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The impact of state and foreign ownership on banking risk: Evidence from the MENA countries

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ABSTRACT

This paper investigates the impact of foreign and state ownership on banking risk. Panel data regression analysis is applied to a sample of 171 commercial banks from the MENA region during the 2006–2012 period. Two-stage least-squares analysis is conducted. Our results show that State ownership encourages banks to take more risks while foreign ownership reduces risk-taking. In addition, state-owned banks tend to increase capital adequacy ratio to hedge against high level of risk. Our finding also indicates that all categories of shareholders take a prudent attitude that influences risk reduction after the 2008 crisis.

1. Introduction

Banking risk is a major concern for policy makers since the banking system is a prerequisite for the proper functioning of the financial system as a whole and the stability of the entire economy in general. Excess risk-taking by banks may lead to financial crises and the collapse of the financial system. According to agency theory, risk taking is largely affected by ownership structure. In fact, controlling shareholders have incentives and power to affect corporate decisions in order to maximize profit by increasing risk-taking (Shleifer and Vishny, 1986) and they can compensate for losses by diversifying their portfolios.

Previous studies reached a consensus that ownership concentration is the main factor behind risk-taking differences between banks, but they failed to agree on the manner with which ownership concentration affects banking risk. For instance, Saunders et al. (1990), Laeven and Levine (2009) and Haw et al. (2010) showed that concentrated ownership is associated with greater risk. However, Burkart et al. (1997) and Iannotta et al. (2007) show that ownership concentration is associated with lower risk.

Theoretically, there is a conflict between agency managers and shareholders. On the one hand, managers are reluctant to undertake risky decisions because they may lose their titles (Jensen and Meckling, 1976). On the other hand, shareholders prefer increasing bank risk after collecting funds of depositors and bondholders to maximize their expected profit (Galais and Masulis, 1976). Ownership concentration seems to solve this conflict since majority holders have strong incentives to monitor managers, and even replace them in case of poor performance (Franks et al., 2001). Therefore, risk-taking is expected to be more prominent in firms with concentrated ownership than in firms with a dispersed ownership structure.

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Table 1
Banking sector figures in MENA countries. 2006–2011.

	Number of commercial banks[a]	Bank concentration	Bank deposit to GDP	Bank credit to bank deposits	Bank return on assets
Algeria	20	75.273%	42.175%	30.85%	1.169%
Bahrain	110	81.911%	66.280%	90.26%	0.945%
Egypt	40	57.716%	71.189%	53.06%	0.758%
Jordan	23	91.807%	97.226%	83.11%	1.373%
Kuwait	16	81.769%	57.103%	82.39%	1.789%
Lebanon	46	49.371%	206.219%	78.37%	0.912%
Morocco	15	71.139%	80.892%	115.48%	1.287%
Oman	16	74.091%	30.542%	32.26%	2.166%
Qatar	17	85.049%	45.580%	174.06%	2.776%
Saudi Arabia	12	54.224%	22.970%	102.85%	2.428%
Tunisia	21	42.417%	47.340%	120.99%	0.535%
Turkey	49	47.696%	42.996%	77.70%	2.666%
UAE	52	53.900%	61.120%	107.44%	1.862%

Source: Global Financial Development GFDD (2013).
[a] World Bank. Bank Regulation and Supervision Database (2012).

However, when majority holders do not own diversified portfolios, they will not have the incentive to increase banking risk. Thereby, controlling shareholders do not have the same motivations, objectives, means and effectiveness of control. It would be appropriate to study the identity of the controlling shareholder.

While a large body of literature has examined the impact of ownership structure on banking risk for US banks and for financial institutions in Europe and in large emerging markets (Brazil, China), empirical evidence on the MENA countries is scarce. This paper attempts to fill this gap, by assessing the impact of ownership structure on banking risk in the MENA countries. More specifically, we examine whether foreign ownership and state ownership affect risk-taking of banks.

Our study was initially motivated by the scarcity of studies on bank risk and ownership structure in MENA countries although the region presents itself as a favorable field of research for many reasons. First, banking sector plays an important role in financing MENA economies.[1] The majority of studies have analyzed the role of banking sector at a macroeconomic level. They pointed to the substantial role of banks in financing economies since they control most financial flows and own most financial assets (e.g. Creane et al., 2004; Ben Naceur and Ghazouani, 2007; Rejichi and Aloui, 2012). Second and according to Ayadi et al. (2011), ownership structure is very important in developing countries where protection of shareholders' rights is weak like in the MENA countries.

Another motivation is the important reforms initiated in the region under the auspice of the International Monetary Fund (IMF). Indeed, after the adoption of financial repression policies during many decades, most of MENA countries governments have undertaken a comprehensive financial reform agenda, concentrated on banking reforms.[2] They privatized many state banks, gave commercial banks more freedom to expand their activities and alleviated entry barriers for foreign investors. Accordingly, within a short period of time, foreign participation became considerably present in the banking sector in many countries.[3]

These latest developments in terms of privatization and foreign entry highlighted the need to examine their effect on bank risk in the MENA region, which is a main concern in policymakers' agendas.

Our empirical analysis uses a sample of 171 commercial banks from 13 MENA countries over the period 2006–2012. After controlling for endogeneity and simultaneity between owner's identity and risk-taking, we found that state ownership is positively related to risk-taking while foreign ownership is negatively related to risk-taking. These results imply a divergence in the interests of different types of shareholders. Our results are robust to a series of tests which took into account the different proxies for risk-taking.

The remainder of this paper is organized as follows. Section 2 presents an overview of the banking systems in the MENA countries. Section 3 summarizes some relevant illustrative theoretical contributions. Section 4 focuses on data and methodology. The empirical results are presented in Section 5. The final section concludes.

2. Highlights of the banking sector

Although the MENA countries exhibit several similarities because of social and geographical proximities, they present several disparities at the level of the economic and institutional environments, including the banking systems.

Table 1 presents some banking sector indicators (average) between 2006 and 2011. First, the number of commercial banks varies substantially from one country to another. Bahrain has a large number of commercial banks compared to others (110)

[1] Banking assets account for 130% of GDP (Rocha et al., 2011).
[2] Involvement of these countries in these structural reforms varies from one country to another.
[3] According to Farazi et al. (2013) state banks accounted for 33% of total assets in 2008 and foreign banks increased from 18% of total bank assets in 2001 to 20% in 2008.