependent variable (Rate of Return). The marks clear the removal of I.V and D.V from \( \bar{u} = 1.000 \) that shows all the analysis shows the RR is \( 0.744 \), Interest rate growth is also significant. This outcome is positively related and has a strong connection of promotional equipment on Islamic Finance under infrequent study of advertisement operation by banks. Table 1.6 shows the societal influences where 90.1% community is based on Muslims and 9% population is based on non Muslims selected by me. Short-term consistency reliability shows the reliability coefficients of the one independent (Islamic Finance) and one dependent variable (Rate of Return) was obtained. The result shows the value of Cronbach’s alpha 0.774.

Table 3 shows Explanatory Statistics Quantifying Mean and Standard deviation. Variables represent average values that satisfy our study. It is also expressive statistics such as mean and standard deviation was examined for the time scaled dependent and independent variables (given in the table). Therefore, this research clears that data are more dependable and reliable and arranged by respondents in an average. S.D is near to 1.0. So it shows sturdy impact on Islamic Finance. Last column shows the population N = 130. Presents the variable values and their impact with respect to their minimum and maximum values. It also finds the middle value and risk that may is beneficial for this study. Table 4 shows the Pearson correlation mild is attained for the five intervals scaled variables. From the results, we find out that sales performance is positively correlated with ‘RR’ and ‘IF’. The relationship ‘r’ lies between -1 to +1. The results must be highly correlated and highly negative correlated. Here the results of Rate of Return and Islamic Finance are positively correlated because the results are approximately 0.7, so performances are highly correlated with each other. Table 5 shows the lists the variables which are put in the regression representation and R (0.662) is the correlation of the I.V with the dependent variable, following all the inter correlations between the two independent variables are taken into description. In the summary of table, the R square (0.43), which give details of variance, is in fact the square of the multiple R (0.662)². The standard error of estimate is 0.32964. The study is very useful for Muslim societies and can produce good results. The model shows goodness of fit.

RESULTS

From the Correlation table4, we conclude that our independent variables i.e.; Islamic Finance all are +vly connected with the D.V. So entire hypotheses are accepted.

CONCLUSION

The behavioral consequences of the investors and employees working in different sectors show a direct causal relationship with the Islamic investment. This can be taken as a significant finding, especially in the Pakistani context. It can be considered that the rate of return and Islamic investment elements are very important for the Muslim society which ultimately reduce their problems and increase interaction among investment and banks. This study produced very good results which were obtained from the SPSS statistical analysis software; theoretically, behavioral influences the organizations’ and their environment. Attitude, psychological and Islamic financial practices must be reviewed time to time for getting the better results.

Limitations:

- This study was conducted in twin cities of Pakistan (Rawalpindi/Islamabad) due to time and budget restraints.
- Covering only banks and investors.
- The sample size may be on the lower side, it is possible that if there is large sample size, results would be clearer and specified.
Future Work: This research is limited to Pakistan only; leaders working in Pakistani environment can make their organization well by using international methods. We can make our study more efficient if we judge and contrast with other environmental factors.

REFERENCES