

Discussion of

**Capital Adequacy Ratios, Efficiency and
Governance: A Comparison Between
Islamic and Western Banks**

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Research Focus

Research Focus

- ❖ The relationship between capitalization requirements and bank performance in Islamic banks
 - Hypothesis: weaker than that in their Western counterparts
 - Profit and loss sharing principle in Islamic finance: In Islamic banks, depositors are closer to shareholders in terms of residual claiming on profits
- ❖ Explore the relationship between capitalization and bank efficiency for all types of banks
- ❖ Compare the relative impact of capitalization on the efficiency of different types of banks, such as Islamic and Western banks

Research Focus

- ❖ “As far as the Western model of banking is concerned, traditional theory on agency costs (Jensen and Meckling, 1976; Myers, 1977, among others) states that the weight of equity, relative to other forms of funds provision could, under certain conditions, push managers towards an efficient behavior.” (page 2)
- ❖ In Islamic banks, the positive influence of capital ratios may be weaker as depositors can serve as monitors
- ❖ Risk reallocation between depositors and shareholders may result in a higher level of monitoring incentive of depositors

Research Focus

- ❖ Islamic bank contracts - Mudaraba and Musharaka
- ❖ The Musharaka principle: “is similar to the modern concepts of partnership and joint stock ownership” (page 5)
- ❖ The rules of Mudaraba: the bank manages depositors’ funds to generate profits, but depositors “are not allowed to participate to decisions concerning funds allocation” (page 5)
- ❖ “... within the Islamic framework, equity and deposits should not be considered identical in any situation” (page 6)
 - Equity holders can interfere with the bank’s activity

Data

Data

- ❖ 49 Islamic banks from 1996 to 2002 from Bankscope
- ❖ 14 dropped due to mortality and mergers, and a total of 245 observations

- ❖ 8017 European-15 banks as a representative sample of the Western banking system
- ❖ 1217 dropped due to mortality and mergers

Methodology and Major Results

Methodology

- ❖ Widely used ways to measure inefficiency
 - Data envelopment models
 - Free disposable hull analysis
 - Stochastic frontier analysis
 - Thick frontier approach
 - Distribution free approach

- ❖ The one adopted by the current research
 - Stochastic frontier analysis: due to the availability of the panel data

- ❖ Determinants of inefficiency
 - Fixed effects
 - Random effects
 - Maximum likelihood

Major Results

- ❖ The equity-deposits ratio negatively affects inefficiency in both Islamic and Western banks
- ❖ This negative effect is undersized in Islamic banks as compared to European ones: almost twice as weak for Islamic banks
- ❖ “... a clear signal of inefficiency emerges from an insufficient role of staff members in Islamic financial institutions.” (page 16)

Comments

Comments: A Potential Selection Issue

- ❖ As pointed out by the author, depositors can only monitor Islamic bank manager's behavior, but "are not allowed to participate to decisions concerning funds allocation" (page 5)
- ❖ Since the depositor shares profit/loss, his/her behavior may be similar to that of mutual funds in emerging markets
 - Mutual funds in emerging markets usually do not have a say (or do not vote), but are shareholders
- ❖ Thus, it is likely that a depositor in the Islamic banking system may not be willing, or may not have the ability, to monitor

Comments: A Potential Selection Issue

- ❖ It is also possible that, in the Islamic banking system, depositors only choose their banks using certain criteria, such as profitability, reserves/bad loan ratio, equity ratio, and so on
- ❖ According to Table 1, the average reserves/bad loan ratio of Islamic banks is much higher than that of European banks. Any reason?
- ❖ Addressing this potential selection issue may strengthen the empirical results

Comments: Potential Size Effects

- ❖ According to Table 1, we observe that the average value of total assets of Islamic banks is much lower than that of European banks.
- ❖ Is it possible to show size effects on the relationship between capitalization requirements and bank performance?