Partnership financing and bank efficiency

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\textbf{A B S T R A C T}

This paper aims to analyze the effect of partnership financing on bank efficiency. Partnership financing, which has similar concept with venture capital, refers to the equitable sharing of risks and profits between the client and bank. By employing output distance function on Malaysian and Indonesian Islamic bank over 1996 to 2012, we estimate bank efficiency score using Stochastic Frontier Approach and examine its determinants. Our results show that banks with partnership financing are more efficient than other banks. Banks with low capital risk coupled with large amount of partnership financing tend to be more efficient. However, when estimating the probability of crises using an early warning system, banks with high partnership financing appear to be less efficient during crises. The results suggest that the use of partnership financing improves efficiency, especially for banks with low capital risk except during crisis.

1. Introduction

Venture Capital (VC) has played a major role in the funding of start-up firms, especially in the technology and innovation sectors. Academics and industry professionals now recognize VC as an important driver of the success of entrepreneurial ventures. VC-backed companies grow faster, have better financial and operating performance, are more innovative, and are more likely to go public compared with their non-VC-backed peers (Gompers and Lerner, 2004). In addition, according to several studies (Chemmanur and Krishnan, 2011; Croce et al., 2013), VC enhances firm productivity. The increased in the firm’s efficiency and productivity is due to improved screening and coaching activities by VC investors. According to Cazorla-Papis and Haro-de-Rosario (2014), the efficiency of VC firms is due to excellent investment and diversified ownership structures. The diversity of shareholders, including banks, private companies, and public administration, enrich the decision making process, thereby increasing efficiency. Private VC-backed firms are found to be more efficient than government VC-backed firms (Alperovych et al., 2014). VCs and banks are similar in terms of their role as financial intermediary operators. Both can be viewed as profit maximization organizations. Against this background, applying VC may be a good strategy for banking institutions to improve bank performance. So far, some Islamic banks have applied a similar concept to VC known as, partnership financing (Mughal, 2017). Partnership financing refers to both Mudharabah and Musharakah financing. In Mudharabah financing, the entrepreneur returns the principal and profit to the investor based on a predetermined ratio, whereas any losses are exclusively borne by the capital provider. Similarly, the return for venture capitalists can be very high or a complete loss (Gifford, 1997). In Musharakah financing, the profit and loss are shared based on capital contribution or agreed ratios (Chazi and Syed, 2010). As VC can significantly affect firm performance, it is relevant to examine whether similar effect persists for
The objective of this paper is to determine the effect of partnership financing on bank efficiency. By employing output distance function on Malaysian and Indonesian Islamic 1996 to 2012 bank data, we estimate bank efficiency scores using SFA and test both the significance of partnership financing on bank efficiency. We further test whether financial crises affect the partnership financing-efficiency relationship. Theory does not provide a strong argument concerning whether banks with partnership financing are more efficient than banks with low or no partnership financing. Institutions providing higher partnership financing may increase the potential to direct financial resources to the most productive investments, thereby increasing the efficiency of the financing process (Khan, 2015), which may eventually lead to bank management efficiency. This is supported by Farooq (2007), who highlighted that the implementation of partnership financing with proper safeguards will make Islamic banking more efficient. However, due to limitation on the standardization in credit risk management, monitoring various profit and loss arrangements becomes more complex. It results in higher adverse selection and moral hazard that leads to higher risk (Čihák and Hesse, 2010; Daher et al., 2015), hence decreases the efficiency of Islamic banks. The impact of financial crises on Islamic banks is minimal because partnership financing stimulates macroeconomic stability (Beck et al., 2013). In fact, Islamic banks are anti-crisis financial intermediaries whereas conventional banks are subject to losses and repetitive crises (Khoutem and Nedra, 2012). In the case of VC, the previous research does not clearly state that VC is affected by the crisis; however, VC investment has declined during the global financial crisis (Harrison and Mason, 2015; Ullah et al., 2011). With respect to Islamic banks, a previous descriptive study shows that partnership financing helps minimize the effect of crises (Hassan and Dridi, 2011). We therefore empirically test whether financial crises affect partnership financing-efficiency relationships.

Our finding shows that banks with partnership financing are more efficient than other banks. Lower risk bank couple with higher partnership financing tends to be more efficient. However, banks with high partnership financing appear to be less efficient during crises. These results imply that partnership financing helps to improve bank efficiency, especially for banks with lower risk except during crisis.

As far as the authors are aware, the research on partnership financing and bank performance has been theoretical in nature (Farooq, 2007; Khan, 2015). There is no empirical evidence that links partnership financing and bank efficiency. Therefore, we examine 1) the efficiency of Islamic banks with partnership financing, 2) the relative efficiency of high partnership financing banks with the probability of crisis, and 3) the relative efficiency of high partnership financing banks with risk. Daher et al. (2015) show that ASEAN, Middle Eastern, and North African countries (MENA) are among those that offering the highest levels of partnership financing. Because we aim to capture the crisis impact, we choose ASEAN rather MENA countries due to the former’s crisis experience (Laeven and Valencia, 2012). In the ASEAN region, we focus on Malaysian and Indonesian Islamic banks because these countries have the highest number of partnership financing offerings and provide a complete data set. Our paper sheds light on an important debate. Although advocates of partnership financing argue that partnership financing promotes higher efficiency (Alperovych et al., 2014) and lower risk (Beck et al., 2013; Daher et al., 2015), Daher et al., 2015 found that partnership financing reduces risk for ASEAN bank but increases risk for South Asian banks. Similarly, partnership financing has exposed Sudanese (Ahmed, 2008) and South Asian regional banks (Daher et al., 2015) to higher risk exposure. Theoretically, implementing partnership financing principles without proper safeguards may lead to inefficiency (Farooq, 2007).

The rest of the paper is organized as follows: Section 2 reviews selected studies on the efficiency of Islamic banks. Section 3 explains the data and methodology undertaken in this study. Section 4 discusses the result and empirical specifications, Section 5 concludes.

2. Review of literature

2.1. Overview of Islamic banking

Islamic banking can be defined as banking that operates in accordance with the rules of Islamic law (Shariah). Islamic banking is governed by three principles (Beck et al., 2013; Čihák and Hesse, 2010; Imam and Kpodar, 2013). The first principle is the prohibition of interest (riba). Islam prohibits all forms of interest paid on loans because it is perceived as a form of exploitation and injustice to society. The second principle is the prohibition of gharar (risk or uncertainty). This prohibition applies to doubtful or uncertain contracts, such as undertaking a business venture without sufficient information or taking excessive risks. In addition, the third principle is the prohibition of financing illegal activities, such as financing the construction of a plant to make alcoholic beverages.

Furthermore, according to Beck et al. (2013) and Čihák and Hesse (2010), Islamic banks are based on the principles of profit and loss sharing. Under this principle, all transactions should be backed by real economic transactions that involve tangible assets. Islamic banking has been spreading from Middle East to Indonesia, Malaysia, sub-Saharan Africa, Europe, and the Americas. The number of operating Islamic financial institutions has increased to 308 institutions in > 48 countries (Global Financial Development Report, 2014). Islamic banking can be domestically or foreign owned and can take the form of fully Islamic banks, Islamic subsidiaries of conventional banks, or Islamic banking divisions/windows in conventional banks. Over the past several decades, Islamic banks have developed specific products to ensure that their services comply with Shariah and avoid using interest in its operations. Among the most common products are partnership financing between banks and borrowers based on profit-loss sharing, which are known as Musharakah and Mudarabah.
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