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Capital adequacy and lending and deposit behaviors of conventional and Islamic banks



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ABSTRACT

Capital adequacy plays an important role in determining banking activities. A bank must hold a minimum level of capital to ensure sufficient funds to buffer against unexpected losses or adverse shocks. This study analyzes and compares Islamic and conventional banks in 14 Organization of Islamic Conference (OIC) countries from 1999 to 2009. The empirical evidence suggests that capital requirements have a significant impact on the deposit and lending behaviors of the 52 Islamic banks (IBs) and 186 conventional banks (CBs) in the sample. There is a strong positive relationship between capital requirements and deposit and loan growth for both IBs and CBs.

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1. Introduction

The issue of capital requirement for financial institutions has become more important since the financial crisis in the USA since 2007, and is now found in most of the current banking literature¹ ever since the introduction of the Basel Accord. Insufficient equity capital has been partly blamed for the Global Financial Crisis, and a similar situation also occurred during the Asian financial crisis of the late 1990s. The U.S. economic crisis has put the spotlight back on the issues of subprime lending and the importance of maintaining sufficient

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¹ Some of the studies on the impact of capital requirement include: Chiuri et al. (2002)—a high minimum capital requirement causes bank credit to shrink, Barrell and Gottschalk (2006)—an increase in capital adequacy ratios has an adverse impact on Brazil and Mexico's GDP, but for Mexico, increases in capital adequacy ratios do not affect commercial loan supply, as is the case in Brazil, and Peek and Rosengren (1995)—binding capital requirements cause bank loans to shrink.

enough capital to support adverse market conditions. During the crisis, many institutions did not have a sufficient enough financial cushion to absorb the losses from the large loan defaults, and the capital growth of the banks fell far below the growth of total credit and overall riskiness of the assets (Cannata and Quagliariello, 2009). The losses have adversely impacted banks and their ability to lend, causing economic activity to slow down.

Ensuring that banks develop and maintain a minimum capital adequacy requirement (CAR) is crucial in preventing them from failing. A bank with a sound capital position is able to pursue business opportunities more effectively and has more time and flexibility to deal with problems arising from unexpected losses, thus achieving increased profitability (Athanasoglou et al., 2008). When the Bank of International Settlements (BIS) first introduced the minimum capital requirement in 1996, it was to ensure that banks are prudent in maintaining adequate reserves as a shield to protect themselves and their depositors. The idea behind the CAR is to ensure that banks set aside capital from their own money for each set of investments they make. The riskier the banks or their businesses, the more capital is required to be put aside. This ensures a safer investment return for both shareholders and depositors.

The nature of banking activities is another issue that needs to be addressed in determining the adequacy of bank capital. Since banks are funded by deposits, which are short-term in nature, banks should only be allowed to finance short term loans from depositors' funds. However, if banks use this short-term fund to finance long term securities such as mortgage securities, it will cause a crucial maturity mismatch. Therefore, if there is an unexpected rise in interest rates, particularly once the economy declines, banks may not be able to maintain the investments on their books. As banking theories recognize, the function of banks is to transform short-term securities into the long-term securities that borrowers desire (Freixas and Rochet, 1997). The maturity mismatch exposes the bank to interest rate risk and is a pertinent issue that needs to be addressed.

During the 2008 U.S. financial turmoil, the collapse of major financial institutions was due to increasing amounts of capital, mainly by the top financial institutions, being placed into long term and risky investments, such as those of the real estate market. These investments were made during the booming economy without diligent analyses of the risks involved. The collapse resulted in a credit or capital crunch, and other banks began to tighten their lending due to a heightened fear of defaults. A similar scenario also happened in Indonesia in 2001. The dependency on bank loans by most of the Indonesian businesses resulted in a mismatch crisis, whereby banks were using too much of their short term deposits to finance long term investments, which later contributed to the economic crisis in Indonesia (Vandenbrink, 2005). The financial crisis of the late 1990s that occurred in many East Asian countries and the 2007 credit crisis in the U.S. were due, in part, to the vulnerabilities of banks, and conventional banks (CBs) were often the most significantly affected. Additionally, in light of the fact that Islamic banking has become more prominent in the global financial sector, this concern has also led to an increased interest from many researchers. There is a general belief that Islamic banks (IBs) are less vulnerable than CBs to economic distress, due to the fact that the assets of IBs are backed by profit-loss sharing deposits.

From one point of view, the minimum CAR is irrelevant in IBs, because the profit-loss sharing contract helps to reduce the overall risk of investment faced by the bank (Pellegrina, 2007). Islamic banking is an ethical banking system based on the principles of no interest and profit loss sharing contracts (see Adebayo and Hassan (2013), Farook et al. (2012), Rashid et al. (2012)). Theoretically, the risk sharing nature of the profit and loss principle in IBs should conceptually make them less risky, but the conceptual theory is difficult to translate into the real world, due to market imperfections and information asymmetries (Muljawan et al., 2004). These information problems can cause bank managers to react heterogeneously, which could affect the stability, soundness, and efficiency of the bank. Furthermore, Hassan et al. (2011), Smolo and Hassan (2010), Hassan and Chowdhury (2010), Grais and Kulathunga (2007), and Hassan and Dicle (2005, 2007) argue that CAR is an essential safety net for IBs, due to the specific risks of their products and the nature of IBs as intermediaries. The importance of capital requirements is still as poignant and significant to IB performance as it is to CBs, and it deserves further empirical study, particularly in countries with dual banking systems. Furthermore, due to the unique principles upheld by IBs, it is important to contrast the impact of CAR between CBs and IBs with regard to the capital crunch hypothesis, because the applicability of CAR is potentially different between the two banking systems.

The first objective of this paper is to investigate how deposit and loan growth react differently in CBs and IBs. It is found that both IB and CB deposit and loan growth react positively with increased level of

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