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   REVIEW OF LITERATURE

   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

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- Garg, Bhavet (2011): Towards a New Natural Gas Policy, Political Weekly, Viewed on January 01, 2012 http://epw.in/user/viewabstract.jsp

INTEREST RATE FLUCTUATIONS AND FINANCIAL OUTCOMES OF BANKNG SECTOR: A CASE STUDY OF PAKISTAN

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ABSTRACT
The main idea behind this study was to evaluate the impact of interest rate variations on profitability of Pakistani banks. Financial performance is measured by return on assets, return on equity, earnings per share and independent variables include Interest rate, loans or advances, investment and deposits with other banks. A sample of top 20 banks operating in country from 2007 to 2011 was selected for analysis and data were collected from primary sources. Descriptive, correlation and regression analysis were used as statistical techniques. Outcomes of analysis suggested that interest rate have a great impact on financial results of commercial banks working in Pakistan.

KEYWORDS
Interest rate, Karachi stock exchange, Return on Assets and Return on equity.

INTRODUCTION
In previous decade enormous growth and potential has been seen in the banking sector of Pakistan. It shows the stability and development of banking system. The financial institutions are operating in a very competitive market where they have to offer attractive rates to borrowers and lenders. The main issue for banks is to avoid their liquidity and solvency related problems. This mean they always have to maintain a good portion of cash to meet their liquidity issues. The impact of change in cash reserve requirement by the state bank of Pakistan has also affected the lending power of banks. Government is empowered to borrow from these financial institutions but too much borrowing of state from these banks also limits their profitability because these institutions have to maintain a large amount as reserve and provisions against non-performing loans (NPL). The role of state bank of Pakistan (SBP) cannot be ignored in the stability and growth of banking sector because it provides guidelines for efficient and effective working of banks. The effective monetary and transparent fiscal policies are the measures which provide support and stability to the smooth running of banking system. If the banking system of the country is stable it means the overall economy of country is also stable. Stable economic condition leads towards saving and investment decision trend, all these measure are vital for the successful operations of the banks. Now a day's ability of banks to forecast and avoid risk contributes in their success; through this they can cover the risk of losses. Profit is the most vital thing and also necessity for growth of banking system in financial market. These important facts are leading toward key issues about profitability of banks. Banks have spread their portfolio assets & liabilities in a manner that influence its profitability, where is room to increase the profit

bank definitely go to that area for increasing their profit, it shows the importance of financial outcomes for banks. Assets of bank are grouped into two categories earning assets and non-earning assets: earning assets means on which the banks earn some sort of profit and these are the major source of income for the bank. Other includes those assets which are used for the reserve requirements. The earning assets have main influence on the profitability of bank so these are consider in our research paper. The efficiency of banking operations contributes in economic growth of country because banks play a vital role as financial intermediaries. Banks provide the financial services and demand interest as reward for these services; funds of bank come through deposits and bank pay interest on these deposits to its customers. Banks profit margin is the difference between the amount earned through earning assets and amounts paid to depositors. These interest rate or bank margin varies with the state bank of Pakistan monetary policies as recently state bank of Pakistan announced the decrease in interest rate from 10.5 to 10 percent which also affect the KIBOR, which is base for charging interest.

LITERATURE REVIEW

The study of Maisal and Jacobson (1978) showed that in an efficient market there is no need to consider the institutional forces of market. Financial institution can easily get the result from available information to predict the future actions and reactions. Financial institutions always find new ways to equalize their cost and return. Analysts assumes that, in an efficient market complete information is available and no information cost because the lending, hedging, borrowing and arbitrage are conducted on risk free rate of return. They believed that through an efficient financial market they predict their asset management results very efficiently and rapidly like cost and return, assets, liabilities without wasting their funds on information cost or on institutional forces which reduce the efficiency and increase the cost. Authors conducted this study on the base of cross section banks cost and revenue from the period 1962-1975. Their estimate was based on cost of book value of assets and the net rate of income which shows the result of the net return of assets differ from if computed on the basis of average. The results also showed the major shifting occurred during period of 1970-1975.

The study of Demirguc-kunt and Huizinga (1999) studied the determinants of the bank profitability and interest rate are: macroeconomic conditions, regulations, organization financial structure, implicit and explicit bank taxation, deposit insurance regulations, bank characteristics and several legal underlying institutional indicators. Study also clarified that foreign banks had higher profit margin in developing countries as compared to domestics banks and a reverse situation is entailing in industrial countries. Another evidenced came from this study is that in developing countries there is a direct impact of the corporate taxes on the consumer because the banks shifts it toward consumer while no high reserve restriction had to maintain with central bank. The regression technique was used on the data to find out the results of determinants on profit and interest rates which were collected from banking institutions of 80 countries from 1988-1995. The economic conditions, size, composition and structure were different in various countries so the impact of above mentioned determinants was also mixed. Data of several countries had been used to analyze the conditions and various characteristics of the banks which affect the interest rates and margin of profit, results showed that some variables had negative relations while some had positive relations with each other.

The paper of Davies and Vaught (2010) described “the impact of interest rate on the profitability of banks in south specific”. Findings show that the profit margin of this region banks is in accordance with the line or criteria mentioned by the central banks of all the countries in that specific region. The lending rate to the customer is stable or related to the interest rates spread of these banks, this evidence showed the stability within the region commercial bank profit and restriction of inappropriate fluctuations in both profit and interest rates. The data was gathered through the region’s central banks prudential, the income was also more as compare to other region’s due to too much income from the operations of foreign exchange. Economic and country risk relatively high in this region, the cost of compliance with prudential regulations also effect the interest rates, the banks profit remain was high because the ROA is 4.8% since 2001, which comes mostly through the foreign exchange dealings of goods and services.

This paper of Kedar and Leong (2009) discussed the impact of interest rates changes on Islamic banks related with the Malaysian market of Islamic finance, which shows great development during the short period of time. Here the results showed that Malaysians customers consider profit motives and their decisions is based on the movement in Base Lending Rate (BLR) in case of Babbitt amin Ajil (BBA) financing or deferred payment sale financing, during the period of high interest rate customers preferred Islamic bank financing and in case of low rate their decision shifted toward conventional banking which was cheaper to them at that situation. At the time of conducting this research the BLR in Malaysia was falling down, this simply implies that the Islamic banking was costly than the conventional banking system and growth rate was also slow in case of Islamic banking. The data were used for the period of 1999-2007, results showed that appreciation in the BLR induce the customer to move from Islamic banks to conventional banks and vice versa.

Research paper of Tamoorespouri and Ardekani (2012) investigated the impact of interest rate on the bank return and size of the bank. For the purpose of study researchers considered different financial ratios and bank return as variables. The analysis indicates the different positive and negative results due to fluctuations of interest rate. This is due to difference in market size, macro economic conditions, monetary policy and difference among countries. The data is taken from 14 different markets from the period 2001 to 2010. Most countries banks showed positive relationships with return and interest rate variance but few countries like India, Japan, Denmark, and Switzerland were not in line with it. Hence, it’s not possible practically to demonstrate comprehended conclusions of all markets because the each ratio affects the size and return differently in accordance to that market. Only possibility was to give the specific conclusion regarding to that particular market which is different in economic determinants, characteristics and national monetary policy.

The study of Kassim, Majid and Yusof (2009) investigated the impact of monetary policy shocks on the Islamic and conventional banks in a dual banking system economy. According to study reactions and response of the conventional banks were different from Islamic banking due to monetary policy shocks because Islamic banking is based on interest free concepts. The study investigated the impact of interest rates changes on deposits and financings. To get meaningful result same test also applied on the conventional banks. The research based on the vector–auto-regression (VAR) method. Result showed that monetary policy shocked merely Islamic banks than conventional banks because changes in monetary policy destabilize the balance sheet items of Islamic banks.

The study of Bakeel and Alrashidi (2012) investigated the impact of interest rate on the profit margin of the SME companies of UAE, by using the qualitative technique. Interest rate considered as an important factor that had positive relationship with savings level of economy, but apart from the good impact on the savings, the results indicate that the interest rate had an adverse impact on the profit SME companies of the UAE which differ through various variables.

The research of Ahamd and Nafees (2010) investigate the impact of few internal factors on profitability of Pakistani commercial banks. The results were based on the random effect data regression model. ROA was used as dependent variable and four costs, LOSRES, LIQ, and EQAS as independent variables. Bank tries to manage the cost of its operations effectively because its effect the bank’s return negatively. EQAS also effected the return, reason behind was that the bank strength as bank didn’t hold great volume of capital. Banks will invest in that area where the cost of project is low and recovery policy had to be effective, easy, less risky and ultimately produce a high return.

The findings of Guru, Staunton and Shanmugam (1990) about determinants of conventional banks profitability in Malaysian market also paved a way to our research material. Their findings suggested that determinants only provide the significant profit by managing the expense efficiently. The focus of bank was on controlling the cost of operations. In recent years saving accounts were not the only tool to increase profitability, but banks also had improved the services of current account by maintaining less cost on the account in efficient way. These tools and demand deposits both lead toward the attraction of the customer that improved the profitability of bank as compared to other non-banking financial institutions. In their portfolios banks should focus on safe and productive sectors by keeping sound monitoring system. Base lending rate was the main tool used in the measurement of capital scarcity. The difference between interest paid and interest received showed the profit capacity.

Another research was conducted by Bennaceur and Goaied (2008) the determinants of conventional bank interest margins and profitability evidence from Tunisia. The study investigated those characteristics of a bank which explain the variability in bank interest margins and its profit within the country. Large amount of capital leads toward high profit and interest margins. The negative impact on profit comes through bank size which showed Tunisian banks were operating above the level. Macroeconomics variable had no impact but financial structure had significant impact on profit and interest margins. Stock market reflected the common growth characteristics between banks and stock market. Complete liberalizations rate of interest had positive effect on net margin of interest but partial liberalization had adverse effects. Ownership size also had a great deal of influence on the profitability of banks in Tunisian economy.

PROBLEM STATEMENT

In today's environment interest rate fluctuation is a hot topic in many decision making areas. Too much fluctuation in interest rate has a great impact on the economy as well as individual and corporate level decision making. The variation of interest rate has immense influence on savings and investments decisions.

OBJECTIVE OF STUDY

The purpose of this paper is to calculate and investigate the impact of interest rate fluctuations on profitability of the banks on the base of following variables

- Interest rate
- Investment
- Advances or loans
- Deposits with other bank

RESEARCH METHODOLGY

This section provides information about Population and sample selected for the study. Furthermore it discusses the type of current study, the strength of the research and data collection & analysis techniques used in current study.

SAMPLE SELECTION

Sample of this study is made of 20 banks out off 33 banks operating in country and listed at Karachi stock exchange from 2007-2011. This five years period was selected due to two reasons. First during this period of time too much fluctuation was observed in the interest rates and profit margin of banks. The second reason is that before 2003 banking sector was using PKRV rate as benchmark rate after that KIBOR rate was introduced as benchmark in baking sector. Twenty leading banks of Pakistan have been selected for this purpose from the banking sector. These twenty banks were selected on the basis of high market share and return.

TYPE OF STUDY

The type of current study was cross-sectional. Banks listed at Karachi Stock exchange KSE- 100 indexed were selected on the basis of high return and market share from 2007 to 2011.

DATA SOURCES

- Audited annual reports of sample banks
- Websites of concerned banks
- Website of Karachi Stock Exchange
- Publications of State bank of Pakistan
- Press Publications and media reports.

DEPENDENT VARIABLES

RETURN ON ASSETS

ROA measures how effectively bank is utilizing its assets to generate return. It is calculated by dividing the profit after taxation available to shareholders' by the simple average total assets at end and beginning of the period.

$$\text{Return on Asset} = \frac{\text{Net Income}}{\text{Average Assets}}$$

RETURN ON EQUITY

ROE measures how well the bank using shareholders invested money. It is calculated by dividing the profit after taxation available to shareholders by average shareholder equity.

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Shareholder Equity}}$$

EARNINGS PER SHARE

EPS reflect the profit after taxation generated per share. It is calculated by dividing the profit after taxation available to shareholders by the average number of shares outstanding during the year.

$$\text{Earning per Share} = \frac{\text{Profit after Taxation}}{\text{Weighter Average Common Share}}$$

INDEPENDENT VARIABLES

INTEREST RATE

It means borrowing cost earned by bank and KIBOR rate is taken as benchmark during this period.

DEPOSITS WITH OTHER BANKS

The banks kept their liquidity reserve with other banks for different periods and earn a return.

LOANS OR ADVANCES

These consist of the amount of money borrowed to customers to fulfill their need, expenditure or obligations.

INVESTMENTS

These include the certificates purchased by the banks from different borrower and at maturity banks will sell back these certificates to the borrower.

EMPIRICAL MODELS

$ROA = \beta_0 + \beta_1 INT_1 + \beta_2 DWOB_2 + \beta_3 ADV_3 + \beta_4 INV_4 + \mu$

$ROE = \beta_0 + \beta_1 INT_1 + \beta_2 DWOB_2 + \beta_3 ADV_3 + \beta_4 INV_4 + \mu$

$EPS = \beta_0 + \beta_1 INT_1 + \beta_2 DWOB_2 + \beta_3 ADV_3 + \beta_4 INV_4 + \mu$

Here,
ROA represents the Return on Assets
ROE represent the Return on Equity
EPS represents the Earnings per Share
INT represents the Interest
DWOB represent the Deposits with other Banks
ADV represents the Advances and
INV represents the Investment.

RESULTS AND DISCUSSIONS

Table 1, 2 & 3 are used to elaborate the outcomes of descriptive, correlation and regression analysis. Table- 1 shows the five year summary of mean, median and standard deviation of variables for a sample of 20 banks listed at Karachi stock exchange from 2007 – 2011.

Table- 2 exhibits the results of correlation analysis. Correlation is known as interdependence of variables. For the purpose of this study researchers have checked the correlation of independent variables with themselves to find out multicolinearity among variables. The advances or loans (ADV) are positively associated with DWOB, INT and INV. Deposits with other banks are also having positive relationship with interest rates and investment of banks. Investment is found to have a direct relationship with interest rate. The main diagonal value of correlation coefficient is 1 which shows the perfect and strong positive correlation among each other.

Table- 3 demonstrates the regression results for dependent variables ROA, ROE, EPS with respect to independent variables. The first column represents the coefficient for each independent variable which is showing the strength of influence between the determinants and the profitability measures. Second column represents the T-Statistics values which are showing the significance of the regression results. R-Square for ROA is 0.43754 which means that of 43% samples describes ROA. This means that 43% variation in dependent variable is explained by the independent variables of the model. The remaining 57% variation in ROA is unexplained by the independent variable. It also has F-Statistics 8.75164 which show its significance. ROA is having a positive relationship with advances and investment while negatively related to interest rate and deposits with other banks. R-Square for ROE is 0.30059 which is less significant than ROA and it means that of 30% samples describes ROA. Its F-Statistics is 4.835153. Return on equity is found to have an insignificant relationship with all independent variables. It is negatively associated with INT & DWOB but positively connected with INV and ADV. R-Square for EPS is 0.71794 which is more significant than both models discussed above. In this model 71% changes in dependent variable is due to e independent variable of the model. The remaining 29% variation in EPS is not caused by independent variable. It has F-Statistics 28.63514 which is highest from both ROA & ROE. As per regression results advances and investment have strong favorable impact on earnings per share. On the other hand deposits with other banks and interest rate are having an inverse but significant impact on EPS.

CONCLUSION
The main motive behind this research was to evaluate the impact of interest rate on profitability of banks. The results made it clear that the profitability is significantly affected by the interest rate, advance or loans, investment and deposits with other banks. It means profitability of banks depend upon interest rate which is main tool of monetary policy. When interest rate will rise then lending rate will increase more as compare to deposit rate, which means banks profit is going up because it will results in a high bank spread. In an opposite scenario where interest rate is low, In this case of increase in interest rates the lending rates tend to move faster than the deposit rates. While in case of decrease in interest rate the deposit rates tend to change or move faster than the lending rates. But a point that must be kept in mind is that a further increase in lending rates will slow the growth of advances and increase the ratio of bad debts. The paid-up capital requirement of Rs. 15 billion by state bank of Pakistan until 31-12-2011 also encourages the further consolidation of banking sector. It was used to decrease the impact of risk, conservative growth in advances and deposits, bringing downward advances to deposits ratio. But the major concern is the interest rate movement which is damaging up to great extent. It will be very difficult for individuals to save money and made investment in economy due to fluctuations of interest rate.

RECOMMENDATIONS
- Banks in Pakistan are not following the international level of interest rate due to this they are enjoying healthy profit which is the difference between the lending and deposit rate.
- These interest margins are high in the world which shows the monopoly of commercial banks and also pointing out the poor governance of the Central bank of Pakistan.
- The banking quality of services should create the profitability by giving more benefits or margin to depositors and charging less from the borrower.
- The banks should also have to maintain a decent capital adequacy ratio and adopt some required measures on too much changes or fluctuation in the interest rates.
- The banks can minimize their risk associated without involvement of funds by producing or developing their more focus on non- interest income.

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ANNEXURE
TABLES

TABLE 1: DESCRIPTIVE STATISTICS

	ROE	ADV	DWOB	INT	INV	ROA	EPS
Mean	0.040682	1.702308	8749050	1.234966	8.665677	0.457238	5.450465
Median	0.089464	1.364083	3696117	1.458312	7.618450	0.665693	1.594761
Std. Dev.	0.275239	1.320849	11630990	1.590071	2.966235	1.989601	8.196682
Observations	100	100	100	100	100	100	100

TABLE 2: CORRELATION MATRIX

	ADV	DWOB	INT	INV
ADV	1	-	-	-
DWOB	0.821849	1	-	-
INT	0.064083	0.12250	1	-
INV	0.818911	0.70107	0.279948	1

TABLE 3: REGRESSION ANALYSIS

	ROA		ROE		EPS	
Variables	**Coefficient**	**t-Statistic**	**Coefficient**	**t-Statistic**	**Coefficient**	**t-Statistic**
C	0.46011	1.25163	0.33816	1.11527	0.08598	1.49795
INT	-0.29702	-1.93541	-0.03929	-1.65954	-0.99052	-2.21323*
ADV	0.95037	2.45518*	0.67093	1.78109	0.04738	3.95398*
INV	0.85097	1.82799	0.76361	1.05463	0.02548	3.82717*
DWOB	-0.80728	-2.38413*	-0.64569	-1.23437	-0.03807	-3.92139*
R-Square	0.43754		0.30059		0.71794	
F-Statistics	8.75164		4.83515		28.6351	
Observations	100		100		100	

*t-Statistics is Significant at Level of 5%

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