The Moderating Role of Profitability: a Conceptual Study

MUHAMMAD SAJJAD HUSSAIN[1], ABDELNASER OMRAN[2] , ABDULKARIM OMRAN GEBRIL[3]
[1]University of Management and Technology,
Lahore, PAKISTAN
[2] Faculty of Engineering, Libyan Academy for Postgraduate Studies, Ajdabiya branch,
Ajdabiya city, LIBYA
[3]Department of Business Administration, Faculty of Economic, University of Benghazi,
Al-Abyar Branch, LIBYA

Abstract: - This study investigates the moderating impact of profitability on relationships of the owner's behavior and implementation of regulations, risk-taking. Many of the previous studies mentioned the owner's attitude towards risk-taking and implementation capital regulations but ignored the role of profitability on these relationships. Especially, in developing countries where financial performance is below standard, the owner's behavior toward risk-taking and policy implementation affected by the profitability. This study concluded that profitability/financial performance moderate the relationships of the owner's behavior and risk-taking, implementation of regulations. Profits associated with investment have the characteristics to change the owner's behavior regarding regulations implementation and risk-taking activities of financial institutions.

Key-Words: - Profitability, Risk-taking, Banks of Pakistan, Financial Performance

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1 Introduction

Financial and economic development of any country depends upon the performance of their financial system. All the financial institutions together with regulatory authorities are the part of this financial system and their contribution towards resolving the financial issues and its development increasing intensely with time [1]. Similarly, the World Bank Report [2] also mentioned the increasing trend in the role of the baking institution towards resolving financial issues and its development. Moreover, the World Bank is also playing its imperative part to unravel the financial issues faced by the developing countries in the world. Financial aids, low bearing cost loans and poverty eliminating projects by creating jobs opportunities are the foremost steps taking by the world leading financial institution. These steps are crucial for improving the developing countries in the world that making them able to contribute their part in the development of the financial and economic condition of the world [3]. Furthermore, developing countries and their financial condition are very crucial for economic stability in the world. The majority of the part of the world are in developing phase and needs to develop with extensive rate, and this objective could not be achieved without the contribution of the developed part of the world. In addition, this growing importance of financial institutions around the world has opened the new avenue regarding research on the performance of these financial institutions, which focuses on their role on financial and economic development [4].

2 Financial Institutions of the world

Financial institutions are the establishments that conducted financial transactions with individuals and other financial institutions. Their foremost functions are to depositing money, providing loans and exchanging the currencies. Some of the major categories of financial institutions are mentioned below:

2.1 Banking Institutions

Banking institutions are foremost part of the financial institutions of the world, which provide finance to the other institutions and industry. They accept the deposits and giving that funds to the business and generate financial cost [5]. Moreover, Bongini et al. [6] revealed that the financial performance of the trading and manufacturing industry depends upon the financial performance of the banking industry. Finance is the blood of business and the major part of this blood provided by the financial institutions, especially banking institutions. The banking industry also has various types of banking institutions such as commercial banks, investment banks, saving banks and development banks, etc. Every type of the banking industry has specific functions such as commercial banks provide the services of mortgage lending, accepting deposits and giving business loans while, investment banks perform the services of intermediary between the issuer of securities and investing public as well as acting as a broker for institutional client [3]. Moreover, saving banks promote the saving ability of the low waged or salaried personals by sharing the profit on their deposits. On the other hand, development banks facilitate and promote the underdeveloped sector of the country such as agricultural development banks promote the agriculture sector, while industrial development banks promote and facilitate the particular underdeveloped industry in the country [7]. All the banks in the country control by the state bank of that country and other regulatory authorities such as securities exchange commission and Basel Committee on Banking Supervision (BCBS). These authorities provide a set of rules and regulations regarding risk-taking, minimum capital requirement, and other financial matters. These regulations must be followed by the banking institution for its better financial performance and soundness [8]. Thus, the financial performance of the baking institution has an impact on the performance of other institutions in the country, and this growing importance of financial institutions around the world has opened the new avenue regarding research on the performance of these financial institutions.

2.2 Insurance Institutions

The primary function of the insurance companies to pool risk by collecting premium that protects the client against the particular loss such as accident, fire, illness, disability or death. Insurance companies indemnify the losses of its clients arises due to the causes mentioned in the insurance policy [9]. Insurance services, mortgage, loans and buying or selling service of the real estates are the foremost functions of the insurance companies nowadays. All the insurance companies in the country control by the securities exchange commission, which provides a set of rules and regulations regarding risk-taking, minimum capital requirement, and other financial matters. These regulations must be followed by the insurance institution for its better financial performance and soundness [8]. They reserve some part of its funds to pay the claims because all insured clients will not suffer losses at the same time and invested the remaining part of collected funds to different industries and earn financial cost. Many of the companies also protect their losses and risks by giving some part of their funds as premium [10]. Thus, the financial performance of insurance companies has a significant impact on the performance of the other institutions of the country, and this growing importance of financial institutions around the world has opened the new avenue regarding research on the financial performance of these financial institutions.

2.3 Brokerage

Brokerage provides the facility of intermediary between the buyer and seller in the transaction of the security. They charged the commission of their services provided to the investor and the issuer of the security after the transaction has been completed successfully [11]. Brokerage houses and stockbrokers provided the facility of online trading of securities on behalf of the investor. In this regard, the broker acts on an investor’s behalf and eventually charge a commission of his services [12]. Brokerage is either full services or discount. Full services brokerage provides to his client full services such as portfolio management, investment advice, and trade execution and also charge significant commission. On the other hand, discount brokers do not provideinvestment research and portfolio management services. They allow the client to make their investment research and portfolio management. Discount brokers execute the trade contract between the issuer and investor and charge minor commission [13]. Thus, the performance of the brokerage influences the performance of issuer companies, and this growing importance of brokerage opened the new opportunity regarding research on the performance of these financial institutions.

2.4 Investment Companies

An investment company is a trust or a corporation that facilitate the individual investor to invest in professionally managed and diversified portfolio of securities by pooling their funds rather than purchasing the securities individually [14]. It is an indirect way of purchasing the securities through a packaged product just like a mutual fund. Naheem [15], mentioned in his study that there are three fundamental types of investment companies are existing in the market such as Unit Investment Trust (UIT), managed investment companies and face amount certificate companies. Unit Investment Trust (UIT) established under an indenture agreement and sold a fixed number of shares. On the other hand, face amount certificate companies issue debt securities at a predetermined interest rate. While, managed investment companies, actively managed a portfolio of securities and has two types ofopen end and closed-end investment companies. A closed-end investment company does not offer new shares and does not redeem its shares. It deals with issuance of share in one time public offering. On the other hand,open-end investment companies also deal with the issuance of new shares and also redeem their shares [16]. Thus, the performance of the investment companies influences the performance of issuer companies, and this growing importance of investment companies opened the new opportunity regarding research on the performance of these financial institutions.

3 Literature Review

One of the foremost elements and objective of any organization is the profitability, for which an organization is established. All the efforts of an organization are only for the achievement of profit maximization goal [17]. Similarly, Surroca et al. [18] indicated in their study that financial performance objective is the clear goal of an organization and all of the smart strategies or detailed action plans will lead to achieving this goal. Furthermore, the prime goal of the management is to maximize the owner's wealth, and it can be possible through profit maximization [19]. Net earnings of the company have become the part of the shareholder's funds, either distributed to them as a dividend or retain in the business as a reserve or as an additional investment [20]. Financial performance is one of the imperative measures of a successful business. Thus, the owner and management of the business concern have an acute observer of it and put all the efforts to attain this milestone [21]. Moreover, the survival of any business concern depends upon its performance, and the outcome of superior performance is the profitability of the business concern. Thus, without strong financial performance, business could not survive in the market [22]. In addition, Alshehhi et al. [23] conducted the conceptual study on corporate financial performance and concluded that firm's profitability plays a vital role in the survival of the business concern in the market.

3.1 Profitability of Financial Institutions

The strong financial performance of the financial institutions is evidence that all other business concerns in the market are in a strong position to produce extraordinary profits [24]. The reason behind this statement is, all the business concerns are linked with financial institutions concerning their financial need and return pay financial cost. If other businessesproduce extraordinary profits, then they can payback their debts as well as their costs. Thus, the strong financial performance of the financial institutions shows that almost all other linked business concerns have achieved extraordinary profit goals [24]. Moreover, Ozkan et al. [25] conducted the study of financial performance on the Turkish banking sector and found that financial sector's profitability depends upon their associated firm's performance, in which they invest their funds because financer gets benefit only if its client gain some extraordinary profits. Otherwise, in case of losses, financer may lose its financed funds instead of profit [25]. Additionally, Hussain et al. [26] conducted the study on commercial banks of Pakistan and concluded that profitability of the financial institutions could change the owner's behavior towards their decision making regarding risk, regulatory implications and other financial matters. Thus, the prime focus of this study is to examine the moderating impact of financial performance (profitability) on different decisions of the financial institutions.

3.2 Moderating role of Profitability

The profitability of the business concern (financial institutions) can change the owner's behavior towards decision making regarding regulatory implication, risk-taking, investment and other financial matter of the business [26].

3.2.1 Moderating role on Regulation Implication Decision

Many of the organizational decisions depend upon the financial performance (profitability) of the entity. If the organization is in a strong position regarding financial terms, then interest regarding the implication of regulatory measures is different than the economically pathetic firms [27]. Moreover, Catarineu et al. [28] conducted the study on Basel Accord and mentioned in their study that the owners of relatively high profit producing financial institutions are in strong position to implement the minimum capital requirement given by the Basel Committee on Banking Supervision (BCBS). Similarly, Aldao and Nolen-Hoeksema [29] revealed in their study that the implementation decision of many regulations is very crucial for the owners due to their earning capacity. Implementation of these regulations need some extra efforts, trained workforce, and excessive capital. Thus, the implementation depends upon the earning capacity of the owners. High profit earning owners are in a position to implement such expensive regulations but others could not [29] .In addition, Montgomery [30] conducted the study on the banking sector of Japan and found that Basel regulations are very tough to implement especially in developing countries. Lack of resources such as trained employees and scarcity of finance are the hurdles faced by the owners in the implementation of Basel regulations. Thus, earning capacity and financial position of the owners can change the owner's behavior towards regulations implementation. On the basis of all previous literature, the current study has proposed the conceptual framework (See Figure 1) and suggests that less attention has been paid on profitability as moderator and moderating impact of profitability on the owner's behavior towards regulation implementation can be empirically evaluated which is mentioned in Fig. (1) as shown below:

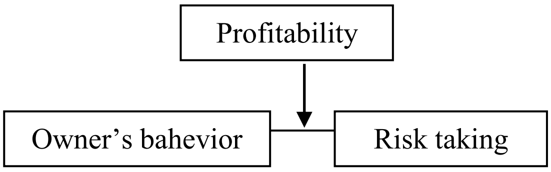

Figure 1. Presents the Conceptual Framework of the study

3.2.2 Moderating role on Risk Taking

Financial performance of the business concern changes the owner's behavior towards risk-taking. Similarly, Hussain et al. [21] conducted the study on the owner's behavior regarding risk taking and found that profitability can modify the investor's thinking about risk taking. Moreover, decision making of financially strong organization on risky financial matters is entirely different from weak entities [31]. Furthermore, Ashraf et al. [32] conducted the study on the banks of Pakistan and revealed that low profit making organizations are risk-averse instead of excessive profit-seeking entities. In addition, Sheedy and Griffin [33] conducted the study on risk governance, structure, culture and behavior. They found that the governance and structure of the organization have influenced the risk-taking of the financial institutions for the achievement of high financial performance goals. Furthermore, low financial performance is the result of low risk-taking of financial institutions. Thus, for the sake of high financial goals, the owners of banking institutions may change their behavior regarding the risk-taking [34]. Similarly, risk-taking ability affected by the profitability goals of the ownership structure of the firm. Extensive profitability goals of the owners lead towards them high risk-taking [35]. Moreover, Welker et al. [36] found in their study that the personal goals of the owners motivate them to take the extensive risk. Thus, earning capacity and financial position of the owners can change the owner's behavior towards risk-taking. On the basis of all previous literature, the current study has proposed the conceptual framework (See Figure 2) and suggests that less attention has been paid on profitability as moderator. The moderating impact of profitability on the owner's behavior towards risk-taking can be empirically evaluated which is mentioned in Fig. (2) as shown below:

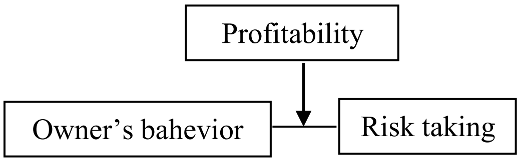

Figure 2. Shows the Conceptual Framework of the study

4 General Discussions

Excessive profitability goals of the owners modify their attitude regarding the implementation of capital regulations given by the Basel committee of banking supervision and risk-taking behaviors. Similarly, researches by [30; 37; 38; 39 & 40] investigated in their studies that policy implementation and risk-taking decisions depend upon the firm's financial performance. Especially, most of the decisions of financial institutions are relying on their financial performance. In addition, studies by [41; 42 & 43] also concluded in their study that excessive profitability goals have characteristics to change owners' attitude about regulations implementation and risk-taking. Same in the case of banks of developing countries, the owner's excessive profitability goals affected the implementation of regulations and risk-taking. In the end, it is summarized that the regulator's intentions must be on the owner's prime goal that affected the implementations of regulations and behavior of risk-taking. Regulators must change their intention from maintaining only the capital adequacy ratio to other factors that affecting the purpose of capital regulations.

5 Conclusion

This study concluded that extensive profitability goals of the institutions significantly modify their attitude regarding taking risk and implementation of regulations. Especially, the institutions of developing countries are not much strength in terms of financial performance. Their prime focus to increase the financial performance even by taking an extensive risk or ignoring the implementation of regulations given by the regulators. Moreover, the regulator’s intention towards the implementation of capital regulations in developing countries is not appropriate. Regulators are only focusing on the minimum capital ratio but ignoring the other factors in the implementation of capital regulations. Thus, regulatory authorities and risk management teams must target the risky investment activities of financial institutions for excessive profit-seeking and avoid the management to take unnecessary risks. Additionally, less attention has been paid on moderating impact of profitability especially in these relationships, and this study suggests that future studies should empirically evaluate the conceptual framework (See Figures 1 and 2) given in this study.

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Conflict of Interest

The authors have no conflicts of interest to declare that are relevant to the content of this article.