



Full length article

## Financial fragility of banks, ownership structure and income diversification: Empirical evidence from the GCC region

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### ABSTRACT

This paper investigates the role that ownership structure and diversification of income plays in the financial stability of banks from the GCC region. We find evidence that suggests that higher concentration of ownership in any type of shareholding is associated with higher insolvency risk. However, this higher insolvency risk is not associated with any specific type of shareholders. Higher financial fragility is also associated with the size and whether the bank is an Islamic bank. Banks engaged in substantial fee-based activities are more financially stable as compared with banks that predominantly generate their incomes from traditional intermediation activities.

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## 1. Introduction

During the recent global financial crisis (GFC) the fragility of the financial system and elevated risk-taking behavior of banks became more pronounced especially for banks located in the more financially open and globally integrated economies. At the time when international banks were facing a financial turmoil, banks from the GCC<sup>1</sup> region exhibited a lower probability of default as compared with most of their Western counterpart. The banking sector of the GCC region is roughly 10% of the US banking sector in terms of asset size<sup>2</sup> with comparable income streams from non-traditional fee-based activities.<sup>3</sup> The ownership of banks in most developed countries is widely held. However, the ownership structure of banks in the GCC region is concentrated either through significant government, institutional, or family-group membership. Aside from a dissimilar ownership structure a sizeable proportion of banks in the GCC region are Islamic banks adhering to Shari'ah principles for

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<sup>1</sup> GCC member countries include Bahrain, Kuwait, Oman, Qatar, United Arab Emirates and Saudi Arabia.

<sup>2</sup> FDIC reports total assets of all insured commercial and saving banks assets in the US, as at December 31, 2011 stands at USD 13.892 trillion versus our compilation of the total assets of GCC commercial, savings and Islamic banks assets of USD 1.423 trillion at the same time.

<sup>3</sup> The fee-based activities of Western banks are not similar to that of banks in the GCC region. However, the motivation behind the fee-based activities is 'income diversification' and we focus on that part only in this paper.

**Table 1**  
GCC Financial Institutions Survey: Significant shareholding ownership holding (over 15%).

Country	Public shareholding	Government shareholding	Individual shareholding	Institutional ownership		Total
				Local	Foreign	
Saudi Arabia	3	5	3	4	4	13
Qatar	3	7	–	5	2	13
Kuwait	5	9	2	20	2	30
Oman	1	4	3	5	4	8
UAE	3	16	5	13	4	33
Bahrain	4	9	2	22	11	37
TOTAL	19	50	15	69	27	134

Source: Authors' own compilation from Bankscope, local stock markets, and annual reports of individual banks.

Notes: The total number of financial institutions surveyed was 134. Some institutions had significant shareholding in more than one category.

their investment and financing activities. These differences warrant an investigation into whether there is any association between the financial stability of banks in the GCC region with that of their ownership structure, the type of bank (Islamic or conventional) and their respective income diversity. To the best of the authors' knowledge, there is no empirical study that provides an insight into the relationship between the ownership structure and financial fragility of banks from the GCC region.<sup>4</sup> This paper attempts to address this shortcoming in the literature by providing empirical evidence as to whether higher ownership concentration and income diversification has any association with the financial stability of banks from the GCC region.

Using a panel data set extracted from the financial statements of 125 GCC banks from 2000 to 2011 matched with cross-section ownership data,<sup>5</sup> we asked whether cross-sectional variation in ownership concentration is related to the subsequent financial stability of these financial institutions. Specifically we evaluate the impact that ownership patterns, types of banks, diversification of income along with other bank-specific and macroeconomic variables has on the financial stability of banks within the GCC region. Z-score is used as a composite measure of financial stability/risk among GCC banks. As a robustness check, we further test whether any deviation from traditional lines of business (disintermediation) affected the financial stability of banks in a simultaneous equation framework.

The key finding from the empirical estimations is that a higher concentration of ownership in any type of shareholders (government, institutional, or family-group) affected the financial stability of banks in the GCC region over the sample period. Banks with higher ownership concentration in any type of shareholders exhibited a higher financial fragility and thus higher risk-taking. Furthermore, banks larger in size and Islamic banks exhibited a lower risk aversion. We do not find any statistically significant change in the financial stability indicator during the peak of the GFC. Contrary to the findings of Demirgüç-Kunt and Huizinga (2010) we found that engagement in non-intermediation fee-based activities improved the financial stability of banks in the GCC region after controlling the endogeneity.

The findings of this paper should be of interest to both banking academics and policy makers. The engagement in non-traditional fee based activities is usually considered as detrimental to the financial stability of banks. However, careful diversification of income sources may result in more financially stable banks. However, there is clearly a need for careful regulatory scrutiny to ensure that these activities are not used in ways that jeopardize financial stability.

The remainder of the paper is organized as follows. Section 2 provides the literature review. Section 3 presents an overview of the GCC financial sector. Section 4 describes the specification of the empirical model. Section 5 describes the data sources and reports descriptive statistics. Section 6 presents and interprets empirical estimations. Section 7 addresses endogeneity concerns and presents the results of the robustness test. Section 8 summarizes and concludes the paper.

## 2. The GCC financial sector

The GCC region has experienced a tremendous growth over the last decade due to high oil prices, expanded oil production and expansionary fiscal policies. Regulatory authorities across the GCC region have put in place some advanced regulatory practices, drawing upon international standards as well as domestic requirements to reduce systemic financial risk (Naceur and Omran, 2011). During the financial crisis, regulatory authorities of the region stepped in to provide a range of supportive policies to stabilize any fallout to domestic financial markets. The crisis did lead to a few non-banking financial institutions and family business groups to default.<sup>6</sup> However, these defaults were isolated and did not have systemic consequences.

The GCC region is host to a large number of local, joint-venture, government and foreign owned banks. Table 1 presents the ownership structure within GCC region with shareholding of 15% and above. It is evident from Table 3 that ownership

<sup>4</sup> Hassan et al. (2013) and Abraham (2013) provide some insight on the performance of banks with foreign ownership in the area but neither of these studies specifically examined the relationship between financial stability and the ownership structure of banks within the GCC region.

<sup>5</sup> Since there is very little variation in the ownership of banks within the GCC region we used cross-sectional data.

<sup>6</sup> These include Saudi owned Al Sane'i and Al Gosaibi groups, and Bahrain based Awal Bank and Arcapita, with the latter becoming the first Gulf institution to filing bankruptcy under Chapter 11 in 2011 and later emerge from it in 2013.

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