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# Ownership structure and risk-taking behaviour in conventional and Islamic banks: Evidence for MENA countries

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**Abstract**

This paper investigates the impact of ownership structure, measured by two dimensions: nature of owners and ownership concentration, on bank risk, controlling for country and bank specific traits and other bank regulations. Particularly, it compares risk-taking behaviour of conventional and Islamic banks in 10 MENA countries under three types of bank ownership (family-owned, company-owned and state-owned banks) over the period 2005–2009. The result shows a negative association between ownership concentration and risk. We also find that different categories of shareholders have different risk attitudes. Family-owned banks have incentives to take less risk. State-owned banks display higher risk and have significantly greater proportions of non-performing loans than other banks. By comparing conventional and Islamic banks, the empirical findings show that private Islamic banks are as stable as private conventional banks. However, Islamic banks have a lower exposure to credit risk than conventional banks.


*JEL classification:* C26; G21; G32

*Keywords:* Commercial banks; Ownership structure; Bank risk-taking; Islamic banks; MENA countries

## 1. Introduction

Islamic banking has grown rapidly and it is considered as one of the fastest growing segments of global financial industry (Hasan & Dridi, 2010). According to Ernst and young's report 2011, Islamic finance assets around the world are expected to rise by 33% from their 2010 level to $1.1 trillion by the end of 2012, boosted by the aftermath of the Arab spring uprisings and dissatisfaction with conventional finance in the world in the wake of the global debt crisis.

In the Middle East and North Africa (MENA) countries, the growth of Islamic banking also indicates an impressive growth trend. In 2010, the total assets were $416 billion and are expected to rise to $990 billion by 2015 as new countries (e.g., Tunisia, Egypt) open up to Islamic finance. The Islamic banking sector in this region is expected to grow over the next five years at an annual rate of 20%, compared to less than 9% for conventional banks. However, the sector remains fragmented (Islamic banks hold less than $13 billion in assets, while conventional banks hold $38 billion in assets on average) and a lack of benign legislative, regulatory and tax environment among the organization of the Islamic conference countries will continue to pose barriers for the sector by increasing costs for Islamic financial institutions.

Throughout the recent global financial crisis, the Islamic banking sector in the MENA region has demonstrated resilience compared to conventional banks (Boumediene & Caby, 2009; Hasan & Dridi, 2010). According to Syed Ali (2011), three factors helped Islamic banks to remain stable during the

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early phase of the crisis: (i) the financing activities of Islamic banks are more tied to real economic activities than their conventional counterparts, (ii) Islamic banks avoided direct exposure to exotic and toxic financial derivative products and (iii) Islamic banks have kept a large proportion of their assets in liquid form compared with conventional banks.

During the last decade, most studies on Islamic banking have focussed on issues related to the comparison between the performance and instruments used in Islamic and conventional banks (Olson & Zoubi, 2008; Srairi, 2009). Other studies have discussed the regulatory and supervisory challenges of Islamic banking. The analysis of the behaviour of Islamic banks in the perspective of financial stability becomes more important at least for two reasons (Solé, 2007): (i) Islamic banks may become systemically relevant as they grow and increasingly interact with conventional banks that are systematically important, (ii) the lack of Islamic instruments for hedging results in the concentration risks in a small number of institutions. In addition, the implementation of Islamic institutions in many countries did not come from the government but from individuals or small groups. Islamic banks tended to become closely owned entities. According to Syed Ali (2006, 2007), this situation opens Islamic banks to risks emanating from lack of sound corporate governance and contributes to financial distress. Despite the importance of these issues, a few empirical papers (e.g. Cihak & Hesse, 2008; Gamaginta & Rokhim, 2011; Hasan & Dridi, 2010; Sayd, Kabir, & Gregory, in press) have analysed the question of risk and stability in Islamic banks and whether and how these aspects differ from conventional banks. None of these studies investigates the determinants of bank risk-taking or compares the stability of the two types of banks under a specific ownership structure. To fill this gap in the empirical literature on the stability of Islamic banking, we attempt in the first part of this paper to carry out an empirical study of the effect of ownership structure on the risk of commercial banks, controlling for country and bank characteristics and other bank regulations such as insurance deposit and shareholder rights. In addition, our second objective is to analyse the link between ownership structure and risk for both conventional and Islamic banks. Specifically, we try to answer two questions. First, we investigate the determinants of risk-taking in the Middle East and North Africa (MENA) banking industry during the 2005–2009 period, with special emphasis on both dimensions of ownership structure, namely (nature of the owners and ownership structure). Second, we compare and assess the risk-taking behaviour of conventional and Islamic banks under specific ownership profiles concerning family-owned, company-owned and state-owned banks.

Our empirical analysis extends the existing literature in three main directions. First, to our knowledge, this is the first study that analyses the risk-taking behaviour of conventional and Islamic banks under three types of bank ownership. Second, our model comprises two measures of risk, two measures of ownership structure and several variables relative to country and bank specific traits. Third, our sample comprises more than 90% of MENA Islamic and conventional banks, which makes it the most comprehensive database on commercial banks in this region.

The remainder of the paper is organized as follows. Section 2 is a review of the literature related to the determinants of bank risk-taking and the comparison of the level of stability between conventional and Islamic banks. Section 3 describes the data, variables and descriptive statistics. Section 4 presents the methodology and the risk-taking model. Section 5 discusses the empirical results. Section 5 provides robustness checks, and the paper ends with concluding remarks in Section 7.

## 2. Review of literature

Our aim in this section is to survey key studies related to the factors influencing bank risk taking and to the differences in stability between conventional and Islamic banks.

### *2.1. Studies on determinants of bank risk taking*

A review of the theoretical and empirical literature reveals numerous attempts to analyse the determinants of bank risk taking. According to agency theory, risk taking behaviour is influenced by conflicts between managers and shareholders (Jensen & Meckling, 1976). Theory predicts that managers are risk-averse to protect their position and personal benefits whereas shareholders with a diversified portfolio have incentives to increase bank risk after collecting funds bondholders and depositors (Esty, 1998; Galai & Masulis, 1976). However, the agency problem may be mitigated in firms with concentrated ownership structure, as controlling shareholders have strong incentives to monitor managers, and even replace them in the case of poor performance (Franks, Mayer, & Renneboog, 2001). Thus risk-taking is expected to be more pronounced in firms with concentrated ownership than in firms with dispersed ownership structure. Empirically, the relationship between ownership concentration and risk is ambiguous. Several studies (e.g. Haw, Ho, Hu, & Wu, 2010; Laeven & Levine, 2009) showed that concentrated ownership control is associated with greater risk. In contrast, Shehzad, De Haan, and Scholtens (2010) find that if ownership concentration increases, the credit risk decreases. The type of shareholders could also represent a source of risk in firms. Family companies, for example, may also avoid risk taking because their objective is to transfer a firm to the next generation (Anderson, Mansi, & Reeb, 2003). However, other researchers (e.g. Laeven, 1999; Anderson et al., 2003) found that family firms are significantly less diversified, and therefore riskier, than non-family firms. In addition to the difference between family and non-family owned firms, other aspects have been well established in the literature concerning state-owned and privately-owned firms. Iannotta, Nocera, and Sironi (2007), compare performance and risk in a sample of 181 banks from 15 European countries. They find that state-owned banks have poorer loan quality and higher insolvency risk than private and mutual banks while mutual banks have better loan quality and lower asset risk than both private and public sector banks.